Hedge Fund Activism and the Revision of the Shareholder Rights Directive

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I wish to thank Marcello Bianchi, Luca Enriques, Rolf Skog and participants in the International Working Group on CMU Conference in Amsterdam (January 2017) and in the Corporate Governance Forum in Stockholm (March 2017) for helpful comments on this and a related project. All errors are mine.

Abstract

This paper looks at shareholder activism from the perspective of the revision of the EU Shareholder Rights Directive, which was approved by the European Parliament on 14 March 2017. The main findings are as follows.

First, the effective engagement of institutional investors in corporate governance must rely on hedge fund activism. Whether the latter is desirable depends on the characteristics of the particular company.

Second, the Shareholder Rights Directive includes a number of rules that curb, albeit marginally, hedge fund activism for want of a longer-term engagement by institutional investors that cannot stand on its own feet. EU law missed the opportunity to let individual companies choose the efficient regime regarding shareholder activism, and alter it over time.

Third, the rather prescriptive stance of the Shareholder Rights Directive on shareholder activism seems based on the broader macroeconomic concerns underlying the EU project of Capital Markets Union. Although promoting long-termism in the asset management industry makes sense for the purpose of financial stability, this may undermine the efficiency of corporate governance. The latter is arguably more important than capital market regulation to support innovation and economic growth.

Keywords: shareholder activism, hedge funds, agency costs, conflict of entrepreneurship, institutional investors, index funds, R&D, ESG, short-termism, Shareholder Rights Directive, asset management, financial stability

JEL Classifications: G34; K22

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I. Introduction

One of the main goals of the Capital Markets Union (CMU) is to improve European firms' access to the capital markets.[1] In 2013, about three-quarters of European firms were reliant on bank funding as opposed to capital market funding; the picture is reversed for U.S. firms.[2] High quality of corporate governance is instrumental to making the European capital market attractive. This explains the efforts of the European Union (EU) in this field. These efforts have led ultimately to the approval of a revision of the Shareholder Rights Directive (SRD).[3] This Directive aims inter alia to encourage shareholder engagement in corporate governance, particularly by institutional investors, as a way to tap the funds of the asset management industry in Europe and worldwide.[4] However, the Directive goes much further than that. The EU legislator wants to shape the engagement of shareholders in terms of long-term investment and the pursuit of Environmental, Social and Governance (ESG) goals.[5] This is at odds with the shareholder engagement that is most prominently observed in modern stock markets, which is hedge funds activism.

This paper discusses hedge fund activism as a major driver of institutional shareholders' engagement, particularly in Europe. Hedge fund activism is on the rise in Europe. Whereas hedge funds activism has been so far largely a U.S. phenomenon, there is survey evidence suggesting that hedge funds are looking for new targets.[6] Europe is particularly attractive in this respect because the European jurisdictions support broader rights than those available to the shareholders of a typical Delaware-incorporated U.S. public company.[7] Shareholder rights are an important part of the activist hedge fund's toolbox, although they must be understood in light of the activist's business model. In this

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1 European Commission, Green Paper on Building a Capital Market Union, COM(2015) 63 final 18.2.2015.
2 Deutsche Börse, 'Principles for a European Capital Markets Union – Strengthening capital markets to foster growth', Policy Paper (February 2015), available at http://deutsche-boerse.com/blob/2532340/a1ae3aad16f3c04ad0e27ee55a7a4ba8/data/principles-for-a-european-capital-markets-union_en.pdf, p. 8.
3 European Parliament, Position of the European Parliament adopted at first reading on 14 March 2017 with a view to the adoption of Directive (EU) 2017/... of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, file P8_TC1-COD(2014)0121 (hereinafter, revised SRD).
4 According to the Green Paper, the European asset management industry is €17 trillion large. According to the Boston Consulting Group, Doubling Down on Data (July 2016), available at https://www.bcgperspectives.com/content/articles/financial-institutions-global-asset-management-2016-doubling-down-on-data/, the world's asset management industry is $ 71.4 trillion large ($ 36.1 trillion in North America).
5 See PRI, Principles for Responsible Investment, available at https://www.unpri.org.
6 Activist Insight, Activist Investing – Annual Review 2017 (February 2017), available at https://www.activistinsight.com/amp/issues/TheActivistInvestingAnnualReview2017.pdf.
7 CMS, Shareholder Activism: A European Perspective (June 2016), available at https://cms.law/en/ITA/Publication/Shareholder-Activism-A-European-Perspective.

perspective, this paper will argue that the revision of the SRD curbs rather than supports hedge funds activism, therefore casting some doubts as to whether the SRD will effectively foster engagement and investment by institutional shareholders as it purports to do.

Hedge fund activism is a particular form of shareholder activism, which is called "entrepreneurial" shareholder activism because it is a bet on a forthcoming change.[8] After having screened the market for targets, activist hedge funds engage the management of an underperforming listed company in which they have bought a significant stake. Hedge funds seek to determine a change in the governance or in the strategy of the target, with the goal to profit from this change by selling their shares at a premium after the target's performance has returned to full potential. Due to the peculiar business model, hedge fund activism has been more effective in corporate governance than any other form of activism. The power of hedge funds has attracted significant attention by policymakers who, in most cases, have been concerned with how to curb such power. From a law and economics standpoint, which is the approach informing this paper, the question is not so much whether the power of activist hedge funds is excessive, but rather whether their impact on corporate governance is efficient.[9] Efficient corporate governance makes capital markets more attractive for companies to raise funds, which aligns with the goals of the CMU.

Concerns with hedge fund activism are puzzling at first sight. By way of monitoring management, hedge fund activism reduces the average cost of capital for companies.[10] In dispersed ownership structures, hedge funds foster managerial accountability to investors, particularly when managers perform poorly. In concentrated ownership structures, where hedge funds are increasingly playing a role, too,[11] they guard minority shareholders against outright expropriation by dominant shareholders. The trouble with hedge fund activism is the so-called short-termism that, allegedly, they inject

[8] Shareholder activism can be defined as actions by a shareholder or a group thereof aimed at bringing about change in a public company without trying to gain control. S. Gillan and L.T. Starks, 'The Evolution of Shareholder Activism in the United States' (2007) *Journal of Applied Corporate Finance*, 19, 55. Hedge fund activism is called "entrepreneurial activism" to distinguish it from more traditional shareholder activism, which does not aim to profit from the change sought for. *See* A. Klein and E. Zur, 'Entrepreneurial shareholder activism: Hedge funds and other private investors' (2009) *Journal of Finance*, 64, 187.
[9] See text accompanying notes 62-63.
[10] See R. La Porta et al., 'Legal determinants of external finance' (1997) *Journal of finance*, 52, 1131.
[11] See e.g. T. Poulsen et al., 'Voting power and shareholder activism: A Study of Swedish shareholder meeting' (2010) *Corporate Governance: An International Review* 18, 329; W. Bessler et al., 'The returns to hedge fund activism in Germany' (2013) *European Financial Management*, 21, 106; M. Belcredi and L. Enriques, 'Institutional investor activism in a context of concentrated ownership and high private benefits of control: the case of Italy' in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* (Cheltenham: Edward Elgar, 2015), p. 383.

into corporate governance. The standard narrative about hedge funds is that they go for the "quick buck" and use their influence to induce managers to sacrifice long-term shareholder value for short term-performance.

If financial markets were informationally efficient, there would be no conflict between short-term and long-term value maximization. The short-termism problem arises because, at least temporarily, stock markets overweigh the short-term profits of a company relative to its long-term profits.[12] This is not necessarily a problem for corporate governance so long as short-termism does not steer managers towards value-destroying choices.[13] There is nothing intrinsically wrong with corporate performance being evaluated on a short-term basis. In the same vein, whether hedge fund activism is responsible for short-termism is not straightforward, as they may simply correct company's underperformance as they claim they do.[14] Defining short-termism is conceptually difficult in the absence of a consensus on what constitutes the 'right term' to maximize profits.

The scepticism of policymakers towards hedge funds activism is based on a twofold assumption. One is that hedge fund activism leads to short-termism in corporate governance. The other is that that short-termism is always value-destroying. Thus, long-term shareholding is regarded as panacea. Although hedge funds are key to activate the voice of long-term investors,[15] on both sides of the Atlantic several policy measures have been proposed to curb hedge funds activism and to encourage long-term shareholdings instead. The SRD revision includes a number of these measures, on which this paper will focus.

In this paper, I will argue that the approach of the SRD is misguided. Drawing on a companion article,[16] in Section II I will argue that the short-termism debate cannot shed light on the fundamental question whether the presence of hedge funds activism is desirable for corporate governance. Short-termism may well be a problem for corporate governance, and so may hedge fund activism be; but as such, the problem is ill-defined. As

[12] See C.A. Hill and B. McDonnel, 'Short and Long Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?' in C.A. Hill and S.D Solomon (eds) *Research Handbook on Mergers and Acquisitions* (Cheltenham: Edward Elgar, 2016), p. 396.
[13] M.J. Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' (2013) *Business Lawyer*, 68, 977, 985.
[14] L.A. Bebchuk et al., 'The long-term effects of hedge fund activism' (2015) *Columbia Law Review* 115, 1085.
[15] See R.J. Gilson and J.N. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and Revaluation of Governance Rights' (2013) *Columbia Law Review* 113, 863.
[16] A.M. Pacces, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) *Erasmus Law Review* 9, 199.

I will discuss in Section III, the choice of the horizon to maximize profits is idiosyncratic to a particular company in a particular point in time. This choice belongs to the entrepreneur, and the views of different entrepreneurs on this differ. Consequently, hedge fund activism is to be framed as a conflict of entrepreneurship between the activist's and the incumbent management's view on how the company should look like, including the right term to be profitable. In section IV, I will discuss how the recent EU legislation misses the opportunity to resolve this conflict efficiently. The conflict of entrepreneurship framing counsels towards letting companies decide whether to be exposed to hedge funds activism and alter their choice over time. In contrast, the SRD revision promotes long-termism and other non-market goals as a one-size-fits-all solution. Moreover, the SRD is quite prescriptive in terms of curbs to hedge fund activism. In Section V, I will argue that, however misguided from a corporate governance perspective, the SRD approach may be interpreted as an attempt to cope with the externalities of the asset management industry on financial stability. I will conclude with Section VI.

II. Entrepreneurial Shareholder Activism

Shareholder activism is not new. Activists have always been prompting corporate managers to act on some issue, even unrelated to the conduct of the company's business. However, such traditional activism has not been very effective and, before the advent of hedge funds activism, investors seemed unable to achieve concrete outcomes through this channel.[17] Despite the regulatory differences, a similar conclusion could be made about comparable channels for traditional activism in Europe.[18]

Hedge funds activism is different.[19] Hedge funds strive to profit from changing the way the company is managed. Therefore, this is called "entrepreneurial activism." The change can be quite radical, such as the departure of the CEO or some other executives, if not the restructuring of the company. Likewise, activist hedge funds may seek to stop a change wanted by the management, for instance an acquisition.

[17] D. Yermack, 'Shareholder Voting and Corporate Governance' (2010) *Annual Review of Financial Economics*, 2, 103. But see, more recently, J.C. Coates IV, 'Thirty years of evolution in the roles of institutional investors in corporate governance', in Hill and Thomas (n. 11, 2015), p. 76.

[18] L. Renneboog and P.G. Szilagyi, 'Shareholder engagement at European general meetings' in M. Belcredi and G. Ferrarini (eds), *Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms* (Cambridge: CUP, 2013), p. 315.

[19] J. Macey, *Corporate governance: Promises kept, promises broken* (Princeton: Princeton University Press, 2008), p. 244-251.

The mark of entrepreneurial activism's success is not so much the level of shareholder support at the general meeting, but whether the desired change happens or not.[20] Hedge funds have a different business model than other institutional investors.[21] Hedge fund managers charge a performance fee in addition to a percentage of the asset under management. This aligns their incentives with investors having a relatively high appetite for risk. Hedge funds profit from investing in stock that they can buy, hold and resell at a higher price. The purpose of entrepreneurial activists' engagement with the management of the target company is to achieve meanwhile a change that will increase the stock price.

Two factors are key for the success of entrepreneurial activism. First, the hedge fund needs to be able to buy the bulk of its stake in the company while the stock market does not anticipate the engagement. The moment the engagement is revealed, investors will anticipate gains and, discounting those for the probability that the engagement fails, the stock price will rise. Second, the activist needs to be able to persuade the management to implement the desired changes. To increase its leverage with the management, the activist can use several techniques, ranging from news campaigns to threatening a lawsuit. The last resort, however, is a shareholder vote. Reached that point, the success of the engagement will depend on whether the activist has managed to attract sufficient support from other shareholders to get a favourable vote. This explains the importance of proxy contests for activisms in the U.S and of the rules for initiating and executing a shareholder vote in the European jurisdictions.

The support by institutional investors is crucial for successful engagement. The typical hedge fund stake in the target company is substantial, but not nearly a controlling one.[22] As a result, activists must persuade institutional investors to vote for them. By the same token, engagement may succeed based on the sheer threat of winning a contested vote. From the moment the hedge funds formulate their demands to the management, both parties start to speak with the largest institutional investors while the investing public is in the dark about the engagement. Management will give in to the activists' demands when it

[20] M. Becht et al., 'The Returns to Hedge Fund Activism: An International Study', *European Corporate Governance Institute (ECGI) - Finance Working Paper* No. 402/2014 (revision 15 September 2016). Forthcoming in *Review of Financial Studies*.

[21] Gilson and Gordon (n. 15), 896 ff.

[22] Becht et al. (n. 20) report an average stake of 11% for their global sample. In the U.S., the median stake of activist hedge funds is only 6.3%. See A. Brav et al, 'The Anti-Activist Legislation: The Curious Case of the Brokaw Act' *Working Paper* (27 October 2016), available at http://dx.doi.org/10.2139/ssrn.2860167.

is clear they are going to lose the vote, whereas hedge funds will withdraw from engagement when they realize that not enough institutional investors will vote for them. The fight becomes public only when the outcome is ambiguous. Consequently, a substantial portion of hedge funds engagement takes place behind closed door.[23]

As explained by professors Gilson and Gordon, the tremendous influence activists have gained in corporate governance depends on the reconcentration of ownership occurred in the past few decades.[24] The bulk of equity investment is no longer in the hands of dispersed individual stockholders, but is managed by institutional investors. Gilson and Gordon report that, in 2009, institutional investors held on average 73 percent of the equity of the thousand largest U.S. corporations.[25] Institutional ownership is often concentrated in the hands of a few asset managers. In the U.S., the representatives of institutions jointly holding control of a typical company would fit around a boardroom table.[26] This is very important for activists, who need to be able to speak rapidly with the people casting the majority of the votes. The situation is similar in Europe. A recent OECD study reveals that institutional investors own nearly 90% of UK listed equities.[27] The concentration of institutional ownership is also reported in the Continent's countries where dominant shareholders are more frequent, for instance in Sweden and in the Netherlands.[28] Although the style of engagement differs considerably across countries, hedge funds activism consistently gets traction wherever institutional ownership is concentrated.

If institutional investors are crucial for the success of hedge fund activism, one may wonder why they do not act as activist themselves. Although, particularly in Europe, institutional investors occasionally take actions, they most typically react to institutional activists such as hedge funds.[29] The reason is agency costs. Institutional investors charge flat fees to manage a diversified portfolio of stocks on behalf of their clients. Differently from hedge funds, institutional investors care about performance only relatively to their competitors. They do not have incentives to monitor individual companies. The activists'

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[23] M. Becht et al., 'Hedge fund activism in Europe: does privacy matter?' in Hill and Thomas (n. 11, 2015), p. 116.
[24] Gilson and Gordon (n. 15), 874.
[25] ibid 874.
[26] ibid 875.
[27] M. Isaksson and S. Celik, 'Who cares: Corporate Governance in Today's Equity Markets', (2013) *OECD Corporate Governance Working Papers* 8, 28.
[28] See e.g. P. Lekvall (ed.), *The Nordic Corporate Governance Model* (Stockholm: SNS Forlag 2015); A. de Jong et al., 'Changing national business systems: corporate governance and financing in the Netherlands, 1945–2005' (2010) *Business History Review* 84, 773.
[29] Renneboog and Szilagyi (n. 18), 339.

teaming up with institutional investors seems therefore to be beneficial for corporate governance.[30] On the one hand, activists lower the agency costs of institutional ownership. On the other hand, institutional investors screen the activists' proposals and should sanction only the value increasing ones. Empirical evidence also suggests that successful shareholder activism is, on average, associated with a stock price increase.[31]

Reducing agency costs undoubtedly improves the efficiency of corporate governance. However, this does not imply that hedge fund activism is always value increasing. Several objections have been raised concerning the judgment of institutional investors. Having reviewed them extensively in a companion article,[32] I summarize them briefly below.

Sometimes it is argued that institutional investors do not really exercise judgment, but blindly follow the recommendations of proxy advisors, notably including global market leaders such as Institutional Shareholders Services (ISS) and Glass-Lewis.[33] Legislation, particularly in the U.S., has encouraged institutional investors to purchase proxy advisory services to meet the obligation to disclose their voting and avoid embarrassment.[34] That said, recent research suggests that the impact of proxy advisors on the voting by institutional investors may be overstated. To begin with, only the smaller institutional investors systematically follow the proxy advisors.[35] Large asset managers, such as Blackrock or Vanguard, seem to vote independently.[36] Finally, every study of proxy advisors' impact faces a fundamental reverse causality problem. Proxy advisors may just follow the policies set by large institutional investors. Survey evidence suggests that this is actually the case.[37] Although there are no specific studies on the impact of proxy

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[30] In corporate governance, institutional investors are "rationally reticent:" They are not proactive in influencing corporate management, but they are responsive to other, entrepreneurial actors, who bring the case for engagement to their attention. Gilson and Gordon (n. 15), 895.

[31] A. Brav et al., 'Hedge fund activism, corporate governance, and firm performance' (2008) *Journal of Finance* 63, 1729.

[32] Pacces (n. 16).

[33] J.C. Coffee, Jr. and D. Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) *Annals of Corporate Governance* 1, 17-19.

[34] E.B. Rock, 'Institutional Investors in Corporate Governance' *University of Pennsylvania, Institute of Law and Economics Research Paper* No. 14-37 (21 July 2015), p. 13-14. Forthcoming in *Oxford Handbook on Corporate Law and Governance*.

[35] P. Iliev and M. Lowry, 'Are Mutual Funds Active Voters?' (2015) *Review of Financial Studies* 28, 446, 453.

[36] S. Choi et al., 'Who Calls the Shots: How Mutual Funds Vote on Director Elections', (2013) *Harvard Business Law Review* 3, 35.

[37] J. McCahery et al., 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2016) *Journal of Finance* 71, 2905, 2929.

advisors on hedge funds activism, a U.S. study of uncontested elections revels that ISS advice against the management shifts at most 10 percent of votes.[38]

Another fundamental critique levered at hedge funds is that they may succeed without the screening by institutional investors, if they act as a coalition, namely as a so-called "wolf pack". Empirically, wolf packs account for about 22% of engagements observed internationally and are associated with a higher success rate than individual engagements (78% as opposed to 46%).[39] On this basis, professor Coffee and Palia have argued that wolf packs are a nearly riskless strategy for hedge funds, suggesting that this may lead to over-engagement.[40] The impact of wolf packs seems to be overestimated, however. Firstly, in more than one-fifth of observed wolf pack engagements, the engagement has been unsuccessful and thus unprofitable. Second, wolf packs are never large enough to control a majority of the votes, which makes institutional investors still decisive.[41] Finally and most importantly, 78 percent of the overt engagements mapped internationally are *not* wolf packs. This cannot be random because, by definition, hedge funds choose their battles.[42] If they decide to join and form a wolf pack only when success is more likely, the success rate of wolf packs is obviously overestimated.

The third and recurrent objection to hedge funds activism is short-termism. This is the most difficult critique to handle because short-termism means different things to different people. In one respect, this critique is not borne out by the empirical evidence. Both in the U.S. and internationally, the short-term gains stemming from the announcement of the engagement are not reversed for up until five years down the road, provided that the engagement is effective in determining change.[43] Therefore, hedge funds are not short-termist in the conventional sense of 'cutting and running.' While useful to defend hedge fund activism from the easy rhetoric against them, this result says nothing about whether the stock markets is myopic relative to some horizon longer than the

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[38] S. Choi et al., 'The Power of Proxy Advisors: Myth or Reality?' (2010) *Emory Law Journal* 59, 869.
[39] Becht et al. (n. 20), 24.
[40] Coffee and Palia (n. 33), 29.
[41] R.J. Gilson and J.N. Gordon, 'The Sotheby's Poison Pill Case: The Plate Tectonics of Delaware Corporate Governance' *CLS Blue Sky Blog*, available at http://clsbluesky.law.columbia.edu/2014/05/15/the-sothebys-poison-pill-case-the-plate-tectonics-of-delaware-corporate-governance/. But see Coffee and Palia (n. 33), 32, arguing that proxy advisors are the ones to decide, which is the argument discussed earlier in the text.
[42] Pacces (n. 16), 206. For evidence that hedge funds are unlikely to tip one another on which companies to engage, see Brav et al. (n. 22), 19-20.
[43] Bebchuk et al. (n. 14) and Becht et al. (n. 20).

activists' holding period (1.7 years on average),[44] let alone whether it makes sense to consider such a longer horizon to assess the performance of any particular company.

Underlying the short-termism discussion there is a fundamental question about the desirability of hedge fund activism. This question cannot be answered empirically because such activism produces unobservable effects and because the companies for which we observe engagements cannot be meaningfully compared to those that are not engaged.

The first part of the problem is that we only observe a portion of the true activism, the overt part, whereas a great deal of activism take places behind closed doors.[45] This would not undermine empirical analysis if the distribution between overt and covert activism were random, but it is not. Better-managed companies react in anticipation of hedge fund engagement, whenever this is a credible threat. Activists, on the other hand, may have to make their campaign public precisely when the targeted is more mismanaged, which overestimates the observable returns from engagement.

The second part of the problem is that companies that are or can be targeted by activists fundamentally differ from those that are not and cannot be targeted. The fact that companies successfully engaged outperform a market index, on average, does not really prove that activism improves performance.[46] It only shows that target companies were undervalued relative to a market benchmark and that activism brings performance back in line with that benchmark. These studies cannot rule out the possibility that a target company would outperform the benchmark by a larger extent, if not engaged, because this counterfactual company does not exist and, if it existed, it would be a different firm.[47] This fallacy affects as well the studies arguing that hedge fund activism is value decreasing

[44] ibid 54.
[45] Becht et al. (n. 23).
[46] The credibility of empirical analysis is based on the definition of a control group, which provides the counterfactual firm to which the firm receiving the treatment – i.e. hedge fund engagement – is to be compared in order to establish causality. See V.A. Atanasov and B.S. Black, 'Shock-based causal inference in corporate finance research' (2017) *Critical Finance Review* 5, 207; J.D. Angrist and J-F. Pischke, *Mostly harmless econometrics: An empiricist's companion* (Princeton: Princeton University Press, 2012).
[47] Recent empirical analyses of hedge fund activism have tried to improve on the identification of causality through matching samples. See e.g. A. Brav et al., 'How Does Hedge Fund Activism Reshape Corporate Innovation?' *NBER Working Paper* No. 22273 (May 2016); K.J.M. Cremers et al., 'Hedge Fund Activism and Long-Term Firm Value' *Working Paper* (January 2016), available at http://dx.doi.org/10.2139/ssrn.2693231. This approach does not entirely solve the problem. Matching creates an artefact, which may still differ from the counterfactual firm that has not been engaged, and therefore might not be sufficient to identify causality.

based on the superior long-term performance of comparable companies, which have not been engaged.[48]

In order to determine whether and under what conditions hedge fund activism is desirable for corporate governance, we need theory, to which I turn in the next section.

III. Hedge Fund Activism as a Conflict of Entrepreneurship

1. The Real Issue about Short-Termism

Hedge fund activism is an important feedback mechanism in corporate governance.[49] However, whether such activism is efficient depends on context. Many companies benefit from the correction of underperformance fostered by activist hedge funds, particularly in the presence of investor expropriation or misuse of free cash. For other companies, though, underperformance is temporary and the change of strategy promoted by hedge funds may destroy value. Not knowing the proper length of time in which to assess corporate performance (call it the "right term"), whether management errs towards the long term ("long-termism") or hedge funds err towards the short term ("short-termism") is hard to say when the conflict occurs.

The "right" term to measure profit depends on the "right" strategy to maximize it; both are difficult to identify. Stock markets are an impressive source of information in this respect, but alas, they imperfect.[50] Because they overreact to news, misprice risks, and are prone to asset bubbles,[51] stock market prices may temporarily fail to incorporate the value of future profit opportunities. When this is the case, the Efficient Capital Market Hypothesis (ECMH) does not hold true.[52] Therefore, there may be a conflict between the

[48] Cremers et al. (n. 47). The problem, as discussed in the next section, is that the optimal horizon to maximize profit is endogenous to firm-specific circumstances.
[49] See A.O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970) and Pacces (n. 16), 207-211, discussing hedge fund activism within Hirschman's framework.
[50] See e.g. R.J. Gilson and R.H. Kraakman, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs' (2014) *Virginia Law* Review 100, 313.
[51] See A. Shleifer and W. Vishny, 'The limits of arbitrage' (1997) *Journal of Finance* 52, 35; A. Fuster et al., 'Natural expectations, macroeconomic dynamics, and asset pricing' (2011) *NBER Macroeconomics Annual 26*; and P. Bolton et al., 'Executive compensation and short-termist behaviour in speculative markets' (2006) *Review of Economic Studies* 73, 577.
[52] The ECMH is based on arbitrage. A fundamental principle of economics is that arbitrageurs would not forego a profit opportunity so long as they can grab it. When they cannot, because for instance they are capital constrained or there is uncertainty, price may deviate from fundamentals. Until this situation is corrected, market may overvalue short-term strategies and undervalue long-term strategies. Although this

pursuit of short-term results, which are immediately impounded in market prices, and long-term projects, whose expected results are underweighted or even overlooked by stock prices.[53] At that point, short-termism becomes an issue for corporate governance to the extent that it affects managerial choices.[54] Because the hedge fund's business model – buying undervalued stock and reselling it after a successful engagement – is based on stock market prices, pressure from activist hedge funds may well turn the short-termism of stock market into short-termism of managerial choice.

Short-termism tells us only so much, though. Because short-termism is an issue only if the ECMH fails, the value of a long-term option is defined by what it is not: the market price failing to incorporate it. As a result, opinions of reasonable minds differ as to what is the "right" long term for purposes of profit maximization. Secondly, even if one could settle on a conventional definition of long term (say, above 5 years), companies oriented to this long term would be different from those oriented to a shorter term. Comparing the performance of these companies on horizons different from what they have chosen is not very meaningful.[55] Thirdly, whether managing for the long term or the short term is preferable is theoretically unclear. It has been shown that, under certain conditions, pursuing the interest of long-term shareholders can lead management to destroy more value than if they managed in the interest of short-term shareholders.[56] More in general, the "right" horizon to maximize profit is endogenous to the company's business and the state of product market competition. [57] Whether managers suffer from short-termism or long-termism relative to this horizon also depends on company-specific circumstances.[58]

The disagreement on the proper length of time in which to assess performance is a more fundamental conflict between two views of the target firm, one by the activist hedge fund and the other by the incumbent management. These views normally differ on strategic issues, such as whether the company should be leaner, more focused on certain

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difference will be arbitraged away, eventually, long-term value might be destroyed in the process. See A.M. Pacces, *The Future in Law and Finance* (The Hague: Eleven International Publishing, 2013).

[53] A.G. Haldane and R. Davies, 'The short long', *29th Société Universitaire Européene de Recherches Financières Colloquium: New Paradigms in Money and Finance*? (Brussels, 2011).

[54] Roe (n. 13).

[55] See text accompanying notes 47-48.

[56] J.M. Fried, 'The Uneasy Case for Favoring Long-Term Shareholders' (2014) *Yale Law Journal* 124, 1554.

[57] For instance, M. Giannetti and X. Yu, 'Adapting to Radical Change: The Benefits of Short-Horizon Investors' *European Corporate Governance Institute (ECGI) - Finance Working Paper* No. 467/2016 (revised version 15 January 2017), show that long-termism undermines the ability of companies to deal with a highly dynamic and competitive environment.

[58] For a similar argument applied to takeovers, see L. Enriques et al., 'The Case for an Unbiased Takeover Law (with an Application to the European Union)' (2014) *Harvard Business Law Review* 4, 85, 88.

businesses and cost-effective in carrying them out, which hedge funds typically like to see perhaps because they are impatient to cash in the profit from engagement. The opposite view that the company should pursue longer-term goals, typically fostered by the management, is equally legitimate although it may procrastinate the acknowledgement of mistakes or conceal the extraction of private benefits of control.

Hedge fund activism can thus be interpreted as a conflict of entrepreneurship. The opposing views of the activist and the incumbent management regarding the time horizon in which the firm should be profitable are entrepreneurial to the extent that they reflect a shortcoming of stock prices, rather than managerial opportunism. Apart from instances of blatant fraud, managerial opportunism is hardly crystal clear. In contrast, the stock price can never fully account for the future because it is uncertain. In dealing with uncertainty, the opinions of different entrepreneurs typically differ.

According to two prominent students of uncertainty – Frank Knight and John Maynard Keynes – financial markets are one special way to deal with uncertainty, by incorporating all available information into a probabilistic risk assessment.[59] Because nobody knows how a distant future, call it "long term," will look like, stock markets process information within a relatively short horizon, in which no change from established trends can be assumed. The vast majority of investors make decisions under the same assumption, which is reflected by market prices. Entrepreneurs, instead, deal with genuine uncertainty,[60] which differently from risk cannot be quantified. Entrepreneurship is based on long-term expectations, which incorporate all information available to financial markets, but include a guess about forthcoming change, too.[61] In this perspective, hedge fund activists and their opponents advocate two different strategies to "beat the market." The discussion about the right horizon to assess performance is in fact a conflict between entrepreneurs having different opinions about the changes to happen, and their impact on performance.

[59] F.H. Knight, *Risk, uncertainty and profit* (first published 1921, Kelley 1964), p. 233-263; J.M. Keynes, 'The general theory of employment' (1937) *Quarterly Journal of Economics* 51, 209, 214-215.
[60] Knight (n. 59), 264-290.
[61] J.M. Keynes, *The general theory of employment, interest and money* (first published 1936, BN Publishing 2008), p. 96-106.

2. Who Decides?

Framing hedge fund activism as a conflict of entrepreneurship brings up the question who decides on the conflict and whether this is efficient. I define efficiency in terms of net shareholder value,[62] following the argument against the inclusion of other stakeholder constituencies in the company's objective function. This argument is based on two assumptions.[63] First, differently from shareholders, stakeholders can protect their investment through contracts. Second, because there are no negative externalities (on stakeholders) stemming directly from corporate governance, corporate governance rules should not deal with negative externalities.[64] None of these assumptions applies to entrepreneurship as a source of potential shareholder value, which is not (yet) revealed by the stock price. Entrepreneurs cannot effectively protect this value by contract. Moreover, foregoing this potential value in listed companies could lead to negative externalities, such as depriving society of nonlinear innovation. Efficiency of decision-making on hedge fund activism depends on whether the decision-maker has sufficient incentive to maximize shareholder value, intended as the sum of stock market price and entrepreneurship potential.

As explained in Section II, institutional investors are decisive on hedge funds engagement. Institutional investors, however, differ considerably from each other in terms of investment strategy and incentives. In a companion article,[65] I have argued that index funds are typically decisive in hedge fund engagements because their business model does not allow them to exit an investment they are dissatisfied with, so long as this investment is part of the index they track. This theoretical argument is confirmed by a recent empirical study, finding that ownership by index funds increases the frequency and the success rate of certain hedge funds' engagements, at least in the U.S.[66] Assuming that also elsewhere index funds are decisive between the opposing views of the hedge funds and the incumbent management, whether they are the right arbiters for this choice depends on context.

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[62] This is a Kaldor-Hicks measure. A change is efficient if it increases the (long-term) stock price, assuming that the winners from the change could compensate the losers and still be better off. J.R. Hicks, 'The Foundations of Welfare Economics' (1939) *Economic Journal*, 49, 696; N. Kaldor, 'Welfare Propositions of Economics and Interpersonal Comparisons of Utility' (1939) *Economic Journal*, 49, 549.
[63] See A.M. Pacces, *Rethinking Corporate Governance: The Law and Economics of Control Powers* (Abingdon: Routledge, 2012), p. 74-82.
[64] I will partly relax this assumption in section V dealing with financial stability.
[65] Pacces (n. 16), 208.
[66] Appel et al., 'Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism' *NBER Working Paper* No. 22707 (September 2016).

One strategic issue on which the views of activists and incumbent management often collide is quality and quantity of R&D expenditures. Activist hedge funds want the companies to focus on developing specific products, which usually results in cuts of R&D expenditures and larger short-term profits.[67] The managers usually ask for the return on R&D expenditures to be assessed over a longer horizon. Reducing R&D expenditures does not necessarily imply that a company is less innovative. On the contrary, there is evidence that activism increases R&D productivity and *output*.[68] Hedge fund activism, however, systematically reduces R&D *input*. This may be not the right choice for a number of companies. In particular, nonlinear innovation with long lifecycles benefits from conglomerate structures in which R&D resources can be redirected internally from a project to another. [69] Those are precisely the structures that activists seek to break up.

Drawing on their long-term commitment to index tracking, managers of large index funds such as Blackrock and State Street have recently made public statements to distance themselves from the short-termism of activist hedge funds.[70] Such statements must be taken with a grain of salt. Index fund managers do not really have an incentive to discern whether the activist's call for lower R&D expenditures fits a particular company.[71] Interestingly, although institutional ownership is empirically associated with higher R&D investments, this association does not depend on index funds.[72] This finding aligns with theory. Index fund managers do not benefit from firm-specific screening. Because their income depends on the size of their portfolio, they choose low–cost voting policies that investors appreciate overall, including best practices in corporate governance.[73] Arguably, index funds may decide to support a hedge fund's request to cut on R&D expenditures if the target does not meet the prevailing corporate governance standards. Whether the target company should engage in linear or nonlinear innovation is a more idiosyncratic question than an index fund manager can answer. Yet, the efficient level of long-term investments

[67] Coffee and Palia, (n. 33), 42-46.
[68] Brav et al. (n. 47).
[69] S. Belenzon, P. Bolton & U. Tsolmon, 'The Organization of Innovation across Countries and Industries', *Unpublished Working Paper, Duke University* (January 2013).
[70] See Blackrock, *Larry Fink's 2016 Corporate Governance Letter to CEOs*, 1.2.2016; State Street Global Advisors, *Ronald P. O'Hanley's Letter to Directors and Guidelines on Effective Independent Board Leadership*, 26.2.2016.
[71] As I explain in Pacces (n. 16), 208, actively managed funds do not have this incentive either, because it is more profitable for them to govern through exit.
[72] P. Aghion, J. van Reenen & L. Zingales, 'Innovation and Institutional Ownership', 103 *American Economic Review* 277 (2013).
[73] Appel et al., *Passive investors, not passive owners* (2016) Journal of Financial Economics 121, 111, 113.

depends on idiosyncratic variables such as the competitive environment, including whether the innovation cycle faced by a particular company is a short or a long one.

Relying on the judgment of index funds is efficient in other situations. Often, what prompts hedge fund activism is simply the management's wasting resources. Because index funds are expected to vote in a standardized, predictable fashion on a hedge fund's memo showing waste, hedge fund activism protects investors by way of committing management. Facing the threat of hedge funds teaming up with institutional investors, managers have to be more careful about misusing fee cash or being unresponsive to the competitive environment. In this perspective, hedge funds activism is a tremendous tool to stop management from being lazy, or building empires. Moreover, because hedge fund activism has traction also in concentrated ownership structures,[74] also dominant shareholders have to be careful with self-dealing to avoid that activists engage them with the support of index funds.

In conclusion, index funds cannot be trusted to decide on a conflict of entrepreneurship implied by hedge fund activism because they do not have the incentive to make an informed decision regarding a portfolio company's strategy. Nevertheless, the incentives of index funds are aligned to the interest of the investing public regarding the control of agency costs, particularly if the costly screening for expropriation and waste is performed by hedge funds. In other words, the decision whether a company should be exposed to hedge funds activism entails a trade-off between control (on strategy) and commitment (towards investors).[75] As the foregoing discussion reveals, this problem does not warrant a one-size-fits-all solution. Different companies may need different degrees of exposure to activism at different points in time. As a result, individual companies should be able to choose the exposure of management to the scrutiny by hedge funds, and to alter this choice over time.

IV. The Shareholder Rights Directive: A Missed Opportunity

Shareholder engagement is the mantra of the SRD revision. This is instrumental to the goals of the CMU, particularly in terms of attracting stock market funding to European enterprises, which are overly dependent on bank funding. Facilitating shareholder

[74] See note 11 and accompanying text.
[75] Pacces (n. 16), 211.

engagement – the argument runs – make investors more willing to become equity-holders because engaged shareholders may exercise control on how their investment is managed, after all. This reasoning is only slightly complicated by institutional ownership, which commands the bulk of equity investment in Europe as in the United States.[76] Because institutional asset managers invest other people's money, they should foster the interest of their clients in engaging with portfolio companies.

Reflecting the aversion of policymakers towards short-termism, the EU legislator has decided to promote a different kind of engagement than hedge fund activism. In particular, following the example of the UK Stewardship Code,[77] the revision of the SRD supports the engagement of institutional investors based on long-term policies. Moreover, by way of amendments by the European Parliament, the new SRD links the definition of long-term engagement with the pursuit of Environmental, Social and Governance (ESG) goals as identified by the UN-supported Principles of Responsible Investment.[78] Both the long-term policies and their ESG connotation could, in principle, be opted out by institutional investors. However, the possibilities for institutional investors to profile themselves as short-termist and anti-ESG are nowadays only theoretical.

The revised SRD includes mandatory rules, too, which curb shareholder activism directly. These are the rules on shareholder identification. Every member state will have to implement mandatory shareholder identification with the exception of stakes below a 0.5% threshold, which may remain anonymous if the national legislator so decides. While such a rule seemingly facilitates shareholder voice by increasing transparency, it undermines the business model of the main activator of such voice – the hedge funds. The revised SRD includes several other provisions to facilitate the exercise of shareholder rights across EU borders, as it should be.[79] In what follows, I will focus exclusively on those rules having the unintended effect to curb, rather than enhance, shareholder voice.

1. Curbs on Hedge Fund Activism

The business model of activist hedge funds is based on the purchase of undervalued stock (a so-called "toehold") while the market is still in the dark about the hedge fund's

[76] Isaksson and Celik (n. 27), 28, report that institutional investors own about one-half of the equities listed in OECD countries.
[77] Financial Reporting Council, *The UK Stewardship Code* (2nd edn, September 2012).
[78] Principles for Responsible Investment (n. 5).
[79] See Enriques at al. 'Mandatory and contract-based shareholding disclosure' (2010) *Uniform Law Review* 15, 713, 738-739, for a similar argument applied to takeovers.

intentions. Purchasing this toehold is the way for hedge funds to secure a reward for their actions. The most significant of hedge funds' investments is screening the market for potential targets. If the identification of the target were revealed before the engagement, the hedge funds would not be able to purchase the undervalued stock and profit from the price increase of a (successful) engagement, because all other investors will expect that hedge fund's engagement and try to free ride on it. Free-riding is a mechanism that fundamentally undermines hedge fund activism, as it undermines (hostile) takeovers for comparable reasons.[80] The regulation of ownership disclosure and shareholder identification have the side effect to nurture free-riding.

Ownership disclosure is meant to reveal the build-up of significant stakes in a company. A large shareholding implies influence on the management of listed company. This is important information for both the investing public – the presence and identity of large shareholders has a bearing on investment decisions – and the company's management – in order for them to prepare to potentially hostile engagements.[81] Regulation mandates transparency of large ownership on both sides of the Atlantic. The specific rules, however, differ between the U.S. and the EU. In the U.S., ownership disclosure is a matter of federal regulation. Disclosure is triggered by the crossing of a 5% beneficial ownership threshold, after which the shareholder has 10 days to disclose its stake.[82] These rules are sufficiently lenient to make the U.S. one of the most favourable legal environment to hedge fund activism. Although EU regulation also mandates a 5% beneficial ownership threshold, the time window to disclose it is shorter (4 days), and most importantly, these are only minimum requirements.[83] The EU member states can set lower thresholds and shorter time windows, as in fact many do. For example, the threshold is 3% in the UK, Italy, and the Netherlands, whereas the time window is 2 days in the UK and nil ('without delay') in the Netherlands.[84] These stricter rules make hedge fund activism less profitable, and thus less likely to happen.

[80] O. Hart and S. Grossman, 'Take-Over Bids, the Free Rider Problem and the Theory of the Corporation' (1980) *Bell Journal of Economics* 11, 42.
[81] Ownership disclosure was introduced into U.S. federal law by the Williams Act, clearly with antitakeover purposes. Macey (n. 19), 122.
[82] Section 13(d) of the Securities Exchange Act (17 CFR 240.13d-1).
[83] Art.8 and Art.12 of Directive 2004/109/EC, as amended by Directive 2013/50/EU (hereinafter, Transparency Directive).
[84] See, in the UK, Financial Conduct Authority, Disclosure Guidance and Transparency Rules (DTR), Chapter 5; in Italy, Art.120 Legislative Decree n. 58 of 24.2.1998, as amended by Legislative Decree n. 25 of 15.2.2016; in the Netherlands, Art.5:33 Wet op het financieel toezicht (Wft), as amended by Wet corporate governance of 15.11.2012.

The revised SRD does not deal with ownership disclosure, but with shareholder identification. Shareholder identification has a slightly different purpose. Because nowadays shares are held through a chain of intermediaries, companies may not know who their shareholders are unless they vote their shares or cross the large shareholder's threshold. This may undermine the communication between the company and its shareholders, and among the latter. Because the SRD promotes broad engagement of shareholders, it may seem only natural to set rules making it easier for companies to identify their shareholders.[85] However, while shareholder identification has different goals than ownership disclosure, it has the same chilling effect on hedge fund activism. Moreover, because the threshold for identification is lower than the one defining large ownership, and could even be set close to zero, shareholder identification has a potentially stronger impact on hedge fund activism. To be sure, the EU legislator has struggled with the threshold for identification, although for reasons of privacy, hence different from the concerns discussed in this paper.[86] As a result, member states will have to establish a system of mandatory shareholder identification, although they may exempt percentages of voting rights not exceeding 0,5%.[87]

To assess the impact of shareholder identification on hedge fund activism, one will have to wait for the implementation of the Directive by the member states. It is worth noting, however, that a more enabling approach to shareholder identification would have been preferable. Different European jurisdictions have different rules on shareholder identification.[88] In the U.S., shareholders can even opt out of identification altogether, as institutional investors typically do.[89] The EU rules could have been limited to harmonizing the sharing of information between intermediaries, which is the real obstacle to cross-border identification and likely undermines communication between shareholders. Most

[85] Recitals 4 to 7 of the revised SRD.
[86] Report by the EU Parliament Committee on Legal Affairs on the proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (Cofferati Report, 12.5.2015).
[87] Art.3a revised SRD.
[88] For instance, in the Netherlands, shareholder identification (above the 0.5% threshold) may only be requested 60 days prior to a shareholder general meeting. Art.49(b)(1) Wet op het giral effectenverkeer ('Giro Act').
[89] U.S. investors have the possibility to object to shareholder identification (Objecting Beneficial Owners, OBO). The SEC considered changing this regime, but dropped the proposal given the opposition by institutional investors. See Council of Institutional Investors, 'The OBO/NOBO Distinction in Beneficial Ownership', *White Paper* (February 2010).

important, for purposes of corporate governance, law should enable companies and their shareholders to opt out of identification if they so wish.[90]

Shareholder identification is not always efficient because it entails costs, which sometimes may be higher than the benefits. Particularly the cost for hedge fund activism can be substantial, unless hedge funds manage to circumvent identification and purchase a toehold. In this respect, the implementation of the exemption by member states will be crucial. 0,5% is still quite a low threshold for a hedge fund to stay below the radar, unless the target is a large-cap, but it can be a good start. Because, differently from ownership disclosure, the purpose of shareholder identification is not to unveil influence on management, the member state implementation may allow hedge funds to purchase their toehold through different corporate vehicles, all of which would stay under the 0,5% threshold. This would still raise the cost of hedge fund activism, but not enormously compared to the money at stake in a typical activist's campaign.[91] A much bigger question is whether any of the member states will interpret the exception of the Directive as including only the direct stake of the final holder of record, or will rather follow the ownership disclosure approach that includes all indirect holdings and acting in concert.[92]

2. The Myth of Institutional Investor Engagement

One may object at this point that hedge fund activism is exactly the kind of activism which the EU legislator does *not* want. Indeed, the revised SRD encourages a different kind of engagement, by institutional investors. The latter should have, and disclose publicly, an engagement policy geared towards the long term and including social, environmental, and governance (ESG) factors.[93] Moreover, institutional investors would have to disclose the implementation of this policy through their voting, clarifying the extent to which voting is based on proxy advisory services.[94] Finally, the incentive schemes of asset managers should be disclosed to the investing public, too, and align with the long-termism expected from institutional investors.[95] All of these provisions are established on a comply-or-explain basis: Institutional investors may deviate from them if they explain why deviation is warranted. But, for reputational reasons, it will be hard to

[90] See also Enriques et al. (n. 79), 740.
[91] I thank Luca Enriques for having made this point in a private conversation.
[92] Art.10(g) Transparency Directive.
[93] Art.3g(a) revised SRD.
[94] Art.3g(b) revised SRD. As in the U.S., the obligation for institutional investors to disclose their voting is a regulatory subsidy to proxy advisors. See Rock (n. 34).
[95] Art.3h(2) revised SRD.

see institutional investors opting out of long-termism and the pursuit of ESG goals. This suggests that institutional investors could become less supportive of hedge fund activism in the European Union. Whether this also implies that institutional investors will become more engaged, as the EU legislator expects, is another story.

As explained by Gilson and Gordon,[96] the business model of institutional investors does not incentivise them to be proactive in engaging companies. They may well be reactive, but this presupposes that the engagement is initiated by hedge funds, which have incentives to screen the market for potential engagement targets. The revised SRD will not likely generate more pro-activeness by institutional investors than the publishing and implementation of standard voting policies. Moreover, the Directive's long-termism might curb hedge fund activism only marginally. If all is needed to get the institutional investors' support is framing the engagement in terms of long-term and ESG goals, hedge funds can deliver this at a relatively low cost. As mentioned in Section III.1, what long term exactly means is in the eye of the beholder. The inclusion of ESG factors in the company's values, on the other hand, is highly correlated with the quality of corporate governance and higher financial performance.[97] Combine this finding with the fact that activist hedge funds are increasingly heralding their interest in ESG factors.[98] Institutional investors subject to the new SRD will likely support the engagement of an underperforming company in the name of ESG goals, whether or not the activist's strategy is effectively a long-term one.

If the goal of the EU legislator was to counter short-termism in corporate governance, the SRD has failed it entirely. Promoting the engagement of long-term investors does not solve the problem. As discussed in Section III.2, long-term investors such as index funds are normally decisive on a hedge fund engagement; the Directive is not going to change this. The problem is that index funds cannot be trusted to decide whether the (threat of) engagement by hedge funds, and the relative short-termism that it entails, is efficient because that depends on the particular company. Looking at shareholder activism through the lens of conflict of entrepreneurship, companies, not institutional investors, should decide whether to support hedge funds activism. The mistake by the EU legislator has been to assume that hedge funds activism is always

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[96] Gilson and Gordon (n. 15), 889 ff.
[97] A. Ferrel et al., 'Socially responsible firms' (2016) *Journal of Financial Economics*, 122, 585.
[98] See 'Activist Investor Takes a Page from Greenpeace, Pushing Companies for Change', *Wall Street Journal* 19.03.2017.

detrimental for efficiency. As discussed earlier, neither theory nor empirical evidence support this proposition.

The EU legislator missed the opportunity to offer European companies an efficient regime to deal with hedge fund activism. Hedge funds activism is not efficient or inefficient per se. For some companies, in a certain stage of their lifecycle, exposure to activism is value-increasing; for others, or for the same companies at another point in time, it is value-decreasing. As I argued in previous work,[99] law should enable individual companies to tailor exposure to activism to their circumstances, for instance depending on whether is optimal for them to profile on short-term or longer-term strategies.

In several jurisdictions, companies can effectively opt out of hedge fund activism through dual-class shares, which are to be preferred to low-trigger poison pills and variation thereof because they at least commit some of the controller's own wealth.[100] The problem is that dual class shares can hardly be introduced after the company has gone public, unless they are presented as loyalty shares. Formally, loyalty shares do not discriminate between shareholders because they provide super-voting rights to any owner that retains the shares for long enough. Practically, loyalty shares are only interesting for controlling owners, because institutional investors are reluctant to give up the higher liquidity of common stock regardless of the length of their investment horizon.[101]

The European Parliament flirted with loyalty shares for a while, but in the end dropped the proposal.[102] This is understandable considering the risk that loyalty shares may end up being imposed on existing companies, as happened in France.[103] However, loyalty shares could be taken a step further to engineer dual class recapitalizations, which can be efficient so long as institutional investors retain veto rights on them.[104] In the wake of Brexit, it is not unthinkable that the UK could choose to distance itself from the SRD and offer the loyalty shares option to attract incorporations from the Continent.

[99] Pacces (n. 16), 212.
[100] ibid 214.
[101] ibid 214.
[102] See Cofferati Report, 12.5.2015 ('Article 3ea – Support for long-term shareholding').
[103] In France, the change of the default rule made impossible even for a majority of institutional investors to opt out of loyalty shares in the Renault (state-owned) company. See 'Shareholders Rights in Europe - Short-term or short-changed?' *The Economist* 02.5.2015.
[104] See Pacces (n. 16), 215. The veto right by institutional investors would also imply the temporary character of the restriction (as opposed to regular dual-class voting structures).

V. Shareholder Rights Directive as Capital Market Regulation

As noted by a UK commentator, the revision of the SRD is significantly more regulatory than the UK Stewardship Code which inspired it.[105] Although they both promote the long-term engagement of institutional investors, the SRD departs from the Stewardship Code in two fundamental respects. First, whereas the Code binds only its signatories, the Directive, once implemented, will bind every institutional investor purchasing shares in companies traded on an EU exchange. Although both the Code and the Directive follow a comply-or-explain model, investors in EU stocks will have fewer possibilities to opt out of long-termism, if any at all, because they will be bound to the SRD framing as a matter of default. The second difference from the Stewardship Code is the inclusion of ESG goals in the engagement policy, as requested by the European Parliament. Such a pro-social approach does not belong to the more market-oriented tradition of UK company law.[106] This tradition is reflected by UK soft law instruments, such as the Stewardship Code, wherein ESG factors are mentioned as an option to define the engagement policy, not as the default rule as in the SRD.

As mentioned earlier, the stronger emphasis of EU law on long-termism and ESG factors is unwarranted as one-size-fits-all solution. However, the adverse impact of this on hedge fund activism will probably not be dramatic. The question remains, though, why the revised SRD takes such a prescriptive stance towards corporate governance, and whether such a stance fulfils any public interest goal. An important clue comes from the Directive itself. Institutional investors have to disclose not only their engagement policy, but also their investment strategy, particularly in relation with their long-term liabilities.[107] Similarly, their arrangements with asset managers must reflect an alignment of the investment strategy with the profile and duration of their liabilities.[108] These provisions have nothing to do with corporate governance, although they can be regarded as the investment preconditions of long-term engagement.

The revised SRD may be pursuing a bigger goal than fighting short-termism in corporate governance. The above-mentioned provisions seem rather to foster matching

[105] Iris Chiu, 'European Shareholder Rights Directive proposals: a critical analysis in mapping with the UK Stewardship Code?' (2016) *Era Forum* 17, 31, 35-39.
[106] This is also known as stakeholder approach to corporate governance, which I discuss above, text accompanying notes 62-64.
[107] Art.3h(1) revised SRD.
[108] Art.3h(2) revised SRD.

between the maturity of assets and liabilities in the asset management industry. This aligns with one of the macroeconomic goals of the CMU, which is to channel long-term savings towards long-term investments. The only problem is that this is the domain of capital market regulation, not of corporate governance.

One could see a silver lining looking at this approach from a financial stability perspective. Let me relax, for a moment, the assumption that there may be no negative externalities of corporate governance. Institutional investors, which are also key corporate governance players, undermine financial stability by having too little of their portfolios invested in equities.[109] Rather, institutional investors invest part of long-term liabilities in scarce, short-term safe assets.[110] This creates demand for shadow banking, which produces safe assets out of risky investments, but poses global challenges for financial regulation.[111] Being based on short-term funding, shadow banking does not only contribute to the short-termism of financial markets, but also generates systemic risk. These negative externalities, in principle, justify regulation aiming to curb the demand for shadow banking, such as the SRD's call for longer-term investment. Nevertheless, for several reasons, corporate governance is not the right tool to improve the matching between assets and liabilities of the asset management industry.

Firstly, using corporate governance to regulate the asset management industry creates a bias in favour of long-term management. Long-term feedback, however, does not fit certain companies. Companies that are slow to react to a rapidly changing environment benefit more from hedge funds than from long-term investors.[112] Secondly, using corporate governance to regulate capital markets may be ineffective, particularly if the rules can be opted out of, or circumvented. This may be good news for the companies that benefit from short-term feedback, but is arguably inefficient for the society. Finally, steering investors towards longer horizons may be not enough to cure the imbalances nurturing financial

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[109] On the so-called "de-equitization" of the asset management industry, see A.G. Haldane, 'The age of asset management?' (2014), Speech at the London Business School, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

[110] This is called reverse maturity transformation. See Z. Pozsar and M. Singh, 'The nonbank-bank nexus and the shadow banking system' *IMF Working Papers No. 11/289* (1 December 2011).

[111] Hossein Nabilou and Alessio M. Pacces, 'The Law and Economics of Shadow Banking' *European Corporate Governance Institute (ECGI) - Law Working Paper No. 339/2017* (21 January 2017). Forthcoming in *Research Handbook on Shadow Banking*.

[112] Hedge funds and long-term investors may well co-exist, particularly when the latter are index funds. See text accompanying notes 70-73.

instability. According to one view,[113] the financial instability of these days is a reflection of secular imbalances, such as the difference between profit expectations and the slow growth of the productivity of labour, or the underfunding of pensions due to ageing population. If this theory is correct, the whole approach of the CMU will be insufficient to prop up economic growth in Europe, in the absence of entrepreneurship and innovation. Corporate governance can better support these two than capital market regulation.

VI. Concluding Remarks

In this paper, I have analysed shareholder activism from the perspective of the CMU, particularly the recent revision of the SRD. The main findings are as follows. First, the effective engagement of institutional investors in corporate governance must rely on hedge fund activism. Whether the latter is desirable depends on the characteristics of the particular company. Second, the SRD includes a number of rules that curb, albeit marginally, hedge fund activism for want of a longer-term engagement by institutional investors that cannot stand on its own feet. EU law missed the opportunity to let individual companies choose the efficient regime regarding shareholder activism, and alter it over time. Third, the prescriptive stance of the SRD can be explained out of the broader macroeconomic concerns underlying the CMU. Although promoting long-termism in the asset management industry makes sense for the purpose of financial stability, this may undermine the efficiency of corporate governance. The latter is arguably more important than capital market regulation to support innovation and economic growth.

[113] Z. Pozsar, 'A Macro View of Shadow Banking: Levered Betas and Wholesale Funding in the Context of Secular Stagnation' *Working Paper*, available at http://dx.doi.org/10.2139/ssrn.2558945 (31 January 2015).

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