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“Too Big to Be Activist”

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Too Big to Be Activist

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Abstract. Why are activist hedge funds always managed by small investment management firms? Why don’t the biggest managers, like Fidelity, Blackrock, or Goldman Sachs, ever start dedicated hedge funds to engage in corporate governance activism? The question is important, because the potential for activism is massive. If Fidelity ever started an activist hedge fund, it could theoretically leverage the holdings of Fidelity’s many mutual funds to become the most powerful activist hedge fund in the world. The answer cannot be that activism is not profitable for mutual funds, because activism plainly can be profitable for hedge funds. And since a large manager will often operate a diffuse array of small hedge funds in all manner of niche investing strategies, it is not at all obvious why an activist hedge fund should not be included among them.

This essay argues that the reason Fidelity and other big investment managers remain so passive is that they are simply too big to be activists. Large managers become big by simultaneously managing money for many different funds and clients. And the interests of these many funds and clients often conflict—especially when it comes to aggressive corporate governance activism. Even as activism might benefit one client, it will inevitably hurt others, placing a large manager in extremely difficult legal and economic dilemmas.

The conflicts among clients over activism come from several directions. Some conflicts are purely economic, such as when one of a manager’s funds invests in a bankrupt company’s equity while another invests in the company’s debt. Other conflicts are legal, such as when activism by one fund creates unbearable obligations for other funds under section 13(d) of the Securities Exchange Act of 1934. The combined effect of these conflicts is to make aggressive corporate governance activism all but impossible for large investment managers. Though large managers can engage in soft forms of activism, they can never exercise direct corporate control.

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The future of American capitalism belongs to a handful of giant investment managers. Registered investment companies like mutual funds collectively hold $19.2 trillion in total assets, enough to give them 31% of the outstanding common stock of America’s public companies. Of this amount, fully 64% — or $12.2 trillion — belongs to just four massive investment management firms: Blackrock, Vanguard, State Street, and Fidelity. Blackrock alone has more than $5 trillion in assets under management, and Vanguard more than $4 trillion. These giants are growing much faster than their smaller competitors. In 2006, the four biggest managers held 51% of all assets in mutual funds; by 2015, they held 68%. Vanguard in particular is booming. Between 2006 and 2015, Vanguard took in 8.5 times as many assets as all 4,000 other firms in the mutual fund industry combined.

With so much wealth under management, these big managers have enormous potential to control the companies in which they invest. Vanguard, Blackrock, and State Street hold so many shares in America’s public companies that they each control one of the five largest stakes in at least 25 of the 25 largest U.S. corporations. One of Vanguard, Blackrock, and

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2 INVESTMENT COMPANY INSTITUTE, at 14.
5 PENSIONS & INVESTMENTS, The World’s Largest Managers (Oct. 1, 2007, 12:01AM). See Table 4A (indicating that the four biggest managers held $5.7 trillion in 2006) INVESTMENT COMPANY INSTITUTE, at 9. See Table 5 (indicating that in 2006, assets in mutual funds totaled $11.2 trillion).
6 Gregg A. Runburg, Table: The World’s Largest Money Managers, PENSIONS & INVESTMENTS (Oct. 31, 2016, 12:01AM), www.pionline.com/article/20161031/INTERACTIVE/161029928. See Table 4B. (indicating that the top four managers held $12.3 trillion in 2015); INVESTMENT COMPANY INSTITUTE, at 9. See Table 3 (indicating that all mutual fund managers held $18.1 trillion).
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State Street is the largest shareholder in 88% of all firms on the S&P 500. Blackrock and Vanguard manage one of the ten largest stakes in 65% of all publicly traded firms, State Street in 35%, and Fidelity in 28%. Blackrock is the largest shareholder in one in five U.S. public companies.

The immense potential influence of these big investment managers has inspired equally immense fear — and hope — that they will use their influence to change the way companies do business. Academics in both law and economics have generated a tidal wave of research — much of it in the last two years — contemplating what this consolidation in corporate ownership is going to mean. What is at stake is not just the hopeful possibility of improvements in shareholder oversight, but also the much darker risks that big managers will cartelize whole industries, launch vast programs of political influence, or destroy the delicate balances of power between shareholders and directors.

The thesis of this essay, however, is that for better or worse, much of the largest managers’ potential for influence is destined to remain unrealized. And the reason, paradoxically, is that the biggest investment managers are simply too big. Large investment managers attain their great size not by owning assets directly, but by managing them on behalf of outside clients. In a large management firm, these clients can number in the
hundreds or thousands, and may include a diverse mix of different investment strategies spread across a wide array of hedge funds, private equity funds and mutual funds. Thus, although we often speak of large managers as though they “own” shares in public companies, in fact large managers own very little; almost all the shares they manage are actually owned by a diffuse array of legally distinct clients.

This fragmentation of a large manager’s shareholdings is crucial to understanding how a large manager does business, because it tightly constrains what the manager can do. When a manager simultaneously works for many different clients, it faces enormous conflicts of interest among those clients. Actions that benefit one client can often harm another. The need to avoid and minimize these conflicts thus influences every aspect of a large investment manager’s business.

Indeed, the argument of this essay is that these conflicts can become especially acute when it comes to corporate control. For reasons that I will explain, any attempt by a large manager to use its clients’ shares to directly control or aggressively influence a public company will inevitably hurt some of the manager’s clients, even as it benefits others. These conflicts over activism can become so profound that for even a moderately sized manager, conflicts can render aggressive forms of activism all but impossible. Though a large investment manager can practice soft forms of activism like quietly talking to corporate directors or voting for board candidates nominated by smaller investment managers, a large manager can never practice more direct forms of activism and control. Large investment managers almost never solicit proxies in merger disputes and almost never nominate their own candidates to corporate boards.

Aggressive activism heightens conflicts among clients in a number of ways. Some of these ways are economic. To pick just one very simple example, if one client invests in a company’s equity while another client invests in the company’s debt, then if the company ever goes bankrupt, the interests of the two clients will be directly opposed. This will inhibit activism by preventing the manager from voting its’ two clients’ securities as a single unified bloc. Other conflicts come from not from economics, but from law. The most serious problem is section 13(d) of the Securities Exchange Act of 1934, which regulates investors who own more than a certain percentage of a company’s securities. Crucially, section 13(d) combines an investment manager and all of its various clients into a single unit for purposes of regulation.
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Shares owned and actions taken by one of a manager’s clients are automatically attributed to all of the manager’s other clients. The details of section 13(d) thus interact in surprising ways to ensure that corporate governance activism by one of a manager’s clients can have catastrophic regulatory consequences for many of the manager’s other clients. Other statutes and rules create similar problems, including section 16(b) of the Securities Exchange Act, Rule 10b-5 of the Securities Exchange Act, and privately adopted corporate poison pills.

This focus on conflicts of interest is useful, because it pushes our understanding well beyond existing explanations for large managers’ passivity, allowing us to perceive and answer deeper and more important questions than we have encountered before. Current writing about the corporate governance activities of large investment managers has focused not on the managers, but on the individual mutual funds that they manage. Commentators have argued that the reason big mutual funds tend to be so passive in corporate governance is simply that they simply do not find activism profitable.\(^{15}\) Elements of their marketing and investment strategies make it so that spending money on activism does not generate a benefit commensurate with the cost.\(^{16}\)

This argument is useful and convincing as far as it goes, but it fails to appreciate the full depth of the problem. The question I ask here is not why large managers do turn their mutual funds into activists—it is why large managers do not turn their hedge funds into activists. Though we know that large mutual funds do not find activism profitable, we also know that large hedge funds plainly do. This is why the market for hedge fund activism is presently booming. Moreover, it would seem that if any managers could run an activist hedge fund strategy profitably, it ought to be the very largest ones. Large managers already run all manner of niche strategies, and corporate governance activism could in theory become one of those strategies. And since the basic currency of corporate activism is shareholder votes, large

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\(^{16}\) Stephen Bainbridge makes a similar argument in a highly cited paper. Bainbridge, supra note 14. Though Bainbridge does not focus specifically on mutual funds, he argues that the costs of activism are so high and the benefits so low that large institutional investors rarely engage in activism. He notes, however, that activism is nevertheless relatively common among pension funds and certain hedge funds. Id. at 11. In Part VI of this essay, I offer an explanation why.
managers would seem to hold greater promise for activism than their smaller counterparts, because large managers tend to have many more votes. Whereas Pershing Square, the most prominent activist hedge fund in America, has two funds and about $12 billion dollar under management, Fidelity has hundreds of funds and about $2 trillion under management. Thus, if Fidelity ever formed a $12 billion activist hedge fund of its own to add to its stable of other clients, Fidelity could theoretically support this relatively small activist hedge fund by directing all $2 trillion of its other clients to vote alongside the fund. Fidelity could form a voting bloc several orders of magnitude larger than Pershing Square, guaranteeing Fidelity’s small activist hedge enormous influence and massive potential profits.

And yet, one of the little noticed facts of modern corporate governance is that Fidelity and other large managers never do this kind of thing—only small managers like Pershing Square do. The reason, of course, is that the large managers are just too big to be activists. They have so many clients that they cannot overcome these clients’ many conflicts.

I will proceed first by explaining how large investment managers are structured and how they come to contain so many conflicts among their clients. I will then clarify what I mean by “activism” and identify how activism aggravates these conflicts. I will consider other possible explanations for large investment managers’ passivity before contemplating the implications of my thesis for law and policy reform.

I. Investment Managers and Corporate Influence

To understand the conflicts over corporate control in large investment managers, we must first understand how investment managers come to take on so many different obligations to so many different clients.

A. The Investment Management Industry

The business of an investment manager is to invest other people’s money. Individuals and institutions entrust their money to an investment manager in the hope that manager will earn a better investment return at less cost than if the investors chose the investments themselves. In exchange for providing this service, the investment manager charges a fee, which may be calculated in a variety of ways, such as a percentage of the assets under management, or a percentage of investment returns. An investment manager invests money in a variety of ways, but the most common—and the one that has the greatest effect on corporate
governance—is to buy stocks, bonds, and other securities in operating businesses. An
investment manager might invest its clients’ money, for example, in the common stock of
General Motors, IBM, or Microsoft.

The investment management business has become so large and profitable that the
modern investment managers who account for the bulk of the industry’s assets tend not to be
individuals, but large corporate firms with diversified financial businesses. Examples of large
corporate investment managers include Fidelity, Blackrock, Goldman Sachs and TIAA-
CREF. As we have seen, the benefits of the investment management industry’s growth have
not been equally distributed among all investment managers. A handful of the very largest
management firms have grown astonishingly quickly in recent years, with the effect that the
industry’s assets are becoming increasingly concentrated in just a handful of the biggest firms.

For present purposes, the crucial fact about these large investment managers is that
they do not work for just one client. A large institutional manager like Fidelity or Blackrock
works simultaneously for many different clients, each with its own investment strategy, its
own owners, and often its own distinct corporate existence. It is partially the accumulation
of all these different clients that accounts for a big investment manager’s great size. Fidelity,
for example, is best known for managing mutual funds, and it operates nearly a hundred of
these funds, including the Fidelity Magellan Fund, the Fidelity 500 Index Fund, and the
Fidelity Ohio Municipal Income Fund. These funds attract a variety of investors, including
individuals saving for retirement or college, as well as institutions seeking returns on their
endowments or other assets. In addition to these mutual funds, Fidelity also manages an array
of so-called private funds, including private equity and hedge funds, which exclude the
general public and accept investments only from large and sophisticated institutional
investors. Fidelity further manages thousands of so-called separately managed accounts,
which are individualized accounts, similar to bank accounts, that each contain the assets of
only a single investor. Fidelity also runs a large trust company, which serves as a trustee to
thousands of donative trusts of the kind that grandparents commonly establish at their deaths
for their grandchildren. The net effect of all these mutual funds, private funds, and individual
accounts and trusts is to give Fidelity and other large investment managers a huge number of
distinct clients, likely reaching into the tens of thousands.

In each of these businesses, the clients will rely heavily on Fidelity for their operations. Each investment fund or individual client will have a contract with Fidelity that specifies the terms of Fidelity’s authority and the fee to be paid. Very often, especially in the case of investment funds, Fidelity will have almost total discretion about how to manage the fund. The fund will have no employees of its own, and only minimal mechanisms of corporate governance. A Fidelity fund is effectively controlled and dominated by Fidelity.

It is thus easy to conflate Fidelity with its various clients, but we must nevertheless keep them conceptually distinct, because the clients of an investment manager are not all pooled together, and their assets do not formally belong to the manager. Each Fidelity mutual fund, for example, is a separate legal entity with a separate group of shareholders and a separate set of investments. The stocks and other investment assets of the fund legally belong to the fund, and not to Fidelity or to Fidelity’s other clients. Each Fidelity mutual fund is thus a separate client—as is each hedge fund, private equity fund, trust, and separately managed account.

The distinctions between a manager’s many clients are important, because they mean that each client is a separate locus of fiduciary duty. An investment manager’s fiduciary obligation runs not to all of the clients in the aggregate, but to each client individually. Like a lawyer who represents multiple clients at the same time, an investment manager has a fiduciary responsibility—rooted in the laws of agency, trusts, corporations, and contract—to serve the interests of each client individually without sacrificing that client for the benefit of any other.

The proliferation of these sites of fiduciary duty does not stop with the manager’s external clients. In addition to its external investment management clients, a management firm may also have responsibilities to its own shareholders and to the clients of its many other business lines in addition to investment management. Investment management is often not the only business an investment management firm carries out. An investment management firm may also operate a far-flung array of other financial services businesses that work in tandem.

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18 Some investment management clients, such as the one who set up separately managed accounts, may not formally own the investment assets in their portfolios in separate legal entities. Instead, the assets will formally belong to the manager, with the client merely having a contractual claim against the manager. Although this ownership formality is important for purposes of creditors’ rights, it is not important for purposes of fiduciary duty. Whether or not a client holds separate title to its investments, each client is a separate site of fiduciary duty.
with investment management. Goldman Sachs, for instance, operates a huge investment management business covering mutual funds, hedge funds, private equity funds, and separately management investment accounts. But Goldman is best known for its many other financial services businesses, including investment banking, commercial lending, securities underwriting, consulting, and derivatives underwriting. Goldman also has its own proprietary investing operation, in which it invests its own money for its own benefit. A large investment manager thus has to balance not only the interests of its many investment management clients, but also the interests of its own shareholders and its many customers in its array of other business lines.

The proliferation of sites of fiduciary duty is thus a major component of an investment manager’s business. Balancing these various duties is one of the major organizational projects of an investment management, not just for the lawyers, but for everyone who works inside these firms. Striking the right balance is often difficult, however, because an investment manager often holds extensive discretion. Since the purpose of conveying money to an investment manager may be to gain the benefit of the manager’s expertise, the manager might have the power to make a great many discretionary decisions about how to invest the money and what to do with it. Mutual funds, private equity funds, and hedge funds, for example, do not have any of their own employees, instead delegating total control to the management companies that establish and operate the funds. Some clients, such as index mutual funds, place contractual limits on what a manager may do, but nevertheless leave formal authority in the hands of the manager. This system of delegating total authority makes sense for reasons I have described elsewhere.\(^{19}\) But it nevertheless forces a manager often to make difficult decisions with extensive consequences for fiduciary duties.

**B. The Management of Portfolio Voting**

When an investment manager has the authority to decide how its clients invest their money, the manager also usually has the authority to decide how its clients will vote the securities of the companies in which they invest. It is thus usually the responsibility of the manager — rather than the client — to decide how a client will vote on director elections, mergers and other matters. The task of voting is important, but it can quickly become

\(^{19}\) Morley, supra note 17, passim.
overwhelming in its logistical details. A large manager might easily invest in 10,000 or more companies, meaning that the manager will have to vote in a shareholder meeting in almost every one of these companies every year. And each time the manager votes in one of these meetings, it may do so on behalf of many different clients. Thus, the number of distinct voting decisions can potentially become enormous. If in a given year a manager were to vote in 10,000 elections on behalf of an average of 10 different clients each time, the manager could be responsible for making as many as 100,000 distinct voting decisions a year.

To get a sense of how large managers handle this colossal challenge, I interviewed about a dozen current and former lawyers and executives at large investment management firms and asked them how they do it. Their responses trace out a broadly similar set of bureaucratic and technical devices that can be arranged along a continuum of centralization and decentralization.

At the centralized end of the continuum, a management company might have a dedicated department headed by a fairly senior executive and staffed by a dozen or more professionals whose job is to formulate voting policy for the entire firm. In a centralized firm of this kind, the central voting office might decide how to vote all of the manager’s different clients’ shares on each matter in each portfolio company. If a hedge fund, a mutual fund and a separately managed account each owned shares in Delta Airlines, for example, the centralized voting office would make a decision for all three of these clients and vote each of their shares the same way. In a centralized firm of this kind, however, the central voting office commonly gives an individual portfolio manager the right to vote her client’s shares differently from the rest of the firm. When the central voting office announces a vote for Delta, for example, the portfolio manager of a single hedge fund can choose, if she wishes, to vote the fund’s shares in Delta against the rest of the management firm’s other clients.

In contrast to a centralized firm, a decentralized firm might place responsibility for most of the initial decision-making about voting directly in the hands of individual portfolio managers. If three different funds each hold shares in Delta, the managers of each different fund may make the decision about how to vote the shares independently without any central guidance. Such a decentralized firm may nevertheless have a central voting office with a small staff whose purpose will be to safeguard the reputation of the firm as a whole. The office will not allow an individual portfolio manager to issue a public statement on a corporate
governance dispute unless the rest of the management’s company’s clients—via the central voting office—agree to take the same position as well. Thus, even a management firm with a decentralized voting operation will rarely put its reputation on the line in public without a firm-wide consensus that requires all of the manager’s clients to sign on off.

II. The Different Degrees of Activism

Voting, of course, is just one of many factors that determine a shareholder’s influence in a company. A shareholder’s influence can also be a function of other factors such as the shareholder’s willingness to offer shareholder proposals, its ability to run proxy contests, and its willingness to speak out against a company’s executives in public. We can thus arrange the potential forms of shareholder activism along a continuum of directness. Since my basic thesis is that the conflicts among an investment manager’s clients grow as we move upward on this continuum, it is important to understand the continuum clearly.

For a large manager, the forms of influence at the top of the continuum of directness—and the ones that bring clients into greatest conflict—are those that satisfy the technical definition of “control” in section 13(d) and Rule 13d-1 of the Securities Exchange Act of 1934. As we will see, section 13(d) and Rule 13d-1 regulate activism by large stockholders, and they impose much greater burdens on stockholders who intend to “change[e] or influence[e] control” of a company than on stockholders who do not. Any activity that qualifies as an attempt to “change or influence control” is thus at the top of the spectrum of directness in activism.

Unfortunately, the definition of “control” under section 13(d) and Rule 13d-1 is difficult to pin down precisely, because the statute and rule contain no express definition, and the SEC’s guidance suggests that whether an investor exercises control is a multifactor inquiry that depends heavily on the specifics of a given circumstance. Nevertheless, it is clear that even some fairly modest forms of influence can qualify as control. According to recent guidance provided by the SEC, examples of control include “engag[ing] with an issuer’s management on matters that specifically call for the sale of the issuer to another

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company, the sale of a significant amount of the issuer’s assets, the restructuring of the issuer, or a contested election of directors.” In other words, simply to “engage with an issuer’s management” on a “contested election of directors” is to exercise control. It is not obvious what it means to “engage with an issuer’s management,” but it seems clear that nominating a candidate in a contested election would qualify.

Activities that qualifies as “control” under section 13(d) thus occupy the top of the continuum of directness. Below these activities rank many other forms of activism that pose fewer conflicts of interest, but may nevertheless still be complicated. One common form of relatively indirect activism occurs when a large manager votes its clients’ shares in solidarity with the activism campaign of a smaller manager. Quite often, activist hedge funds operated by small managers with only one or two clients will launch proxy campaigns or public relations offensives and then recruit larger managers to support them. In these scenarios, the small managers who are running the activism campaigns almost always satisfy the definition of “control” under section 13(d), but the larger manager who support the smaller managers generally do not. So long as a larger manager does not materially assist the smaller manager or work with the smaller manager as a member of a group, the larger manager can safely vote for the smaller manager’s campaign without running afoul of section 13(d).

Another relatively indirect form of influence involves quiet, behind-the-scenes engagement. A manager might implement this strategy by, for example, meeting with the board members and senior executives of a portfolio company and talking about how the company should be managed. A recent survey of institutional investors confirms that this form of activism is quite popular, even among large managers. The lawyers and management company executives I spoke with claimed that although this sort of activism happens frequently, it rarely turns into formal voting and it almost always happens behind closed doors, away from public view. A manager who prefers this kind of quiet influence can exercise its formal voting rights in ways that do not qualify as “control” under section 13(d).

The final and least problematic form of influence is simply for a manager to do nothing, effectively consent passively to the status quo of a company’s activities. If an

23 SEC. & EXCH. COMM’N, EXCHANGE ACT SECTIONS 13(D) AND 13(G) AND REGULATION 13D-G BENEFICIAL OWNERSHIP REPORTING (2016) (Question 103.11).
investment manager controls a large stake in a company, but chooses never to speak to the company’s executives or become involved in the company’s management, this passivity can function as kind of a tacit approval of whatever the company’s executives are then doing. To remain passive in the face of a particular set of executive choices, in other words, is effectively to approve those choices. This is the kind of activism that features in the recent academic arguments about the phenomenon of horizontal shareholding, and I will revisit it again in a moment.\(^\text{25}\)

In addition to these forms of activism, a manager may also become connected to a company simply by accumulating shares. And as we will see, this, too, can raise conflicts of interest among different clients. Though a large investment position can be most difficult to sustain when it is coupled with the more aggressive forms of activism just mentioned, even the mere acquisition of shares can sometimes be difficult when a manager has a large and diverse array of clients. As we will see, acquiring shares is especially costly when it brings the total holdings of a manager and its various clients to 5% and then 10% of an issuer’s total shares outstanding.

III. Economic Conflicts of Interest

As forms of activism grow more direct, they raise more and more conflicts among the many clients of a large investment manager. Aggressive forms of activism can trigger a variety of conflicts of interest, both among the manager’s external clients and also between the manager’s external clients and the manager’s other internal business lines. These conflicts may not arise when a manager and its clients choose merely to be passive or to employ the mild forms of activism noted above. But they can become debilitating when managers pursue more aggressive forms of activism.

The conflicts that make activism costly in a diversified investment management firm come from many sources, some economic and some legal. Let us begin with the economic conflicts. These economic conflicts may or may not rise to the level of breaches of legal fiduciary duties. But they are conflicts all the same, and they can complicate the administration of a manager’s business, even if they do not make a manager legally liable.\(^\text{26}\)

\(^{25}\) *Supra* note Error! Bookmark not defined. and accompanying text.

\(^{26}\) There is an interesting parallel here to problems of shareholder heterogeneity in ordinary companies. As Hansmann has argued, collective decision-making among the owners of an
A. Other Business Lines

Perhaps the biggest source of conflicts arises not between a manager's external clients, but between the external clients and the manager’s other internal business lines. As we have seen, investment management is rarely the only thing that a large investment manager does. In addition to managing investments, Goldman Sachs, for instance, also runs business lines in commercial banking, investment banking, securities underwriting, and derivatives underwriting. Other investment managers also operate diverse businesses. Vanguard, Fidelity, and TIAA-CREF each run a business as an administrator of 401(k) accounts and similar retirement plans for big employers. Fidelity administers the 401(k) plan for Microsoft, for example, by keeping track of each Microsoft employee’s monthly contributions and withdrawals and by providing a web site and phone number that employees can call for customer service. Fidelity profits from this role both by charging Microsoft a fee to administer the employee accounts and by charging each employee a fee when she chooses to invest her 401(k) savings in Fidelity mutual funds, which Fidelity may promote to Microsoft employees as part of its administrative activities.

The trouble with an investment manager having lines of business beyond investment management is that the interests of these other lines of business can be hurt by investment management client’s efforts at activism. Consider, for example, investment banking. The investment banking division of Goldman Sachs sells a variety of professional and financial services to big companies, including loans, securities underwriting and advice on mergers and acquisitions. If Goldman Sachs were ever to start an activist hedge fund, the antics of the fund might easily damage Goldman’s investment banking relationships. If the fund went around terrorizing the CEOs of S&P 500 companies, how many of these CEOs would hire Goldman for merger and acquisition advice? Fidelity might face a similar problem if one of its hedge funds became aggressively active. Fidelity’s 401(k) business serves the human resources enterprise is very costly when the decision-makers have systematically different preferences. This parallel would be worth exploring more deeply. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) (arguing that the cost of heterogeneity forces companies to be owned by single classes of patrons); see also Anabtawi, supra note 14 (arguing that heterogeneity among the shareholders of public companies diminishes the value of shareholder empowerment).
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departments of many of America’s big companies, and an activist hedge fund that attacked
these companies might complicate Fidelity’s efforts to build relationships with them.

The conflicts between an investment manager’s various business lines has been seen
before in the ongoing controversies over analyst reporting. Analysts affiliated with investment
banks often sell research reports on public companies that advise investors on whether they
should buy or sell the stock of these companies. In the early 2000s, these analysts generated a
raft of lawsuits when plaintiffs’ lawyers alleged that the analysts were writing inaccurately
positive reports in order to curry favor with companies that might later hire the analysts
banks’ to provide financial services.27

Just recently, evidence has surfaced of similar conflicts between analysts and their
banks’ investment management units. Many public companies permit the clients of some
investment managers to speak to the companies’ senior executives, and investment managers
sometimes earn money by charging clients for this privilege. Walmart, for instance, might give
certain preferred clients of Goldman Sachs the right to speak directly with Walmart
executives. Many companies like Walmart, however, have a policy of only permitting an
investment manager to grant this kind of access if the manager’s analysts have written positive
reports about the company.28 If a Goldman analyst writes a bad report on Walmart, the access
of Goldman’s investment management clients may be cut off.

The controversies over analyst reports illustrate the potential for conflicts over
corporate governance activism. If Walmart will deny access to Goldman clients on the basis of
a Goldman analyst report, then Walmart would surely do the same on the basis of an
antagonistic Goldman hedge fund activism campaign.

B. Differing Tastes for Activism

Activism can also bring an investment manager’s clients into conflict because it can
affect each of the clients differently. It might hurt some clients even as it helps others. For
example, if a manager operates both a debt fund and an equity fund, and they both invest in
the same company, how should the manager vote its holdings if the company becomes

27 Randall Smith et al., Wall Street Firms Settle Charges Over Research in $1.4 Billion Pact, WALL ST. J.,
28 Serena Ng & Thomas Gryta, New Wall Street Conflict: Analysts Say ‘Buy’ to Win Special Access for their
distressed? The interests of the debt and equity holders will be in direct opposition to one another, since every dollar given to a debt holder is a dollar not given to an equity holder. For this manager to actively influence the outcome of a bankruptcy bargaining process is thus a profound conflict of interest. If both the debt and the equity belonged to a single entity, as in a small investment management firm with only a single distressed debt fund to manage, then there would be no conflict. The management firm could simply push for the interests of either debt or equity so as to maximize the payoffs to the single entity that owns both. But if instead the debt belongs to one client and the equity to another, then the conflicts can be serious indeed.

In conversations, professionals from large management firms downplay the conflict between debt and equity, saying that debt and equity rarely come into tension in a large manager’s day-to-day operations. But this may only be because large investment managers deliberately structure their investments to avoid these conflicts. Large managers rarely invest in the debt of distressed companies. Distressed debt investing is overwhelmingly the province of funds run by small, focused investment managers, rather than funds run by large, diversified investment managers. It is not surprising that large managers do not find debt and equity coming into conflict, because they deliberately steer clear of situations where conflict is imminent.

Activism can affect clients differently in other ways as well. Consider taxes. What if one fund is full of taxable investors, such as wealthy individuals, and another is full of untaxable investors, such as 401(k) plans and university endowments? How should the manager of these two funds vote on a campaign to approve a going-private merger transaction that will cause the company’s shareholders to realize profits and tax liabilities? Different funds will have different preferences based on their different tax statuses.

Or imagine that one fund is focused on socially responsible investing and another is not. Should the manager use its influence to make a portfolio company more responsible at the cost of reducing its profitability? Or what if one fund has bet on Apple and another on Huawei? Since Huawei makes super cheap smart phones that are undermining Apple’s core business, Apple and Huawei are competitors — and so are the funds that invest in them. So as between Apple and Huawei, where should the manager devote its activist time and energy?
The usual answer for a manager when the interests of clients point in opposite directions is to vote each client’s holdings in that client’s best interests, ignoring the interests of the other client. A manager who operates both a debt and an equity fund might vote the debt fund’s holdings in the interests of debt, and the equity fund’s holdings in the interests of equity, even if that means voting the two funds’ holdings in opposite ways.

This strategy works fine in most cases, but it only proves my point. By voting its clients’ holdings in opposite directions, a manager effectively gives up on the prospect of turning its various clients’ holdings into a single, unified bloc. To vote clients’ holdings in opposite directions is effectively to adopt a strategy of uncoordinated passivity, not coordinated activism.

C. Differing Strategies for Engagement

A further problem is that even if every one of a manager’s various clients agrees on the need to influence a portfolio company, they might prefer different time horizons and strategies for implementing that influence. Compare, for example, the different preferences of an index mutual fund and an activist hedge fund. An index mutual fund’s investment strategy is to hold the stocks that appear on an index, which is a list of securities compiled by a third party. Examples of popular indices include the S&P 500 and the Russell 2000. Index funds have grown enormously in recent years and they now account for nearly a quarter of the assets of all equity mutual funds. The reach of indexing spans even farther if we consider the many funds that employ a so-called “closet indexing” strategy. As Martijn Cremers and other financial economists have shown, many fund managers that purport to make careful discretionary decisions about how to invest their funds actually just invest in almost exactly the same stocks that appear on index lists.

Index funds and their closet indexing counterparts tend to prefer less assertive forms of activism than other kinds of funds. Indexers tend to prefer quiet, closed-door meetings with company executives over aggressive public contests. The main reason is that an index fund cannot sell its shares in a company even if its relationship with the company’s executives turn sour. An index fund has to hold the stocks listed on its index, no matter how bad the fund’s

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29 Investment Company Institute, supra note 2, at 46.
relationship with the company’s board becomes. This naturally makes an index fund conservative in the way it relates to a board. An index fund will tend to want to make peace with the managers, in the hopes of maintaining a productive long-term relationship.

Contrast these preferences of an index fund with the preferences of an activist hedge fund. An activist hedge fund does not share an index fund’s preference for conservatism. If an activist hedge fund tries to change a company and fails, the activist can just sell the shares and move on to another company, leaving the buyers of the shares to develop a more positive relationship with the company’s directors. Thus, even if an activist hedge fund and an index fund have identical beliefs about the direction of a company and the need for activism, they will have different preferences for how the activism is carried out.

These differing preferences come into conflict, because they cannot be acted out independently. If both funds are operated by the same manager, then one fund’s actions will inevitably spill over onto the other fund. In interviews, investment management professionals insist that when a corporate voting officer from Fidelity shows up in the boardroom of an operating company like Delta Airlines, Delta’s directors will presume that the Fidelity officer speaks on behalf of all Fidelity clients, not just a single client. If a Fidelity officer showed up representing an activist hedge fund, anything she says will therefore almost certainly be attributed to Fidelity’s index mutual funds. If the activist fund comes in with guns blazing, the index fund will not get any more access to quiet, closed-door meetings.

Such a conflict can also spread beyond the companies that the activist fund specifically targets. If an activist fund targets Delta, for instance, the fund’s manager and its other clients may find it hard to get meetings not only with the board of Delta, but also with the boards of American Airlines, United Airlines and maybe even Microsoft.

**D. Cost and Profit Allocation**

Further conflicts arise in allocating the costs and profits of activism. Activism is expensive. If a manager wants to influence the operations of a portfolio company, it has to pay investment analysts to identify the company and then develop a plan for improving it. The manager also has to pay lawyers to get around takeover defenses and comply with legal regulations, as well as proxy solicitors to send out mailings and recruit investors to vote.

With this large set of costs to pay, a large investment manager may have a difficult time deciding which of its many clients should pay the costs. If three different funds all buy
stock in a target company, which ones should pay the costs, and in what proportions? There is no easy answer, because a large manager may have hundreds of clients invested in a particular public company at any given time. Maybe the manager could ask each of these clients to pay costs in proportion to the size of their investments. But what if a client does not want to pay? Or what if a client’s investment strategy does not permit corporate activism? What if, as in a mutual fund, the client has a fixed fee that does not fluctuate with actual expenses? And what if a client’s proportionate ownership changes over the life of the investment for reasons beyond the client’s control, such as investor redemptions that force the client to sell off some of its shares?

Perhaps more difficult than the allocation of costs is the allocation of profits. The profits from influence are inherently scarce, because an investment manager can only buy so many shares in a target company before the opportunities to buy it at a low price dry up. An activist investor’s basic strategy is to buy shares at a low price before the activism campaign has begun and then to sell later at a higher price after the campaign has succeeded. This strategy works well, but only if the activist can keep its intentions secret at the time it is buying. If the rest of the market knows that an activism campaign is coming, then other traders will bid up the share price in anticipation of the campaign, and the opportunity to buy at a low price will disappear. The need to keep activist intentions secret thus renders the opportunity for profit a limited resource. If a manager buys too many shares on behalf of too many clients, the supply of shares will run dry, or the manager’s intentions will become obvious, and the share price will go up in response. A manager may thus be unable to buy as many shares in a target company as each of its many clients might want. How then should the manager allocate the opportunity to buy shares? The answer involves a conflict of interest.31

IV. Legal Conflicts

In addition to these economic conflicts, a large investment manager can also face legal conflicts. Activism poses a host of legal challenges, and in a large investment manager, these challenges can spill from an activist client onto non-activist clients. Legal rules often treat an

31 Managers already recognize the inherent fiduciary conflict in allocating other kinds of scarce investment opportunities. The Financial Industry Regulatory Authority already has rules, for example, governing how an investment manager allocates scarce shares in an initial public offering. But there are no easy solutions for the opportunities created by activism, because it is difficult to know just what the size of the opportunity is and how much each client would want it.
investment manager and its various clients and business lines as a single unit, and so the
actions of one part of the unit tend to be reflected back on the whole.

A. Exchange Act Section 13(d)

The first problem is Section 13(d) of the Securities Exchange Act of 1934. Section 13(d) is often described as an early warning system for corporate acquisitions. Roughly speaking, section 13(d) requires anyone who “beneficially owns” more than 5% of any class of a company’s equity securities to file a report with the Securities and Exchange Commission within 10 days after crossing the 5% threshold. The contents of the report can vary — more on this in a moment — but the report must generally disclose the extent and character of the owner’s investment and the owner’s intentions for future voting and control. The purpose of section 13(d) is to let an issuer and other shareholders know when a potential controlling shareholder is amassing a big interest.

Section 13(d) is a headache for anyone who attempts to influence a public company, but it is especially painful for a large investment manager with many clients. The special problem for a big investment manager is that section 13(d) and its administrative rules generally combine a manager and all of its various clients into a single legal unit. If Fidelity has 100 different clients that each own stock in Delta Airlines, for example, it is Fidelity—not the various clients—that becomes the “beneficial owner” for purposes of section 13(d) reporting. Hence, even if each of Fidelity’s 100 clients owns only 0.06% of Delta’s common stock, so that none of them would cross the 5% threshold individually, all of these holdings will nevertheless be added together and attributed to Fidelity, bringing the total to an even 6%. Fidelity will thus have to file a 13(d) report in its own name reporting its beneficial ownership. The lesson is that as a manager gets bigger, the 5% threshold becomes easier and easier to cross.

The reason a manager and its clients get aggregated in this way is that the regulations under section 13(d) define the term “beneficial owner” very broadly. Rule 15d-3(a) says that the term “beneficial owner” of a security includes anyone who has the “power to vote” or the “power to dispose” of the security under the terms of a contract or other arrangement or

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This broad definition clearly reaches most investment managers, because the essence of an investment management contract is to give a manager discretionary authority to vote and dispose of a client’s securities. Thus, the beneficial owner for purposes of section 13(d) in most investment management relationships is not the fund that owns the shares, but the manager that decides how to vote them.

Managers and their clients face a further risk of aggregation through the concept of a “group.” For purposes of the 5% threshold, section 13(d)(3) combines together any people who act as a “group...for the purpose of acquiring, holding or disposing of the securities of an issuer.” Thus, if two hedge funds work together to acquire 2% and 3% of an issuer’s securities, respectively, their holdings can be added together to total 5%, because they are working together as a group. Both hedge funds must then comply with section 13(d). This is true even if the hedge funds are distinct beneficial owners.

The definition of a group has been elaborated extensively by the courts, and the inquiry is highly fact-specific, making the resolution of particular cases very hard to predict. But we can nevertheless say with confidently that if two clients who are both under the control of the same investment manager both acquire shares in the same company, the clients will be at grave risk of being treated as a group if the manager is not already treated as the beneficial owner of the funds’ securities under Rule 13d-3(a).

The logic of the group concept and the broad beneficial ownership definition is to prevent clever strategies for avoidance. In the absence of these aggregation rules, an investor could easily subvert the 5% limit by simply spreading its investment across multiple subsidiary entities. A shareholder could allocate 2% of a company’s shares to each of five different entities that the shareholder controls, and thereby gain 10% of the company’s shares without having to report under section 13(d).

The 5% standard of section 13(d) draws in an enormous number of investment positions for large investment managers. As of March 2016, Blackrock was the beneficial owner of...
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owner of 5% or more of the stock of 2,632 different companies.56 For Vanguard, the number was 1,855 and for Fidelity it was 1,309.37 At least fifteen other investment managers beneficially owned 5% or more of more than 200 companies.38

Whatever their policy logic, the net effect of these aggregation rules is to make it very difficult for a large and diversified investment manager to acquire large stakes and convert them into influence. Because these policies combine a manager and its clients for purposes of reporting and tallying ownership, they effectively yoke a manager and all of its various clients together for purposes of liability and obligation. Activism or share purchases by one client can trigger section 13(d) problems for every other client.

Consider, for example, what may happen if a client of a large investment manager tries to execute a so-called creeping acquisition of shares in a public company. A creeping acquisition is one in which an investor slowly accumulates 4.9% of the target company’s shares and then buys as many shares as it can over a period of ten days after crossing the 5% threshold. Creeping acquisitions are a common strategy for governance activists, because section 13(d) gives an investor a grace period of ten days after crossing the 5% threshold before the investor has to disclose its ownership publicly. Creeping acquisitions are controversial, but virtually everyone seems to agree that they are central to both the success and the profitability of an activism strategy. If news of an activist acquisition leaks out too early, the target can set up defenses and other shareholders can buy up shares and drive the price up, making it impossible for the activist to turn a profit by buying at a low price before the strategy becomes public knowledge.

Section 13(d) makes a creeping acquisition much harder for a client of a large investment manager than for a similar investor acting independently, because the large manager’s client will already start from a position of several percentage points of ownership for purposes of section 13(d) reporting before the client even purchases its first share. Imagine, for example, that an activist hedge fund wishes to buy 10% of Netflix, Inc., as an activist fund managed by Carl Icahn did in 2012. For a fund working independently outside of a large management group like Icahn’s, 10% is a fairly attainable goal. The fund can buy 4.9%

56 Fichtner, Heemskerk & Garcia-Bernardo, supra note Error! Bookmark not defined., at 16.
57 Id.
58 Id.
slowly and quietly, and then buy another 5.1% over a 10-day period of rapid acquisition before filing its section 13(d) report. For a fund managed by a large manager such as T. Rowe Price, acquiring 10% would be much harder. As of year-end 2015, T. Rowe Price clients collectively owned 3% of Netflix.\(^{39}\) Hence, if T. Rowe Price started an activist hedge fund, the fund could only buy 2% of Netflix’s stock before the 10-day clock began ticking, rather than 4.9%. Things would be harder still if, instead of being managed by T. Rowe Price, this hedge fund were managed by Blackrock or Vanguard. At year-end 2015, Blackrock and Vanguard clients already owned 6.6%\(^{40}\) and 5.6% of Netflix, respectively,\(^{41}\) meaning that if Blackrock or Vanguard were ever to start an activist fund, the fund would have to disclose its acquisitions almost immediately any time it purchased an additional 1% of Netflix’s shares.\(^{42}\)

Section 13(d) thus makes it relatively difficult for a client of a large investment management company to accumulate a stake in a public company through a creeping acquisition. But this is not the end of the problem If ever a client of a large manager did manage to get a large stake, section 13(d) would create even more serious problems if that client tried to turn its stake into influence.

The problem is that aggressive forms of activism can change how an investment manager complies with section 13(d). Most large investment managers, it turns out, do not actually file reports under section 13(d). Instead, they file under section 15(g), because section 13(g) imposes a much lighter set of obligations than section 13(d). The form prescribed by section 13(d), which is known as Schedule 13D has to be updated every time a beneficial owner’s holdings change by more than 1% of the target company’s stock, and each the time form is filed or updated, the beneficial owner also has to disclose all trades made 60 days prior to the time the schedule is filed or updated. The form prescribed by section 15(g), which is known as Schedule 13G, only has to be updated once a year and does not require disclosure of prior trades.

Eligibility for the two forms turns on an investor’s intentions for control. An investor who intends to exercise control must file on Schedule 13D; an investor who does not intend to exercise control can file on Schedule 13G. As we have already seen, the definition of “control”

\(^{39}\) T. Rowe Price Associated, Inc. (Schedule 13G) (Dec. 31, 2015).
\(^{40}\) BlackRock, Inc. (Schedule 13G) (Dec. 31, 2015).
\(^{41}\) The Vanguard Group (Schedule 13G) (Dec. 31, 2015).
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is ambiguous, but it is nevertheless clear that even fairly modest forms of influence can qualify, including contesting the election of a director or soliciting a proxy. And crucially, because all of an investment manager’s clients get aggregated with the investment manager itself, eligibility to file on Schedule 13G depends on the intentions of each and every one of a manager’s various clients. If just one activist hedge fund exercises “control” over an issuer within the meaning of section 13(d), then the entire investment management complex will tip from a Schedule 13G filer to a Schedule 13D filer.

It is thus quite easy for a large investment manager to fall from Schedule 13G to Schedule 13D status. Just one activist client could do it. And a fall from 13G to 13D status would be enormously painful. Every professional I spoke with in the investment management industry insisted that the distinction between 13G and 13D was far and away the most important problem they worried about when they considered the possibility of influencing a portfolio company. The biggest challenges, they say, are technical. The prompt updating and prior trade disclosure requirements of Schedule 13D are exceedingly costly for a large investment manager, because the technical difficulties of compliance multiply with the number and diversity of the manager’s clients. Regular reporting is difficult when a manager has many clients, because with all of these clients trading, the manager’s total ownership percentage in a portfolio company can change constantly. A manager could thus be required to update its holdings in a company very frequently—perhaps even daily. Updating all of the reports for a large number of clients and issuers would be difficult enough by itself, but it becomes especially difficult when it is added to the 60-day trade reporting requirement. Though trades that occur on the same day within $1 of each of each other can be consolidated on a single line, the number of trades that might have to be tracked and consolidated could be enormous.

Imagine, for example, what would happen to an manager that operated both a corporate governance activist hedge fund and a high-frequency trading hedge fund. Once the activist fund tipped the manager from 13G to 13D status, the manager would have to disclose every trade over a 60-day period by the high-frequency trading fund the first time the clients’ aggregate holdings went above 5% and then every time the holdings changed in either

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43 Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 110.08 (Updated July 14, 2016).
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direction by more than 1%. Filling out the 13D form could require crunching data on millions of trades—and it might have to be updated every day!

Even if the technical challenges of consolidating millions of trades could be overcome, a responsible manager would still worry about the huge privacy breach involved in doing so. If a manager were to disclose every one of its trades over the 60 day periods required by regular updates to Schedule 13D, it would end up giving away a huge amount of information about its transacting habits, which other traders could then use to front-run and otherwise game the manager’s future trades. And the cost of this intrusive disclosure would not be borne exclusive—or even mainly—by the one client that triggered the obligation. The activist hedge fund that tripped the 13D trigger would be only one of many clients that would have to throw open their trading histories.

A further problem is that if a manager had to file updates for thousands of different transactions for hundreds of different clients, errors would be inevitable—and so would be litigation about them. If Fidelity started an activist fund that took a large stake in Netflix, for example, Fidelity would inevitably make a mistake in updating the 13D form for its hundreds of different clients. Netflix could then use the mistake to enjoin Fidelity from voting any of the shares held on behalf of any of its clients—including the activist fund. Netflix might further enjoin Fidelity from purchasing additional shares. Fidelity might then face suits for damages under Rule 10b-5 or Section 18(a) of the Exchange Act by anyone who traded in the company’s stock while the inaccurate disclosure was in effect. Of course, Fidelity might defend against all of these claims by arguing that its errors were accidental and immaterial. But that would not stop a plaintiff’s lawyer or a defensive board of directors from at least filing a complaint in federal court and forcing a settlement. One financial adviser in a single client’s separately managed account could screw up the entire activism strategy for the activist hedge fund.

Of course, one might argue that many of these problems under Section 13(d) can be avoided if a manager just restricts its efforts at control to a few companies on behalf of just a

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44 Section 13(d) does not by itself create a private right of action. Motient Corp. v. Dondero, 529 F.3d 532 (5th Cir. 2008). Note that section 18(a) requires a plaintiff to plead and prove specific reliance, without the benefit of the fraud-on-the-market theory available under rule 10b-5. Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir. 1968).
few clients. But this is easier said than done. As noted above, in a large investment management firm, there are so many clients that it is inevitable that many of them will want to invest in the same companies, making it very difficult to limit the number of clients in a particular company. Further, even if a manager were able to focus its influence on just a few companies for just a few clients, this would simply prove my point, which is that a large manager cannot influence anything more than a small number of companies for a small number of clients. Turning the holdings of many clients into a focused program of corporate influence in major companies is tremendously difficult.

**B. Exchange Act Section 16(b)**

Section 13(d) is just one of many legal rules that an investment manager can trigger if its clients exceed an aggregate ownership threshold. Another legal rule that flips on upon the crossing of a percentage threshold is section 16(b) of the Exchange Act. Section 16(b) requires certain investors known as “statutory insiders” to disgorge any profits on trades that occur within six months of each other. A purchase of Facebook stock at $100 and a sale four months later at $105, for example, can be matched together under section 16(b) to produce a $5 profit, which the trader must then disgorge to Facebook. Section 16(b) creates an express private right of action in any holder of the issuer’s securities to sue for disgorgement, and plaintiffs’ lawyers often use this right of action on the hope that they can take a portion of the settlement as a legal fee for themselves. In addition to requiring disgorgement of profits, section 16(b) has a companion provision in section 16(a) that requires a statutory insider to disclose its ownership on forms known as Form 3 and Form 4. The statutory insiders covered by the statute include officers, directors, and—most important for my purposes—shareholders who own more than 10% of an issuer’s equity securities.

The purpose of section 16(b) is to serve as a prophylaxis against insider trading. By categorically prohibiting all short-swing profits by the kinds of people who are most likely to have private information about an issuer, section 16(b) reduces the odds that anyone will trade while she possesses private information. Because section 16(b) only applies to certain high-risk categories of statutory insiders, it does not require a plaintiff to prove that an insider actually possessed private information at the time of its trade. The mere fact of insider status is enough to trigger disgorgement if an insider makes a short-swing trade.
For a large investment manager, section 16(b) creates conflicts over activism for the same reasons as section 13(d): it applies a restriction to any person who “beneficially owns” more than a certain amount of the issuer’s equity and lumps a manager and all of its clients together for purposes of determining beneficial ownership. Like section 13(d), section 16(b) aggregates the investments of a manager’s various clients and attributes them to the manager itself. Exchange Act Rule 16a-1(a)(1) expressly borrows the aggregation framework of section 13(d) by defining a beneficial owner under 16 to mean any person who is deemed to be a beneficial owner under section 13(d) and its implementing rules. Section 16 softens this borrowing provision by providing a special exemption for an investment adviser who has become a beneficial owner of securities merely by virtue of its management of the securities for the account of a client.\(^\text{45}\) This has the practical effect of exempting most large investment managers, even if their clients own more than 10% of a company, which is the threshold level that triggers section 16(b). The implementing rules under section 16 further soften the aggregation rules by providing that whenever two entities are combined for purposes of determining 10% ownership, these entities may nevertheless be broken apart for purposes of matching trades under the disgorgement requirement.\(^\text{46}\) In other words, even if an investment adviser were aggregated with its clients to obtain a combined ownership total of more than 10%, the adviser would nevertheless only have to disgorge profits on its own trades, and not on the trades of its clients. The adviser’s various clients would similarly have to disgorge profits only on their own trades, and not on the trades of the manager or the other clients.

These softening exemptions prevent section 16(b) from being completely unworkable, but they do not prevent section 16(b) from being a very costly headache. Section 16 still creates major problems for an investment manager with many different clients. One problem is that the exemption for investment advisors only applies if a client has bought its shares “in the ordinary course of business” and “without the purpose or effect of changing or influencing control of the issuer.”\(^\text{47}\) “Control” here is defined in the same hair-trigger manner as in section 13(d), meaning that if a manager’s client solicits proxies in connection with a board election,

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\(^{46}\) Id.

\(^{47}\) Id.
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both the manager and the client could run afoul of section 16. Once again, activism by one client can send shrapnel flying toward every other client.

To put the risks in perspective, the largest investment managers through their clients are the beneficial owners of 10% or more of the stock of hundreds of public companies. As of March 2016, Fidelity was the beneficial owner of 10% or more of the outstanding stock of 506 companies.\(^{48}\) For Blackrock the number was 375 and for Vanguard it was 165.\(^{49}\) The only thing keeping these firms from having section 16(b) obligations in hundreds of companies is that none of the clients of these firms exercises control over any of these companies.

The results of having to comply with section 16 would be catastrophic. Though the aggregation principles of section 16 say that a manager is not responsible for disgorging the profits of its clients, the manager would nevertheless be responsible for disgorging its own profits if one client exercised too much control, which is a major concern since many managers operate proprietary trading operations for their own account. If a Goldman Sachs activist hedge fund tried to influence an election at Delta Airlines, Goldman’s proprietary traders—who could be trading billions of dollars in large-company stocks for the bank’s account—would have to disgorge any profits they earned on Delta trades. Goldman would also have to disclose all of these trades publicly and identify itself as the buyer and seller. This would be simply unworkable.

Also infuriating would be Goldman’s obligation to disgorge profits on trades by its private funds. Many large investment managers, including Goldman, operate dozens of hedge funds, and it is customary for an operating agreement in a hedge fund to require the manager to own a certain percentage of the fund. The idea is to force a manager to own a stake in a fund, so that its interests will align with those of the fund’s investors. A manager like Fidelity may thus own stakes in dozens of hedge funds at any given time. The problem under section 16 is that if any of these funds buys shares in a company with regard to which Fidelity has to comply with section 16(b), then Fidelity will have to disgorge not only the profits from its proprietary trading operations, but also its proportionate share of any profits on trades by the

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\(^{48}\) Fichtner, Heemskerk & Garcia-Bernardo, supra note Error! Bookmark not defined., at 16.

\(^{49}\) Id.
hedge fund in which Fidelity owns a stake.\textsuperscript{50} This is an accounting nightmare, to say nothing of the economic consequences.

A further problem is that even if a manager is able to keep itself distinct from its clients under section 16(b), the clients could nevertheless find themselves getting aggregated with one another. A manager’s clients could find themselves getting lumped together under the “group” aggregation concept, which the rules under section 16 borrow from section 13(d). The definition of a group under section 13(d) combines any two persons who work together for the purpose of acquiring a security.\textsuperscript{51} Thus, if an advisor operates two funds, one of which owns 7\% of an issuer and another of which owns 4\%, the two funds could end up getting lumped into a group of 11\% simply by virtue of having the same manager. The risks might be especially severe if one of the clients tried to use its shares for influence, making it appear, perhaps, that the acquisition of shares was part of a deliberate plan to work together.

\textbf{C. Poison Pills}

Poison pills trigger yet another set of conflicts upon the crossing of a certain ownership threshold. A \textit{poison pill}, also known as a shareholder rights plan, is an antitakeover device that a company’s board can adopt to prevent a potential acquirer from accumulating too large a stake in the company without the board’s permission. A poison pill works by diluting the ownership of any shareholder who acquires shares in excess of a certain percentage specified by the company’s board. If the acquirer buys more than the specified percentage, then all of the company’s other shareholders—not including the acquirer—get the right to buy new shares in the company at a deeply discounted price. The result is to decrease the ownership of the acquirer in terms of both value and percentage, and to increase the ownership of everyone else. The threshold that triggers a poison pill can vary, often between 10\% and 20\%. Although few companies maintain a poison pill on a regular basis, a company’s directors can always adopt a pill at a moment’s notice if ever they perceive a threat.\textsuperscript{52}

Like sections 16(b) and 13(d), a poison pill is triggered on the crossing of a certain ownership threshold. Poison pills thus commonly borrow the regulatory and conceptual

\textsuperscript{50} Exchange Act Rule, 17 C.F.R. § 240.16a-1 (2016).
apparatus of section 13(d) to police avoidance of the threshold. Most poison pills define “beneficial ownership” of a security by express reference to the definition in section 13(d) and its implementing rules. Thus, much like section 13(d), a poison pill usually says that the beneficial owner of the holdings of an investment management complex is the investment manager itself.

Since the limits imposed by a poison pill put a cap on the combined ownership of a manager and all of its various clients, the manager will have to ration out the opportunity to invest in a company with a pill. This could limit the ownership percentage of any of the manager’s clients, but the consequences may be most profound for a manager itself. Many investment managers, like Goldman Sachs Asset Management, are part of large financial conglomerates that buy and hold securities in connection with various parts of their far-flung businesses. Goldman, for instance, does a major business in derivatives underwriting. As part of this business, Goldman sells large quantities of swaps and options on other companies. Goldman might agree with a hedge fund, for example, to sell the fund a swap on the stock of Delta Airlines, which requires Goldman to pay the fund the value of any increases in Delta’s stock price and requires the fund to pay Goldman the value of any decreases in Delta’s stock price. Goldman regards a transaction such as this one as a financial service, rather than an investment decision, and so in order to hedge the risk that the stock price might go up—forcing Goldman to pay out the value of the increase—Goldman will buy stock in Delta Airlines in an amount roughly equal to the number of swaps Goldman sold to the hedge fund. This ensures that Goldman will have the ability to meet any obligations on the swap as they come due.

The trouble is that as Goldman Sachs accumulates stock and options in hedging positions such as this one, Goldman can unintentionally run afoul of a poison pill. Goldman does such a large volume of derivatives underwriting that Goldman could very plausibly own or have the option to purchase close to 10% of a company’s outstanding equity securities at any given time. Goldman thus faces a risk that if one of its investment management clients accumulates too large a stake in a company, the client’s holdings will be aggregated with those

\[53\] Goldman might also buy options on the securities, which would be clearly qualify as “equity securities” under section 13(d). Exchange Act Rule, 17 C.F.R. § 240.3a11-1 (2016).
of Goldman’s derivatives desk and Goldman’s many other investment management clients and Goldman will topple over a poison pill threshold.

This problem is not lost on issuers, and they have generally tried to help their shareholders avoid the problem using a strategy known as a “two-tier” poison pill. Borrowing once again from the conceptual apparatus of section 13(d), a two-tier poison pill applies a lower triggering threshold to a Schedule 13D filer than to a Schedule 13G filer. In response to the activist campaign by Carl Icahn mentioned above, for example, Netflix adopted a pill with a 10% threshold for 13D filers and a 20% threshold for 13G filers. The reason for the two distinct tiers was that a 13G filer poses less threat to a board’s autonomy than a 13D filer, since in order to be eligible for 13G, a filer can have no intention of changing a company’s control.

A two-tier poison pill works fine for exempting a large manager that is eligible to file on Schedule 13G, but not for a manager that has to file on Schedule 13D. A manager that has to file on Schedule 13D may find itself triggering the lower tier threshold, even if most of its holdings are bland derivative hedges. The cost of exercising control over a portfolio company—even through just one of a manager’s many clients—are thus extremely high, because control is what tips a filer from 13G to 13D status. If, for example, Goldman’s derivative desk and asset management clients together owned 13% of Netflix, then Goldman would probably have no problem under Netflix’s 20% pill threshold for 13G filers, so long as all of the asset management clients remained passive. But if just one Goldman hedge fund owning just 0.5% of Netflix’s common stock solicited a proxy for a Netflix board election, Goldman’s entire operation would suddenly tilt into Schedule 13D status, and Goldman would find itself on the wrong side of Netflix’s 10% poison pill threshold for 13D filers. There would be no point in Goldman asking Netflix for a special one-off exemption under these circumstances, because Netflix would never give it. The lesson, once again, is that in a large investment management firm, everything is connected. The activism of just one client can potentially damage the entire firm.

55 Klein et al., supra note 46.
D. Insider Trading

Yet another legal tripwire for a large investment manager is the insider trading prohibition of Exchange Act Rule 10b-5. As the Supreme Court has interpreted it, Rule 10b-5 prohibits a person from trading a company’s securities while the person possesses material nonpublic information about the company if the person has taken that information from someone else in breach of a duty of trust or confidence owed to the source of the information. The source of the information need not be the company whose securities are being bought and sold. It can be anyone from whom the trader received the information. The class of plaintiffs who can pursue an insider-trading suit is broader than the class of plaintiffs who can pursue a suit for breach of fiduciary duty. An insider-trading suit may be brought by the SEC or by anyone who traded on the opposite side of the insider trader on the same day.

The problem that insider trading creates for a large investment manager is that if one client trades on information about another client’s impending acquisitions, then such a trade is not just a breach of fiduciary duty—it is also an act of insider trading. Recall from above that trading on information about an impending activist campaign or large acquisition is tempting, because this information is likely to be both material and nonpublic. Once an activist discloses a large acquisition and an intent to engage in activism, the market price of the target company’s stock will move quickly upward in response, making it impossible to buy shares at a low price. Activist investors thus take great pains to keep their acquisitions and their intentions secret.

Secrets, however, are tempting. If a portfolio manager for Fund A learns that a portfolio manager for Fund B is about to go active or buy a large stake in a company, the portfolio manager for Fund A will be tempted to buy shares for Fund A in anticipation of the impending change in price. This, however, is insider trading, even if it happens inside of the same fund manager. Information traded around the water cooler in a fund manager’s offices is a clear breach of insider trading law.

Big managers are aware of this problem, and they have strategies for dealing with it. They deal with the market-moving force of large acquisitions, for example, by creating a

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57 Id.
queue for trades and carefully managing the order in which different clients’ trades are executed. Managers also try to establish procedures to prevent employees from talking with one another about different clients’ trades. These procedures cannot completely eliminate risk, however. Managing the order of trade execution cannot prevent an illegal trade from being placed in the first instance. And there is no fail-safe way to stop employees from communicating about material, nonpublic information. As one investment management lawyer said in an interview, “you can’t control what people say around the water cooler.” And, in any event, these solutions to the problem of insider trading once again simply prove my point. They show that the various clients of a management company are often forced by law to act independently, so that they have a very difficult time coordinating to maximize the potential of their collective voting power.

V. Other Theories of Passivity in Perspective

We have seen how conflicts over activism make activism unusually costly for a large and diversified investment manager. Conflicts, however, are not the only possible explanation for why large managers do not become activist. There may be other explanations as well, and these other explanations are not mutually exclusive with this focus on conflicts—all of these various explanations could be correct simultaneously. Still, a focus on conflicts of interest fills a number of gaps that other explanations leave open.

One common explanation for why large investment managers do not seek greater influence is that there is no market for funds that invest for influence. A manager simply cannot attract investors to funds that try to influence portfolio companies. This argument usually focuses on mutual funds and on their investors’ lack of sophistication. Mutual fund investors, it is said, cannot assess the value of activist investing strategies, and so they simply will not pay for activist funds. This argument came up over and over again in conversations with the executives and lawyers I interviewed, and it has surfaced in some academic writing as well.58

This theory certainly has a great deal of merit to it. The market for aggressively activist investing strategies is surely limited. But this theory nevertheless has serious limitations. The most important is that investors quite obviously do have an appetite for activist funds. This is

58 [Citation to Robert Pozen.]
John Morley
Too Big to Be Activist

evident in the success of many activist hedge funds in recent years. Pershing Square Capital, for instance, has raised more than $12 billion dollars for a hedge fund that invests in corporate governance activism. So although it may be true that mutual fund investors have no appetite for activism, it is clearly also true hedge fund investors do have an appetite for activism. Of course, this appetite may be fairly small, but there is no reason why a large investment manager could not offer an activist hedge fund to appeal to this small appetite as a part of a diverse array of product offerings. The appetite for investment in corporate influence may be limited, but so is the appetite for Tennessee municipal debt—and yet one can find several large investment management companies that offer funds specifically devoted to Tennessee municipal debt. The same is true of other niche funds, from airline funds to oil funds, to high-frequency trading funds. So why shouldn’t a large investment manager start a niche fund focused on activism?

The absence of corporate activism strategies among the diverse products of large investment managers is especially surprising, because at a naïve first glance, a large investment manager would seem to be the best sort of place in which to locate an activist hedge fund. Should activist funds exist, it would seem like they ought to exist only at the biggest investment managers. As we have seen, if an activist fund were managed by a large manager, the fund could—on a naïve understanding—leverage the holdings of all of the manager’s many clients to magnify its influence. Even if Fidelity could only raise an activist fund with $1 billion, for example, the fund could potentially leverage the influence of all $2 trillion in Fidelity’s other client accounts. A Fidelity activist fund would thus seem to have a massive advantage over a stand-alone activist fund like Pershing Square Capital. And yet we only find activist funds in small management companies. What this suggests, of course, is that the naïve understanding leaves something out—namely, the high costs of conflicts between a big manager’s many clients.

Another common explanation for why large managers tilt toward passivity is that the Investment Company Act of 1940 and its associated tax provisions prohibit mutual funds from buying large stakes in portfolio companies. Basically, the argument is that if a mutual fund wants to avoid corporate-level taxation—as it must—then it cannot buy securities in any one

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59 Note that the Pershing Square management firm also operates a public closed-end fund in Europe.
issuer in excess of certain limits. This argument was first made by Mark Roe, and it has since become popular with other academic commentators.

This argument is true as far as it goes, but it, too, has a number of serious limitations. First, it only applies to mutual funds. It does not apply to hedge funds, separately managed accounts or other private vehicles that do not sell their securities to the general public. None of these other vehicles has to comply with the Investment Company Act or its associated tax provisions and so there is no reason under the Investment Company Act why a large mutual fund manager could not separately establish an activist hedge fund to operate alongside all of the more passive mutual funds.

Additionally, the Investment Company Act and its tax rules only apply to mutual funds individually, and not to the aggregate investment management complexes of which they are a part. Thus, even if the Fidelity Magellan fund were prohibited from owning more than a certain percentage of the stock of a company like Delta Airlines, there is no reason why the Fidelity management company could not combine the holdings of the Magellan Fund with the holdings of Fidelity’s many other funds to give Fidelity much greater control. Fidelity could easily control 51% of Delta’s outstanding stock without running afoul of the Investment Company Act and its tax rules if Fidelity spread its investment in Delta across its Magellan, Stock Select Large Cap Value, S&P 500 Index, Select Transportation, Growth Company, Mega Cap Stock, and Air Transportation funds.

Further, the Investment Company Act and its tax rules are not actually very restrictive. The tax code imposes two distinct restrictions on the portfolios of registered investment companies. One of them says that in fifty percent of a fund’s portfolio, no single issuer’s securities can comprise more than 5% of the fund’s total portfolio, and a fund cannot own more than 10% of the outstanding voting securities of any single issuer. The other restriction says that a fund cannot invest more than 25% of its portfolio in the securities of any one issuer or the securities of two or more issuers which the fund controls. These rules are hard to grasp at first, and they sound frighteningly restrictive. But in application, they quite permissive.

mutual fund can invest in as few as 12 different companies, owning up to 10% of the outstanding equity of each the first ten, 49% of the eleventh, and 100% of the twelfth. This is at least as much concentration and control as an activist hedge fund would typically take—and possibly much more.

A related argument for why large managers are not interested in influence is that mutual funds require too much liquidity. Since a mutual fund permits its investors to withdraw their money every day, the fund needs to be able to raise cash quickly to pay withdrawals. Such liquidity needs are arguably incompatible with a large investment in a single issuer, because a large investment in a single issuer can be difficult to sell. This argument is also true as far as it goes, but it has the same limitations as the argument about regulation of portfolio composition. The need for liquidity does not apply to hedge funds and other private vehicles that can restrict redemptions. And the need for liquidity can be addressed by spreading a holding across many different funds in a larger management company. Though liquidity needs may prevent one fund from accumulating a massive stake, they need not prevent many funds from each holding only a moderate stake. Aggregated across an entire management company, the holdings of many funds can add up to indisputable control.

VI. Activist Funds Contrasted

Though it is often said that “institutional investors” don’t become activist, in fact certain kinds of institutional investors frequently do become activist: private equity funds, pension funds, and hedge funds operated by small management firms. These differences in activism have always been generally known by corporate governance commentators, but to my knowledge, no one has ever clearly explained why.

The logic of conflicts of interest offers the needed explanation. Let us begin with private equity funds. Private equity funds do not invest in public companies—hence the term “private”—but they exercise extensive corporate control. When a private equity fund buys a private company, it tends to keep a majority or even 100 percent of the company’s shares, and

64 The Investment Company Act only requires a mutual fund to pay redemptions every seven days, but in practice most mutual funds process redemptions daily. Investment Company Act, 15 U.S.C. § 80a-22 (2016).
65 Bainbridge, supra note 16, at 11.
it will usually retain the power to appoint all of the company’s directors and to dictate every aspect of the company’s business and affairs. This is “activism” in the extreme.

So why does it work? There are two reasons. First, private equity managers tend not to manage funds with overlapping investments. For reasons I have explained elsewhere, private equity managers police conflicts of interest among their funds very closely, meaning they rarely allow multiple funds to invest in a single company. Such rigid policing of boundaries is possible, because the universe of private companies is much larger than the universe of public companies, meaning that different funds are not forced to invest in the same companies, as large mutual funds are when they invest in broad cross-sections of the public markets.

Additionally, when multiple private equity funds of a single manager do invest in a single company, the funds face many fewer conflicts of interest than mutual funds or hedge funds would, because the companies in private equity portfolios are not public. By virtue of remaining private, private equity portfolio companies are not subject to sections 13(d), or 16(b) the Exchange Act, and they have no need for poison pills, since private equity funds only buy companies in friendly acquisitions.

Pension funds also practice activism, commonly nominating candidates to corporate boards and initiating proxy contests in large public companies. The explanation is again simple: pension fund managers do not have multiple clients. Though pension funds can be extremely large, pension funds have a fundamentally different structure from hedge funds, private equity funds, and mutual funds, because they internalize their management. Whereas mutual funds tend to be controlled by distinctly organized external management firms with separate owners and many different clients, pension funds employ their managers directly. The managers of a pension fund work for that fund and no one else. Hence, pension fund managers have no inter-client conflicts to worry about.

Of course, sometimes pension funds outsource their management by hiring large external managers like Blackrock and Fidelity to invest portions of their portfolios in public equities. And, not surprisingly, when pension funds do this, all of the usual conflicts of interest apply. My interviews with practicing professionals indicate that a large manager like

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66 Morley, supra note 17.
Blackrock will never independently use its own discretion to engage in activism on behalf of a pension fund client.

Tellingly, however, although Blackrock will never independently use the investments of its pension fund clients to engage in activism on its own, it nevertheless will follow the pension fund’s instructions on how to vote those investments—even if that means voting them in favor of activism. This is an exception that proves the rule. Unlike mutual funds and hedge funds, pension funds that hire large investment management firms commonly retain the right to vote the shares in their portfolios. If CalPERS opens an investment account with Blackrock, in other words, the terms of the contract will say that CalPERS, not Blackrock, gets to decide how the shares in the account will be voted. CalPERS will do this precisely in order to preserve its capacity for activism. This arrangement can work without triggering massive conflicts of interest, because Blackrock does not have the discretion to make the voting decisions. This means (a) that Blackrock’s fiduciary duty is attenuated and (b) that Blackrock is not the beneficial owner of the securities for purposes of sections 13(d) and 16(b) of the Exchange Act. Section 13(d) only attributes beneficial ownership to the person who holds discretionary voting power. And so if that power belongs to CalPERS, then Blackrock faces no problems.

Lastly, certain hedge funds engage in activism. This fact is well known, because it has been written about extensively in academic journals and the popular press. What has gone unnoticed, however, is that all of these activist hedge funds are associated with relatively small management companies. Name an activist hedge fund—Pershing Square, Third Point, ValueAct, Trian—and it is managed by a small firm with only a single client, or, on rare occasions, two or three clients. Although hedge fund activism is in a golden age, none of it is coming from large investment management firms with hundreds of different clients. The reasons, of course, should be obvious. Since these small managers have only one or two clients, they face almost no conflicts of interest among those clients.

VII. Policy Implications

Once we understand that large managers are too big to be activists, we face an obvious set of questions: Should they be activists? Could they be activists? Would the right set of legal
reforms make it possible for them to become activists, and would those reforms make the world a better place?

To these questions, I can offer no definitive answers. The debate about the merits of corporate governance activism is so vast that I cannot hope to resolve it here. Instead, I am content to point out that in certain ways, at least, the debate has been seriously misinformed. Whether activism by large investment managers turns out to be good or bad, it is only ever likely to happen if we understand exactly why it remains so rare. Serious reforms to sections 13(d), 16(b), and Rule 10b-5 of the Exchange Act will be necessary, and some work around will have to be found for poison pills.

There will always remain serious questions, however, about whether the law could ever effectively enable activism by large managers. Even if Congress and the SEC gained the political will to do so, eliminating the obstacles to large manager activism will be very difficult. The aggregation rules that make section 13(d) so problematic serve important functions, and eliminating those rules might seriously undermining section 13(d). Additionally, some of the economic conflicts that prevent activism will never go away with any amount of legal reform. No legal change, for example, can eliminate the basic conflicts between equity and debt, or between taxable and nontaxable investors. These conflicts are not legal accidents—they are facts of life. And whether they could ever be eliminated is an open question.

Still, the insights I have offered here remain important, because they tell us how the debate about corporate governance activism should proceed in the future. It helps us both to understand when activism is realistically likely, and where we must focus our energies if we ever want to make it more likely in the future.

VIII. Conclusion

The paradox at the heart of this invest is that as an investment manager gets bigger, its capacity for corporate influence can get smaller. The largest investment management firms, in other words, may be too big to influence their portfolio companies. The constraints on a big investment manager come from the conflicts that arise among its many clients in business strategy and law. Each of these conflicts is driven by the fact that everything in an investment management complex is connected. The actions of every client can influence the welfare of
every other client — as well as the manager itself. Attempts at activism by one client can send regulatory and managerial shrapnel flying into every corner of a manager’s business.

Together, these conflicts place serious constraints on a large investment manager’s influence. Though large managers can still exercise a degree of influence, these conflicts place an upper bound on how assertive that influence can be. Although the increasing concentration of the investment management industry raises immense questions, the consequences of this consolidation may be neither as promising nor as damaging as many of us hope and fear.