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The Case for Empowering Quality Shareholders

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Abstract

Anyone can buy stock in a public company, but not all shareholders are equally committed to a company's long-term success. In an increasingly fragmented financial world, shareholders' attitudes toward the companies in which they invest vary widely, from time horizon to conviction. Faced with indexers, short-term traders, and activists, it is more important than ever for businesses to ensure that their shareholders are dedicated to their missions. Today's companies need "quality shareholders," as Warren Buffett called those who "load up and stick around," or buy large stakes and hold for long periods.

While scholars in recent years have extensively debated indexers, short-term traders, and activists, they have paid scant attention to quality shareholders and their critical role in corporate finance and governance. This Article corrects this oversight by highlighting the quality shareholder cohort. Adding this fresh perspective confirms some of the angst about myopic short-termism on the one hand and ignorant indexing on the other, but rather than regulate related behaviors, the fresh perspective invites attention to empowering quality shareholders. In particular, rather than taxing short-term shareholders or passing through indexer voting rights, this Article explains how companies could simply increase the voting power of their quality shareholders.

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THE CASE FOR EMPOWERING QUALITY SHAREHOLDERS

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INTRODUCTION

The growing size and power of institutional investors is among the most important contemporary trends in American corporate life.[1] In recent years, their rise has drawn special attention to shareholder activists on the one hand and passive index funds on the other. Lively debates address whether such powerful investors have the right vision or conviction to faithfully discharge the trust so many Americans have placed in them.

On vision, for two decades scholars have debated whether investors, especially activists, are too short-term oriented for markets and managers to maintain a long-term view.[2] On conviction, just in the past two years scholars began to debate whether certain kinds of investors, particularly passive indexers, have sufficient incentives to actively monitor managers to assure performance over any horizon.[3] In a related debate on shareholder voice in corporate affairs, some scholars propose reducing the voting power of short-term shareholders to encourage long-term thinking while others propose eliminating that of indexers due to their passivity.[4]

These are vital debates in corporate America, implicating fundamental questions of the balance of power between directors and shareholders as well as among shareholders. As such, they stoke numerous sub-debates on every aspect of corporate governance, such as board structures, director-officer relationships, and shareholder rights.[5] Participants see wide-ranging effects on the national economy.[6]

Although such debates are sophisticated, increasingly data-driven, and involve overlapping participants, a peculiar binary characterizes the first two that afflicts the third. The horizon debate juxtaposes short-term against long-term visions but mutes the issue of conviction, while the conviction debate juxtaposes passive against active investment styles while muting the issue of

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[1] See John C. Coates, IV, The Future of Corporate Governance Part I: The Problem of Twelve (September 20, 2018) (available at www.ssrn.com/abstract=3247337) (the trend of rising power of institutional investors increases the "likelihood that in the near future roughly twelve individuals will have practical power over the majority of U.S. public companies").

[2] Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005); Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735 (2006); William W. Bratton & Michael L. Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 655 (2010); Jesse M. Fried, The Uneasy Case for Favoring Long-Term Shareholders, 124 Yale L. J. 1554 (2015).

[3] Compare Lucian A. Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy, 119 Colum. L. Rev. 2029 (2019) (agency cost indictment of indexer capability) with Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev. 17 (2019) [hereinafter Fisch, The New Titans] (ringing theoretical defense of indexer capability).

[4] Paul H. Edelman, Wei Jiang & Randall S. Thomas, Will Tenure Voting Give Corporate Managers Lifetime Tenure?, 97 Tex. L. Rev. 991 (2019); Dorothy S. Lund, The Case Against Passive Shareholder Voting, 43 J. Corp. L. 493 (2018); David J. Berger, Steven Davidoff Solomon & Aaron Benjamin, Tenure Voting and the US Public Company, 72 Bus. Law. 295 (2017).

[5] See infra Part II.C.

[6] E.g., Berger, et al., supra note 4, at 307-309.

horizon. Hence in the voting debate, there are calls to limit voting power of both short-term shareholders or indexers, but not both.[7]

In fact, however, while time horizon and relative conviction are vital, neither taken alone captures the nuanced reality of investor behavior which, at a minimum, calls for examining both features simultaneously. This Article proposes to incorporate such concurrent analysis of horizon and conviction into all three of these corporate law debates. By switching from binary conceptions to one that combines both attributes, analysis permits recognizing another cohort of shareholders whose role has been missing in all three debates: long-term concentrated shareholders.

While contemporary data suggest that a large plurality of institutional shareholders qualify as short-term and another plurality as indexers, the long-term concentrated cohort remains a significant force in market and corporate behavior.[8] It should accordingly have an important place in debates over horizon, conviction and voting.

This Article draws on related literature in finance and accounting, cited in these corporate law debates, delineating multiple shareholder types based on both horizon and conviction.[9] To visualize the combined model, blended shareholder cohorts can be identified using a 2 x 2 diagram arraying investment conviction across the top and investment horizon down the side to reveal combinations of conviction and horizon.

		INVESTMENT CONVICTION	
		Lower	**Higher**
INVESTMENT HORIZON	**Shorter**	Transients	Activists
	Longer	Indexers	Quality

To animate the approach, descriptive names are assigned: *transients* to shorter-term/diversifiers; *indexers* to longer-term diversifiers; *activists* to shorter-term concentrators; and *quality* to longer-term concentrators. Investment conviction is measured by the degree of an investor's portfolio diversification versus concentration, with lower conviction meaning the most

[7] See infra Part IV.

[8] See Lawrence A. Cunningham, Quality Shareholders (forthcoming Columbia University Press 2020) [hereinafter Cunningham, Quality Shareholders], Appendix.

[9] Brian Bushee, Identifying and Attracting the "Right" Investors: Evidence on the Behavior of Institutional Investors, 16 J. App. Corp. Fin. 28, 29 (2004) [hereinafter Bushee, The "Right" Investors]; Lynne L. Dallas & Jordan M. Barry, Long-Term Shareholders and Time-Phased Voting, 40 Del. J. Corp. L. 541, 549 n.6 (2016).

diversified portfolio—epitomized by index investors.[10] Investment horizon is measured by the investor's average holding period in its investments.[11]

In corporate law scholarship, the horizon debate considers shorter versus longer investment horizons (lower left panels of the graph) while the conviction debate considers lower versus higher investment concentration (upper right panels in the graph). Combining the two would shift the terms of debate from two pure binaries to an interactive quadrant (lower right panels of the graph). Three immediate normative consequences follow.

First, adding conviction to the horizon debate would unlock stalemates on fundamental issues addressing allocation of power between management and shareholders. In recent years, after two decades of intense discussion, the empirical evidence concerning whether short-termism is problematic remains inconclusive.[12] One reason, however, is a tendency in this literature to overlook significant differences among investors in their relative concentration, not merely time horizons. It may be that short-term traders who also concentrate offset other perceived problems of short-termism. Segmenting quality shareholders in research could help to inform sub-debates on particular governance topics, such as board structures and director-manager relations.[13]

Second, including horizon in the indexing debate will illuminate equally fundamental issues about the allocation of power among shareholders. The literature has tended to compare and contrast passive indexers on the one hand with all other shareholder types as a whole, collectively dubbed "active."[14] This tendency overlooks distinctions among the active cohort, lumping together activists, transients and quality shareholders. Indexers may well engage too little, but so might transients, perhaps warranting giving quality shareholders a special place in corporate decision making. Likewise, transients may compare themselves to annualized index benchmarks, but quality shareholders do not, focusing instead on long-term results.[15]

That leads to the third and most specific implication, concerning shareholder voting. Combining shareholder conviction and shareholder time horizon opens new approaches to this ultimate feature of the debates' normative implications. To date, critics of short-termism prescribe enhanced voting rights for long-term shareholders, in order to encourage longer time horizons while critics of indexers prescribe excluding indexers from voting on the grounds of their passivity and ignorance; opponents of both have pushed back accordingly.[16]

The critics in both such sub-debates may both be right to propose reducing the power of transients and indexers, respectively. But the logic of combining the two critiques identifies a third

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[10] Martijn Cremes, Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity, 73 Fin. Analysts J. 61 (2017).

[11] See Brian Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acc. Rev. 305, 330 (1998) [hereinafter Bushee, Myopic R&D].

[12] See Assaf Hamdani & Sharon Hannes, The Future of Shareholder Activism, 99 B.U.L. Rev. 971 (2019) (symposium issue on the horizon debate); Elisabeth de Fontenay, The Myth of the Ideal Investor, 41 Seattle L. Rev. 425 (2018) (symposium issue on the horizon debate).

[13] See infra text accompanying notes 187-200.

[14] See infra note 219.

[15] See infra text accompanying notes 105-108.

[16] See infra Part IV.

way: voting rules that reward longevity and conviction. Call it quality voting. It is the clearest and most important example of the many aspects of these three debates that would change by analyzing investor horizon and conviction in combination.

The stakes are high, as these debates touch fundamental issues in corporate governance. With the rise of institutional investors has come increasing shareholder voice on a wide range of matters, from director elections to say on executive pay and influence on corporate proposals spanning from climate change and gender diversity to strategic direction and corporate priorities. This Article is the first to offer a comprehensive view of quality shareholders, pointing to how their role should reshape these three debates. It proceeds as follows.

Part I presents the quadruple (2 x 2) typology of shareholder cohorts based upon time horizon and relative concentration. These are the recognized categories in the broader literature, and the two that dominate the respective debates on horizon and conviction. However, this discussion focuses not on the activist or indexer—well covered in the literature and reconsidered in ensuing Parts—but on the quality shareholder. While the quality shareholder is well-described elsewhere in corporate law scholarship, and more broadly in financial scholarship and general media, it has been virtually ignored in the corporate law debates on horizon, conviction and voting.

In the wider literature, the exemplar of quality shareholders are Warren Buffett and his company, Berkshire Hathaway. With a pedigree dating back to John Maynard Keynes and a following today commanding several trillions of dollars in invested assets, this cohort is vital. Its distinguishing features are a long-term view and concentrated portfolios, in stark contrast to transients and indexers. Part I introduces these investors, profiles their behavior, and demonstrates their competitive position and enduring force in the marketplace.[17]

Part II reviews the horizon debate. In thumbnail fashion, given the age and extent of this debate, it outlines the theoretical positions, empirical data, and normative legal implications. It then expands upon the quadruple classification scheme and how adding this approach can reinvigorate the horizon debate. While scholars cannot agree on whether short-termism is a problem, critics who believe it is may be comforted by the force of quality shareholders and defenders of the status quo may appreciate how such a contrast underscores additional limits of short-term behavior. This Article illustrates the effects of adding quality shareholders using sub-

[17] Among corporate law professors, I may be uniquely suited to elaborate on Buffett and this cohort, having spent nearly three decades immersed in their ecosystem and publishing numerous articles and books about them. See Stephen M. Bainbridge, Cunningham's Latest Book on Warren Buffett, Professor Bainbridge Blog (July 21, 2014) ("Few people have done a better job of chronicling Warren Buffett's illustrious career than Law Professor Lawrence Cunningham. I've read all of [his] Buffett books and have found each to be highly entertaining and informative."). Work dates to the mid-1990s when I organized a law review symposium featuring 25 corporate law professors dissecting my collection of Buffett's writings. See Lawrence A. Cunningham, Conversations from the Buffett Symposium, 19 Cardozo L. Rev. 719 (1997); Warren E. Buffett & Lawrence A. Cunningham, The Essays of Warren Buffett: Lessons for Corporate America (5th ed. 2019) [hereinafter Buffett & Cunningham, The Essays]. Recent articles include Lawrence A. Cunningham, Berkshire's Disintermediation: A Managerial Model for the Next Generation, 50 Wake Forest L. Rev. 509 (2015); Lawrence A. Cunningham, Berkshire's Blemishes: The Visible Costs of Buffett's Managerial Model, 2016 Colum. Bus. L. Rev. 1. Recent books include Lawrence A. Cunningham, Berkshire Beyond Buffett: The Enduring Value of Values (Columbia University Press 2014); Lawrence A. Cunningham & Stephanie Cuba, Margin of Trust: The Berkshire Business Model (Columbia University Press 2019).

debates over staggered boards and splitting versus combining the roles of board chairman and CEO.

Part III reviews the conviction debate. In somewhat more detail, given the nascent stage of this debate, it reviews the positions, data, and upshot. As a critique of the current literature's focus on indexers versus all others (habitually called "active"), this delineates the active cohort further. Among lessons that are uncovered, scholars focus on formulaic incentive models that assume all "active" funds measure themselves against annual index benchmarks or growth in assets under management,[18] whereas quality shareholders put no stock in such references.[19] The result is that current research ignores the relevant incentives and must be expanded in order to increase its relevance and reliability.

Part IV turns to shareholder voting implications. This is the most obvious topic requiring updating to incorporate quality shareholders. After all, one upshot of the horizon debate is revived interest in voting power based on holding periods ("tenured voting"); one upshot of the conviction debate is new interest in reducing indexer voting power. Logic dictates considering voting rules that do both, by increasing the voting power of quality shareholders.

Amid the fragmentation of the shareholder base and related debates, for instance, dual class voting structures have proliferated to insulate companies from pressures of shareholder activists.[20] Tenured voting has been advocated as a way to discourage short-term shareholdings[21] while exclusionary voting is being proposed to dilute the voice of indexers, seen to lack requisite incentives or knowledge.[22] All such proposals are reasonable responses to perceived imbalances. But they are all incomplete, and point to the validity of a more complete shareholder voting protocol, one based on both central behavioral tendencies of horizon and conviction.[23]

It is sometimes difficult to map theory onto practice, given the constraints of their different realms.[24] This reality may partially explain why the quality shareholder cohort has not received the attention it should: it has been relatively easy to model and measure the incentives and profiles of activist shareholders and index funds while the quality shareholder cohort contains more numerous and idiosyncratic members. But by providing a behavioral profile along with data about their performance and roles, this Article offers the promise of theorizing the practice.

I. QUALITY SHAREHOLDERS

This Part reviews the rise of the institutional investor industry, noting legal scholarship reviewing it, and ensuing shareholder fragmentation. It reviews attempts to classify this fragmented shareholder base, highlighting one that delineates according to normatively significant dimensions of both horizon and conviction. The combination introduces a new shareholder cohort

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[18] See infra text accompanying notes 215-217.

[19] See infra text accompanying notes 105-108.

[20] See infra Part IV.A.

[21] See infra Part IV.B.

[22] See infra Part IV.C.

[23] See infra Part IV.D.

[24] See Louis Lowenstein, Efficient Market Theory: Let the Punishment Fit the Crime, 51 Wash. & Lee L. Rev. 925, 925 (1994); Lynn A. Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 Iowa J. Corp. L. 635, 639 (2003).

to longstanding corporate law debates: the quality shareholder. Its behavioral attributes are explained, along with the cohort's competitive position, relative performance, and advantages this approach offers to companies and fellow investors.

A. Fragmentation

In decades past, most shareholders were individuals. In 1965, for example, institutional investors held $436 billion of $1.4 trillion in total market capitalization, with nearly $1 trillion owned by individual households.[25] Less than 15% of the market, or $100 billion, was held by the day's mutual funds, pension funds, and insurance companies (respectively holding $36, $43, and $21 billion 5%, 6%, and 3%).[26]

With shareholders so dispersed, prominent corporate theorists had for decades described the challenge of corporate life as the "separation of ownership from control."[27] It would be difficult for shareholders to act collectively and often irrational for them to incur the costs necessary to monitor corporate management.[28] In this structure, managers held the balance of power over corporate destiny—in American corporate finance, there were strong managers yet weak owners.[29] Corporate law's principal task, then, was to mitigate the attendant agency costs.[30]

Post-1965, however, trends moved from individual to institutional ownership and, by the 1990s, those trends had become so powerful that corporate law scholars came to believe that they might mitigate these historical problems.[31] A promising agenda emerged to enable institutional investors to monitor management more effectively.[32] Guidance was provided on what to expect, including realistic cautionary notes, but in general the rise of institutional investors held out great promise for corporate governance.[33]

These hopes, however, have been disappointed, as the rise of institutional investors altered but did not resolve the longstanding challenges. Today, institutions command the vast majority of

[25] Board of Governors of the Federal Reserve System, Financial Accounts of the United States: Historical Annual Tables (1965-1974).

[26] Id.

[27] See Adolf A. Berle, Jr.& Gardiner C. Means, The Modern Corporation and Private Property (1933).

[28] See Mancur Olson, The Logic of Collective Action (1965).

[29] See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

[30] See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

[31] Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990).

[32] See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991).

[33] See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811 (1992); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445 (1991); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991).

the $30+ trillion in total market capitalization.[34] Among these are mutual funds, pension funds, and insurance companies together commanding a decisive majority (respectively, $9.1 trillion, $2.3 trillion, and $811 billion). They present the old problems of agency costs in new ways due to three critical changes in the institutional investor landscape that have occurred in the past two decades.

Foremost, a large and growing percentage of shares are held by indexers. Indexing involves buying proportional stakes in every stock listed in some benchmark index, such as the S&P 500 or Russell 3000, without doing any research or being exposed to anything but the market risk-return. Popularized by the late Jack Bogle, indexing was a marginal practice through the 1990s, but today is a familiar approach. Bogle's company, Vanguard, is a household name. Large indexers command trillions of assets, representing one-quarter to one-third or more of total U.S. public company equity. In 1997, less than 8% of mutual funds were indexed, whereas today more than 40% are.

Second is the substantial shortening of average holding periods, indicative of increased trading for arbitrage, momentum strategies, and other short-term drivers. The best-selling financial author, Michael Lewis, dramatized the stakes in his 2014 book, *Flash Boys*, and the pace of acceleration continues with sustained technological advances in computing algorithms, artificial intelligence and machine learning.[35] Average holding periods shortened significantly from the mid-1960s through the early- or mid- 2000s;[36] while the average has held steady since, this appears to be due to how the shorter horizons of many are offset by the more permanent holdings of the indexers.[37]

Third is the rise of activism. Shareholder gadflies have roamed corporate America since the Gilbert brothers popularized the practice in the 1950s.[38] And from the 1970s through the 1990s, incumbent managers faced constant threats to corporate control from rival firms, takeover artists, and colorful raiders such as Carl Icahn and Nelson Peltz.[39] But it is only in the past two decades that a vast pool of capital developed among specialty firms, dubbed shareholder activists, dedicated to the practice and featuring a well-developed playbook, a cadre of professional advisers, and repeat players such as Bill Ackman, Dan Loeb and Paul Singer.[40]

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[34] Board of Governors of the Federal Reserve System, Financial Accounts of the United States: Historical Annual Tables (2005-2015); Board of Governors of the Federal Reserve System, Financial Accounts of the United States, Second Quarter 2018 at 130.

[35] See Tom C. W. Lin, Artificial Intelligence, Finance, and the Law, 88 Fordham L. Rev. 531 (2019).

[36] Anne M. Tucker, The Long and The Short: Portfolio Turnover Ratios & Mutual Fund Investment Time Horizons, 43 Iowa J. Corp. L. 581 (2018) (through 2000); Edelman, et al., supra note 4, at 992 (through 2007).

[37] K.J. Martijn Cremers & Simone M. Sepe, Institutional Investors, Corporate Governance, and Firm Value, 41 Seattle U. L. Rev. 387, at n. 42 (2018) [hereinafter Cremers & Sepe, Institutional Investors].

[38] See Lawrence A. Cunningham & Stephanie Cuba, Annual Shareholder Meetings: From Populist to Virtual, Financial History (Fall 2018)

[39] See Knights, Raiders and Targets (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

[40] See William W. Bratton & Joseph A. McCahery, Introduction to Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation 1-38 (2015).

Facing these forces, it has been easy to overlook the enduring power of the traditional cohort of individual and institutional investors who prefer old-fashioned techniques famously known as buy-and-hold. The style is epitomized by Warren Buffett and Berkshire Hathaway and boasts such notable historical figures as John Maynard Keynes and Benjamin Graham, along with such legacy names as John Neff of Wellington Management or Thomas Rowe Price and his eponymous firm, T. Rowe Price Group Inc.[41]

B. Classification

Today's diverse shareholder base can be classified in a variety of ways. Examples include formal, functional or behavioral. Which approach is appropriate depends on the purpose of the classification, such as the viewpoint of potential customers, regulators, or researchers.

An obvious formal starting point distinguishes individuals from institutions, which is both straightforward and useful. This delineation is useful for fundamental issues such as the role of government. For example, a government agency might plausibly be charged with developing educational programs for individuals but not institutions and likewise be asked to provide oversight for institutional investors but not individuals.[42]

A classic formal delineation of institutional investors considers legal form of organization. Examples: banks, hedge funds, index funds, investment advisors, insurance companies, and mutual funds.[43] Such a scheme is useful for many purposes, such as determining beneficiaries and fiduciary duties, regulatory restrictions and competitive pressures.[44]

In more functional terms, investment strategy is a way to sort institutional investors, such as technical versus fundamental, growth versus value, or quantitative versus qualitative.[45] Those alternatives would be of special interest when investigating relative investment appeal, such as risk-adjusted returns or volatility.[46]

Another functional approach would examine trading behavior. For instance, how different shareholders use information may be important when studying market efficiency[47] or formulating

[41] See Cunningham, Quality Shareholders, supra note 8.

[42] Donald C. Langevoort, The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 Va. L. Rev. 1025 (2009).

[43] See Edelman, et al., supra note 4, at 992. Institutions cater to different clienteles, such as consumers, retirees, labor union members or high net worth individuals.

[44] Bushee, The "Right" Investors, supra note 9.

[45] Institutional investors follow a variety of different investment strategies (such as value, growth or income) or different target size (such as small or large cap). Some funds combine these features, classifying as large value, large growth, small value, or small growth. They may rivet on particular sectors or geographic regions or attempt to buy small stakes in essentially every company in the stock market.

[46] Some have objectives in addition to traditional shareholder returns, such as promoting the interests of labor See David Webber, The Rise of the Working-Class Shareholder: Labor's Last Best Weapon (2018); Ashwini K. Agrawal, Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting, 25 Rev. Fin. Stud. 187 (2012); Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795 (1993).

[47] See Sanford J. Grossman & Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393 (1980).

securities regulations.[48] Helpful categories include: insiders, market makers, noise traders, liquidity traders, and information traders.[49] These groups differ in terms of their access to and use of information, with significant effects on market performance and optimal disclosure laws.[50]

A behavior-based classification of investors might incorporate such varying approaches to handling information. The behavioral division might also consider the central questions in the corporate law debates over time horizons and conviction levels.

In the early 1990s, for example, Harvard Business School Professor Michael Porter compared institutional investor behavior in the U.S. with counterparts in Germany and Japan, whose economies were operating more productively.[51] He reported a U.S. propensity toward either indexing or trading compared to the more concentrated and patient investor model prevalent abroad.

In the late 1990s, University of Pennsylvania Wharton Business School Professor Brian Bushee extended Porter's analysis.[52] Bushee noted that Porter's critique overlooked the significant group of U.S. investors who both concentrate and hold—a blind spot that persists in the corporate law literature.[53] But he stressed that Porter's insight warranted focusing on differences among shareholders represented by two variables: time horizon and conviction.[54] Bushee identified three categories of institutional investors as follows:

> "transient" institutions, which exhibit high portfolio turnover and own small stakes in portfolio companies;
> "dedicated" institutions, which provide stable ownership and take large positions in individual firms; and
> "quasi-indexers," which also trade infrequently but own small stakes (similar to an index strategy).[55]

Bushee's empirical work was straightforward. He computed various measures of horizon and conviction: horizon by quarterly portfolio turnover as well as portion held more than two years and conviction by average percentage ownership of investees, the percentage of investees

[48] See Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L.J. 711, 722 (2006).

[49] See Paul Rose & Bernard S. Sharfman, Shareholder Activism as a Corrective Mechanism in Corporate Governance, 2014 BYU L. Rev. 1015, 1023-24.

[50] Insiders have company information but securities laws limit their right to use it; market makers may have the information but their trades support balancing supply and demand; noise traders chase fads; liquidity traders act for nonfundamental reasons, such as funding needs or calibrating to an index; and information traders do the heavy lifting of digesting and acting on information. See id.

[51] Michael Porter, Capital Choices: Changing the Way America Invests in Industry, 5 J. App. Corp. Fin. (1992).

[52] Bushee, The "Right" Investors, supra note 9, at 29.

[53] See infra Parts II & III.

[54] Bushee, The "Right" Investors, supra note 9, at 29-30 (using the words stability and stakes rather than horizon or conviction but synonymously).

[55] Id. Shareholder activists are introduced into this schematic below, infra text accompanying note 70.

representing at least a 5% share of the portfolio, and the average size of each investment.[56] He then combined the horizon and conviction computations to capture the two factors together.

With that ranking, Bushee clustered the results into the three shareholder types and identified exemplars of each. *Transients*, with short time horizons and small stakes, are typified by Numeric, he said, a fund that specializes in exploiting dynamic stock market activity, not fundamental investment analysis of business; *quasi-indexers*, which buy small stakes in 500 to 3000 stocks representing an entire market basket, is exemplified by CalPERS, Bushee wrote, the large California pension fund; and *dedicated* shareholders, those who buy large stakes and hold them for long periods, are epitomized by Warren Buffett's Berkshire Hathaway, he said.[57]

Professor Bushee's work has been widely influential. For example, decades after publication, consulting firm McKinsey & Company offered a similar take.[58] It calls equivalent categories by different names: intrinsic instead of dedicated; mechanical instead of quasi-indexers; and traders instead of transients. But the analytical utility of the McKinsey and Bushee lexicons are the same and offer a valuable lens for purposes ranging from evaluating investor performance to expected handling of information and likelihood of different shareholder cohorts being informed participants in shareholder voting.

In finance scholarship, numerous empirical studies develop tests to identify shareholders who rank high by combined horizon duration and portfolio concentration. For instance, University of Connecticut finance professor Paul Borochin, and researcher Jie Yang, developed such a database to determine the effects of shareholder base on a company's governance structure and economic value.[59] Finance professors Martjin Cremers of Notre Dame University and Ankur Pareek of University of Nevada created a large data set of all institutional investors dating to 1980, presenting, quarter-by-quarter, each shareholder's concentration and average holding period.[60] The scholars have been using this data to conduct a variety of tests concerning relative investor performance.[61]

In legal scholarship, Professor Belinfanti, in her research on how companies can shape their shareholder base, canvassed multiple alternative methods of classifying investors.[62] Belinfanti features Professor Bushee's method prominently, describing it as a "contemporary"

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[56] Bushee, The "Right" Investors, supra note 9, at 29-30.

[57] Id.

[58] Robert N. Palter et al., Communicating with The "Right" Investors, in McKinsey on Finance: The Enduring Value of Fundamentals, 40 McKinsey & Co. 57, 58-59 (2011).

[59] Paul Borochin & Jie Yang The Effects of Institutional Investor Objectives on Firm Valuation and Governance, 126 J. Fin. Econ. 171 (2017) (including a robust propensity score model for identify quality shareholders, dubbed DED for dedicated, after Bushee, in the model).

[60] Martjin Cremers & Ankur Pareek, Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently, 122 J. Fin. Econ. 288 (2016). (concept of "active share" measures relative concentration of a portfolio compared to a benchmark index, with a pure index active share equal to zero and a completely concentrated portfolio equal to one).

[61]The data and related research are posted on the Notre Dame University web site. https://activeshare.nd.edu/academic-research/.

[62] Tamara C. Belinfanti, Shareholder Cultivation and New Governance, 38 Del. J. Corp. L. 789, 818 (2014).

method to "drill down" beyond conventional classifications to focus on important behaviors and propensities.[63]

Professors Dallas and Barry use Bushee's classification system in their empirical work on shareholder voting regimes.[64] They too note alternative approaches to classifying investors, such as formal categories like type of business organization.[65] But for purposes of corporate law, they stressed that what matters most is behavior, particularly time horizons and conviction levels.[66] Dallas and Barry summarize the implications of Bushee's classification scheme for this purpose as follows:[67]

> Transient shareholders . . . have the least incentive to "understand drivers of long-run value."
>
> Dedicated investors . . . have the greatest incentive to think about the long term and to take an active role in corporate governance and monitoring of portfolio companies. . . .
>
> Quasi-indexers fall between the other two categories. They . . . have good incentives to think about the company's long-term value, but do not have good incentives to be involved in corporate governance and oversight.

Since Bushee developed his classification system in the late 1990s and early 2000s, the activist shareholder segment developed into a distinctive cohort.[68] Within Bushee's system, they might be classified as transients if they held for short periods and in low concentrations. But most are highly concentrated in their positions, and sometimes even hold for above-average periods, though their time horizon is routinely portrayed in the literature as short-term.[69]

Given that shareholder activists adopt a unique approach to engagement,[70] by public campaigns for corporate change, separately classifying this cohort is analytically useful. The scholarship in the corporate horizon debate provides behavioral profiles of activists, transients and indexers, to be reviewed in Parts II and III. It has not developed a behavioral profile of the quality shareholder, though this cohort features in other strands of corporate law scholarship. Accordingly, this Part will continue by presenting such a profile.

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[63] Id.

[64] Dallas & Barry, supra note 9, at 549 n.6 (2016). Part IV of this Article addresses the literature on shareholder voting regimes and normative implications of this Article's analysis.

[65] Id. at n.270.

[66] Behavior changes over time. For example, Bushee estimates that about 1/5 of institutional investors change their Bushee classification over a three-year period. See Dallas & Barry, supra note 9, at n. 116 (citing correspondence between Bushee and Dallas).

[67] Dallas &. Barry, supra note 9, at 625-627 (citations omitted).

[68] See Bratton & McCahery, supra note 40.

[69] See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1083 (2007) ("Hedge funds come close to being the archetypal short-term investor"); John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 Iowa J. Corp. L. 545, 573-574 (2016) (observing that hedge funds might be "archetypical" short-term shareholder but noting that many mutual funds are too).

[70] See Bratton & McCahery, supra note 40.

C. Behavior

Professor Bushee named Buffett as exemplifying the "dedicated" or quality shareholder.[71] Other empirical research identifying quality shareholders invariably place Buffett and Berkshire Hathaway at or near the top.[72] Many other corporate law scholars have echoed the point, including Professor Dallas in her use of the Bushee model in her empirical work.[73] Professors Choi and Pritchard, in their discussion of the various behaviors that diverse shareholders exhibit, suggested that Buffett is the "paradigm" of such an approach.[74] Buffett's standing as a model of the patient committed shareholder has been particularly common among scholars of trust law, where investment theory plays a central role.[75]

Based on my extensive research and writings with and about Buffett over the past three decades, I concur in the conclusion and can explain the behavior.[76] First, while Bushee's reference was to Buffett as a shareholder, it is equally true that Buffett, as CEO of Berkshire Hathaway, consciously cultivated such a cohort among *its* shareholders.[77] He began doing so two decades before Bushee minted his classification, when Buffett referred to Bushee's cohort of "dedicated" shareholders as "quality" shareholders.[78] Since this is also an adjective often used by corporate scholars to designate a variety of shareholder behaviors, it is the term this Article will use.[79]

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[71] Bushee, The "Right" Investors, supra note 9, at 30-31.

[72] E.g., Borochin & Yang, supra note 59; Cremers & Pareek, supra note 60; Cunningham, Quality Shareholders, supra note 8, Appendix.

[73] Dallas & Barry, supra note 9, at 625-627.

[74] Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1, 15 n. 65 (2003).

[75] E.g., Jeffrey A. Cooper, Empty Promises: Settlor's Intent, The Uniform Trust Code and the Future of Trust Investment Law, 88 B.U. L. Rev. 1165, 1190-1195 (2008) (sharply contrasting Buffett with indexers as well as transients, drawing on prominent detailed accounts of Buffett's philosophy, including my work); see also Stewart E. Sterk, Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?, 95 Cornell L. Rev. 851, 873-874 (2010) (noting my views on Buffett).

[76] See supra note 17.

[77] See Buffett & Cunningham, The Essays, supra note 17, at 185-188.

[78] See Edward B. Rock, Shareholder Eugenics in the Public Corporation, 97 Cornell L. Rev. 849, 879 (2012) (quoting Buffett's description of Berkshire's goal and strategy to attract "high quality shareholders"); Buffett & Cunningham, The Essays, supra note 17, at 185-188 ("attracting quality shareholders").

[79] E.g., Cynthia A. Williams & John M. Conley, An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct, 38 Cornell Int'l L.J. 493,519 (2005) (quoting a U.K. government official as favoring "high quality shareholder engagements"); Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, Does Majority Voting Improve Board Accountability? 83 U. Chi. L. Rev. 1119, 1164 n. 114 (2016) (referring to shareholder proposals as being of "higher- or lower- quality"); Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Activism, 113 Colum. L. Rev. 863, 913 (2013) (referring to the relative quality of shareholder activist proposals).

The term should be compared with that of quality investing, referring to an investment strategy seeking to find high-quality businesses that may be purchased at a reasonable price. See infra note 88.

While Buffett is certainly an exemplar, he is part of a long tradition extending back many decades, and will leave a legacy of legions of followers in his wake. As for predecessors, consider John Maynard Keynes, the distinguished economist, scholar and investor. Keynes stated his philosophy, based on years of experience and reflection: "I get more and more convinced that the right method in investments is to put fairly large sums" in select enterprises and that it is "a mistake to think that one limits one's risk by spreading too much between [diverse] enterprises."[80] Rather, Keynes avowed: "I believe now that successful investment depends on . . . a steadfast holding . . . in fairly large units through thick and thin, perhaps for several years. . . ."[81]

Professor Amy Westbrook noted Keynes' influence on Buffett in her portrait of their style, stressing patience and conviction as defining features.[82] On concentration, she notes that diversification is "close to godliness" on Wall Street, but that Buffett holds the opposite conviction.[83] On the long-term view, Westbrook explains how Buffett consciously cultivated fellow shareholders with such a view because it was so important to his own approach. She explained: "In a world in which investors are told that seconds matter and trading is easy, he advocates buying Berkshire stock and then not touching it again."[84]

Another Buffett predecessor was Benjamin Graham, his professor at Columbia University and a renowned investor and educator.[85] Graham taught Buffett—and two generations of followers—the art of value investing.[86] This involves conducting fundamental analysis of businesses to estimate their value and then buying only the small number that can be obtained at a price substantially below estimated value.[87] A modern variation on Graham's technique is called quality investing, or growth investing, which expands the pool to include buying stocks at a price that is low in relation to reasonably anticipated growth in intrinsic value.[88]

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[80] John F. Wasik, Keynes's Way to Wealth: Timeless Investment Principles from the Great Economist (McGraw Hill 2014).

[81] David Chambers, Elroy Dimson & Justin Foo, Keynes the Stock Market Investor: A Quantitative Analysis, 50 J. Fin. Quant. Analy. 843 (2015). Keynes managed investments for Cambridge University's King's College from 1927 to 1945. He concentrated as much as half the portfolio in five companies, and held them at least five years apiece. See Allen C. Benello, Michael Van Biema & Tobias E. Carlisle, Concentrated Investing (2017), at 48, 51. Despite working in a challenging era that included the Great Depression and World War II, returns were impressive: a compound annual growth rate of 9.12% in contrast to the broad U.K. market return of negative 0.89%. Id. at 58.

[82] Amy Deen Westbrook, Warren Buffett's Corporation: Reconnecting Owners and Managers, 34 Okla. City U. L. Rev. 515, 544-545 (2009).

[83] Id.

[84] Id. at 535.

[85] See Benjamin Graham, The Intelligent Investor (1959); Benjamin Graham & David Dodd, Security Analysis (1962).

[86] See Lawrence A. Cunningham, How to Think Like Benjamin Graham and Invest Like Warren Buffett (2001); Warren Buffett, The Superinvestors of Graham and Doddsville, Hermes (1985).

[87] Bruce N. Greenwald, et al., Value Investing: From Graham to Buffett and Beyond (2001).

[88] See Cornelius C. Bond, T. Rowe Price: The Man, The Company, and The Investment Philosophy (2019); Lawrence A. Cunningham, Torkell T. Eide & Patrick Hargreaves, Quality Investing (2016);

Professor Lowenstein distilled the Buffett/Graham approach in his corporate law scholarship.[89] Lowenstein stressed that this approach to investing is based on fundamental business analysis—neither indexing nor trading. The principal criteria are: conviction, by holding fewer than 20 stocks, and patience, by holding stocks for an average of at least two years.[90]

Quality shareholders adopt a wide variety of diverse strategies for buying, holding or selling, and engaging with management. Buying may be made in accordance with the tenets of Graham's pure value investing, the growth investing extension, or some other variant.[91] In all cases, however, the investment decision is based upon fundamental business analysis—neither trading activity nor indexing.[92] Concentration is invariably the result.[93]

Likewise, quality shareholders may adopt different policies concerning whether and when to sell shares. Although most usually follow Buffett to prefer permanent holding periods,[94] some may sell when price rises to a significant multiple of value.[95]

Finally, quality shareholders have varying propensities concerning engagement, though their tendency is monitoring at a distance and consulting when asked.[96] Buffett is again seen to exemplify this stance. Professors Bratton and McCarey put it this way:

> The model block owner is the legendary Warren Buffett, a fundamental value investor who takes large, under-diversified, long-term positions; monitors carefully; but does not attempt to interfere with the formulation or implementation of the business plan, except in a crisis.[97]

Manifestations of Buffett's approach include Berkshire's large long-term stakes in a relatively small number of companies. Exquisite examples of stakes still held today are 17.9% of American Express, initially acquired in 1962; 9.4% of Coca-Cola, initially acquired in 1984; and 9.8% of Wells Fargo, initially acquired in 1989.[98] All of these companies have faced business

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Clifford S. Asness, Quality Minus Junk, 24 Rev. Acc. Stud. 34 (2019); Robert Novy-Marx, Quality Investing (2014), https://pdfs.semanticscholar.org/9480/0c35aff62f304d42ac8a9112cd9f40d8e59f.pdf.

[89] Louis Lowenstein, Searching for Rational Investors In a Perfect Storm, 30 J. Corp. L. 539, 547 (2005). Professor Lowenstein was a close personal friend of Warren Buffett and long-time investor in Berkshire Hathaway. His son, Roger, a prominent journalist and author, wrote the classic biography, Warren Buffett: The Making of An American Capitalist.

[90] Lowenstein, Searching, supra note 89, at 547.

[91] See John Train, Money Masters of Our Time (2000), p. 306.

[92] Robert G. Hagstrom, The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy 31 (1999).

[93] See Allen C. Benello, Michael Van Biema & Tobias E. Carlisle, Concentrated Investing (2017).

[94] See Buffett & Cunningham, The Essays, supra note 17.

[95] E.g., John Neff, On Investing (1999) 116-117 (Neff, a quality shareholder, explaining that "you don't have to buy and hold forever").

[96] See Robert P. Miles, Warren Buffett Wealth: Principles and Practical Methods Used by the World's Greatest Investor 33-34 (2004).

[97] William W. Bratton & Joseph A. McCahery, Regulatory Competition, Regulatory Capture, and Corporate Self-regulation, 73 N.C. L. Rev. 1861, 1919, n. 224 (1995).

[98] Berkshire Hathaway Inc. Annual Report (2019).

challenges during Berkshire's ownership and Buffett has helped behind the scenes, but never interfered publicly.[99]

Concerning conviction, quality shareholders view themselves as part owners of a business. Such an ownership sense requires conviction, reflected in thorough research and disciplined decisions. As put by the venerable firm of Ruane Cunniff, founded by another Graham student and Buffett classmate, William Ruane: "We take pride and pleasure in investigating a company from all angles, doing the kind of on-the-ground, primary research that an enterprising journalist might do."[100] Quality shareholders concentrate, often limiting their portfolios to some 20 companies.[101]

Concerning time horizon, quality shareholders are fond of following Buffett in saying their favorite holding period is forever.[102] They are not motivated to beat the market in any given year but to generate returns over long periods of time. Since quality shareholders are generally risk averse, sustained patience reduces both reinvestment risk and expense risk.[103] Owning outstanding companies for very long periods not only limits risk but reaps the benefits of compounding, a cherished principle of quality shareholders.[104]

Quality shareholders reject the prevailing fashion of comparing their annual return with some benchmark index.[105] They eschew reference to the relative volatility of the indexes.[106]

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[99] See Lawrence A. Cunningham & Stephanie Cuba, Margin of Trust 78 (2019). In 2014 a shareholder activist launched a public campaign challenging Coca-Cola's executive compensation plan and urged Berkshire to support it. Instead, Buffett privately engaged outside of the spotlight to resolve the issue. In 2016 concerning American Express, Buffett declined an overture from a shareholder activist seeking change, favoring direct consultation with long-time chief executive officer.

[100] Ruane Cuniff website.

[101] E.g., Ruane Cunniff & Goldfarb: "Our small collection of investments bears little resemblance to the S&P 500 or any other index. In fact, our top ten investments often account for >60% of the value of our portfolios. The S&P 500 may be relevant for assessing our performance over the long term, but it has no bearing on how we construct our portfolios."

Southeastern Asset Management: "We are long-term owners, not traders or speculators, and invest for the long-term based on objective intrinsic values with a horizon of at least five years. We construct our portfolios with what we believe to be our best 18-22 global investment ideas. Concentrating allows for adequate diversification while providing some of the best opportunities to maximize returns, and minimize loss of principal."

[102] See Buffett & Cunningham, The Essays, supra note 17.

[103] On reinvestment risk, selling shares results in capital needing to be reinvested and finding new outstanding investments is time-consuming and difficult. On expense risk, trading and taxes are immediate costs of selling, disguising the stated nominal returns that draw attention.

[104] See Warren Buffett, The Joys of Compounding (1963).

[105] E.g., FundSmith: "Over a sufficient period of time, you will no doubt want to assess our performance against a range of benchmarks – the performance of cash, bonds, equities and other funds, and we will assist you in that process by providing comparisons. However, we do not think it is helpful to make comparisons with movements in other asset prices or indices over the short term, as we are not trying to provide short term performance."

[106] E.g., Cedar Rock Capital Partners: "We make no effort to minimize volatility relative to any national, regional or global index of equity market performance. However, we expect our emphasis on both quality and value to generate satisfactory absolute and relative performance over the long term."

Quality shareholders object to the common habit of distinguishing between passive index funds on one hand and all others, dubbed "active," on the other.[107] They invest for, and measure performance, over many years, not annually as is the obsession of many commentators.[108]

The philosophy of quality shareholders can be further illuminated by contrasting it with that of indexers. Indexers believe in efficient markets: that share prices reflect future prospects. Quality shareholders doubt that numbers capture all, whether computed by humans, powerful computers, or elaborate algorithms. Quality shareholders conduct the fundamental analysis that is necessary in order to promote stock market efficiency. In their view, passive funds free ride off of that work.[109]

The Keynes-Graham-Buffett model continues to attract a large following of quality shareholders. Many are powerful names recognized in the institutional investor world. To illustrate, the following lists top quality shareholders as identified by Professors Borochin and Yang:[110]

Top Quality
Berkshire Hathaway
Capital Research & Management
Fidelity Management & Research

[107] E.g., Baillee Gifford:

We are not passive investors who think that current share prices capture the future prospects of companies. We don't believe that investment decisions can be made on numbers alone, even by supercomputers and complex algorithms. Passive has its place, providing low-cost market access with, on average, better after-fees results than active managers. However, it has little to do with the process of allocating capital to innovative companies—though on that point it has much in common with many active managers.

We are not a typical active manager either: we believe this term has become a one-size-fits-all description which is very unhelpful for investors. It has been hijacked by many fund managers who think it suggests 'activity' and simply being different from an index. The reality is that much of this activity has more to do with trying to outsmart other investors than with the creative deployment of capital, and that defining active as being different from an index is to start in the wrong place. This is why most active investors fail to deliver returns that outperform passive investment strategies over the long term. They're not even trying to do the fundamental job of investing.

[108] Gardner Russo Gardner:

[Portfolio concentration] may mean temporary depression of market values for companies if and when they are out of favor. However, reduced share prices as a result of market sentiment do not necessarily relate to reduced prospects for our companies' operations. Accordingly, we prefer not to move from sector to sector, following the bubble of the moment. Rather, we prefer to patiently await the market's return to recognition of our businesses' intrinsic value. [T]his may mean that our portfolios undergo periodic under-performance versus the market as a whole. . . . Because our core positions can be heavily weighted, performance of our portfolios can be dampened by market sentiment, which we regard, however, as immaterial to our investments' long-term potential.

[109] See Howard Marks, Investing Without People (2018).

[110] Borochin & Yang, supra note 59.

Harris Associates (Oakmark Funds)
State Farm Insurance
Southeastern Asset Management
Wellington Management

Like Berkshire, these quality shareholders have large parts of their portfolios invested in sizable stakes of major companies held for many years. Examples: Capital Research in Abbott Labs; Fidelity in SalesForce; Harris in Tenet Health; State Farm in Air Products; Southeastern in Graham Holdings; and Wellington in Marsh & McLennan and PNC Financial.[111] Other examples of such quality shareholders and stakes are the positions of Franklin Resources in Roper and Massachusetts Financial in Accenture.[112]

Despite convictions, quality shareholders face relentless competitive pressures.

D. Competition and Performance

Today's institutional investors face pressure to favor indexing or transience. Compensation of fund managers is often based on annual returns, so the question becomes whether an investor beat the market for a given year or not. In such an environment, pressure is substantial to diversify widely on the one hand and, on the other, to chase returns by rapid trading. While quality shareholders reject and resist such approaches, the result is a rising portion of indexers and transients compared to quality shareholders.

The effects of this intensive environment are reflected in estimates of the relative size of these cohorts. The number of different indexes has proliferated—at least 60 major ones by one count, with Morningstar alone designating at least 300 different indexes.[113] Self-described index funds easily manage at least 20% of total market capitalization, a figure that rises to as much as 40% if counting funds that hug indexes without describing themselves as index funds.[114]

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[111] See Cunningham, Quality Shareholders, supra note 8.

[112] Id.

[113] Families of benchmarks propagate multiple indexes, now numbering as many as 60. These include Dow Jones (at least 6: DJ Industrial Average, DJ US Select Dividend, DJ Wilshire 4500 and DJ Wilshire 5000); FTSE (4: FTSE High Dividend Yield, FTSE RAFI US 100 and Mid Small 1500); NASDAQ (2: NASDAQ 100 and the NASDAQ Composite); and Schwab (2, including the Schwab 1000 and Schwab Small Cap. Dozens more are offered by several behemoths delineating among small, mid and large cap plus their value and growth components: MSCI (15 different ones), S&P (14) and Russell (13).

[114] Recently, total market cap of the Russell 3000 was about $30 trillion. Of that, operators of the largest passive indexers commanded nearly half at around $14 trillion (though some run stock-picking funds too). Pension funds as a group held about 1/3 or $9 trillion, much prone to quasi-indexing, though some to dedication. Activist hedge funds own a sliver—around $100 billion or 1%—though they back that capital with powerful game-changing strategies for companies. Given the high level of aggregate share turnover—average holding periods barely near one year—many on the typical shareholder list don't stay a long time, making for a sizable portion of transients.

More specifically, five of the largest activist hedge funds command in aggregate perhaps $100 billion (Ichan, Third Point, ValueAct, Pershing, Trian) whereas the largest four financial institutions manage $14 trillion (BlackRock, State Street, Vanguard and Fidelity). Among pension funds, the five largest together run nearly $1 trillion (CalPERs, CALSTRs, STRS Ohio). The quality investing cohort represents the rest. Yet the power of even such relatively small stakes is immense. For perspective, the

Transient holders are numerous, reflected in high share turnover. In the past two decades, average holding periods for hedge funds have fallen to under one year and for mutual funds under two.[115] In recent years, overall average time horizons have remained unchanged, though this is likely due to the rise of indexers, which trade infrequently, offset by the rise in transients, which trade often.[116] Together, this transient cohort represents perhaps as much as 40% of total market capitalization as well.[117]

At the other extreme, activists in aggregate command relatively small stakes, not likely more than 5% of all, though they strategically leverage their power during campaigns. Quality shareholders make up the rest.[118] While small overall—perhaps 15% of all equity—this cohort can be mobilized for amplified influence, sometimes playing important roles in corporate power struggles.[119]

What leads a particular investor, or institution, to adopt one investment strategy or another is partly a function of personality and partly of expected returns.[120] For nearly two decades, debate has raged around whether stock indexing or stock picking is a superior strategy, often delineating further into types of broad indexes (by size, sector, or geography) with stock pickers competing against that benchmark.[121] Debate dates to a 1997 article by Mark Carhart, then a professor of finance at the University of Southern California, finding no evidence of successful mutual fund stock pickers.[122]

Ensuing research contributed to what became conventional wisdom, such as: average active funds underperform the market after fees;[123] top fund performance doesn't persist;[124] and, while some managers are skilled, few deliver on that value for customers after fees.[125] Yet debate

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largest listed companies now boast market caps around $1 trillion and many smaller ones around $4 to $10 billion.

[115] See supra note 36 (citing sources).

[116] See supra text accompanying note 37.

[117] See supra note 114.

[118] See supra note 114.

[119] See Cunningham, Quality Shareholders, supra note 8 (chapter 2) (giving examples of quality shareholders' roles in activist campaigns concerning Pernod Ricard, Ashland Global Holdings, and United Technologies).

[120] See Henrik Cronqvista, Stephan Siegelb, & Frank Yua, Value Versus Growth Investing: Why Do Different Investors Have Different Styles?, 117 J. Fin. Econ. 333 (2015).

[121] See Martijn Cremers, Jon Fulkerson & Timothy B. Riley, Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds, 75 Fin. Analysts J. 8 (2019).

[122] Mark Carhart, On Persistence in Mutual Fund Performance, 52 J. Fin. 57 (1997) (finding that the empirical evidence did "not support the existence of skilled or informed mutual fund portfolio managers"). Michael Jensen conducted an earlier kindred study. Michael Jensen, The Performance of Mutual Funds in the Period 1945-1964, 23 J. Fin. 389 (1968).

[123] William Sharpe, The Arithmetic of Active Management, 47 Fin. Analysts J. 7 (1991).

[124] Mark Carhart, On Persistence in Mutual Fund Performance, 52 J. Fin. 57 (1997).

[125] Eugene Fama & Kenneth French, Luck Versus Skill in the Cross-Section of Mutual Fund Performance, 65 J. Fin. 915 (2010).

continues—and Buffett won a famous bet siding with indexers over hedge funds—at least those charging particularly high fees.[126] Multiple editions of best-selling books continue to showcase dueling university professors: University of Pennsylvania finance professor Jeremy Siegel has repeatedly shown that buy-and-hold works,[127] while Princeton University finance professor Burton Malkiel continues to release new editions of the book that legitimized indexing as a strategy.[128]

Changes in shareholder demographics during the past two decades, including increased competition and lower fees, has produced a new strand of research challenging these conventional views. For instance, there is evidence that the average active fund does outperform an equivalent index;[129] some top-performance records do persist;[130] and a sizable cohort of managers with particular traits demonstrate skill that covers their fees.[131] Among those traits are conviction and patience, the defining traits of quality shareholders.

E. Advantages

Each shareholder segment adds unique value: activists promote management accountability; index funds enable millions to enjoy market returns at low cost; and traders offer liquidity.

With such advantages, however, come disadvantages: activists becoming overzealous; indexers lacking resources to understand specific company details; and traders inducing a short-term focus. Quality shareholders balance the base, and counteract these downsides.

As to curbing overzealous activism, quality shareholders can be white squires—a term dating to the 1980s referring to block shareholders tending to support management.[132] When a board perceives activist excess, it helps to have a few large long-term owners to consult. As a

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[126] In 2008, Buffett bet a hedge fund manager the S&P 500 would, over the ensuing ten years, outperform, after fees, any hedge fund portfolio the manager cared to assemble. See Buffett & Cunningham, The Essays, supra note 17, at 180-183. The manager assembled a fund of funds, a configuration charging multiple layers of high fees. During the first three years, the S&P lagged the fund, but by bet's end, the S&P won. If many took from the bet the lesson that indexers are always superior to non-indexed investing, that is a mistake. The primary point was to stress that ordinary individuals are almost certainly better off, given the risks and fees, of staking their savings in index funds rather than entrusting it to high-cost hedge funds.

[127] See Jeremy J. Siegel, Stocks for the Long Run (5th ed. 2014); see also Louis Engel & Henry R. Hecht, How to Buy Stocks (8th ed. 1994).

[128] See Burton G. Malkeil, A Random Walk Down Wall Street (12th ed. 2019).

[129] Jonathan Berk & Jules van Binsbergen, Measuring Skill in the Mutual Fund Industry, 118 J. Fin. l Econ. (2015); Jonathan B. Berk & Jules H. van Binsbergen, Mutual Funds in Equilibrium, 9 Ann. Rev. Fin. Econ. 147 (2017); Hyunglae Jeon, Jangkoo Kang & Changjun Lee, Precision About Manager Skill, Mutual Fund Flows, and Performance Persistence, 40 N. Am. J. Econ. Fin. 222 (2017).

[130] Nicolas Bollen & Jeffrey Busse, Short-term Persistence in Mutual Fund Performance, 18 Rev. Fin. Stud. 569 (2005); Robert Kowoski, Allan Timmermann, Russ Wermers & Hal White, Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis, 61 J. Fin. 2551 (2006).

[131] Yakov Amihud & Ruslan Goyenko, Mutual Fund's R2 as Predictor of Performance, 26 Rev. Fin. Stud. 667 (2013); Martijn Cremers & Antti Petajisto, How Active is Your Fund Manager? A New Measure that Predicts Performance, 22 Rev. Fin. Stud. 3329 (2009).

[132] See supra text accompanying note 119.

united front, the company's hand is strengthened, resisting excess while addressing legitimate concerns activist may have.[133]

Quality shareholders study company specifics which indexers, being stretched thin, cannot.[134] Indexers may be good at analyzing dynamic issues as they arise, but rarely develop deep knowledge that quality shareholders command. Indexers invest most of their limited resources to develop views about what is best generally in corporate governance, not what is best for particular companies.

Quality shareholders differ from both activists and indexers regarding director elections. While activists often nominate directors fellow board members resist, and indexers almost never nominate directors at all, quality shareholders offer a supply of outstanding directors for their investees, often themselves.[135]

Being long-term, quality shareholders offset the short-term preferences of transients. A high density of quality shareholders, with their characteristic patience, helps managers operate strategically, with a long-term outlook.[136] Such effects can percolate throughout a company. If less pressure comes from shareholders to produce short-term results, then directors, officers, employees, suppliers, strategic partners and others can operate in the same manner.[137]

Shareholder cohorts have different preferences about the price levels of stocks they own. Transients generally prefer the highest price possible for maximum profit on immediate sale; indexers favor the highest reasonable price because they assume, consistent with efficient market theory, that price and value are substantially the same; and quality shareholders, generally uninterested in an immediate sale and attune to stock market volatility, prefer a stock price that bears the most rational relationship possible to the company's intrinsic business value.[138] (At purchase, of course, quality shareholders seek prices below value.)[139]

Many managers tend to likewise prefer the highest possible stock price, perceiving it as a measure of their own performance, the higher the better.[140] But while they often complain that their company's stock price is too low, under- and over-pricing are equally likely and neither is

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[133] See James Woolery, Rob Leclerc & Richard Fields, The Ashland-Cruiser Proxy Contest—A Case Study, Harvard Governance Blog (Feb. 20, 2019).

[134] See infra Part III for an extended discussion of the related debate.

[135] See infra text accompanying notes 260-270; Cunningham, Quality Shareholders, supra note 8 (Chapter 3) (examples from AutoNation, Berkshire Hathaway, Constellation Software, Credit Acceptance Corporation, Enstar, Fairfax Financial, Teledyne, The Washington Post Company).

[136] See Brian L. Connelly, Laszlo Tihanyi, S. Trevis Certo & Michael A. Hitt, Marching to the Beat of Different Drummers: The Influence of Institutional Owners on Competitive Actions, 53 Acad. of Mgmt. Rev. (2010) (adapting Bushee's empirical method and classification finding positive association between high density of quality shareholders and strategic management decision making).

[137] Cunningham, Quality Shareholders, supra note 8 (chapter 3) (citing Leucadia Corporation and Markel Corporation).

[138] See Buffett & Cunningham, The Essays, supra note 17, at 38.

[139] Graham, Intelligent Investor, supra note 85.

[140] See Baruch Lev, Winning Investors Over: Surprising Truths About Honesty, Earnings Guidance, and Other Ways to Boost Your Stock Price 103-105 (2014).

desirable.[141]

A share price that is rationally related to business value can be a huge asset for several purposes, including making acquisitions, compensating employees, and facilitating fairly priced gains (or losses) when shareholders must sell.[142] While there is a lively debate over the degree of such market efficiency—of how well price approximates value—companies with the closest nexus enjoy clear advantages over those with the widest gaps. Evidence suggests that companies with ownership dominated by quality shareholders tend to enjoy stock prices that are less volatile and more rationally related to business value.[143]

With such advantages on offer, amid today's fragmented shareholder base, the quality shareholder cohort remains a valuable force in the investment community and stock markets.

II. Time Horizon

For decades, corporate law professors have debated shareholder time horizons. Critics focus on the short-termism of the shareholder activist. Defenders dispute the claim that short-termism is a problem at all, let alone one exemplified by activists.

Amid the academic debate, considerable policy changes occurred in the broader process of legal and business evolution. These policy dynamics were so diverse—expanding shareholder power in some areas while curtailing it in others—that both sides of the academic debate could cite accomplishments but would also have to acknowledge setbacks.[144]

At present, therefore, the academic debate is at something of a stalemate. This Part reviews the academic theory and debate, along with the major policy implications, illustrating important

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[141] Id.

[142] See Buffett & Cunningham, The Essays, supra note 17, at 38 (Berkshire's owner-related business principles, number 14).

[143] See Borochin & Yang, supra note 59. Other recent research affirms other advantages that long-term investors contribute to companies they invest in. Jarrad Hartford, Ambrus Kecksés & Sattar Mansi, Do Long-Term Investors Improve Corporate Decision Making? (2017) (SSRN abstract_id=2505261). Longstanding empirical research has generally found that inclusion in an index drives stock price up. See Prem C. Jain, The Effect on Stock Price of Inclusion in or Exclusion from the S&P 500, Financial Analysts Journal, 43:1, 58-65 (1987), DOI: 10.2469/faj.v43.n1.58. Early evidence showed the increase ranged from 3 to 9%. Antti Petajisto, The Index Premium and Its Hidden Cost for Index Funds, 18 Journal of Empirical Finance 271, 272 (2011); Andrei Shleifer, Do Demand Curves for Stocks Slope Down?, 41 Journal of Finance 579, 584 (1986); William B. Elliott et al., What Drives the S&P 500 Inclusion Effect? An Analytical Survey, Financial Management (2006), at 31, 32. This occurs as a result of supply and demand, as indexers buy the stock automatically. This drives price above value. Moreover, much of the evidence indicates that this price effect was not temporary. Although recent research suggests the effects have diminished over time and on more prominent indexes, Pyemo N. Afego, Effects of Changes in Stock Index Compositions: A Literature Survey, 52 International Financial Analysis 228, 239 (2017), permanent market distortions remain a factor. See Scott Hirst & Kobi Kastiel, Corporate Governance and Index Exclusion, 99 B.U. L. Rev. 1229 (2018).

[144] See infra text accompanying notes 170-172.

effects of adding quality shareholders on topics such as staggered boards and splitting versus combining the roles of board chairman and CEO.

A. Theory and Debate

In traditional economic theory concerning stock market prices and managerial behavior, short-termism cannot exist.[145] For one, competitive processes optimize any trade-off between short- and long-term values.[146] In addition, efficient stock markets rapidly impound into price all relevant long-run information.[147] At a minimum, current stock price is the best estimate of long-term corporate value.[148] Strategies that will deliver value tomorrow are manifest in stock price today.

A rival stance in economic theory contends that short-termism can arise from two sources: market myopia or managerial myopia. Market myopia occurs when investors fail to price shares correctly due to informational asymmetry between managers and investors. For example, managers may fear short-term market punishment for failure to meet quarterly earnings expectations, and therefore might forego costly research and development ("R&D") in order to maintain current share price.[149]

Managerial myopia occurs when managers take opportunistic advantage of information asymmetries favoring them. A manger's decision may yield rewards that are optimal for them—without regard to time horizon—though impair long-term shareholder value. Examples are permanent boosts to a manager's reputation or immediate bonuses from executing projects with inferior long-term corporate payoffs.[150]

The law and economics literature on short-termism adds another source: impatience. Some shareholders have immediate liquidity needs prompting them to sell.[151] The effect is to rivet on prevailing price rather than longer-term value. Again, under efficient market theory, this cannot

[145] See, e.g., Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 68 Bus. Law. 977, 1004 (2013)

[146] See Michael C. Jensen, The Takeover Controversy: Analysis and Evidence, 4 Midland Corp. Fin. J., Summer 1986, at 6.

[147] See Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851 (1992).

[148] See Lucian A. Bebchuk, The Myth that Insulating Boards Serves Long-Term Value, 113 Colum. L. Rev. 1637, 1661-62 (2013)

[149] See e.g., Michael J. Brennan, Latent Assets, 45 J. Fin. 709 (1990); Kenneth A. Froot et al., Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation, 47 J. Fin. 1461 (1992); Stewart C. Myers & Nicholas S. Majluf, Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have, 13 J. Fin. Econ. 187 (1984).

[150] See, e.g., Bengt Holmstrom & Joan Ricart I Costa, Managerial Incentives and Capital Management, 101 Q. J. Econ. 835 (1986); Tim S. Campbell & Anthony M. Marino, Myopic Investment Decisions and Competitive Labor Markets, 35 Int'l Econ. Rev. 855 (1994).

[151] See John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum, L. Rev. 1277 (1991).

occur, but under this rival theory such behavior can pressure managers to pursue short-term profits at the expense of long-term investment.[152]

Since such liquidity effects arise only for impatient investors, legal scholars wondered whether there are too many of them and what, if anything, corporate law might do about that. Critics targeted shareholder activists, especially hedge funds specializing in that approach. Opponents, while acknowledging some costs, stressed the gains in accountability and long-run prosperity.[153] Shareholders are the best incentivized participants to assure managerial accountability, after all.[154] Many are even better informed than corporate boards and therefore likely to be effective in overseeing wayward managers.[155] They develop expertise in governance and strategy to provide superior solutions.

In the ensuing corporate law scholarship debate, contestants dispute the extent of the empirical evidence on short-termism. Prominent among the empirical researchers is the work of Professor Bushee—although not so much embracing his entire classification scheme as focusing on his related research on the effects of a high density of transients in a shareholder base.[156]

In an often-cited work,[157] Bushee found that "transient ownership creates incentives for managers to sacrifice long-term investment to avoid a decline in current earnings."[158] He profiled all companies positioned to reverse a year-on-year earnings decline by reducing R&D spending. Companies with a high density of transients were significantly more likely to do so than those with lower transient populations.

Professors Coffee and Palia attest to the significance of Professor Bushese's work and the long line of research that has followed and affirmed it. In their 2016 article on activism, for example, they introduce the line of scholarship to "strongly suggest" that shareholder base influences corporate time horizons.[159] The authors note that Bushee's research dates to 1998, and

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[152] See Choi & Pritchard, supra note 74; Lawrence A. Cunningham, Behavioral Finance and Investor Governance, 59 Wash. & Lee L. Rev. 767 (2002).

[153] Lucian A. Bebchuk et al., The Long-Term Effects of Hedge Fund Activism, 114 Colum. L. Rev. 1085, 1089 (2015); Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439 (2001).

[154] See Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395 (1983). Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 73 (1991).

[155] Gilson & Gordon, supra note 79, at 897.

[156] See Brian Bushee, Do Institutional Investors Prefer Near-Term Earnings Over Long Run Value?, 18 Contemp. Acct. Res. 207, 213 (2001) [hereinafter Bushee, Near-Term]; Brian J. Bushee & Christopher F. Noe, Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility, 38 J. Acct. Res. 171 (2000).

[157] Bushee, Myopic R&D, supra note 11, at 330 (this article is cited some 4,000 times according to Google Scholar) (last visited January 15, 2020): see also Zohar Goshen & Assaf Hamdani, Corporate Control and Idiosyncratic Vision, 125 Yale L.J. 560, 581 (2016) (citing Brian J. Bushee, The Influence of Institutional Investors on Myopic Investment Behavior, 73 Acct. Rev. 305 (1998)); David Millon, Shareholder Social Responsibility, 36 Seattle U. L. Rev. 911, 913-914 (2013).

[158] Bushee, Myopic R&D, supra note 11.

[159] John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 Iowa J. Corp. L. 545, 573-574 (2016).

highlight two major articles, finding that companies with high transient density are (1) more prone to earnings management such as R&D spending cuts and (2) more likely to be valued based on near-term earnings rather than long-term earnings.[160] They reference further studies affirming the findings and adding that high transient density weakens shareholder oversight of managers and adds pressure for near-term earnings over long-term value.[161]

Other participants in the horizon debate start by citing Bushee's work as evidence of short-termisn, before moving on to argue broader normative implications. For instance, Professor Dallas challenges the shareholder value maximization norm because, per Bushee, short-term shareholders pressure managers for short term results with related evidence of earnings management.[162] For another, Professor Millon, who elaborates on Bushee's shareholder classification scheme more fully, finds compelling evidence of short-termism to demand that corporations take greater social responsibility.[163]

On the other side of the debate, many corporate law scholars find evidence of short-termism too limited to warrant substantial legal or policy changes. Professor Fried, for one, says "only a few" studies have found significant short-termism.[164] Professors Bebchuk, Dent, and Roe all separately arrived at similar conclusions.[165] Despite that point, Fried says there's no question that short-term shareholder interests "are not perfectly aligned with [profit] maximization."[166]

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[160] Id. at notes 110 & 111 (citing, respectively, Bushee, Myopic R&D, supra note 11, at 330; Bushee, Near-Term, supra note 156).

[161] Coffee & Palia, supra note 159, at notes 111-113 (citing numerous articles, including Kevin J. Laverty, Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research, 21 Acad. of Mgmt. Rev. 825 (1996); Yia Chen et al., Monitoring: Which Institutions Matter?, 86 J. Fin. Econ. 279 (2007); Jose-Miguel Gaspar et al., Shareholder Investment Horizons and the Market for Corporate Control, 76 J. Fin. Econ. 135 (2005); Francois Derrien et al., Investor Horizons and Corporate Policies, 48 J. Fin. And Quantitative Analysis 1755 (2013); Katherine Guthrie & Jan Sokolowsky, Large Shareholders and the Pressure to Manage Earnings, 16 J. Corp. Fin. 302 (2010)).

[162] Lynne Dallas, Is There Hope for Change? The Evolution of Conceptions of "Good" Corporate Governance, 54 San Diego L. Rev. 491, 538 (2017) (citing Bushee, Myopic R&D, supra note 11, at 330); Bratton & Wachter, supra note 2.

[163] David Millon, Shareholder Social Responsibility, 36 Seattle U. L. Rev. 911, 914 (2013) ("there is broad agreement that short-termism is widespread in the current investment landscape").

[164] Jesse M. Fried, The Uneasy Case for Favoring Long-Term Shareholders, 124 Yale L.J. 1554, 1582 (2015) (citing Bushee. Myopic R&D, supra note 11 and Natasha Burns et al., Institutional Ownership and Monitoring: Evidence from Financial Misreporting, 16 J. Corp. Fin. 443, 444 (2010) (finding association between transient density and probability and severity of restated financial reports)).

[165] Bebchuk, The Myth, supra note 148, at 1643-44 (little evidence that short term holder influence undermines long-term value creation); George W. Dent, Jr., The Essential Unity of Shareholders and the Myth of Investor Short-Termism, 35 Del. J. Corp. L. 97, 149-50 (2010) (very little evidence of short-termism); Roe, supra note 145, at 1004 (insufficient evidence to warrant changes in corporate law).

[166] Fried, supra note 164, at 1584.

If the empirical evidence is mixed,[167] so are the realities: even if some activists have short-term bias, they need support of a large bloc of other shareholders to influence corporate policy.[168] Importantly, that group would be comprised of a diverse group of shareholders, including transients, indexers and quality shareholders. Yet the literature in this debate tends to group all such others under the broad umbrella of "institutional investors."[169]

Amid such disagreement on the facts as to short-termism, corporate law scholars have joined debate over the legal stakes. All participants agree that these are vast. At the most general level, they pose the hoary corporate law question of allocation of power between directors and officers on the one hand and shareholders on the other.[170] Those who see short-termism as a serious problem look to weaken shareholder power and strengthen managerial power; opponents, viewing short-termism as at best an annoyance, worry about insulating managers from accountability.[171]

In play are all aspects of corporate governance, from proxy access and poison pills to voting rules. During the course of the horizon debate, proponents of shareholder empowerment won many victories, but so too did their opponents.[172] Still up in the air are a variety of debated governance devices, such as staggered boards, chairman/CEO roles, and shareholder voting—all of which are considered later in this Article. These unresolved debates reflect how, to a significant degree, the horizon debate has reached a stalemate, as the next Section shows. Adding quality shareholders to the discussion could help unlock them, as the ensuing Section illustrates.

B. Status and Direction

For a snapshot of the current state of the horizon debate, consider the content of a major 2018 symposium on the subject, which Professor Tucker hosted.[173] It featured a dozen rich and original pieces, all making fascinating contributions, and sustaining attention on the relative virtues and differences in time horizon. Indeed, a few delineated time horizon more finely or sought to rephrase the horizon issue as whether a given time horizon accords with related risk assumed.[174]

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[167] See also Tucker, The Long and the Short, supra note 36; Cremers & Sepe, Institutional Investors, supra note 37; supra text accompanying notes 36-37.

[168] See Luca Enriques, Ronald J. Gilson & Alessio M. Pacces, The Case for An Unbiased Takeover Law, 4 Harv. Bus. L. Rev. 85, at n. 36 (2014).

[169] E.g., Enriques et al. supra note 168.

[170] See Marcel Kahan & Edward B. Rock, Embattled CEOs, 88 Tex. L. Rev. 987 (2010).

[171] See sources cited supra note 2.

[172] See Cremers & Sepe, Institutional Investors, supra note 37, at n. 42 (delineating a variety of pro-shareholder victories arising from this debate, including: shareholder activism, emergence of proxy advisory firms, majority voting and withhold campaigns, growing use and success of shareholder proposals, amendments to proxy filing requirements facilitating use of shareholder proposals, amendments to the Delaware corporate law statute favoring proxy access, say-on-pay shareholder votes and expansion of the scope of shareholder proposals to effect changes in corporate election procedures).

[173] See Anne M. Tucker, 20/20 Vision in the Long & Short-Termism Debate, 41 Seattle U. L. Rev. 337 (2018).

[174] E.g., Jim Hawley & Jon Lukomnik, The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons, 41 Seattle U. L. Rev. 449, 449 (2018); Frank Partnoy, Specificity and Time Horizons, 41 Seattle U. L. Rev. 525 (2018); Andrew Verstein, Wrong-

Some prescribed sweeping systemic steps to counteract short-termism for social benefit through such innovations as federal savings accounts or universal equity funds[175] or at the very least designing executive pay to reward long-term performance.[176]

In a more skeptical contribution to the symposium, Professor de Fontenay detected a tendency of debaters to imagine an ideal shareholder to measure others against.[177] In the literature, the ideal is vaguely reported as a "long-term" and "active monitor" but without much detail, de Fontenay says, and for good reason, she adds: there is no such ideal. Rather, given both the diversity of shareholders and the dynamic rate of change in capital markets, lawyerly interventions to promote or retard particular shareholder types are doomed, she argues.

de Fontenay may be right, and the evidence in the horizon debate is mixed enough to warrant caution. But the literature's nearly-exclusive emphasis on horizon obscures the element of relative concentration, whose inclusion might alter the case about whether there is such an ideal. At minimum, further delineation of shareholder types based on conviction would help move the debate forward.

Two empirical pieces in the symposium make such headway towards a more complete picture. In one, Professors Sampson and Shi drew upon Bushee's classification, finding evidence that transients have a greater presence and quality shareholders (dedicated) a lesser presence over the period from 1980-2013.[178] These observations take into account both time and conviction. While valuably delineating shareholder types, these scholars examined the implications for national economic performance rather than for corporate governance.

In their contribution to the symposium, Professor Cremers and Sepe explicitly add relative shareholder concentration to relative time horizons. They explain that accounts in the legal literature tend to present investors in "dichotomic" terms, as always short-term or always long-term, while the truth is more complex, requiring "a more exact taxonomy of institutional investor behavior along the two crucial dimensions of institutional investors' investment horizons and activism."[179] They conclude by mediating the horizon "debate's "polarized rendering" in favor of capturing "nuances that depend on a variety of factors" that the "law and economics literature has paid relatively little attention to."[180]

Termism, Right-Termism, and the Liability Structure of Investor Time Horizons, 41 Seattle U. L. Rev. 579 (2018).

[175] William A. Birdthistle, Federalism of Personal Finance: State & Federal Retirement Plans, 41 Seattle U. L. Rev. 367 (2018); Lynn Stout & Sergio Gramitto, Corporate Governance as Privately-Ordered Public Policy: A Proposal, 41 Seattle U. L. Rev. 551 (2018).

[176] Caroline Flammer, Long-Term Executive Compensation as a Remedy for Corporate Short-Termism, 41 Seattle U. L. Rev. 419, 420 (2018).

[177] de Fontenay, The Myth of the Ideal Investor, supra note 12.

[178] Rachelle Sampson & Yuan Shi, Are Investor Time Horizons Shortening?, 41 Seattle U. L. Rev. 543 (2018).

[179] Cremers & Sepe, Institutional Investors, supra note 37, at 388.

[180] Id. at 398-399.

This is a promising advance, although subtle and limited. It is so subtle, for instance, that the innovation was not among those highlighted in the editor's overview of the symposium.[181] It is limited in that the study uses conviction ("active share") as a proxy for activism.[182] Active share is usually about investment concentration, however, not inclination or style of engagement.[183] It can be a partial proxy for activism, but concentration is a defining trait of quality (dedicated) shareholders. A next step in the research would tease out, within the data, those shareholders with high concentrations as well as long holding periods. That would be the quality shareholder cohort.[184] A few of the many implications of doing so are reviewed next.[185]

C. Policy Implications

Adding discussion of quality shareholders to the horizon debate would enable distinguishing not merely short- versus long-term but long-term with or without concentration. To illustrate how the addition would illuminate specific corporate law debates, consider two controversial governance features: staggered boards and splitting versus combining the roles of board chairman and CEO.

First, a longstanding sub-debate in corporate law considers the superiority of unitary versus staggered boards. With unitary boards, all seats are filled in annual elections; with staggered boards, each director serves a term of two or three years.[186] Proponents of staggered boards stress advantages such as continuity and institutional knowledge while critics cite insulation from accountability.

Corporate law scholars, as well as major indexers, challenge staggered boards as excessively pro-management. Professor Bebchuk has been an outspoken opponent of staggered boards.[187] Students at his law school mounted national campaigns to de-stagger boardrooms across

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181 Tucker, 20/20 Vision, supra note 173, at 337.

182 Id. at 405.

183 See supra text accompanying notes 56-60.

184 I confirmed my interpretation via email with Professor Sepe (January 20, 2020).

185 Boston University Law Review published a symposium in 2019 with 22 articles—spanning some 600 pages—under the heading "Institutional Investor Activism." Important and broad ranging, several pieces focused on aspects of the horizon debate as well as the conviction debate. None, however, discussed combining the two behaviors.

On horizon debate: Marcel Kahan & Edward Rock, Anti-Activist Poison Pills, 99 B.U. L. Rev. 915 (2019); Assaf Hamdani & Sharon Hannes, The Future of Shareholder Activism, 99 B.U. L. Rev. 971 (2019).

On conviction debate: Lucian Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. 721 (2019); Scott Hirst & Kobi Kastiel, Corporate Governance by Index Exclusion, 99 B.U. L. Rev. 1229 (2019).

On voting: David H. Webber, Reforming Pensions While Retaining Shareholder Voice, 99 B.U. L. Rev. 1001 (2019); Sean J. Griffith & Dorothy S. Lund, Conflicted Mutual Fund Voting in Corporate Law, 99 B.U. L. Rev. 1151 (2019).

186 E.g., Del. Code Ann. tit. 8, § 141(d) (2020).

187 E.g., Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. Fin. Econ. 409 (2005).

corporate America.[188] He and his colleagues marshalled impressive research data to contend that staggered board reduced firm value.

In the other corner of this contentious debate stood Professor Cremers and his colleagues, who mounted equally intense counterarguments and opposing data sets, showing that staggered boards increased firm value. This camp of scholars, which included some judges and prominent lawyers,[189] argued for staggered boards as either a default rule or as a requirement.[190]

Recent scholarship challenges the reliability of both empirical sides of the argument, contending instead that neither is right: whether a staggered board is good or bad depends on the company.[191] The attempt to settle this debate is another way of recasting the horizon debate in more holistic terms. In some of the empirical work, and in much of the rhetoric—described as "polemical"[192]—the board structure sub-debate was a microcosm of the horizon debate: proponents of staggered boards urged long-term value against short-term interests while opponents of staggered boards denied that they had a short-term focus.

In attempting to settle the debate, the scholars pointed to research myopia in the data. It riveted too narrowly on horizon issues to the exclusion of many other factors that bear on firm value. And firm value, recall, is something beheld differently by the wide variety of shareholder types.[193]

Moreover, Cremers and Sepe disagree that the debate is settled.[194] But they are also moving helpfully forward to focus on shareholder time horizon as well as conviction. For example, in their recent symposium article, they found a higher density of quality shareholders reduces, though only slightly, the value of staggered boards.[195] They say this might reflect that activists apply short-term pressure.

But another explanation is that quality shareholders do not take a blanket approach to staggered boards. The evidence suggests that quality shareholders may slightly favor companies

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188 See https://hls.harvard.edu/academics/curriculum/catalog/index.html?o=64841.

189 William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide, 69 U. Chi. L. Rev. 1067, 1097 (2002) (judges proposing three year terms); Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 225-30 (1991) (prominent corporate lawyers proposing five year terms).

190 See K.J. Martijn Cremers & Simone M. Sepe, The Shareholder Value of Empowered Boards, 68 Stan. L. Rev. 67, 77 (2016) (proposing that staggered boards be made the default rule).

191 Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, Settling the Staggered Board Debate, 166 U. Pa. L. Rev. 1475 (2018).

192 Id.

193 See supra text accompanying notes 139-141 (quality shareholders focus on business value, seeking to purchase at a discount and otherwise seek rational pricing; indexers assume market efficiency; and transients prefer the highest price possible).

194 K.J. Martijn Cremers, Simone M. Sepe, & Saura Masconale, Is the Staggered Board Debate Really Settled?, 167 U. Pa. L. Rev. Online 9 (2019).

195 Cremers & Sepe, Institutional Investors, supra note 37, at 417.

with unitary boards, those with staggered boards nevertheless attract sizable quality shareholder cohorts.[196] Companies certainly continue to be divided on the right approach.[197]

The scholarly attempt to "settle" the board structure sub-debate is consistent with the views of quality shareholders on such matters: context matters, and different companies need different governance features. While on its face such an assertion seems obvious to make and easy to defend, many scholars and most indexers—but not quality shareholders—have assumed that staggered boards are always good or bad. Adding quality shareholders to the debate challenges that assumption.

Second, consider ongoing debate over whether to split or combine the roles of chairman of the board and CEO. Traditionally, the CEO held the board chairman role as well. But in recent years, critics have challenged such a practice. Their theory is that boards elect and oversee the CEO so having one person wear both hats creates a conflict. Yet that is only one vote on boards with many independent directors, so any conflict can easily be neutralized.

Many corporations thrive when led by an outstanding person serving as both chairman and chief executive just as others have failed when the roles are split.[198] Companies are about evenly divided on the practice: about half the S&P 500 split the functions while the other half combine them.[199] For their part, quality shareholders appear to think about this case-by-case and, if anything, slightly favor companies that combine rather than split the functions.[200]

Finally, consider a case study that illuminates the importance of both horizon and conviction. Professors Jennifer Riel and Roger Martin of the University of Toronto profiled the example of Unilever. In 2009, hoary old Unilever's share turnover mapped that of other multinationals, plagued by a large portion of shareholders with holding periods of less than one year.[201] To CEO Paul Polman, the high level of transients translated into urgent demands for maximizing quarterly profits and daily share prices.

Such a capital markets outlook adversely affected operations, strategy, and reporting. Unilever published quarterly earnings guidance, forming expectations among market watchers. Then, to meet these expectations, division managers cut spending on R&D, information technology, and capital projects.

Polman recognized this flawed strategy. He adopted new policies and clearly communicated these to shareholders and the market. Unilever would cease quarterly guidance and reporting. It would no longer seek to deliver maximum profits each quarter or year but would seek consistent and sustained profits across multiple years. At first, the stock price dropped.

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[196] See Cunningham, Quality Shareholders, supra note 8 (within the S&P 500, 61 have staggered boards, of which 14% are in the top 10% of quality shareholder density versus those with unitary boards where 37% are in the top 10%).

[197] See Bebchuk & Hirst, supra note 2 (indicating that about half the Russell 3000 companies have staggered boards).

[198] To give a dramatic case, the chairman and CEO roles were split at Enron Corporation.

[199] See Cunningham, Quality Shareholders, supra note 8 (within the S&P 500, 229 split and 245 combine).

[200] Id. (of those splitting, 16% are in the top 10% in terms of quality shareholder density and of those combining, 28% are in the top 10%).

[201] See Jennifer Riel & Roger Martin, How Unilever Won Over Shareholders with Its Long-Term Approach, The Globe & Mail (October 13, 2017).

But within two years, it recovered and continued to rise over the next eight years, in tandem with sustained profits. In the process, transient shareholders were chased away, replaced by a concentration of long-term holders. As of late 2017, not long before Polman retired, Unilever's largest 50 owners boasted an average holding period of seven years.

Many of these were quality shareholders, but a substantial cohort of indexers were among them.[202] In other words, Polman's campaign was only half successful.

In 2018, after Unilever announced plans to move to an Amsterdam-only listing, rather than maintain its longstanding dual listing in London, indexers howled. They wanted Unilever to retain its London listing so that it would remain in their favored index. Unilever succumbed to their pressure.

While doing so was consistent with seeking long-term shareholders, the move compromised the other goal of attracting concentrated shareholders, those with conviction. Putting horizon and conviction together is important in practice as well as in theory.

III. Portfolio Conviction

Corporate law professors have begun to wade into their version of the hottest debate in finance: passive versus active investing. As referenced at the end of Part I, the debate in finance concerns the relative performance of these two broad approaches to investing.[203] In corporate law, the debate concerns the relative incentives and capacities of shareholders in these two broad categories to cast informed votes on corporate matters. All participants in both debates face a huge challenge: the two categories are not self-defining and the available tools to distinguish between the categories are limited.

Passive usually refers to an investing strategy that buys all stocks in an index, without requiring active decision making concerning which stocks to buy or sell, whereas active denotes everything else. "Everything else" is a huge diverse category, however, encompassing countless alternative investment strategies and styles—value, growth, momentum, chartist, quantitative. Finance researchers deal with this problem by exploring, within "everything else," any strategies or styles that an investor could use systematically to outperform the market indexes. While that delineation helps researchers to canvass more comprehensively, it may often exclude distinctive strategies of quality shareholders who do not compare performance with annual benchmarks.[204]

In the nascent legal literature, moreover, the focus to date has been on the indexers, especially the largest ones, and their incentives and capacities, rather than on exploring the various alternative types and their incentives and capacities. For instance, a wave of current scholarship focuses intensively on the incentives and capabilities of the three largest indexers, contrasting those few firms with everything else dubbed "active."[205]

While useful to gain insight into the major indexers, such a focus obscures the contributions of rivals and muddies the meaning of any related policy implications. In particular, there is a big difference between an "active" fund that is long- or short-term as between an active fund that is

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[202] Among quality shareholders, Unilever has attracted AKO Capital, Gardner Russo Gardner, and Hotchkiss & Wiley. See Cunningham, Quality Shareholders, supra note 8.

[203] See supra text accompanying notes 121-131.

[204] See supra text accompanying notes 105-108.

[205] See sources cited supra note 3.

heavily concentrated (1 to 20 stocks), moderately concentrated (20 to 50) or somewhat diversified (up to 100). While delineating every cohort for purposes of legal analysis may be more daunting than hunting for market-beating results in finance, it is relatively easy and highly illuminating to add the quality shareholder. This Part explores how to do so by incorporating perspectives on the quality shareholder into the principal terms of evolving debate in corporate law scholarship about index funds.

A. Theory and Debate

The business model of the large index funds is to develop a broad portfolio of securities, minimize costs, and match the index. Compensation is based on size of the fund rather than performance of the fund, the traditional approach in the investment management industry. Accordingly, indexers strive to increase assets under management (AUM). Beyond that description, corporate law scholars begin to disagree.

The disagreement starts with theory. Recall references to the course of corporate life during the 20th century.[206] The challenge of corporate life was bridging the separation of ownership from control and the job of corporate law was to mitigate the agency costs that arise when strong managers control companies with weak owners. The rise of institutional investors heralded a new era where such agency costs would be vastly reduced. But experience has disappointed such hopes, as institutional investors, holding funds for others, bring agency costs of their own.

Today's scholarly disagreement concerns the magnitude of those costs and what corporate law might do about it. Two main rival theories contend in portraying the index fund sector. One account is the value maximization view. In this account, agency costs are real but modest, as funds have requisite incentives to act on behalf of their investors to monitor investments to assure the best outcomes for their investors. The rival view see as agency costs as large and forbidding, where fund managers face offsetting personal incentives and lack economic incentives to invest in stewardship to improve the performance of particular companies.

Both theories have a certain appeal. Both sides can point to evidence to support their theories. All positions could be improved, however, by adding the perspective of quality shareholders. The following reviews some leading theoretical positions on incentives of the largest indexers, and related evidence, with notes adding the perspective of the quality shareholder.

1. Incentives

In a recent book-length article, Professors Bebchuk and Hirst make the case for an agency cost theory of indexing among the largest such funds.[207] To start, they identify several benefits index fund managers may obtain from solicitude toward investee managers compared to what their investors would prefer. These include: business relationships, avoiding triggering regulatory duties that can arise from taking an adversarial stance such as securities disclosures, and minimizing the risk of regulatory backlash by overplaying their hand against corporate America.

In another long article, Professors Fisch, Hamdani and Solomon-Davidoff, counter that such incentives may be neutralized by fiduciary standards and moral norms.[208] For their part,

[206] See supra text accompanying notes 27-34.

[207] See Bebchuk & Hirst, Index Funds, supra note 3 (120,000 words).

[208] Fisch, Titans, supra note 3 (60,000 words).

Professors Kahan and Rock add a reputational argument.[209] They cite the public relations campaigns mounted by leading industry figures, such as the letters directed to chief executives by BlackRock CEO Laurence Fink.

Norms and reputational concerns may constrain behavior, but probably imperfectly and no more than among other shareholder types. For instance, while the largest index funds and their CEOs may have name recognition, that is not true of those who manage funds. In contrast, quality shareholders often put their names on the door, write books, issue newsletters, speak at conferences.[210] They become well-known, showing substantial investment in reputation. Quality shareholders form exclusive membership fraternities and even offer an examination-based certification that is regarded as the toughest in the industry.[211]

On the other side of this debate, presenting the value maximization theory of the largest indexers, stand Professors Kahan and Rock.[212] In an intricate draft article, they offer an account of the direct incentives index fund families have to increase the market capitalization of investees: doing so increases AUM. To Kahan and Rock, incentives are measured by the increased fees that follow from increases in AUM. They conclude: "the most important factor by far in determining how much a fund adviser stands to gain from being informed is the size of the holdings."[213] On that basis, they say the largest indexers—those with trillions in AUM—have the greatest incentives.

Bebchuck and Hirst respond to Kahan and Rock's AUM thesis by focusing on individual index fund managers.[214] Their compensation is based on a tiny percentage of a fund's AUM, so increasing the value of a particular investee yields little gain for them.

Two more fundamental problems face the AUM thesis from a quality shareholder perspective. First, quality shareholders do not measure themselves by the growth in size of their investees but by their return on shareholders' equity over long periods of time.[215] Those may often increase by virtue of a company shrinking in size, as through dividends, buybacks or spinoffs, not growing market capitalization.[216] Growth in AUM due to growth in investee market capitalization

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[209] Marcel Kahan & Edward Rock, Index Funds and Corporate Governance: Let Shareholders Be Shareholders (working paper 2020) [hereinafter Kahan & Rock, Let Shareholders Be].

[210] Individual examples: Chuck Akre at Akre Capital Management; Shelby and Chris Davis at Davis Selected Advisers; Ingrid Hendershot at Hendershot Investments; Tom Russo at Gardner Russo Gardner; Sir John Templeton at Templeton Funds; and Thomas Rowe Price at T. Rowe Price & Co. See Cunningham, Quality Shareholders, supra note 8, Appendix.

[211] See Julia LaRoche, 11 Horror Stories About The Killer Exam That Wall Streeters Will Be Taking This Saturday, Business Insider (May 30, 2013) (CFA exam); Daren Fonda, Even Wall Street Pros Have a Tough Time Getting Into This Club, Barons (Aug. 24, 2018) (Value Investors' Club).

[212] Kahan & Rock, Let Shareholders Be, supra note 209.

[213] Id.

[214] Bebchuk & Hirst, Index Funds, supra note 3.

[215] See supra text accompanying notes 105-108.

[216] See Cunningham, Quality Shareholders, supra note 8. For instance, The Washington Post Co. in 2015 spun off its Cable One subsidiary, renaming the remaining company Graham Holdings. Cable One began trading at around $400 per share and today is worth $1,500. Indexers focused on Graham as a factor in AUM might have balked at this extraordinarily valuable transaction. But capital allocation is a vital topic dear to quality shareholders so often myopically ignored in this way by indexers and their supporters alike. See William Thorndike, The Outsiders (2012). Companies may grow merely by retaining and deploying

does not capture this source of incentives. The absence of such a baseline prevents a comparative assessment of the incentives of the major indexers.

Second, Kahan and Rock's AUM model lacks attention to the important variables included in the research of Bushee and others.[217] These are the variables that delineate the quality shareholder cohort and define its incentives. In Bushee's model, for example, they are average percentage ownership of investees, the percentage of investees representing at least a 5% share of the portfolio, and the average size of each investment.[218] The incentives that arise from having such high stakes in a company likely dwarf those of large indexers with relatively small stakes in thousands of companies. Again, in any event, the AUM incentives model fails to offer a way to compare the incentives of quality shareholders.

Professor Fisch and her co-authors offer a different account of indexes incentives to support their theory of indexer value maximization.[219] They think that indexers compete with other indexers as well as with "active" funds.[220] They say this competition gives indexers incentives to improve investee corporate governance because such improvements remove the advantages of stock picking. In other words, indexers try to outperform "active" rivals.

Bebchuk and Hirst doubt this creates indexer incentives to invest in stewardship.[221] They explain that people migrate from "active" to passive investing because of the observed difficulty of funds beating market averages. Under this motivation, indexers compete for customers not with active funds but with fellow indexers. True, "active" funds still manage substantial assets, because some do beat their index benchmark, Bebchuk and Hirst theorize. That will remain so even if indexer stewardship increases investee value. In fact, active investors with concentrated ownership in given companies benefit more from indexer efforts targeted to improve such companies, hardly creating indexer incentives to intervene.

Both Fisch's thesis and the Bebchuk-Hirst response suffer from the same problems as Kahan and Rock's AUM thesis: quality shareholders do not measure their performance against annual index performance. Their incentives are entirely different, so such a theory of indexer incentives is inapposite.

Kahan and Rock add another perspective on the incentives debate, one that inadvertently touches on quality shareholders. While agreeing with Bebchuk and Hirst that indexers lack incentives to compete with "active" funds for new business ("inflows"), they say concentrated fund managers may have such incentives. Drawing on the finance literature,[222] they estimate that

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earnings in suboptimal projects, which may help a fund grow its AUM but not drive higher corporate returns to shareholders.

[217] See supra text accompanying notes 54-57.

[218] See supra text accompanying note 56.

[219] Fisch, Titans, supra note 3.

[220] Thorough the corporate law literature on the conviction debate, writers routinely juxtapose passive indexers with "active" investors, without distinguishing among activists, transients, quality or other distinctive categories. When examples appear in this discussion, the word active is placed in quotation marks.

[221] Despite their equally sympathetic view of large indexers, Kahan and Rock also reject Fisch's indirect incentives theory. Kahan & Rock, Let Shareholders Be, supra note 209.

[222] Id. (citing Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentives to be Engaged at 12 (working paper 2018)).

competitive funds may increase AUM via inflows by 1.3% for every point by which they beat a benchmark index. At certain investment concentration levels, incentives to boost inflows are stronger than those to increase AUM through investee growth alone, they say.

They instance a fund concentrating 3.5% of its portfolio in a single stock. That is the average level among smaller funds, with AUM around $1.2 billion. For that cohort, inflow-based incentives are 20% larger. On the other hand, they contrast a fund concentrating merely .5% in a single stock—the average level for larger funds, with AUM around $736 billion. The difference disappears. Overall, Kahan and Rock conclude, the inflow-based incentives of this cohort are slight—low for the smaller firms and scant for the larger ones.[223]

But if you change the flawed assumption of AUM growth as an incentive for quality shareholders and make some adjustments that *are* relevant to them, this approach offers some promise. For example, consider medium-size quality shareholders—say with $25-50 billion in AUM—and concentrated holdings in some companies of 5% to 10%. Even within the AUM-based model, that could spell substantial inflow-based incentives. If also taking account of the actual incentives of quality shareholders—long-term returns on investment and strong reputations among constituents—their incentives could swamp those of the large indexers.[224]

Being explicit about the quality shareholder cohort, and its particular incentives that indexers lack, would improve the theoretical debate over the relative incentives of indexers and others to operate as informed shareholders. After all, many skeptics continue to doubt the rationality of an indexer incurring costs of x to increase investee value knowing they would share most of any gain with rivals, and net a tiny fraction of x.[225] Kahan and Rock counter that the largest three indexers have stronger incentives than "*most*" other institutional and all but the largest individuals.[226] Quality shareholders are certainly within the referenced population boasting stronger incentives.

2. Capacity

Debate over indexer incentives leads directly to questions about their capacity for informed shareholder conduct. While this aspect of the debate can be measured to some degree, scholars view the same facts differently.

Participants agree that large indexers cast votes at more than 4,000 annual meetings adding up to more than 30,000 proposals. Champions such as Kahan and Rock stress that most do not matter and only a few dozen annually are important.[227] They then ask if indexers have the demonstrated capacity to handle those and the question answers itself.[228]

Fisch and her co-authors stress that the large volume of meetings and proposals endows large indexers with substantial economies of scope—each vote produces knowledge useful in

[223] Kahan & Rock, Let Shareholders Be, supra note 209.

[224] See supra text accompanying notes 105-108.

[225] Kahan & Rock, Let Shareholders Be, supra note 209, n. 44.

[226] Id. (emphasis added).

[227] Id.

[228] Id., Part II.E (calling these Type C votes).

other votes.[229] Critics counter that across so many votes, little study can possibly be made, so little knowledge can possibly accrue.[230]

Fisch embraces the widely-publicized commitment these funds made to increase their stewardship staffs.[231] But Bebchuk and Hirst find the results underwhelming.[232] They compare staff size—after the vaunted increases—in relation to the number and size of companies to be followed. Among the largest indexers: BlackRock doubled its stewardship staff to 45; Vanguard has 21 people; and State Street 12. Yet these indexers have holdings in more than 11,000 companies each worldwide, and at least 3,000 in the U.S. alone.

In dollar terms, total stewardship investment by these big indexers is a miniscule fraction of their budgets: about $13.5 million, $6.3 million, and $3.6 million, respectively, all less than one-fifth of 1%– only 0.2%—of total fees and expenses. Even if the staff focused only on the largest companies—say where their stakes exceed $1 billion, that still adds to hundreds of companies. They could only devote two to four person-days per year studying that small portion of their total portfolio.

The following table starkly presents the picture:

Indexers' Limited Stewardship Stakes[233]

	BlackRock	Vanguard	SSGA
Stewardship Staff	45	21	12
Investees Worldwide	11,246	13,225	12,191
Investees U.S.	3,765	3,672	3,117
Maximum Person Day	<4	<2	<2
Stewardship Expense	$13.5M	$6.3M	$3.6M
Total Fees & Expenses	$9.1B	$3.5B	$2.6B

For context, consider the head count at two other companies involved in investment analysis. Moody's, the bond rating agency covering a large swath of capital markets, employs 12,000 people. Among the largest quality shareholders, Capital Research, which keeps up with a far smaller portfolio of companies, 7,500.

Bebchuk and Hirst find it hard to believe that the limited resources of the large indexers suffice to yield informed opinions on the tens of thousands of shareholder decisions required of an owner of shares in many thousands of companies. Even if Kahan and Rock are right that most are quotidian and few grave, Bebhcuk and Hirst say at least a significant portion would require some knowledge that would entail reading the annual report and proxy statement, determining the company's strategic plan and past performance, components of its executive compensation plans,

[229] Fisch, Titans, supra note 3.

[230] Bebchuk & Hirst, Index Funds, supra note 3.

[231] Fisch, Titans, supra note 3, at 48-49 (quoting materials of the large indexers, BlackRock, Vanguard, among others).

[232] Bebchuk & Hirst, Index Funds, supra note 3.

[233] See id. (compiling data from Morningstar).

and pending shareholder and management proposals. Yet the evidence indicates that the big indexers access only 29% of governance related public filings of their investees.[234]

Fisch and her colleagues stress the extensive private engagement in which the large indexers say they are heavily engaged.[235] Bebchuk and Hirst probe the data to find the probabilities and public record pointing to inherent limitations. From 2017 through 2019, the largest indexers reported having multiple annual engagements with only a handful of their investees—3.9% at Blackrock, 2.3% at Vanguard, and 0.6% at State Street; they had just one engagement with another 7.2%, 3.5%, and 5.0%, respectively.[236] In other words, over a recent three-year period, these firms had no engagement with the overwhelming majority of the companies they invest in.

The implication of the current debate may be that indexer critics would prefer the rest of the investment community—the group so often dubbed "active" without delineation—to seize power in the shareholder voting arena. But at least for Bebchuk and Hirst, that is not the case. They see high agency costs across the investment community.[237] The upshot of their critique for them is to create incentives to induce indexers to engage more and become more active. But there is more to the debate, concerning the indexers' favored approach of using formulaic guidelines to cast votes, and how different that is from the quality shareholder approach.

B. Guideline Best Practices

All the major indexes, as well as two leading specialist companies that advise the rest of the institutional investor market on shareholder voting, publish guidelines on their views of corporate best practices. Rather than examining each vote in the context of a particular company, these guidelines promote certain precepts for all companies: splitting the roles of board chairman and CEO, annual rather than staggered terms for directors, and simple majority shareholder voting. Scholars have different views on what this approach says about the indexers.

Critics say it reflects the thin staffing that would prevent firms from reaching an informed opinion for each particular company. Just as the large indexers are stretched thin, so too are the two main proxy advisers,. ISS and Glass Lewis. Both operate with lean staffs on low budgets, and just 1,000 employees at ISS and 1,200 at Glass Lewis. Yet they address a huge market: ISS boasts 1,700 institutional clients while Glass Lewis's clients together manage $35 trillion in assets.[238]

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[234] Peter Iliev, Jonathan Kalodimos & Michelle Lowry, Investors' Attention to Corporate Governance 3 (Mar. 6, 2019) (unpublished manuscript), https://ssrn.com/abstract=3162407.

[235] Fisch, Titans, supra note 3.

[236] Bebchuk & Hirst, Index Funds, supra note 3.

[237] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, The Agency Problems of Institutional Investors, 31 J. Econ. Persp. 89 (2017) (distinguishing somewhat between passive indexers and "active" funds then sharply contrasting activists, but never addressing the quality shareholder cohort of long-term concentrated shareholders).

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

Their small crews opine on hundreds of thousands of separate decisions annually—ISS addresses 40,000 annual meetings and Glass Lewis 20,000.[239]

In contrast, proponents of indexers treat the guideline approach as an efficient demonstration of economies of scope.[240] Kahan and Rock theorize that the indexers have a special advantage concerning broad market wide issues to which the guidelines speak, such as the relative appeal of staggered boards.[241] They acknowledge, however, that other investors may have an advantage when it comes to firm-specific issues such as a given director's fit for a particular board. Of course, few issues are purely firm-specific or purely issue-specific, but they think the degree of importance varies and can delineated.[242]

One concern with the guideline method, however, is it condones a once-size-fits-all approach to corporate governance. While Kahan and Rock deny holding any such view,[243] others come closer to countenancing it. For example, Fisch and colleagues say indexers compete by "engaging in broad-based efforts to improve the *overall performance of the market*, addressing cross-cutting issues such as corporate governance, risk management, cybersecurity and sustainability."[244] That is notable for its suggestion that, rather than trying to maximize the prosperity of each given company in the index, indexers seek to get the highest market return.

In developing their theory of the value indexers add to corporate governance, Fisch and colleagues cited several empirical finance articles showing an association between high indexer density in a shareholder base and various governance features the indexers favor, such as more independent directors, fewer takeover defenses and equalized shareholder voting rights.[245] But

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[239] The 12,000-person workforce at Moody's, conducting comparable coverage in scope, is ten to twelve times these; the Capital Group team of 7,500, covering a fraction of the scope, is four to seven times as large.

[240] Kahan & Rock, Let Shareholders Be, supra note 209. Kahan and Rock make this point favoring quality shareholders on certain issues: "Fund families weighted towards active strategies with more concentrated portfolios will tend to have relatively stronger incentives to develop company-specific information." Perhaps—but here's a place where adding long-term would help—quality shareholders yes, transients not so much.

[241] Consider, on the other hand, the contentious debate on staggered boards described earlier. See supra text accompanying notes 187-195.

[242] Characteristic of the literature in this debate, supra note 220, Kahan and Rock theorize that indexers have an advantage on broad issues while "active" funds benefit most from company-specific votes—without distinguishing between transient and quality. Similarly, they say index funds "tend to hold stock over longer periods of time than actively-managed funds," true of transients but not of quality shareholders.

[243] Kahan & Rock, Let Shareholders Be, supra note 209. "We do not mean to say that a staggered board is necessarily good or bad for all companies, just that it is likely to be good or bad for certain types of companies, and thus that the only relevant company-specific information is what type of company it is." They add that the distinction "is highly relevant in determining incentives to become informed. While incentives to obtain company-specific information derive primarily from one's holdings *in a single company*, incentives to obtain issue-specific information derive from one's holdings *in all companies* where a vote on the issue has to be cast."

[244] Fisch, Titans, supra note 3, at 25.

[245] Id. at 26, n. 38 (citing, among other research, Ian Appel, et al Passive Investors, Not Passive Owners, 121 J. Fin. Econ. 111 (2016)).

Bebchuk and Hirst pointed out an uncited subsequent paper reporting similar research revealing that such high indexer density is associated with certain reforms indexers disfavor, such as CEOs becoming chairman.[246]

No issue is so generic as to be universal—not even the ritualistic shareholder ratification of an auditor of the company's financial reports.[247] The same is true for a wide variety of guideline practices whose utility and value varies by company and is heavily debated in the literature.[248] That's certainly the quality shareholder view. Among the best illustrations of the stakes and the different approaches between indexers and quality shareholders concerns the central nervous system of corporate life: directors and boards, discussed next.

C. Directors and Boards

Corporate law puts boards of directors at the center of corporate governance.[249] Corporate law empowers shareholders to elect directors. It is perhaps the shareholders' most consequential decision. Yet approaches to this critical issue vary widely between indexers and quality shareholders. It would illuminate the indexing debate to compare and contrast these two approaches. The following first reviews the formulaic approach of the indexer guidelines and second the analytical approach of the quality shareholder.[250]

1. Indexer Guidelines

Consider the approach of the leading proxy adviser, Institutional Shareholder Service (ISS). ISS opens its discussion of the board of directors not with statements of competence or corporate stewardship, but with "four fundamental principles [that] apply when determining votes on director nominees."[251] These are enumerated as independence, composition, responsiveness and accountability. Only the assessment of "responsiveness" is contextual—voting "case-by-base."

On independence, ISS makes three prescriptions: (1) a majority of directors must be independent; (2) the board must have three standing committees operating under formal charters

[246] Cornelius Schmidt & Rüdiger Fahlenbrach, Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?, 124 J. Fin. Econ. 285, 293–94 (2017). Another criticism of asserting an association between indexer density and their favored policies, like reducing takeover defenses, is that many other informed participants contend that such defenses are sometimes desirable and should be evaluated case-by-case. Sharon Hannes, The Hidden Virtue of Antitakeover Defenses, 24 Cardozo L. Rev. 1903 (2003); Sharon Hannes, The Market for Takeover Defenses, 101 Nw. U.L. Rev. 125 (2007).

[247] See, e.g., J. Robert Brown, Jr., The Politicization of Corporate Governance: Bureaucratic Discretion, the SEC, and Shareholder Ratification of Auditors, 2 Harv. Bus. L. Rev. 501, 511 (2012).

[248] E.g., supra notes 187-195 and accompanying text (staggered boards); supra notes 196-200 and accompanying text (CEO-chairman split or combined).

[249] E.g., Del. Code Ann. tit. 8, § 141(a) (2020).

[250] Indexer critics note a further anomaly: indexers seldom nominate directors. In fact, during the past five years, none of the largest three indexers have formally nominated a single director to any public company board See Bebchuk & Hirst, Index Funds, supra note 3. In contrast, quality shareholders frequently suggest nominees and quite a few have served on boards themselves. See Cunningham, Quality Shareholders, supra note 8 (chapter 3).

[251] Institutional Shareholder Service, Proxy Voting Guidelines (2019) [hereinafter ISS Guidelines].

and staffed only with independent directors—audit, compensation, and nominating; and (3) there must either be a lead independent director or an independent chairman (not also serving as an executive officer).

Many such rules have become commonly accepted in recent decades, but the empirical evidence on their economic value remains inconclusive.[252] Consider the issue of director independence.[253] Some evidence suggests a board's independence is less important than its active engagement.[254] Other evidence suggests that certain kinds of outside directors improve the performance of certain functions, such as adherence to accounting requirements.[255] But, clearly, there is a trade-off between the expertise of inside directors and the independence of outside directors.[256]

On composition, ISS again states three rules: (1) directors should have diverse skills that add value to the board, rather than duplicating backgrounds from particular viewpoints, ideally presented in a graphical skills matrix to illustrate; (2) regular meeting attendance is expected, defined as at least 75% of meetings of the full board and committees; and (3) attention is expected, determined by caps on the number of public company boards individual directors may serve—five in general or two for CEOs. [257]

Critics challenge these composition directives as intrusive and formulaic. Taking (2) and (3) first, attendance and attention are clearly necessary, but not sufficient, to determine a valuable board member. Rules of thumb are useful, but that's not how these rules operate. That is why the board of directors' section of so many corporate websites portray check marks ticking off all the governance formulas that major indexers and proxy advisors champion. Attention is important, but caps are clearly arbitrary.[258]

On accountability, ISS calls for regular director elections, opposes staggered terms, and believes in shareholder removal power, with or without cause. But state corporate law permits all these and many other approaches to director election and removal, and leaves it to companies to choose those best suited for their circumstances. As we have seen, there are good arguments to evaluate these on a case-bay-case basis.[259]

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[252] See supra text accompanying notes supra notes 196-200 and accompanying text (addressing the issue of the role of the chairman/CEO). The listed committees are functionally required by law; other committee subjects are mentioned infra text accompanying notes 267-268.

[253] E.g., Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921 (1999); Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. Corp. L. 231 (2002).

[254] See Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 Colum. L. Rev. 1283 (1998).

[255] See Lawrence A. Cunningham, Rediscovering Board Expertise: Legal Implications of the Empirical Literature, 77 U. Cinn. L. Rev. 465 (2008).

[256] See Usha Rodrigues, The Fetishization of Independence, 33 J. Corp. L. 447 (2008).

[257] ISS Guidelines, supra note 251.

[258] See Cunningham, Quality Shareholders, supra note 8, at 8(giving the example of ISS opposing nomination of widely-recognized executive and director for exceeding the board service limit due solely to fact that an incumbent company was divided into two separate entities).

[259] E.g., supra notes 187-195 and accompanying text (staggered boards); supra notes 196-200 and accompanying text (CEO-chairman split or combined). A final prong of ISS's accountability plank

2. Comparing Quality

Warren Buffett has often expressed his views on ideal directors and boards—ideas that have a wide following among the rest of the quality shareholder cohort.[260] They seek directors with a shareholder orientation, business savvy, and interest in the particular company and its stewardship.[261] Particular director traits and the specific context of a given company are more important than following general formulas or perceived best practices.

The number-one question quality shareholders want to know about any director candidates, however, is whether they are shareholder oriented. That is, all directors should act as if there is a single absentee owner and do everything reasonably possible to advance that owner's long-term interest.[262]

This is not a mandate for the immediate maximization of shareholder value, but rather a mentality to evaluate every decision from the shareholder perspective. To that end, it is desirable for directors to buy and hold sizable personal stakes in companies they serve, so that they truly walk in the shoes of owners.[263]

The board's most important job is selecting an outstanding CEO. If the board secures an outstanding CEO, it will likely face few other major problems. All CEOs must be measured according to a set of performance standards. A board's outside directors must formulate these standards and regularly evaluate the CEO in light of them—without the CEO being present.[264]

Standards should be tailored to the particular business culture but should stress fundamental baselines, such as returns on shareholder capital and progress in market value per share over multiple years. Above all, directors should evaluate the CEOs record on capital allocation measured against a hurdle rate it sets.[265]

If the CEO's performance persistently falls short of the standards set by the directors, then the board must replace the CEO. The same goes for all other senior managers boards oversee, just as an intelligent owner would if present.

In addressing these problems, the director's actions must be fair, swift, and decisive. Directors who perceive a managerial problem should immediately alert other directors to the issue. If enough are persuaded, concerted action can be readily coordinated to resolve the problem.

Here, too, shareholders can play a role. Companies can make their directors available to

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prescribes that each board undertake regular performance reviews of itself. This is another fashion in corporate governance that is reinforced by consulting firms offering the service Christopher D. McKenna, The World's Newest Profession: Management Consulting in the Twentieth Century (2006). The task of self-evaluation, while important, is challenging, and observers are justified in skepticism about the results.

[260] See Lawrence A. Cunningham, Warren Buffett's Ten Commandments for Directors, NACD Directorship (July-August 2017); European Financial Review (July-August 2017); and CNBC (July 2017).

[261] See Buffett & Cunningham, The Essays, supra note 17.

[262] Id. at 45.

[263] Id. at 31-32 (Berkshire's owner-related business principles, number 2).

[264] Id.

[265] See Phil Ordway: Case Studies of Companies That Do Capital Allocation Right, The Manual of Ideas (2019).

their largest long-term quality shareholders.[266] These representatives can discuss issues put to shareholder votes that affect enduring value. A few influential quality shareholders, acting together, can effectively reform a given company's corporate governance simply by withholding their votes for directors who were tolerating odious behavior.

On board committees, finally, corporate law requires that boards approve major acquisitions and dividends, and as a practical matter to approve share buyback programs.[267] Along with such approvals, good practice dictates that the board's principal role is setting applicable hurdle rates, for reinvestment and acquisitions.

Companies wishing to make capital allocation a priority could consider whether to create a board committee with this oversight. At S&P 500 companies, boards maintain an average of four committees, and about 1/3 include a committee on capital allocation, finance or investment.[268] Charters might call for post-investment reviews on all important allocations, especially organic growth initiatives, acquisitions, and share buybacks.

With capital allocation being the central driver of business value, from the quality shareholders' analytical perspective, it is natural that this cohort would discuss the idea of a board committee on the subject. The indexer guidelines, of course, do not.

3. A Note on Activists

A turn to the subset of quality shareholder who go activist is in order. Activist shareholders regularly identify and recruit able director nominees to serve on boards of corporations they target. These director nominees are often experts in the relevant industry or on aspects of perceived board weaknesses, such as corporate governance. They may often be the kinds of directors quality shareholders would seek and nominate themselves. But the context where such nominations arise can compromise actual or perceived stewardship.

First, there is longstanding concern that directors appointed as the result of activist support will be more beholden to the activist than to the other shareholders. This concern is constrained somewhat by a director's fiduciary duties, which require acting for the corporation, not any particular shareholder.

But circumstances can aggravate the problem. For instance, some activists have offered their nominees bonuses for achieving stated corporate results during their tenure, including certain stock price levels. Such "golden leashes," as they are called, increase the risk that the director is beholden to the sponsor.

In addition, a payout set based on stock price could influence important business judgments, such as optimal borrowing levels and whether to make or accept acquisition offers. For these reasons, special bonuses for certain directors risk creating board factions and infighting.

Second, when appointed as the result of a settlement, outside normal governance procedures, the other shareholders did not get a vote. Such arrangements can lead to board members that appeal unduly to the activist and incumbents.

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[266] See Cunningham, Quality Shareholders, supra note 8 (chapter 8).

[267] E.g., Del. Code Ann. tit. 8, § 154 (2020) (dividends); § 160 (repurchases technically do not explicitly require board approval but statutory rules violations expose directors to personal liability); § 251 (mergers).

[268] See Ordway supra note 265.

One solution to this problem is to put settlements to votes of the other shareholders.[269] This would assure appointment of directors with consensus support, as well as validate any other aspects of the settlement, such as committee assignments, director removal, terms and term limits and corporate governance guidelines.[270]

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The indexing debate over incentives, capacity, and "guideline" approach to governance is vital. It can be enriched by adding the perspective of the quality shareholder. All of this matters, above all, because of the increasingly important role shareholders play in corporate governance. The frequency and significance of shareholder voting and the fragmentation of shareholder types is what leads to ultimate debates in corporate law concerning shareholder voting, to which we turn next.

IV. Shareholder Voting

State corporate law requires corporations to submit certain matters to a shareholder vote.[271] These matters include election and removal of directors, by-law or charter amendments, mergers, substantial asset divestments, and dissolution.[272] Federal securities law supplements these state laws by regulating the process of shareholder voting,[273] and sometimes requiring votes, most notably on executive compensation.[274] Managers or shareholders can make additional proposals calling for a shareholder vote, on topics ranging from interested transactions to disclosures about climate change.[275]

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[269] John H. Matheson & Vilena Nicolett, Shareholder Democracy and Special Interest Governance, 103 Minn. L. Rev. 1650 (2019). These authors start with the premise that shareholder democracy is a virtue, manifested in improved governance or voting on staggered boards, majority elections, say on pay, proxy access. They are concerned that settlement of activist threats impairs democracy. It operates outside main governance mechanisms through private means advancing private agendas—of both activists and target boards against the rest of the shareholders. They analogize to other similar settings—threats to corporate control to interested director transactions—to offer a statute making such settlement agreements void unless approved by a majority of the other shares.

[270] Finally, investors with holding periods less than one year cast votes in annual elections despite the fact that they will not continue to be a shareholder for the directors' full term. Even investors with holding periods less than two or three years who cast votes in electing staggered boards will not be around for as long as the directors they elect.

[271] See Julian Velasco, The Fundamental Rights of the Shareholder, 40 U.C. Davis L. Rev. 407, 413 (2006).

[272] E.g., Del. Code Ann. tit. 8, § 211 (2020) (director elections); § 242 (charter amendments); § 251 (mergers); Model Bus. Corp. Act § 11.04 (mergers); § 10.03 (charter amendments); 10.20 (bylaw amendments).

[273] 17 C.F.R. § 240.14(a) (2019).

[274] Dodd-Frank Section 951(a)(2); Exchange Act Section 14A(a)(2); 15 U.S.C. § 78n-1(a)(2).

[275] Lisa M. Fairfax, Social Activism Through Shareholder Activism, 76 Wash. & Lee L. Rev. 1129 (2019).

State corporate law provides that each corporate share is entitled to one vote on all such matters, unless a company's charter adopts a different rule.[276] State law permits a wide variety of alternative voting regimes, including several classes of shares with different voting rights; shares without votes or with multiple votes; as well as shares that accrue votes when held for long periods or that enjoy fewer votes when held by a large block owner.[277] Although federal securities laws defer almost entirely to state corporate law on voting rules, stock exchange rules limit some of this variation, at least for companies already listed.[278]

While state corporate law grants vast power to boards of directors to oversee and manage a corporation,[279] these shareholder voting rules give shareholders a significant voice on many consequential issues. In recent years, the number and importance of matters submitted for shareholder voting have both increased.[280] Fragmentation of the shareholder base has accentuated the importance of shareholder voting, as this is the favored route for shareholder activists to shape corporate policy and an occasion when indexers wield their power. These forces have combined to produce experimentation with alternative voting arrangements.

Although the baseline voting rule remains one share one vote, more companies have switched to alternatives and debate has ensued.[281] In this debate, the traditional rule is heralded as a democratic gold standard, against which all alternatives must be measured. This Part reviews the three alternatives that have attracted the most attention: dual class, tenured, and exclusionary, putting each in context, and assessing the pros and cons.

The review leads logically to a novel alternative, which I propose, that increases the power of long-term committed owners—quality shareholders. I dub this regime "quality voting." Besides logical closure in relating the relevant elements of the debate to voting rules, quality voting will appeal to companies interested in attracting higher densities of quality shareholders.

A. Dual Class: Anti-Activist

The one-share, one-vote regime is easiest to conceptualize and implement in a company with a single class of stock outstanding. Every share of that class has one vote, and all other shareholder rights are the same, as to matters such as dividends or liquidation rights. But state corporate law has long permitted companies to have more than one class of stock, with variable voting and other rights, so long as the rights of each class are the same within the class.[282] This approach is valuable to enable issuing preferred stock, for instance, a security that blends features

[276] E.g., Del. Code Ann. tit. 8, § 212(a) (2020).

[277] See Velasco, supra note 271.

[278] See Paul Mason et al., Does Shareholder Voting Matter? Evidence From the Takeover Market, 53 Wake Forest L. Rev. 157 (2018).

[279] E.g., Del. Code Ann. tit. 8, § 141(a) (2020).

[280] See Fisch et al., The New Titans, supra note 3.

[281] E.g., Grant M. Hayden & Matthew T. Bodie, One Share, One Vote, and the False Promise of Shareholder Homogeneity, 30 Cardozo L. Rev. 445 (2008); Paul H. Edelman & Randall S. Thomas, Corporate Voting and the Takeover Debate, 58 Vand. L. Rev. 453, 464 (2005).

[282] E.g., Model Bus. Corp. Act. § 8.04.

of common equity with debt.[283]

While allowable under state corporate law, maintaining two classes of common stock has sparked controversy since at least 1925. The details of each dual class structure vary, but the general design grants greater voting power to one class than to the other. Participants all see a trade-off between the increased incentives of those with the greater voting power to make value enhancing decisions and the decreased monitoring capability of those with lesser voting power. People disagree, often strongly, about the net effects of the trade-off. This Section charts the regulatory path of this debate back to 1925 through today, stressing how a greater emphasis on the distinctive role that quality shareholders play would add to this debate.

1. Law and Practice

In a famous 1925 offering, Dodge Brothers, Inc. adopted two classes of stock, with different voting rights.[284] One class had multiple votes per share while the other had the usual one vote per share. A public howl of protest erupted, as the era's populists condemned the lopsided arrangement. Critics observed that the owner of the high-vote stock held shares worth only $2.25 million in a company with a market value of $130 million—yet controlled a majority of the voting power.

In this era, such matters were governed entirely by state corporation law, though this episode contributed to the forces leading to enacting of federal securities laws in 1933 along with exploring how stock exchange listing rules could supplement state corporate law.[285] The real issue with such dual class capital structures is that they vest control in a group without matching economic risks: despite equal investments, one class has more votes per share than the other. The controlling class is insulated from short term pressure but also from accountability.

In the aftermath of the Dodge Brothers offering, the stock exchanges barred listing of new companies using multiple classes of stock. That ban remained in effect through 1985. The New York Stock Exchange granted a few waivers, with conditions, particularly when founders showed having special skills or vision warranting such enhanced power.[286] Other exchanges, such as Nasdaq, also banned dual class subject to conditions such as a minimum portion of minority board seats, a maximum ratio of control shares to minority shares, and anti-dilution protections.

In the late 1980s, the dual class structure's voting arrangement captured newfound public attention after many boards began to use it defeat unwanted tender offer bids.[287] In a common practice, a company facing a threat to control would recapitalize by offering to replace one existing class of stock with two new classes. One of the new classes offered low voting rights but high

[283] See Lawrence E. Mitchell, The Puzzling Paradox of Preferred Stock (and Why We Should Care About It), 51 Bus. Law. 443, 445 (1996).

[284] See Joel Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 Geo. Wash. L. Rev. 687 (1986).

[285] See John C. Coffee, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1 (2001).

[286] For instance, in 1980 it listed Nike Inc., whose shares were identical except that those held by founder Phil Knight could elect ¾ of the board. Knight said he would not have taken the company public otherwise.

[287] See Jeffery N. Gordon, Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Cal. L. Rev. 3, 44 (1988).

dividends while the other offered the reverse.[288]

As board's making such an offering intended, managers and other pro-management shareholders traded their shares for the high vote class while public shareholders, preferring cash dividends to abstract voting rights, went for the low vote class. While state corporate law allowed such a gambit, the SEC regarded the practice as coercive. In 1989, it adopted a federal rule prohibiting stock exchanges from listing companies proposing dual class capital structures.[289]

A federal court struck the SEC's rule on administrative grounds.[290] But the exchanges nevertheless adopted the listing rules, and they remain in effect.[291] These rules apply to existing companies, barring recapitalizations, but not to newly-listed companies with dual class structures upon initial public offerings (IPOs). Dual class structures have been particularly appealing to new listings for technology companies, with a wave of such offerings occurring in the mid-2000s as the tech sector rallied and again in the last few years since 2017. Today, some 250 companies maintain dual class capital structures.[292]

2. Debate and Data

In the longstanding debate, proponents of dual class argue that entrepreneurs need to retain voting control to protect their companies from intense, short-sighted pressure of activist shareholders. The reasoning follows, however, that the founder's "special sauce" offers initial value, but tends to fade with time and depends on consistent personal engagement.

More recently, debate has come to focus on duration: people could accept the structure as long as it wasn't permanent.[293] The question being asked was: how long would the dual class terms endure and under what circumstances might they cease? Before 2000, nearly two-thirds of dual class offerings had no sunset provisions. But expiration terms have become common, whether at fixed times such as five to ten years or upon events such as the founder's death or incapacity.[294]

Despite such compromises, extreme cases arise that lead to extreme reactions. Take the 2017 IPO of Snap Inc., whose public shares carried no voting rights. Many observers

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[288] See Louis Lowenstein, Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson, 89 Colum. L. Rev. 979 (1989).

[289] SEC Rel. Nos. 34-25891, 34-25891A (July, 1988).

[290] Bus. Roundtable v. SEC, 905 F.2d 406, 407-08 (D.C. Cir. 1990).

[291] See Stephen M. Bainbridge, The Short Life and Resurrection of SEC Rule 19c-4, 69 Wash. U. L. Q. 5675 (1991).

[292] See Council of Institutional Investors, Dual Class Companies List (2017) (culled from Russell 3000 companies), available at https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf. Actually, quite a few have multiple classes of stock with varying voting rights, so they are "multiple class" capital structures but the phrase "dual class" is most commonly used to capture all variations.

[293] See Lucian A. Bebchuk & Kobi Kastiel, The Untenable Case for Perpetual Dual-Class Stock, 103 Va. L. Rev. 585 (2017).

[294] See Jill Fisch & Steven Davidoff Solomon, The Problem of Sunsets, 99 B.U. L. Rev. 1057 (2019) (protesting calendar expiration dates though willing to accept event-driven terminations).

fulminated.[295] Some campaigned for the SEC or stock exchanges to ban the practice.[296] Although authorities refrained, advocates persuaded certain market index compilers to exclude such companies from their indexes,[297] adding a new force in corporate governance.[298]

Advocates for dual class take a different view. As Professor Lund explains, the debate over nonvoting stock—and dual class generally—pits critics concerned that the approach impairs accountability against proponents who stress the long-term value.[299] She then explored how such capital structures segment the shareholder base into informed and uninformed investors. Informed investors are better motivated to support optimal governance for long-term value, and may even pay a premium to own higher-voting stock. Companies catering to different shareholder types with such tailored share offerings therefore increase firm value, she says.[300]

Turning to the evidence, it does not support a flat ban on dual class structures nor a universal endorsement of them. First, despite being excluded from some indexes, many companies continue to offer them and many shareholders continue to buy them.[301] The number and percentage of newly listed companies with dual class structures has not changed much[302]—though the total market capitalization of such companies has fallen substantially.[303] The frequency and duration of sunset provisions has not moved much either—about 1/5 of new dual class structures continue to have sunsets, typically after ten years.

Second, many dual class structures are carefully tailored to suit individual corporate and shareholder circumstances. For example, about 15 companies use complex formulas to allocate corporate power and another 15 provide for specific allocations of board seats, some by number of slots and others by percentage.[304] Several adjust the voting rules on extraordinary matters such

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[295] Council of Institutional Investors, Position Paper on Dual Class [hereinafter CII Multi-Class Paper] (calling the Snap IPO "egregious"). For a calmer, intellectual approach, see Amy Deen Westbrook and David A. Westbrook, Snapchat's Gift: Equity Culture in High-Tech Firms, 46 Fla. St. U. L. Rev. 861 (2019).

[296] CII Multi-Class Paper, supra note 295 (reporting numerous investor requests to major index providers to exclude multi-class structures).

[297] Id. (reporting that FTSE Russell excludes any company whose share float is less than 5% of total voting power; S&P Dow prospectively excludes any company adopting multi-class).

[298] See Scott Hirst & Kobi Kasitel, Corporate Governance by Index Exclusion, 99 B.U. L. Rev. 1229 (2019).

[299] Dorothy S. Lund, Nonvoting Shares and Efficient Corporate Governance, 71 Stan. L. Rev. 697 (2019).

[300] Distinguishing between informed and uninformed shareholders is useful to probe shareholder base, cultivation, and related policies. Standing alone, however, the attribute is difficult to test. Other behavioral categories probe this factor, however, particularly the combination of horizon and conviction.

[301] See Council of Institutional Investors, Dual-Class IPO Snapshot: 2017-2019 Statistics.

[302] Id. (19%, 11%, and 26% in 2017, 2018, 2019 (through first half), respectively).

[303] Id. (49%, 17% and 15%).

[304] See Council of Institutional Investors, Dual Class Companies List (2017) (culled from Russell 3000 companies), available at https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf. [hereinafter CII, Dual Class List] (for instance, at Forest City Realty Trust, Graham Holdings, Madison Square Garden, Scholastic, and Scripps, one class is entitled to elect a majority of the board, typically 2/3, while another can elect the rest). Some have plain vanilla terms—more votes on all matters to one class

as mergers, either reducing the super-voting shares to one vote or increasing the other class to one vote.[305]

Third, and most important for this Article's thesis: quality shareholders often embrace companies with dual class structures. Among companies with dual class structures, most attract a high density of quality shareholders.[306] One reason for this appetite, particularly in contrast to the indexers' universal condemnation: a categorial condemnation of dual class capital structures ignores their utility in specific scenarios.[307]

In fact, one leading voice in the quality shareholder community publishes an investment advisory entitled "index orphans."[308] It highlights investment opportunities among excellent companies expelled from the indexes for various reasons, including thanks to having dual class structures.

As this evidence suggests, debates over the merits of dual class would benefit by considering views of the quality shareholder cohort.

B. Tenured Voting: Anti-Transient

Scholars whose normative goal is to encourage long-term share ownership have recently advocated for increasing the voting power of long-held shares. This concept—synonymously called tenured voting, time-weighted voting or time-phased voting—prescribes that a share's voting power is increased after it has been held for a given number of years.

A common approach grants four votes instead of one to each share held longer than four years. When those shares are sold, they revert back to one-vote shares. Designs vary to suit, with differences in the definitions of short and long term (upping votes after three, five or ten years say), reward increments (adding one vote per two years or two votes per one year), and matters covered (all matters coming to a vote or only designated matters, such as mergers).[309]

In theory, by rewarding long-term ownership, average holding periods should rise and stock volatility fall. From the shareholders' viewpoint, tenured voting remains as democratic as one-share, one-vote: all shares and shareholders enjoy identical opportunities to gain enhanced

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than another, including some 50 companies within the Russell 3000 that have at least one class of stock without any voting rights. Id.

305 Id. (examples: News Corporation, Sinclair Broadcast, Sonic Automotive, Virtu Financial).

306 See Cunningham, Quality Shareholders, supra note 8. The analysis compares CII's list of 225 companies with my ranking of companies based on the density of quality shareholders in their shareholder base. In particular, 135 companies appear on both lists. Among those, 64% appeared in the top half for quality shareholder density.

307 Adopters include family companies (such as Tootsie Roll Industries); entrepreneur firms (such as Tilly's); and those whose industries demand with a long-term focus, such as journalism (New York Times Co.), spirits (Brown Forman) and finance (Houlihan Lokey).

308 See Boyar Research, Boyar's Index Orphans (vol. XLIII, Issue VII & VIII) (October 12, 2017). Boyar has identified some 750 public companies of this sort—all with market capitalizations exceeding $1 billion and 60 exceeding $10 billion. Examples: IAC/InterActiveCorp, Axalta Coating Systems, Madison Square Garden Company, and MSG Networks.

309 See Rock, Eugenics, supra note 78, at 901 ("Each implementation can have a different effect on the shifting of influence among the shareholding population.").

voting rights.[310]

A major and underappreciated problem, however, is that holding period length is an imperfect proxy for wisdom or good judgment.[311] After all, if long-term shareholders are indexers with insufficient interest in particular companies while newer shareholders are prepared to engage productively, tenured voting backfires.[312]

While the emerging literature is increasingly robust, most of the analysis has focused on the horizon effects of tenured voting, with limited attention to this issue of conviction. This sub-section reviews the prevailing literature while stressing that an equal emphasis on conviction should inform debate over tenured voting.

1. Law and Theory

Unlike dual class, only a dozen U.S. public companies have ever adopted tenured voting, though laws in France and Italy since 2014 have required it for many public companies there.[313] As a result, far less scholarly attention had been paid to tenured voting, until recent years.[314] Interest in tenured voting was sparked by a series of major articles led by Lynne Dallas, appearing in 2012, 2016 and 2017.[315] Since then, in addition to numerous passing references, two important articles on shareholder cultivation treated the innovation carefully[316] and two more recent articles take the topic up head on.[317]

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[310] See *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977).

[311] See Rock, Eugenics, supra note 78, at 902.

[312] See Richard, Buxbaum, The Internal Division of Powers in Corporate Governance, 73 Cal. L. Rev. 1671, 1718-1719 (1985) (among the earliest criticisms, calling tenured voting “problematical” and a “showstopper” against hostile takeover bids since shares, upon purchase by hostile bidder, would lose voting power for several years, longer than any could wait, making this anti-takeover defense “immovable”).

[313] In France, lawmakers in 2014 made tenured voting the default for listed French companies, unless shareholders vote to opt out of it. Many companies, including half the largest listed companies, have been using tenured voting, with a two-year minimum holding period, Early empirical results suggest considerable value associated with tenured voting—called loyalty shares in France. See Francois Belot, Edith Ginglinger & Laura T. Starks, Encouraging Long-Term Shareholders: The Effects of Loyalty Shares with Double Voting Rights, www.ssrn.com/abstract=3475429 (2019). Companies opting out of loyalty shares suffered a negative market reaction while those adhering to tenured voting enjoyed a positive market reaction. The theory? Loyalty shares encourage costly monitoring by long-term shareholders, providing potential benefits to all shareholders.

[314] This assertion is based on a Lexis search in the law review library for “time-phased voting” or “time-weighted voting” or “tenured voting.” Aside from a flurry of references during the period surrounding the SEC’s intervention concerning dual class recaps, scattered and indirect references appeared in the following years during that period (one per year unless otherwise noted): 1999, 2000, 2002, 2004, 2005 (three times, all in lists of examples), 2006, 2007 (two times), 2008 (two times), 2009, 2010.

[315] Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. Corp. L. 265 (2012); Dallas & Barry (2016), supra note 9; Lynne Dallas, Is There Hope for Change? The Evolution of Conceptions of “Good” Corporate Governance, 54 San Diego L. Rev. 491 (2017).

[316] See Belinfanti, Cultivation, supra note 62; Rock, Eugenics, supra note 78.

[317] See Berger et al., supra note 4; Edelman et al., supra note 4.

Most of this literature reviews the legal authority to permit tenured voting. These discuss state corporation law as well as stock exchange listing rules—the federal securities laws having virtually no role since the SEC's aborted flirtation with intervening in the dual class context.[318] The consensus is overwhelming that state corporation law, certainly in the leading state of Delaware, authorizes this and many other variations of voting arrangements.[319]

Two landmark cases support this consensus conclusion, one by analogy and one directly. In the analogy case, *Providence & Worcester Co. v. Baker*[320] upheld a scaled voting scheme where voting power varied with a shareholders' stake—in this case, the greater the stake, the lower the voting power.[321] Plaintiffs challenged the scheme under a state corporate statute requiring uniform voting powers by class.[322] In rejecting this challenge, the court reasoned that the provision applied equally to every share, and thus was uniform as to shares, and operated unevenly only as to those shareholders crossing certain ownership levels.[323]

The other landmark case, *Williams v. Geier*,[324] directly upheld a proposed tenured voting structure. Existing shares won ten votes per share. Upon their transfer, they would revert to one vote per share, and newly issued shares would also have one vote per share—but all those held 36 months would accrue ten votes. The court considered the board's proposal to be an ordinary business judgment, entitled to utmost judicial deference.[325]

If scholars agree that the case law clearly upholds tenured voting, there is more debate about whether stock exchange listing rules restrict it. Scholars routinely point to the New York

[318] See Rock, Eugenics, supra note 78, at 902 ("it is also permissible under federal securities regulation. . . . Federal securities law takes no official position regarding departures from one-share, one-vote."); Edelman, et al., supra note 4.

[319] See Del. Code Ann. tit. 8, § 212(a) (2020) (making one-share one-vote the default rule and authorizing substantial tailoring, so long as consistent with other provisions of the statute, by the board alone before a stock sale and by board-shareholder approved charter amendment afterwards).

[320] 378 A.2d 121 (Del. 1977).

[321] See Buxbaum, supra note 312, at n. 101 ("The provision allocated one vote for each twenty shares owned after the first fifty shares, and prohibited a stockholder from voting more than one-quarter of the shares issued and outstanding, unless as proxy for others. As a result, the plaintiff, who was the largest shareholder, had twenty-eight percent of the shares yet only three percent of the voting power.")

[322] Del. Code Ann. tit. 8, § 151(a) (2020).

[323] The case is cited in the time weighted voting literature as an analogous structure See Edelman et al., supra note 4, at 999 ("The scaled voting structure in *Providence & Worcester* is analogous to tenure voting, simply substituting the limiting factor of holding duration for holding size.") Its holding squarely covers one of the features that could be used to define quality voting, as discussed in Section D.

[324] Williams v. Geier, 671 A.2d 1368 (Del. 1996) (also overruling a New York federal district court that purported to reject the validity of tenured voting under Delaware law, Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985)).

[325] The plan was neither a defensive measure, under Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), requiring elevated scrutiny for reasonableness as the trial court had held, nor an infringement on the shareholder franchise, under Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988), requiring enhanced scrutiny as the plaintiffs had urged.

Stock Exchange listing rule on voting rights which, by its terms, prevents a listed company from switching to tenured voting.[326]

But three qualifications have been made: Professor Belinfanti notes that stock exchange interpretive guidelines could warrant a waiver for a company with rational business concerns about short-termism;[327] Professor Rock views any such impediment to recognized alternative voting regimes as ill-advised;[328] and Professors Berger et al. believe that the reasoning in *Providence* should apply to the interpretation of the NYSE rules to permit tenured voting.[329]

As a matter of corporate policy, two corporate law scholars have recognized tenured voting as a valid method of shareholder cultivation for companies seeking a longer-term base. Belfanti opines: "As a cultivation tool, it rewards stewardship capital on one hand, and potentially discourages . . . flippers and short-term gamblers."[330] Rock stresses incentives: "it provides greater incentives to longer-term shareholders to invest in making those decisions and greater incentive to remain shareholders to enjoy the increased voting rights."[331] Rock refrains from opining on whether this would be desirable or not, however, noting downsides.[332] On balance, though, Rock favors the flexibility offered:

> In an age of empowered shareholders, in which firms should think about selecting and shaping an optimal shareholder base, prohibiting a key design tool is

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[326] E.g., Rock, Eugenics, supra note 78, at 903, quoting NYSE listing rule:

> Voting rights of existing shareholders of publicly traded common stock . . . cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.

NYSE Manual, § 313.00(A). The NACD has a similar counterpart.

[327] Belinfanti, Cultivation, supra note 62, at p 834 (quoting NYSE listed company manual: "[t]he Exchange's interpretations under will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time") (citing para. 313.00 Interpretation No. 95-01, N.Y. Stock Exch. (Jan. 10, 1995), http://nysemanual.nyse.com/LCM/pdf/voting rights.pdf).

[328] Rock, Eugenics, supra note 78, at 903.

[329] Berger et al., supra note 4, at 319-320 (rule forbids "disparately" reducing voting rights whereas switching to a tenured voting is non-disparate because equally applicable to all shares held for stated durations). Edelman et al. are not so sure and say they are not aware of any company that has done so. Edelman, et al, supra note 4, at 1002-1003 ("The NYSE voting rights policy precludes companies from adopting tenure voting plans for existing shares. . . . most commentators agree that listing rules allow the adoption of tenure voting at only the IPO stage.").

[330] Belinfanti, Cultivation, supra note 62, at 843.

[331] Rock, Eugenics, supra note 78, at 901-902.

[332] Downsides are the "inverse of the upsides," including cementing insider control despite small stakes. Another is this caution: "if long-term shareholders are typically index funds who, in competing on price, resist portfolio firm-specific investments." Rock, supra note 78, at 902. This is an important caution about how a voting regime focused on horizon can be impaired by a problem of conviction. It is an example of the importance of combining both horizon and conviction in a single analysis as well as the need to recognize that not all long-term shareholders are "typically index funds." Many are quality shareholders.

inappropriate. [F]irms and shareholders should at least have the option to experiment with different ways of shaping the shareholder base.[333]

2. Research and Data

The research that reignited interest in tenured voting began with Professors Dallas, whose 2017 work with Professor Berry investigated its implications for corporate governance and effects on managerial myopia.[334] The article's main points were a policy view of tenured voting and an examination of the dozen U.S. companies that have tried it. They considered three rationales for tenured voting: increasing power of long-term shareholders; encouraging longer hold periods; nudging corporate culture towards a long-term value focus.[335]

The study found that the plans did not reduce managerial myopia by lengthening shareholder holding periods.[336] Nor did it affect institutional ownership or increase long-term ownership, which actually decreased. They found that, like dual class, tenured voting increased the wedge between ownership and control, as insiders could sell shares over time while maintaining voting power. The increased agency costs were not offset by a greater long-term focus.[337] Despite these findings, the authors encouraged continued experimentation with tenured voting, stressing almost exclusively its implications concerning horizon, rather than conviction.

More recently, Professor Berger and co-authors propose tenured voting as a way to address short-termism, presenting it as a better alternative to dual-class.[338] They approach the prescription principally in terms of time horizon, stressing perceived short-termism from shortening average holding periods and increased activism.[339] They argue that tenured voting creates incentives to hold for long periods, reduces short-term myopia, attracts long-term capital, and promotes a long-term corporate culture.[340]

Amid the authors' impassioned entreaties focused on time horizon, there is only limited attention to conviction, and none to the quality shareholder. On the subject of conviction, the scholars say only that tenured voting should not be expected to attract any additional indexers to a shareholder base. That is true, of course, because indexers do not make investment decisions based on such firm-specific governance features.

Most recently, Professor Edelman and his co-authors were motivated by concerns that tenured voting can entrench management.[341] So they analyzed its likely effect in a contested board

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[333] Id. at 903-904.

[334] Dallas & Barry, supra note 9, at 551.

[335] Id. at 570-571.

[336] Id. at 620-21.

[337] Id. at 611-12.

[338] Berger et al., supra note 4, at 297.

[339] Id. at 298-300.

[340] Id. at 307-09.

[341] Id. at 297. This concern appears particularly strong in Italy, where critics express concern that the intention to elongate shareholder time horizons can also entrench managerial tenures. Chiara Mosca, Should Shareholders Be Rewarded for Loyalty? European Experiments on the Wedge Between Tenured Voting and Takeover Law, 8 Mich. Bus. & Entrepreneurial L. Rev. 245 (2019) ("tenured voting rights disappoint their expectations and are rarely used to meet a true need of long termism"). Such regimes do not increase the level of engagement of passive indexers. See Giovanni Strampelli, Are Passive Index Funds

election. Their model recognizes additional tenured voting power in incumbents, less voting power in the hands of an activist new to ownership, and variable voting power among the variety of other shareholders. (The model did not distinguish among varying levels of concentration or diversification.) They made two major findings.

First, when insiders of a company adopting tenured voting own and keep a sizable block—20% to 30%—that proves a formidable deterrent to even their most committed opponents who might seek to acquire voting control. Second, if such insiders instead sold down to a point where majority voting power fell into institutional investor hands, the tenured voting mechanisms no longer protect the insiders' control.

The upshot, for the authors, is to view tenured voting as a reasonable compromise between one-share/-one-vote and dual class, in that it grants incumbent inside controls an edge but only if they maintain substantial skin in the game. Given that finding, it would also be interesting to investigate the further effects of granting additional voting power based on conviction—more votes to concentrated than to diversified shareholders. We move to that in Section D; first consider, briefly, current proposals to sterilize the votes of index funds.

C. Variations: Anti-Indexer

Corporate law scholars have identified numerous concerns about indexers casting shareholder votes, ranging from limited monitoring capabilities to incentives to favor managers, as discussed in Part III. Calls to eliminate or curtail related shareholder voting rights ensue. All focus on indexer passivity—lack of conviction—rather than time horizon.

Professor Lund proposes for index funds to abstain from voting altogether—contrary to current law which requires large institutional investors to cast their ballots.[342] The rationale is that indexers, based on the critical evidence summarized in Part III, lack requisite incentives or capacity to become informed about corporate voting. The effect would increase the voting power of quality shareholders as well as all non-indexers, whatever their time horizons or other attributes.[343]

Professors Bebchuk and Hirst oppose Lund's proposals for two reasons. First, despite their criticism of indexers outlined in Part III, that does not lead them to think that the voting decisions of other investors are superior. Their main criticism here, however, lumps all non-indexers (and non-managers) together without separately recognizing the quality shareholder cohort.

Instead, they single out "individual retail investors," as lacking requisite incentives to become informed,[344] and "active mutual fund managers," as not having shown superior investment in becoming informed compared to indexers.[345] Attention to quality shareholders might change this analysis.

Active Owners? Corporate Governance Consequences of Passive Investing, 55 San Diego L. Rev. 803 (2018).

[342] Dorothy S. Lund, The Case Against Passive Shareholder Voting, 43 J. Corp. L. 493 (2018); see also Todd M. Henderson & Dorothy S. Lund, Index Funds Are Great for Investors, Risky for Corporate Governance, Wall Street J. (June 22, 2017).

[343] Lund, at 528-530. An alternative would focus on the perceived pro-management bias of index funds and allocate indexers' votes in proportion to the votes of non-management non-indexers. See id. at 530-31.

[344] Bebchuk & Hirst, supra note 2, at 2218 n. 227.

[345] Id., n. 228.

A second form of anti-indexer voting measures would require the funds to pass their voting rights through to the beneficial owners of the fund.[346] This likewise seeks to remedy the limited incentives and capacity the fund has to cast informed votes. Bebchuk and Hirst again disagree, here for three reasons, most of which are valid, though they could benefit from delineating the shareholder base further. As they stand, the objections are almost entirely concerned with individual fund beneficiaries, when indexers also manage assets for many different kinds of institutions (if not quality shareholders).[347]

The logical next step after these criticisms—and all three pending debates over shareholder voting regimes—is quality voting, an approach that zeroes in on two behaviors all participants seem to laud: shareholders with a long-term horizon and high level of conviction.

D. Quality Voting: Pro-Quality

To recap this Part so far, dual class voting structures are motivated by entrepreneurs averse to shareholder activism or other short-term pressures, though their own economic stakes are not as concentrated; tenured voting is motivated by policy advocates to reduce short-termism; and anti-indexer variations are motivated by policy advocates to negate the arguably ill-informed of diversified indexers. The rationale of each scheme is binary—a focus on short- or long-term horizon for dual class and tenured and a focus on relative concentration for the anti-indexer variations.

It is logical to consider conjoining both long-term and concentrated behavior in a voting policy that I will call quality voting. It refines tenured voting to account not only for duration but conviction.

Participants in the debate will have varying responses to a proposal to increase voting power of both long-term and concentrated shares. But while many skeptics may remain skeptics, some may see things differently; proponents of one or the other approach may agree or disagree with quality voting; those who support both may have already come to the same conclusion as this Article does without having yet contributed it to the literature.

1. Comparing Regimes

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[346] See Caleb N. Griffin, We Three Kings: Disintermediating Voting at the Index Fund Giants, Md. L. Rev. (forthcoming).

[347] Professor Griffith offers another approach which would compromise based on the type of voting topic in terms of whether funds have a plausible information advantage compared to their customers, distinguishing between, for instance, mergers versus social proposals See Sean J. Griffith, Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority, Texas L. Rev. (2020). While interesting, this proposal faces the definitional challenge of classifying the type of voting topic as well as the same issue of rational apathy of the account holders. I concur with the rationale for such an assertion, which is that funds and many corporate governance experts, overestimate their ability to rank governance provisions from good to bad on an abstract basis.

Professors Lund and Griffith co-authored another piece advocating an even more interesting approach to address conflicts of interests that index funds face. Sean J. Griffith & Dorothy S. Lund, Conflicted Mutual Fund Voting in Corporate Law, 99 B.U. L. Rev. 1151, 1181-86 (2019). They look at conflicts arising from mutual fund structures and suggest the solution of excluding their vote in votes requiring a minimum level of disinterested shares to carry.

Unlike dual class voting, this remains democratic. It does not inevitably or irremovably cement control in designated hands, but operates as a fluid advantage that fluctuate as investors rebalance their portfolios over time in varying weights.

As with tenured voting, quality voting is almost certainly permitted under corporate law—in fact, one of the two landmark cases in this area, *Providence*, addressed a plan more akin to quality voting than to tenured voting (though it was the inverse, capping voting rights of concentrated shares whereas quality voting would multiply voting rights of concentrated share). The case under New York Stock Exchange rules remains equivocal but is stronger than for tenured voting, since the text of the rule expressly refers to "time phased voting plans."[348]

Also as with tenured voting, quality voting would be a valuable shareholder cultivation mechanism. It would probably be of greater effect for the discrete group of quality shareholders. It would pose less risk than tenured voting of entrenching managers after they decrease ownership because concentration levels would still be counted. It would pose none of the downside risk of increasing the voting power of ill-equipped indexers.

As with dual class and tenured voting, the exact terms could be tailored to suit.[349] Reliable references can draw upon the selection criteria used by researchers in identifying the quality shareholder cohort, all of which is publicly filed with the SEC for most institutional investors and relatively easy for reasonable investors to determine from their regular records.

As to conviction, examples of such inputs are percentage of a shareholder's portfolio in the stock, average stock percentage in the shareholder's portfolio, and number of other stocks in the portfolio.[350] Companies could access the relevant data bases of scholars who maintain ongoing records of shareholder quality.[351]

To illustrate, consider a simple model comparing one-share, one-vote first with tenured voting and then quality voting. Imagine a simple shareholder base, where the period of ownership of outstanding shares is about equally distributed among older and newer shareholders and those in between—such as 33% own for less than one year, more than three years, and in between.

With 99 shares outstanding, each cohort controls 33 votes. No single cohort can command the outcome of any vote. But if time-weighted voting added three votes to each share held longer than three years, then that cohort would have 99 votes, the others would still have 33 each and a combined 66. The seasoned cohort would then dictate the outcome of every vote. But it is not obvious that such seasoning translates into proportionally greater wisdom for a company.

Time-weighted Voting Power

Duration & Multiple	Normal Votes	Time-weighted Votes
< Year = 1x	33	1x = 33

[348] See supra note 326 (quoting the rule).

[349] See supra text accompanying notes 302-305 (noting how dual class can vary voting rights with the subject matter of the vote, among other ways) and supra text accompanying note 309 (noting how tenured voting can vary voting power according to duration, multiple, and subject matter of the vote).

[350] See supra text accompanying notes 56-58 (summarizing the criteria used in Professor Bushee's research).

[351] See supra text accompanying notes 59-60 (summarizing the methods and data of both Professor Cremers and Borochin).

1-3 years = 1x	33	1x = 33
>3 yrs. = 3x	33	3x = 99

That invites consideration of quality voting. To take one of the potential proxies for conviction, suppose this is shares representing a substantial portion of a shareholders' portfolio, measured as a percentage of the shareholders' total public company equity portfolio. For example, two votes per share could be granted to shareholders allocating between one percent and five percent of their portfolio to the company and three votes per share to those allocating more than five percent. If tenured voting implicitly assumes that longer-held shares cast higher-quality votes, the hypothesis follows that shares owned by those with greater exposure will also have such merit.

To adjust the previous illustration, suppose portfolio concentration is randomly distributed across durations. Combining duration with concentration, the short term unconcentrated cohort would remain entitled to 33 votes while the longest-holding and most-concentrated would enjoy 199 votes. Updating the previous table that showed the effects of duration in tenured voting, This table adds the effects of concentration.

Quality Voting Power

	Duration Multiple	Concentration Multiple
None	< Year = no multiple	< 1% x = no multiple
Some	1-3 years = 2x	1-5% = 2x
Substantial	> 3 years = 3x	> 10% = 3x

The outcome of any vote would be determined by a fluid combination of shareholders boasting relatively longer durations and higher concentrations. To complete the illustration, the next table applies the multiples to the previous example of a company with 99 shares outstanding, with 33 each held for varying durations and concentrations.

Votes Given Combinations of Concentration and Duration

Concentration **Duration**	*< 1% = no multiple*	*1% to 5% = 2x*	*>5% = 3x*
< 1 year = no multiple	33	66	99
1-3 years = 2x	66	132	165
>3 years = 3x	99	165	198

Shared area reflects number of votes commanded given concentration and duration levels.

(This example presents the multiples in the proportion of 1-2-3. That is a high magnitude of change in multiples, which may be too large for comfort in an experimental stage. More modest multiples could be set, such as 1, 1.33, 1.66 or even 1, 1.2, 1.4.)

2. Pros and Cons

Quality voting can be adopted by charter amendment under state corporation law along with an application to the stock exchange for a waiver of any restrictions on alternative voting regimes. In this legal sense, it is akin to dual class or tenured voting—all of which are easier than the variations of anti-indexer regimes, which would require legal changes and related political support.

As with dual class and tenured voting, quality voting enables each company to design the details and tailor the arrangements to suit in a joint exercise involving solely board and shareholder approval. Each company must weigh the following costs and benefits of adoption.

Administrative burdens may be high. While the five-year old experience in France suggests that administration is feasible, the U.S. system has some different features. One problem is how most U.S. equity is held in the names of depository nominees rather than ultimate owners, complicating the task of tracking ownership concentration.[352] Recordkeeping and calculations can be complex, especially for large institutions investing through multiple funds, including those with diverse mixes of debt, equity, and other securities.[353]

In fact, companies that rescinded tenured voting often cited administrative complexity as a reason.[354] Administering commitment-weighted voting would pose additional cost, particularly in recordkeeping and verification. For example, duration is a fixed measure of time, whereas concentration can vary substantially over time.

On the other hand, those maintain tenured voting invoked common solutions. For example, one common solution to the challenge of street name ownership was to deem street name stock as low-vote.[355] Such an approach could be modified by making that a presumption that each shareholder would have the right to challenge.

Such a simple approach can be implemented immediately for all shareholders, including individuals, by shifting the burden of disclosure to the shareholder: any shareholder wishing to exercise quality shares would be required to submit qualifying evidence to the corporate secretary accordingly. The corporate secretary can create uniform rules describing what evidence qualifies and standardized procedures to verify it.

Moreover, holdings are readily observable from public filings for institutional investors and can be verified by reference to disclosure that is legally required and subject to federal anti-fraud rules. For these shareholders, enhanced voting power could be made optional and subject to the company's confirmation of verified shareholder applications.

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[352] See Edelman, supra note 4, at 297 (drawing on David C. Donald, Heart of Darkness: The Problem at the Core of the U.S. Proxy System and Its Solution, 6 Va. L. & Bus. Rev. 41, 50 (2011)). In brief, before the 1970s, share ownership records were maintained manually in a traditional paper recording system maintained by individual brokerage firms. Trading volume proved too much for such a system, however, creating backlogs in updating transfer records. To meet this challenge, the industry developed a computerized system maintained in a central depository, called the Depository Trust Company (DTC). Today, the vast majority of stock is held through DTC, with stock formally owned by its nominee, Cede & Co., and held in the name of the brokerage firm that arranged the purchase (called "street name" on behalf of the "beneficial" owner).

[353] Corporations must maintain stockholder lists to determine associated rights, on voting and other matters. E.g., Del. Code Ann. tit. 8, § 219(a) (2020). In the process, companies contact DTC to enumerate the breakdown of brokers holding shares through Cede. The Cede breakdown can be cumbersome, involve numerous interactions between the company and DTC, and is error-prone. Edelman, et al., supra note 4, at 1004. Such challenges and risks multiply for companies with peculiar voting rules, such as tenured voting, as this requires additional information such as duration of holdings.

[354] See Edelman, supra note 4, at n. 89 (quoting Church & Dwight Co., Inc., Proxy Statement (Form PRE 14A), at 27 (Mar. 21, 2003)).

[355] See Dallas & Barry, supra note 9, at 602.

Just as technology helped solve the paper crisis, technology is likely again to solve the street name problem, including the administration of special voting rules. Advances in tracking technology, particularly digital ledgers based on blockchain tools, promise to make administration of quality voting manageable. In 2017, Delaware corporate law was amended to permit companies to use blockchain (or distributed ledgering) to maintain their shareholder lists.[356] These enable digital records showing every transaction involving every share of stock, with precise details of beneficial rather than street ownership as well as duration and other data.[357]

In any event, such costs must be compared to the gains. In general, gains can be approximated by reference to some of the common contexts where suboptimal voting has been recognized. These would include many of the instances where indexers have conflicts of interest as well as the legal contexts in which courts have recognized transient shareholder appetites to be problematic.

Under quality voting, finally, activist shareholders may often gain enhanced power when they hold meaningful stakes for long periods. Voting power could also increase during the course of multi-year campaigns, as more votes accrue over time. Both points may attract activists, but while managers may see some associated costs, they will be activists more patient and focused than other shareholders, producing comparative gains.

CONCLUSION

Why have quality shareholders, including Warren Buffett, been neglected in the corporate law scholarship on horizon, conviction and shareholder voting? One possibility is the familiar difference between theory and practice. Scholars work with theories that may or may not map onto actual behaviors. A tension sometimes resides between academic and practical perspectives in scholarly work.[358]

In corporate law and finance scholarship last generation, for instance, a disconnect occurred between modern finance theory and Buffett.[359] Theorists developed the efficient capital market hypothesis, capital asset pricing model, and modern portfolio theory as a construct that contradicted most everything Buffett thought and did—the theorists even suggested he could not have done what he did.[360] The theories being developed in today's corporate law debates recall a flavor of that gap, where the light shines on short-term activists and long-term indexers but none at all on the long-term concentrated, quality shareholder.

As Professor Bebchuk and his colleagues have noted in one of their many major contributions to the conviction debate, they are putting forward a theory of institutional investor

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[356] Del. Code Ann. tit. 8, § 219(c) (2020).

[357] See Edelman, supra note 4, at 1006 (these tools would be a "great advantage" for tenure voting to "make it easier for companies to trace the identity of their shareholders and therefore more accurately assign high and low voting rights").

[358] See, e.g., Eric A. Posner, Standards, Rules, and Social Norms, 21 Harv. J.L. & Pub. Pol'y 101, 106 (1997) (exploring a theoretical model that has little practical use).

[359] See Lowenstein, supra note 24, at 934.

[360] Id. (reviewing finance theory of the era which theorists simply ignored Buffett's record, wished it away, or dismissed him as an outlier: "it is odd, is it not, that not one EMT theorist has seen fit to study Buffett?" and their "response to Buffett has been either a deafening silence or a clumsy attempt to avoid the engagement.").

incentives that predicts impoverished decision making while acknowledging that actual decision making may be superior to the model.[361] Other scholars in this debate likewise theorize and model without necessarily accounting for all relevant incentives of all the diverse actors, especially quality shareholders.

"Well, it may be all right in practice, but it will never work in theory," Buffett has famously quipped.[362] Quality shareholding works in practice, and requires only slight adjustment to work in theory. Both theory and practice will be richer when horizon and conviction are combined for study and the quality shareholder's role is explored. This Article lights the way.

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[361] Bebchuk, Cohen & Hirst 237, at 90:

> We recognize that well-meaning investment managers of index funds and active mutual funds may sometimes make stewardship decisions that are superior to those suggested purely by their incentive calculus. Our focus, however, is on understanding the structural incentive problems that should be recognized in assessing the current governance landscape.

[362] See Katherine Florey, Big Conflicts Little Conflicts. 47 Ariz. St. L.J. 683, 685 (2015) (quoting Buffett's "famous quip").