Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs

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ABSTRACT

This Article sets out the first comprehensive analytical framework for non-activist shareholder cooperation, showing that coordinated engagement by non-activist institutions can be a promising lever by which to foster a more effective and viable corporate governance role for non-activist institutional investors and provide an alternative to activist-driven ownership involvement.

After considering the diverging incentives structures of activist and non-activist investors and showing how they are reshaped in a context where investors collaborate in the engagement process, this Article shows how non-activist driven collective engagements are beneficial in several respects. Specifically, collective engagements favor the redistribution of engagement costs and, therefore, increase the net return earned by each institutional investor involved. In doing so, they also lower the free-rider problem, which generally affects institutional shareholders' behavior. Moreover, the presence of a third-party entity coordinating the engagement initiatives can work as an effective tool for reducing potential regulatory risks, mainly concerning 13D group disclosures and Regulation FD.

Against this background, this Article concludes that, in order to promote non-activist collective engagement initiatives, there is the need for the SEC to provide greater clarity concerning the circumstances under which engaging collectively through an enabling organization will not, as a rule, be regarded as control-seeking or acting in concert, and will not trigger group filing obligations under Section 13 of the Securities and Exchange Act. In addition, the SEC should explicitly recognize the role of such coordinating entities—that adopt predefined frameworks governing the process of engagement and establish rules of conduct for participating investors—in promoting collective engagement initiatives in line with the applicable regulatory framework.

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I. INTRODUCTION

In a world where the agency ownership model of publicly traded shares is largely predominant and the ownership of publicly listed corporations is increasingly institutionalized, active institutional shareholders are considered key to firms' corporate governance. The case for institutional oversight is that "product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available".[1] From the public policy standpoint, institutional investors' active ownership is believed to serve the efficient allocation of capital to the most promising business ventures as well as informed corporate monitoring, so as to ensure that the best possible use is made of the capital provided.[2] Ownership engagement by institutions is therefore regarded as essential to value creation, economic growth, and the fostering of a well-functioning market economy.[3]

Ever since the late 1980s, many have viewed institutional investors as the potential sharp-eyed natural champions of corporate monitoring and stewardship.[4] Institutions holding large blocks, more power and greater access to company information, along with the requisite skills, behave differently–so it is argued–from dispersed individual investors and play a more active corporate governance role. They reduce agency costs associated with the separation of ownership and control and ultimately promote shareholder welfare. It is then asserted that institutional shareholders monitor investments by voting and engaging informally through dialogue with portfolio companies and support enhanced directors' accountability; when needed, they lever formal shareholder rights and run campaigns to challenge the board's authority.

By the end of the 1990s, however, supporters of institutional active ownership had to acknowledge that only a small number of U.S. institutional investors, mostly public pension plans, were actually active shareholders, and that institutions' spending on governance efforts

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[1] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815 (1992).

[2] *See* Serdar Çelik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2013/2 OECD J.: FIN. MKT. TRENDS 93, 104 (2014).

[3] *Id. See also* INT'L CORP. GOV. NETWORK, GLOBAL STEWARDSHIP PRINCIPLES, https://www.icgn.org/ (conceiving of stewardship as part of a responsible investment approach owed by money managers to end-investors, aimed at preserving and enhancing long-term value and "overall financial market stability and economic growth") [hereinafter, ICGN GSP].

[4] *See, e.g.*, Black, *supra* note 1; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

was very limited.[5] Moreover, empirical evidence seemed not to convincingly support any relationship between activism and company performance.[6] Overall, shareholder activism, conceived of "as *proactive* efforts to change firm behavior or governance rules",[7] proved to be quite limited, and the skeptical view of the institutional investor as the shareholders' champion appeared to be justified.[8] Simply put, monitoring costs were considered likely to outweigh the potential benefits of playing an active role.[9] Collective action problems arising out of institutions' fractional ownership combined with regulatory impediments to communication with fellow shareholders in disincentivizing shareholders' joint action. The resulting mismatch between private cost-bearing and collective gain-sharing with free-riding passive investors frustrated the possibility of then playing an active role in corporate governance.[10] Some institutions' pro-manager conflicts of interest, as well as shareholder-unfriendly corporate law rules which generally favored entrenched boards, also contributed to passivity.[11] Overall, with rare exceptions, institutions appeared to be as rationally apathetic as individual shareholders.[12]

Since then, however, the features of shareholder activism have evolved and forces capable of overcoming such disincentives have arisen. First, pension funds and other categories of traditional institutions have increasingly left space for alternative institutional investors, such as private equity firms and, particularly, hedge funds with more significant equity positions in a limited number of individual companies and strong incentives for proactive, strategic governance and performance intervention.[13] Starting from the second half of the 2000s, hedge

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[5] Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States* 459-465, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed., *1998*), https://ssrn.com/abstract=45100.

[6] *Id*.

[7] *Id.*

[8] *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

[9] *See* Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009 (1994).

[10] *See* Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 12-14 (Sept. 2005), UCLA School of Law, Law & Econ. Research Paper No. 05-20, https://ssrn.com/abstract=796227.

[11] *See* Black, *supra* note 1, at 822-827 (referring (i) to the cumulative chilling effect of blockholder filing requirements under section 13(d) of the Securities and Exchange Act and related SEC rules, company poison pills, the SEC's proxy rules and the shareholder proposal 14a-8 Rule, and (ii) to bank and insurers' extensive dealings with corporate managers, managerial control over corporate pension funds, and public pensions funds' responsiveness to political pressure).

[12] *See* Bainbridge, *supra* note 10.

[13] *See* Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. OF APPLIED CORP. FIN. 55, 55 (2007); Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1097 (2015); William W. Bratton & Joseph A. McCahery, *Introduction to Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation, in* INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS AND PRIVATE EQUITY, ECONOMICS AND

funds have grown into prominent players in corporate monitoring and have boosted shareholder activism at an unprecedented rate.[14]

Second, although it attracted much less attention than the rise of hedge funds, both practitioners and scholars—albeit still a limited number—point to shareholder collective initiatives as another means by which to voice concerns about corporate governance and performance in a more effective and cost-saving manner.

Where individual blockholdings are small, weight matters. This means that collective action can obviously be by far more convincing than independent conduct in pressurizing the board of directors, holding the management accountable and assembling non-trivial voting power.[15] In addition, shareholder collective engagement initiatives can help to share costs, overcome collective action problems and alleviate regulatory risks. [16]

Against this backdrop, the form of coordinated intervention that has received most consideration from corporate governance scholars and practitioners, and even lawmakers, is possibly that of so-called wolf packs formed by like-minded activist hedge funds with the aim of bringing about significant corporate changes at targeted companies.[17]

One further form of shareholder cooperation frequently in the spotlight is that which involves non-activist institutions teaming up with activist shareholders, mostly following support-seeking publicity via the press. Hedge funds that act as specialized "governance intermediaries" by monitoring company performance and actively submitting proposals for business strategy have proven to be a powerful driver for activating the reactive response from mainstream non-activist institutions: "activists gain their power not because of their equity stakes, which are not controlling, but because of their capacity to present convincing plans to institutional

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REGULATION 2 (William W. Bratton & Joseph A. McCahery eds., *2015*); U. Penn., Inst. for Law & Econ. Research Paper No. 16-12, https://ssrn.com/abstract=2785587.

[14] *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 682-684 (2007).

[15] *See*, *e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523-24 (1990) (however highlighting legal obstacles to shareholder coordination); Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 276 and 303 (2000) (finding that shareholder proposals sponsored by coordinated groups—investor associations or investment groups—were able to garner substantially more voting support than proposals sponsored by individuals); Tim C. Opler & Jonathan Sokobin, *Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors* 5 (Dice Center for Res. in Fin. Econ., Working Papers Series 95-5) (1995), https://ssrn.com/abstract=46880 (showing that coordinated engagements facilitated by the Council of Institutional Investors (CII) positively impact target firms' performance, "consistent with the view that coordinated monitoring and 'quiet' governance activism by institutional investors is effective").

[16] *See infra* Part IV.C.

[17] *See infra* part IV.A.

shareholders, who ultimately will decide whether the activists' proposed plan should be followed".[18]

However, these are not the examples of shareholder coordination to which this Article seeks to draw attention. In order to fill a gap within the existing legal scholarship, drawing on empirical and anecdotal evidence of the relevance of such an alternative shareholder cooperation model that does not mean to achieve or influence corporate control,[19] we analyze a non-activist-driven approach to collective engagement, which is based on the coordination function performed by a third-party enabling entity.[20]

Over the last few years, representative organizations, such as, to some extent, the Council of Institutional Investors in the U.S., and even more so the Institutional Investors' Forum in the UK, Eumedion in the Netherlands, Assogestioni in Italy, and many more, have emerged as a cost-saving and efficient tool for supporting institutions' active stewardship collectively and "mak[ing] the case for long-term investment approaches."[21] Organizations that provide affiliate institutions with corporate governance services and actively lobby to consolidate investors' votes and encourage dialogue with corporations have proven to be effective in stimulating the collective involvement of institutional shareholders with investee companies in spite of their weak individual incentives and the free-rider disincentive. Since the engagement strategies, programs and agendas promoted are chiefly based on the constructive discussion of key issues with portfolio companies to convey investors' shared views without asking for significant corporate changes nor intervening in the details of the management decision-making, the coordinating organizations typically adopt a non-confrontational and collaborative stance. Institutional investor organizations are a collective monitoring tool aimed at minimizing institutions' stewardship costs, hence reducing corporate agency costs and enhancing the collective voice of investors. Thus, coordinating organizations promote an institutional investor-driven model of non-activist, relationship-building corporate monitoring and oversight that is fundamentally different from that adopted by activist hedge funds and wolf packs.[22]

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[18] Gilson & Gordon, *supra* note 35, 867, 897-8.

[19] *See infra*, Part IV.C.1.

[20] *See infra*, Part III.C.

[21] FIN. CONDUCT AUTHORITY & FIN. REPORTING COUNCIL, BUILDING A REGULATORY FRAMEWORK FOR EFFECTIVE STEWARDSHIP 5 Discussion Paper DP19/1 (2019), https://www.fca.org.uk/publications/discussion-papers/dp19-1-building-a-regulatory-framework-effective-stewardship.

[22] *See generally* Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 186 (2015).

The importance of promoting the corporate-governance role of coordinated non-activist shareholders is further underscored when the re-concentration of U.S. corporate ownership and the concentration of the asset management industry is taken into account. There is little doubt, in fact, that corporate ownership, asset and asset industry concentration render institutions' stewardship inescapable. This is even more so the case if it is considered that, over time, the increases in both institutional ownership and ownership concentration have prompted regulatory action aimed at enhancing institutions' "responsibilities" in performing the corporate governance functions associated with share ownership.[23] Furthermore, the promotion of cost-effective pathways for institutions' collective monitoring can also help to activate passively managed funds with particularly weak financial incentives for being active and attentive owners, and to counteract the potential for "unthinking and automated approach to governance that is unlikely to be in the company's best interest".[24]

Against this backdrop, this Article seeks to provide a comprehensive analytical framework for non-activist shareholder cooperation by extending the perspective for analysis beyond hedge-fund wolf packs and activist-driven teaming up. It aims to demonstrate that coordinated engagement by non-activist institutions can be a promising lever by which to foster a more convincing and viable corporate governance role for non-activist institutional investors and provide an alternative to activist-driven ownership involvement.

With a view to illustrating how collective engagement can be key in making non-activist institutional investor stewardship more effective and can provide an actual alternative to hedge fund-driven activism, this Article proceeds as follows. Part II sets the scene by drawing some relevant distinctions. In order to examine the issue of collaboration between non-activist institutions, it is first necessary to draw a clear distinction between *activist* and *non-activist* shareholders, as well as the non-overlapping notions of *activism* and *engagement*. Based on these distinctions, Part III examines the diverging incentives structures underlying activist and non-activist investors' ownership within a context of solo-engagement. Part IV reconsiders those incentives structures in a context where investors collaborate in the engagement process. First, we provide an overview of the different types of shareholder coordination that take place in the practice. Taking account of the recommendations made by a growing body of soft regulation—chiefly stewardship codes and principles—we highlight the distinction between activist-driven and non-activist-driven forms of shareholder collaboration. Second, we contend

[23] *See infra* Part III.A.3.

[24] *See* Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 510 (2018).

that hedge-fund wolf packs and the activist-driven receptive teaming up phenomenon need to be kept distinct from the non-activist collective engagements that are recommended by the stewardship principles adopted in several countries.[25] This is because these forms of shareholder collaboration substantially differ in terms of the potential up- and downsides of their operation. We then analyze the potential benefits of collective engagements and how they can stimulate institutions' active ownership. Part V examines the regulatory framework applicable to the various types of shareholder collaboration, showing that they need to be kept separate also from the regulatory standpoint. Crucially, we contend that, if collective engagement is to be incentivized to promote non-activist stewardship as an actual alternative to activist-driven share ownership, it is necessary to clarify the grey areas still remaining within the relevant regulatory framework. In particular, regulators should acknowledge the facilitating role played by third-party coordinating entities and provide greater clarity concerning the circumstances in which collective engagement through an enabling organization will not, as a rule, be regarded as control-seeking or concerted action and will not trigger group filing requirements under Section 13 of the Securities and Exchange Act. Part VI concludes.

II. SETTING THE SCENE

Before examining institutional shareholder collaboration and its role in corporate governance, it is first necessary to set the conceptual framework and the definitions that are relevant for the purposes of this Article. Within the debate on shareholder activism, the very notion of activism is usually used to refer to any kind of ownership engagement by institutional investors, irrespective of its specific character or degree, which may vary, and investor characteristics. However, there are significant differences between being, or not being, an active shareholder, which mainly depend on the business model of the relevant investor. Thus, the undifferentiated use of the term "activism" may be misleading. Accordingly, some distinctions must be drawn for the purposes of the following analysis.

A. *Activist vs Non-Activist Institutional Investors*

[25] *See generally* Jennifer G. Hill, *Good Activist/Bad Activist: The Rise of International Stewardship Codes*, 41 SEATTLE U. L. REV. 497 (2018).

As early as 1994, Briggs clearly stated his position concerning the concept of shareholder activism, noting that "[a]ctive investors … are not "typical" institutional investors".[26] The latter were, in fact, essentially passive shareholders. Briggs drew the attention to "several kinds of private investment funds commonly known as hedge, risk arbitrage, value investment or vulture funds" for whom

> "'[A]ctivism" does not mean putting a resolution on management's proxy card asking shareholders to vote to end discriminatory employment practices or redeem a poison pill. For these investors, activism means securing board representation with a view to fundamentally changing a company's policies, dismissing management or taking over a company'".[27]

Traditional institutional investors, such as public and private pension plans, actively managed mutual funds and insurance companies, could not reasonably be expected to be truly *activist* shareholders. Portfolio diversification and fragmentation predicted that these institutions would be likely to dedicate attention to "process and structure issues", rather than company-specific concerns.[28] They would not exert day-to-day control over individual investee companies, and would be even less likely to engage in company-specific "micro-management".[29] Institutions would engage with portfolio companies chiefly concerning general issues such as antitakeover devices, plurality voting, the composition and structure of the board of directors, director elections and compensation.[30]

In fact, the issue at the very roots of the large differences in the quality and quantity of ownership involvement with portfolio companies is the varying features and choices that define institutional investors' business models.[31] Çelik and Isaksson identify seven factors, each of which must be further distinguished based on a set of options available to the institution, which taken together shape the institution's business model and determine its likely attitude towards ownership engagement.[32] These factors include: the purpose of the institution (for profit or not for profit); its liability structure, in terms of whether or not an institution is under a profit

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[26] Thomas W. Briggs, *Shareholder Activism and Insurgency under the New Proxy Rules*, 50 BUS. LAW. 99, 147 (1994).

[27] *Id.* at 101-102.

[28] *See* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* 4-5, 34-35 (NYU L. Econ. Res. Paper No. 18-39) (2019), https://ssrn.com/abstract=3295098

[29] Black, *supra* note 1, at 818.

[30] *Id*. *See also* Kahan & Rock, *supra* note 28, at 35.

[31] *See* Çelik & Isaksson, *supra* note 2, at 93.

[32] *Id*. at 105, table 1.

maximizing obligation towards its owners; the investment strategy (ranging from passive indexing to active fundamental, up to purely quantitative active strategies); the portfolio structure (whether concentrated or diversified); the fee structure (ranging from performance through flat fees, to no fees); and an institution's possible political or social objectives. The applicable regulatory framework also contributes to shaping an institution's behavior as an owner, depending on whether any requirements, or limitations, are set as regards an institution's engagement with investee companies, e.g. voting and voting disclosure requirements, or voting prohibitions.[33]

Along the same lines, Kahan and Rock attribute the diverging features of hedge fund and traditional institutions' activism to the differences between the underlying business models, the resulting incentive structures and the set of regulatory and political constraints, as well as conflicts of interests which are largely typical for traditional institutions.[34] Also according to Gilson and Gordon, the business models, and the resulting incentives structures, explain why traditional institutions usually adopt a passive, or at best a reactive, stance towards engagement with portfolio companies.[35] Furthermore, Bebchuk, Cohen and Hirst consider that the structural incentive problem that negatively affects stewardship by actively managed mutual funds and index funds with a significant share of the market for managed investments is likely to undermine the effectiveness of any principle or guideline put forward by stewardship codes.[36]

Following this line of reasoning, it is clear that engagement remains a costly endeavor, which cannot easily be aligned with traditional investors' prevailing business models—which are primarily based on asset diversification and, as a consequence, portfolio fragmentation—and the corresponding incentive structures. The inadequate incentives hypothesis points to a number of factors that characterize the industry structure as the primary explanation for traditional institutions' reduced levels of engagement.[37] These factors include: the highly competitive structure of the market for money managers, which puts pressure on lowering costs; rational

[33] *Id*. at 111, table 2.

[34] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1060-70 (2007).

[35] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism. Activist Investors and the Revaluation of Governance Rights,* 113 COLUM. L. REV. 863, 867; Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1408 and 1415-1417 (2014).

[36] *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. OF ECON. PERSPECTIVES, 89, 108 (2017).

[37] Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 373-4 (Jeffrey N. Gordon & Wolf-Georg Ringe eds*., 2018).*

apathy and the free rider problem; the institutions' revenue model which, being typically a percentage of assets under management, encourages increases in funds' size and complexity; the perverse incentives of asset managers based on a fund's relative performance, which improves where underweighted portfolio companies perform badly; the enduring belief that involvement in corporate governance reduces resources that could be better employed in selecting investments in order to increase the fund's relative performance—and portfolio managers' compensation; and finally the various conflicts of interests facing asset managers.[38]

Hence, based on their strongly diverging incentives, activist shareholders should be kept distinct from non-activist shareholders. Such a distinction, which draws on investors' natural attitudes towards share ownership, as shaped by the business model adopted, is useful in order to explain the determining features and different patterns of shareholder collaboration and to analyze how they impact the corporate governance role of institutional investors. For the purposes of this Article, we shall therefore refer to fundamentally "activist" and "non-activist" institutions as meaning, respectively, investors with high incentives for strategic, proactive, and costly, company-specific governance and performance intervention (as exemplified by alternative institutions such as activist hedge funds and private equity funds), and on the other hand investors with weak incentives for activism other than low-cost engagement, such as most traditional institutions with active or passive investment strategies.

B. *Activism vs Engagement*

In keeping with the broadening of the gap between the actual behavior of activist and non-activist institutional shareholders as owners, the rise of hedge fund activism has contributed to somehow shifting the original meaning of the notion of shareholder activism towards a more strategic and often confrontational kind of governance and performance engagement. Hedge fund activism typically embraces "any actual or overtly threatened proxy contest or any other concerted and direct attempt to change the fundamental strategic direction of any solvent […] public corporation other than a mutual fund".[39] Based on costly fundamental and company-specific analysis, activists seek specific targets for investment, typically picking the stocks of underperforming companies, with a view to bringing about a significant change in corporate governance practices, business plans and operations, capital structure or strategic direction. In functional terms, the activist takes up a significant but non-controlling equity position in the

[38] *Id.*

[39] Briggs, *supra* note 14, at 695.

target company and starts to step up pressure—from persuasion behind the scenes through to proxy contests—to bring about the particular changes advocated. Activists seek to benefit from the improved stock price performance returns that usually follow responsive changes by company management.[40]

By contrast, the promise of traditional non-activist institutional shareholder initiatives was originally conceived of as lying with voting and voicing their views, the latter involving primarily informal shareholder monitoring efforts, as well as, on a residual basis, reacting to unresponsiveness to investors' demands.[41] Over the last decade, the stewardship efforts of traditional institutions have increasingly focused on dialogue with portfolio companies, which in many cases occurs privately. A survey of large institutional investors—chiefly U.S., continental European and UK asset managers, mutual funds and pension funds—has found that the use of private discussions with management or members of the board of directors is widespread, which supports the view that "investors try to engage firms behind the scenes through direct negotiations, and take public measures (e.g., shareholder proposals, public criticism) only if these private interventions fail".[42] In effect, discussions with the management have been found to be the mostly frequently used channel for engagement, followed by voting against the management.[43] Alongside the ability to voice their views when dissatisfied with a firm's governance, respondent institutions reported that they also use, on a complementarily basis, exit, or the threat thereof, as a disciplinary governance mechanism.[44] By contrast, the submission of shareholder proposals as a corporate governance mechanism was reported to be used far less frequently, as also were the initiation of legal action against, and the public criticism of, portfolio companies.[45]

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[40] *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. Corp. L. 51, 57 (2011); Bebchuk et al., *supra* note 36, at 104-05 (explaining that activists' incentives to spend on stewardship depend on the likeliness of inducing large governance-generated value increases); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007).

[41] Black, *supra* note 1, at 817; *see also supra* notes 29-30 and accompanying text. Non-activist investors' voice has also taken the form of shareholder proposals which, in spite of being precatory, have proven to prompt management to effect the changes sought. *See* Yonca Eritmur, Fabrizio Ferri & Stephen R. Stubben, *Board of directors' responsiveness to shareholders: Evidence from shareholder proposals*, 16 J. CORP. FIN. 53, 58-59 (2010).

[42] Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. OF FIN. 2905, 2912 (2016).

[43] *Id*. at 2911-13.

[44] *Id*. at 2913, 2918-20.

[45] *Id*.

In line with the findings that non-activist institutional investors' preferences focus on dialogue, scholars emphasize that "[i]ncreasingly, the insider-shareholder dynamic in the modern corporation is *collaborative*, not competitive", with institutional investors being at the forefront of such "constructivist" trend offering "a new source of well-resourced and sophisticated knowledge from *outside* the corporation" which complements that of insiders.[46]

According to McCahery et al., institutions' engagement is primarily triggered by inadequate corporate governance and excessive compensation, as well as disagreement with long-run strategic issues—e.g. large diversifying mergers or acquisitions.[47] On the other hand, dissatisfaction with company performance does not seem to be a key driver of shareholder engagement.[48] Hence, mainstream institutions' ownership engagement is mostly about exerting a monitoring function and providing portfolio companies with valuable informational inputs.[49]

Therefore, when compared to situations involving more aggressive activism in which "hedge funds can often shape a firm's business policy unilaterally",[50] terms such as shareholder *engagement,* or, as a broader category, *stewardship*—which have grown popular with the rise of best practice codes and principles for institutional investors—appear to be capable of capturing the actual meaning, and the extent, of non-activist investors' behavior as owners much better than the term *activism*. As compared to activism, the milder terms "engagement" and "stewardship" point towards a kind of active—but non-*activist*—ownership the approach of which to portfolio companies is by far less adversarial, more collaborative, and primarily based on mutual understanding. At the same time, engagement and stewardship obviously assume investee companies to be attentive and responsive to investors' concerns.[51]

Initially, the concepts of engagement and stewardship may perhaps have been more familiar with the European context, where pioneering pieces of soft regulation developed and took hold more readily than in the United States. Those concepts were first established in a systematic way thanks to the UK Stewardship Code published by the Financial Reporting Council in July

[46] Jill. E. Fisch & Simone M. Sepe, *Shareholder Collaboration* 3, 5 (Eur. Corp. Gov. Inst. (ECGI) Law Working Paper No. 415/2018) (July 25, 2018), https://ssrn.com/abstract=3227113 (emphasis in original).

[47] McCahery et al., *supra* note 42, at 2924.

[48] *Id.*

[49] *See* Fisch & Sepe, *supra* note 46, at 14-5.

[50] *Id*. at 11.

[51] *See*, *e.g.*, ICGN GSP, at 22.

2010.[52] Based on the premises that responsibility for stewardship of publicly listed companies is shared between the board, which oversees its management, and investors, who hold the board accountable for its responsibilities, in its current version the Code explains that stewardship is more than just voting:

> "Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings".[53]

The Code states that effective monitoring is an essential component of stewardship (Principle 3), and that institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities, regardless of whether an active or passive investment policy is followed (Principle 4). While initial discussions concerning investors' concerns should take place on a confidential basis, if companies do not respond constructively, then institutional investors should consider whether, e.g., to hold additional meetings with management specifically in order to: discuss concerns; express concerns through the company's advisers; meet with the chairman or other board members; intervene jointly with other institutions on particular issues; make a public statement in advance of general meetings; submit resolutions and speak at general meetings; and requisition a general meeting, in some cases proposing changes to board membership.[54]

Similarly, in the Stewardship Code drafted in 2017 by the European Fund and Asset Management Association (hereinafter, EFAMA)—a revision of its 2011 Code of External Governance—the concept of stewardship covers the monitoring of, voting the shares of, and engagement with, investee companies. Stewardship is defined as

> "engagement, i.e. the monitoring of and interaction, with investee companies, as well as exercising voting rights attached to shares. Engagement can be on matters such as: business strategy and its execution; risk management; environmental and social concerns; corporate governance issues such as board composition and the election of independent directors, together with executive remuneration; compliance, culture and ethics; and

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[52] FIN. REP. COUNCIL (FRC), THE UK STEWARDSHIP CODE (July 2010), https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf.

[53] FIN. REP. COUNCIL (FRC), THE UK STEWARDSHIP CODE (Sept. 2012), https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf., Guidance to Principle 1 [*hereinafter* UK Stewardship Code 2012].

[54] *Id.*, Guidance to Principle 4.

performance and capital structure. Asset managers have a duty to act in the best interests of their clients as they are entrusted with their money."[55]

EFAMA Principles are intended to enhance the quality of dialogue with companies, and "do not constitute an obligation to micro-manage or intervene in the day-to-day affairs of investee companies or preclude a decision to sell a holding where that is the most effective response to such concerns."[56]

Even European legislation has explicitly embraced the concept of engagement. Directive (EU) 2017/828 of 17 May 2017 amended Directive 2007/36/EC—the so-called Shareholders' Rights Directive (hereinafter, SRD II)—precisely "as regards the encouragement of long-term shareholder engagement".[57] Based on "clear evidence" of the inadequacy of the current level of institutional monitoring of, and engagement with, portfolio companies, and the excessive focus on short-term returns, the SRD II is aimed at encouraging long-term shareholder engagement.[58] According to the SRD II, "effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies".[59] Hence, Article 3(g) of the SRD II requires Member States to ensure (on a comply-or-explain basis) that institutional investors and asset managers "develop and publicly disclose an engagement policy" describing

> "how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement."[60]

While it is rooted in Europe, in recent years the need for non-activist institutional investors' engagement has gained momentum also in the United States, where it is conceived of as the

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[55] EUR. FUND AND ASSET MANAG'NT ASS'N (EFAMA), STEWARDSHIP CODE. PRINCIPLES FOR ASSET MANAGERS' MONITORING OF, VOTING IN, ENGAGEMENT WITH INVESTEE COMPANIES (2018), https://www.efama.org/Publications/Public/Corporate_Governance/EFAMA%20Stewardship%20Code.pdf.

[56] *Id*. at 5.

[57] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, 2017 O.J. (L 132), 1 [hereinafter, SRD II].

[58] *See* Recitals 2 and 3 of SRD II.

[59] *See* Recital 14 of SRD II.

[60] Article 3(g) (1)(a) of SRD II.

missing middle-ground approach within the polarized board-versus-shareholder debate, and, alongside voting, as "another legitimate mechanism for influencing management and potentially bringing about change".[61] Indeed, successful engagement can bring about changes at portfolio companies as "the result of a consensus process".[62]

The same collaborative tone shapes the relationship between institutional shareholders and corporations in at least four different—fairly new—sets of corporate governance and stewardship principles, as well as similar initiatives, which recommend non-activist institutional investor engagement in line with the model initially set out by the UK Stewardship Code.

First, Martin Lipton's "New Paradigm" to corporate governance provides "a synthesis of the corporate governance codes applicable in a number of markets and various efforts underway to articulate a new corporate governance framework".[63] The New Paradigm was proposed in 2016 under the auspices of the International Business Council of the World Economic Forum with the aim of achieving "sustainable long-term investment and growth" and countering short-termism in managing and investing in businesses. Subsequent updates provide guidance on the practice of engagement and stewardship, suggesting, *inter alia*, that investors "should raise critical issues to companies as early as possible in a constructive and proactive way, and seek to engage in a dialogue before submitting a shareholder proposal. Public battles and proxy contests have real costs and should be viewed as a last resort where constructive engagement has failed".[64]

Second, the Commonsense Principles of Corporate Governance, drafted by representatives of some of America's largest corporations and institutional investors, also underscore the importance of a company's engagement with shareholders and receiving feedback concerning matters that are relevant to long-term shareholder value, and recommend that the CEO should

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[61] Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 NYU J. L. & BUS. 385, 392 (2016). *See also* Fisch & Sepe, *supra* note 46, at 19-20.

[62] *Id*. at 20.

[63] *See* Martin Lipton et al., *The New Paradigm. A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* 6 (2016), http://www.wlrk.com/docs/thenewparadigm.pdf.

[64] Martin Lipton et al., *Some Thoughts for Boards of Directors in 2019 (Including The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth)* 18 (2018), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.26288.18.pdf

actively engage with corporate governance and key shareholder issues when meeting with shareholders.[65] The Principles also recommend that

> "Asset managers should actively engage, as appropriate, based on the issues, with the management and board of the company, both to convey the asset manager's point of view and to understand the company's perspective. Ideally, such engagement will occur early in the process to facilitate alignment on resolution of issues where possible and avoid unnecessary disruption. Asset managers should give due consideration to the company's rationale for its positions, including its perspective on certain governance issues where the company might take a novel or unconventional approach."[66]

Finally, further groups have also adopted analogous self-regulatory and non-binding initiatives. The Investor Stewardship Group (hereinafter, ISG) published its Framework for U.S. Stewardship and Governance, which came into effect in January 2018, recommending that institutional investors address and attempt to resolve differences with companies in a constructive and pragmatic manner.[67] The Business Roundtable published its Principles of Corporate Governance in 2016, likewise emphasizing the importance of constructive engagement with long-term shareholders.[68]

III. DIVERGING INCENTIVE STRUCTURES

If the actual behavior of activist and non-activist institutional shareholders as owners is so radically different, this is largely due to their diverging incentives structure, which fundamentally contributes to shaping investors' conduct. Once again, those differing economic incentives can be illustrated by examining more closely the opposition between non-activist and activist institutional investors.

A. *Non-Activist Institutional Investors*

[65] The Commonsense Principles of Corporate Governance 2.0 are hosted on the Columbia Law School Millstein Center webpage, https://millstein.law.columbia.edu/content/commonsense-principles-20.

[66] *See* Commonsense Principles of Corporate Governance 2.0, VIII(a).

[67] *See* Stewardship Principle E, https://isgframework.org/.

[68] BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE, 26 (2016), https://s3.amazonaws.com/brt.org/Principles-of-Corporate-Governance-2016.pdf.

The long-standing collective action and limited benefits problems, alongside conflicts of interest,[69] are the main obstacles to active ownership by mainstream institutional investors. Nevertheless, as the conduct of some leading fund managers seems to suggest, reputational concerns can prompt fund managers to increase their investments in stewardship and play a more active monitoring role in relation to investee companies.

1. Collective Action Problems and Limited Benefits

As is known, portfolio diversification only allows investors to take limited advantage of successful individual stewardship efforts with investee companies.[70] Since stakes held in individual companies account for a minimal part of the fund's portfolio and, even more so, the overall assets managed by the fund manager, the benefits potentially deriving from active engagement will affect fund performance in a way that is necessarily very limited.[71] By contrast, engagement-related costs can be fairly high and will not be shared with fellow passive shareholders, which will nonetheless take advantage of the company's improved performance.[72] Costly to produce as they are, and subject to a form of "non-rivalrous consumption", "the gains resulting from institutional activism are a species of public goods."[73] Moreover, engagement-related costs cannot be passed on to end-investors, since investment managers are precluded by regulation from charging stewardship expenses to their funds, or from tying fees to increases in the value of their portfolios.[74] Hence, sensitivity to the free-rider problem is high, particularly in contexts where competition for investor capital is high, as is the

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[69] *See, e.g.,* John D. Morley, *Too Big to Be Activist,* 1 S. CAL. L. REV. (forthcoming) (May 7, 2019), https://ssrn.com/abstract=3225555.

[70] *See generally* McCahery et al., *supra* note 42, at 2921; Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* 17-19 (Eur. Corp. Gov. Inst. Working Paper No. 433/2018 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

[71] *See* Rock, *supra* note 38, at 373. Whether corporate governance improvements will actually improve the firm's value remains however questionable: *see* J.B. Heaton, *All You Need is Passive A Response* to *Professors Fisch, Hamdani, and Davidoff Solomon* (July 7, 2018), https://ssrn.com/abstract=3209614 (stating that "corporate governance initiatives have little effect on financial performance").

[72] Stewardship-related expenses escalate proportionately to the measures adopted. *See* Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. OF FIN. ECON., 610-631 (2013).

[73] Bainbridge, *supra* note 10, at 14.

[74] Bebchuk, Cohen & Hirst, *supra* note 40, at 108. *But see* for an alternative view Simone Alvaro, Marco Maugeri & Giovanni Strampelli, *Institutional Investors, Corporate Governance and Stewardship Codes: Problems and Perspectives* 60 (CONSOB Legal Research Papers No. 19) (2019), https://ssrn.com/abstract=3393780; Hannes, *supra* note 22, at 201.

case within the asset management industry,[75] where fund managers compete to attract assets under management based on performance relative to alternative investment opportunities.[76]

As specifically regards passive index funds (i.e. index fund and exchange traded funds-ETFs), some argue that these prefer to free-ride on stewardship initiatives performed by other (active) fund managers. Indeed, since index fund portfolios are typically much larger than those held on average by actively managed mutual funds, "any investment in improving governance at a single portfolio company will be even less likely to impact the fund's overall performance."[77] Due to the very low fees that index funds charge, "the increased revenue they receive—through increased fee revenue—will be only a tiny fraction of the expected value increase from governance improvements."[78] In addition, governance interventions seem especially costly for index funds because passively managed funds are not informed traders: they "do not generate information about firm performance as a byproduct of trading and thus must expend additional resources to identify underperforming firms and evaluate interventions proposed by other investors".[79]

However, this line of argumentation is controversial since other scholars contend that, in order to reduce the comparative advantage that competing actively managed funds enjoy vis-à-vis passive funds on account of their ability to trade, passive funds need to exert their voice to improve the corporate governance and performance of investee companies and to prevent asset outflow.[80] Because passive investors are, by definition, quasi-permanent shareholders that cannot exit underperforming companies, or adjust their relative weight in their portfolio, they should naturally be incentivized to monitor managers, use their votes and further stewardship

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[75] John C. IV Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).

[76] *See* Bebchuk, Cohen & Hirst, *supra* note 40, at 98; Black, *supra* note 5, at 9.

[77] Bebchuk & Hirst, *supra* note 70, at 17; Shapiro Lund, *supra* note 24, at 511.

[78] Bebchuk & Hirst, *supra* note 70, at 18.

[79] Shapiro Lund, *supra* note 24, at 497 and 511-12.

[80] *See* Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *Passive Investors*, 14-6 (Eur. Corp. Gov. Inst. (ECGI) Law Working Paper No. 414/2018) (2018), https://ssrn.com/abstract=3192069; Kahan & Rock, *supra* note 28, at 26-29. *But see* Heaton, *supra* note 71, at 17.

tools to improve the company's performance.[81] Owing to the large size of their portfolios, passive fund managers can exploit economies of scale deriving from "identifying governance 'best practices' that are likely to reduce the risk of underperformance" to be "deployed across a broad range of portfolio companies" at a relatively low cost.[82]

Evidence concerning how passive investment strategies impact fund managers' incentives to engage actively with portfolio companies is mixed. Some findings suggest that, where passive institutions make their voice heard, this is associated with significant corporate governance improvements. In particular, index fund influence has been found to support greater board independence, favor the removal of takeover defenses—such as classified boards—and promote more equal voting rights by opposing dual-class share structures.[83] However, findings that a greater proportion of passive investors in the shareholder base is associated with more value-destroying mergers and acquisitions suggest on the other hand that passive investors are less likely to monitor managers.[84]

The free-rider disincentive can not only affect truly passive funds which mimic a given market index, but also so-called "closet index" funds. Closet index funds adopt formally active investment strategies for portfolio holdings that, however, more or less duplicate some defined market benchmark; these are, in other words, funds that "charge for active management, but deliver investments that mostly overlap with the holdings of a much cheaper passive index fund."[85] In fact, for a closet indexer, "a desire to improve relative performance would provide no incentives to move stewardship decisions toward optimality for any of the portfolio companies where the company's weighting in the investment fund's portfolio is approximately

[81] *See* Ian Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 113–14 (2016); *see also* HORTENSE BIOY ET AL., MORNINGSTAR, PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP 3 (2017), http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf; Nan Qin & Di Wang, *Are Passive Investors a Challenge to Corporate Governance?* 3 (2018) (unpublished manuscript) (on file with author); Zohar Goshen & Sharon Hannes, *The Death of Corporate Law* 39 (Eur. Corp. Gov. Inst. Working Paper No. 402/2018) (2018), http://www.ecgi.global/sites/default/files/working_papers/documents/finalgoshenhannes.pdf; Leo Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law,* 114 COLUM. L. REV. 449, 478 (2014).

[82] Fisch, Hamdani & Davidoff Solomon, *supra* note 80, at 15 and 17.

[83] *See* Appel et al., *supra* note 81, at 114.

[84] Cornelius Schmidt & Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?*, 124 J. FIN. ECON. 285, 298-300 (2017).

[85] K. J. Martijn Cremerst & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay for: Securities Law and Closet Index Funds*, 11 VA. L. & BUS. REV. 31 (2016).

equal to its weighting in the index; improving the value of those portfolio companies would not enhance performance relative to the index".[86]

At the same time, competitive pressure to improve performance relative to peers can disincentivize investing in engagement also for actively managed funds. Indeed, they may rationally prefer to invest in fundamental analysis of portfolio companies in order to search for the best selling opportunities, rather than to initiate engagement. In fact, unlike a successful engagement effort, a successful trade will produce a private gain for the fund.[87] More generally, unless some specific companies are overweighed in the fund's portfolio compared to competing funds' portfolios, or in the index tracked by passive competitors, an actively managed fund has little incentive to take any active stewardship initiatives, since free riding peers with comparatively greater stakes would benefit from the improved value in those companies more than the active fund.[88] In addition, "to the extent that funds depart from an index, but still compete with managers of similar funds, a fund's relative performance improves when "underweighted" companies in their portfolio [relative to the index] perform badly".[89]

2. Cost Issues

Portfolio diversification discourages active ownership also due to cost considerations. Identifying relevant corporate governance pitfalls would require a potentially active owner to closely monitor any of its portfolio companies. However, portfolio companies are most often simply too many in number in order to realistically allow fund managers to operate such screening effectively. Arguably, due to their limited size, dedicated in-house stewardship teams built up at major asset managers are not capable of dedicating the same degree of attention to

[86] Lucian A. Bebchuk & Scott Hirst, *Are Active Mutual Funds More Active Owners than Index Funds?* HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Oct. 3, 2018), https://corpgov.law.harvard.edu/2018/10/03/are-active-mutual-funds-more-active-owners-than-index-funds/.

[87] *See* Gilson & Gordon, *supra* note 35, at 890.

[88] *See* Bebchuk, Cohen & Hirst, *supra* note 40, at 98-99 (explaining that "the extent to which improving the value of the corporation would improve fund performance will depend on the extent to which the corporation is overweight in the portfolio". In fact, " any increase in the value of the portfolio company will be substantially shared by rival funds that track the index at least partly. Indeed, the increase in value of the portfolio company will worsen the performance of the investment fund relative to rival funds that are more overweight with respect to the portfolio company. Thus, even for companies that are overweight within the portfolio of the investment fund relative to the index, the impact of the desire to improve relative performance would be diluted by the presence of the company in the benchmark index and in the portfolios of rival funds."). *See also* McCahery et al., *supra* note 58, at 2915.

[89] Rock, *supra* note 38, at 373.

all portfolio companies.[90] In fact, although they are expanding,[91] stewardship teams are still too small even at the leading fund managers. For example, at Blackrock—the world's largest asset manager—, the stewardship team is made up of around forty people, who are tasked with monitoring corporate governance issues at around 17,000 companies and voting in around 17,000 shareholder meetings each year.[92] Therefore, even for major asset managers' stewardship teams, "[s]imply voting the shares, without even considering how to vote them, is an enormous task."[93]

As a consequence, stewardship teams most often draw up nearly identical voting guidelines, which they normally tend to follow fairly closely.[94] These voting patterns may also be a consequence of the fact that asset managers largely rely on proxy advisory firms which adopt standardized in-house voting policies, or assist clients in drafting their own voting policies, in both instances according to mainstream corporate governance principles and practices.[95] True, institutions do not seem to follow proxy advisors' voting recommendations blindly at all times, and this is the case especially at larger institutions with in-house stewardship teams and stronger

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[90] *See* Bebchuk, Cohen & Hirst, *supra* note 40, at 98-99; Shapiro Lund, *supra* note 24, at 516.

[91] Bioy et al., *supra* note 81, at 19. For instance, in 2018 Vanguard created a new European stewardship team to include at least five members. *See also* Chris Flood, *Vanguard Creates New European Stewardship Team*, FIN. TIMES (Feb. 17, 2018), https://www.ft.com/content/5dbd7d56-1256-11e8-940e-08320fc2a277.

[92] BLACKROCK, INVESTMENT STEWARDSHIP: PROTECTING OUR CLIENTS' ASSETS FOR THE LONG-TERM 5, 13, and 17 (2019), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.

[93] Rock, *supra* note 38, at 370 (emphasis omitted); *see also* Bebchuk, Cohen & Hirst, *supra* note 40, at 100; Bebchuk & Hirst, *supra* note 70, at 31-34; Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77, 93 n.118 (2015); John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve*, 14 (Sept. 20, 2018), https://ssrn.com/abstract=3247337.

[94] *See, e.g.*, VANGUARD'S PROXY VOTING GUIDELINES, VANGUARD, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/# [https://perma.cc/2D42-LCYP] ("[T]he guidelines . . . provide a rigorous framework for assessing each proposal. . . . each proposal must be evaluated on its merits, based on the particular facts and circumstances as presented."); *see also* STATE ST. GLOB. ADVISORS, ANNUAL STEWARDSHIP REPORT 2017 YEAR END 12 (2018), https://www.ssga.com/investmenttopics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf [https://perma.cc/DT23-ZSP8] (declaring that State Street adheres strictly to adopted voting policy and all its voting and engagement activities are centralized within the asset stewardship team irrespective of investment strategy or geographic region).

[95] *See* recently James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* 7 (Rock Ctr. for Corp. Governance at Stan. U. Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-72; Stan. U. Graduate Sch. of Bus., Research Paper No. 18-27) (2018), https://ssrn.com/abstract=3188174.

reputational incentives to be active.[96] Nevertheless, adhering to a low-cost box-ticking approach to voting is consistent with the need to keep fees low.[97]

This is especially so for passive index fund managers. As they charge very low fees and can, therefore, capture only a tiny fraction of the expected revenues originated by stewardship initiatives, stewardship-related costs have a significant impact on passive funds' fee structure.[98] As one of us has already noted, this prediction seems to be confirmed by available data and evidence suggesting that passive index funds can have a positive impact on corporate governance issues for which low-cost interventions are required, such as voting according to pre-defined policies at annual meetings.[99] By contrast, passive investors are deemed to be generally passive owners "when it comes to high-cost governance activities such as monitoring of M&A, the choice of board members, or the accumulation of titles that often happen outside of annual general meetings and require continuous monitoring."[100]

3. Reputational Incentives

While collective action and cost issues can significantly discourage non-activist institutional investors from engaging with investee companies, especially when engagement comes with higher costs, there is growing reputational and regulatory pressure for leading fund managers—mainly the largest passive fund managers[101]—to be active monitors.[102]

First, reputational concerns that leading fund managers should play an active monitoring role are fueled by regulatory pressure to exercise voting rights in keeping with mutual fund fiduciary duties to end-investors.[103] The SEC has adopted a disclosure-based regulatory strategy that has

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[96] *See, e.g.,* Rock, *supra* note 38, at 370-71.

[97] *See* Shapiro Lund, *supra* note 24, at 495 (noting that passive investors tend to approve any shareholder proposal that meets pre-determined qualifications); *see also* Rana Foroohar, *Investors Pass the Buck on Governance*, FIN. TIMES (Oct. 29, 2017), https://www.ft.com/content/f2510d5a-b961-11e7-8c12-5661783e5589; Attracta Mooney & Robin Wigglesworth, *Passive Fund Managers Face Showdown in US Gun Debate*, FIN. TIMES (Mar. 2, 2018), https://www.ft.com/content/517fbbb6-1d4c-11e8-956a-43db76e69936.

[98] *See* Bebchuk & Hirst, *supra* note 70, at 18-19.

[99] *See generally* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 823 (2018).

[100] Schmidt & Fahlenbach, *supra* note 84, at 287.

[101] *See infra*, notes 104-105 and accompanying text.

[102] *See* Bioy et al., *supra* note 81, at 3; Kahan & Rock, *supra* note 28, at 32.

[103] *See* MORNINGSTAR, PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP 3 (2017) http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf; Fisch, Hamdani & Davidoff Solomon, *supra* note 80, at 30.

prompted (albeit without imposing a duty) institutional investors to vote all portfolio shares.[104] Second, it is also credible that creating the appearance of governance expertise will help funds managers to win over clients, especially among institutional investors.[105] Moreover, fund managers may see corporate engagement "as a branding or marketing tool that provides them with another dimension on which to compete for assets."[106]

In line with the underlying assumption that the three leading passive fund managers "are simply too-big-to-be-passive,"[107] the conduct of the Big Three appears to confirm this prediction. Indeed, they frequently reiterate that they participate in the governance of investee companies, e.g. in open letters sent to the CEOs of world's largest companies.[108] As Kahan and

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[104] Voting by mutual and public pension funds was fueled by regulatory action taken to enhance fiduciary obligations applicable to voting proxies (*see* Sec. & Exch. Comm'n, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003); *Id.*, Proxy Voting by Investment Advisers, 68 Fed. Reg. 6586 (Feb. 7, 2003)) and by Department of Labor interpretative guidelines concerning the standards under sections 402, 403 and 404 of Title I of the Employee Retirement Income Security Act (ERISA) (*see* Interpretative Bulletin relating to written statements of investment policy, including proxy voting policy or guidelines, 59 Fed. Reg. 38.863 (July 29, 1994) (29 CFR 2509.94–2)). Those rulings were largely (mis-)interpreted as requiring addressees to vote *every* proxy (*see e.g.* Rock, *supra* note 38, at 374-78; Shapiro Lund, *supra* note 24, at 526-28). Further SEC material explicitly recognized that votes based upon the recommendations of an independent third party can serve investment advisers to fulfill their fiduciary obligation under Rule 206(4)-6, and was further interpreted as requesting investment advisers to vote on all matters: *see* the SEC's no-action letters to Egan-Jones Proxy Services (May 27, 2004), https://www.sec.gov/divisions/investment/noaction/egan052704.htm, and to ISS (Sept. 15, 2004), https://www.sec.gov/divisions/investment/noaction/iss091504.htm. In order to tackle these unintended consequences, in 2014, the SEC Divisions of Corporate Finance and Investment Management released new guidance regarding the responsibilities of investment advisers concerning proxy voting: *see* Sec. & Exch. Comm'n, Staff Legal Bulletin No. 20 (IM/CF), Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014), http://www.sec.gov/interps/legal/cfslb20.htm#_ftn1. Similarly, the Department of Labor revised its guidance in 2008 and 2016: *see* Dep't of Labor, Interpretative Bulletin relating to the exercise of shareholder rights, 73 Fed. Reg. 61.732 (Oct. 17, 2008) (clarifying that proxies should be voted as part of the process of managing the plan's investment in company stock unless the time and costs associated with voting proxies in respect to certain types of proposals or issuers may not be in the plan's best interest). IB 2008-2 was later withdrawn and replaced by Interpretive Bulletin 2016-1, which reinstates the language of Interpretive Bulletin 94-2 with certain modifications: *see* Dep't of Labor, Interpretative Bulletin relating to the exercise of shareholder rights, 81 Fed. Reg. 95.879 (Dec. 29, 2016).

[105] Shapiro Lund, *supra* note 24, at 527. *See also* Jennifer Thompson, *Pension funds raise concern over index manager stewardship*, FIN. TIMES (June 23, 2019), https://www.ft.com/content/f75459e3-3a6d-383e-843b-6c7141e8442e (noting that "[a]t a time of fierce competition between passive managers . . . the quality of stewardship will become a way for them to stand out").

[106] Fisch, Hamdani & Davidoff Solomon, *supra* note 80, at 13; Kahan & Rock, *supra* note 28, at 31.

[107] Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective* 14 (Eur. Corp. Governance Inst. Working Paper No. 393/2018) (2018), https://ecgi.global/sites/default/files/working_papers/documents/finalenriquesromano.pdf [https://perma.cc/K4KR-8GCH]. *See also* John Gapper, *Index fund managers are too big for comfort*, FIN. TIMES (Dec. 12, 2018), https://www.ft.com/content/ad8c8a12-fd5f-11e8-aebf-99e208d3e521.

[108] *See* LARRY FINKS'S ANNUAL LETTER TO CEOS. A SENSE OF PURPOSE, https://www.BlackRock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited, Feb. 19, 2019) (stating that, in managing its index funds, "BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever."). For similar remarks on the part of State Street CEO *see* CYRUS TARAPOREVALA, *State*

Rock note, leading passive investors "have strong reputational interests to be perceived, by investors, regulators, and politicians, as responsible actors who are a force for the good."[109] In addition, the considerable attention paid by some leading institutional investors to ESG matters could help to attract clients that are especially attentive to socially responsible investing.[110]

B. *Activist Institutional Investors*

Unlike traditional institutions, activist investors, and especially hedge funds, conceive of activism not as a tool for remedying a particular corporate flaw (according to an ex post perspective), but rather as a strategic ex ante lever by which to increase returns on investment. As Kahan and Rock summarized, activism by traditional institutions is aimed at achieving small, systemic changes, entails low costs and is incidental and ex post.[111] On the contrary, hedge fund activism aims at achieving significant changes at individual companies, entails higher costs, and is strategic and ex ante, in that "[a]ctivists first identify a problematic company, then decide whether intervention can improve matters. If activists conclude that an intervention is warranted, they buy a stake in order to intervene."[112]. Hedge funds' usual investment strategies and the applicable regulatory regime are such that they weaken some of the disincentives that reduce the readiness of mainstream institutional investors to engage with portfolio companies.

1. Portfolio Concentration and "Two Twenty-Like" Rules

Hedge funds can hold under-diversified portfolios since they are exclusively intended for professional investors and, therefore, are not subject to the prudential regulatory framework which typically applies to mutual funds and other categories of traditional institutions in order

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Street's letter to board members 2019, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 4, 2019), https://corpgov.law.harvard.edu/2019/02/04/state-street-and-corporate-culture-engagement/.

[109] Kahan & Rock, *supra* note 28, at 28-32.

[110] *Id.* at 30.

[111] Kahan & Rock, *supra* note 34, at 1069. *See also* Alvaro et al., *supra* note 74, at 39.

[112] Rock, *supra* note 38, at 382. *See also* Cheffins & Armour, *supra* note 40, at 56-58 (defining mainstream institutional investors' activism as "defensive" in nature, as opposed to hedge funds' "offensive" activism, the former relying on pre-existing stakes in the company and the latter being based upon ad hoc stake-building).

to protect unskilled end-investors.[113] Higher levels of portfolio concentration allow hedge funds to be committed to more actively engaging with investee companies as compared with traditional diversified institutions since, by holding higher stakes, they can reap higher benefits associated with improved corporate performance following successful intervention. First, improvements in a single target's performance have a greater effect on the fund's overall returns than is the case for diversified portfolios.[114] Second, portfolio concentration reduces the likeliness that the activist may be faced with free-riding from competitors that hold a position in the same company.[115] Third, portfolio concentration allows greater resources to be dedicated to the monitoring of, and engagement with, individual investee companies.[116]

Hedge funds' fee structures also provide a strong incentive towards active engagement as well. In fact, despite criticism, "two twenty-like" fund manager compensation structures are widespread in the hedge fund industry, where "[t]he "two" refers to an annual management fee of two percent of the capital that investors have committed to the fund. The "twenty" refers to a twenty percent share of the future profits of the fund".[117] The upside potential of performance fees, which are now usually charged on profits above the hurdle performance levels that the fund manager has agreed to with the investor, provides a potent financial incentive for activism, since "[i]f the fund does well, the managers share in the treasure. If the fund does badly, however, the manager can walk away."[118] Capturing 20 per cent of the value increase of the position in the target is "an order of magnitude more than the percentage of any value increase that a mutual fund manager would be able to capture".[119]

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[113] *See generally* Wulf A. Kaal & Dale A. Oesterle, *The History of Hedge Fund Regulation in the United States*, *in* HANDBOOK ON HEDGE FUNDS (Ohio State Public Law Working Paper No. 326 & Univ. of St. Thomas (Minn.) Legal Stud. Res. Paper No. 16-05) (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract-id=2714974.

[114] Bebchuk, Cohen & Hirst, *supra* note 40, at 105.

[115] *Id*.

[116] *Id*.

[117] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008). *But see* Robin Wigglesworth, *DE Shaw to revert to '3 and 30' model as cost pressures bite*, FIN. TIMES (Apr. 19, 2019), https://www.ft.com/content/fe2799b4-6252-11e9-b285-3acd5d43599e (noting that "only 3 per cent now charge a 2 per cent management fee, and 16 per cent take a fifth of profits . . . The average is now just 1.45 per cent and 16.9 per cent respectively"). Although, due to growing pressure from low- or zero-fee passive funds and to performance not always adequate, two-and-twenty rules appear to be declining, hedge funds' fee models still remain expensive, with average management fees of around 1,5 per cent and performance fees rarely lower than 15 per cent. *See* Chris Flood, *Hedge fund fee model morphs from 'two and 20' to 'one or 30'*, FIN. TIMES (Apr. 1, 2019), https://www.ft.com/content/7e4e2cdc-8c2a-34d4-a7e2-60c9db9e2a2d (citing JPMORGAN CHASE & CO, 2019 INSTITUTIONAL INVESTOR SURVEY 11, https://www.jpmorgan.com/country/HK/en/prime-services/institutional-investor-survey-2019?source=cib_ps_li_Aiinvestor0319).

[118] *Id*. *See also* Bebchuk, Cohen & Hirst, *supra* note 40, at 104; Rock, *supra* note 38, at 382.

[119] Bebchuk, Cohen & Hirst, *supra* note 40, at 104.

2. The Absence of Business Ties with Investee Companies

Unlike non-activist institutions, most hedge funds do not sell money management services to portfolio companies or, more generally, have no business ties with the public corporations in which they invest, and do not hold horizontal shareholdings in a vast number of issuers.[120] Hence, they are less subject to the conflicts of interest that are associated with the desire to attract business from investee companies and, as a consequence, with bias toward non-adversarial, if not overtly manager-friendly, ownership behavior.[121] As Morley notes, normally activist hedge funds are not run by large investment managers—e.g. BlackRock, Vanguard, Fidelity—since these managers are simply too big to be activists.[122] Specifically, since the largest investment managers run different business lines, an activist initiative promoted by one of their fund managers could harm the clients of other funds managed by the same investment conglomerate.[123]

3. The Corporate Governance Limits of Hedge Fund Activism

However, hedge fund activism also suffers from limitations that can weaken its potentially beneficial corporate-governance effects. First of all, activist intervention mostly occurs in relation to underperforming targets, which means that intervention is worth the costs in terms of the expected returns.[124] Therefore, companies that do not match activists' stock picking will not usually become involved in any of the corporate changes on the activist's usual playbook.[125]

Second, and more broadly, there is still a question as to whether the effects of hedge fund activism are actually positive or negative. Those who view activists as valuable corporate monitors that can benefit all shareholders underscore the fact that no evidence has been found to suggest that activist intervention, including investment-limiting and adversarial intervention, is followed by any short-term gains in performance at the price of long-term performance.[126]

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[120] Rock, *supra* note 38, at 382.

[121] *See* Bebchuk, Cohen & Hirst, *supra* note 40, at 105-06; Bebchuk & Hirst, *supra* note 70, at 22-25.

[122] Morley, *supra* note 69, at 1.

[123] *Id.*

[124] Bebchuk, Cohen & Hirst, *supra* note 40, at 106.

[125] *See* Strampelli, *supra* note 99, at 839.

[126] *See* Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

Supporters of hedge fund activism further highlight the fact that operating performance increases at targeted firms;[127] and that innovation output (as measured by patent counts and citations) also increases.[128] Moreover, activism is claimed to induce industry peers that are not targeted to respond proactively to the threat of possible activist intervention by implementing policy changes that mimic those made by targeted firms.[129] Finally, it is asserted that activist investment-limiting proposals effectively curb the management's bias towards inefficient expansion and empire building.[130]

However, further evidence supports the view "that the substantial private gains hedge funds realize through activism come at the expense of long-term firm value, rather than from the activists' ability to hold managers more accountable".[131] Activism is also believed to have a perverse deterrent effect on the long-term focus of the management, since it distorts the ex-ante incentives of managers and other stakeholders to invest optimally in the firm.[132] Moreover, activists are unlikely to have superior knowledge, skills or expertise at running the business, as compared to the firm's management.[133] In addition, in favoring riskier projects or an increase in financial leverage, hedge fund activism is argued to increase corporate risk-taking and to heighten the risk of wealth-transfers from creditors to shareholders.[134] Finally, hedge fund representation in the board of directors has been associated with an increase in informed trading

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[127] *See* Matthew R. Denes, Jonathan M. Karpoff & Victoria B. McWilliams, *Thirty years of shareholder activism: A survey of empirical research*, 44 J. CORP. FIN. 405, 411 (2017).

[128] Alon Brav et al., *How does hedge fund activism reshape corporate innovation?* (July 3, 2017), J. OF FIN. ECON. (2018) (forthcoming), https://ssrn.com/abstract=2409404.

[129] *See* Nickolay Gantchev, Oleg Gredil & Chotibhak Jotikasthira, *Governance under the Gun: Spillover Effects of Hedge Fund Activism* (EUR. CORP. GOV. INST. (ECGI) Working Paper No. 562/2018) (May 2018), https://ssrn.com/abstract=2356544.

[130] *See* Nickolay Gantchev, Merih Sevilir & Anil Shivdasani, *Activism and Empire Building* (Eur. Corp. Gov. Inst. (ECGI) Finance Working Paper No. 575/2018) (Sept. 8, 2018), https://ssrn.com/abstract=3062998.

[131] Martijn Cremers, Saura Masconale & Simone M. Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261 (2016); Martijn Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, *Hedge Fund Activism, Firm Valuation and Stock Returns* (June 16, 2018), http://ssm.com/abstract=2693231; Ed deHaan, David F. Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions* (Eur. Corp. Governance Inst. (ECGI) Finance Working Paper No. 577/2018) (Oct. 3, 2018), https://ssrn.com/abstract=3260095.

[132] Cremers et al, *supra* note 131, 278; John C. Jr. Coffee & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 593 and 605 (2016).

[133] *See* Leo E. Jr. Strine, *Who Bleeds When the Wolves Bite: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L. J. 1870, 1953-1954 (2017); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755 (2008).

[134] *See* April Klein & Emanuel Zur, *The impact of hedge fund activism on the target firm's existing bondholders*, 24 REV. FIN. STUD. 1735 (2011); Sandeep Dahiya, Issam Hallak & Thomas Matthys, *Targeted by an Activist Hedge Fund, Do the Lenders Care?* (June 4, 2018), https://ssrn.com/abstract=3191072. *But see* Brav et al., *supra* note 133, at 1732.

in the corporation's stock, suggesting that activist board representation imposes new agency costs.[135]

IV. RECONSIDERING INCENTIVE STRUCTURES IN THE CONTEXT OF COLLECTIVE ENGAGEMENT

The previous analysis of institutional investors' incentive structures implicitly relies on the assumption that investors conduct their engagement initiatives individually. In fact, it is generally assumed that institutional investors act in a solo-engagement context where free riding problems and cost issues are particularly acute.

It is undeniable that some engagements may best be conducted privately by a single—activist or non-activist—institutional investor.[136] However, there is a growing body of anecdotal evidence and academic studies to suggest that coordinated engagements by institutional investors are becoming increasingly widespread and can have a positive impact on investee companies, especially with regard to corporate governance issues.[137]

While wolf packs have received comparatively greater consideration within the literature, increasing attention is being paid to non-activist shareholders' collective engagement initiatives. For example, according to Dimson et al., collective engagement initiatives are "effective in successfully achieving the stated engagement goals and subsequently improving target performance".[138] Doidge et al. note that coordinated actions can help to overcome free-rider problems affecting institutional investors.[139] Similarly, Crane et al. maintain that coordinated initiatives can improve institutional shareholders' voice.[140]

However, while highlighting the potential benefits of shareholder collective action, available empirical studies present some limitations. First, the distinction between activist-driven and non-activist-driven engagement is not always clear. Second, and more importantly,

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[135] *See* John C. Coffee Jr. et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?* (Colum. Bus. School Research Paper No. 18-15) (Jan. 12, 2018), https://ssrn.com/abstract=3100995.

[136] *See*Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Coordinated Engagements* 9 (July 1, 2018). https://ssrn.com/abstract=3209072.

[137] *See, e.g.*, *id.* 27-28; Elroy Dimson, Oğuzhan Karakaş & Xi Li; *Active Ownership*, 28 REV. FIN. STUD. 3225, 3240-3242 (2015); Craig Doidge et al., *Collective Action and Governance Activism* (Aug. 30, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2635662; Tanja Artiga González & Paul Calluzzo, *Clustered Shareholder Activism,* 27 CORP. GOVERN. INT. REV. 210 (2019).

[138] Dimson et al., *supra* note 137, at 3.

[139] Doidge et al., *supra* note 137, at 25-28.

[140] Alan D. Crane, Andrew Koch & Sebastien Michenaud, *Institutional Investor Cliques and Governance* (June 22, 2017) J. FIN. ECON. (forthcoming), https://ssrn.com/abstract=2841444.

they do not provide an unambiguous definition of shareholder cooperation. Indeed, institutional investors can be associated with each other in a number of ways. As is noted by Enriques and Romano, formal, geographical, employee, and co-ownership ties can exist among institutional investors.[141] Also proxy advisors[142] and hedge fund activists[143] can act as connections among institutions. Although informal connections among institutional investors can "contribute to shaping institutional investors' incentives to vote 'actively'",[144] as far as coordinated engagement initiatives are concerned formal connections prove to be more significant, since only ex-ante formalized cooperation allows institutional investors to share costs and can help to overcome potential free-rider problems.[145]

Hence, as this Article mainly points towards solutions that seek to stimulate collective engagement initiatives by institutional investor, we do not consider informal shareholder connections. Accordingly, we focus on coordinated initiatives that imply the decision by participants to engage alongside other institutional investors in order to meet a shared goal.

A. *Activist-Driven Forms of Shareholder Cooperation*

The distinction between activist-driven and non-activist-driven engagements is sometimes blurred. To begin with, there appears to be no clear distinction between so-called wolf packs and the different, although equally activist-driven, phenomenon of the receptive teaming up by non-activist institutional investors with an activist. Second, also non-activist-driven collective engagement comes in different shapes. In this Part, we provide an overview of these different forms of shareholder collaboration with the aim of highlighting the fundamental differences, thus laying the premises for a discussion both of the benefits of collective engagements vis-à-vis activist, or activist-driven, types of shareholder collaboration as well as their policy implications.

1. Wolf Packs

[141] Enriques & Romano, *supra* note 107, at 244.

[142] *See* Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* (Apr. 16, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039).

[143] Gilson & Gordon, *supra* note 35, at 897-8.

[144] Enriques & Romano, *supra* note 107, at 223. *See also* Bubb & Catan, *supra* note 142, at 7-18; Crane et al., *supra* note 140, at 7-13.

[145] *See infra*, Part IV.C.

The form of shareholder collaboration that relies on wolf pack formation has been found to be "the most profitable type of engagement, reflecting the high probability of achieving successful outcomes".[146] While it has been pointed to as an explanation for the recent spike in hedge fund activism,[147] the wolf pack tactic has been reported since at least 2005 as a form of pseudo-cooperation between mutually supportive hedge funds "interested in the same prey but who are careful not to form a Schedule 13D group".[148] Avoiding formal coordination between the members of the pack means preventing their stakes from being aggregated under section 13(d) of the Securities Exchange Act, followed by their notification as a joint stake, which would trigger earlier disclosure obligations regarding potential changes in corporate control, including the "purposes of the transaction" and any plans or proposals involving material corporate transactions relating to the issuer.[149]

Based on parallel—though formally uncoordinated—action, the wolf pack exploits the voting power held collectively by its members to enable relatively small blockholders to gain significant influence, thereby increasing the prospects of success of an activist campaign.[150] Importantly, focusing on trading in the target's stocks around individual 13D filings, the process by which the wolf pack is formed involves a markedly speculative stance. Participation in the pack is thus likely to be premised on trading-profits incentives. Such a characterization of the wolf pack tactic holds despite some ambiguity surrounding the particular mechanism by which wolf packs are formed as well as the very definition of a wolf pack; in actual fact, two competing views have been conceptualized in this regard, although they are not necessarily mutually exclusive.

Some take the view that wolf packs are formed spontaneously as a result of independent activity by their members based on investors' understanding of the lead activist's playbook, as can be inferred from its trading. It is considered that no direct communication between the players need take place; reputational concerns are key in leading smaller investors who compete for investor capital to purchase the target's stock following a 13D filing and to join the

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[146] Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2936 (2017).

[147] *See* Coffee & Palia, *supra* note 132, at 549-50.

[148] Briggs, *supra* note 14, at 698.

[149] 17 C.F.R. § 240.13d-5 (b)(1) (2018) ("When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.")

[150] *See* Alon Brav, Amil Dasgupta & Richmond Mathews, *Wolf Pack Activism* 2-3 (Eur. Corp. Gov. Inst. (ECGI) Finance Working Paper No. 501/2017) (Mar. 1, 2018), https://ssrn.com/abstract=2529230.

campaign triggered by the larger, better-informed lead activist.[151] Mindful that a significant degree of participation in the campaign is necessary in order for it to be successful, and that only a successful campaign will increase the reputation of the institutions participating in the campaign, small institutions are apparently motivated to join the lead activist implicitly in order to increase their perceived skills and reputation and to attract additional capital inflow.[152] Admittedly however, trading profits resulting from private pre-filing tips from the lead activist may increase followers' incentives to buy the target stock prior to the 13D filing by the lead activist. Therefore, informed trading may complement the spontaneous reputation-driven mechanism by which the pack is formed.[153]

However, the data seem to more strongly support the view that wolf packs are "a loose network of activist investors that act in a parallel fashion but deliberately avoid forming a 'group' under section 13(d)(3) of the Securities Exchange Act of 1934".[154] Accordingly, wolf packs are formed intentionally, and are motivated by low-risk informed trading occurring *prior* to 13D filings. While buying up the target's stock at lower prices until it reaches 5% threshold ownership level, thus triggering the 13D filing obligation–and, usually, up to no more than 10% during the following ten-day window set by section 13d(1) for the filing[155]–the lead activist is argued to encourage other investors to join it by positively tipping them off about its upcoming campaign prior to the filing in exchange for wolf pack member support.[156] Circumventing the application of 13D group disclosures allows the pack to accumulate fairly significant stakes in the target while "escap[ing] old corporate defenses (most notably the poison pill) and … reap[ing] high profits at seemingly low risk".[157] In effect, ungrouped holders of stock in the target remain undetected for the purposes of Regulation 13D, provided that no investor

[151] *Id.* at 4-5, and 7 (finding an average abnormal turnover "of over 30% of the activist's typical stake" over the ten-day period *following* 13D flings).

[152] *Id*. at 5-6.

[153] *Id.* at 29.

[154] Coffee & Palia*, supra* note 132, at 562.

[155] 17 C.F.R. § 240. 13d-1(a). *See* Coffee & Palia, *supra* note 132, at 563 (explaining that crossing the 10% threshold would subject the activist to section 16(B) of the Exchange Act, which "may force it to surrender any "short swing" profit to the corporation on shares acquired in excess of 10%"); *see also* Lucian A. Bebchuk, Robert J. Jr. Jackson & Wei Jiang, *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 4-5 (2013).

[156] *See* Yu Ting Forester Wong, *Wolves at the Door: A Closer Look at Hedge Fund Activism,* 2 and 4 (Colum. Bus. School Research Paper No. 16-11, Oct. 2, 2016), https://ssrn.com/abstract=2721413 (conceptualizing the "coordinated effort" hypothesis for wolf pack formation).

[157] *See* Coffee & Palia*, supra* note 132, at 549.

participating in the coalition individually crosses the 5% ownership level, thus triggering the 13D filing obligation.

The intentional nature of wolf pack formation is inferred from data concerning trading volume and the appreciation of the stocks targeted during the period of time close to the public announcement of the campaign. Trading volume is found to increase abnormally *prior* to the public announcement of the campaign and then to drop sharply immediately after the 13D filing by the lead activist, with most of the stock appreciation occurring during the ten-day window.[158] This suggests that many other investors buy the target's stock during the ten-day window.[159] The wolf pack members "most likely have been informed by those filing the Schedule 13D of their intentions. The inference then seems obvious: tipping and informed trading appears to characterize both the formation of the 'wolf pack' and transactions during the window period preceding the filing of the Schedule 13D".[160] In enlisting other investors in the formation of the pack by tipping them off, the 13D-filing activist relies on the expected increase in stock returns that usually follows the public announcement of the campaign as a way of compensating them for their support. In effect, investors "who learn of the incipient Schedule 13D filing face a nearly riskless opportunity for profitable trading if they act quickly, as the Schedule 13D filing usually moves the market upwards".[161]

Further empirical research has found evidence that is consistent with the notion that wolf pack formation is intentional. Specifically, share turnover is found to be about 325% of the normal trading volume on the day the 13D filer crosses the 5% threshold, whereby the bulk of

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[158] *See* Bebchuk et al., *supra* note 155, at 23-24 (finding that stock purchases by 13D-filer activist hedge funds are "disproportionately concentrated on the day on which the investor crosses the five-percent threshold and, to a lesser extent, the immediately following day".); Coffee & Palia, *supra* note 132, at 565.

[159] Coffee & Palia, *supra* note 132, at 565. *See also* Choonsik Lee, *Activism of Blockholder Investors: Who Drives the Purchases of the Target Shares before Schedule 13D Filing?* 4-5 (Jan. 2015), http://www.fmaconferences.org/Orlando/Papers/Activism_of_Blockholder_Investors_2015FMA.pdf. *But see* Alon Brav, J.B. Heaton & Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, 11 J. BUS. ENTREPRENEURSHIP & L. 329, 345-47 (2018) (contending that activists' 13D filings often occur well before the ten-day window closes, and that "the anomalous pattern of abnormal volume disappears . . . when trading data are centered on the date the reporting threshold is crossed rather than the filing date." While not excluding that some tipping or wolf pack formation may take place after the crossing of the 5% threshold, they note that

> the number of additional shares purchased by the elusive pack is economically small . . . unless much of the trading on the trigger date is by investors forming a wolf pack. It is also likely that an important part of the trading on the threshold day is by investors other than the hedge fund activist. Such trading can arise either because of leaked information about the activist's intent to cross the 5% threshold or because activists choose to trade precisely when they anticipate or observe uninformed selling.

[160] Coffee & Palia, *supra* note 132, at 565.

[161] *Id*. at 565.

the trading volume is attributable to trades by investors other than the lead activist.[162] That finding ranks against the view that wolf pack are formed spontaneously, since synchronicity in block building by many investors cannot be fully explained by any sudden changes in market conditions. In addition, wolf packs are found to be more likely to occur in better-defended companies: this, in turn, consistent with the notion that wolf packs are used to circumvent securities takeover defenses.[163]

2. Non-Activist Institutions Teaming Up With Activists

Having accepted that both the practice and the definition of wolf packs is characterized by informed trading based on tipping, it is necessary to consider another type of activist-driven uncoordinated shareholder collaboration, which differs from that underlying wolf packs. In effect, it is increasingly the case that–chiefly in the context of proxy fights[164]–actively managed mutual funds, pension funds and index investors share the views of an activist whom they consider to be a credible actor,[165] and are willing to support its campaign, either privately or publicly, and to vote in line with it at the shareholders' meeting. Ultimately, receptively teaming up with an activist "seems to be developing into a broader market trend".[166]

This form of shareholder collaboration is not restricted to activist players alone or, at least, to actively managed funds motivated by trading profits, but also involves passive investors. Since passively managed investors can hardly be expected to be in a position that allows them to exploit trading–either after or before 13D filings–voting support provided by them to an activist's campaign cannot be assumed to be motivated by the prospects of profits associated with trading in the target's stocks during the period of time close to the announcement of the campaign. It can hence be assumed that implicit, spontaneous support by passive investors is

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[162] *Id*. *See also* Bebchuk et al., *supra* note 155 , 23-4.

[163] *See* Wong, *supra* note 156*,* at 5-6 (finding wolf pack campaigns to be 6% more likely to achieve at least part of the activist's objectives, and 9% more likely to obtain board seats in the target; also, wolf packs are associated with an 8.3% higher buy and hold abnormal return over the duration of the campaign).

[164] *See, e.g*., Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* (Eur. Corp. Gov. Inst. (ECGI) Fin. Working Paper 601/2019) (March 1, 2018), https://ssrn.com/abstract=3101473.

[165] *See* ACTIVIST INSIGHT-SCHULTE ROTH & ZABEL, THE ACTIVIST INSIGHT ANNUAL REVIEW 2018 6 https://www.activistinsight.com/resources/reports/(. *See also* C.N.V. Krishnan, Frank Partnoy, Randall S. Thomas, *The second wave of hedge fund activism: The importance of reputation, clout, and expertise*, 40 J. CORP. FIN. 296, 297 (2016) (pointing at reputation, clout and expertise built up by top hedge funds as a consequence of being successful in difficult interventions as factors further driving success).

[166] Wolf-Georg Ringe, *Shareholder Activism: a Renaissance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 5, 20 (Jeffrey N. Gordon & Wolf-Georg Ringe eds*., 2015*).

provided in the basis of pre-existing stakes held by them in the target. Institutions the decide to vote in line with the activist at the target's shareholder meeting as a result of the activist's ability to convince fellow shareholders of its allegedly superior value-enhancing entrepreneurial views, as compared to those of the target's management.[167] Under the model of shareholder collaboration considered here, there is no need for any direct communication between the activist and its potential followers.[168] After building up its stake, the activist exerts pressure on the target publicly, e.g. by means of open letters to the board of directors and to all shareholders explaining its prospects in terms of the changes advocated along with the reasons for those changes–whether regarding the firm's corporate governance, policies, strategy, etc. Where the activists' views align with those of mainstream fellow investors, the latter may decide to lend support to the campaign and to back the activist's proposals, which obviously increases the likelihood of success. In fact, the activist succeeds in its campaign "by coming public, not so subtly suggesting a willingness to scuffle, and by reaching an accommodation with the target's management that involves the hedge fund gaining board seats"[169]–which often occurs by means of a settlement concluded "well before the ballot box".[170]

B. *Different Forms of Non-Activist Collective Engagements*

Turning to non-activist-driven forms of collective shareholder action, this Part provides an overview of the practice of non-activist shareholder cooperation, taking account of the recommendations contained in stewardship codes aimed at promoting collective engagement by institutional investors.

1. Collective Engagements in Stewardship Codes

Stewardship codes recommend that institutional investors as stock owners collaborate, where appropriate, on the grounds that (individual and) collective engagement with portfolio

[167] *See, e.g.*, Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 312 (2008); Kahan & Rock, *supra* note 28, at 33-34 However, activist-driven teaming up cannot be regarded as a functional substitute for non-activist collective engagements (*infra*, Sec. B). The former can only occur where the views of mainstream institutions converge with those of the activist: which may happen occasionally, but is certainly not always the case. In fact, in line with the differing business models and incentives structure characterizing different investor types, their views often diverge. Therefore, institutions' teaming up with an activist may be thought of as being complimentary to non-activist driven engagements.

[168] *See* Kahan & Rock, *supra* note 28, at 40.

[169] Strine, *supra* note 133, at 1902.

[170] *Id*. at 1904.

companies is part and parcel of a money manager's duty to act in the best interests of its clients, with a view to maintaining and enhancing long-term value and "with the aim of preserving or adding value to the clients' assets."[171]

In Europe, a common reference to collective engagement is contained in the EFAMA Stewardship Code. In its current version, EFAMA Principle 4 recommends that asset managers "should consider acting with other investors, where appropriate". Emphasizing that shareholder collaboration may sometimes be "the most effective manner in which to engage", the Guidance to Principle 4 illustrates that collective action with individual investee companies may in particular be appropriate "at times of significant corporate or wider economic stress, or when the risks posed threaten to destroy significant value or the ability of the company to continue in operation". In addition, the Code also welcomes ongoing collective engagements concerning policy issues.

As the very wording of Principle 4 makes clear, the EFAMA Code heavily borrows from the UK Stewardship Code, Principle 5 of which is re-stated almost verbatim by the EFAMA. The UK Code also states that institutions' policies on collective engagement "should indicate their readiness to work with other investors through formal and informal groups when this is necessary to achieve their objectives and ensure companies are aware of concerns", along with the circumstances under which they would consider participating in collective engagement.[172]

Not surprisingly, given its precedence, the UK model for collective stewardship has also inspired a number of similar initiatives at Member State level. Examples include the 2018 Dutch Stewardship Code, drafted by Eumedion,[173] which emphasizes the potential upsides of shareholder cooperation and joint initiatives, noting that collective discussion with investee companies may sometimes generate "a wider and deeper range of analysis compared to a one-to-one meeting", especially where issues of common interest are concerned. It also suggests that collective engagement may be beneficial to both investee companies and investors, "because both the board and investors get familiar with each other's views and perspectives and

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[171] EFAMA STEWARDSHIP CODE, Background, 3; ICGN GSP, Preamble, 5.

[172] S*ee* FIN. REP. COUNCIL, PROPOSED REVISIONS TO THE UK STEWARDSHIP CODE - ANNEX A REVISED UK STEWARDSHIP CODE, Guidance to Sec. 4, Provision 20, https://www.frc.org.uk/consultation-list/2019/consulting-on-a-revised-uk-stewardship-code. [hereinafter: PROPOSED REVISIONS TO THE UK STEWARDSHIP CODE]

[173] Eumedion is an independent foundation, managed by representatives of participants, representing the interests of dutch and international institutional investors in the field of corporate governance and sustainability performance; it is currently participated by about 60 institutional investors and umbrella organizations collectively managing more than € 5.000 billion in assets. *See* https://www.eumedion.nl/en/abouteumedion.

engagement is made more cost effective".[174] The cost consideration is thus explicitly mentioned as a factor in favor of shareholder collaboration.

While also recommending that institutions' engagement policies also describe "how they will act collectively with other investors in order to achieve greater effect and impact", the Danish Stewardship code emphasizes that shareholder collaboration that does not occur in relation to the acquisition of shares or other kinds of stake accumulation in the relevant company is not ad odds with the European regulatory framework for takeover bids, including in particular the provisions on concerted action.[175] Therefore, the Danish code suggests that the rules on concerted action, specifically the risk of triggering a mandatory bid, should not in principle discourage shareholder collaboration or be used as an excuse to avoid collective engagement.

Closely following EFAMA, also the Italian Stewardship Principles acknowledge that the collective one "may be the most effective method of engagement".[176] Over the years, Assogestioni has been increasingly taking on an active role in providing operational support to its affiliates.[177] As has been shown by the Italian model, by catalyzing investors' stewardship, investor associations can play an active role within the framework for stewardship, and can turn into a cost-saving vehicle for collective engagement.[178]

Similarly, the Global Stewardship Principles (hereinafter, GSP) adopted by the Corporate Governance Network in 2016 acknowledge the proactive role that can potentially be played by investor associations. Guidance 4.5 to ICGN GSP 4 illustrates that investors should "be prepared to form or join investor associations to promote collective engagement", noting that the aim of collaborating with (both domestic and overseas) investors is "to leverage the voice of minority investors and exert influence, where required, with investee companies."[179] Identical recommendations in relation to investor associations are also set out in the guidance to Stewardship Principle 5 drafted by the Canadian Coalition for Good Governance (hereinafter,

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[174] DUTCH STEWARDSHIP CODE, Guidance to Principle 4, https://ecgi.global/node/6972 (June 20, 2018)

[175] DANISH STEWARDSHIP CODE, Comments to Principle 4, https://ecgi.global/code/danish-stewardship-code-2016 (Nov. 2016).

[176] ITALIAN STEWARDSHIP PRINCIPLES, Recommendations to principle 4, https://ecgi.global/code/italian-stewardship-principles-2016 (2016).

[177] *See generally* Strampelli, *How to Enhance Directors' Independence at Controlled Companies*, 44 J. CORP. L. 103, 134-135 (2018).

[178] *See infra* Part IV.B.3.

[179] ICGN GSP, Guidance 4.5 to Principle 4.

CCGG)[180], an organization formed and run by a wide range of institutions investing in the Canadian capital market, which currently includes pension funds, mutual funds and third party money managers managing a total of almost $4 trillion in assets. Finally, collective engagement is mentioned as a beneficial tool also in the Japanese Stewardship Code, revised in 2017, as well as the 2016 Singapore and Taiwan Codes, and the 2016 Hong Kong Stewardship Principles.[181]

The relevance of collective engagement is clearly highlighted also by the stewardship principles recently adopted in the United States. Specifically, the investor-led Investor Stewardship Group (ISG) provides a framework of basic investment stewardship (and corporate governance) standards for U.S. institutional investor conduct, which took effect on January 1, 2018. Principle F states that institutional investors "should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles."[182] As the Guidance to that principle explains, collaboration not only relates to institutions' efforts "to ensure that the framework continues to represent their common views on corporate governance best practices";[183] it also, and more importantly, entails "addressing common concerns related to corporate governance practices, public policy and/or shareholder rights by participating, for example, in discussions as members of industry organizations or associations."[184] Here, too, the role of investor associations in coordinating collective stewardship is explicitly acknowledged.

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[180] *See* CANADIAN COAL'N FOR GOOD GOVERNANCE, STEWARDSHIP PRINCIPLES (2017), https://www.ccgg.ca/.

[181] *See* THE COUNCIL OF EXPERTS ON THE STEWARDSHIP CODE, PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS ("Japan's Stewardship Code" — To promote sustainable growth of companies through investment and dialogue) (2017), Guidance 4.4 to Principle 4; SINGAPORE STEWARDSHIP PRINCIPLES WORKING GROUP, SINGAPORE STEWARDSHIP PRINCIPLES FOR RESPONSIBLE INVESTORS (2016), Guidance to Principle 7; TAIWAN STOCK EXCHANGE, STEWARDSHIP PRINCIPLES FOR INSTITUTIONAL INVESTORS (2016), Guideline 4.3 to Principle 4; HONG KONG SECURITIES AND FUTURES COMMISSION, PRINCIPLES OF RESPONSIBLE OWNERSHIP (2016), Principle 5. All Stewardship Codes mentioned above are available at https://ecgi.global/code/stewardship-principles-institutional-investors.

[182] *See* INV'R STEWARDSHIP GROUP, STEWARDSHIP FRAMEWORK FOR INSTITUTIONAL INVESTORS, Principle F, https://isgframework.org/stewardship-principles/ (hereinafter ISG principles). The ISG, formed in January 2017, currently includes "some of the largest U.S.-based institutional investors and global asset managers, along with several of their international counterparts. The members include more than 60 U.S. and international institutional investors with combined assets in excess of US$31 trillion in the U.S. equity market." (https://isgframework.org/, last visited Jan. 25, 2019). *See also* Hill, *supra* note 25, at 522-23 (noting that "ISG's new stewardship principles are more tentative and ambiguous than the U.K. Stewardship Code", as institutional investors' "collaboration appears to be directed at encouraging the adoption and implementation of corporate governance/stewardship principles, rather than engaging in collective activism per se".

[183] *Id.*, F1.

[184] *Id.*, F2.

2. Investor Forums

Although stewardship principles and guidelines do sometimes mention specific tools for collective engagement, such as coordination by investor associations,[185] those principles and guidelines are not prescriptive and feature a highly flexible approach. It is left to investors to decide when and how, based on their differing investment strategies and the interests they may share with other investors, it is appropriate to exert active ownership collectively. As a consequence, different pathways for collective engagement have developed.

In some countries, investor collaboration is supported by organizations that specifically seek to facilitate coordination between institutions when engaging with portfolio companies. One prominent example is the UK Investor Forum, a "member-founded not-for-profit organization" which includes many UK and third-country institutional investors.[186] Following the explicit recommendations set out in the UK equity markets review carried out by Professor John Kay and promoted by the UK Government,[187] the Investor Forum was established in 2014 with the specific purpose of promoting collective engagement by institutional investors.[188] The Investor Forum has its own team of corporate governance and financial experts.[189] At present, there are forty-three institutional investors in the Investor Forum, of which fourteen are international, accounting for around 30% of FTSE All Share market capitalization.[190] Between 2015 and 2018, the Forum assessed forty-two collective engagement initiatives and engaged with twenty-three companies.[191] In 2018, the range of participants in collective engagement initiatives varies between six and twenty, representing company market capitalization of between 7% and 22%.[192]

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185 *See supra*, notes 176-180 and accompanying text.

186 *See* https://www.investorforum.org.uk.

187 *See* THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 51–53 (2012), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf [https://perma.cc/8AJG-3U4D] [hereinafter, KAY REVIEW]. Such recommendation followed the one already made in Sir David Walker's corporate governance review: *see* A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES. FINAL RECOMMENDATIONS (2009), https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf [hereinafer, WALKER REVIEW].

188 ROGER. M BARKER & IRIS H.-Y. CHIU, CORPORATE GOVERNANCE AND INVESTMENT MANAGEMENT, 175 (2017).

189 *See generally* INV'R FORUM, REVIEW 2018 (2019), https://www.investorforum.org.uk/. [hereinafter, INV'R FORUM REVIEW]

190 *Membership Summary*, INV. F. (Oct. 1, 2018), https://www.investorforum.org.uk/membership-summary/ [https://perma.cc/C6T7-VH52].

191 INV'R FORUM REVIEW*supra* note 189, at 3.

192 *Id.* at 6.

In line with the recommendations of the Kay Review, the Investor Forum takes a flexible approach.[193] Crucially, collective engagements occurring under the auspices of the Investor Forum must follow the specific formal procedures outlined by the Forum in its collective engagement framework, which was put in place *inter alia* "to prevent inadvertent violation of legal or regulatory requirements" and, thus, to reduce member institutions' disincentives to participate.[194] According to that framework, "[m]embers retain full voting and other investment rights in respect of their shareholdings" and are free to "choose[] to participate in an [e]ngagement involving a [c]ompany in which [they are shareholders or] to opt out of an [e]ngagement at any time."[195] As regards the steps that must be followed within the procedures set out by the Forum, both affiliated institutional investors and portfolio companies can propose an engagement.[196] The Forum's Executive evaluates the proposal and, once it has determined that the proposal is consistent with the Forum's engagement framework, the team engages in consultation with the major shareholders of the company to determine the level of member support for the proposed engagement.[197] The Forum then only proceeds with the engagement if the proposal attracts an adequate level of support.[198]

Similarly, in Japan, the Institutional Collective Engagement Forum was established in 2017 as a response to recommendations concerning collective engagement incorporated into the Japanese Stewardship Code, according to which "[I]n addition to institutional investors engaging with investee companies independently, it would be beneficial for them to engage with investee companies in collaboration with other institutional investors (collective engagement) as necessary".[199]

In line with the UK model, the Japanese Collective Engagement Forum seeks to "help institutional investors conduct sound and appropriate stewardship activities, especially in collective shareholder engagements in which multiple institutional investors work together in an aim to hold constructive dialogues with listed companies in Japan.[200] To this end, the Forum

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[193] *See* KAY REVIEW, *supra* note 187, at 51.

[194] INV'R FORUM, COLLECTIVE ENGAGEMENT FRAMEWORK. SUMMARY (2016) 2, https://www.investorforum.org.uk/wp-content/uploads/2018/08/Collective-Engagement-Framework-Summary.pdf [hereinfater, the "INV'R FORUM, FRAMEWORK"]. *See also infra* Part. IV.C.

[195] *Id.* at 3.

[196] *Id.* at 5.

[197] *Id.*

[198] *See id.*

[199] Japan's Stewardship Code, Guidance 4-4.

[200] https://www.iicef.jp/en/.

"will promote/organize Institutional Investors Collective Engagement Program, which coordinates collective engagement events and activities with listed companies, in collaboration with multiple institutional investors."[201] According to the Program, investors meet to discuss engagement agendas before contacting the companies and form a common view concerning each engagement agenda. The Forum, acting as a coordinator, conveys participants' shared views to targeted companies by sending summary letters, including the names of participating institutions, with a view "to shar[ing] their awareness and understanding of the issues the companies are facing"[202] and inviting comments from the companies concerned. In addition, the Forum asks companies to set up meetings for face-to-face discussions where needed in order to exchange views, and to facilitate dialogue by moderating investor-issuer meetings. Since investors participating in the Program are "those who conduct passive investment, such as index investment",[203] the Forum is specifically aimed at supporting investors that follow a long-term, 'buy and hold' investment strategy and that may have weak incentives to engage. Hence, the Forum operates in such a way as to reduce engagement-associated costs and to counter any cost-related disincentives to active stewardship.

3. Associations Representing Institutional Investors

Efforts to support coordinated engagement are sometimes made by institutional investor associations, with varying degrees of intensity and in different forms—from providing member institutions with forums for discussion, through to more organized coordination initiatives, usually in relation to upcoming shareholder meetings.

Looser forms of support for shareholder collaboration may be exemplified by the model provided by the Canadian Coalition for Good Governance (CCGG). Despite not being focused on collective engagements and not playing a role as specialized as that of UK and Japanese Forums, the CCGG offers members the possibility to utilize the organization "to distribute governance-related information to other Members, on the Hub, an online discussion forum where Members can share their views on governance issues and/or post links to relevant articles and resources".[204]

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[201] *Id*.

[202] *Id.*

[203] *Id*..

[204] *See* CANADIAN COAL'N FOR GOOD GOVERNANCE, BENEFITS OF MEMBERSHIP IN THE CANADIAN COALITION FOR GOOD GOVERNANCE, https://www.ccgg.ca/site/ccgg/assets/pdf/benefits_of_membership_in_ccgg_-_the_hub.pdf.

As specifically regards environmental, social and governance issues, a tool similar to that provided by the CCGG is available for signatories to the Principles for Responsible Investment—a set of international principles drafted by a group of the world's largest institutional investors, acting in partnership with the United Nations Environment Programme Finance Initiative and the United Nations Global Compact. The PRI were launched in 2006 to encourage the use of responsible investment to enhance returns and to better manage risks; the initiative currently has more than 1,800 signatories internationally.[205] The "Collaboration Platform" available to PRI signatories is "a unique private forum that allows signatories to pool resources, share information and enhance their influence on ESG issues".[206] The platform enables signatories, for instance, to send invitations to sign joint letters to companies as well as to request for support in relation to upcoming shareholder resolutions. In addition, it also offers opportunities to join investor-company engagements concerning particular ESG issues, alongside the support services provided by the PRI.[207] The PRI 2018 annual report states that 333 posts (7.4% up on 2017) and 282 shareholder resolutions (a 21% increase on 2017) were added to the collaboration platform in 2018, and that 22% of signatories had been active on the platform; 65% of signatories reported having actively engaged with investee companies via individual or collaborative engagements.[208]

More institutionalized support for collective engagement is provided by some other investor associations. As mentioned above, one such example is that provided by Assogestioni, the Italian non-profit Investment Management Association, which represents most of the Italian and foreign asset managers operating in Italy. The role played by Assogestioni in collective engagement is closely intertwined with the Italian regulatory framework for director elections at listed companies, which is based on the so-called slate voting system. Based on the mandatory adoption of that system, the Italian regime is intended to ensure that at least one of the seats on the board is reserved for minorities, provided that minority shareholders actually submit a slate of nominees to be voted on at the shareholders' meeting.[209] Minority shareholders

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[205] https://www.unpri.org/about-the-pri.

[206] https://www.unpri.org/esg-issues/explore-the-pri-collaboration-platform.

[207] *Id*.

[208] PRINCIPLES FOR RESP. INV., ANNUAL REPORT 2018, 13-14, https://d8g8t13e9vf2o.cloudfront.net/Uploads/g/f/c/priannualreport_605237.pdf.

[209] *See* Decreto Legislativo 24 febbraio 1998, n. 58, Art. 147-ter (It.) (Consolidated Law on Finance), available in English at http://www.consob.it/web/consob-and-its-activities/laws-and-regulations/documenti/english/laws/fr_decree58_1998.htm (stating that shareholders holding a minimum threshold of shares—set by the Italian Supervisory Authority and currently varying between 0.5% and 4.5%—can present lists of candidates for election to the board. At least one member must be elected from the minority

are thus offered a way of gaining access to the boardroom and obtaining a direct insight into the company's affairs. The activation of this pathway requires a willingness to submit a slate of director nominees to be voted on according to the applicable rules, and to bear the (non-negligible) cost associated with this. Since the introduction of the this system, Assogestioni has played a central role in selecting candidates and submitting minority slates.

In doing so, Assogestioni adopts a formalized procedure. In particular, candidates are selected in accordance with the "principles for the selection of candidates for corporate bodies of listed companies" drawn up by the Assogestioni Corporate Governance Committee, which is composed of members of the Association's Board and representatives of member companies.[210] Candidates for election as minority representatives to the corporate bodies of investee issuers are selected by the Investment Managers' Committee—which is comprised solely of representatives of Italian or foreign institutional investors—with the assistance of an independent advisor. This advisor is charged with both maintaining a database of possible candidates and submitting to the Investment Managers' Committee a shortlist of those that appear to best meet with the requirements for each corporate office.[211] In addition, the selection principles drawn up by the Assogestioni Corporate Governance Committee require that candidates must have adequate professionalism, integrity, and independence and, to avoid possible conflicts of interest, that the legal representatives of investment management companies and—unless at least one year has elapsed since the relevant appointments were relinquished—anyone who has served in a senior management or executive role in an investment management company may not be selected as a candidate.[212]

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slate, having obtained the largest number of votes, and this person must not be linked in any way, even indirectly, to the shareholders who presented or voted on the list which received the largest number of votes). According to Consob, the Italian Supervisory Authority, 96—out of 242—listed companies' boards currently include at least one minority-appointed director: *see* COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA (CONSOB), REPORT ON CORPORATE GOVERNANCE OF ITALIAN LISTED COMPANIES*,* 15 (2017), http://www.consob.it/web/consob-and-its-activities/report-on-corporate-governance. Moreover, several bylaws, especially of larger corporations, have actually made room for two or three minority-appointed directors, and the average number of directors appointed by the minority is approximately two: Piergaetano Marchetti, Gianfranco Siciliano & Marco Ventoruzzo, *Disclosing Directors* 7 (Eur. Corporate Gov. Inst. (ECGI) Law Working Paper No. 420/2018) (2018), https://ssrn.com/abstract=3264763.

[210] *See* ASSOGESTIONI, PROTOCOL OF DUTIES AND RESPONSIBILITIES OF THE CORPORATE GOVERNANCE COMMITTEE AND THE INVESTMENT MANAGERS' COMMITTEE 20–21 (2017), http://www.assogestioni.it/index.cfm/3,139,12309/protfunzccg_cge_dic_2017.pdf [hereinafter "ASSOGESTIONI PROTOCOL"].

[211] *Id.* at 24–25 (specifying that "[e]ven when minority slates are presented for elections to boards, the Committee members undertake no obligation in regard to the exercise of voting rights during general meetings").

[212] *Id.* at 28–29 (also stating that persons who hold a senior management or executive role in investment management companies may not be selected as candidates for company boards).

In the Netherlands, Assogestioni's equivalent, Eumedion, also seeks to facilitate cooperation amongst its members. The association does so, amongst other things, by "encouraging joint consultations between institutional investors, listed companies and their representative organisations", and providing services in the field of corporate governance to its members.[213] In particular, through its Investment Committee, Eumedion plays a facilitating role for investor collaboration with regard to upcoming shareholders meetings, in that it

> "draws up a summary of the AGMs and sends this AGM schedule to all Eumedion members; this schedule contains a proposal stating which member(s) wish to attend a certain AGM. The person going to an AGM makes a (preliminary) analysis of the items on the agenda and forwards this to the members. Members can decide on the basis of the AGM schedule and analysis whether to give a proxy to the person attending the AGM. … If required, the person attending the AGM can consult in advance on the items on the agenda for the AGM with other members attending the AGM. … A member can decide on the basis of the analysis of the items on the agenda for the AGM to give the person going to the AGM a proxy to vote in favour or against an item on the agenda, depending on the discussion during the AGM."[214]

Thus, Eumedion provides a kind of "consultation platform" for its members, although does not provide any analysis of its own concerning the items on the agenda, or issue any voting recommendation, and also does not receive proxies or vote on behalf of its members.[215] As is also explained, the objective of the joining of forces in the Eumedion investment committee is to enable "the exchange of information in order to arrive at a stance with regard to subjects related to corporate governance", and not to form a coalition to exercise member voting rights at the shareholders meeting.[216]

Also the U.S. Council of Institutional investors (CII) sometimes acts as "a facilitator of interactions among members and asset management industry players".[217] Specifically, the CII hosts occasional "engagement exchanges" where corporate and investor members can meet

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[213] EUMEDION, MISSION, https://www.eumedion.nl/en/abouteumedion#what-does-eumedion-do.

[214] EUMEDION, CORPORATE GOVERNANCE MANUAL 50 (2008), https://www.eumedion.nl/en/public/knowledgenetwork/manual/2008-manual-corporate-governance.pdf.

[215] *Id*.

[216] *Id.* at 51 (explaining that "Eumedion members may naturally pursue the same course of action because they share the same opinion, but this does not mean that they are acting in concert.").

[217] Enriques & Romano, *supra* note 107, at 245.

one-on-one or in small groups to discuss particular issues of concern.[218] In addition, the CII annually publishes the "Focus List" of underperforming companies with the aim of attracting members' attention to such companies so as to "compel company managers to step up efforts to improve performance."[219] However, it does not perform a coordinating function for affiliated investors similar to that of its foreign equivalent counterpart institutions.[220] The action encouraged by the publication of the Focus List does not require consultation among investors, and usually does not result in collective engagements by members.[221]

C. *The Benefits of Non-Activist Collective Engagements*

While the impact of wolf pack activism on targeted firms has been investigated in a number of studies, both theoretical and empirical,[222] the potential benefits of non-activist collective engagements are as yet underexplored. This Part illustrates how different forms of non-activist investors' cooperation can help to lower costs, and make engagement more effective and safer.

1. Cost Sharing and Limiting Collective Action Problems

Available empirical evidence–albeit still limited–consistently shows that collective engagements are more successful than solo-initiatives. In fact, so the argument goes, coordination between several institutional investors increases the potential influence of engagement activities "via louder voice and larger power".[223] The pioneering study by Gillan and Starks dealing with the corporate governance role of institutional investors shows that "proposals sponsored by institutions or through coordinated activities receive significantly more favorable votes than those sponsored by independent individuals or religious

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[218] https://www.cii.org/engagement.

[219] Gary L. Caton et al., *The Effectiveness of Institutional Activism*, 57 FIN. ANALYSTS 21, 21 (2001). *See also* Andrew J. Ward et al., *Under the spotlight: institutional investors and firm responses to the Council of Institutional Investors' Annual Focus List*, 7 STRATEGIC ORG. 107 (2009) (showing that "institutional investors respond to this negative third-party signal by reducing their holdings in firms that received this public repudiation" and that "targeted firms with more independent boards respond by increasing the intensity of incentives of the CEO, thus signaling their responsiveness to investor concerns").

[220] *See* Andrew F. Tuch, *Proxy Advisor Influence*, 99 B. U. L. REV. 1459, 1486-7 (2019).

[221] Wei-Ling Song & Samuel H. Szewczyk, *Does Coordinated Institutional Investor Activism Reverse the Fortunes of Underperforming Firms?*, 38 J. FIN. QUANTITATIVE ANALYSIS 317, 318 (2003).

[222] *See supra* Part IV.A.1.

[223] Dimson et al., *supra* note 137, at 9.

organizations".[224] More recently, Dodge and others have found that collective engagement initiatives promoted by the Canadian Coalition for Good Governance (CCGG) has a notable rate of success.[225] Specifically, CCGG-led engagements increase the likelihood that targeted investee companies will adopt governance reforms (e.g. majority voting, say-on-pay advisory votes, shareholder-aligned compensation policies) requested by institutional investors.[226] Along the same lines, Dimson and others show that coordinated engagements have a fairly high rate of success, especially when the investor leading the initiative is located in the same geographic region as the targeted firm.[227]

While, of course, the greater likelihood of success of collective engagements proves to be an effective incentive,[228] it does not help to exhaustively explain why institutional investors should be willing to become involved in such initiatives. To clarify this point, it is essential to consider how collective engagement initiatives can promote more active conduct by institutional investors by favoring the redistribution of the engagement costs among the institutional investors that carry out engagement activities collectively[229], thereby increasing the net return earned by each institutional investor involved.[230] Moreover, in doing so, collective engagement initiatives also lower the free-rider problem that significantly contributes to the institutional investors' "rational reticence".[231]

Indeed, while according to conventional wisdom each investor maximizes its wealth by declining to participate in collective initiatives and by free-riding on other investors' efforts,[232] there is an apparent economic incentive to join forces, irrespective of whether particular investors might nonetheless prefer to free-ride. Since fund managers are remunerated by a fee that is usually a percentage (1%-2%) of the assets under management, they are naturally

[224] Gillan & Starks, *supra* note 15, at 277.

[225] Doidge et al., *supra* note 137 at 14.

[226] *Id.* at 17-24.

[227] Dimson et al., *supra* note 137, at 23-26.

[228] Tanja Artiga González & Paul Calluzzo, *supra* note 137, at 212 (noting that "greater costs would increase the incentive for activists to pool their resources through clustering").

[229] *See* OECD, THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE 38 (2011), https://www.oecd.org/daf/ca/49081553.pdf [https://perma.cc/9RZD-9377] ("The ability for institutional investors to co-operate is fundamental to resolving the free rider problems . . . .").

[230] Artiga González & Calluzzo, *supra* note 228, at 212; Doidge et al., *supra* note 137, at 7.

[231] Gilson & Gordon, *supra* note 35, 888–902; Kahan & Rock, *supra* note 34, 1048–57; Rock, *supra* note 8, 453–64. *See also* Paul Davies, *Shareholders in the United Kingdom* 16 (Eur. Corp. Gov. Inst. (ECGI) Law Working Paper No. 280/2015) (Jan, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2557680

[232] *Id.* at 15-16.

interested in any actions in relation to an investee company that is likely to increase the value of assets under management, since this implies higher fees in monetary terms.[233]

A simple example can help to reinforce the point. First, where an engagement intervention is expected to result in an increase in the returns of assets under management of $ 1,000,000 and implies costs of $ 15,000, an investor charging a fee equal to 2 per cent of assets under management will earn an additional fee of $ 20,000, and thus a net gain of $ 5,000. While such initiative will be per se profitable even if it is taken individually, profits would be higher for our investor if the same initiative were to be carried out collectively. For example, if the $ 15,000 costs were to be shared among (say) 10 investors, our investor would earn a net profit of $ 18,500.[234]

Second, collective engagement may prompt investors to engage in initiatives that would not be profitable if pursued individually. For example, where engagement is expected to result in an increase of the returns of assets under management of $ 1,000,000 and has a cost of $ 30,000, an investor charging a fee equal to 2 per cent of assets under management would not engage, as it would suffer a net loss of $ 10,000. Conversely, if the same initiative were to be carried out by a number of investors—say 10—that share the costs, it would become profitable for our investor as it would earn a net profit of $ 17,000.

However, a coordinating entity is required in order to make the collective engagement mechanism actually work.

First, a coordinating entity can reduce free-riding problems by lowering the risk that engagement costs are borne by a limited number of investors, while benefits are shared by all other investors who are shareholders in the same investee company. For example, with the aim of favoring the sharing of engagement-related benefits and costs among investors, in order to allocate costs in proportion with the "size" of associated asset managers, Assogestioni's bylaws state that each member must pay a fee comprised of a fixed amount and a variable amount, which is established by dividing the remaining portion of the budget amongst all members in proportion with the assets collected and/or managed at the end of the previous year.[235] As is

233 Kahan & Rock, *supra* note 28, at 15-29.

234 Even if we assume that collective engagement comes with higher costs due to the fee to be paid to the coordinating entity, a clear economic incentive to engage collectively remains. Where, referred to the example in the text above, such fee is $ 10.000—and overall engagement costs are $ 25.000—our investor would still earn a net profit of $ 17.500.

235 *See* ASSOGESTIONI BYLAWS 34 (2016), http://www.assogestioni.it/index.cfm/3,813,11301 /statuto-marzo-2016.pdf.

reported by Dodge and others,[236] the CCGG adopts a more complex cost-sharing mechanism, which favors cost allocation among affiliated investors by providing for increased fees in line with the size (in terms of assets under management) of the institution, with a cap above a certain threshold.[237] Along the same lines, a similar solution is advanced by Sharon Hannes, who argues that the crucial issue of the funding of collective engagements coordinated by a specialized task force (called "Super Hedge Fund") should follow a two-tier structure aimed at: i) placing the greatest burden on those that have invested in the specific target company identified by the task force, based on a pro-rata mechanism that takes account of the size of investors' holdings;[238] ii) sharing the lower tier—unrelated to specific engagement initiatives—minimal funding serving the pre-engagement activities of the task force among all investors involved in the task force. [239]

If it is considered that "the most important factor by far in determining how much a fund advisor stands to gain from being informed is the size of the holdings",[240] cost-sharing mechanisms that allocate costs among participating investors proportionately with the size of their stakes could also help to alleviate another potential disincentive against joining collective initiatives. In fact, where engagement costs are allocated equally amongst participating investors, irrespective of the size of their holdings, investors with an overweighting of the shares of the target companies in their portfolio will earn more than investors that have underweighted those shares in their portfolio, and can hence improve their relative performance, attracting

[236] Doidge et al., *supra* note 137, at 28.

[237] *See* CANADIAN COAL'N FOR GOOD GOVERNANCE, 2017 ANNUAL REPORT 26 (2018), https://www.ccgg.ca/annual-report/ ("Annual Member fees are based on total assets under management (AUM). The annual fee for Members with total AUM below $1.5 billion is $2,500. As total AUM increases above $1.5 billion, the fee escalates on a straight-line basis by $1,500 for every $1 billion to a maximum annual fee of $44,000. An affiliate of a Member paying the maximum annual fee of $44,000 is eligible to become a Member for an annual fee of $2,500 irrespective of that affiliate's total AUM").

[238] *See* Hannes, *supra* note 22, at 183 (noting that "[t]his capital call to the direct investors of the target forges the link that is missing today between the institutional long-term shareholders of the target of the activism and the agent that executes the activism").

[239] *Id.* at 182-83 (explaining that "Tier-one funding would be quite minimal and used to support the task force before it engages in activism ... However, once the task force begins to zero in on a target, it would become entitled to call for additional and much more substantial tier-two funding … to cover major possible expenses such as proxy fight costs, litigation, and public and investors relations campaigns. Most importantly, the source of funding for the two tiers would differ as follows: the low-tier-one funding would be provided by all institutional investors that have signed an agreement with the task force. [By contrast,] funding called for after the task force has zeroed in on a target would … be borne solely by the institutional investors that invest in the specific potential corporate target and pro-rata to their holdings in the target." (footnotes omitted)).

[240] Kahan & Rock, *supra* note 28, at 21.

clients from other institutional investors.[241] By contrast, a size-related allocation of engagement costs among participating investors can level out the relative performances of investors involved in the collective initiatives, and therefore reduce stake size-related disincentives.

Second, a third-party coordinating entity can facilitate the circulation of information and agreement among institutional investors.[242] Such a facilitating role is especially important in order to save costs and time when the investors involved in collective initiatives have different geographic and cultural backgrounds. In fact, absent such an entity, cooperation between investors would appear to be ineffective and excessively expensive. In particular, without an entity playing a coordinating role, "to achieve agreement among many investors from diverse geographic and cultural backgrounds may prolong the process. The delayed action may reduce the effectiveness of engagements on issues that are time sensitive".[243]

2. Alleviating Regulatory Risks

The presence of a third-party coordinating entity can also help to reduce potential disincentives against joint collective engagement initiatives posed by regulatory hurdles and also to lessen compliance costs.[244] Although the chilling effect of regulatory hurdles on collective engagement cannot be completely eliminated, there are ways in which cross-jurisdictional regulatory concerns can be effectively kept under control. Chiefly, a third-party entity taking on an active coordination function (which function will be most effectively performed where it is based on specific formal procedures and safeguards) can work as an effective tool to reduce the risk of concerted action, group formation, or the selective disclosure of relevant information in breach of Regulation FD–or the Market Abuse Regulation in the EU.[245] Indeed, practical experience with some existing organizations seems to be encouraging.

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[241] *Id.* at 23 (illustrating that since "it is relative performance, rather than absolute performance, that affects fund flows . . . attracting future fund flows generates *no incentives* for a portfolio managers to cast an informed vote to increase the value of stock in which a fund is *underweight* relative to competing funds or the benchmark").

[242] The coordinating entity could help investors interested in joining collective initiatives to reach an agreement by creating confidence that "costs of intervention will be spread across a number of institutions". *See* Davies, *supra* note 231, at 10.

[243] Dimson et al., *supra* note 137, at 10. *See also* Jean-Pascal Gond & Valeria Piani, *Enabling Institutional Investors' Collective Action: The Role of the Principles for Responsible Investment Initiative*, 52 BUS.& SOCIETY 64, 72 (2013).

[244] Dimson et al., *supra* note 137, at 10. *See infra* Part V.A.

[245] *See*, for a similar view, *id*. at 10.

The most illustrative example of this is UK Investor Forum, whose framework for collective engagements was designed with a view to preventing "inadvertent violation of legal or regulatory requirements" imposed by multiple jurisdictions involved in cross-border investment decisions.

As regards concerted action or group formation, the framework requires members wishing to participate in an engagement to "agree that they will not … form a concert party in respect of the relevant Company, including by requisitioning or threatening to requisition the consideration of a board control-seeking proposal or seeking to obtain control of the relevant Company, or otherwise form a group that could trigger regulatory reporting or other regulatory requirements."[246] To that end, any engaging member will need to confirm its adherence to the Forum's no-concert party and no-group undertaking, as well as its code of conduct; additionally, the Forum's executives will carry out appropriate monitoring to ensure consistency with the Forum's principles and code of conduct, ask members to withdraw from an engagement (or expel them if necessary) "if their behaviour compromises the Forum's activities", and ensure liaison with the UK Takeover Panel, seeking specialist advice whenever required.[247]

As far as inside information is concerned, the Forum is committed to "actively seek to avoid obtaining inside information from Companies and Members without its prior consent" and to "actively seek to avoid passing on any inside information that it may receive to Members without their prior consent", while also applying certain procedures aimed at identifying and quarantining inside information, where such information may possibly have been received or generated by the Forum.[248]

In addition, since members are subjected to confidentiality obligations during an engagement, communications between the Forum's Executive and the members involved are based on a bilateral model, and communication with the issuer is conducted by the Forum's Executive itself, it is clear that coordination by the Forum (or similar organizations) relies on the organization's leadership in heading the dialogue as a means of avoiding direct action by member institutions, as well as direct communications between participating members and between companies and the engaging members.[249] In fact, to develop the engagement strategy,

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[246] *See* INV'R FORUM, FRAMEWORK, *supra* note 194, at 4.

[247] *Id*.

[248] *Id*. at 3.

[249] *Id*. at 6.

the Forum provides members with a description of the range of views expressed by them with the Executive, thus allowing mutual oversight by investors; however, the Forum refrains from both exercising any advisory function and from seeking "to form an agreement between Members, in particular in relation to their investment or voting decisions".[250]

Overall, under a formalized model similar to that put forward by the UK Investor Forum, the particular engagement follows a course that ensures as far as possible that its strategy and outcomes cannot be regarded, with hindsight, as being either premised on intentional, let alone agreed, group formation or concerted action, or built on the exploitation of inside information.

3. Enhancing Expertise

Collective initiatives involving a large number of investors can also improve the effectiveness of the engagement "by borrowing expertise from investors in the group who are more knowledgeable about an issue or target company".[251] This assumption is in line with empirical evidence showing that, as far as ESG-related engagements promoted by the PRI are concerned, success rates of collective initiatives are increased by around one-third "when there is a lead investor who heads the dialogue, especially when that investor is located in the same geographic region as the targeted firm" and is therefore supposed to have a superior knowledge of the local economic and regulatory context. [252]

While, of course, even engagement initiatives coordinated by one of the participating institutional investors that takes the lead within the group of investors can prove to be successful, the facilitating role played by a third-party coordinating entity seems to be crucial also in this respect. First, absent such an entity, collective action problems can prevent leading investors–which are theoretically capable of enhancing the group's expertise–from undertaking collective engagements. While the lead investor bears a considerable costs burden to gather the necessary information, potential benefits of the engagement efforts, such as improved firm performance and a higher stock price, are shared among all stakeholders.[253]

In addition, although they are deemed to have adequate knowledge and resources to perform a coordination function, even the biggest international institutional investors –in terms of assets under management–might not be able to provide case-specific expertise. First, those leading

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[250] *Id*.

[251] Dimson et al., *supra* note 137, at 9.

[252] *Id.* at 5, 22.

[253] *Id.*

actors may not add to expertise where the engagement initiatives take place outside their country of origin as they might not have adequate knowledge about the foreign regulatory and business context or the investee company to which the engagement relates. Given the considerable number of portfolio companies, the stewardship teams at leading institutional investors are not capable of dedicating the same degree of attention to all portfolio companies or preparing detailed reports for each one.[254] Second, the major institutional investors, and especially passive investors holding stakes in thousands of companies, draw up standardized voting guidelines which they normally tend to follow fairly closely. Therefore, leading investors are generally unwilling to go beyond their standardized guidelines and to make significant investments in any company-specific analyses that may be required by engagement in more complex situations, such as proxy contests or M&A and related-party transactions.[255]

Against this background, an adequately organized third-party coordinating entity employing high-skilled professionals[256] can play a key role in providing institutional investors that intend to cooperate with the necessary expertise. For example, such enabling institutions can help to identify issues of interest to heterogeneous investors as well as investors that may potentially be interested in joining the collective engagement,[257] or to develop an engagement strategy that meets with the expectations of all investors concerned.[258] Moreover, the third-party coordinating entity can keep member institutional investors informed concerning issues relevant to engagement. For example, the Canadian Coalition for Good Governance aims to provide its members with updated information concerning corporate governance developments by publishing a range of materials–including best practice guidance, policies and principles, and research studies–and hosting educational initiatives on governance topics on a continuing basis.[259] In addition, the Canadian Coalition for Good Governance also provides members with a detailed analysis of the governance practices of each listed company that is involved in the Coalition's engagement program.[260]

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[254] *See generally* Strampelli, *supra* note 99, at 820; Bebchuk & Hirst, *supra* note 70, at 31-35.

[255] See e.g. Bebchuk & Hirst, *supra* note 70, at 36 (note 83).

[256] For example, all members of the UK Investor Forum's teams have a strong financial background and past working experiences in the financial services and investment sector. *See* INV'R FORUM, *Team*, https://www.investorforum.org.uk/about/meet-the-team/.

[257] See Gond & Piani, *supra* note 243, at 72-73.

[258] INV'R FORUM, FRAMEWORK, *supra* note 194, at 6.

[259] CANADIAN COAL'N FOR GOOD GOVERNANCE, *supra* note 237, at 4.

[260] *Id.* at 5.

In this respect, as the activity of the UK Investor Forum or the Canadian Coalition for Good Governance indicates, it must be borne in mind that such institutions are able to empower collective engagement initiatives by providing expertise concerning relevant issues related to the engagement and company-specific information as they manage a limited number of engagements, usually concerning issues that go beyond the routine matters usually covered by the voting and engagement policies adopted by most of leading institutional investors. While such investors engage with a huge number of investee companies,[261] in the first 4 years of its life the UK Investor Forum evaluated 42 UK company engagements and engaged in 23 engagement initiatives.[262] Similarly, the Canadian Coalition for Good Governance usually engages with the boards of approximately 45 to 50 companies every year.[263] Therefore, it is apparent that such third-party coordinating entities will have more skilled human resources to dedicate to each engagement and, in doing so, can help to overcome problems posed by the small size of leading institutional investors' investment stewardship teams.

Therefore, as one of us has already noted, coordinated engagement cannot—and does not seek to—radically modify non-activist institutional investor engagement practices. Arguably, third-party enabling entities can help to promote more proactive engagement with non-routine issues, such as proxy contests or M&A and related-party transactions.[264] By contrast, given also the size of existing enabling entities, investors are likely to "continue to adopt standardized voting policies and to rely largely on proxy advisory services for routine matters."[265]

4. Reinforcing Reputational Incentives

[261] For example, BlackRock–the world's largest asset manger–reports about 2.000 engagements in 2018, even though most engagements were qualified as "basic" and generally amounted to one single conversation concerning a routine matter. *See* BLACKROCK, INVESTMENT STEWARDSHIP REPORT: 2018 VOTING AND ENGAGEMENT REPORT 3 (2018), https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2018.pdf.

[262] INV'R FORUM REVIEW, *supra* note 189, at 3.

[263] CANADIAN COAL'N FOR GOOD GOVERNANCE, *supra* note 237, at 5.

[264] Strampelli, *supra* note 99, at 845. *See also* Davies, *supra* note 231, at 10 (arguing that "[n]on-routine intervention by shareholders in the management of investee companies thus requires the construction of a coalition of institutions to be effective").

[265] *Id.*; Kahan & Rock, *supra* note 28, at 38; Hannes, *supra* note 22, at 179 (noting that, as for pension funds, "[t]hey do not have to delve into the business activities of any single company in order to conduct such activism . . . In other words, this is an inexpensive type of activism, and it does not cost much to develop the agenda or manifest it, nor does it need to be tailored to the business challenges and failures facing any single corporation"). *But see* Tuch, *supra* note 220, at 1504 (contending that the empowerment of coordinating entities aimed at promoting institutional investors' collective initiatives could limit proxy advisors' influence in the United States).

Since it is widely acknowledged that reputational concerns can prompt leading fund managers to play an active monitoring role over their investee companies,[266] it must be also noted that collective engagements are, to some extents, able to reinforce such a reputational mechanism. In fact, it can plausibly be argued that institutional investors could be incentivized to join collective initiatives where these prove to be successful or to be viewed positively by end clients.[267]

This intuition is backed up by the model designed by Brav and others showing that "reputational rents can be achieved only by participating in a successful activism campaign", while "[t]here are never rents for remaining inactive, even when activism fails."[268] In addition, this line of reasoning is also supported by anecdotal evidence.[269] In particular, although the benefits of collective engagement for passive investors are, in theory, more limited due to the presence of internal stewardship teams, as well as the fact that each portfolio company has a lower relative weight, collective engagement can also incentivize passive index fund managers to engage in costlier engagement activities. For example, BlackRock carefully emphasizes in its proxy voting guidelines for European securities that "under the umbrella of the Collective Engagement Framework of the Investor Forum [BlackRock participates] in collaborative engagements with other shareholders where concerns have been identified by a number of investors."[270]

In addition, actions could be taken both by the coordinating entity itself and by regulators to enhance the incentivizing power of collective engagements.

Fist, as is suggested by Hannes, the coordinating entity could stipulate that a minimal number of adhering investors is a necessary condition for initiating engagement initiatives, thereby limiting the potential chilling effect of conflicts of interest affecting institutional investors that do significant business with investee companies, and which are therefore not willing to gain a reputation for being troublemakers.[271] In fact, such an approach already characterizes the operations of the UK Investor Forum, since the Forum only initiates an

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[266] See *supra* Part III.A.3.

[267] *See* Hannes, *supra* note 22, at 189 (noting that "[i]nstitutional investors that choose to opt out of a scheme that seems socially beneficial would suffer reputational loss").

[268] Brav, Dasgupta & Mathews, *supra* note 150, at 20.

[269] Strampelli, *supra* note 99, at 848.

[270] BLACKROCK, PROXY VOTING GUIDELINES FOR EUROPEAN, MIDDLE EASTERN AND AFRICAN SECURITIES 2 (2019), https://www.blackrock.com/corporate/about-us/investment-stewardship#principles-and-guidelines.

[271] Hannes, *supra* note 22, at 187 (highlighting that such "provision would ease the reputational concern of potentially conflicted institutional investors").

engagement when there is the "reasonable prospect of securing sufficient support among the company's largest shareholders".[272]

Second, the incentivizing role of collective engagement could be further strengthened by the broader disclosure of collective engagement initiatives. In particular, where a third-party entity acts as the coordinator, it could disclose the identity of any institutional investors that join each engagement initiative. Currently, coordinating entities usually publish only a list of affiliated institutional investors, without specifying the specific engagements of each member. Given that some institutional investors would prefer to keep their involvement in collective engagement initiatives confidential, a flexible approach would be one under which the identity of the investors involved in specific engagement initiatives would only be disclosed with the consent of the investors themselves. Moreover, to avoid any potential unintended consequences of such an enhanced disclosure, the list of the investors joining a specific engagement should only be published once the engagement initiative in question has been concluded.

In addition, to enhance the reputational incentive, as suggested in the new draft version of the UK Stewardship Code, investors could be required to disclose "whether or not they participate in collaborative engagement with other investors and/or other market participants" and to provide additional information, including "their objective(s) for collaborative engagements in which they plan to participate or have already done so"; "the number of collaborative engagements they have participated in during the previous year"; and "an assessment of the effectiveness of the collaborative engagements they have participated".[273]

V. IMPLICATIONS

As described in Part IV, one distinction that can be made in relation to shareholder collaboration is whether collaboration is driven by activist or non-activist institutions.

As they are promoted by activist shareholders that generate profit by implementing major changes in their portfolio public companies, wolf-packs clearly seek to gain control of corporate boards to influence corporate decision making. Specifically, "activist investors' purchases of a large stake in a public company are direct to "lobby the company's management to implement changes that the investors believe would increase shareholder value".[274]

[272] *See* INV'R FORUM, FRAMEWORK, *supra* note 194, at 5.

[273] PROPOSED REVISIONS TO THE UK STEWARDSHIP CODE, *supra* note 172, at 17.

[274] Carmen X. W. Lu, *Unpacking Wolf Packs*, 125 YALE L. J. 773, 774 (2016).

On the other hand, stewardship codes, principles and guidelines that offer guidance on how investors should exert active ownership and interact with portfolio companies, explicitly make it clear that "[e]ngagement by active and index-tracking investors differs from the approach taken by activist investors who purchase large numbers of shares in a company and may try to obtain seats on the company's board with the goal of effecting a major change in the company".[275] Based on the assumption that investments are focused on a horizon longer than that which is usual for activists, stewardship codes underscore the need that traditional institutions—whether actively managed or index-tracking funds—should conceive of engagement as a tool for building constructive relationships with investee companies, based chiefly on mutual understanding.[276] Hence, investor engagement is generally regarded as being premised on pre-existing stakes and being focused on longer-term relationships with investee companies. Therefore, the nature of an engagement-based form of shareholder cooperation that is explicitly supported by virtually any stewardship code is very different from that of wolf packs.

Accordingly, these different types of shareholder collaboration should be kept distinct also as regards the applicable regulatory framework. In particular, non-activist driven collective engagements should not be reined in by the rules on group formation that are relevant to blockholder disclosure requirements and the rules imposed on inside information.

A. *Smoothing the 13D Filing Obligation Hurdle*

From the regulatory standpoint, the debate concerning wolf-packs largely focuses on the circumvention of 13D-filing obligations by wolf-pack members as a group. The rationale of blockholder disclosure under section 13(d) is "focused on informing investors about purchases of large blocks of shares acquired in a short period of time by individuals [or groups] who could then influence or change control of the issuing company."[277] In essence, 13D disclosures provide investors with an early warning concerning potential shifts in corporate control. Delaying disclosures by avoiding formal coordination while exploiting tipping regarding an

[275] EFAMA Stewardship Code, Background, at 4.

[276] *Id*. at 3-4. *See also* WALKER REVIEW, *supra* note 187, 72.

[277] Kristin Giglia, *A Little Letter, A Big Difference: An Empirical Inquiry Into Possible Misuse of Schedule 13G/13D Filings*, 116 COLUM. L. REV., 105, 110 (2016); Hill, *supra* note 25, at 523.

upcoming activist campaign may well be lawful under both insider trading rules[278] and section 13(d)(3) of the Exchange Act. However, wolf pack tactics could potentially facilitate creeping control acquisitions. Moreover, trading on asymmetric information over the ten-day window is regarded as "com[ing] at the expense of selling shareholders", since it allows for wealth transfers in favor of the activists.[279] In general terms, the passing of "material non-public information to a select few", which seems to be inherent in the wolf pack tactic, feeds a perception of unfairness.[280]

By contrast, collective engagement by non-activist institutions does not call for the same degree of regulatory concern as the conscious parallelism of the wolf pack. In the first place, the very notion of collective engagement—as conceived of within the context of stewardship codes and principles—makes it clear that collective action is not about seeking control or exerting decisive influence over the firms' management, but basically about performing active monitoring. Engagement-related coordination will not seek to bring about major corporate changes, unless such changes result from a "consensus process" with the issuer. That feature explains why, as a rule, collective engagement levers pre-existing equity stakes in order to develop longer-term foundational corporate relations. This is particularly evident where passive index-tracking investors are involved, who simply cannot trade their stocks unless changes in the benchmark index occur. Consequently, since "any promising involvement by shareholders will require more than acting in concert for one vote,"[281] stewardship is not meant to be occasional but implies an ongoing activity aimed at disciplining corporate managers. By contrast, coordinated activist intervention, such as that underlying wolf packs, more easily falls into the category of what has been termed "an ad hoc, one-period affair".[282]

Furthermore, as experience with Assogestioni concerning corporate elections in Italy shows,[283] even where board representation is sought, coordinated collective engagements do

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[278] *See* Strine, *supra* note 133, at 1897 (explaining that "so long as they are not disclosing nonpublic information which they obtained as a result of an insider's breach of duty, hedge funds are normally free to tip third parties about their own plans or intentions without running afoul of Rule 10b-5.").

[279] *See* Coffee & Palia, *supra* note 132*,* at 597.

[280] *Id*. at 600.

[281] *See* Manuel A. Utset, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition*, 44 EMORY L. J. 71, 76 (1995).

[282] *Id*.

[283] *See* Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. CO. & FIN. L. REV. 328, 371 (2013). *See also* Massimo Belcredi et al., *Board Elections and Shareholder Activism: The Italian Experiment*, *in* BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES: FACTS, CONTEXT AND POST-CRISIS REFORMS 414 (Massimo Belcredi & Guido Ferrarini eds., 2013); Luigi Zingales, *Italy Leads in Protecting Minority Investors*,

not depart from the constructivist approach fostered by stewardship principles internationally and are not aimed at gaining control of the board. The number of nominees included in the lists of director nominees submitted according to the procedure adopted by Assogestioni corresponds to fewer than half of the seats on the board.[284] In addition, only nominees who meet with specified independence requirements are included in the lists.[285] In keeping with the predominantly monitoring role that is to be performed by minority-appointed directors, director nominees are required to declare that, if elected, they will act in full independence and exercise autonomous judgment in the pursuit of the company's interests.[286] This approach is very different from that characterizing activist intervention,[287] where hedge fund executives are frequently appointed[288] and board representation mostly serves as a toehold which can be exploited to promote, if not to force through, wider-ranging objectives.[289] Such objectives may be "related to business strategies, balance sheet actions (such as returning cash to shareholders through dividends or share repurchase) and divestitures or other M&A actions (such as encouraging a sale of the target company or opposing a merger) by target companies".[290]

All in all, engaging collectively does not in itself mean that the collaborating shareholders are motivated by the purpose of bringing about the effect, "of changing or influencing the control of the issuer" (or a willingness to do so).[291] Therefore, the collaborating investors should not, in principle, be required to switch from a 13G to a 13D filing and be treated as a group.[292]

FIN. TIMES (Apr. 13, 2008), https://www.ft.com/content/357c40c4-094d-11dd-81bf-0000779f2ac (a vote for a list sponsored by Assogestioni is not "a vote against the management but a vote to ensure truly independent board members and avoid the representation of other opportunistic minority shareholders, who might have other goals in mind").

[284] ASSOGESTIONI PROTOCOL, *supra* note 210, at 25. *See also* Coffee & Palia, *supra* note 132, at 560, n. 57 (noting that "The goal of the short slate rule also was to encourage 'constructive engagement' through minority board representation...").

[285] ASSOGESTIONI PROTOCOL, *supra* note 210, at 25 and 28 (stating that appointed directors "do not entertain and have not entertained, whether directly or indirectly, relationships which may affect their independence of judgment with the company for which they are nominated for a corporate office, or with the persons or entities who nominate them, or with persons or entities related to said company or to the nominators").

[286] *Id.* at 29.

[287] *See* Matteo Erede, *supra* note 283, at 370.

[288] *See generally* Matthew D. Cain et al., H*ow Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649 (2016).

[289] Coffee & Palia, *supra* note 132, n. 57.

[290] Sullivan & Cromwell, *2016 U.S. Shareholder Activism Review and Analysis* 15 (Nov. 28, 2016), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2016_U.S._Shareholder_Activism_Review_and_Analysis.pdf .

[291] *See* 17 C.F.R. § 240.13d-1 (b) (2017).

[292] *See* Hill, *supra* note 25, at 523 (noting that some regulators "have attempted the difficult task of differentiating between "good" and "bad" collective activism, with the aim of encouraging the former and deterring the latter"). *See e.g.* AUSTL. SECS. & INV. COMM'N REGULATORY GUIDE COLLECTIVE ACTIONS BY

Yet, it cannot be denied that the current regulatory framework for blockholder filings remains a roadblock that can thwart engagements by non-activist investors. For example, as Bebchuk and Hirst point out, to avoid taking on Schedule 13D filer status, the three leading passive investors "refrain entirely from communications about particular individuals who they believe should be added to or removed from the board in the vast number of situations in which one or more of the Big Three had positions of 5% or more in portfolio companies."[293]

Uncertainty as regards the continuing eligibility to file (individually or jointly) on Schedule 13G cannot be ruled out completely within the context of collective engagement activities, since the determination as to whether beneficial ownership of equity securities has been acquired or is held for the purpose of or with the effect of changing or influencing corporate control "is based upon all the relevant facts and circumstances".[294]

Given that "a control purpose reflects the state of mind of a filing person",[295] the SEC's view of the types of activity that could reveal a controlling purpose is a broad one. Indeed, the Commission's interpretations in this area are ambiguous and inconclusive; thus, investors routinely filing on Schedule 13G may not without some reason be wary that participating in a collective engagement could result in the loss of their passive investor status.

In fact, regarding eligibility to use Schedule 13G under Exchange Act Rule 13d-1(b) or 13d-1(c), the SEC has illustrated that "[t]he subject matter of the shareholder's discussions with the issuer's management may be dispositive in making this determination, although the context in which the discussions occur is also highly relevant."[296] According to the examples provided by the Commission,

> Generally, engagement with an issuer's management on executive compensation and social or public interest issues (such as environmental policies), without more, would not

INVESTORS 4 (2015), http://download.asic.gov.au/ media/3273670/rgl28-published-23-june-2015.pdf ("there is a difference between investors expressing views and promoting appropriate discipline in entity decision making and investors effectively taking control of entity decision making. Regulatory support for collective action by investors must recognise that the takeover and substantial holding provisions place limits on cooperation between investors to avoid control over an entity being acquired inappropriately").

[293] Bebchuk & Hirst, *supra* note 70, at 47-48. *See also* BLACKROCK, THE INVESTMENT STEWARDSHIP ECOSYSTEM 5, 13, 17 (2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf ("BlackRock has *never* sought a seat on a public company board as part of its stewardship activities").

[294] *See* SEC'S & EXCHANGE COMM'N, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Compliance and Disclosure Interpretations, Question 103.11 (July 14, 2016), https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

[295] Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2854 (Mar 31,1998), www.sec.gov./rules/final/34-39538.txt.

[296] *See supra*, note 294.

preclude a shareholder from filing on Schedule 13G so long as such engagement is not undertaken with the purpose or effect of changing or influencing control of the issuer and the shareholder is otherwise eligible to file on Schedule 13G.[297]

In its adopting release, the SEC also stated that a shareholder's proposal or soliciting activity relating to such topics would not generally cause a loss of Schedule 13G eligibility. Moreover,

> Engagement on corporate governance topics, such as removal of staggered boards, majority voting standards in director elections, and elimination of poison pill plans, without more, generally would not disqualify an otherwise eligible shareholder from filing on Schedule 13G if the discussion is being undertaken by the shareholder as part of a broad effort to promote its view of good corporate governance practices for all of its portfolio companies, rather than to facilitate a specific change in control in a particular company.[298]

On the contrary,

> Schedule 13G would be unavailable if a shareholder engages with the issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors.[299]

As is apparent from the above, engaging with a company could entail entering a grey area as regards the judgment over whether the investors concerned are pursuing the goal of changing or influencing corporate control. That is especially the case when "putting forward or supporting proposals to sell or restructure the portfolio company, proposing governance changes that make it easier to replace the managers of the portfolio company, or engaging with the portfolio company to propose or facilitate the appointment of particular individuals as directors."[300]

Against this backdrop, it is quite clear that cost considerations associated with the prospect of a possible switch from a 13G to a 13D filing can discourage collective engagements. As has been summarized in relation to the major index fund managers,

[297] *Id*.
[298] *Id*.
[299] *Id*.
[300] *See* Bebchuk & Hirst, *supra* note 70, at 26.

Schedule 13D filings must be made much more frequently than Schedule 13G filings and are much more extensive. Schedule 13D must be filed within ten days after every acquisition and subsequent change in holdings, compared to once-per-year for Schedule 13G. Schedule 13D filings also require particularized disclosure of each acquisition, entity-by-entity, compared to disclosure of aggregated positions for Schedule 13G. Schedules 13D and 13G apply not just to the index funds managed by the index fund manager but to all the investments they manage, including active funds, and separate client accounts. This increases the differential in compliance costs exponentially: given the frequency of trades in all of these portfolios, making the extensive disclosure for every single change in position that Schedule 13D requires would be incredibly costly and time consuming.[301]

13D filings not only restrict an investors' ability to trade following the initial filing; they also "may cause the target firm to become hostile to the blockholder and restrict access to management and thus a source of information"; they are "typically accompanied by credit downgrades…, higher bank loan spreads, and shorter bank loan maturities"; finally, a 13D filing "signals that the blockholder believes that the target is underperforming and intervention is warranted. Thus, if she subsequently fails to intervene and firm performance does not improve, she loses reputation among her own end investors".[302] Those additional effects of 13D disclosures are in sharp contrast with any engagement-only intention that an investor might have. Still, U.S. disclosure rules "are believed to chill concerted action by institutional investors, making them wary to cooperate with their peers and engage with portfolio companies."[303]

In addition, a chilling effect on institutions' willingness to coordinate for engagement purposes may be further enhanced by the way in which U.S. courts have handled group disclosures, given that "[c]onventional wisdom holds that courts are more willing than the statutory language suggests to find that shareholders are acting as a "group.""[304]

[301] *Id*. at 26-27 (pointing at the costs of a switch to 13G filings as an incentive towards "deferential stewardship" for index fund managers). *See also* Tuch, *supra* note 220, at 1497.

[302] Alex Edmans, Vivian W. Fang & Emanuel Zur, *The Effect of Liquidity on Governance,* 26 REV. FIN. STUD. 1443, 1449 (2013).

[303] Tuch, *supra* note 220, at 1498.

[304] *Id.* at 1497. *See also* Colleen D. Ball, *Regulations 14A and 13D: Impediments to Pension Fund Participation in Corporate Governance*, 1991 WIS. L. REV. 175, 176 (1991).

If non-activist collective engagements are to be seriously supported, legal concerns raised by the current legislation regarding Schedule 13G eligibility should be removed by clarifying under which conditions, as a general rule, collaboration between like-minded investors exerting stewardship functions will not be associated with an influence or control-seeking purpose, and will not trigger the obligation to switch to 13D reporting.[305]

In designing a safer regime for collective engagement initiatives promoted by non-activist investors that do not seek to gain influence over the corporation's control, some insights can be drawn from the European regulatory framework, where institutions that engage collectively could be regarded as parties "acting in concert", thereby the mandatory bid rule where their aggregate stakes exceed the relevant threshold.[306]

Following calls concerning the importance of ensuring "that there are no regulatory impediments, real or imagined, to the development of effective dialogue" and the need to provide for a safe harbour for collective engagements,[307] the European Securities and Markets Authority (ESMA) has identified a "White List" of activities shareholders may wish to engage in with a view to exercising good corporate governance, but without seeking to acquire or exercise control over the company.[308] Specifically, although "national competent authorities, when determining whether cooperating shareholders are acting in concert, decide each case on the basis of its own particular facts",[309] the ESMA states that "[w]hen shareholders cooperate to engage in any activity included on the White List . . . that cooperation, in and of itself, will not lead to a conclusion that the shareholders are acting in concert."[310]

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[305] For a similar—but only sketched—proposal *see* Hannes, *supra* note 22, at 200, 203 (arguing that "the SEC should clarify that the indirect cooperation between those who sign the agreement with the task force does not amount to holding their securities together and that the member institutional investors would still be considered passive investors").

[306] *See* BARKER & CHIU, *supra* note 188, at 174; Davies, *supra* note 231, at 13-14.

[307] WALKER REVIEW, *supra* note 187, at 85-86. *See also* FIN. CONDUCT AUTH. & FIN. REPORTING COUNCIL, BUILDING A REGULATORY FRAMEWORK FOR EFFECTIVE STEWARDSHIP 14 Discussion Paper DP19/1 (Jan. 2019), https://www.fca.org.uk/publication/discussion/dp19-01.pdf (claiming that firms "need to be able to demonstrate to their internal compliance functions that they are not 'acting in concert' when engaging on a collective basis with a subset of the company's investors").

[308] EUR. SEC. & MARKETS AUTH., INFORMATION ON SHAREHOLDER COOPERATION AND ACTING IN CONCERT UNDER THE TAKEOVER BIDS DIRECTIVE. 1ST UPDATE 4 (2014), https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-677.pdf

[309] EUR. SEC. & MARKETS AUTH., INFORMATION ON SHAREHOLDER COOPERATION AND ACTING IN CONCERT UNDER THE TAKEOVER BIDS DIRECTIVE 4 (2019), https://www.esma.europa.eu/document/information-shareholder-cooperation-and-acting-in-concert-under-takeover-bids-directive-0.

[310] *Id. See also* Davies, *supra* note 231, at 14 (stressing that "[s]imply proposing or supporting change of executive directors (or of managerial policy) does not necessarily amount to board control, in the absence of evidence of a wish to exert continuing control of the board.").

The White List's activities include, among others, "making representations to the company's board about company policies, practices or particular actions that the company might consider taking", "agreeing to vote the same way on a particular resolution put to a general meeting", such as proposals relating to directors' remuneration or ESG issues.[311] Moreover, even though it is not included in the White List, the ESMA also provides guidance on shareholder cooperation in relation to the appointment of board members. According to the ESMA, when determining whether or not shareholder cooperation in relation to board appointments will lead to the shareholders being regarded as persons acting in concert, a number of factors must be considered, including "the number of proposed board members being voted for pursuant to a shareholders' voting agreement"; "whether the shareholders have cooperated in relation to the appointment of board members on more than one occasion"; "whether the appointment of the proposed board member(s) will lead to a shift in the balance of power on the board."[312]

In line with the ESMA's statement, the Italian experience with minority-appointed directors clearly suggests that, under an explicit model for formal coordination led by third-party organizations and involving the adoption of adequate procedures and safeguards, investors seeking to appoint some non-executive independent directors on the board as a lever by which to improve corporate governance should not be considered to be control-seeking. As mentioned above, when managing the submission of short slates for the appointments of independent directors, Assogestioni relies on formalized procedures which enhance the active management role that is to be played by the association's internal committees throughout the process while keeping member institutional investors in a fundamentally reception-only position[313]. Thus, the Italian case is of particular interest since it shows that—despite the rules on acting in concert set at the EU-level, which are particularly attentive to board elections involving a possible aggregation of the stakes of those acting in concert, which may trigger a mandatory bid—collective engagements nonetheless may very well disassociate itself from any control-seeking intent and instead remain within the limits of active monitoring and stewardship.

Hence, several lessons can be learned from the European experience. First, it confirms that there is no clear-cut solution for avoiding 13D-related concerns for institutional investors.[314]

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[311] *Id.* at 5-6.

[312] *Id.* at 7.

[313] *See supra* Part IV.B.3.

[314] Namely, a clear-cut solution based on the distinction between activist and non-activist institutional investors aimed at excluding the latter from the scope of 13D disclosures is not advisable, since there appears to be a not

Second, based on the ESMA's approach, the SEC could adopt a similar view to provide a safe harbor for collective engagement initiatives that do not seek to gain control of the company.[315] In particular, the SEC should consider providing a—white—list of engagement-related activities that, in themselves, are considered to fall beyond the scope of section 13D, unless it is demonstrated on the basis of a case-specific analysis of all relevant circumstances that such activities have control-seeking purposes.

B. *Limiting the Risk of Regulation FD Infringements*

As mentioned above,[316] one further potential hurdle for investor engagement with portfolio companies is associated with Regulation FD, which concerns the selective disclosure of material non-public information to certain specified persons.[317] Specifically, any dialogues between an issuer and selected investors occurring within the engagement process could possibly (either inadvertently or not) result in the selective communication of price-sensitive information, such as advance warnings of earnings results, before such information is disclosed to the public. Since shareholders are explicitly included within its scope, Regulation FD has an impact on board-shareholder engagement.[318] In particular, due to the obligation to not trade on material non-public information, institutional investors deploying active investment strategies might be disincentivized to engage directly with portfolio companies.

However, concerns related to Regulation FD within the context of engagement should be largely scaled down.[319] First, investors are unlikely to discuss topics that are more likely to be

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negligible tendency of some non-activist institutional investors to adopt activist tactics that are more likely to have an influence over the control of investee companies. *See e.g.* Justin Baer & Dawn Lim, *Mutual Fund Managers Try a New Role: Activist Investor*, WALL ST. J. (Dec. 30, 2018), https://www.wsj.com/articles/mutualfundmanagerstryanewroleactivistinvestor11546174800; LAZARD, REVIEW OF SHAREHOLDER ACTIVISM –1Q 2019 1, 12-13 (2019), https://www.lazard.com/perspective/lazards-quarterly-review-of-shareholder-activism-q1-2019/ (reporting e.g. that "Wellington Management switched its 13G filing to a 13D and publicly opposed Bristol-Myers Squibb's $74bn acquisition of Celgene").

[315] *See*, for a similar view, Bebchuk & Hirst, *supra* note 70, at 57 (suggesting that U.S. "[p]olicy makers should facilitate such pooling by making it clear that the shared use of such resources would not create a group for the purposes of Section 13(d)").

[316] *See supra* Part. IV.C.2.

[317] Regulation FD, 17 C.F.R. § 243.100 (2017).

[318] *See* Joseph W. Yockey, *On the Role and Regulation of Private Negotiations in Governance*, 61 S.C. L. REV. 171, 206 (2009).

[319] *See, e.g.*, Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 834-836 (2013); Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 871, 898 (2012); Eugene Soltes, *What Can Managers Privately Disclose to Investors*, 36 YALE J. REG. BULLETTIN 148, 149 (2018-2019). *See also* BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 25 (2016), http://businessroundtable.org/corporate-governance.

classified as material. In fact, investors are mostly concerned with issues—such as "succession planning, executive compensation, director nominating criteria, governance philosophies, and general board oversight (including of accounting, internal controls, risk, auditing and other related matters)"[320]—that do not usually fall within the scope of Reg FD.[321] Second, advance arrangements are usually made to ensure that investors do not receive any material non-public information through contact with directors, so as to avoid trading prohibitions under insider trading law.[322]

That said, it is worth noting that regulatory risks associated with board-shareholder dialogue are minimized to a greater extent within a context of collective engagement. Arguably, if various investors are involved jointly in the dialogue, cross-control among investors could help to reduce the likelihood of infringing Regulation FD, since the disclosure of material nonpublic information during contacts with the company would limit the ability of all participating investors to trade in the company's securities. Moreover, as the above-mentioned example of the UK Investor Forum clearly shows,[323] this is especially the case where a third-party entity takes on the coordination of collective engagements and adopts formalized procedures capable of substantially preventing investors from receiving of material non-public information.

C. *Recognizing the Facilitator Role of a Coordinating Entity*

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[320] *See* THE SHAREHOLDER-DIRECTOR EXCHANGE, INTRODUCTION AND SDX PROTOCOL 13 (2014), http://www.sdxprotocol.com/what-is-the-sdx-protocol/.

[321] *See* Fairfax, *supra* note 319, 836 (citing STEPHEN DAVIS & STEPHEN ALOGNA, MILLSTEIN CENTER FOR CORPORATE GOVERNANCE AND PERFORMANCE, TALKING GOVERNANCE: BOARD-SHAREHOLDER COMMUNICATIONS ON EXECUTIVE COMPENSATION 10 (2008)). According to the SEC, material information mostly concerns topics such as earnings information; mergers, acquisitions, tender offers, joint ventures, or changes in assets; new products or discoveries, or developments regarding customers or suppliers; changes in control or in management; change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; events regarding the issuer's securities; and bankruptcies or receiverships. *See* SEC, WRITTEN STATEMENT CONCERNING REGULATION FAIR DISCLOSURE (May 17, 2001), www.sec.gov/news/testimony/051701wssec.htm#P7817603.

[322] *See* F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 24, 2015), https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/ ("[L]arge shareholders are not looking for inside information on strategy or future expectations. What they're looking for is the chance to provide the perspective of a long-term investor. Companies individually have to decide how to best manage that risk, but it shouldn't be by shutting out the shareholders completely."). With reference to the European context, *see* UK STEWARDSHIP CODE 2012, *supra* note 53, at 7.

[323] *See supra*, Part IV.C.2.

Coordinated engagements by traditional asset managers may occur in different ways. As has been shown above, the relevant factor common to any such form of intervention is the enabling role played by a representative third-party entity.[324]

Support provided by such entities can be categorized based on whether the action carried out by the organization is light-touch or more significantly institutionalized. While some such organizations provide for loose forms of support to members, but do not themselves take on a truly active stance (as is the case, for instance, with those that merely run of platforms enabling the investors to exchange views concerning specific portfolio companies), other entities operate as real drivers of engagement. These organizations proactively stimulate collective action by performing a propositional and monitoring function concerning the initiation, management and overview of specified engagement initiatives within a formalized procedural framework. In some cases, they also perform a scouting function to select director nominees regarding whom members could potentially arrive at a consensus. Of course, other arrangements fall between the two extremes.

To a greater or lesser extent, all forms of support provided by third-party entities facilitate and promote collective engagement as they reduce institutional investors' costs and enhance their aggregate voice, ultimately fostering management accountability. In general terms, the enabling effect of such entities results from their very operation, which may consist in

> "triggering the initiative for collective action; … (providing for) mobilizing structures that allow potentially interested investors to network and to identify partners in engaging the collective action; … (reducing) incentives to free-riding in engaging the reputation of investors …; and providing a monitoring context and an administrative structure that bear a significant a significant amount of the coordination cost …."[325]

However, it seems to be apparent that this enabling effect is likely to depend on the extent to which the deployment of collective initiatives follows specific procedural patterns outlined and monitored by the organization and is proactively supported by it. For collective action by traditional asset managers and asset owners to be effectively subsidized, organizations should therefore both adopt a more active role in supporting the engagement process and also take the procedural steps required to create an organizational structure and context that is capable of effectively fostering and supporting the engagement initiatives within a formalized framework.

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[324] *See supra* Part IV.B.

[325] Jean-Pascal Gond & Valeria Piani, *Organizing the collective action of institutional investors: Three case studies from the principles for responsible investment initiative* 53 *in* INSTITUTIONAL INVESTORS' POWER TO CHANGE CORPORATE BEHAVIOR: INTERNATIONAL PERSPECTIVES (2014), https://doi.org/10.1108/S2043-9059(2013)0000005010.

The adoption of formalized safeguards and procedures not only enhances the enabling effect of third-party organizations with regard to collective engagements. Even more crucially, an enhanced degree of formalization within the engagement process allows third-party entities to perform a truly facilitating function: the procedures adopted can, in fact, effectively counteract the regulatory disincentives against collective action described above. Organizations that actively perform a coordination function based on specified procedures and safeguards can provide a safer environment that reduces the risk that any investors wishing to participate in a collective engagement initiative may be viewed as seeking to influence the company's management, thus becoming subject to heightened regulatory requirements, including the filing of a long-form Schedule 13G instead of a short-form Schedule 13G.

Constraints on shareholder collaboration imposed by 13D disclosures are considered to account as an explanation for the comparatively limited role played by trade groups, such as investor associations, in fostering collective engagements in the United States.[326] However, a complementary explanation for this limited role of trade groups may be found in the fact that the existing U.S. organizations do not yet appear to have embraced the proactive, organized approach adopted by certain entities such as the UK Investor Forum in Europe. The more third-party organizations act as a filter between the investors and the company with which they engage, the more they require members participating in an engagement initiative to comply with requirements and procedures set out in advance, and the more they perform a monitoring function over the process and the conduct of participating members, the greater the degree of assurance they will provide. As a result, investors wishing to take part in a collective initiative may reasonably do so without breaching the relevant provisions and being exposed to the related consequences. Indeed, as mentioned above, the drafting of a framework for collective engagements by the UK Investor Forum specifically took account of the need to prevent "inadvertent violation of legal or regulatory requirements" imposed by multiple jurisdictions involved in cross-border investment decisions.[327]

If third-party coordinating entities are believed to actually promote the more effective involvement of institutions with portfolio companies, investors should be encouraged to participate in such entities. To this end, the SEC should explicitly recognize the role of those coordinating entities in promoting collective engagement initiatives in line with the applicable regulatory framework.

[326] Tuch, *supra* note 220, at 1480.

[327] *See supra* Part. IV.B.2.

Therefore, in designing safe harbors for collective engagements that do not seek to influence or control investee companies,[328] the SEC should accept that—unless a control-seeking purpose can be inferred from the relevant circumstances of the case —collective engagement will not be relevant under Section 13D where the institutional investors participating in the initiative have explicitly committed not to form a control-seeking group and have appointed a third party to monitor compliance with the agreement according to predefined frameworks governing the process of engagement and establishing rules of conduct for participating investors.

In addition, to enhance the regulatory relevance of coordinating entities by limiting conflicts of interests and distorting incentives, the SEC or, perhaps, stewardship principles could recommend that, where the engagement process is managed and overseen by the facilitating entity and not by the investors themselves (as is advisable in order to minimize the risk of forming a group), independence requirements could apply to the coordinating entity's executives who actually lead the initiative. This would be particularly advisable if some executives of the coordinating entity are former representatives of the institutions participating in the engagement or potential target companies. For example, it could be stipulated that a member of the coordinating entity's team should avoid participating in engagement initiatives involving any investors with whom she/he has had business relations during the previous 12 months. Such additional requirements would reasonably promote independent monitoring throughout the collective engagement process.

VI. CONCLUSIONS

Looking beyond hedge-fund wolf packs and activist-driven teaming up, this Article sets out the first comprehensive analytical framework for non-activist shareholder cooperation, showing that coordinated engagement by non-activist institutions can be a promising lever by which to foster a more effective and viable corporate governance role for non-activist institutional investors and provide an alternative to activist-driven ownership involvement.

After considering the diverging incentives structures of activist and non-activist investors and showing how they are reshaped within a context in which investors collaborate in the engagement process, this Article illustrates that non-activist driven collective engagements are beneficial in several respects. First, collective engagement favors the redistribution of engagement costs and, therefore, increases the net return earned by each institutional investor

[328] *See supra* Part V.A.

involved. In doing so, it also lowers the free-rider problem generally affecting institutional shareholders' behavior. Second, the presence of a third-party entity that coordinates the engagement initiatives can work as an effective tool for reducing potential regulatory risks, mainly concerning 13D group disclosures and Regulation FD. Third, collective engagements can exploit the expertise of more skilled investors who participate in the initiative or of the third-party coordinating entity. Finally, collective engagement initiatives can enhance reputational incentives for being active owners, as institutional investors may be incentivized to join collective initiatives where these prove to be successful or are viewed positively by end clients.

Against this background, this Article concludes that, to promote non-activist stewardship as an actual alternative to activist-driven share ownership, collective engagement initiatives should he incentivized by clarifying the remaining grey areas within the relevant regulatory framework. In particular, there is the need for the SEC to provide greater clarity concerning the circumstances in which collective engagement through an enabling organization will not, as a rule, be regarded as control-seeking or concerted action and will not trigger group filing obligations under Section 13D of the Securities and Exchange Act. In addition, the SEC should explicitly recognize the role of such coordinating entities— that adopt predefined frameworks governing the process of engagement and establish rules of conduct for participating investors—in promoting collective engagement initiatives in line with the applicable regulatory framework. Thus, the CII or similar institutions could play a more significant role in promoting effective institutional investors stewardship, following the patterns of counterparty institutions in other countries.