Article

Corporate Governance in an Age of Separation of Ownership from Ownership

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INTRODUCTION

The financial crisis of 2008 spurred far-reaching government responses in the form of federal regulation: the immediate "bailout" legislation[1] and the later Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[2] These initiatives shape in profound ways the capital structure of financial institutions and the vibrancy of the global economy. But what has been the impact on the mechanisms of corporate governance? Congressional responses to the crisis sound in familiar keys, because they call for increased disclosure, greater independence of board members, more say-on-pay, and proxy access for shareholders.[3] To this point, however, Congress has failed to address a fundamental tension in modern corporate stock ownership: the increasing use by long-term investors of short-termist intermediaries (mainly mutual funds and hedge funds), despite an inherent mismatch in their respective time horizons.

Dodd-Frank and its bailout antecedents invoke remedies that shareholder activists have developed over the past twenty years to prod boards of directors of corporations whose share prices underperform the market in the short term.[4] My thesis is that the use of these remedies in an effort to enhance long-term

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1. *See infra* notes 91–93.
2. Pub. L. No. 111-203, 124 Stat. 1376 (2010).
3. *See infra* Part II.A.
4. *See infra* Part II.A.

decisionmaking for individual companies is misguided and counterproductive.[5]

Central to the post-crisis law of corporate governance are reforms based on two key premises. The first premise is that the financial crisis was the result of systemic risk, which in turn arose from companies' failure sufficiently to internalize the long-term dangers of their conduct to both themselves and the larger economy.[6] The second premise is that increased shareholder involvement will ameliorate this pernicious short-termism.[7] By short-termism, I mean the taking of actions that result in a short-term gain, but which sacrifice the long-term benefit of the firm to a suboptimal degree.

This Article focuses primarily on the flaws inherent in the second premise of Congress's bailout reforms. In particular, I suggest that the government's reform tactic of shareholder empowerment ignores the fact that the immediate shareholders of the vast majority of publicly traded corporations have short-term investment horizons that can be measured in months, or even days.[8] Each regulatory measure fails to take account of the short-termist shareholder problem. Expanding the choices of a myopic shareholder electorate to include shareholder nom-

5. To situate my argument within the literature, others have also criticized shareholder empowerment as an effective reform measure. *See generally* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) [hereinafter Bainbridge, *Director Primacy and Shareholder Disempowerment*]; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010); Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* (UCLA Sch. of Law, Law & Econ. Research Paper Series, Paper No. 05-20, 2005) [hereinafter Bainbridge, *Shareholder Activism and Institutional Investors*], *available at* http://ssrn.com/abstract=796227.

6. *See infra* notes 96–100 and accompanying text.

7. *See infra* notes 106–08 and accompanying text.

8. This is not to mention the even shorter time horizons of flash traders, who precipitated the "flash crash" of May 6, 2010. Zachary A. Goldfarb, *SEC Launches Inquiry into Market's Flash Crash*, WASH. POST, May 21, 2010, at A14, *available at* 2010 WLNR 10488275. Flash traders seek to exploit minimal price differentials and hold shares for only minutes or seconds. *See, e.g.*, Jenny Anderson, *S.E.C. Moves to Ban Edge Held by Fast Traders*, N.Y. TIMES, Sept. 18, 2009, at A1, *available at* 2009 WLNR 18348003 ("[T]he average [flash] trade is executed, or completed, in less than 10 milliseconds and often as fast as 5 milliseconds."). This Article will ignore flash trading on the theory that these traders, indifferent to corporate governance concerns, generate trading volume without affecting corporate policies.

inees will not make short sighted shareholder voters focus on the long term. If they vote, they will simply pick similarly short-termist directors. Worse still, empowering short-term investors to vote on executive pay might well have the perverse effect of creating an incentive structure that *encourages* short-term risk. Disclosure as reform, while politically expedient, relies on the market processing the information being disclosed and pricing securities accordingly—a supposition called into serious question by recent empirical studies.[9] More generally, these empirical studies raise questions about the efficacy of what has become the standard toolkit of shareholder activists when ownership is no longer simply separate from control, but also from ownership—that is, when the ultimate beneficial owners of corporations do not themselves own shares in any real sense, but instead rely on institutional fund managers and other intermediaries.

Faced with these difficulties, Congress should contemplate a very different approach to reform. Shareholder empowerment is likely an imperfect tool to address systemic risk, given the collective action problem, complacency, and other limitations.[10] That said, the most promising shareholder empowerment reform strategy involves aligning the interests of long-term investors and those of the funds through which they invest. Unfortunately, current regulation permits and even encourages short-termism on the part of the managers of these intermediary funds.[11] Even those funds with the longest of time horizons—including so-called target-date funds—operate in a manner that subordinates the interests of investors to those of the funds themselves.[12] Disclosure, the SEC's proposed regulatory fix, fails to address the problem with target-date funds because investors in these funds are, by definition, not likely to be active monitors.

This Article accepts three propositions that others have questioned. First, it views Congress's legislation in this area as,

9. *See* discussion *infra* Part III.A.

10. *See* Iman Anabtawi & Steven Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. (forthcoming 2011) (manuscript at 31), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670017 (discussing the complacency problem).

11. *See, e.g.*, *infra* notes 39–42 and accompanying text.

12. *Cf.* Leslie Wayne, *A Bead on Ordinary Investors*, N.Y. TIMES, June 25, 2009, at B1, *available at* 2009 WLNR 12109242 (illustrating the enormous risks to investors).

at least primarily, a sincere effort to deal with short-termism.[13] One could view these reforms instead as the product of political logrolling. From this perspective, the reforms were never intended to address the causes of the financial crisis, but were merely a sop to corporate governance activists,[14] creating a dangerous placebo effect pursuant to which cosmetic governance changes would lull the public into thinking substantive reform had occurred.[15] A less cynical view holds that, if the public truly believes that the reforms have created a safer, less fraudulent, or more favorable investing climate (that is, if society swallows the placebo), then the reforms will be effective at reassuring investors and have the positive effect of stabilizing the economy. If this reassurance is ultimately misplaced, however, investors are merely duped into feeling an unwarranted sense of security in the market. Whether one takes a sincere or cynical view of the bailout's corporate governance provisions, this Article argues that their failure to address the new stockholding landscape, while purporting to address managerial short-termism, is a problem that corporate scholars should take seriously.

This Article also embraces a second proposition that some scholars have questioned—namely, that long-term investors are deserving of heightened protection.[16] One can object to this outlook on the ground that the long-term investor is already adequately protected. Why? Because the long-term investor is, after all, an investor. She is taking a risk in the hope of higher return and, in an efficient market, long-term investors are compensated for running risks, including systemic risk, by receiving a higher rate of return.[17] In response, I posit that the market in which long-term investors operate is *not* completely efficient: the "true" value of shares does not always equal stock price because of the informational asymmetries that exist be-

13. *See infra* Part II.B.

14. Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1802, 1818–19 (2011).

15. *See* Amitai Aviram, *The Placebo Effect of Law: Law's Role in Manipulating Perceptions*, 75 GEO. WASH. L. REV. 54, 65–66 (2006) (explaining the placebo effect of law as objectively impacting behavior and resulting from law's manipulation of subjective perception).

16. Lawrence E. Mitchell, *The 'Innocent Shareholder': An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 246 (stating that long-term investors are "most in need of protection").

17. Thanks to Larry Ribstein for raising this objection.

tween managers and public investors.[18] In other words, I assume that at least sometimes market prices reflect short-term interests, rather than the long-term value of the firm, and that the market does not fully price in systemic risk.

In addition, one may question whether long-term investors exist at all today—if they ever did. The individuals we think of as long-term investors—those saving for retirement or their children's college education—might be more properly seen as short-term investors with long-term *interests*. Such investors, so the argument goes, will be indifferent as to how that long-term goal is achieved; they may, indeed, prefer a series of short-term investments that cumulatively result in a bigger payoff than investments that are held for a period of many years. If this suggestion is true, then focusing on the long-term investor's interests will not help the situation.

Even if we believe that no long-term investors exist, however, we still face a problem. It is in everyone's best interest for firms to be run for the long term. Stable firms create stable employment, wealth, and goodwill that short-lived companies cannot provide. The question our society faces is how to encourage long-lived firms when individual players, including even long-horizoned investors, may be looking for a quick payoff. While aligning the incentives of fund managers with those of long-term investors remains the best alternative to substantive government regulation, the efficacy or validity of focusing on them remains in doubt. Shareholder empowerment simply may not be an adequate tool for addressing systemic risk. My core point is simply to offer a critique: the bailout's shareholder empowerment regulatory fixes are internally incoherent because they fail to address the short-termist realities of shareholder ownership today.

I. THE NEW SEPARATION OF OWNERSHIP FROM OWNERSHIP

The idea that shareholder empowerment will address managerial short-termism grounds itself in the Berle-Means vision of the public corporation, first articulated in 1932,[19] that has shaped corporate law for decades. In *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means pit the

18. Bratton & Wachter, *supra* note 5, at 698–703.

19. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Harcourt, Brace & World, Inc. 1968) (1932).

interests of the dispersed shareholder-owners of a public corporation against interests of the managers of the corporations they own.[20] The tale is one of disenfranchisement and loss of control: because of their dispersal, shareholders are powerless to discipline management.[21]

In the Berle-Means world, vertical agency costs are the chief corporate concern.[22] Managers can rent-seek unfettered by any meaningful shareholder control. Corporate reforms such as proxy access and say-on-pay attempt to mitigate these vertical agency costs by providing shareholders a voice to check management's excesses.[23] Disclosure rules seek to reinforce the power of shareholders, on the theory that some subset of motivated owners, proto-owners, or short-sellers will vigilantly monitor all available information about the corporation and buy or sell accordingly.[24] The corporate governance provisions of the bailout legislation, then, faithfully follows the Berle-Means shareholder-versus-manager script, according to the

20. *See generally id.*

21. Alternative models to the Berle-Means corporation have arisen, such as Eugene Fama and Michael Jensen's framework. Fama and Jensen view the corporation as a contract rather than property. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983) ("An organization is the nexus of contracts . . . among owners of the factors of production and customers." (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976))). Shareholders contract for the residual claim, decision rights are generally allocated to management, and the outside board provides a monitoring role. *Id.* at 311–15. Importantly, however, under the Fama-Jensen model, shareholders reserve the right to vote on important matters as a way to constrain managerial agency costs. *Id.* at 313. In this world, shareholders share a single motivation: maximizing the value of their residual claim. A conflict of interest among shareholders—what I have termed a "separation of ownership from ownership"—thus matters even in Fama and Jensen's contractarian world, given its dependence on the shareholder vote as a corrective mechanism. *See* Bratton & Wachter, *supra* note 5, at 665 ("The shareholders [in the Fama and Jensen model] emerge as owners-in-part, bearing the residual risk and, as voters, sharing in control at a step removed from business decisionmaking and direct monitoring."); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 138 (2009) ("[T]he vote by shareholders exhibits less of the legitimizing function in the selection of directors than one sees in a political election of a representative, and more of the error-correcting purpose as to directors' behavior.").

22. *See generally* BERLE & MEANS, *supra* note 19.

23. *See* discussion *infra* Part II.A.

24. *See infra* note 257 and accompanying text.

common presupposition that "if management [i]s the problem, shareholders must be the solution."[25]

This line of logic, however, must confront a troubling practical reality: the ownership landscape of American public corporations has shifted dramatically over the past seventy-five years. No longer do we have merely a separation of ownership and control; we now also have a separation of ownership from ownership.[26] Individual long-term capital holders no longer hold shares of corporations directly; the direct holders of shares predominantly are institutional investors.[27] As Jill Fisch has observed, "the feasibility of improving corporate decision-making through shareholder empowerment depends critically on the actions and incentives of those empowered shareholders."[28] We thus must consider whether the incentives created for institutional investors—the "empowered shareholders" of today—tilt toward the short term or may be otherwise biased.

Institutional investors come in different shapes and sizes. Individuals saving for retirement or their children's education—whose investing time horizons can be measured in decades—may hold stocks through mutual funds and pension funds. Wealthier investors may use hedge funds. In each case, the corporation's vote holder is not the ultimate beneficial owner of the corporation, but instead an intermediary that enables

25. Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 335 (2011).

26. This resonant phrase comes from Vice Chancellor of the Delaware Court of Chancery Leo Strine, and this section is largely indebted to his insights into the modern shift in stock ownership. *See* Leo E. Strine Jr., *Why Excessive Risk-Taking Is Not Unexpected*, N.Y. TIMES DEALBOOK (Oct. 5, 2009, 1:30 PM), http://dealbook.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/ [hereinafter Strine, *Excessive Risk-Taking*].

27. In 2009, institutional investors owned fifty percent of total U.S. equities. Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 879 (2010) (citing BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (2010), *available at* http://www.federalreserve.gov/releases/z1/Current/z1.pdf). In 2007 institutional investors owned 76.4 percent of the largest 1000 companies. *Id.* at 879–80 (citing Press Release, The Conference Bd., U.S. Institutional Investors Boost Ownership of U.S. Corporations to New Highs (Sept. 2, 2008), *available at* http://www.thefreelibrary.com/_/print/PrintArticle.aspx?id=184326501).

28. *Id.* at 879. Fisch's article points out the problems securities intermediaries pose for shareholder empowerment, although not in the specific context of governmental responses to the financial crisis. *Id.* at 879–84.

the investor to own an interest in a mix of shares packaged as a unitary investment vehicle.[29]

This mediated ownership gives rise to a troubling set of horizontal conflicts. These conflicts exist when investors have conflicts of interest, not with managers, but amongst themselves.[30] If shareholders have different interests, most notably divergent investment time horizons,[31] then simply empowering investors risks advantaging one group of shareholders to the detriment of the rest. More fundamentally, the theory of shareholder empowerment is that shareholders, as the residual claimants, will maximize long-term firm value because they are last in line at the time of liquidation, and thus have strong reasons to guard against near-term collapse. But if some shareholders have a short-term perspective, or have idiosyncratic causes to advance, then shareholder empowerment merely substitutes a new horizontal conflict between shareholders in place of the old vertical manager-shareholder conflict.[32] These short-term shareholders may well not vote at all or may sell their shares to other investors if the vote is a valuable one. But there will be some decisions in which a short-term shareholder would vote, rather than sell or abstain, and where the short-term gain comes at the expense of the corporation over time.

This Part will survey various ways in which ownership has separated from ownership in modern investing. This separation has deep ramifications for this Article's central thesis: shareholder empowerment cannot solve the problem of managerial myopia if it is only the short-term intermediary (e.g., the mutual fund, the hedge fund, or the pension fund) that is empowered, and not the ultimate holder, who is investing for the long term. This Part concludes with the ultimate separation of ownership from ownership: "empty voting," where the power to vote has been stripped of any connection to economic interest.[33]

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29. Strine, *Excessive Risk-Taking*, *supra* note 26.

30. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 285 (1998) (citing Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 591 (1992)).

31. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1745.

32. Smith, *supra* note 30, at 285–86.

33. *See* discussion *infra* Part I.D.

A. MUTUAL FUNDS

Mutual funds control a significant portion of the modern-day market. In 2004, mutual funds held $4.49 trillion in assets, or about twenty-four percent of total U.S. stock market capitalization.[34] In 2006, mutual funds held thirty-two percent of U.S. equities.[35] And by year-end 2009, the U.S. mutual fund industry had grown to manage $11.1 trillion in assets, making the U.S. mutual fund market the largest in the world.[36] These funds are the savings vehicles of choice for most Americans, who seek a diversified investment that will fund retirement and other long-term needs—investments with decades-long time horizons.[37] Such investors can choose between actively managed funds or the increasingly popular index funds,[38] which track a particular stock index such as the S&P 500. Each type of fund poses separate problems for reformers seeking to use shareholder empowerment as a way to control vertical agency costs.

Actively managed mutual funds attempt to beat the market by investing in stocks that appreciate faster than average. One might think that because active mutual fund managers bet on particular companies, they would monitor management and

34. Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157, 159–60 (2006).

35. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 10 n.31 (2010) [hereinafter Strine, *Fundamental Corporate Governance Question*] (citing Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 655 (2009)).

36. INV. CO. INST., INVESTMENT COMPANY FACT BOOK 21–22 (50th ed. 2010), *available at* http://www.ici.org/pdf/2010_factbook.pdf. The U.S. mutual fund market constitutes forty-eight percent of the world's $23 trillion mutual fund market. *Id.* at 22.

37. Strine, *Excessive Risk-Taking*, *supra* note 26.

38. *See, e.g.*, INV. CO. INST., *supra* note 36, at 32 ("Index mutual funds continued to remain popular with investors. . . . As of year-end 2009, 359 index funds managed total net assets of $837 billion."); Ben Baden, *Why Investors Are Flocking to Index Funds*, U.S. NEWS & WORLD REP., Mar. 16, 2010, http://money.usnews.com/money/personal-finance/investing/articles/2010/03/16/why-investors-are-flocking-to-index-funds ("Lately, investors have voted with their feet and chosen indexing over actively managed funds. Huge losses in the stock market in 2008 prompted many investors to sell actively managed stock funds. During that year, investors withdrew more than $214 billion from actively managed stock funds, while stock index funds saw inflows of more than $47 billion, according to Morningstar. The trend continued in 2009, with investors withdrawing more than $37 billion from actively managed stock funds and about $36 billion flowing into stock index funds.").

clamorously voice concerns about the companies within their portfolios. In truth, active funds are short-term investors, "turning over 100% or more of their portfolios each year."[39] Additionally, they hold stock in myriad companies and therefore lack the incentive to expend research costs in determining which votes in which particular companies would most increase value.[40] In addition, investments in mutual funds are highly liquid, meaning that a mutual fund investor discontented with a fund's performance can withdraw her money at any time.[41] Mutual fund managers thus feel intense pressure to maximize short-term returns in order to attract and retain investors.[42] Fund manager compensation is tied to outperforming a particular index in a year- or quarter-long period,[43] and deviations from that index are slight.[44]

Index funds offer a low-cost alternative to actively managed funds, which generally do not beat the market despite charging hefty management fees.[45] Index funds offer the near-automation of investing, purporting to do no more than mimic

39. Anabtawi & Stout, *supra* note 5, at 1290.

40. Lucian A. Bebchuk & Scott Hirst eds., *The Harvard Law School Proxy Access Roundtable* 31 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 661, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1539027.

41. *See* INV. CO. INST., *supra* note 36, at 193 ("By law, investors are able to redeem mutual fund shares each business day. As a result, fund shares are very liquid investments.").

42. Anabtawi, *supra* note 5, at 580; Simon C.Y. Wong, *Why Stewardship Is Proving Elusive for Institutional Investors*, 25 BUTTERWORTHS J. INT'L BANKING & FIN. LAW 406, 406 (2010).

43. Fisch, *supra* note 27, at 882–83.

44. Bebchuk & Hirst, *supra* note 40, at 39. Roundtable participant Robert Mendelsohn recounts a telling conversation with a mutual fund manager that reveals how, perversely, fund managers can actually prefer a particular portfolio company to fare poorly. *Id.* Mendelsohn's firm constituted one percent of the relevant index, and the fund manager, pessimistic about Mendelsohn's company, owned 0.75 percent instead of one percent. *Id.* His chief mutual fund competitor was bullish on the stock and owned 1.25 percent. *Id.* "This guy was very candid. He said 'I'm rooting against you, I hope your shares go down.' I said that's not good for your shareholders. And he said, 'well, I'm in the business of competing for assets under management with Company X. And if your shares go down, it's going to hurt Company X a lot more than it's going to hurt me. And that helps my business.' Very honest. Now is that actually the kind of behavior we want from the people we give our pension money to?" *Id.*

45. William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 83 ("Time and time again, studies demonstrate that passive funds consistently outperform active funds in the long run.").

the return of a particular stock index.[46] The managers of index funds thus have even *less* incentive to monitor the elections of the companies whose shares their funds hold or to use their votes to express displeasure with management. The whole point of such funds is to minimize management fees by avoiding the introduction of human evaluation in the selection of portfolio companies. The lack of human evaluation, in turn, effectively ensures the lack of any monitoring of managerial performance.

One might argue that index fund managers have an increased incentive to engage in shareholder activism, since they are locked into a set of portfolio companies. Two problems make activism less likely for index funds. First, the cost of free riding would be huge. Take an S&P 500 index fund manager who lobbies for beneficial corporate governance changes at a portfolio company. Any upside gained from the increase would be automatically shared equally with every other S&P 500 index fund and exchange-traded fund (ETF), despite the lack of any effort on the part of these competitor funds. Couple this with the second fact that index funds market themselves largely on their low fees and fidelity to the underlying index, and there is little incentive for an index fund manager to engage in activism of any kind.[47]

B. HEDGE FUNDS

Hedge funds are nonpublic entities exempt from regulation under the Investment Company Act of 1940.[48] They invest for the short term, sometimes turning over an entire portfolio three times a year.[49] Although smaller players than mutual funds,[50] hedge funds control a significant portion of the market.

46. *See* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 658 (1995) (noting the strategy of index funds to purchase stock of a certain index).

47. Wong, *supra* note 42, at 409.

48. *See* STAFF, U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (defining the term "hedge fund"). The fund must limit its number of owners to 100 persons, 15 U.S.C. § 80a-3(c)(1) (2006), or have an unlimited number of individual investors that have at least $5 million net of debt in investments exclusive of the hedge fund in question. *See id.* § 80a-3(c)(7).

49. Anabtawi & Stout, *supra* note 5, at 1290–91.

50. *See* ZVI BODIE ET AL., INVESTMENTS 902 (8th ed. 2009) ("While mutual funds are still the dominant form of investing in securities markets for most individuals, hedge funds have enjoyed far greater growth rates in the last decade . . . .").

As of June 2009 more than 8900 hedge funds held over $1.43 trillion in assets.[51]

Marcel Kahan and Edward Rock call hedge funds the "archetypal" short-term investment vehicle, observing that, "[f]or some funds, holding shares for a full day represents a 'long-term' investment."[52] One class of hedge funds involves "activist" or "event driven" investors.[53] These investment managers seek short-term payoffs such as dividend declarations, recapitalizations, sales of assets, and other actions that generate an immediate payoff.[54] These activist funds are the ones most likely to participate in say-on-pay or shareholder access proposals because they invest in order to accomplish a specific goal.[55]

Hedge fund structures are, in short, shaped by a desire for a quick return. The lifespan of any particular hedge fund is typically short, and therefore hedge fund managers must return to capital markets often in search of fresh assets in which to invest.[56] Such a temporary focus might encourage a hedge fund to force a company to take actions such as selling a division or declaring a dividend—actions that generate a quick payout but harm the long-term health of the company.[57]

Short-termist criticism can, it is true, be overstated. Activism focused on the short term is not necessarily a bad thing.[58] Long-term and short-term interests can be aligned in disciplining managers, forcing them to shed ill-advised acquisitions or

51. COAL. OF PRIVATE INV. COS., HEDGE FUNDS: HOW THEY SERVE INVESTORS IN U.S. AND GLOBAL MARKETS 3 (2009), *available at* http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf. Hedge fund assets were even higher in 2008, totaling $1.9 trillion. BODIE ET AL., *supra* note 50, at 902.

52. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083 (2007).

53. This class is opposed to corporate-governance focused activist investors. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 8 n.20 (citing Charles Nathan & Parul Mehta, *The Parallel Universes of Institutional Investors and Institutional Voting*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. n.1 (Apr. 6, 2010, 9:01 AM), http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting).

54. *Id.*

55. There are, however, anecdotal signs of unwillingness to do so. *See* Bebchuk & Hirst, *supra* note 40, at 25 ("[A]t a recent meeting of shareholders in hedge funds, the question was asked, how many in that room would use access? Not a single hedge fund raised his or her hand.").

56. Anabtawi, *supra* note 5, at 580.

57. *Id.* at 581.

58. Kahan & Rock, *supra* note 52, at 1084.

to return excess cash to investors.[59] The partnership-based governance structure of hedge funds—which fosters close ties between firm and investor well-being, management by investors, and encouragement of distribution—may make these entities less subject to agency costs.[60] Even so, some hedge fund decisions inevitably will focus on the short term at the expense of the long term, if we assume that market price does not equate to long-term firm value.[61]

Kahan and Rock argue these concerns are overblown because hedge funds can only affect corporate policy by gaining the broad support of "corporate management, independent directors, traditional institutional investors with large stakes, and other large shareholders."[62] Yet we have already seen that mutual funds, the biggest institutional investors, invest for the short term.[63] Corporate management hardly provides a corrective to investor myopia.[64] As Kahan and Rock themselves acknowledge, managers naturally bias toward the short term: chief executive officer (CEO) turnover is high, and many high-level executives are close to retirement.[65] Management's natural desire to produce short-term returns feeds on and is reinforced by hedge funds' desire to make a quick buck.[66] Hedge fund activism, then, may sometimes cut down on vertical agency costs, but it does so by increasing horizontal conflicts, most notably with longer-term shareholders.

C. LABOR UNIONS AND PENSION FUNDS

Funds such as CalPers, CalSTERS, and the AFL-CIO strike terror into the hearts of firm managers. Such funds often agitate for reform on corporate governance matters, such as the elimination of classified boards and poison pills, majority voting, and proxy access.[67] Labor unions and pension funds, more than any other intermediary investor, have the time and motivation to monitor the long-term health of companies in which

59. *See id.* at 1088–89.

60. *See* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 290–93 (2009).

61. Bratton & Wachter, *supra* note 5, at 703.

62. Kahan and Rock, *supra* note 52, at 1089.

63. *Id.* at 1083.

64. *Id.* at 1088.

65. *Id.*

66. *Id.* at 1088–89.

67. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 8 n.20.

they invest. Proudly carrying the mantle of true corporate governance activists, they are concerned with fundamental changes in corporate decisionmaking rather than the quick payouts that concern event-driven activists.[68]

There is, however, a fly in the ointment. The difficulty is that labor unions and pension funds may well have interests that have no relation to the financial health of the company—whether short-term or long-term—such as favoring labor-friendly policies or seeking publicity for causes (e.g., domestic job creation over offshoring) that serve the ends of their own fund participants rather than the good of the company as a whole.[69] For example, the pension fund for the Safeway workers' union used its position as shareholder to try to remove the Safeway CEO after he failed to meet union demands in collective bargaining negotiations.[70] This series of events illustrates how a horizontal conflict can result from the divergence of the interests of a particular investor from the concerns of investors in the aggregate regardless of a difference in time horizons.[71] It is true that these investors will need to market their initiatives to appeal to the broader shareholder electorate, but if that electorate is largely passive, coalition building has less of a chance to temper the idiosyncrasies of labor unions and pension funds.

As we will see in Part II.A.2, if reform empowers investors who are largely focused on the short term, two different problems can result based on whether short-term shareholders do or do not exercise their newfound voice. If they do not, the risk is that short-termist silence will accord disproportionate power to the idiosyncratically motivated long-term shareholders. If short-termists do rouse from their apathy and exercise their

68. Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41, 48–49 (1998).

69. *See, e.g.*, Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1754–55 ("[U]nion and public employee pension funds, which generally have been the most active institutions with respect to corporate governance issues[,] . . . are precisely the institutions most likely to use their position to self-deal—that is, to . . . reap private benefits not shared with other investors. . . . Public employee pension funds are especially vulnerable to being used as a vehicle for advancing political or social goals unrelated to shareholder interests."); Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1271 (2009) (describing the tendency of public pension funds and other "social investors" to use shareholder power to advance idiosyncratic agendas).

70. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1755 n.100 (citing Anabtawi, *supra* note 5, at 34).

71. *Id.* at 1745.

vote, the firm's policies presumably will tilt even more toward the short term.

D. EMPTY VOTING

The phenomenon of empty voting provides the starkest example of the problems that stem from relying on unfettered shareholder action to protect long-term shareholder interest.[72] Henry Hu and Bernard Black have identified situations in which investors have decoupled voting rights from economic interests.[73] These cases demonstrate that, at least in extreme cases, relying on the shareholder franchise to protect any shareholder economic interests—including long-term interests—can be foolhardy.[74]

In one example of empty voting, Perry Corp., a hedge fund, owned a significant stake in King Pharmaceuticals.[75] Mylan Laboratories agreed to buy King at a substantial premium to its then-current trading price.[76] Mylan's shares dropped when the deal was announced, and the company needed shareholder approval in order for the deal to go through.[77] Perry then bought 9.9 percent of Mylan, becoming Mylan's largest shareholder, in order to help assure a positive shareholder vote and completion of the deal.[78] But Perry at the same time fully hedged any economic risk associated with its Mylan ownership, so that it was protected even if the firm lost value.[79] It therefore both held 9.9 percent voting ownership in Mylan and had no economic interest in Mylan. Perry thus could vote its Mylan

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72. *See generally* Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011 (2006) [hereinafter Hu & Black, *Empty Voting I*]; Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) [hereinafter Hu & Black, *Empty Voting II*]; Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007) [hereinafter Hu & Black, *Hedge Funds*]; Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) [hereinafter Hu & Black, *The New Vote Buying*].

73. Hu & Black, *Empty Voting II*, *supra* note 72, at 629.

74. Hu & Black, *Empty Voting I*, *supra* note 72, at 1056; Hu & Black, *Empty Voting II*, *supra* note 72, at 655–58; Hu & Black, *Hedge Funds*, *supra* note 72, at 345–53; Hu & Black, *The New Vote Buying*, *supra* note 72, at 854–57.

75. Hu & Black, *The New Vote Buying*, *supra* note 72, at 816.

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

shares unreservedly for the acquisition, even if Mylan was about to pay too high a price for King. Perry would profit from an inflated price because of its investment in King, yet remain shielded from any counterbalancing loss because of its investment in Mylan.[80] Hu and Black refer to this type of voting divorced from economic interest as "empty voting."[81]

Some critics have questioned whether empty voting is the problem Hu and Black see it to be.[82] The authors defend the importance of the phenomenon by observing that the number of decoupling examples has grown from twenty-one in 2006 to over eighty in 2008 in more than twenty countries.[83] To be sure, this remains a small number of cases. Even if empty voting is only an isolated phenomenon, however, it reveals the clearest imaginable case of horizontal conflict, casting in sharp relief the danger of relying on the shareholder vote to empower shareholders and discipline managers.[84] In some cases, a vote holder may have no economic interest in the firm at all.

Not all commentators view empty voting as pernicious; Bruce Kobayashi and Larry Ribstein argue the benefits of empty voting—which they term "outsider trading"—on the ground that it encourages traders to generate and trade on socially productive information.[85] As long as this information is not obtained by fraud or misappropriation, it should be rewarded.[86] But even if empty voting is beneficial to the market overall, it nonetheless illustrates the problems of relying on the shareholder franchise for the protection of shareholder interests.[87]

This Part has elucidated a disconnect between the short-term interests of intermediary corporate shareholders such as mutual funds and hedge funds, and the interests of long-term investors in these intermediaries. Even when time horizons

80. Hu & Black, *The New Vote Buying*, *supra* note 72, at 816.

81. Hu & Black, *Empty Voting II*, *supra* note 72, at 629; Hu & Black, *The New Vote Buying*, *supra* note 72, at 816.

82. *See, e.g.*, George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 112 (2010) ("Despite the scholarly jeremiads over empty voting, it has never yet altered the result of a shareholder vote, and problems from it are likely to remain rare or nonexistent.").

83. Hu & Black, *Empty Voting II*, *supra* note 72, at 630.

84. *Id.* at 701.

85. Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 67 (2006).

86. *Id.*

87. *See generally* Hu & Black, *Empty Voting II*, *supra* note 72; Hu & Black, *The New Vote Buying*, *supra* note 72, at 816.

converge, as in the case of pension funds and labor unions, the potential for horizontal conflict arises because of particular causes such funds are interested in advancing.[88] Empty voting illustrates in the clearest way the risk of horizontal conflict costs by showing that the shareholder franchise does not always represent the interests of other shareholders, let alone the firm as a whole.[89] It is not necessary, of course, that each type of shareholder have a long-term focus in order for the market to function effectively, as long as the overall governance system balances competing interests.[90] The question is whether a regulatory regime strikes the right balance. Part II will consider regulatory responses to the financial crisis, demonstrating the problems posed by undue reliance on shareholder empowerment as a cure for managerial short-termism and the systemic risk such reliance has engendered.

II. THE THEORIES BEHIND THE REGULATORY RESPONSES TO THE FINANCIAL CRISIS

Shortly after the financial crisis, Congress enacted the Emergency Economic Stabilization Act of 2008 (EESA),[91] which created the Troubled Asset Relief Program (TARP)[92] to provide funds for failing companies. The next year it enacted the American Recovery and Reinvestment Act of 2009 (ARRA), which imposed rules and restrictions on recipients of TARP funds.[93] More recently, in July 2010, Congress enacted Dodd-Frank, which imposes new corporate governance rules on all publicly traded companies.[94] As we will see, many themes from the bailout regulation reemerge in Dodd-Frank, and these themes focus on shareholder empowerment.

The evolution from atomistic shareholding to concentrated institutional ownership discussed in Part I raises significant questions about the efficacy of the standard shareholder activism toolkit as a response to the financial crisis. This Part will focus on the shareholder-empowerment regulatory strategy and

88. Smith, *supra* note 30, at 285.

89. Anabtawi, *supra* note 5, at 580.

90. Kahan & Rock, *supra* note 52, at 1088–89.

91. Pub. L. No. 110-343, 122 Stat. 3765.

92. *Id.* §§ 101–136.

93. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

94. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

its failure to deal with the problem posed by the modern separation of institutional ownership from beneficial ownership of corporate shares.

A. ACCOUNTABILITY AND THE FIGHT AGAINST SHORT-TERMISM

The corporate governance reforms of both the bailout legislation and Dodd-Frank are concerned with self-interested managerial short-termism, particularly with regard to executive compensation. Major corporate governance provisions of the bailout focused on executive compensation, due to a widespread perception that managers were concerned with short-term financial results and failed to consider the long-term effects of their actions.[95] Under key provisions of the bailout legislation, for example, the senior executives of TARP recipients[96] could not receive compensation that created incentives for those officers to take "unnecessary and excessive risks that threaten the value" of the firm.[97] The law further prohibited any compensation plan that encouraged the manipulation of reported earnings.[98] A clawback provision required that bonuses paid to the twenty-five most highly compensated employees be recoverable if based on "materially inaccurate" financial statements or performance-metric criteria.[99] The concern of these clawbacks is that short-term managers can manipulate earnings or results, reap a large payout, and then lose nothing when the company suffers in the long term as a result of their actions. Recipients' compensation committees were also required to undertake reviews of compensation plans to guard against short-termism.[100]

Dodd-Frank also requires assessments of excessive risk fostering in compensation:

> Not later than 9 months after the date of enactment of this title, the appropriate Federal regulators shall jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment ar-

95. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 360 (2009).

96. Defined as one of the top five most highly paid executives. American Recovery and Reinvestment Act § 7001 (amending Emergency Economic Stabilization Act § 111 to include § 111(a)(1)).

97. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(A)).

98. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(E)).

99. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(B)).

100. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(e)(1)).

> rangement . . . that the regulators determine encourages inappropriate risks by covered financial institutions—(1) by providing . . . excessive compensation, fees, or benefits; or (2) that could lead to material financial loss . . . .[101]

Comparable clawbacks on bonuses also appear in Dodd-Frank.[102] The tenor of these provisions, especially when taken as a whole, is that managers are in it for the short term. Thus, we need to shift incentives to discourage schemes that encourage excessive risk.

Aside from these prescriptive remedies, other reforms—regarding say-on-pay, proxy access, and disclosure—focused on bringing heightened accountability to the board by way of empowering shareholders.[103] These provisions embrace the Berle-Means narrative of separated ownership and control.[104] The goal of both proxy access and say-on-pay is to give a new voice to these disenfranchised shareholders with the hope that they will make boards and managers more accountable for their decisions.[105] Indeed, the Dodd-Frank subtitle dealing with executive compensation is called "Accountability and Executive Compensation."[106]

To be clear, accountability and a need for a more long-term perspective from managers are not synonymous. The desire for a say-on-pay and for proxy access are more about giving shareholders power to voice concerns over managerial overreaching than addressing particular concerns related to short-termism.[107] The Securities and Exchange Commission (SEC) explicitly draws a line between accountability and the shareholder franchise: "A principal way that shareholders can hold boards accountable . . . is through the nomination and election of directors."[108] But a central presumption of the reform tactic of giving shareholders more voice to make managers more accountable is that shareholders are motivated to use their voice

101. Pub. L. No. 111-203, § 956(b) 124 Stat. 1376, 1905 (2010).

102. *Id.* § 954.

103. Bruner, *supra* note 25, at 318.

104. *See generally* BERLE & MEANS, *supra* note 19, at 112–16.

105. *See* Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 42 ARIZ. ST. L.J. (forthcoming 2011) (manuscript at 17), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1537211.

106. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951–957, 124 Stat. 1376, 1899–907 (2010).

107. *See* McDonnell, *supra* note 105, at 17 ("The leading broad value favoring proxy access is accountability.").

108. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,669 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

to further the long-term health of the corporation.[109] As Part I showed, this presumption may not hold. We now turn to an examination of specific corporate governance provisions to examine how shareholder myopia creates problems for specific corporate governance reforms of the bailout.

1. Say-on-Pay

Concern about oversize CEO pay packages and option plans has increased in recent decades,[110] and the options-backdating scandal of 2006[111] heightened concerns that executives were lining their pockets at the expense of shareholders.[112] Not surprisingly, recent legal reforms have focused on shareholder control of executive compensation. Giving the shareholders a say on executive pay at least allows investors some input on the payment of managers.

ARRA imposed a say-on-pay requirement on TARP recipients,[113] a regulatory measure that quickly affected corporate governance more broadly. On January 12, 2010, the SEC adopted Rule 14a-20, which requires a shareholder say-on-pay vote at any "annual (or special meeting in lieu of the annual) meeting of security holders" for all publicly held corporations.[114] Following the lead of the ARRA, the say-on-pay vote is not binding on the board of directors, but merely advisory.[115] Executive compensation also took center stage in Dodd-Frank. The Act requires companies to conduct both say-on-pay[116] and say-on-golden-parachute votes, although again these votes are nonbinding.[117]

Say-on-pay provisions rely on shareholders processing and evaluating CEO pay and casting an informed vote on whether

109. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 8–9.

110. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 61–79 (2004).

111. *See generally* Jesse M. Fried, *Options Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853 (2008).

112. *Id.* at 880.

113. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3765, 3776–77, to include § 111(e)).

114. 17 C.F.R. § 240.14a-20 (2010).

115. *Id.*

116. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–905 (2010).

117. *Id.*

the pay package is good or bad.[118] Dodd-Frank in particular makes the populist move of requiring public companies to disclose the ratio of CEO pay to median employee pay.[119] But in light of the current investment landscape, reliance on shareholders to check managerial greed is all but incoherent.[120] Hedge funds, mutual funds, and empty voters are unlikely to pay much attention to CEO compensation.[121] While the manner of compensation and the incentives it creates might be of concern, an up-or-down, after-the-fact vote on an overall compensation plan does not address these worries. Because even an outsized pay package represents only a small portion of a public corporation's expenses, executive compensation poses little cause for concern to a strategic investor like a hedge fund.[122] Mutual funds lack the motivation to vote at all, let alone in a principled way, given the relatively small position any one company represents in their portfolio and the funds' high rates of churn.[123] The votes that an empty voter is buying are not nonbinding votes on executive compensation, but rather votes on acquisitions, dividends, and the like.[124] In terms of institutional investors, then, we are left with pension funds and labor unions. Even these managers, however, may not vote against executive pay packages to foster long-term corporate value.[125] Instead, they are more likely to voice opposition to curry favor with constituents or to express a political view.[126]

In short, relying on say-on-pay votes to create useful correctives to high short-term executive compensation schemes—and the threat to long-term corporate well-being that such schemes entail—seems ill-conceived. Some short-term-focused investors will not care about the issue at all. Others will prefer

118. *Id.* §§ 953, 955.

119. *Id.* § 953.

120. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 21 n.67.

121. Thomas & Martin, *supra* note 68, at 68.

122. *Cf.* Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager*, 2005 U. ILL. L. REV. 269, 281 (discussing the relationship between management pay and company income); Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* 38 (Vanderbilt Univ. Law & Econ. Research Paper, No. 06-21, 2006), *available at* http://ssrn.com/abstract=931254 (discussing hedge fund trading strategies).

123. *See supra* Part I.A.

124. *See supra* Part I.D.

125. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1754.

126. *See supra* Part I.C.

compensation schemes that reward a managerial short-term focus that mirrors their own. Finally, pension and union funds may vote, but not necessarily with an eye to the best interests of the firm. Shareholder empowerment as to say-on-pay thus provides little, if any, safeguarding of long-term corporate interests.

2. Proxy Access

Proxy access advocates have long criticized the uncontested nature of the typical annual director election, in which the company proposes a slate and shareholders then vote for the management-designated directors—or, as most do, simply toss the ballots in the trash can.[127] While insurgents have always been able to launch proxy contests, waging these battles is costly for the protesting shareholders, so that they are seldom undertaken except in the context of takeovers.[128] Outside of a hostile takeover (by necessity, the preserve only of extremely wealthy shareholders), the most voice a discontented shareholder can muster is purposefully not voting, or withholding her vote for the management slate, as a sign of displeasure. The idea of proxy access is to give large shareholders a chance to nominate their own candidates, creating a contested election that gives all shareholders a meaningful choice at the corporate ballot box.[129]

While Dodd-Frank does not require the SEC to promulgate proxy access rules, it affirms its power to do so.[130] Acting pursuant to this grant of authority, the SEC duly issued a final rule that at last made proxy access a reality on August 25,

127. Fairfax, *supra* note 69, at 1264–67.

128. *Id.* at 1265.

129. *Id.* at 1267–68.

130. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010). Dodd-Frank also requires national securities exchanges to prohibit broker discretionary voting, unless the stock's beneficial owner specifically instructs the broker to vote, a measure that will remove many desultory votes for management's slate. § 957. The New York Stock Exchange (NYSE) had earlier eliminated broker discretionary voting this proxy voting season. Order Approving NYSE Proposed Rule Change Relating to Broker Discretionary Voting, SEC Release No. 60215 (July 1, 2009) [hereinafter SEC Rule 452 Release], *available at* http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf. Discretionary voting enables brokers to vote on behalf of the ultimate shareholders, without receiving specific instructions from them. Fairfax, *supra* note 69, at 1292. Interestingly, uncontested elections of companies regulated under the Investment Company Act are exempt, an important fact given the power of institutional investors like mutual funds and pension funds. SEC Rule 452 Release, *supra*.

2010.[131] A nominating shareholder or shareholder group must fulfill certain requirements to be able to put forward an alternative director or directors.[132] In particular, it must: (1) own at least three percent of the company's securities entitled to be voted at the meeting, (2) have owned these securities continuously for at least three years, and (3) maintain this ownership through the meeting date.[133] The nominator cannot hold the securities with an intent to gain control of the firm or have an agreement with the company regarding the nomination.[134] The SEC rule, however, has not yet taken effect. Rather, the SEC has stayed its operation pending resolution of a suit filed by the Business Roundtable and the Chamber of Commerce.[135]

The logic of proxy access presumes that the corporation as a whole will benefit if shareholders have a choice among potential directors, including nominees that come from shareholders who are disconnected from corporate managers.[136] Proxy access critics voice two main fears. First, the firm will suffer the ill-effects of short-term-focused investors if the board is no longer insulated from proxy challenge.[137] Second, shareholder nominees will be special-interest candidates, focused on idiosyncratic agendas rather than the overall good of the corporation.[138] The SEC took steps to address the first concern by imposing a holding period of three years on would-be director nomina-

131. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

132. *Id.* at 56,689.

133. *Id.*

134. *Id.*

135. Brief of Petitioner at 4, Bus. Roundtable v. U.S. Sec. & Exch. Comm'n, No. 10-1305 (D.C. Cir. Nov. 30, 2010), 2010 WL 5116461.

136. Brief for Respondent at 25–26, *Bus. Roundtable*, No. 10-1305 (D.C. Cir. Jan. 19, 2011), 2011 WL 496545.

137. *See, e.g.*, Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rule: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 379 (2010) ("[P]roxy access generates 'megaphone externalities' that are exceptionally valuable to labor unions and public pension funds. These megaphone externalities describe the additional publicity that accrues, at very little cost, to shareholder groups that run their own board nominees advocating a particular cause."). However, as Lisa Fairfax points out, proxy access might actually decrease the power of special interest groups by broadening access to include more shareholders. Fairfax, *supra* note 69, at 1272.

138. Proxy access advocates such as Lisa Fairfax and Brett McDonnell counter that candidates still need to obtain the majority of the shareholder vote, which offers protection against the special interest danger. Fairfax, *supra* note 69, at 1272; McDonnell, *supra* note 107, at 19.

tors.[139] This requirement, however, provides only a partial solution to the problem of shareholder short-termism. The difficulty is that the holding-period requirement only ensures that director *nominators* will be (relatively) long-term investors.[140] Investors, however, now wear two hats—as both nominators and voters—and solving the short-term nominator problem does not address the short-term *voter* problem.[141]

A key question thus presents itself: Who will vote in the greater number of contested board elections likely to result from the SEC's new proxy access rules? Empty voters, hedge funds, and pension funds could all vote, and their votes would count all the more in light of the elimination of broker discretionary voting.[142] The new proxy access rules, however, forbid shareholders from nominating candidates if their intent is to gain control over the corporation, which will make hedge funds and empty voters less likely to nominate directors or participate in the process.[143] Mutual fund managers are also unlikely to participate because of the diversity of their portfolios and their short-term focus;[144] it is simply a waste of effort for managers to expend energy on researching director candidates because they will likely not hold a corporation's stock for more than a year.[145] Because only long-term shareholders are eligible

139. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,674 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

140. *See id.* For purposes of this discussion I will take as a given that three years constitutes a long-term investment horizon. As we have seen, in the current investing climate, it certainly does.

141. Fairfax, *supra* note 69, at 1263.

142. Under the former model, uncontested director elections were considered "routine," and brokers could vote shares for management candidates without voting instructions from shareholders. Fairfax, *supra* note 69, at 1292–93. Under the new NYSE rules, and Dodd-Frank, brokers will no longer be able to vote for management candidates without specific instructions from shareholders. *Id.* at 1292; *see supra* notes 130–35 and accompanying text.

143. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,675.

144. *See, e.g.*, Lilian Ng et al., Do Mutual Funds Vote Responsibly? Evidence from Proxy Voting 5 (Jan. 2007) (unpublished manuscript), *available at* http://69.175.2.130/~finman/Orlando/Papers/MFVoting_Jan07.pdf ("[C]orporate governance experts have long questioned often conflicted voting of mutual funds and their failure to be vocal in cases of gross corporate mismanagement. Some mutual funds are suspected of not casting their votes, others are assumed to blindly vote with management . . . . Moreover, mutual funds have historically been considered less involved in governance, compared with other institutions, especially pension funds. Their frequent trading due to short investment horizons, as contrasted with pension funds, has been considered part of the reason.").

145. *Id.*

to nominate directors, presumably few short-termist candidates will make it to the corporate ballot.[146] In short, proxy access offers a choice to shareholders that many may be rationally uninterested in choosing.

The rational apathy of mutual funds and hedge funds in director elections magnifies the second concern—the idiosyncratic shareholder.[147] The three percent holding requirement seeks to ensure substantial commitment to the firm by nominators, and proxy-access defenders can argue that any shareholder-nominee still requires the buy-in of other shareholders in order to succeed.[148] However, combine the rational apathy problem with the elimination of broker discretionary voting, and labor unions and pension funds may well have a disproportionately large voice in any corporate vote.[149]

Proxy access, then, gives long-term shareholders a voice in ballot composition, but does not address the question of who will vote. Two problems arise from this state of affairs. First, many intermediaries may not vote at all.[150] Second, those who do vote may well be the most idiosyncratic of shareholders.[151] In sum, proxy access as currently implemented is unlikely to address the short-termist problem at all.

B. Empowering Short-Term Shareholders Will Not Make Corporations Focus on the Long Term

The corporate governance reforms in both the bailout legislation and Dodd-Frank are fundamentally concerned with companies' short-term focus. Yet the solutions they offer rely on empowering shareholders who, as we have seen, are themselves predominantly focused on the short term. The reforms are thus unlikely to achieve their goal.

Before turning to this central thesis, two related arguments—the first in opposition to the bailout reforms themselves and the second in opposition to the central thesis of this Article—must be acknowledged and addressed. The first is that the bailout reforms are ill-advised *because* they seek to maximize the long-term wealth of a corporation; according to some critics, any shareholder-focused agency model should encourage

146. *See supra* note 139 and accompanying text.
147. *See supra* Part I.C.
148. Fairfax, *supra* note 69, at 1268.
149. *Id.* at 1271.
150. *Id.* at 1269.
151. *Id.* at 1270–71.

management to maximize the corporation's short-term stock price.[152] This view, however, is in tension with several principles of corporate law.[153] The shareholder-wealth-maximization norm gives managers a great deal of leeway in how they go about their maximizing, and the pursuit of short-term price appreciation is clearly not required.[154] It is true, as Jeffrey Gordon has pointed out, that short-term stock prices are more reliable today than in the past as a measure of management's performance.[155] But that observation is largely beside the point. There is ample room in the shareholder-wealth-maximization norm to privilege long-term over short-term wealth maximization, as the governmental response to the bailout seeks to do.

The second argument opposes this Article's suggestion that empowering short-termist investors will not protect a corporation's long-term interests. On this view, because present market price merely reflects long-term value, there is no problem.[156] In other words, even short-term investors have incentives to maximize long-term value, so that both groups' incentives are aligned.[157] Long-term projects, however, may require expensive investments that are difficult for the market to process.[158] Both firm and fund managers have historically been compensated based on quarterly numbers, which encourages short-termism, earnings management,[159] and, in the worst cases, outright fraud.[160] As William Bratton and Michael Wachter argue, "maximizing the corporation's fundamental value and maximizing its stock price can amount to distinct objectives in the presence of information asymmetries."[161] Inevitably, such asymmetries exist between managers and public investors.[162]

152. Bratton & Wachter, *supra* note 5, at 711–12.

153. *Id.* at 658–59.

154. *Id.* at 711–12.

155. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1541 (2007).

156. Bratton & Wachter, *supra* note 5, at 668.

157. *Id.*; Dent, *supra* note 82, at 122–23.

158. Bratton & Wachter, *supra* note 5, at 700–01.

159. *See id.* at 702.

160. David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 892–97 (2002) (discussing quarterly earnings pressures and instances of fraud at Enron, WorldCom, and others).

161. Bratton & Wachter, *supra* note 5, at 703.

162. *See id.* at 697. The author acknowledges that market myopia can be used as an excuse to shield poor managers from criticism. *See* Kahan & Rock,

What is most problematic for the bailout reforms is that shareholders with a predominantly short-term focus probably *want* managers to opt for a similarly short-term focus.[163] Both groups want to maximize corporate earnings in terms measured in days, months, or quarters, rather than in years. Thus, for example, relying on the shareholders' say-on-pay vote does not achieve the goal of ensuring that pay is in any sense fair or in keeping with the long-term interests of the corporation.[164] Similarly, compensation structures that encourage short-term gains at the cost of long-term risk might actually be attractive to a shareholder looking for a quick payday and early exit from her investment.

This is not to say that efforts to render managers accountable to shareholders are inevitably futile. The point instead is that empowering shareholders—because of their predominantly short-term outlook—is not well calculated to achieve the ends financial reform appears to have intended, particularly the end of reducing larger systemic risks that arise from corporate managers' short-term focus.[165]

The question, then, is where to go from here. Shareholder advocates argue that the need for some check on vertical agency costs—in the form of heightened managerial accountability—remains.[166] As Brett McDonnell succinctly puts it, "The political deck is stacked in favor of managers and boards and against shareholders . . . ."[167] He rightly observes that corporate managers and boards are better able to organize politically and that states cater to them because managers choose the place of incorporation.[168] This Article does not deny the existence of these forces and resulting vertical agency costs; it merely questions whether shareholder empowerment as currently conceived offers a coherent solution.

Advocates of the status quo manager-shareholder balance counter that capital markets—particularly the market for corporate control—provide needed correctives to managerial over-

supra note 52, at 1085 n.271 (collecting finance literature on the market's alleged short-termism).

163. *See* Bratton & Wachter, *supra* note 5, at 711.

164. *Id.* at 710–11.

165. *Id.* at 711.

166. *Id.* at 655.

167. Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 188 (2009).

168. *Id.*

reaching.[169] According to Stephen Bainbridge, for example, some agency costs will inevitably exist,[170] but critics have greatly overemphasized their extent and seriousness.[171] There are, however, significant problems with this view. To begin with, saying that agency costs are overemphasized is not saying that these costs do not exist. And, in any event, the logic of the bailout regulation is that managerial short-termism has created systemic risk by imposing negative externalities on the larger economy.[172] On this view, market mechanisms cannot solve the problem; if anything, they may exacerbate it by driving managers to ever-more-risky decisions that increase shareholder welfare in the immediate term at the expense of the long-term.[173] Taking this concern seriously, Part III will canvass remaining regulatory mechanisms designed to focus managers on the longer-term interests of their firms.

III. OTHER POTENTIAL SOLUTIONS TO MANAGERIAL SHORT-TERMISM

As the last Part has shown, giving greater voice to myopic shareholders will not solve the problem of managerial short-termism. Shareholder empowerment simply pushes agency costs down a level, creating horizontal conflicts as shareholder groups privilege idiosyncratic interests and differing time horizons.[174] This section surveys potential solutions to the problem of suboptimal managerial short-termism apart from shareholder empowerment.

169. Bratton & Wachter, *supra* note 5, at 669; Bainbridge, *Shareholder Activism and Institutional Investors*, *supra* note 5, at 7.

170. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1747.

171. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 232 (2008) ("[M]odern corporate governance scholarship has focused on finding a means to bridge the agency gap between diversified risk bearers and managers."); Bainbridge, *Shareholder Activism and Institutional Investors*, *supra* note 5, at 7.

172. Bratton & Wachter, *supra* note 5, at 659.

173. *See* Fisch, *supra* note 27, at 882 ("Indeed, the objectives of the diversified institutional shareholder do not provide meaningful limitations on managerial risk-taking and may cause managers to take excessive risk in an effort to boost share price.").

174. *See supra* Part I.C.

A. DISCLOSURE

Disclosure is the hallmark reform in the American system: Brandeis's sunshine[175] works its magic because, when investors have the relevant facts, the market is able to price stocks fairly, at least according to a semistrong efficient capital markets hypothesis.[176] Unlike say-on-pay and proxy access, disclosure does not focus specifically on giving a voice to current shareholders.[177] Instead, it is an accountability mechanism that ensures that the overall market—including prospective investors—have an accurate picture of the health of the organization.[178] Aside from shareholder empowerment, disclosure is the chief tactic that financial reform legislation has embraced.[179] As this section will show, although it is politically easy to impose a disclosure mandate, recent research questions whether disclosure alone is enough to influence investor behavior.[180] Furthermore, disclosure of short-term incentives in executive compensation may only attract investors already biased to the short term themselves, thus undercutting the very purpose of requiring disclosure in the first place.

The bailout legislation required less disclosure than Dodd-Frank, and in the case of private firms it needed only to be made to the Treasury Department.[181] However, in direct response to the AIG corporate retreat scandal, the ARRA did require disclosure of company-wide policies on excessive or luxury

175. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY—AND HOW THE BANKERS USE IT 62 (Nat'l Home Library Found. ed. 1914).

176. The classic explanation for the mechanism by which the market processes information is set forth in Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 553 (1984).

177. *See id.* at 638 (arguing that members of the professional trading community benefit most from disclosure).

178. Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis* 3 (U.C. Berkeley Pub. Law Research Paper No. 1585953, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1585953 (noting that disclosure was expected to allow investors to analyze credit risk).

179. Gilson & Kraakman, *supra* note 176, at 635 (detailing the debate over the Securities Exchange Act of 1934).

180. Bartlett, *supra* note 178, at 51 (showing how disclosure in a sector of the market did not appear to change investor behavior).

181. *See* Katie Feuer, *What Dodd-Frank Means for Public Companies*, INSIDE INVESTOR REL. (Aug. 1, 2010), http://www.insideinvestorrelations.com/articles/16271/dodd-frank-means-public-companies/ (describing the additional reporting requirements enacted in Dodd-Frank).

expenditures.[182] Public TARP recipients were required to disclose narrative descriptions of compensation plans,[183] and to provide explanations of how they did not encourage senior officers to take unnecessary and excessive risks.[184] Recipients also had to explain how general employee compensation plans limited unnecessary risks,[185] and explain why these plans did not encourage the manipulation of reported earnings.[186]

Dodd-Frank likewise requires disclosures on executive compensation,[187] the ratio of median compensation of employees to the CEO's annual compensation,[188] employee and director hedging,[189] compensation structure,[190] and the reasons why the company has elected to combine or split the CEO and chairman of the board positions.[191]

What could be wrong with legal mandates of this sort? Disclosure requirements are, after all, the easiest reform to implement because they refrain from imposing any substantive mandate on corporations.[192] One problem is that the semi-strong efficient capital markets hypothesis argues that market prices take account of all publicly available information.[193] Subsequent research in behavioral finance, however, has challenged this model by questioning whether the market actually

182. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(d), 122 Stat. 3765, 3777, such that "[t]he board of directors of any TARP recipient shall have in place a companywide policy regarding excessive or luxury expenditures," including "entertainment or events; office and facility renovations; aviation or other transportation services; or other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures").

183. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(4)).

184. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(A)).

185. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(c)(2)).

186. *Id.* (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(B), (b)(4)).

187. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953(b)(1)(B), 124 Stat. 1376, 1904 (2010).

188. *Id.* § 953(b)(1)(C).

189. *Id.* § 955.

190. *Id.* § 956.

191. *Id.* § 972.

192. Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 3 (2010).

193. Lynn Stout, *The Mechanics of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639 (2003).

does accurately reflect all publicly available information.[194] Recent literature has highlighted how even professional investors can be distracted from processing relevant public information.[195] The information's salience appears to play a large role in its ability to affect the market.[196] For example, when the scientific journal *Nature* published information on a potential cancer breakthrough for pharmaceutical company EntreMed, the stock appreciated significantly—by 28.4 percent.[197] The information was concurrently reported in the *New York Times* and in other mainstream media, but not in headline stories.[198] Five months later, a front page *New York Times* article containing "virtually the same information" caused a second much higher, and permanent, rise in the company's stock price.[199] In short, "it seems that the no-new-news [front-page] *Times* article caused the stock price to more than double, on a permanent basis."[200]

A recent study by Robert Bartlett likewise casts doubt on the market's ability to process low-salience information.[201] Bartlett examines the monoline insurance industry in 2008.[202] Because of European regulatory requirements, investors had information not only on some monoline insurers' exposure to collateralized debt obligations (CDOs), but also on underlying portfolio compositions and ratings downgrades for bonds included in them as significant investments.[203] Bartlett found insurers' stock prices virtually unaffected despite announcements of downgrades in these important underlying securities.[204] Even more interesting, a hedge fund that had been shorting one of the insurers failed to account for the publicly available information.[205] A possible reason for this failure lies in the accessibility of the information. Even though the information was publicly available, obtaining it would have meant analyzing

194. *Id.* at 651–59.
195. *Id.* at 659.
196. *Id.* at 655.
197. Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 J. FIN. 387, 390 (2001).
198. The *New York Times* story, for example, was on page A28. *Id.*
199. *Id.* at 391.
200. *Id.* at 388.
201. Bartlett, *supra* note 178.
202. *Id.* at 4–5.
203. *Id.* at 5.
204. *Id.* at 6.
205. *Id.* at 39.

300- to 400-page prospectuses for each of 534 underlying CDOs, a logistical challenge apparently too great even for highly motivated and sophisticated arbitrageurs.[206] Bartlett's work suggests that it is not the act of disclosure, but the visibility of disclosure—that is, its salience—that matters most.[207] Investors, including professionals, have only limited attention to devote to processing information.

Despite this research, the regulators have continued to assume that more disclosure is better than less, while giving little attention to the salience of required disclosures.[208] In the most extreme case, following corporate spending scandals,[209] the luxury expenditures section of ARRA required that the boards of TARP recipients adopt

> a companywide policy regarding excessive or luxury expenditures, as identified by the Secretary, which may include excessive expenditures on—(1) entertainment or events; (2) office and facility renovations; (3) aviation or other transportation services; or (4) other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the business operations of the TARP recipient.[210]

Treasury regulations permitted such disclosures via website.[211] But website disclosure is of relatively low salience, and therefore of little utility, to investors.[212] In contrast to information made readily available to all in centralized SEC filings, this information is contained on each individual company web-

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206. *Id.* at 40–41.

207. *Id.* at 49.

208. *Id.* at 51.

209. *E.g.*, Peter S. Green, *Merrill's Thain Said to Pay $1.2 Million to Decorator (Update 1)*, BLOOMBERG, Jan. 23, 2009, *available at* http://www.bloomberg.com/apps/news?sid=aFcrG8er4FRw&pid=newsarchive (noting former Merrill Lynch & Co. CEO John Thain's reported $1.2 million office renovations in January 2009); Ed Henry, *Citi Says No to $45 Million Jet*, CNNMONEY, Jan. 27, 2009, http://money.cnn.com/2009/01/27/news/companies/citigroup_jet/?postversion=2009012716 (describing the Citigroup plane fiasco); Sean Lengell, *AIG Execs Hold $440K Post-Bailout Retreat*, WASH. TIMES, Oct. 7, 2008, http://www.washingtontimes.com/news/2008/oct/07/aig-execs-hold-440000-post-bailout-retreat/?page=1 (reporting the over $440,000 AIG retreat in October 2008).

210. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3765, 3776–77).

211. 31 C.F.R. § 30.12 (2010).

212. *Cf.* Rodrigues & Stegemoller, *supra* note 192, at 26 (describing the problems with Internet disclosure in the context of ethics codes).

site and thus must be looked up separately.[213] The information is also transitory in nature, and subject to modification at the discretion of the company.[214]

Cynics will point out that luxury-expenditure disclosure requirements were politically motivated and that no one actually expects these policies to affect the market. Fair enough. In fact, I will go a step further. Requiring trivial disclosures with little expected effect once more risks the placebo effect of regulation—the illusion that regulation addresses a problem when it in fact does not. Furthermore, requiring additional disclosure risks crowding out information actually useful to the average investor.

Dodd-Frank mandates disclosures to be made in proxy statements.[215] This information is thus made more visible to investors. Rather than combing websites or European regulatory filings, analysts merely have to read SEC filings that are readily accessible online.[216] Still, proxies contain a great deal of information, and some research suggests that this disclosure is "noisy" and easy for investors to ignore.[217]

Disclosure requirements are easy to impose, largely because they promise to thread the needle between firm autonomy and government regulation. Although conservatives will gripe about the compliance costs and litigation risks imposed by these legal mandates, they have much to commend them. Instead of deciding what corporations should actually do in the highly politicized realm of executive compensation, corporations are merely required to disclose what they are doing.[218] Yet increased disclosure in this area seems to have led only to higher corporate pay packages and an increase in relatively

213. *Cf. id.* at 65–66 (explaining that ethics code disclosures would be easier to access if it were available from a centralized SEC source).

214. *Cf. id.* (noting that website information about ethics codes is often deleted by companies after a year).

215. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–900 (2010).

216. Rodrigues & Stegemoller, *supra* note 192, at 1.

217. *See id.* at 45 ("[P]roxy disclosure is muddled disclosure, providing companies with the opportunity to obscure negative information by disclosing it along with a plethora of other matters. If investors have a large amount of information to process and only limited time and attention (as they do), then disclosing information in a 'noisy' setting may distract investors from otherwise pertinent information." (citing DANIEL KAHNEMAN, ATTENTION AND EFFORT 5–11 (1973))).

218. Dodd-Frank Wall Street Reform and Consumer Protection Act § 951.

low-salience information, with little promise of true change.[219] Particularly given the investor myopia documented in Part I, disclosure of pay packages that motivate managers to pursue short-term gain at the expense of long-term risks for the firm may do nothing more than increase the attractiveness of the firm to similarly short-term investors.

B. INDEPENDENCE

I have written in the past on the fetishization of independence as a governance goal.[220] Here I will observe only that a regulatory focus on independence reflects a misplaced conviction that problems often lie in hidden ties between management and the board that result in rent-seeking. From a pro-independence perspective, the ideal board member is defined by the absence of conflict rather than the presence of any affirmatively good quality, such as business acumen, specific industry knowledge, or financial sophistication. This section will discuss independence only briefly in part because the basic point is simple: while a lack of independence may have intensified the financial crisis, board independence was not the problem.

Treasury regulations promulgated under EESA and ARRA required that TARP recipients establish compensation committees composed solely of "independent" members of the company's board of directors.[221] Post-Sarbanes-Oxley (SOX), these requirements already applied to most publicly traded companies via stock exchange rules.[222] Even before the recent financial crisis, many large private companies had already conformed to this requirement, taking the precautionary approach of follow-

219. *See, e.g.*, Jonathan R. Macey, *Washington's Plans May Result in Even Higher Executive Pay*, WALL ST. J., Oct. 24, 2009, at A15 ("The government also has tried to regulate executive compensation by requiring greater disclosure of the details of compensation plans. Perversely, this too has contributed to an increase in executive pay. How so? No self-respecting board of directors is willing to admit that their company's CEO is below average. So anytime the new disclosures indicate that an executive's pay is below average in any way, a pay increase is ordered.").

220. *See generally* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008).

221. 31 C.F.R. §§ 30.1–.4 (2009).

222. Order Approving NYSE & NASD Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,175 (Nov. 12, 2003) (approving NYSE Final Rule codified at NYSE LISTED COMPANY MANUAL § 303A (2002) and NASD Amendments to Rules 4200 and 4350(c)).

ing corporate governance best practices.[223] The new rules thus called on public companies to do what they already largely had done.

Conflicts in outside rating agencies may well have exacerbated the financial crisis by creating seemingly independent evaluators that actually tailored their ratings to the needs of their clients, the institutions offering the securities.[224] This was, and is, a genuine problem, which Dodd-Frank addresses much as SOX had previously addressed conflicts between corporate managers and outside auditors.[225] In contrast, within corporations or banks there were few allegations of boards or board committees having ties to executives or managers that skewed their compensation. Although compensation schemes may have been marked by flaws, those flaws seemed rarely to involve classic cases of conflict that an independent compensation committee seeks to avoid, such as overpaying a trader who was a director's or officer's brother or former boss, for example. Despite the lack of a demonstrated problem with compensation committee independence, the general approach of EESA and ARRA seems to be that independence is good, and more independence is better. Given the preexisting prevalence of independent compensation committees, imposing an independence requirement on TARP beneficiaries[226] was a near-costless governance reform.

Dodd-Frank broadened the independent compensation committee requirement to include all public companies.[227] It specified that, when promulgating rules regarding defining independence, the SEC should consider "the source of compensation . . . , including any consulting, advisory, or other compensatory fee" paid to the director and whether the director is affiliated with the issuer or a subsidiary.[228] The regulatory presumption again appears to be that where there is a problem, its

223. *See generally* FREDERICK D. LIPMAN, CORPORATE GOVERNANCE BEST PRACTICES 84 (2006) (asserting that private companies should retain compensation committees).

224. *See* Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47, 47–48 (2010).

225. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010).

226. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3765, 3776–77).

227. Dodd-Frank Wall Street Reform and Consumer Protection Act § 952.

228. *Id.*

root must lie in a hidden conflict of some kind, even though the existence of such conflicts was already extremely unlikely given the near-universality of independent compensation committees.

The real conflict is structural. Excessive compensation is more likely the product of increased use of compensation consultants and benchmarking against the packages offered to comparable executives within the same industry.[229] Use of consultants tends to inflate fees.[230] A 2007 Corporate Library Report, for example, concluded that "companies using consultants offer significantly higher pay than companies not using consultants and that engaging the services of a compensation consultant does not appear to increase the effectiveness of incentive

229. *See* Macey, *supra* note 219.

230. Kevin J. Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants*, 49 J. ACCT. & ECON. 247, 248 & n.2 (2010). This correlation has been largely attributed to the use of compensation consultants with significant conflicts of interest, which can arise when a compensation consultant provides other services to a company (e.g., "employee benefit administration, human resource management, and actuarial services") at the same time as it provides advice on compensation. STAFF OF H.R. COMM. ON OVERSIGHT & GOV'T REFORM, 109TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS 1–2, 6 (Comm. Print 2007) [hereinafter Waxman Report]. According to the Waxman Report, in 2006, over one hundred of the Fortune 250 companies used compensation consultants with such conflicts of interest. *Id.* at 9. The twenty-five Fortune 250 companies that used the most conflicted compensation consultants paid their CEOs a sixty-seven percent higher median salary than the median salary paid by Fortune 250 companies that did not use conflicted consultants. *Id.* at 6. Another source of consultant conflict comes from the fact that compensation consultants traditionally have been hired by management—on whose pay the consultant is supposed to objectively advise and from whom the consultant expects future business—rather than the compensation committee. Murphy & Sandino, *supra* at 252; *see also* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 772 (2002) ("Because managers choose which compensation consultants to hire, the consultants have a clear incentive . . . to make recommendations favorable to managers . . . . Thus, the information presented and the way it is framed will be chosen with an eye toward maximizing managers' compensation."). Some studies have found, on the contrary, that consultant conflicts of interest might not relate to increases in executive compensation. For example, while concluding that CEO compensation was indeed higher in companies that used compensation consultants that provided other services, Murphy and Sandino found surprising evidence that CEO compensation was lower when the compensation consultant was retained by management. Murphy & Sandino, *supra*, at 260; *see also* Brian Cadmun et al., *The Incentives of Compensation Consultants and CEO Pay*, 49 J. ACCT. & ECON. 263, 278 (2010) ("[W]e are unable to find evidence linking potential conflicts of interest of compensation consultants to more lucrative CEO pay packages."). Even if conflicts of interest do occur, criticism focuses at the level of consultants, not with the directors themselves. Increased director independence thus serves little purpose.

plans."[231] The ramifications of increased compensation committee independence are thus relatively modest, as are the payoffs of this reform.[232]

Popular discontent regarding high levels of executive compensation undeniably exists.[233] Yet the regulatory tools employed to address this concern—increased independence and heightened disclosure—are of little practical significance as a curative. Widespread use of independent compensation committees and disclosure, the main regulatory tools of the past two decades, have failed to solve this problem. The logical alternative, both in reining in compensation and in addressing short-termism more generally, is the politically unpalatable path of substantive government regulation.

C. SUBSTANTIVE GOVERNMENT REGULATION

Dodd-Frank has increased capital requirements for large banks.[234] It also has widened the scope of regulation for nonbank financial companies that pose risks to the country's financial stability.[235] The bailout regulations limited executive compensation to $500,000 for recipient firms[236] and prohibited golden parachutes.[237] One can debate whether executive pay is excessive and should be regulated, but substantive regulation that sets clear limits—such as the European Union's recent move to place ceilings on banker bonuses[238]—is a more coherent way of holding down executive pay than offering shareholders a vote on that pay or forcing companies to disclose comparisons of CEO compensation to that of the rank-and-file or

231. Murphy & Sandino, *supra* note 230, at 248 n.2.

232. *Id.*

233. *See generally* Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585 (2007) (discussing concerns about the rising level of CEO compensation).

234. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 171(b), 124 Stat. 1376, 1436–38 (2010).

235. *Id.* § 113.

236. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 302, 122 Stat. 3765, 3909–10.

237. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending Emergency Economic Stabilization Act § 111 to include § 111(b)(3)(C)).

238. Banks must defer forty to sixty percent of bonuses for three to five years, and at least half of the nondeferred (that is, immediately paid) portion must be in securities linked to the bank's performance. Nikki Tait, *EU Parliament Backs Tough Bonus Rules*, FIN. TIMES, (London) July 7, 2010. Thus, only twenty to thirty percent of the bonuses would be in cash. *Id.*

compensation structures, or evaluating their riskiness.[239] Substantive choices on pay are more politically risky than disclosure because they involve backing a particular position, and political realities may preclude imposing hard compensation caps on CEOs.[240] But pretending, in the face of the current investment landscape, that shareholder empowerment mechanisms like say-on-pay and increased disclosure will constrain pay is disingenuous.[241] Short-term investors want short-term managerial incentives, and disclosure of or votes on these incentives will only empower shareholders to reinforce those preferences.

D. GOVERNMENT REGULATION OF THE INTERMEDIARY

If a problem inheres in the disconnect between the long-term beneficial owners of stock and the short-term vehicles they invest in, then a logical regulatory fix involves policing the intermediary. Congress considered, but ultimately declined to incorporate into Dodd-Frank, a fiduciary standard for broker-dealers. Congress, however, did direct the SEC to undertake a study on the matter and granted the SEC discretionary authority to adopt rules on the subject.[242]

Vice Chancellor Leo Strine has offered a number of intriguing solutions, all aimed at aligning the interests of long-term owners and the institutional investors that manage their money.[243] Strine's proposals include:

> 1) pricing and tax strategies to encourage investing and discourage churning by institutional investors and "fund hopping" by end-user investors;
>
> 2) enhanced requirements for institutional investors to factor concern about fundamental risk, leverage, and legal compliance into their investing and corporate governance decisions;
>
> 3) requirements that investment manager compensation be aligned with the investment horizons of end-user investors;
>
> 4) considering a mandated separation of funds managing 401(k) and college savings investments from more liquid investments, and requiring investing practices consistent with retirement and college investment objectives;

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239. *See id.*

240. Liz Alderman, *Cap on Bank Bonuses Clears Hurdle in Europe*, N.Y. TIMES, July 8, 2010, at B1, *available at* 2010 WLNR 13653621.

241. Colin Barr, *Why 'Say on Pay' Won't Work*, CNNMONEY, Nov. 16, 2009, http://money.cnn.com/2009/11/16/news/shareholders.pay.fortune.

242. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(b), 124 Stat. 1376, 1824–25 (2010).

243. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 18–19.

> 5) requirements that index funds vote shares and engage in activism in a manner consistent with the funds' commitment to hold the entire benchmark index;
>
> 6) leverage limitations, broader disclosure and other regulations for hedge funds that decrease the ability and incentive of these funds to effectively push public corporations into risky business decisions;
>
> 7) mandating that institutional investors disclose fuller and more timely information about their economic interests (including their ownership of derivatives and short positions) and about their voting and share lending policies;
>
> 8) restoring the sophisticated investor exception to allow[the wealthy to engage in risky investments], and requiring pension, charitable, and governmental investment funds to only invest through investment advisors covered by the 1940 Act; and
>
> 9) prohibiting pension, charitable, and governmental investment funds from relying on the advice of proxy advisory services unless those services give voting advice based on the economic perspective and goals of an investor intending to hold her stock for at least five years.[244]

These proposals all involve changing the incentives of intermediaries to make them focus on the longer-term investing horizon of investors and, hopefully, to take more responsibility for the votes and choices they make as investors in public companies.[245] At the least, these proposals thus represent a much-needed recognition of the short-term/long-term disconnect. This is not the first time institutional investors have offered a tempting reform target.[246] The Private Securities Litigation Reform Act of 1995 (PSLRA) established a rebuttable presumption that the plaintiff with the largest financial interest—usually an institutional investor—be appointed lead plaintiff in a securities class action,[247] relying on the "money" to do the monitoring.[248] Subsequent evidence revealed an unwillingness of some institutional investors to serve[249] or even to collect

244. *Id.*

245. *See id.*

246. James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 855 (2002) ("Commencing two decades ago, and continuing today, the institutional investor is the most significant focus in reform efforts for securities markets and the American corporation.").

247. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 738–42.

248. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2053 (1995).

249. Charles Silver & Sam Dinkin, *Incentivizing Institutional Investors to Serve as Lead Plaintiffs in Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471, 471 (2008).

money from class action settlements.[250] The legacy of the PSLRA teaches us that policing would be required, either by investors or the government, to ensure that the new requirements of the Strine proposals would be met.

Institutional investors introduce agency costs of their own, which undermine their ability to play an effective monitoring role. Mutual fund managers are rationally unwilling to invest resources in monitoring portfolio companies when that will increase their costs. Bank trust departments have an institutional interest in keeping their client companies happy, as do insurers and mutual fund companies, which often vie for the pension and the defined contribution business of portfolio companies.[251] Strine's suggestions begin to address these problems but require monitoring of their own.[252] The government must make decisions as to which pricing and tax strategies discourage churn and fund hopping, ensure that institutional investors are focusing on "fundamental risk, leverage, and legal compliance" (suggestions 1–2).[253] It must also decide whether manager compensation is in fact aligned with the interests of long-term end investors (suggestion 3).[254] Similarly, an agency must review whether retirement and college savings funds are invested consistent with their objectives, that index funds engage in appropriate activism, and that proxy services are basing their advice on the perspective of a long-term investor (suggestions 4–6, 9).[255] Additionally, requiring disclosure presumes that someone—again, a government agency or investors—is processing the disclosed information (suggestions 6–7).[256] As we have seen, however, the average mutual fund investor, at least, is unlikely to monitor such disclosures very closely.

The solutions rely on disclosure and thus are limited to the extent that ultimate investors are unwilling to invest time and

250. James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 413 (2005).

251. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 5, at 1754.

252. Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 18–19.

253. *Id.* at 18.

254. *Id.*

255. *Id.*

256. *Id.* at 18–19.

effort in learning about the funds in which they invest.[257] To the extent that the government provides this monitoring role, disclosure-based solutions will involve bureaucrats in making choices about appropriate risk levels—choices that inevitably will be criticized as unduly conservative or risky when the next bubble surfaces.

E. THE MARKET? THE PROMISE AND PERIL OF TARGET-DATE FUNDS

Ideally, the market would provide investment vehicles specifically designed for long-term holders.[258] Indeed, one could point to target date funds (TDFs, also called lifecycle funds) to argue that it has.[259] In theory, these funds ideally fit the interests of the long-term investor.[260] They start out with a high level of risk (i.e., highly exposed to stock) and automatically adjust asset allocations over time to end at the target date (which is often the retirement date for the investor) with a much more conservative portfolio.[261] This gradually shifting asset mix is poetically termed the fund's "glide path."[262] The idea is that a forty-year-old investor starting a job in 2010 and expecting to retire at seventy would pick a target-date fund of 2040.[263] At the beginning, the fund's holdings would be mostly stocks and stock funds.[264] It would automatically rebalance according to its preset glide path, so that by the target date it would hold a conservative mix of investments, with a strong emphasis on high-grade bonds.[265] It is, in short, the nature of target-date funds to focus on the long term.

257. *See* Fisch, *supra* note 27, at 879. ("[T]he modern institutional investor itself functions much like the Berle and Means corporation.").

258. *See, e.g.*, Strine, *Fundamental Corporate Governance Question*, *supra* note 35, at 18 (noting that the government could impose such a separation, as explained in Strine's fourth suggestion).

259. *See* Vallapuzha V. Sandhya, Agency Problems in Target-Date Funds 15 (Mar. 14, 2010) (unpublished Ph.D. dissertation, Georgia State University), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1570578.

260. *See id.*

261. CRAIG COPELAND, EMP. BENEFIT RESEARCH INST., USE OF TARGET-DATE FUNDS IN 401(K) PLANS, 2007, at 4 (2009), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_3-2009_TgtDtFnds.pdf.

262. *Id.* at 16.

263. *Id.* at 7.

264. David K. Randall, *Risks and Rewards of Target-Date Funds*, FORBES, July 22, 2009, http://www.forbes.com/2009/07/21/target-date-retirement-personal-finance-target-date-funds.html.

265. *Id.*

Even so, these funds present two distinct problems. First, they are designed and marketed for unsophisticated or time-pressed target-fund investors, and their purchase is often not even the product of conscious choice. Second, the details of target-fund implementation create a heightened risk of vertical agency costs. As to the first problem, TDFs are a popular means of implementing a "set-it-and-forget-it" style of investing, one based on behavioral economics' insights into investor behavior and "nudging."[266] The Pension Protection Act of 2006 (PPA) responded to these insights by putting in place a sign-up structure that simplified the process for employee enrollment in 401(k) plans.[267] In particular, PPA requires employees who do not desire to save for retirement to opt out of, rather than opt into, 401(k)s.[268] One of the permissible default choices employers can select for their employees under the Act is the target-date fund, and many employers use TDFs as their default investment.[269] After automatic enrollment was introduced, "participation rates doubled and 80% of employees accept the default savings rate and default investment fund."[270] TDFs consequently have proliferated to the point that they now represent nearly seven percent of total 401(k) assets,[271] and some $270 billion in assets.[272] Their privileged status as default investment vehicles means that TDFs represent a considerable portion of a huge pool of investments "chosen" by retirement plan participants without actual thought being given to their merits vis-à-vis other investment vehicles. Any move to em-

266. *See* BARRY SCHWARTZ, THE PARADOX OF CHOICE 4 (2004) (discussing "research findings from psychologists, economists, market researchers and decision scientists, all related to choice and decision making"); RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 8 (2008) ("[A] nudge is any factor that significantly alters the behavior of Humans.").

267. Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. 35,920 (proposed June 16, 2010) (to be codified at 17 C.F.R. pts. 230, 270).

268. *Id.* at 35,921 (explaining that the Department of Labor designated TDFs as a qualified default investment alternative under the PPA).

269. *Id.* at 85,791–92 (citing study showing seventy percent of U.S. employers now use TDFs as a default).

270. Sandhya, *supra* note 259, at 17.

271. YOUNGKYUN PARK, EMP. BENEFIT RESEARCH INST., INVESTMENT BEHAVIOR OF TARGET-DATE FUND USERS HAVING OTHER FUNDS IN 401(K) PLAN ACCOUNTS 2 (2009), *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_12-Dec09.TDFs.pdf.

272. Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. at 35,921.

power, or even inform, these most passive of investors is therefore suspect.

The second problem presented by TDFs stems from their "fund-of-fund" investing approach.[273] Rather than investing in individual companies, TDF managers tend to invest in mutual funds, a feature that means that agency costs might be even *more* pronounced in the case of TDFs than in the typical fund.[274] Although the academic literature on this subject is limited, one troubling study found that TDFs underperform balanced funds with similar asset allocations.[275] The authors of the study attributed this underperformance to a preference of the TDFs to invest in funds within their own fund families, thus generating a "double dip" in management fees for the holding company owning the related funds.[276] The study concluded the TDF investments enrich the overall fund company with high expense ratios, rather than optimally serve the interests of investors.[277]

Target-date funds received congressional attention in 2009, when it was reported that the "average loss in thirty-one funds with a 2010 target date was . . . 25%."[278] One 2010 fund lost forty-one percent in 2008 due to heavy exposure in stocks, an allocation that surprised many observers given the proximity of the fund to its target date.[279] On June 16, 2010, the SEC proposed new rules on how target-date funds may be marketed in response to concerns that investors did not understand the funds and underestimated the degree of risk associated with the investments due in part to inadequate disclosures.[280] The proposed rules require that if a TDF has a date in its name, it

273. Sandhya, *supra* note 259, at 3, 19.

274. *Id.* at 6.

275. *Id.* at 39.

276. *Id.* at 15–16. Unsurprisingly, the mutual fund company that serves as the employer's investment advisor generally selects funds from its own family of funds as the employer's default option. For example, Fidelity's TDFs invest in Fidelity stock and bond funds.

277. *Id.* at 4, 21.

278. Barbara Black, *Protecting the Retail Investor in an Age of Financial Uncertainty*, 35 U. DAYTON L. REV. 61, 62 n.11 (2009).

279. Namely, Oppenheimer Transition 2010. Cynthia Lin, *SEC Proposes New Disclosure Rules for Target-Date Funds*, MARKETWATCH, June 17, 2010, http://www.marketwatch.com/story/sec-proposes-new-target-date-fund-rules-2010-06-17.

280. Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. 35,920, 35,922 (proposed June 16, 2010) (to be codified at 17 C.F.R. pts. 230, 270).

must convey information about the asset allocation at that target date.[281] More generally, the rules require enhanced disclosure of a TDF's glide path in its marketing materials.[282]

The regulatory mismatch is clear in the SEC's own proposed rule: target-date funds have been used largely as a default for employees who do not opt out of 401(k) participation.[283] These investors have not made a conscious investment choice, let alone seen or processed any marketing literature at all. Further disclosure will be lost on them. Even investors who consciously choose TDFs are either financially unsophisticated or too busy to make careful investment choices.[284] More disclosure to investors of this sort is unlikely to help remedy problems with target-date funds. Employers could theoretically serve a monitoring role, but most employers use mutual fund companies as investment advisors, and are steered into those very companies' own TDFs.[285] Similarly, disclosure cannot address the fund-of-fund problem, since inattentive investors will not focus on the problems this structure poses.

The TDF case study reveals a clear case of the dangers of separating ownership from ownership. Indeed, because of the fund-of-fund investing favored by TDFs, an employee is three times removed from any actual corporate profit generation because she invests in a mutual fund that invests in other mutual funds in a diversified portfolio.[286] There is nothing to guarantee her that either her TDF or the funds in which it invests are making long-term choices in the investor's interest.[287] Instead, they appear to be lining their pockets with layer upon layer of fees.[288] Worse still, in an environment in which the investor has not made a conscious investment choice at all, the SEC's solution is to require more disclosure. It would be hard to find a better example of regulators' failure to address the root causes of the problems long-term investors face in a short-termist world.

281. *Id.* at 35,923.
282. *Id.*
283. PARK, *supra* note 271, at 2.
284. Sandhya, *supra* note 259, at 1.
285. *Id.* at 9.
286. *Id.* at 4.
287. *See id.* at 17–18.
288. *Id.* at 19.

CONCLUSION

The underlying concern that Congress sought to address in Dodd-Frank is that short-termism causes systemic risk. Regulatory responses to the bailout have fallen back on familiar tools like shareholder empowerment, disclosure, and independence, with no acknowledgement that the investing landscape has changed in ways that make traditional regulatory approaches unlikely to advance underlying regulatory aims. This Article makes no attempt to offer a grand solution to the resulting problems. Instead, it focuses on bringing those problems into clearer view. Without an understanding of the challenges posed by a new financial world in which ownership is separated from ownership, governmental reform efforts will not work and indeed may compound real-world difficulties.

The conclusion may well be that there's no such thing as a free lunch. Ideally, we want public corporations to be monitored by sophisticated long-term investors that have the motivation to watch closely. But rational shareholders often follow a portfolio theory of investing that focuses on the diversification of assets. This style of investing negates incentives to use the tools of shareholder empowerment—proxy access, say-on-pay, even disclosure—which recent financial reform has offered. The better choice appears to be carefully chosen forms of substantive governmental regulation—politically costly though it may be—or restructuring the law to realign the incentives of institutional investors with those of long-term shareholders.