1 Introduction

The value-extracting power of hedge-fund activists is hardly comprehensible to casual observers. They are mere “minority shareholders.” Yet they exert enormous influence over corporations, often forcing them to undertake fundamental restructuring and to increase stock buybacks and dividends substantially. For instance, Third Point Management and Trian Fund Management, holding only 2 percent of the outstanding stock of Dow Chemical and Du Pont, respectively, engineered a merger-and-split of America’s top two chemical giants at the end of 2015, resulting in massive layoffs and closure of DuPont’s central research lab, the first industrial science lab in the United States.[1] Carl Icahn, after acquiring about 1 percent of Apple’s stock in 2013, pressed the most valuable company at the time to repurchase a record-breaking $80 billion of its outstanding stock in 2014–2015 and took $2 billion of profit for himself when he sold his entire stake in 2016.[2]

Elliot Management, which had already attracted wide attention as a “vulture fund” by enforcing full payment of junk bonds issued by poor countries in Africa and Latin America through litigation and other measures, purchased about 0.5 percent of the outstanding stock of Samsung Electronics in early fiscal 2016. It then demanded that the largest electronics company in the world by revenue split itself into a holding company and an operating company while radically increasing “shareholder-friendly” measures by paying out special dividends of about $26 billion (KRW30 trillion). This hedge-fund attack led the company to embark on about $8 billion (KRW9.4 trillion) of additional stock buybacks on top of about $9.9 billion (KRW11.3 trillion) of stock buybacks it had been doing over the previous year, apparently as “compensation” for its rejection of Elliott’s demand to split the company and pay a special dividend.[3] It is now increasingly difficult to find incidents in which management goes against hedge-fund activists’ proposals outright and risks proceeding to a proxy voting showdown in shareholder meetings. As Steven D. Solomon (2015) commented, “companies, frankly, are scared” and “[their] mantra . . . is to settle with hedge funds before it gets to a fight over the control of a company.”

This book explains why and how hedge-fund activists have acquired power disproportionate to their actual shareholding and discusses its implications for government policy and corporate management. Hedge-fund activists are descendants of the corporate raiders whose junk-bond-fueled attacks on US businesses in the 1980s were at the center of what became known as the “deal decade.” With the collapse of the junk bond market in the late 1980s, corporate

[1] Gandel (2015); Team (2016); Traeger (2018). [2] Lazonick et al. (2016).
[3] Merced (2016); Mirae Asset (2017); Kolhatkar (2018).

raiders reinvented themselves as "hedge-fund activists."[4] Both corporate raiders and hedge-fund activists exploit their positions as shareholders to extract value from companies. However, hedge-fund activists differ from their predecessors in that they extract value while remaining minority shareholders, whereas corporate raiders do so by becoming (or threatening to become) majority shareholders.

This book argues that the power of these "minority-shareholding corporate raiders" derives from misguided regulatory "reforms" carried out in the 1980s and 1990s in the name of "shareholder democracy." It points out that shareholder democracy began in the early twentieth century as a political rhetoric to build a more cohesive society by making citizens own shares of corporations and becoming sympathizers of capitalist development. At the time, there was no economic rhetoric. Advocates of shareholder democracy made it clear that it had nothing to do with improving the economic efficiency of corporations and were not interested in making public shareholders influence management decisions. Shareholder democracy remained a political rhetoric, not an economic one, for nearly a half-century until the 1980s (Section 2).

From the 1980s, shareholder democracy began to transform into an economic rhetoric with the rise of shareholder activism. Section 3 delineates how this rhetoric emerged and became broadly accepted by the public and policymakers, and how it was captured by hedge-fund activists for their profits. It deals with various regulatory changes toward encouraging shareholder activism, including the introduction of compulsory voting by institutional shareholders, proxy-voting rule changes that greatly facilitated hedge-fund activists' aggregation of the proxy votes of institutional investors, and allowing hedge funds to draw unlimited funds from institutional shareholders to conduct their attacks on target corporations. It also discusses the rapid growth of institutional shareholding, and the growing acceptance of agency theory and the maximizing shareholder value (AT-MSV) view that underpinned those regulatory changes.

Because of the big discrepancy between the rhetoric and reality of shareholder democracy, shareholder activism failed to achieve its intended objectives. Section 4 investigates empirical evidence of institutional activism and

[4] Corporate raiders in fact bifurcated into hedge-fund activists and private-equity funds. In the latter, traditional methods of corporate raiding by becoming majority shareholders continued to be practiced although the conventional term, "hostile takeover," gave way to simple "takeover" as hostile takeover activities were established as a norm in the corporate and financial world. This book only focuses on the transformation of corporate raiders into hedge-fund activists. I also prefer using "hedge-fund activists" to "activist hedge funds" because some prominent activists like Carl Icahn engage in activism with their own companies without setting up funds although most of those activists are funds.

hedge-fund activism. It emphasizes that it was already evident to researchers by the early 2010s that institutional activism failed and those who were sympathetic to shareholder activism shifted their focus to hedge-fund activism. The section critically examines the research that purportedly shows the positive effects of hedge-fund activism and points out that hedge-fund activism also failed to achieve economic improvement of corporations and is more likely to have resulted in "predatory value extraction."

Section 5 delves into the question of why shareholder activism has gone astray. More than anything else, it was because its economic rhetoric is simply a rhetoric not supported by economic reality. The section explains this detachment of rhetoric from economic reality by the distinction between value creation and value extraction. It also stresses that contrary to shareholder activists' expectation that institutional shareholders would develop capabilities to involve themselves in the value creation process of corporations, they evolved into entities that are less capable of and less interested in corporate affairs because of the rapid growth of index funds. Combined with the dominance of index funds among institutional shareholders, the regulatory changes in the 1980s and 1990s such as imposing voting as a fiduciary duty of institutional shareholders and allowing free communication and engagement between shareholders and corporate management created a large vacuum in the arena of corporate voting that hedge-fund activists can effectively exploit for their own profit. The book concludes with suggestions for rebuilding the shareholder voting and engagement system to encourage the long-term value creation of corporations (Section 6).

2 The Rhetoric and Reality of Shareholder Democracy

In understanding shareholder democracy and the rise of hedge-fund activism in the US, it is crucial to recognize that shareholder democracy started in the early twentieth century as a political project for social cohesion, not as an economic project with economic rationales to support it. As a political project, it was premised on retail shareholders who had political rights in society through voting in elections and other forms of political participation. Institutional shareholders, not having such political rights, were not part of the movement for shareholder democracy. They were instead placed under heavy regulations because regulators then regarded them mainly as potential market manipulators. The early promoters of shareholder democracy also took shareholder passivity for granted, even for retail shareholders. The economic inclusion of retail shareholders was confined to sharing the passive economic benefits of holding shares in the form of receiving dividends and realizing capital gains. This passivity of retail shareholders in the earlier days differed from the current-day shareholder democracy led by the activism of institutional shareholders.

2.1 The Political Origin of Shareholder Democracy in the Early Twentieth Century

When the US public stock market took shape in the early twentieth century, those who came to own public shares sold by retiring founder-shareholders were mostly retail shareholders − that is, individual households. They were fundamentally passive investors. Each holding a minuscule percentage of a corporation's shares outstanding, they had no ability or incentive to engage with corporate management. They were only concerned with monetary rights attached to the stocks they owned, such as entitlements to dividends and capital gains. Their general willingness to leave control to managers stemmed in part from the prior revenue-generating successes of those corporations and partly from the trust the shareholders had in financial intermediaries who had persuaded them to buy those corporate stocks. More fundamentally, being passive was a rational choice for these retail shareholders because the shares they held were liquid so that they could sell them on the stock market at any time, a maneuver that became known as "the Wall Street Walk." They would not have purchased the shares in the beginning had they been obliged to be active and commit time and effort to oversee corporate management.[5]

The movement for shareholder democracy progressed with the emergence of these retail shareholders. Promoters of shareholder democracy envisioned a more cohesive society where mass workers would turn into mass shareholders supporting corporations and capitalism. John Bates Clark, a neoclassical economist, expected at the turn of the century that the share ownership by workers would "blur, or perhaps disappear . . . the old line of demarcation between the capitalist class and the laboring class," and argued that "[t]he socialist is not the only man who can have beatific visions."[6] This vision continued into the 1920s. John Raskob, a financier and businessman who played a crucial role in the expansion of Du Pont and General Motors, for instance, famously stated, "Everybody ought to be rich," when he laid out proposals for working- and middle-class wealth building in a 1929 article in *Ladies Home Journal*.[7]

[5] Lazonick and O'Sullivan (2000). [6] Quoted in Ott (2011, p. 25).
[7] Crowther (1929), Hagley Museum and Library. https://findingaids.hagley.org/xtf/view?docId=ead/0473.xml (accessed August 17, 2021). Ott (2011) similarly points out that political and economic leaders at the time hoped that mass share-ownership of corporations would "shore up the propertied foundations of citizenship, preserve economic mobility and autonomy, enhance national prosperity, and make corporations accord with the will of the people." (p. 4).

In the same context, Julia Ott (2011) states in *When Wall Street Met Main Street: The Quest for Investors' Democracy*, the primary concern of "intellectual, political, corporate, and financial leaders who embarked on a quest for mass investment" was how to build a stable and prosperous political system in the face of not only public distrust of "corporate power and accountability" but also of political challenges of internal integration from "mounting economic inequality, surging immigration, ethnic diversity, Jim Crow segregation, and women's demands for suffrage [that] sparked fundamental debates about citizenship." They hoped that "[m]ass investment could shore up the propertied foundations of citizenship, preserve economic mobility and autonomy, enhance national prosperity, and make corporations accord with the will of the people" (p. 4).

While promoting shareholder democracy as a political project, they made it clear that they did not think of it as being related to raising capital. According to Ott, they "did not view mass investment as a particularly efficient or profitable means of raising capital," and the "[c]orporate need for capital did not call forth popular demand for financial securities spontaneously."[8] In other words, the promoters of shareholder democracy did not employ an economic rhetoric that would improve the economic efficiency of corporations or the economy. William Lazonick and Mary O'Sullivan point out in the same context: "The stock market [at the time] did not serve as a source of funds for long-term business investment. When an enterprise went public, the stock market was the instrument for the separation of stock ownership from strategic control over internally generated corporate revenues."[9]

Because the promotion of shareholder democracy was a political project, institutional shareholders were not included in the movement because they were fiduciaries, not citizens who had political rights of representation. Institutional shareholders, such as mutual funds, were only beginning to emerge and held only about 5 percent of the US equity market capitalization by 1929.[10] They were considered merely money managers who functioned to diversify investments, thereby raising yields on portfolio investments while managing risks, an option not available to most retail shareholders.

This diversifying function of institutional shareholders had been well established from the days of the first collective investment trusts that emerged in Scotland and the UK in the latter half of the nineteenth century. For instance, the stated goal of the Foreign and Colonial Government Investment Trust established in 1868 was "to give the investor of moderate means the same advantages as the large capitalist in diminishing the risk of investing in Foreign and

[8] Ott (2011, p. 4). [9] Lazonick and O'Sullivan (2000, p. 112).
[10] McGrattan and Prescott (2004), cited in Coates (2018, p. 8).

Colonial Government Stocks, by spreading the investment over a number of different stocks."[11]

2.2 New Deal Financial Regulations of Institutional Shareholders

In line with the overall spirit of shareholder democracy in those days, New Deal financial regulations established in the 1930s emphasized the passivity of public shareholders and specifically discouraged institutional activism. As a policy response to the turmoil of the 1929 New York Stock Exchange crash and the subsequent collapse of economic activity, the Securities Act of 1933 and the Securities Exchange Act of 1934 sought to regulate financial markets.[12] A few years later, Congress passed the Investment Company Act of 1940, which regulated institutional shareholders.[13]

These New Deal regulations embodied three enduring principles that would guide the relationship between shareholders and companies: (1) the prohibition of fraud and deceit, including profiting from insider information; (2) regulating any shareholders acting as a group and prohibiting the formation of investors' cartels; and (3) encouraging institutional shareholders to diversify their portfolios and discouraging them from exerting influence over management.

Under the first principle, the regulations required public companies to make regular, accurate, and timely public disclosures of financial information to shareholders[14] and barred shareholders and managers from misappropriating corporate resources and profiting from insider information.[15] They specifically prohibited "fraudulent . . . manipulative [and] deceptive conduct."[16] To deter insider trading, they required those who were deemed insiders, whether manager-owners or investors, to disclose "all the information prior to trading."[17]

[11] Coates (2018, p. 7).
[12] Securities Exchange Act (1933; 15 U.S.C. §§ 77a-77mm) ("1933 Act" henceforth); Securities Exchange Act (1934; 15 U.S.C. § 78a-78jj) ("1934 Act" henceforce). The 1933 Act is the first major federal legislation to regulate the offer and sale of securities. It is based upon a philosophy of disclosure, meaning that the goal of the law is to require issuers to fully disclose all material information that a reasonable shareholder would need in order to make up his or her mind about the potential investment. The 1934 Act forms the basis of regulation of the financial markets and their participants. While the 1933 Act is about the primary market, The 1934 Act regulates the secondary market. It also established the Securities and Exchange Commission (SEC).
[13] Investment Company Act (1940; 15 U.S.C. §§ 80a-1–80a-64) ("1940 Act" henceforth). The 1940 Act specifically regulates investment companies, including mutual funds, and seeks to protect the public primarily by requiring disclosure of material details about each investment company.
[14] 1934 Act, § 13(a) (l). [15] 1934 Act, § 10b, 17 C.F.R. § 240.10b-5.
[16] 1934 Act, §§ 9, 10(b), 15(c), 15 U.S.C §§ 78i(a), 78j(b), 78o(c). See also Blair (1995); Roe (1990).
[17] 1934 Act, § § 10b-5(c), 16(a), 15 U.S.C 78p(a); Blair (1995, p. 51).

In addition, the regulations outlined that, should insiders profit by buying a company's securities and selling them within six months or vice versa, they "are recoverable by the issuer [the company]."[18]

Under the second principle, the formation of a voting group by investors was heavily regulated as establishing an investor cartel. If the combined shares of a group of investors exceeded 10 percent of the company's stock, its members were subject to the same regulations as insiders.[19] Furthermore, communications between investors were subject to strict oversight to prevent the development of such a group. If a group is to be formed, its prospective members should communicate with each other. The regulations, therefore, judged the communication as a proxy solicitation and made it necessary to file it by providing the information specified in Schedule 14A of the 1934 Act.[20] Blair (1995), therefore, points out that the regulations made it "difficult for shareholders to communicate with each other at all . . . without the approval and support of management" (p. 71).

Under the third principle, institutional shareholders were encouraged to diversify their portfolios and discouraged from seeking to control management. The 1934 Pecora Report, the product of a Senate securities investigation, explicitly walled institutional shareholders off from management, making it clear that mutual funds were only allowed to engage in investment activities.[21] This principle was also embodied in the Tax Code of 1936: "another safeguard . . . is to prevent an investment trust or investment corporation [from] being set up to obtain control of some corporation and to manipulate its affairs."[22] In testimony regarding the enactment of the Investment Company Act of 1940, a high-ranking SEC official asserted that "a mutual fund's *only* positive function was to provide diversification; any extension risked thievery."[23]

This regulation clearly separating management from institutional shareholders answered in part the need to remove the potential for conflicts of interest: If institutional shareholders were allowed to control corporations, they would tend to utilize their position for their own profit at the expense of other shareholders. More importantly, behind the regulation was a clear understanding that corporate managers and institutional shareholders serve different functions: While the former seeks to create value in corporations by producing high-quality and low-cost goods and services, the latter helps individuals extract

18 1934 Act, § 16(b), 15 U.S.C. § 78p(b); Blair (1995, p. 51).
19 *See* 1940 Act, §§ 2(a)(2)-(3), 17(a)-(b), 15 U.S.C. §§ 80a-2(a)(2)-(3), 80a-17(a)-(b).
20 *See* 17 C.F.R. § 240.14a-l(k) (2021); SEC Release No. 3347 (December 18, 1942); 17 C.F.R. § 240.14a-2b(1) & 3(a) (2021); Roe (1990, p. 17).
21 U.S. Senate Committee of Banking and Currency (2009); Roe (1991). For details on the Pecora Report, see Perino (2010).
22 Roe (1991, p. 1483).
23 Roe (1991, p. 1488). The emphasis is original.

value from corporations by leveraging size and diversification of corporate shareholding.[24] The mutual fund industry did not oppose the government in imposing the regulations at the time because they legitimized the industry in the eyes of the public.[25]

These three principles had been well enough established and went unchallenged until the 1980s. As recently as 1974, Congress upheld the same principles when it introduced the Employee Retirement Income Security Act (ERISA), a policy response to the growing need to regulate pensions. First, ERISA's rules prevented self-dealing behavior on the part of employers and fund managers.[26] Second, they discouraged pension funds from taking excessive risks and encouraged them to diversify investment portfolios broadly.[27] Third, they urged pension funds to refrain from exercising control over companies in their portfolio.[28] In this context, Peter Drucker, one of the earliest thinkers who envisaged the coming of the Pension Fund Revolution, pointed out that pension funds "have no business trying to 'manage' . . . To sit on a board of directors . . . and accept the obligations of board membership, is incompatible with duties as 'trustees' . . . which have been sharply and strictly defined in the Pension Fund Reform Act of 1974 [ERISA]."[29]

3 The Progression of Shareholder Activism and the Rise of Hedge-Fund Activism

Beginning in the 1980s, however, the three principles established during the New Deal era increasingly came under assault. It became easier for shareholders to form de facto voting groups, seriously impairing the second principle. The loosening of regulations on shareholders' communication and concerted actions was legitimatized by the new credos of "corporate citizenship" and "relational investing" that encouraged the active participation of institutional shareholders,[30] moving drastically away from the third principle. The first principle did not change much for public shareholders, but the adoption of SEC Rule 10b-18 in 1982, which allowed corporate executives to manipulate stock prices through stock buybacks, damaged the first principle and opened room for activist shareholders' demand for stock buybacks.[31]

24 On value creation by business corporation and value extraction through the stock market, refer to Section 5.1. Also see Lazonick and Shin (2020, pp. 14–40, 41–89).
25 Roe (1991, p. 1489).
26 29 U.S.C. § 1104(a)(1)(A)(i); 29 U.S.C § 1101; Blair (1995, p. 157).
27 29 U.S.C. § 1104(a)(1)(C); Blair (1995, p. 157).
28 29 U.S.C. § 1144(b)(2)(B); Blair (1995, p. 157).
29 Drucker (1976, p. 63).
30 For the understanding of these terms, see Section 3.1.
31 On the SEC Rule 10b-18 in 1982 and its impacts, refer to Lazonick (2014a, 2019); Lazonick and Shin (2020).