

THE PROMISE OF HEDGE FUND GOVERNANCE: HOW INCENTIVE
COMPENSATION CAN ENHANCE INSTITUTIONAL INVESTOR MONITORING

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ABSTRACT

Progressive legal scholars argue that institutional investors should play a greater role in disciplining corporate managers. These reformers seek to harness the talent and resources of mutual funds and public pension funds to increase managerial accountability to shareholder interests. Conservative scholars respond that empowering institutional investors would do little more than relocate the underlying agency costs. Although shirking by corporate managers might indeed be reduced, institutional investors suffer from their own set of agency problems and so would need their own monitor. Ultimately, someone must watch the watchers.

This Article argues that neither corporate managers nor institutional investors are properly incentivized to serve shareholder interests. Therefore, neither is appropriately positioned to serve as the ultimate decision maker. A better model of governance is the incentive fee structure employed by hedge funds and other private equity funds. If institutional fund managers were permitted to adopt a similar compensation scheme, their interests and the interests of their investors would merge. As a result, they would be transformed into ideal servants of shareholder interests, capable of bringing much-needed discipline to corporate America.

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INTRODUCTION

Over the past few decades, institutional investors have come to dominate American capital markets. Flush with the savings of the Baby Boom generation, banks, insurance companies, mutual funds, and pension funds have amassed dazzling fortunes. For example, at a time when the average size of even the largest companies listed on the New York Stock Exchange is under \$60 billion, three families of mutual funds each control as much as \$1 trillion in investment accounts.¹ If they combined their resources, institutional investors would be theoretically capable of purchasing outright nearly all of corporate America.

The incredible growth of institutional investors has posed, for corporate governance scholars, both a puzzle and a choice. First, the puzzle: Given their vast resources and accompanying expertise, why have most institutional investors remained largely passive in their investment outlook? Why, for example, when a target company underperforms, do they typically exit the investment rather than seek to translate their influence into better performance?

1. According to the New York Stock Exchange, the one hundred largest listed companies in 2008 had a combined market capitalization of \$5.95 trillion, making the mean average of these companies \$59.5 billion. See NYSE U.S. 100 Index, <http://www.nyse.com/marketinfo/indexes/nyid.shtml> (last visited Oct. 27, 2008). For an estimate of the size of the mutual fund industry prior to the deepening of the credit crisis, see Muralikumar Anantharaman, *Fidelity Lags Main Rivals but Slow Recovery Seen*, REUTERS, Jan. 10, 2007, <http://www.reuters.com/article/companyNewsAndPR/idUSN1031582020070110> (“Overall, Fidelity manages about \$1.3 trillion of assets, Vanguard more than \$1.1 trillion and American Funds . . . about \$1 trillion.”). Of course, as the current economic turmoil continues to evolve, these numbers can be expected to change. Nonetheless, there is reason to believe that their relative magnitude will remain roughly the same.

Second, the choice: Assuming institutional investors could be encouraged to exercise their power over corporate managers, would such oversight be desirable? What, in other words, is the proper role of institutional investors in the American economy? Should they remain mere aggregators of capital, passively funneling shareholder dollars into widely diversified investment portfolios, or would we prefer that they become private-sector watchdogs, actively monitoring corporate wrongdoing and reining in managerial excess?

In a prior article, I argued that the failure of institutional investors to become active monitors results from a lack of proper incentives. For example, because the law generally prohibits them from charging fees based on the quality of their performance, the managers of mutual funds and pension funds have little to gain from the added costs and risks associated with monitoring.² By contrast, the managers of hedge funds and other private equity funds retain a sizeable portion of any profits they generate. Their upside from monitoring is therefore sufficiently large to overcome the practical and legal impediments that make monitoring expensive and burdensome.³ Thus, the answer to the puzzle is to unlock the potential of institutional investor oversight by targeted deregulation of their fee structures.

It remains an open question, however, whether institutional investor activism—were it to occur—would be advantageous to the nation and economy as a whole. On one side of the issue are progressive legal scholars who argue that corporate America is in need of better discipline from outside monitors. Because the corporate form separates ownership from day-to-day control, agency costs accumulate whenever managers fail to aggressively pursue shareholder interests.⁴ When managers pay themselves excessive salaries, fail to diligently pursue profits, or place their own interests ahead of the corporation's, waste is produced and both investors and society suffer.⁵ For reform-minded scholars, institutional investors are needed as outside monitors to check the power of management.⁶

2. Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 231–32 (2007).

3. *Id.* at 302–04.

4. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119–25 (1932) (offering the first complete description of the separation of ownership and control).

5. STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 35–36 (2002) (“Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.”).

6. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815 (1992) (“The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only

In response, many in the law and economics movement have argued that empowering fund managers as outside monitors would do little to reduce overall agency costs. This is because ownership and control are separated within the structure of institutional investors in the same manner as within corporations. Thus, enlisting institutional investors as monitors would serve only to shift the location of the agency problem.⁷ Though corporate managers might have less discretion to shirk, fund managers would have more. Like a game of “whac-a-mole,” the agency costs would disappear at the corporate level only to reappear at the level of the outside monitor. In the end, the question would remain, “Who will watch the watchers?”

However, even if the conservatives are correct that empowering a watchdog would merely shift the locus of the agency problem, the question does not disappear. Instead, it morphs into a different form: Which corporate actor suffers from the fewest agency costs? If the alignment of interests between corporate managers and shareholders is close to optimal, then shifting power to institutional investors would indeed do little to ameliorate overall agency costs. If, on the other hand, the incentives facing institutional fund managers result in a better alignment of interests, then such a shift would result in a net gain in efficiency. In other words, not all potential watchdogs are equally suited to serve shareholder interests. The real question posed by the conservative critique then, is slightly more nuanced: “Which watcher needs the least watching?”

I argue that, at present, none of the available choices is a good one. The interests of corporate managers are poorly aligned with those of their shareholders. The use of stock options at the corporate level has produced too great a focus on the short term and created significant opportunities for abuse.⁸ Meanwhile, the managers of banks and insurance companies are too beholden to corporate interests to be capable of disciplining them.⁹ Finally, because legal regulations generally prohibit mutual funds and pension funds from charging incentive compensation, their managers are largely insulated from the financial impact of their performance, whether positive or negative.¹⁰ As a result, their chief incentive is not to seek to maximize shareholder profits but to attract new investors through advertising.

watchers available.”).

7. See, e.g., Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL’Y 671, 723–29 (1995).

8. See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 138–40, 143–46 (2004).

9. See, e.g., Bainbridge, *supra* note 7, at 725 (“[C]orporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors.”).

10. Illig, *supra* note 2, at 323–32. With respect to the legal limitations on performance compensation, see *id.* at 306–15. See also *infra* Part II.B.

There is, however, a proven model of governance that would create strong and direct incentives in favor of investor interests. Private equity funds—leveraged buyout, venture capital, and certain hedge funds¹¹—have their fortunes tied directly to the outcome of their investments. In the United States, at least, their unique compensation structure is such that fund managers share directly in any profits they produce while simultaneously risking their own personal fortunes when an investment turns sour.¹² As a result, they are, in financial terms, true partners with their investors. The agency costs that are so prevalent in corporations and public equity funds are thus largely absent from private equity funds.

The proper role of institutional investors in American capital markets may therefore depend upon how they are governed. The agency costs that persist among institutional investors make them little improvement over the corporate managers they would seek to monitor. However, were policy makers to deregulate the fees of mutual funds and public pension funds, thereby permitting their managers to adopt the compensation structure of a hedge fund, their incentives to monitor (and monitor well) would be transformed.¹³ They could be trusted in the role of ultimate watcher because their interests would dovetail with investor interests. Agency costs would be reduced to their theoretical minimum because corporate ownership and control would be effectively integrated.

11. Depending on how narrowly one wishes to subdivide these funds into categories, some observers would add two more to the list: buy-in funds and distressed security funds. With respect to hedge funds, they have typically been thought to acquire more esoteric investments, such as derivative securities, commodities, and currencies. Indeed, hedge funds that engage in such investments are not properly thought of as private equity funds. More recently, however, as profitable investment opportunities have become scarcer, many hedge funds have become more active in acquiring corporate equities. *See* SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 33 (2003) [hereinafter SEC HEDGE FUND REPORT] (“[A] number of hedge funds . . . adopt traditional, long-only strategies similar to those used by most registered investment companies.”); Emily Thornton with Susan Zegel, *The New Raiders*, BUS. WK., Feb. 28, 2005, at 32 (“Flush with hundreds of billions of dollars in cash from investors and hard-pressed to maintain the double-digit returns they promise as competition stiffens, many hedge funds are reinventing themselves as private investment firms. . . . [T]hey’re seizing control of companies.”). Thus, to the extent hedge funds move into the territory traditionally held by buyout and venture capital funds, those that do may be properly considered private equity funds. It is this last group that is the subject of this Article.

12. The linchpin of private equity fund compensation is the so-called “carried interest,” whereby the fund managers are entitled to 20% of all profits (plus a management fee intended to cover expenses). JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 2.02[1], 2-6 (2007); WILLIAM M. MERCER, INC., KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 16 (1996) [hereinafter MERCER REPORT]. At the same time, private equity fund managers typically invest a sizeable portion of their own assets in their funds, thereby putting their personal fortunes at risk with each investment. *See* DOW JONES, PRIVATE EQUITY PARTNERSHIP TERMS & CONDITIONS 23 (2007) [hereinafter PRIVATE EQUITY TERMS & CONDITIONS]; MERCER REPORT, *supra*, at 12–14. *See generally infra* Part II.C.

13. Thus, ironically, but probably not coincidentally, the solution to the puzzle of the persistence of institutional investor passivity also appears to be the answer to the choice of whether institutional investor activism would be desirable. Deregulating public equity fund fees would both incentivize their fund managers to become active monitors and make their monitoring desirable. *See* Illig, *supra* note 2, at 339.

In Part I of this Article, I briefly review the existing debate over the desirability of institutional investor oversight. In particular, because most advocates of institutional investor monitoring have focused on the monitoring potential of mutual funds and public pension funds, I do the same. Like hedge funds and other private equity funds, mutual funds and public pension funds are comprised largely of cash and investment securities and thus lack the trappings of traditional operating companies. However, they are also closely analogous to public corporations insofar as they are generally capitalized by large numbers of retail investors, each holding small, dispersed stakes. For convenience, then, I refer to mutual funds and public pension funds collectively as “public equity funds.”

In Part II, I compare the different incentives facing corporate managers, public equity fund managers, and private equity fund managers. I conclude that the incentive compensation structure of private equity funds is superior to those of the other two and therefore represents a proven model for reform. Finally, in Part III, I explore the promise of expanding private equity-style monitoring, both in terms of theory and the existing empirical evidence. I then suggest that removing the statutory prohibitions against incentive compensation for public equity fund managers would so change their incentives as to make them ideal monitors of managerial excess.

I. THE DEBATE OVER INSTITUTIONAL INVESTOR ACTIVISM

Debate over the role of institutional investors in America’s system of corporate governance has, since the early 1990s, been frequent and vigorous.¹⁴ In the following two subparts, I review the primary arguments set forth by the advocates and opponents of institutional investor oversight. Most importantly, I highlight the conservative critique that enlisting institutional investors as corporate monitors would merely relocate, rather than reduce, overall agency costs.

Finally, in the third subpart, I note that the corporate agency problem has two distinct sets of possible solutions. On the one hand, agency costs could potentially be reduced by enlisting some outside monitor to discipline errant corporate managers. On the other hand, agency costs could also be reduced by better aligning the interests of the managers with their investors. I conclude, however, that the desirability of institutional investor

14. The timing of the debate is partly the result of the incredible growth that institutional investors had experienced in the decades leading up to the 1990s. According to one estimate, for example, the total value of institutional investor holdings grew from around \$673 billion in 1970 to over \$11 trillion in 1996—a sixteen-fold increase in under a generation. Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349, 354 & n.8 (2000) (citing a series of “Institutional Investment Reports” published in 1998 by the Global Research Council of the Conference Board).

monitoring really turns on the interplay between the two strategies. By aligning the interests of public equity fund managers with those of their investors, incentive compensation would reduce agency costs at the fund level while simultaneously increasing the likelihood that fund managers will actively monitor corporate agency costs.

A. Proponents

The case in favor of institutional investor monitoring is fairly straightforward. It is premised on the notion that some type of watchdog is required because the managers of public corporations cannot be trusted to act solely in the best interests of shareholders.¹⁵ To borrow one court's well-known and evocative formulation, the separation of ownership and control in the modern American corporation creates an "omnipresent specter" that management will prefer its own interests above those of its shareholders.¹⁶

That being said, however, so long as the stock of large American corporations remains dispersed among many small shareholdings, investors will have little incentive to actively monitor corporate managers.¹⁷ Instead, they will choose to exit underperforming investments rather than expend resources to influence corporate policy. Shareholders, in other words, are and are likely to remain rationally apathetic.¹⁸ If their interests are to be protected, proponents argue, some outside monitor is needed to act on their behalf.

Unfortunately, most market participants recommended as potential monitors have thus far disappointed. Independent directors, for example, have proven to be much less independent than was originally hoped. Although not directly employed by the corporations they serve, these board

15. See, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 235 (1994) ("American managers have often not been held accountable for their performance.").

16. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (justifying its heightened standard of review for anti-takeover measures on "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

17. Note that a number of commentators have pointed out that the rise of institutional investors as financial intermediaries means that the shareholdings of modern corporations have become much less dispersed than was the case when Berle and Means famously identified the separation of ownership from control as the cornerstone of American corporate governance. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567-70, 574 (1990) (tracing the rise of institutional ownership of American corporations). Assuming this observation is correct, however, it remains largely irrelevant for corporate governance purposes so long as institutional investors continue to act as mere aggregators of capital. In other words, so long as large investors remain passive in their investment outlook, their presence as conduits in financial markets makes little difference to the big picture of American corporate law. Management today has little to fear from shareholder activism, whether formal or otherwise. See Illig, *supra* note 2, at 236-37, 258-68.

18. For a more detailed account of the "passivity story," see Black, *supra* note 17, at 526-29 (describing the collective action problems that Berle and Means and others have identified as inherent in American corporate governance).

members are subject to numerous informal incentives that serve to align their interests more with management than with shareholders.¹⁹ In a similar development, the market for corporate control has largely ceased to exist. Scholars had at one point hoped that threatening managers with hostile takeovers would scare them into serving shareholder interests.²⁰ Instead, corporate managers were able to translate their substantial economic power into political power and so insulated themselves legally from most outside threats.²¹ The story is similar with respect to the many other market players periodically considered as potential monitors.²² Thus, for those who fear that management is insufficiently accountable to shareholder interests, some other monitor appears necessary.

On the positive side, however, despite their historic passivity, institutional investors continue to show promise as potential monitors. First, they have the size and resources to effectively challenge corporate management. It is currently estimated that over sixty percent of all securities in the United States are held by institutional investors.²³ In terms of raw dol-

19. See, e.g., Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 658 (1982) (analyzing past performance of independent directors and concluding that it is unrealistic to suggest that they can be successful in fostering social responsibility); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282 (1982) (expressing skepticism that “independent directors will increase shareholders’ welfare”). See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007). For scholars who support expanding board independence, see, for example, Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996), calling the lack of board independence “[t]he most significant problem facing corporate America today.” Some scholars see both pluses and minuses. See, e.g., Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 267 (1997) (arguing that although increased board independence may enhance its monitoring ability, “this gain may come at the expense of a decline in the board’s management capacity”); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 810–14 (2001) (arguing that the small-group dynamics present in the boardroom would be disrupted by too great a concentration of independent directors).

20. See, e.g., Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117–19 (1965) (arguing that takeovers protect the interests of non-controlling shareholders by providing some assurance of efficiency among corporate managers); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 125–33 (1992) (analyzing two value-maximizing efficiency explanations for takeovers: realizing synergy gains and reducing agency costs).

21. See, e.g., Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889–91 (2002) (identifying the prevalence of staggered boards as one of the chief protections U.S. companies have against unfriendly tender offers); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858 (1993) (announcing famously: “The takeover wars are over. Management won.”).

22. Lawyers, accountants, and other securities industry professionals, for example, proved themselves eager participants in, rather than effective checks against, the frauds perpetrated at companies like Enron and WorldCom. See, e.g., JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 55–56 (2006) (summarizing several theories explaining the failure of gatekeepers to avoid the scandals at Enron and WorldCom, including the theory that corporate managers pressured or seduced their advisers into abetting their wrongdoing).

23. See, e.g., Press Release, The Conference Board, U.S. Institutional Investors Continue to

lars, the total value of such holdings are believed to exceed \$24 trillion.²⁴ By contrast, the combined market capitalization of the entire S&P 500 is less than \$14 trillion.²⁵ Therefore, the deep pockets that have thus far made corporate America nearly impervious to outside threats appear less capable of dissuading a determined mutual fund or other large institutional investor. Indeed, few corporations can boast resources comparable to the nearly \$1 trillion in mostly liquid securities controlled by each of Fidelity, Vanguard, and American Funds.²⁶

A second mark in favor of institutional investor monitoring is their professionalism and expertise. Being experienced market players, institutional fund managers are sophisticated students of business and economic matters. Additionally, unlike board members and most other potential monitors, they are full-time investors who devote the entirety of their professional time to managing their investment portfolios. As a result, they are unlikely to be finessed by opponents able to pay greater attention to market developments and other new information.

More important than size or expertise, however, is the fact that institutional investors have a direct financial interest in the success of the corporations in which they invest. As professional stockholders, institutional investors presumably prosper when their investments appreciate and languish when they disappoint. Monitoring corporate performance with an eye toward improving that performance is therefore consistent with their ultimate profit-seeking objective.

As a result of these and other factors, progressive legal scholars have advocated forcefully for an increased oversight role for institutional investors.²⁷ Jeffrey Gordon, for example, has recommended that institutional

Boost Ownership of U.S. Corporations (Jan. 22, 2007), http://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3046; see also INVESTMENT COMPANY INSTITUTE, 2007 INVESTMENT COMPANY FACT BOOK 10 (47th ed. 2007) [hereinafter INVESTMENT COMPANY FACT BOOK] (reporting that registered investment companies—a subset of institutional investor—held 25% of the outstanding stock of all U.S. companies at the end of 2006 and were also the largest holders of U.S. commercial paper). U.S. investment companies also play an outsized role in foreign capital markets. See *id.* (“In 2006, U.S. investment companies purchased approximately 55 percent of the \$290 billion in foreign stocks and bonds that U.S. residents acquired.”).

24. See Press Release, *supra* note 23. Admittedly, however, the dollar value, but not the amount, of equity holdings by institutional investors has probably dropped as a result of recent stock market losses.

25. STANDARD & POOR’S, S&P 500 FACT SHEET (2007), available at <http://www2.standardandpoors.com/spf/pdf/index/500factsheet.pdf> (summarizing various measures as of September 30, 2007). The median sized company included in the index had an approximate market capitalization of just \$13 billion, making it an easy target for many large institutional investors. See *id.*

26. See sources cited *supra* note 1.

27. See, e.g., Black, *supra* note 6, at 812–15 (arguing that institutional investor oversight of corporate wrongdoing is not only possible but desirable); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1336–37 (1991) (arguing that a general lack of conflicts, together with other factors, give public equity funds the potential to serve as excellent corporate monitors); see also Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 449 (1991) (arguing that

investors seek to exercise greater influence by attempting to revive the practice of cumulative voting,²⁸ while Ronald Gilson and Reinier Kraakman see a role for institutional investors in recruiting and selecting a professional cadre of independent directors.²⁹ Mark Roe, meanwhile, though not explicitly endorsing an expanded role for institutional investors, lays the intellectual groundwork for such reform by arguing that the current system of passivity is as much political choice as economic destiny.³⁰ Finally, for Bernard Black and John Coffee, the issue is not so much whether institutional investor oversight is desirable, but how best to craft a regulatory system that would make monitoring less costly and burdensome.³¹

Most recently, in a backhanded sort of way, Lucian Bebchuk has staked out a position as one of the nation's strongest advocates of institutional investor oversight. For him, the key factor that insulates management from outside pressure is its control over the proxy mechanism used to nominate and elect corporate directors.³² To counter this advantage, he seeks to require management to include opponents' board nominees in the company's proxy materials—all paid for, of course, by the company.³³

“the institutional investor would seem to have both the incentive and the abilities to constrain management”).

28. Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 127–28 (1994).

29. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 883–92 (1991) (recommending that institutional investors recruit professional independent directors to serve as monitors on their behalf).

30. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 67 (1991) (“By restricting the terrain on which the large enterprise could evolve, politics created the fragmented Berle–Means corporation and the substitutes that have emerged, every bit as much as have natural laws of economy and technology.”).

31. See, e.g., Black, *supra* note 17, at 523 (arguing that institutional investor monitoring is restrained by a “complex web” of overlapping legal regulations); Coffee, *supra* note 27, at 1317–29 (arguing that, in addition to legal impediments, institutional investors face cultural and structural hurdles as well).

32. See generally Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (advocating proxy reform in order to encourage the exercise of institutional investor voice).

33. See, e.g., Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784–85 (2006) (discussing proposals to increase shareholder oversight of corporate governance); Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 557–61 (2005) (responding to industry-group criticism of the shareholder access proposal); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 694–711 (2007) (offering proposals for reforming corporate elections). Bebchuk's position has been supported empirically. See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 537 (1999) (finding that management that is protected from the risk of takeovers pays itself higher levels of compensation); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 144–45 (2003) (arguing that companies whose boards are more insulated from shareholder action tend to have lower profit margins, lower returns on equity, and slower sales growth).

It should be noted, however, that proxy reform has many opponents, including some among the practicing bar and the Delaware judiciary. See, e.g., K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV. 1425, 1428, 1453–54 (2004); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not*

Bebchuk's challenge, however, has been to recommend proxy reform that would impose greater discipline without opening the floodgates to every political hack and eccentric with a chip on her shoulder.³⁴ His answer has been to grant access only to those shareholders with a significant, long-term investment in the company in question.³⁵ Not coincidentally, however, the only investors capable of holding a sufficiently large stake for the requisite two-year period are public equity funds.³⁶ Thus, as presently constituted, calls for greater "shareholder democracy" can really be interpreted as appeals for increased institutional investor monitoring.

Come, 59 BUS. LAW. 67, 67 (2003); Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1389-90 (2006); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 163-65 (1991); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1759 (2006); E. Norman Veasey, *The Stockholder Franchise Is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811, 811 (2007); Alexander G. Simpson, Note, *Shareholder Voting and the Chicago School: Now Is the Winter of Our Discontent*, 43 DUKE L.J. 189, 189-91 (1993).

34. See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577 (2006) (arguing that shareholders who are provided greater access to the proxy will engage in rent-seeking behavior); see also Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1749 (2006) ("Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors."); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 627 (2006) ("Importantly, however, like all accountability mechanisms, shareholder voting must be constrained in order to preserve the value of authority. . . . Accordingly, shareholder voting is properly understood not as an integral aspect of the corporate decisionmaking structure, but rather as an accountability device of last resort to be used sparingly, at best.").

35. The SEC has twice turned Bebchuk's ideas into proxy reform proposals. The first formulation occurred in 2003 when the SEC proposed new Rule 14a-11. See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, [2003-2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,101, at 88,401 (Oct. 14, 2003). This proposal would have granted limited proxy access to shareholders who had continuously held 5% of the company's voting shares for at least two years. *Id.* at 88, 413-14. The second formulation occurred in 2007 when the SEC proposed amendments to Rule 14a-8. See Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,935, at 85,119 (July 27, 2007). The 2007 proposal would have granted proxy access for shareholders to propose bylaw amendments seeking to increase future access to the proxy. *Id.* at 85,125. Again, however, to be eligible under the 2007 proposal, an individual or group of shareholders had to own more than 5% of the company's voting stock for at least one year prior to submitting the proposal. *Id.* Neither proposal was adopted, however, and shareholder access to the proxy remains limited to the offering of non-binding recommendations under Rule 14a-8. See generally John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 876 (1994) (arguing that the SEC's attitude towards proxy reform is "equivocal, that it is torn between the standard impulse of a bureaucratic agency to expand its jurisdiction and defend its existing turf and the recognition that a regulatory system must have some relevant end purpose if it is to survive"); Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1132 (1993) (arguing that the SEC's efforts at proxy reform have been subject to significant political forces).

36. See Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 47-48 (2003) (proposing that proxy access be granted only to shareholders who have beneficially owned 3%-5% of a company's stock for at least two years). With respect to a billion-dollar company, this would mean holding an illiquid investment worth between \$30 million and \$50 million.

Institutional investor activism has also attracted proponents of litigation reform. The Private Securities Litigation Reform Act of 1995 (“PSLRA”),³⁷ though often viewed as a defeat by advocates of shareholder rights, was actually a victory of sorts for institutional investors. Specifically, the lead plaintiff requirement that the PSLRA imposes on securities class action lawsuits serves to enhance the role of institutional investors in corporate monitoring.³⁸ By requiring the appointment of a lead plaintiff, the PSLRA is designed to encourage institutional investors to take control of securities class action lawsuits and thereby diminish the number of lawyer-driven suits that are ostensibly brought in the name of small investors.³⁹ Thus, advocates of this reform effort—many of whom oppose other attempts to spread shareholder democracy—may have unconsciously signaled a certain comfort level with institutional investor oversight. For them, if private lawsuits are required to enforce the securities laws, it is better that they be conducted at the direction of sophisticated institutional fund managers than by disgruntled individuals.⁴⁰

Indeed, the central point shared by the various advocates of institutional investor monitoring is a sense that, to the extent managerial power is not sufficiently accountable to shareholder interests, only large, sophisticated institutions are capable of reforming the system. Thus, public equity funds, with their size, expertise, and direct financial interest in the cor-

37. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77z-1 to -2, 78j-1, 78u-4 to -5 (2006)).

38. See 15 U.S.C. § 78u-4(a)(3) (2006). The PSLRA had the stated purpose of encouraging institutional investors to serve as the “lead plaintiff” in securities fraud class action lawsuits. See generally Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869 (2005).

39. For an example of this, see *Newby v. Enron Corp.*, 188 F. Supp. 2d 684 (S.D. Tex. 2002). See also THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* §7.17[1], at 215-17 (5th ed. 2005) (noting one of the Act’s purposes is to limit “lawyer-driven suits”).

40. See, e.g., H.R. REP. NO. 104-369, at 34 (1996) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 733 (arguing that “increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions”); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Age[n]cy Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2095 (1995) (“Institutional investors with large stakes in class actions surely are more capable than typical figurehead plaintiffs of effectively monitoring how plaintiffs’ attorneys conduct such litigation.”).

Indeed, as predicted, several hedge funds and other institutional investors have sought to be appointed lead plaintiff under the statute. See, e.g., *In re Tyson Foods, Inc. Secs. Litig.*, No. 01-425-SLR, 2003 U.S. Dist. LEXIS 17904, at *20-21 (D. Del. Oct. 6, 2003) (certifying a hedge fund as lead plaintiff in a securities class action); *Danis v. USN Commc’ns, Inc.*, 189 F.R.D. 391, 401 (N.D. Ill. 1999) (same); see also Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1507 (2006) (reporting that public pension funds have increasingly sought to be appointed lead plaintiff under the PSLRA). But see John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 976 (1996) (arguing that “new players, such as institutional investors willing to take on the responsibilities of the ‘lead plaintiff,’ may or may not materialize”); Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 559-63 (1996) (same).

porations in which they invest, appear capable of overcoming the existing barriers to shareholder action.⁴¹ Empower them as monitors, proponents believe, and institutional investors will bring much-needed discipline to wayward corporate managers.

B. Skeptics

Despite the general enthusiasm for greater institutional investor oversight, a number of skeptics have raised doubts regarding the advisability of increasing the power of America's moneymen.⁴² Though their critiques vary, they can be grouped into three general categories: arguments against monitoring in general, arguments that institutional investors will not serve the interests of their fellow shareholders, and arguments that institutional fund managers will not serve the interests of their investors. I describe each in turn below.

In the first place, many conservative legal scholars are fairly sanguine about the current state of corporate accountability and so oppose any efforts to reform America's governance system.⁴³ For them, nothing is broken so nothing needs fixing.⁴⁴ Indeed, there is even the risk that imposing excessive limits on the discretion of corporate managers could damage one of the most important features of the corporate form—the ability to delegate day-to-day decisionmaking to a centralized authority.⁴⁵ For these skeptics, legal reforms intended to enhance any sort of monitoring are not merely an unnecessary evil but a reckless spin of the dice as well.

This first category of criticisms, however, appears to constitute less of a considered argument in need of a response than a heightened evidentiary

41. The existing legal and other barriers to the accumulation and exercise of shareholder power have been extensively catalogued by Black and Roe. *See, e.g.*, Black, *supra* note 17, at 523 (summarizing his argument that “institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes or undertake joint efforts”); Roe, *supra* note 30, at 11 (arguing that “law prohibits or raises the cost of institutional influence in industrial companies”).

42. Indeed, even Roe, a proponent of greater institutional investor activism, points out that Americans have seldom been comfortable with large accumulations of wealth. *See, e.g.*, Roe, *supra* note 30, at 66 (“In a conservative era, when popular mistrust of accumulated power on the eastern seaboard is directed more at Washington than at Wall Street, it is easy to forget the deep mistrust that divided Main Street and Wall Street.”).

43. *See, e.g.*, Bainbridge, *supra* note 7, at 716 (“[W]here is the evidence that existing constraints [on managerial discretion] are imperfect in any meaningful sense?”).

44. *Id.* (arguing that corporate managers are already sufficiently accountable to a “pervasive web of indirect accountability mechanisms,” including “shareholder derivative suits, mandatory disclosure, state and stock exchange governance requirements, anti-fraud laws . . . outside directors, independent accountants, takeovers, [proxy contests], and competition in the product, capital, and managerial services markets”).

45. *See id.* at 718–19 (“The chief economic virtue of the Berle–Means corporation is not that it permits the aggregation of large capital pools, but rather that it provides a hierarchical decision-making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs.”).

requirement. Without a doubt, the U.S. economy is important enough that policy makers should not tinker with it lightly. The burden should clearly be on would-be reformers to make a strong case for their proposals. However, given that few would suggest that our system of corporate governance is in all ways ideal, serious-minded reform should not be dismissed out of hand. Rather, careful consideration should be given to those proposals that appear to have significant upside potential but little downside risk. As I demonstrate in Part III.C, expanding the influence of public equity funds by fostering a market for good corporate governance is just such a proposal.

A second category of arguments in opposition to increased institutional investor oversight concedes that a monitor may be needed but holds that institutional investors are ill-suited to play the role. Scholars such as Iman Anabtawi point out that, once empowered, an institutional investor could use its influence over a given corporation to further its own particular agenda.⁴⁶ These skeptics therefore doubt that the benefits accruing from increased monitoring would be shared pro rata by all investors but would instead accrue disproportionately to those institutions best positioned to exploit the (new) system. Indeed, Allen Boyer argues that this is precisely what happened among the robber barons of the Gilded Age.⁴⁷ The concern is therefore that newly empowered institutional investors would cause corporations to pursue policies that would be detrimental to investors whose time horizons, risk tolerances, and political goals differ.⁴⁸ After all, corporate law has never required public company shareholders to consider the goals of their fellow investors when taking most shareholder action.⁴⁹

On the contrary, however, there is good reason to believe that public equity fund managers, were they empowered to engage in more activist

46. See Anabtawi, *supra* note 34, at 564 (“Once we recognize that shareholders have significant private interests, it becomes apparent that they may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class.”).

47. Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons*, 50 WASH. & LEE L. REV. 977, 1009–10 (1993) (comparing the potential for institutional investor overreaching with the power and conduct of the robber barons of the late-nineteenth century).

48. See Anabtawi, *supra* note 34, at 577–93 (cataloging the ways in which shareholder interests diverge); Boyer, *supra* note 47, at 984–85 (“It is also likely that controlling shareholders will subject corporations to risks that are pathologies of shareholders’ ordinary interests. Ordinarily, shareholders are interested in yield and liquidity. Given control, they may use their new-found power to recognize profits immediately, even if this impairs the company’s long-term prospects.”) (footnotes omitted). *But see* Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 277–78 (2002) (presenting the counterintuitive argument that permitting management to favor one shareholder or shareholder group at the expense of others would actually benefit all shareholders).

49. One major exception to this rule occurs when a single shareholder or shareholder group obtains control. At that point, many courts impose a duty on the controlling shareholder or shareholders to act in the best interests of the minority. *See, e.g., Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969) (holding that 87% shareholders have “a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner”).

monitoring strategies, would avoid the temptation to use their influence to the detriment of the corporation's other shareholders. As demonstrated in Part III.B, for example, private equity fund monitoring has generally had a significantly positive impact on the returns and overall financial well-being of target companies.⁵⁰ Similarly, several studies have failed to find evidence that private equity gains were the result of wealth transfers or other actions that unfairly disadvantaged any particular corporate constituency.⁵¹ Thus, it appears that private equity fund managers have largely avoided the temptation to pursue selfish goals and have instead sought to improve the long-term performance of their underlying portfolio of companies. Under similar circumstances, public equity fund managers could therefore be expected to do the same.

Additionally, while the possibility of institutional investor overreach may be of concern under the current regime, most of its associated risks would disappear if public equity funds were permitted to charge incentive compensation. As regards the political goals often ascribed to public pension fund managers, for example, the potential to reap huge personal rewards from incentive compensation would likely overwhelm any desire to value political gain over profit. To provide a sense of scale, it is worth noting that in 2007 one hedge fund manager personally netted in excess of \$3 billion in fees.⁵² Although it is all but inconceivable that a pension fund manager could do the same, even the chance to earn 1/1,000th of this sum might be sufficient to overcome any offsetting desire to pursue parochial interests at the expense of the fund's overall financial performance.

The third major critique of institutional investor monitoring, however, is not so easily dismissed. It is based on the very reasonable observation that most institutional investors suffer from the same agency problems as do most corporations. Thus, for scholars like Stephen Bainbridge, agency costs are inherent in the position of final decision maker.⁵³ Investors in

50. See *infra* notes 208–19 and accompanying text; see also Marcel Kahan & Edward B. Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights* 51–52 (N.Y. Univ. Law & Econ. Working Papers, Paper No. 121, 2008), available at <http://lsr.nellco.org/nyu/lewp/papers/121> (finding that corporate bondholders benefit from hedge fund activism).

51. See, e.g., Kenneth Lehn & Annette Poulsen, *Leveraged Buyouts: Wealth Created or Wealth Redistributed?*, in PUBLIC POLICY TOWARDS CORPORATE TAKEOVERS 46, 61 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988) (finding no evidence that shareholder gains due to leverage buyouts came at the expense of debtholders); Alon Brav, Wei Jiang, Randall S. Thomas & Frank Partnoy, *Hedge Fund Activism, Corporate Governance, and Firm Performance* 4 (Eur. Corp. Governance Inst., Finance Working Paper No. 139/2006, & Vanderbilt Univ. Law & Econ. Research Paper No. 07-28, 2007), available at http://ssrn.com/abstract_id=948907 (finding no evidence that shareholder gains due to hedge fund activism came at the expense of debtholders).

52. Gregory Zuckerman, *Trader Made Billions on Subprime: John Paulson Bet Big on Drop in Housing Values*, WALL ST. J., Jan. 15, 2008, at A1 (reporting that private equity funds managed by Paulson rose by \$15 billion in 2007, netting him an estimated \$3 billion–\$4 billion, “believed to be the largest one-year payday in Wall Street history”).

53. Bainbridge, *supra* note 7, at 721 (“Berle and Means correctly believed that the separation of ownership and control inhere in the concept of corporate governance. This is so not simply because of

public equity funds, like investors in public corporations, have imperfect access to information as well as little control over the selection of their agent managers.⁵⁴ It therefore makes no difference whether corporate managers or institutional fund managers (or some other intermediary) have ultimate discretion. As long as investors delegate authority to an agent, that agent will be susceptible of shirking.⁵⁵ As a result, assigning to institutional investors the task of monitoring corporate managers would do little to solve the problems inherent in the separation of ownership and control. Instead, Bainbridge argues, it would merely move the problem up one level.⁵⁶ Corporate managers might thenceforth be trusted, but fund managers could not be.

The remainder of this Article is primarily directed at answering this third critique—that attempts to enlist outside monitors of corporate America ultimately fail to reduce net agency costs because the monitors themselves invariably suffer from their own set of agency problems.

C. (Re-) Locating the Problem

Bainbridge's critique, when considered closely, raises a tantalizing possibility. At root, it assumes that the power to monitor is the power to decide, and that with the power to decide comes the incentive to pursue one's own interests. This is the basis of his conclusion that empowering an outside monitor would merely shift the locus of the agency problem from corporate managers to the outside monitor.⁵⁷ If Bainbridge is correct, however, it means not only that the agency problem might be inadvertently

the exigencies of size, technology, or capital formation, but also because of the unavoidable need for authoritarian decision-making structures in complex organizations.”).

54. See *id.* at 723–24.

55. See *id.* at 723. In making this point, Bainbridge channels Dr. Seuss's story of the town that hired a Bee-Watcher to ensure that its only industry—a bee—would work harder:

His job is to watch . . .
is to keep both his eyes on the lazy town bee.
A bee that is watched will work harder, you see.
. . . .
So then somebody said,
“Our old bee-watching man
just isn't bee-watching as hard as he can.
He ought to be watched by *another* Hawtch-Hawtcher!
The thing that we need
is a Bee-Watcher-Watcher!”

DR. SEUSS, DID I EVER TELL YOU HOW LUCKY YOU ARE? 26–27 (1973) (quoted in part in Bainbridge, *supra* note 7, at 723).

56. See Bainbridge, *supra* note 7, at 722 (“In a very real sense, giving institutions [the] power of review differs little from giving them the power to make management decisions in the first place.”). Here, Bainbridge relies on Kenneth Arrow's work regarding consensus and authority decision making structures. See KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 63–68 (1974) (examining the conflicting goals of those in authority and those not in authority within various societal organizations).

57. See Bainbridge, *supra* note 7, at 722.

relocated but that it could be *purposely* relocated as well. In other words, the locus of the agency problem constitutes a regulatory choice. Thus, by changing the underlying regulatory scheme, policy makers can determine where to situate the problem of corporate agency costs.

What this means is that policy makers should evaluate any potential monitor on two levels. First, is the monitor capable of reducing corporate-level agency costs by pursuing activist investment strategies? Second, and perhaps more importantly, is the monitor itself a superior bearer of the agency costs that would come to reside at the monitor level once the power to decide has shifted? Indeed, this dual-pronged approach offers the advantage of uniting and reinforcing existing monitoring-based and incentive-based strategies for reducing agency costs. It seeks to enlist a monitor while simultaneously aligning managerial and investor interests.

A promising outside monitor should therefore be enlisted only if such monitor's interests are more closely aligned with shareholder interests than are the interests of corporate managers. Thus, if stock options and other forms of executive compensation are sufficient to align the interests of corporate managers and their shareholders, then enlisting an outside monitor would be counterproductive. The result would be to shift the location of the agency costs to a less efficient bearer of such costs. If, on the other hand, some outside monitor could be identified whose interests are more closely aligned with those of investors, then such monitor could more efficiently bear those costs. Shifting the location of the agency problem in this case would constitute a net gain.

In order to determine where best to locate the agency problem, it is therefore necessary to explore the different incentives facing institutional investors and corporate managers. Put in the simplest terms, whichever party has interests that are most closely aligned with those of investors wins. It is they who should serve as the locus of corporate agency costs.

Unfortunately, as I argue in Part II, neither corporate managers nor public equity fund managers are properly incentivized to play the role of loyal servant to shareholder interests. Thus, as presently governed, neither would be an efficient bearer of corporate agency costs. On the other hand, the close alignment of interests that prevails within hedge funds and other private equity funds makes them superb bearers of agency costs. If the governance structure of public equity funds could thus be altered to mirror that of private equity funds, they would be transformed into the ideal locus of the agency problem. Corporate agency costs would be reduced through effective monitoring, while monitor-level agency costs would be reduced through a tight alignment of interests.

II. REDUCING AGENCY COSTS BY ALIGNING INTERESTS

In Part II, I attempt to evaluate the potential of institutional investors as monitors of corporate misbehavior by comparing the incentives of corporate managers with those of public equity fund managers. Having determined that neither has interests that are closely aligned with those of their investors, I then add private equity funds to the mix and conclude that their governance structure approaches the ideal alignment of interests. Based on this analysis, I suggest that public equity funds, were they legally permitted to adopt the incentive compensation structure of private equity funds, would themselves become efficient bearers of corporate agency costs. Furthermore, I draw the tentative conclusion—which is later tested in Part III—that these newly incentivized funds would also be capable of reducing agency costs at the corporate level through more effective monitoring.

A. Executive Pay and Stock Options

Corporate America's increased reliance on stock options and other forms of performance-based pay has had both positive and negative results. On the one hand, it forever banished the pre-1980s era of corporate bureaucracy, wherein management compensation was not tied to performance. On the other hand, it distorted managerial incentives and encouraged manipulation of accounting practices. Thus, while an improvement over the compensation practices of the prior era, stock-based pay remains problematic and agency costs continue to proliferate.

Prior to the 1980s, managers were rewarded primarily on the basis of rank. As a result, their interests overlapped only indirectly with those of their shareholders.⁵⁸ Rather than selflessly pursue higher stock prices, managers were incentivized to engage in empire-building and other stratagems aimed at enhancing their perceived importance.⁵⁹ Predictably, stock prices generally languished while executive compensation and M&A activity ballooned.⁶⁰

58. See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138, 139–40. Although managers were granted stock options prior to the 1990s, the value of such options did not constitute a significant part of their overall compensation package. See *id.*

59. See *id.* at 140.

60. See BEBCHUK & FRIED, *supra* note 8, at 16 (describing the managerial tendency toward empire-building in order to justify a larger salary and additional perks); ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING 1–2 (2004) (“Indeed, in 1976, the market was no higher than its level of *eleven years* before. Adjusted for inflation, the picture was far worse: the purchasing power of the average stock had fallen by two-thirds.”); cf. PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 296 (3d ed. 2002) (noting that firm managers may engage in leveraged buyouts based on the belief that “they could more easily justify higher salaries and other perks if the company were larger”).

Beginning around 1990, however, performance-based pay became part of the national agenda. It was then that Michael Jensen and Kevin Murphy published their provocative work claiming that American business leaders were behaving like bureaucrats because they were paid like bureaucrats.⁶¹ The size of executive pay was not the issue, they argued. Rather, the problem was that compensation had become unmoored from any significant measure of performance.⁶² Thus, if only corporate executives could be made to own substantial amounts of company stock, they would be incentivized to help American businesses remain profitable in the face of increased competition from Europe and Asia.⁶³

Important political support for pay for performance came in 1992, when Bill Clinton pledged to reform executive compensation as part of his first bid for the Presidency.⁶⁴ Consequently, soon after Clinton took office, Congress amended the tax code to penalize most executive compensation that was not tied to specific performance measures.⁶⁵ Meanwhile, until 2006, public companies were not required to record the value of most stock option grants on their income statements.⁶⁶ As a result, compensation in the form of options was given preferable accounting treatment in that such grants—no matter how large—had absolutely no impact on reported earnings.

This combination of developments led to an explosion in the use of stock options and other stock-based awards.⁶⁷ Eighty percent of American

61. See Jensen & Murphy, *supra* note 58, at 138; see also Elson, *supra* note 19, at 127–31 (extending this argument to corporate directors); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (arguing in favor of incentive-based compensation for corporate managers).

62. See Jensen & Murphy, *supra* note 58, at 139.

63. See *id.* at 141, 145, 149.

64. See, e.g., Jeffrey H. Birnbaum, *Campaign '92: From Quayle to Clinton, Politicians Are Pouncing on the Hot Issue of Top Executives' Hefty Salaries*, WALL ST. J., Jan. 15, 1992, at A14.

65. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993) (current version at I.R.C. § 162(m) (2000)) (imposing an excise tax on compensation paid to certain “covered employees” to the extent it exceeds \$1 million, other than “remuneration payable solely on account of the attainment of one or more performance goals” including stock options). It is also interesting to note that Congress had adopted a penalty tax for what it deemed to be excessive golden parachute payments less than a decade earlier. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (current version at I.R.C. §§ 280G, 4999 (2000)) (imposing a 20% excise tax on certain severance pay to the extent it exceeds three times the executive’s average taxable compensation). See also Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 147–49 (2006).

66. See generally Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123R, Share-Based Payment, Dec. 2004, available at <http://www.fasb.org/pdf/fas123r.pdf> (requiring that the fair value of stock options be recorded as an expense). Although FAS 123R was originally scheduled to go into effect in 2005, its application to most companies was later postponed by up to six months. See Floyd Norris, *Audit Board Delays Rule On Options As Expenses*, N.Y. TIMES, Oct. 14, 2004, at C1 (reporting that FASB had acted under pressure from the SEC).

67. Although stock options are the best-known form of incentive compensation, the same or similar financial impact can be created through grants of restricted stock, stock appreciation rights, phantom stock, and other awards. For convenience, however, I use the term “stock options” in this Article

senior executives now receive stock option grants, up from fifty percent in the 1960s and less than twenty percent in the 1950s.⁶⁸ More significantly, however, the size of option grants has increased at an even faster pace. During the 1990s, for example, the average value of management stock options rose at the rate of thirty-two percent, such that more than half of the value of executive compensation now takes the form of gains from stock options.⁶⁹ Thus, by turning managers into shareholders, stock options have partially reunited corporate ownership and control.

Perhaps the best exemplar of this trend is Steve Jobs, the CEO of Apple, who in recent years has limited himself to an annual salary of only one dollar.⁷⁰ With Jobs at the helm, Apple's stock tripled in value over three years, thereby handsomely rewarding its shareholders.⁷¹ As a result of stock-based awards, Jobs received \$650 million in incentive compensation in 2006—an amount sufficient to win him the honor of America's highest paid corporate executive.⁷²

Clearly, then, American pay practices have improved the underlying alignment of interests between managers and shareholders. Indeed, although it has recently stumbled, the United States economy has experienced a near-continuous bull market since moving to a pay-for-performance system in the early 1990s.⁷³ At first blush, then, business managers appear to have proved themselves well-suited to serving as the locus for corporate agency costs.

as a short-hand for all forms of stock-based compensation. For an overview of these forms of compensation, see generally DONALD P. DELVES, *STOCK OPTIONS & THE NEW RULES OF CORPORATE ACCOUNTABILITY: MEASURING, MANAGING, AND REWARDING EXECUTIVE PERFORMANCE* (2004).

68. Carola Frydman & Raven E. Saks, *Historical Trends in Executive Compensation 1936–2003*, at 20 (Nov. 15, 2005) (unpublished working paper, on file with the University of Chicago Graduate School of Business), available at <http://www.chicagogsb.edu/research/workshops/AppliedEcon/archive/WebArchive20052006/FrydmanSecondPaper.pdf>.

69. *Id.* at 18, 20; see also DELVES, *supra* note 67, at 7 figs.1 & 2; David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 661 (2005) (pointing out that, for any one given executive, an overwhelming proportion of her compensation is typically paid in the form of incentive-based awards).

70. See Jordan Robertson, *Apple CEO Takes \$1 Salary in 2007*, ASSOC. PRESS, Jan. 24, 2008, [http://www.thefreelibrary.com/Apple+CEO+takes+\\$1+salary+in+2007-a0161087462](http://www.thefreelibrary.com/Apple+CEO+takes+$1+salary+in+2007-a0161087462).

71. According to Apple's three-year financial history summary, shares of its common stock traded as high as \$155 in 2007, as compared to a peak of \$53.20 in 2005. APPLE INC., *THREE-YEAR FINANCIAL HISTORY*, http://media.corporate-ir.net/media_files/irol/10/107357/AAPL_3YR_Q407.pdf (last visited Oct. 27, 2008).

72. According to Apple's 2007 proxy statement, Jobs was granted ten million shares of restricted stock in March 2003. Apple Inc., *Proxy Statement (Form 14A)*, at 41 (April 16, 2007). All ten million vested in March 2006, netting Jobs a profit of close to \$650 million. See Scott Decarlo, *Big Paychecks*, FORBES, May 21, 2007, at 112. In 2007, Jobs exercised 120,000 stock options, valued by Apple at \$14.6 million. See Robertson, *supra* note 70.

73. Notably, growth in the United States during the period from 1992 to 2000 outpaced that experienced by Italy, France, Britain, Germany, and Japan. See William W. Bratton, *The Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557, 1576 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)).

The true impact of stock options on corporate America, however, has been both muted and perverse. In the first place, compensation packages are often structured in a way that provides little downside risk for managers who underperform. Thus, for example, when a company's stock price deteriorates significantly, it is common for the board to reset the strike price downward, thereby promising rich rewards for managers who simply return the company to its former level.⁷⁴ Likewise, news accounts are rife with stories of failed executives departing with epic paydays.⁷⁵ The current poster child for compensation reform, Robert Nardelli, recently left Home Depot with a \$210 million severance package, even though the company's stock actually dropped during his tenure as chief executive.⁷⁶ The extensive use of other forms of non-performance-based compensation, including retirement benefits and deferred compensation, further mute the impact of options by providing large guaranteed minimums.⁷⁷

Stock options, as presently structured, also sometimes fail to create strong incentives for high-quality performance. Because it is unusual for an option's strike price to be tied to market indices, for example, most options reward managers whenever the company's market sector improves even if the company in question lags its competitors.⁷⁸ There is also evidence that the size of most option grants is largely unrelated to any measure of past or future performance.⁷⁹ In practice then, and despite the best hopes of Jensen and Murphy, stock options appear unlikely to incentivize American executives to truly become "value-maximizing entrepreneurs."⁸⁰

74. See Mark Maremont & Charles Forelle, *Bosses' Pay: How Stock Options Became Part of the Problem*, WALL ST. J., Dec. 27, 2006, at A1.

75. See, e.g., David Carey, *Deliver and You Get Paid*, CORP. DEALMAKER, July–Aug. 2007, at 26, available at http://www.thedeal.com/corporatedealmaker/2007/08/deliver_and_you_get_paid.php (reporting that Carly Fiorina left Hewlett-Packard in disgrace with a \$180 million severance package while Hank McKinnell left a failing Pfizer with \$200 million). See generally Eric Dash, *Has the Exit Sign Ever Looked So Good?*, N.Y. TIMES, Apr. 8, 2007, § 3, at 6 (reporting that "the 35 chief executives who were ousted [in 2006] were handed more than \$799 million on their way out the door").

76. Stephen Taub, *Nardelli Resigns from Home Depot*, CFO.COM, Jan. 3, 2007, <http://www.cfo.com/article.cfm/8486274?f=search>.

77. See BEBCHUK & FRIED, *supra* note 8, at 95–99, 102–05 (describing the use of various non-incentive-based forms of compensation, including retirement programs and deferred compensation).

78. See *id.* at 139–42, 160.

79. See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* 46–47, 245 n.54 (2002). One almost poetic example of this phenomenon is former AT&T CEO Edward Whitacre. After his company's stock had fallen to 67% of its value, the incentive-based portion of his compensation was likewise reduced to 67% of its potential value. Though this might appear even-handed on its face, the result was that Whitacre received two-thirds of his incentive pay while stockholders lost one-third of their investment. See Alan Murray, *CEOs of the World, Unite? When Executive Pay Can Be Truly Excessive*, WALL ST. J., Apr. 26, 2006, at A2 (announcing the entrants to his "pay-for-nonperformance Hall of Shame"). The disconnect between performance and the level of option grants can also be seen in the common practice of "reloading"—automatically granting new options each time the manager exercises an existing option. See BEBCHUK & FRIED, *supra* note 8, at 169–70.

80. Jensen & Murphy, *supra* note 58, at 138.

Even worse, however, to the extent that stock options do create incentives, they are often perverse.⁸¹ For example, opportunities for fraud and accounting manipulation through the selective or timely disclosure of information abound.⁸² The most recent example of this phenomenon has been the almost universal backdating of option grants among Silicon Valley technology companies.⁸³ Meanwhile, vesting schedules accentuate management's near-religious focus on short-term success.⁸⁴ In fact, on one level, much of the blame for the fraud that occurred in the late 1990s at companies like Enron and WorldCom can be attributed to management's intense desire to maintain and enhance quarterly earnings.⁸⁵ Finally, as the Black-Scholes model of option pricing demonstrates, stock options are most valuable when a company's stock is most erratic.⁸⁶ Management is therefore potentially rewarded less for consistency in long-term earnings growth than for pursuing a boom-and-bust mentality.

Importantly, the underlying cause of these defects is no mystery—executive salaries are not negotiated at arm's length. A typical CEO's compensation is set by board members who are nominated and maintained in office by the CEO.⁸⁷ Meanwhile, the compensation consultants that most large companies use to justify executive salaries are themselves hired by the very executives whose salaries they review.⁸⁸ Management, in other

81. See, e.g., Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1930 (2001); Roger L. Martin, *Taking Stock*, HARV. BUS. REV., Jan. 2003, at 19, 19 (“Motivating managers with company stock can do damage on a grand scale, encouraging them to pursue strategies that fatten their wallets at shareholders’ expense.”); Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L.J. 1, 9 (2003) (“[S]tock option programs not only failed to meet their avowed goal of aligning managerial and shareholder interests, they created perverse incentives for abusing shareholders.”).

82. See, e.g., BEBCHUK & FRIED, *supra* note 8, at 174–83, 191; Bengt Holmström & Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?* 12–14, 16–17 (EUR. CORP. GOVERNANCE INST., Finance Working Paper No. 23/2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100.

83. See, e.g., M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1605–06 (2007) (noting that when a manager participates in backdating, “shareholders may be misled into believing that management’s interests are firmly aligned with theirs through the compensation package, when in fact executives can receive additional compensation without stock prices rising”). For a spectacular case of options backdating fraud, see Vanessa Fuhrmans & James Bandler, *Ex-CEO Forfeits \$620 Million in Options Cases*, WALL ST. J., Dec. 7, 2007, at A1, which describes what is believed to be the largest giveback ever in a shareholder derivative action.

84. See BEBCHUK & FRIED, *supra* note 8, at 148, 155–56.

85. See Walter M. Cadette, *How Stock Options Lead to Scandal*, N.Y. TIMES, July 12, 2002, at A19.

86. JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 107 (12th ed. 2001) (“Usually the most important factor in the valuation of options is the price volatility of the associated security. More specifically, the greater the possibility of extreme outcomes, the greater the value of the option to the holder, all other things being the same.”); see also Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 640–45 (1973) (first describing their formula for options pricing).

87. BEBCHUK & FRIED, *supra* note 8, at 23–27.

88. See *id.* at 37–39, 70–71; see also Gretchen Morgenson, *House Panel Finds Conflicts in Ex-*

words, negotiates its compensation package with individuals who are financially beholden to their largesse.⁸⁹

Nor is management's compensation subject to any significant outside review. Unlike in Britain, for example, shareholders do not regularly vote on management's compensation practices.⁹⁰ Indeed, until quite recently, substantial portions of an executive's pay were exempted from federal disclosure requirements, and the SEC remains quite concerned about the quality of compensation disclosures.⁹¹ Legal and practical barriers similarly make it unlikely that outside investors will find it cost effective to challenge management pay in a proxy contest.⁹² As a result, markets provide little in the way of discipline.⁹³

Prevailing compensation practices can thus be best understood as having been co-opted by management. As Lucian Bebchuk and Jesse Fried detail in their recent book, *Pay Without Performance*, the underlying problem is power.⁹⁴ Managers have exploited their control over the corporation's purse and day-to-day affairs to insulate themselves from outside influence and blunt any attempts to hold them accountable for poor performance.⁹⁵ Indeed, as William Bratton brings to light, there is surprising consensus among scholars of all political stripes on this point.⁹⁶ Though incentive-compensation schemes show promise, political realities are such that management has been able to subvert their impact. Rather than discip-

ective Pay Consulting, N.Y. TIMES, Dec. 6, 2007, at C1.

89. See BEBCHUK & FRIED, *supra* note 8, at 18–20 (framing their inquiry around the question: “What would characterize an executive compensation arrangement produced by arm’s-length bargaining between the executive and a board seeking to maximize shareholder value?”).

90. Rules promulgated in 2002 under the Companies Act, 1985, c. 6 (Eng.), engage shareholders in an annual vote on management compensation. The votes, however, are merely advisory in nature and thus do not bind the company so much as they serve as a means for shareholders to publicly express their outrage. As a result, the true impact of the rule remains to be seen. See generally Jesse Eisinger, “No Excessive Pay, We’re British,” WALL ST. J., Feb. 8, 2006, at C1.

91. See Executive Compensation and Related Party Disclosure, Exchange Act Release Nos. 33,8655, 34,53185, 71 Fed. Reg. 6542, 6543, 6545 (proposed Feb. 8, 2006). The prior disclosure rules had been adopted in 1992 in the wake of significant outcry regarding perceived excesses in executive compensation. See Martin, *supra* note 65, at 148–53; Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1069–72 (1999) (finding that, despite rule changes in 1992, shareholders who seek to reform executive compensation face significant structural hurdles). Indeed, the SEC remains concerned that disclosure of executive compensation is too opaque. See Kara Scannell & Joann S. Lublin, *SEC Unhappy with Answers on Executive Pay*, WALL ST. J., Jan. 29, 2008, at B1 (reporting that the SEC had sent letters to 350 companies critiquing the quality of their disclosures).

92. See BEBCHUK & FRIED, *supra* note 8, at 25–27. Indeed, one study found that mutual funds generally oppose shareholder attempts to limit executive pay. Jennifer Levitz, *Do Mutual Funds Back CEO Pay?*, WALL ST. J., Mar. 28, 2006, at C1 (reporting on the results of a study sponsored by AFSCME and the Corporate Library).

93. See BEBCHUK & FRIED, *supra* note 8, at 53–58 (arguing that market constraints only work against larger, higher-profile wealth transfers).

94. See *id.* at 61–117 (discussing the “managerial power perspective” and how that power is often abused).

95. *Id.* at 80–86.

96. See Bratton, *supra* note 73, at 1560–61, 1583.

line underperforming managers, options in fact reward all managers and encourage them to manipulate their financial results. Moreover, as a final insult, they create a veneer of justification, camouflaging the truth with a narrative of hard-working executives who earn—and thus deserve—their outsized pay.⁹⁷

In terms of which party can most efficiently bear the inevitable agency costs, it thus appears that corporate managers are ill-suited to play the role. As foretold by Berle and Means, managerial interests remain distinct from, and in many instances opposed to, the interests of shareholders.⁹⁸ As a result, corporate agency costs flourish, and an outside monitor appears necessary.

B. Fixed Fees and Empire-Building

As is the case with corporate managers, the compensation structure of institutional investors makes them ill-suited to serve as the final bearer of agency costs. Paradoxically, however, the problems associated with institutional investor compensation are the inverse of those currently associated with corporate pay. On the positive side, public equity fund managers are less able to manipulate the structure of their fees. Also, mutual funds and pension funds are mostly free from significant conflicts of interest. On the negative side, because they are generally prohibited from charging fees based on the quality of their performance, the interests of public equity fund managers are poorly aligned with those of their investors. As a result, the managers of public equity funds, like the managers of corporations, appear ill-suited to play the role of the final bearer of agency costs.⁹⁹

97. See BEBCHUK & FRIED, *supra* note 8, at 145 (asserting that executive compensation is structured to minimize the influence of “outrage costs”—expressions of disapproval by influential outsiders—by means of camouflaging its true impact).

98. See Bratton, *supra* note 73, at 1558 (noting that, according to Bebchuk and Fried, “current executive compensation practice demonstrates that the separation of ownership and control identified by Berle and Means more than seven decades ago still hobbles shareholder capitalism”) (footnote omitted).

99. Admittedly, the subject of fund manager incentives is made more complicated by the fact that the senior-most managers of most public equity funds effectively delegate many investment decisions to sub-managers, both inside and outside of the organization. See Rock, *supra* note 27, at 464–78 (examining the agency costs associated with intermediaries and questioning whether sub-agents’ interests are aligned with their principals’ interests). Thus, the incentives of these sub-managers may differ at times from those of the managers ultimately charged with a fund’s administration. Indeed, skeptics like Romano and Bainbridge point to the presence of agency costs within institutional investors as a reason not to trust them with greater authority. See, e.g., Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) (describing the conflicts of interest that arise within public pension funds due to the divergence of interests between the fund advisers and investors); Stephen M. Bainbridge, *Pension Funds Play Politics*, TCS DAILY, Apr. 21, 2004, <http://www.tcsdaily.com/article.aspx?id=042104G> (noting that the managers of public pension funds have political goals that sometimes differ from the financial goals of their investors).

For purposes of the present analysis, however, it remains the ultimate fund advisers whose incentives are most relevant. This is because, whatever the incentives of the senior-most decision

At the outset, we should acknowledge that not all institutional investors have the potential to act as corporate disciplinarians. Banks and insurance companies, for example, are generally considered too closely tied to corporate America to take a strong position against any one company's management.¹⁰⁰ Doing so might tarnish them with an anti-management reputation and jeopardize their ability to attract lucrative contracts for consulting, risk management, and other services. The picture is similar for private pension funds which are almost universally controlled by their corporate sponsors.¹⁰¹ Thus, significant conflicts of interest make banks, insurance companies, and private pension funds poor candidates as corporate monitors. Meanwhile, most university endowments and other institutional players remain too small to have a major impact on corporate governance.¹⁰²

Mutual funds and public pension funds, however, do not suffer from the same level of conflicts that afflict most other institutional investors. Certainly, public pension fund managers periodically display a tendency toward making investment decisions aimed at achieving political, rather than purely financial, goals; as a result, mutual funds, as sponsors of corporate 401(k) plans, are never entirely free from the influence of Wall Street.¹⁰³ As a general matter, however, most public equity funds are professional enough to remain above politics and relatively few rely exclusively on the largesse of corporate America for their continued viability. Instead, much like public corporations, they ultimately answer to a dis-

makers, they will presumably instruct (and compensate) their sub-managers accordingly. In other words, if the interests of the senior-most advisers are not closely aligned to those of shareholders, there is no reason to believe that the sub-managers' incentives will be any better. The converse is also true: if the senior-most managers stand to profit handsomely by pursuing shareholder interests, they will have a strong incentive to appropriately discipline their own sub-managers.

100. See Black, *supra* note 17, at 600–01 (noting that a bank will not “want to develop a reputation for casting antimanager votes, lest it lose current or prospective banking clients”); see also Roe, *supra* note 30, at 17–18, 22–23 (describing regulatory impediments to activism on the part of banks and insurance companies); cf. Bainbridge, *supra* note 7, at 725 (noting that “corporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors”).

101. See Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 77 (1993) (“Few managers want their pension more active in the corporate governance of other companies than they would want their own stockholders to be active in their firm.”); see also Coffee, *supra* note 35, at 857–62 (comparing the corporate governance potential of public and private pension funds).

102. Though many university endowments have attained considerable size in recent years, most of the growth has been concentrated among the very top schools. Thus, while the endowments at Harvard and Yale have grown to as much as \$35 billion and \$23 billion, respectively, only four other universities have ever attained assets in excess of \$10 billion. Karen W. Arenson, *Senate Looking at Endowments as Tuition Rises*, N.Y. TIMES, Jan. 25, 2008, at A1; see also *The Ivory Trade; University Endowments*, ECONOMIST, Jan. 20, 2007, at 82 (arguing that university endowments represent “extremely patient” capital that consistently outperforms most other players on Wall Street).

103. See, e.g., Romano, *supra* note 99, at 796 (arguing that “public pension funds face distinctive investment conflicts that limit the benefits of their activism”).

persed group of retail investors, none of whom exercises any meaningful degree of control.¹⁰⁴

As a result of relatively transparent markets, public equity funds also avoid many of the internal conflicts of interest that are present in most public corporations. As heavily regulated entities, they are subject to multiple, overlapping statutory schemes which impose, among other things, detailed registration and disclosure obligations.¹⁰⁵ Competition over rates therefore takes place in public, with widely available services such as Morningstar providing detailed fee comparisons.¹⁰⁶ Thus, if a particular fund were to announce fees significantly in excess of the market norm, it would risk losing investors.¹⁰⁷ In fact, there is evidence that market forces are functioning appropriately in this arena: total mutual fund fees have dropped by over fifty percent during the past two decades.¹⁰⁸ In this respect, at least, the structure of public equity fund compensation may be superior to that of corporations.

As an additional protection against abuse, public equity fund managers face considerable legal constraints on their freedom of action. Pension fund managers, for example, must comply with broadly interpreted fiduciary duties.¹⁰⁹ Similarly, although the SEC chose not to require that mutual fund fees be “reasonable,” as was once proposed, it did impose a fiduciary standard on fund managers when establishing their fees.¹¹⁰ Thus,

104. See Coffee, *supra* note 35, at 858 (“As a class, public pension funds are pressure resistant, because they have few (if any) conflicts of interest.”).

105. These include, among others, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Employee Retirement Income Security Act (“ERISA”). See MUTUAL FUND REGULATION §§ 1:4.1, at 1-13, 1:4.2, at 1-13 to -16 (Clifford E. Kirsch ed., 2d ed. 2007) (describing the federal securities law registration and disclosure requirements for mutual funds); Peter O. Shinevar, W. Fulton Broemer & Jayne Zanglein, *Reporting and Disclosure*, in 1 ERISA BASICS D-1 to -57 (2000) (outlining the reporting and disclosure requirements imposed on pension funds by ERISA).

106. According to its website, Morningstar was founded in 1984 “to provide individual investors with much-needed mutual fund analysis and commentary.” See Morningstar, <http://corporate.morningstar.com/US/asp/subject.aspx?xmlfile=180.xml> (last visited Oct. 27, 2008). Its first main product, the Mutual Fund Sourcebook, was published quarterly and contained “performance data, portfolio holdings, and other information on approximately 400 mutual funds.” *Id.* Today, most of its reporting activities are centered around the Internet.

107. John C. Coates IV & R. Glenn Hubbard, *Competition and Shareholder Fees in the Mutual Fund Industry: Evidence and Implications for Policy*, at i (AM. ENTER. INST. FOR PUB. POLICY RESEARCH, AEI Working Paper #127, 2006), available at <http://www.law.uchicago.edu/Lawecon/workshop-papers/coates.pdf> (“We estimate that, on average, a 10 percent increase in equity fund fees leads to an approximately 25 percent decline in a fund’s asset share and a 15 to 18 percent decline in a complex’s share of total assets managed by mutual funds.”).

108. See INVESTMENT COMPANY FACT BOOK, *supra* note 23, at 47 (reporting that total fees—including ongoing expenses plus an annualized portion of any sales loads—declined from an average of 2.3% of fund assets in 1980 to only 1.1% of fund assets in 2006).

109. See, e.g., Reich v. Valley Nat’l Bank of Ariz., 837 F. Supp. 1259, 1273 (S.D.N.Y. 1993) (noting that the fiduciary standards applying to pension fund managers are among “the highest known to law” (quoting *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982))).

110. See generally 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS* § 12.03[D], at 12-76 to -97 (2d ed. 2001 & Supp. 2002)

at least with respect to compensation, the decisions of public equity fund managers appear to be subject to a more demanding standard of review than are those of corporate managers.

Despite its apparent promise, however, public equity fund governance suffers from a potentially fatal flaw. Legal regulations effectively prohibit the managers of mutual funds and pension funds from charging most forms of incentive-based compensation.¹¹¹ In practice, this means that public equity fund managers generally charge fees based on a fixed percentage of the value of the assets they manage.¹¹² Like corporate managers of yore, size alone is what determines one's level of compensation.

With respect to mutual funds, § 205(a)(1) of the Investment Advisers Act of 1940 prohibits a registered investment adviser from receiving compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."¹¹³ Broadly

(explaining that the fiduciary duty standard is one of common law reasonableness).

111. The purpose of this limitation is to minimize incentives for fund managers to take overly speculative risks with the savings of retail investors. *See id.* § 12.03[A], at 12-59. Interestingly, however, performance fees were once common among advisers to institutional investors. SEC. & EXCH. COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SEC. & EXCH. COMM'N, H.R. DOC. NO. 92-64, pt. 2, at 254-56 (1971). It was not until 1970 that Congress applied the Investment Advisers Act to advisers of mutual funds. 2 FRANKEL & SCHWING, *supra* note 110, § 12.03[F], at 12-106.3 to -109.

112. Mutual funds generally charge their shareholders two types of fees. *See* 2 FRANKEL & SCHWING, *supra* note 110, § 12.03[A], at 12-58 to -61 (discussing the development of "wrap fee" arrangements and other advisory fees). Sales loads are a type of brokerage fee intended to compensate financial advisers for a particular transaction. INVESTMENT COMPANY FACT BOOK, *supra* note 23, at 22, 47. They are paid either at the time of purchase (front loads) or occasionally when the shares are redeemed (back loads). However, as more and more investors have purchased mutual funds through employer-sponsored savings plans, sales loads have decreased in frequency and amount. Hence, their significance has generally waned. *See id.* at 48 (finding the growth of no-load funds and increased competition in the mutual fund industry as additional causes of the decline in the use of sales loads). More common are fees for ongoing expenses. These are paid from fund assets, rather than directly by the shareholders, and tend to decrease as the fund achieves economies of scale. *Id.* at 47-48, 52. Fees for ongoing expenses typically include an advisory fee, an administrative fee, and so-called 12b-1 fees designed to offset the costs of marketing and distribution of fund shares. *See generally* John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685, 693-96 (2007) (describing the evolution of Rule 12b-1); James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907 (2005) (providing a recent analysis of mutual fund fees).

Pension fund managers are generally limited to fees for ongoing expenses. This is because transaction fees of the kind charged by mutual funds would likely violate ERISA's strict prohibition against related-party transactions. *See* Donald J. Myers & Michael B. Richman, *Class Exemptions from Prohibited Transactions*, in ERISA FIDUCIARY LAW 267, 267-68, 283-94 (Susan P. Serota ed., 1995). Thus, like mutual fund managers, most pension fund managers receive a salary or other compensation based on a percentage of the assets under management. *See* Coffee, *supra* note 35, at 862-66 (discussing the compensation of external fund managers); John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 627-32 (2001) (finding that mutual fund managers receive fees double the amount of those received by pension fund managers).

113. 15 U.S.C. § 80b-5(a)(1) (2006). Note, however, that fees based on a percentage of the assets under management are not deemed to be "on the basis of a share of . . . capital appreciation," even though the fees would necessarily increase as the account appreciates. CLIFFORD E. KIRSCH, INVESTMENT ADVISER REGULATION § 9:4.3[A], at 9-16 (2d ed. 2008).

speaking, this means that a manager of a mutual fund may not charge a fee based on the fund's performance.¹¹⁴ Also prohibited are contingency fees.¹¹⁵

On the pension fund side, although ERISA does not specifically prohibit performance fees, the Department of Labor has interpreted the Act as banning most incentive compensation arrangements that do not meet each of eight specified criteria.¹¹⁶ Most importantly for alignment of interests purposes, fund manager compensation must be based on the net appreciation of plan assets during a pre-established valuation period.¹¹⁷ In other

114. There are two exceptions to the general rule. The first is for funds that limit their membership to "qualified clients." 17 C.F.R. § 275.205-3(a) (2007). This rule was amended in 1998 to remove several additional requirements for advisers to qualified clients, including the requirement that the advisory contract be negotiated at arm's length, and to increase the dollar thresholds. KIRSCH, *supra* note 113, § 9:4.3[C], at 9-19 to -20. These include individuals and companies (not including other mutual funds) with a net worth in excess of \$1.5 million or at least \$750,000 under the management of the investment adviser. 17 C.F.R. § 275.205-3(d)(1)(i)-(ii)(A). It also includes individuals and entities that qualify as "qualified purchasers" under the Investment Company Act, 15 U.S.C. § 80a-2(a)(51)(A) (2006), as well as individuals who are officers or directors of the mutual fund. 17 C.F.R. § 275.205-3(d)(1)(ii)(B), (d)(1)(iii)(A). For purposes of this exception, each investor in a mutual fund would need to satisfy the wealth requirements in order for the manager to charge a performance fee. 17 C.F.R. § 275.205-3(b).

The second exception is for so-called "fulcrum fee" arrangements, which permit the manager of a mutual fund to adjust the base advisory fee depending on how the fund performs relative to a stipulated market index. 15 U.S.C. § 80b-5(b)(2) (2006). This exception was created in 1970, at the same time that the general prohibition against incentive compensation was extended to mutual fund advisers. See SEC STAFF REPORT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 238 (1992). The key to structuring a fulcrum fee is that the percentage charged cannot merely increase when performance exceeds expectations. It must also decrease proportionately when performance lags. KIRSCH, *supra* note 113, § 9:4.3[B], at 9-16 to -17.

The presence of these exceptions, however, has had relatively little impact on the incentives of public equity funds. In the first place, in order to qualify for the wealth exception, a mutual fund would have to refuse subscriptions from all but highly wealthy investors. Given that the primary purpose (and value) of most mutual funds is to aggregate retail dollars, this prospect appears neither practical nor desirable. In the second place, the SEC has promulgated extensive regulations regarding when fulcrum fees may be considered fair. See generally KIRSCH, *supra* note 113, § 12.03[F][5], at 12-118 to -122 (expanding upon the factors the SEC considers to determine the fairness of fulcrum fees, including the fairness of the fee, the index used to determine performance for the fee, and the time period over which such performance is calculated). As a result, their use has been significantly limited. See Eisinger, *supra* note 90, at C1 (reporting that, as of 2005, only 3% of mutual funds charged a performance fee and that such funds accounted for less than 8% of all mutual fund assets); see also Carole Gould, *Mutual Funds; Using Fees as Rewards, or Penalties*, N.Y. TIMES, Oct. 24, 1993, § 3, at 14 (showing that only 59 of 3,682 mutual funds had fees contingent on performance).

115. Contingent Advisory Compensation Arrangements, 45 Fed. Reg. 34,876 (May 23, 1980) (interpreting the Investment Advisers Act as not allowing managers to collect commissions); see also Trainer, Wortham & Co., Frole, Revy Inv. Co., Starbuck, Tisdale & Assoc., SEC No-Action Letter, 2004 WL 3127379, at *3 (Dec. 6, 2004). Note, however, that § 205(a)(1) does not prohibit fees based on other measures of performance. KIRSCH, *supra* note 113, § 9:4, at 9-6.

116. Alliance Capital Mgmt. L.P., Dep't of Labor Op. 89-31A, 1989 WL 224560, at *6 (Oct. 11, 1989); BDN Advisers Inc., Dep't of Labor Op. 86-20A, 1986 WL 38857, at *4 (Aug. 29, 1986); Batterymarch Fin. Management, Dep't of Labor Op. 86-21A, 1986 WL 38858, at *4 (Aug. 29, 1986).

117. See KIRSCH, *supra* note 113, § 9:5, at 9-21 to -22 (listing the other criteria set forth by the Department of Labor as: (1) the plan assets must be large; (2) investment should be in securities with available market quotations; (3) when market quotations for securities are not available, valuation must be done by a third party; (4) arrangement must comply with Advisers Act Rule 205-3; (5) a sophisti-

words, pension fund managers, like mutual fund managers, are generally prohibited from charging performance-based compensation.

What these legal limitations mean for public equity funds is that their incentives parallel those of corporate managers prior to the rise of stock options in the early 1990s. Though their compensation is insulated from easy manipulation by insiders, they have little incentive to fervently pursue excellence on behalf of their investors. Whether or not they outperform their competitors, their compensation remains essentially fixed. As a result, the only way to earn a larger fee is to manage a larger pool of assets.¹¹⁸ Thus, a public equity fund manager's sole direct financial incentive is to grow the amount of assets under management.

Investors, however, appear generally indifferent to fund size. Their goal is profit maximization. Thus, from an alignment of interests standpoint, the real question is whether, in pursuing fund growth, public equity fund managers are simultaneously serving other shareholder interests. In fact, this would be the case only if increasing profits were the exclusive or most direct route to increasing fund size. Otherwise, the interests of public equity fund managers and their shareholders would diverge, causing agency costs to swell.

Unfortunately, although capital appreciation can lead to fund growth,¹¹⁹ fund assets can just as easily be increased through means that are of no benefit to shareholders. In fact, the surest method for increasing the size of a fund may be through advertising, and not through improved performance. By marketing a fund's perceived reputation for integrity, a particular investment strategy, or some other unusual or defining characteristic, its managers can attract new investors, or additional capital contributions from existing investors, without actually increasing the fund's profits.¹²⁰ Advertising, in other words, can serve as an effective substitute for competence and diligence.¹²¹ Moreover, from an advertising perspec-

cated fiduciary must approve the compensation agreement; (6) the agreement must be reasonable; and (7) compensation payments must be predetermined).

118. Due to the cost efficiencies that come with scale economies, however, the size of the percentage often decreases as the size of the fund increases. Coffee, *supra* note 27, at 1363 n.336. Thus, for example, a fund might charge "1/3 of 1% of the first \$500 million, 1/4 of 1% of the next \$250 million, etc." *Id.* at 1326.

119. This assumes that profits are re-invested in the fund rather than distributed as a dividend or other distribution. See Erik R. Sirri & Peter Tufano, *Competition and Change in the Mutual Fund Industry*, in FINANCIAL SERVICES: PERSPECTIVES AND CHALLENGES 181, 182 (Samuel L. Hayes III ed., 1993).

120. Alan Rosenblat & Martin E. Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. PA. L. REV. 587, 594 (1976).

121. TD Waterhouse, for example, which recently merged with Ameritrade, has used several actors from the TV drama *Law & Order* as spokesmen in order to sell a reputation for fair and honest dealing. The first, Steven Hill, played the role of Manhattan District Attorney. More recently, Sam Waterston, who portrayed the DA's chief prosecutor, has taken over the role. See Jen Chung, *Sam Waterston TV Commercial*, GOTHAMIST, Nov. 18, 2003, <http://gothamist.com/2003/11/18/>

tive, so long as a fund's results are roughly equivalent to those of its competitors, performance ceases to be a distinguishing characteristic.¹²² In fact, there is empirical evidence to suggest that the volume of investments in mutual funds is largely unrelated to their level of performance.¹²³ At least on a macro level, then, the ultimate goal of increasing shareholder profits may matter to public equity fund managers only indirectly, as fodder for further publicity.¹²⁴

What this analysis suggests is that public equity fund managers are, like the managers of corporations, ill-suited to serve as the ultimate bearer of agency costs. In the absence of performance-based compensation, the interests of public equity fund managers tend to drift away from those of their investors. Agency costs proliferate because fund managers are not rewarded for pursuing investor profits. Rather, much like the corporate managers of the 1970s, their true financial incentive is to engage in empire-building. What is needed, then, is a compensation scheme that more accurately aligns the interests of managers and investors.

C. Incentive Compensation and the Magic of the "Carried Interest"

The compensation structure utilized by most hedge funds and other private equity funds is superior to those of corporations, mutual funds, and public pension funds. In contrast to public equity fund managers, the managers of private equity funds are compensated almost exclusively on the basis of their performance. Meanwhile, in contrast to corporate managers, their compensation is determined by unrelated third parties through the mechanism of a market for investment dollars. As a result, agency costs are reduced while opportunities for abuse are muted. In fact, the stated goal of private equity fund governance is to align the interests of fund managers with those of their investors.¹²⁵

sam_waterston_tv_commercial.php.

122. See Sirri & Tufano, *supra* note 119, at 190-98 (identifying new products, distribution methods, and low fees as alternative differentiation strategies); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1620 (1998) (finding that consumer reaction to fund performance is stronger for funds that spend more on marketing).

123. Sirri & Tufano, *supra* note 119, at 190. The one main exception to this observation is for the best performing funds, exactly the ones most likely to attract capital from investors who closely track the data. See *id.* (noting that consumers tend to react to very high performance but not very low performance).

124. Indeed, a fund's profits can be used to signal the quality of its managers and thus retain current investors or attract new ones. Thus, for example, several empirical studies suggest that mutual funds increase their advertising following a year with strong performance. See Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 938-39 (2000) (finding that funds that advertise generally perform better than those that do not advertise).

125. See SCHELL, *supra* note 12, § 1.03[3], at 1-14 ("The concept of alignment of interest can provide an important element of consistency to the consideration of the numerous financial and other terms embedded in the contracts governing the organization and operation of a private equity fund. It

The centerpiece of private equity fund compensation is the so-called “carried interest.”¹²⁶ The term is industry shorthand for a scheme whereby any profits are split between fund investors and fund managers, typically at the ratio of eighty/twenty.¹²⁷ Thus, once the fund investors have been allocated the entirety of their initial contribution, such that any remaining monies constitute pure profit, all future allocations are made at the rate of eighty percent for the investors and twenty percent for the managers.¹²⁸

In practice, this means that if a fund manager fails to generate investment profits during any given time period, she is not paid for her (failed) efforts.¹²⁹ If, on the other hand, the manager’s investment strategy generates significant returns, she will be rewarded handsomely with a large share of the profits.¹³⁰ The manager’s incentives, as a result, are focused entirely on increasing the value of the fund’s investment portfolio. Moreover, because the manager’s ability to share in the profits never dissipates, no matter how successful the fund, neither do the incentives.¹³¹ Thus, to

can also provide a basis for identifying economic and other terms that, even if widely accepted as ‘market,’ should be resisted when possible.”); PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 7 (“Private equity finance derives its strength from an organizational characteristic that sets it apart from most other types of finance: It is structured so that the entrepreneurs, the investment managers, and the providers of capital all benefit in very material ways from the success of the businesses receiving financing. This alignment of interest ensures, at least in theory, that all decisions are made in a way that is likely to maximize the success of the business being financed.”).

126. This is sometimes also referred to as a “promote,” “promoted interest,” or “override.” SCHELL, *supra* note 12, § 2.02, at 2-6. For a general discussion of the carried interest, see MERCER REPORT, *supra* note 12, at 4, 16-18.

127. Increasingly, some funds also vary the percentage payable to the fund advisers depending on the fund’s performance. For example, a firm might charge a 20% carried interest if the internal rate of return is below 20%, but a 25% carried interest if performance exceeds the 20% level. PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 39.

128. See SCHELL, *supra* note 12, § 2.02[1], at 2-6 to -9. In fact, the actual percentage may, in many cases, be far higher, as it is industry practice for the fund managers to invest a portion of their own net worth in the funds they manage. *Id.* § 3.02[2], at 3-21 to -23. Thus, not only are they likely to receive their 20% share of the profits, but they are also likely to receive an additional 80% share with respect to any capital they invested.

129. Occasionally, this structure leads to complicated timing questions, especially in venture capital funds where an early investment might pay off quickly while others die a slower death. The result is that fund managers and investors have developed a complicated set of provisions—including so-called “clawbacks”—that ensure that the economics of the fund balance correctly over its life, even if one party or another is inadvertently paid too much at one time or another. See SCHELL, *supra* note 12, § 2.04, at 2-21 to -27. Thus, private equity fund managers who oversee a loss are typically not rewarded for returning the fund to its prior level, as are corporate managers whose options are re-priced. See *supra* note 74 and accompanying text. Rather, they only receive a carried interest to the extent profits exceed prior benchmarks. See MERCER REPORT, *supra* note 12, at 31.

130. These incentives can be quite large in practice. Witness the incredible pay packages for the top hedge fund managers. See Stephen Taub, *The Top 25 Moneymakers: The New Tycoons*, ALPHA, Apr. 2007, at 39, 41-42 (reporting that the top twenty-five hedge fund managers each earned over \$240 million in 2006).

131. This is partly a function of the fact that for most funds, once a certain level of profit has been achieved, the managers are not entitled to any additional incentive fees until (and unless) the fund’s performance exceeds this new “high water mark,” at which point the standard is again adjusted upward. For a mathematical example of how such fees are calculated, see Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 347-48 (2007).

the extent a fund's investors also seek capital appreciation, their interests will be aligned and agency costs will abate. Indirect proof that this structure is working can be found in the fact that highly sophisticated investors—who could easily choose to entrust their monies elsewhere—have poured over \$1.8 trillion into private equity markets during the past decade.¹³²

The structure of private equity fund compensation, in addition to aligning the interests of fund managers and their investors, also reduces opportunities for manipulation and abuse.¹³³ This is because, unlike corporate managers, private equity fund managers have their fees set by outside investors as part of a comparatively well-functioning market.¹³⁴ The market, however, arises not because of federal disclosure obligations or frequent trading in the securities of any one fund, but because private equity fund managers compete to raise money from many of the same investors as other fund managers. As a result, the individuals who review any given fund's fees in anticipation of making an investment are well aware of what other funds are charging. Moreover, their awareness is heightened because the recurring and illiquid nature of private equity fund investing means that the managers must continually raise money to replenish their coffers.¹³⁵ Consequently, fund managers cannot charge significantly off-market terms without running the risk that they will fail to raise sufficient capital. Indeed, the take-it-or-leave-it nature of most fund offerings is such

132. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 30–34. Because private equity funds have a finite term, after which they are wound up and liquidated, it is difficult to measure the total assets under management at any given time. Thus, because the term of most funds is ten years or less, the best gauge of the industry's size may be the amount of funds raised over a rolling ten-year period.

133. That being said, as with any commercial endeavor, there is always the potential for outright fraud in clear violation of legal dictates. The most prominent example of this may have occurred when the principals of Bayou Group disappeared in 2005 with approximately \$300 million of their investors' funds. See Ian McDonald, *Bayou Drained Accounts in '04 of \$161 Million*, WALL ST. J., Sept. 1, 2005, at C1 (tracing Bayou's transfers of funds to and among banks around the world); Ian McDonald, John R. Emshwiller & Ianthe Jeanne Dugan, *Bayou Transfers Set off Alarms*, WALL ST. J., Sept. 12, 2005, at C1 (explaining that the fraud scheme operated by tricking low-level bank employees into accepting funds by confusing them with technical financial language); Gretchen Morgenson, *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1 (detailing the unraveling of fraud).

134. See SCHELL, *supra* note 12, § 1.02, at 1-9 (noting that the relationship between investors and fund managers in private equity funds is characterized by voluntary agreement, rather than dictated by regulation, and so is the result of negotiations that take place within a market for pooled investments). For a discussion of the exemptions utilized by private equity funds to avoid most securities law disclosure requirements, see Illig, *supra* note 2, at 277–78.

135. See PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 23 (2d ed. 2004) (describing the impact of the fact that most private equity funds are “self-liquidating”); THOMAS MEYER & PIERRE-YVES MATHONET, *BEYOND THE J-CURVE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS* 24 (2005) (“To maintain continuous investment in portfolio companies, general partners need to raise new funds as soon as the capital from the existing partnership is fully invested, i.e. about once every 3–5 years.”).

that managers frequently find themselves negotiating against themselves when preparing proposed deal terms.¹³⁶

The true magic of the carried interest, however, lies not only in its ability to align the interests of fund managers with the interests of their investors, but also in the fact that it is solely a creation of the market. There is no legal regulation or other outside influence that requires or rewards the scheme described above, as there are with public equity fund fees and corporate stock options. Rather, the scheme developed over time as a result of repeated—and unregulated—arm’s-length negotiations between fund managers and prospective investors. As a result, it continues to evolve as markets and circumstances change.

This basic scheme is not without flaws, however. In particular, three aspects of private equity fund compensation have the potential to detract from the overarching alignment of interests. Because the funds operate within a more or less transparent market, however—at least with respect to their fee structures—the flaws tend to prove the model’s success, rather than underscore its failings. Thus, two of the more obvious defects have been largely eliminated by market forces, thereby further refining the overall elegance of the structure, while the third is not inherent to the model but rather an outgrowth of its success.

The first of these potential shortcomings has to do with the downside risk associated with an underperforming fund. For a manager who is paid only in the presence of a profit, a large loss is the same as a small one.¹³⁷ Thus, the concern is that a straight carried interest could encourage excessive risk-taking whenever a fund’s activities are yielding a loss. Indeed, as losses accrue, the risk increases that a fund manager would engage in unwarranted speculation in the hope that the fund could be returned to profitability.¹³⁸ Thus, the manager of a losing fund may find her interests diverging from those of her investors.

To address this possibility, fund managers have typically been required to invest a significant portion of their personal wealth in their funds alongside other investors.¹³⁹ Eddie Lampert, for example, the lead principal of ESL Investments, personally contributed almost half of the \$11.5 billion that ESL currently has under management.¹⁴⁰ Although this began

136. See MERCER REPORT, *supra* note 12, at 82 (“The basic premise underlying our [study] was that general partners will attempt to negotiate terms and conditions that the market will bear.”).

137. See SCHELL, *supra* note 12, § 3.02[2], at 3-21 to -23.

138. See *id.*

139. See, e.g., PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 23 (reporting that the mean contribution by general partners in the survey was 3.25% for buyout funds and 2.1% for venture capital funds); MERCER REPORT, *supra* note 12, at 12-14. For a \$1 billion fund, this means an investment by the managers of around \$30 million. Note however, that under current law such an investment by a public equity fund manager would probably violate the prohibition against self-dealing. See 29 U.S.C. § 1106(b)(1) (2000).

140. Gretchen Morgenson, *Saving Sears Doesn't Look Easy Anymore*, N.Y. TIMES, Jan. 27, 2008,

as a way to finesse a quirk in early partnership statutes, it has developed into a means for penalizing fund managers who gamble with their investors' dollars.¹⁴¹ In a similar development, venture capital fund managers frequently co-invest in portfolio companies alongside their fund.¹⁴² Thus, the typical private equity compensation structure already accounts for the downside risk of overspeculation by giving the managers something to lose.¹⁴³ The fund managers are themselves investors with their own capital at risk.

The second defect inherent in the basic carried interest involves the potential for fund managers to benefit from general market movements. To the extent a particular market sector is hot, it is often the case that even the weakest players in that sector will see their share prices increase.¹⁴⁴ Thus, a fund manager who invests in such companies will be rewarded less for the quality of her performance than as a result of fortune's grace. Why, then, should an investor forfeit twenty percent of his profits for an otherwise unremarkable effort?

Private equity fund compensation provides two answers to this prospective risk. First, hedge fund managers generally seek to achieve high *absolute* returns (on a risk-adjusted basis), rather than relative returns.¹⁴⁵ Their goal is therefore not to outperform any particular market index or other stated benchmark, but to achieve positive results regardless of the business environment.¹⁴⁶ For governance purposes, this means that the compensation of hedge fund managers has less correlation to general market movements than would be the case if they sought merely to beat the market. Second, many of the best private equity fund managers charge a carried interest only to the extent that fund profits exceed a so-called "hurdle rate" or "priority return."¹⁴⁷ Although there is a great deal of variation in how such hurdles are defined, they are frequently tied to bond market indices, such as the London Interbank Offered Rate or the yield on twelve-month treasury bills, or to other appropriate financial benchmarks

§ 3, at 1.

141. See SCHELL, *supra* note 12, § 3.02[2], at 3-21 to -23.

142. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 24-25 (reporting that 30% of buyout fund general partners and almost 16% of venture capital fund general partners retain the option of co-investing).

143. See SCHELL, *supra* note 12, § 3.02[2], at 3-21 to -23.

144. See BEBCHUK & FRIED, *supra* note 8, at 139, 143.

145. SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 1.3, at 1-17 to -20 (2007).

146. See DAVID EINHORN, FOOLING SOME OF THE PEOPLE ALL OF THE TIME: A LONG SHORT STORY 17-18 (2008).

147. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 41-42 (reporting that 88.2% of buyout funds and 42.3% of venture capital funds in the survey provided for the payment of priority returns before the advisers earned their carried interest); see also MERCER REPORT, *supra* note 12, at 31-32. *But see* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 82-86 (2005) (noting that venture capital funds, unlike leveraged buyout funds, typically do not calculate fund manager compensation by reference to a preferred return).

or market segments.¹⁴⁸ In such cases, the fund managers receive their carried interest only to the extent they are able to produce profits that exceed such a pre-determined minimum level of performance. As a result, the portion of the fund's success that is attributable to the underlying health of the economy or other factors beyond the managers' control is factored out of the equation.¹⁴⁹ Properly constructed to include hurdle rates, the carried interest therefore rewards only true performance.

Paradoxically, however, the third and most significant defect with the incentive-based nature of private equity fund compensation relates to the fact that the scheme appears to be working too well. As a result of soaring demand for such investments, there is evidence that bargaining power may be shifting away from fund investors. In particular, the recent influx of money from sovereign wealth funds seems to be tipping the balance in favor of fund managers.¹⁵⁰ As could be expected, fund managers appear to be trying to translate this newfound negotiating power into greater protection from downside risk, thereby increasing agency costs.

The most obvious manifestation of this development has been a steady increase in the level of management fees.¹⁵¹ Historically, to offset high

148. See SCHELL, *supra* note 12, § 2.03[2], at 2-17 to -18. For example, many funds use a market index, such as the S&P 500, or simply a fixed rate of return in the range of 6% to 8%. See *id.*

149. Thus, for example, if a \$10 million fund generated \$5 million in profits during its first year, and if the hurdle rate were set at 5%, the first \$10 million would be allocated to the investors as repayment of their initial capital, as would a return of 5% of their \$10 million investment (or \$500,000). The remaining \$4.5 million—which is attributable to the effort and skill of the fund managers—would then be split eighty/twenty between the fund investors and the fund managers. At the end of the day, then, the investors would be allocated \$14.1 million (\$10 million plus \$500,000 plus \$3.6 million) while the fund managers would receive \$900,000. Note, however, that most funds that provide for priority returns also adjust the calculation of the carried interest to permit the fund advisers to “catch up” once they have satisfied the priority amount. See, e.g., PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 42 (providing a detailed mathematical example).

150. See, e.g., *Asset-Backed Insecurity*, ECONOMIST, Jan. 19, 2008, at 78 (identifying seven active sovereign wealth funds each with over \$100 billion in estimated assets); Jason Leow, *The \$2 Billion China Bet*, WALL ST. J., Dec. 5, 2007, at C1 (reporting that Singapore's sovereign wealth fund will invest \$1 billion in a new “China-focused private equity fund set up by Goldman Sachs”); Andrew Ross Sorkin & David Barboza, *In Strategy Shift, China to Buy a Stake in Blackstone*, N.Y. TIMES, May 21, 2007, at C1 (reporting that the Chinese government has agreed to acquire a \$3 billion stake in U.S. hedge fund giant Blackstone Group). In a related story, sovereign wealth funds from the Middle East and Asia, together with several foreign banks, recently agreed to invest \$19 billion in UBS and Citigroup, plus another \$11 billion in Merrill Lynch, Morgan Stanley and Bear Stearns. See Eric Dash, *Merrill Lynch Sells a \$5 Billion Stake to Singapore Firm*, N.Y. TIMES, Dec. 25, 2007, at C1; David Enrich, Robin Sidel & Susanne Craig, *World Rides to Wall Street's Rescue: Citigroup, Merrill Tap Foreign-Aid Lifelines*, WALL ST. J., Jan. 16, 2008, at A1. Each of these firms is a sponsor of, and provider of services to, hedge funds.

151. Note, by contrast, that private equity markets have tackled a similar problem with non-incentive based compensation in the past. The managers of leveraged buyout and other private equity funds are frequently in a position to charge their portfolio companies any number of fees that are not performance based, including investment banking fees, arrangement fees, consulting fees, and break-up fees for transactions that are never consummated. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 35. Until the early 1990s, fund managers generally retained the entire amount of such fees, thereby disrupting their alignment of interests with investors. *Id.* More recently, however, fund investors have begun to claim as much as 80% of such fees so as to minimize their disparate

operating costs, private equity funds have charged a management fee of around two percent in addition to the carried interest.¹⁵² As initially conceived, such fees were intended to have a neutral impact on the fundamental alignment of interests between fund managers and fund investors. Indeed, many funds are structured such that the fund's advisers must return the management fees to their investors, in addition to the investors' invested capital, before taking their carried interest.¹⁵³

Were such fees truly limited to offsetting expenses, however, we would expect to see the stated percentages falling at the same time that the average size of funds has been increasing. In other words, due to the savings that come from economies of scale, the doubling of a fund's assets should not require a doubling of its management fee. Recall, for example, that mutual fund fees have declined by more than half during the past two decades.¹⁵⁴ Private equity fund management fees, however, stated in terms of a percentage, have remained steady.¹⁵⁵

By continuing to charge a fixed *percentage* of assets under management, managers appear to be masking the fact that the absolute size of their non-performance-based compensation has been steadily increasing as the average size fund has increased. Thus, a fund with \$1 billion in assets now receives an annual management fee of \$20 million regardless of its performance.¹⁵⁶ Although its expenses may be significant, it is difficult not to believe that at least a portion of this amount is being used as insurance against a down year. Given that management fees lack any direct relation to profits, their growth undoubtedly serves to undercut the fund's overall alignment of interests.¹⁵⁷

In something of a paradox, however, the current market turmoil appears to be having a positive effect on management fees. As stock and bond markets have tumbled in recent weeks, investors have put increased pressure on fund managers. As a result, a number of funds have been forced to reduce their fees going forward in order to retain their investors,

impact by mirroring the structure of the carried interest. *Id.* at 36.

152. *Id.* at 30; see also MERCER REPORT, *supra* note 12, at 16–19, 25–30; SCHELL, *supra* note 12, § 2.05[1], at 2–28 to –31. Management fees are generally in the range of 1% to 3%, with smaller funds charging the largest percentage fees, and a 2% fee being the most common. See, e.g., PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 30–31 (noting that Blackstone Group's newest fund will charge a management fee of 1.5% for the first \$6 billion and 1% for the remainder of the fund).

153. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 38 (noting that 86.8% of funds surveyed calculated the carried interest net of management fees and other expenses).

154. See *supra* note 114 and accompanying text.

155. Compare PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 30–31, with MERCER REPORT, *supra* note 12, at 25–30.

156. Of course, if performance were to lag too much, investors would presumably withdraw their capital.

157. A similar disalignment occurs as the result of front-end transaction fees earned by managers in connection with leveraged buyouts. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61, 74.

while others are considering such a move.¹⁵⁸ In the short-run, then, concern over the negative impact of high management fees may prove to be overstated.

Even more importantly, however, the long-term ability of private equity fund managers to increase the non-performance-based portion of their compensation may actually suggest that the model has been proved a success. If funds have begun to charge excessive management fees because there is too much demand for their low-agency-cost model of investing, then the solution is to increase supply. Were regulators to permit other market players to charge a carried interest, the uniqueness of the private equity model would ebb. Investors would then be free to select investment vehicles based on their particular strategy or competence, rather than on the basis of their governance structure. As a result, the increase in supply would put downward pressure on private equity fund management fees. Such a reform would therefore have the dual benefit of improving the governance of both public and private equity funds.

Private equity fund compensation constitutes a proven model whereby incentive compensation causes managers to strive for results that are untarnished by inside dealing. Operating free from legal restrictions or management exploitation, private equity markets have developed a sophisticated mechanism for aligning the interests of managers and investors. Unlike the compensation of public equity funds, the carried interest—when subject to a hurdle rate—rewards private equity fund managers only for superior performance. Meanwhile, unlike the compensation of corporate executives, a direct investment by the fund managers penalizes them for failure. The structure of private equity funds therefore recommends them as superb bearers of agency costs. Were they to serve as Bainbridge's final watchers, they would indeed reduce overall agency costs.

D. Tentative Conclusion

The purpose of Part II has been to explore the differing incentives facing the managers of corporations, public equity funds and private equity funds, with an eye toward comparing the degree to which their interests coincide with those of their investors. The result has been a clear winner—private equity fund compensation is far superior in aligning the interests of managers and investors. It therefore constitutes a proven (American) model for reform.¹⁵⁹

158. See, e.g., Stephen Taub, ALPHA, Oct. 2008, at 41; Louise Story, *Hedge Fund Glory Days Fading Fast*, N.Y. TIMES, Sept. 12, 2008, at C1, C7.

159. Using American private equity funds as exemplars of good corporate governance offers the additional benefit of avoiding the risks associated with historical and cross-cultural analyses. See Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2036 (1993) (noting that it is difficult to judge which country's system produces the

Returning to this Article's original question, then, the above analysis suggests a tentative answer. Public equity funds should be enlisted as monitors, but only in the event they are permitted to adopt the governance structure of private equity funds. Policy makers, in other words, should narrow or repeal the limitations against most forms of incentive compensation that are contained in ERISA and the Investment Advisers Act. Furthermore, they should consider adding requirements akin to a hurdle rate and direct equity investment by the fund managers that serve to complete the alignment of interests created by a straight carried interest.

The skeptics' most significant concern was that institutional investors, were they given greater power over corporate management, would themselves suffer from the same or greater agency costs.¹⁶⁰ The analysis in Part II, however, suggests that if public equity fund managers were compensated by means of a carried interest, their interests would merge with those of their investors. Agency costs, at the level of the monitor, would therefore recede.

What remains to be asked is whether such funds, if they were incentivized to pursue shareholder interests, would in fact be capable of bringing discipline to the corporations in which they invest. In other words, would the expanded use of the carried interest reduce agency costs *only* at the level of the monitor, or would improved oversight be sufficient to decrease agency costs at the corporate level as well? I address this question in the first two subparts of Part III by contemplating the quality and impact of the monitoring currently undertaken by private equity funds. My assumption is that, if such oversight is indeed effective, it could be adopted for use by public equity funds, thereby expanding the market for good corporate governance. I explore this possibility in Part III.C.

III. THE PROMISE OF HEDGE FUND OVERSIGHT

The above discussion suggests that the model of governance adopted by hedge funds and other private equity funds is worth emulating. The combination of a carried interest, coupled with a hurdle rate and direct equity stake held by the managers, creates a clearly superior alignment of interests. Thus, if this model could be exported to public equity funds, they would themselves become more efficient bearers of corporate agency costs.

best economic performance); *see also* Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 368-86 (1996) (tracing the emerging interest of comparative corporate governance scholarship). For this reason, this Article does not attempt to draw any conclusions based on the distinctions between American private equity markets and those of Europe or Asia.

160. *See supra* notes 53-56 and accompanying text.

To be successful, however, a monitor must not only be an efficient bearer of agency costs but must also be capable of eliminating agency costs at the corporate level. Otherwise, no matter how closely the monitor's interests were aligned with those of its investors, there would remain an excess of agency costs at the corporate level. Thus, before recommending public equity funds as monitors, we should consider not only their alignment of interests but also their oversight capabilities.

For purposes of this Article, however, it is not the existing level of public equity fund monitoring that is at issue. Rather, in order to assess whether public equity funds would be capable of bringing discipline to corporate America, we must consider instead the quality of monitoring currently undertaken by private equity funds. This is because public equity funds, were they compensated like private equity funds, would presumably adopt many of their activist investment strategies as well.¹⁶¹ An entity's behavior, after all, is driven largely by the incentives facing its managers. It is therefore the investment strategies utilized by private equity funds that require further study.

In Part III.A, I explore the nature of the investment strategies utilized by private equity funds in order to determine their objectives and theoretical underpinnings. I then examine the existing empirical evidence in Part III.B to determine whether such strategies have their intended effects. Finally, in Part III.C, I conclude that the most likely outcome of deregulating public equity fund compensation would be to expand the market for good corporate governance. Moreover, because they are able to tap the vast capital resources of retail investors—resources that far surpass those available to private equity funds—the impact that public equity funds would have on such a market would be significantly enhanced.¹⁶²

A. The Theory

The activist investment style of private equity funds is intended to translate oversight into profits. Indeed, from an investment strategy pers-

161. See Illig, *supra* note 2, at 231 (“Put succinctly, private equity funds invest in active corporate monitoring because the structure of their compensation provides their managers with a direct financial incentive to do so. . . . Permit the fund managers to share in the profits from monitoring and you give them a direct financial interest in more active oversight.”).

162. U.S.-registered investment companies managed over \$11 trillion at year-end 2006, with mutual funds accounting for 93% of the total. INVESTMENT COMPANY FACT BOOK, *supra* note 23, at 7. See also Tamar Frankel, *The Scope and Jurisprudence of the Investment Management Regulation*, 83 WASH. U. L.Q. 939, 944 (2005) (“At the end of 1974, the total net assets of mutual funds was \$46 billion; at the end of 2000 it had reached \$12 trillion.”). Meanwhile, an additional \$3 trillion was held by public pension funds. See Daisy Maxey, *Pension Funds May Feel Little Subprime Strain*, WALL ST. J., Apr. 2, 2007, at C15. But see Neil King, Jr., *Cutting Ties: Should States Sell Stocks to Protest Links to Iran?*, WALL ST. J., June 14, 2007, at A1 (estimating the size of the industry at closer to \$1 trillion). By contrast, private equity funds appear to have managed to raise a relatively paltry \$1.8 trillion. PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 7.

pective, the key attribute that distinguishes private equity funds is that they *intend* to exercise influence over corporate management.¹⁶³ When faced with an underperforming investment, their response is not to exit and lick their wounds in accordance with the so-called Wall Street Rule. Instead, traditional private equity funds seek to use their influence to improve the venture's performance.¹⁶⁴ Indeed, like a sort of financial Henry Higgins, their goal is to profit by discovering undervalued companies that are rife with potential and then making them over into successful enterprises. They are, in theory at least, the ultimate activist monitors.

To exercise oversight, private equity funds frequently seek to acquire formal control over their portfolio of investments.¹⁶⁵ For example, leveraged buyout funds—often in concert with existing management—generally purchase sufficient securities of a target so as to take it private.¹⁶⁶ Venture capital funds, meanwhile, frequently attempt to purchase a majority of the target's voting power.¹⁶⁷ Moreover, when acquiring outright control is not possible (or desirable), such funds generally acquire a significant block of shares coupled with contractual rights to influence management, such as representation on the board.¹⁶⁸ Private equity funds also frequently negotiate for additional “springing” control rights that take effect in the event performance begins to lag.¹⁶⁹ One example of this would be the right to additional board seats in the event that dividend or debt obligations are not paid when due.

163. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1027 (2007) (noting that the investment strategy of many hedge funds “involves taking high stakes in portfolio companies *in order to* become activist, rather than diversifying and becoming involved (if at all) only *ex post* when companies are underperforming”).

164. See Emily Thornton, *Perform or Perish*, BUS. WK., Nov. 5, 2007, at 38, 43–44 (“The paradox of private equity is that expectations are often highest for the weakest companies, which offer the biggest turnaround potential.”).

165. See JACK S. LEVIN, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS* ¶ 102, at 1–3 (2008); SCHELL, *supra* note 12, § 1.04[1], at 1–25.

166. See GAUGHAN, *supra* note 60, at 295. See generally Michelle Haynes, Steve Thompson & Mike Wright, *Sources of Venture Capital Deals: MBOs, IBOs and Corporate Refocusing*, in *MANAGEMENT BUY-OUTS AND VENTURE CAPITAL: INTO THE NEXT MILLENNIUM* 219, 219–37 (Mike Wright & Ken Robbie eds., 1999) (noting that many buyouts occur as a result of management's decision to refocus and narrow its strategy).

167. See, e.g., JOSEPH W. BARTLETT, ROSS P. BARRETT & MICHAEL BUTLER, *ADVANCED PRIVATE EQUITY TERM SHEETS AND SERIES A DOCUMENTS* § 7.02, at 7-5 exhibit 1 (2007) (reporting on a survey of venture capital investment terms that found that 26% of venture capital funds “always” or “often” purchase a controlling interest, while another 33% “sometimes” do).

168. See, e.g., *id.* (summarizing the results of a survey of the frequency with which venture capital funds “always” or “often” demand and receive certain control rights—board seats (96%), anti-dilution privileges (93%), post-IPO registration rights (89%), redemption privileges (78%), negative covenants (73%), and drag-along rights (65%)). Interestingly, however, only 22% of venture capital funds “always” or “often” select the CEO. See, e.g., *id.*

169. See JOSH LERNER, FELDA HARDYMON & ANN LEAMON, *VENTURE CAPITAL & PRIVATE EQUITY* 1 (3d ed. 2005) (noting that private equity funds “protect the value of their equity stakes by . . . retaining powerful oversight rights”).

Control can also be informal. For example, the first venture capital fund to back a particular company is generally able to control the company's future financing opportunities and hence dictate its growth strategy. Although this can certainly be accomplished through formal means such as a right of first refusal or contractual veto right, it is more often a byproduct of the fact that venture funding is difficult to obtain.¹⁷⁰ Thus, because of the risks involved in early stage investments, a company in need of additional rounds of financing may be unable to find anyone else willing to provide the necessary risk capital on better terms than the original venture capital investors.¹⁷¹ Moreover, even if other potential investors are willing to bear the risks associated with an investment, they may be reluctant to do so if their involvement is opposed by the company's initial backers.

Control, however, need not be oppositional. Venture capital funds, for example, frequently offer advice and counsel in addition to financing.¹⁷² It is often the case, in fact, that they will recommend a board of outside advisers for a particular portfolio company or even appoint an experienced financial manager friendly with the fund as the company's chief financial officer.¹⁷³ Gordon Smith describes the relationship between venture capital investors and entrepreneurs as involving aspects of team-production that make it "more like a partnership than a principal-agent relationship."¹⁷⁴ In a similar manner, management-led buyouts represent a partnership among buyout funds and corporate managers that goes beyond mere financing.¹⁷⁵ Even more importantly, managers of portfolio companies are typically

170. See George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1035-64 (1992) (describing methods by which venture capital funds exercise de facto control over their portfolio of companies without owning a majority of the shares).

171. See *id.* at 1043.

172. See, e.g., GOMPERS & LERNER, *supra* note 135, at 242-54.

173. See THOMAS M. DOERFLINGER & JACK L. RIVKIN, *RISK AND REWARD: VENTURE CAPITAL AND THE MAKING OF AMERICA'S GREAT INDUSTRIES* 16 (1987) (describing that the role of venture capital "is to seek out talented engineers, scientists, and business executives who have an idea for a promising new business and give them not just money but 'smart money'—money that is imbued with entrepreneurial savvy, business contacts, executive talent, and patience of financiers with long experience in helping small companies succeed"); Martin Kenney & Richard Florida, *Venture Capital in Silicon Valley: Fueling New Firm Formation*, in UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION 98, 101 (Martin Kenney ed., 2000) ("As partners, venture capitalists actively try to affect the outcome of their investments by offering advice, providing contacts ranging from law firms and commercial real estate brokers to potential customers, assisting in corporate recruiting, and various other tasks.").

174. D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949, 950 (1999) ("The task of analyzing venture capital contracts through the lens of team production is complicated by the fact that the relationship between entrepreneur and venture capitalist does not fit easily into existing economic models of team production.").

175. See GAUGHAN, *supra* note 60, at 317-18 (discussing the conflicting roles of managers engaged in a leveraged buyout); see also William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379, 1403-05, 1427-28 (2007) (finding that hedge funds that acquired 5% to 10% equity stakes in public targets frequently negotiated for a seat on the target's board of directors).

given large equity stakes in their companies, thus further tying their interests to those of their private equity fund masters.¹⁷⁶

Control acquisitions are not pursued uniformly by all players in the private equity markets, however. Hedge funds, in particular, avoid easy categorization.¹⁷⁷ As Marcel Kahan and Edward Rock point out, most traditional hedge funds pursue quantitative strategies and freely invest in a wide variety of non-equity securities, including options, derivatives, and debt instruments.¹⁷⁸ Many others, though they invest in order to exercise influence, acquire relatively small stakes, seek to work in concert with their peers, or both.¹⁷⁹ Indeed, such hedge funds are not properly considered private equity funds and, though important in both financial and governance markets, are not the subject of this Article. On the other hand, there is a small but growing group of hedge funds that operate more like traditional private equity funds in that they purchase control with the goal of realizing capital gains after a period of illiquidity that can last for several years.¹⁸⁰ One of the best known among them is ESL Investments, which in the past few years has acquired controlling stakes in both Kmart and Sears Roebuck, among other American corporate icons.¹⁸¹

176. See Jensen, *supra* note 157, at 65. Indeed, according to Jensen “the salary of the typical LBO business-unit manager [in 1989 was] almost 20 times more sensitive to performance than that of the typical public-company manager.” *Id.* at 68. Although this ratio has almost certainly changed as stock options have proliferated at public companies, the early leadership of the buyout industry in the realm of incentive compensation is nonetheless instructive regarding the special relationship that exists among buyout investors and the managers of their portfolio companies. Additionally, because managers of buyout targets typically receive options only at the time of the leveraged buyout—and not each time their old options expire—their incentive to increase firm performance is greater than at companies where options are uniformly reloaded. See Carey, *supra* note 75, at 28.

177. See SEC HEDGE FUND REPORT, *supra* note 11, at 33–34 (“The organizational documents of most hedge funds establish broad objectives and authorize multiple strategies in order to provide flexibility to take advantage of changing market conditions. . . . Hedge funds use a wide variety of investment styles and strategies.”).

178. See Kahan & Rock, *supra* note 163, at 1046 (citing a study by J.P. Morgan to the effect that as little as 5% of all hedge fund assets are invested in activist monitoring strategies).

179. See *id.*; see also Bratton, *supra* note 175 (studying hedge funds that acquire 5% to 10% stakes in public companies).

180. See SEC HEDGE FUND REPORT, *supra* note 11, at 33 (“Certain hedge funds take large, concentrated positions in securities. . . . Finally, a number of hedge funds eschew all of these techniques and adopt traditional, long-only strategies similar to those used by most registered investment companies.”); cf. Brav, Jiang, Partnoy & Thomas, *supra* note 51, at 5, 19 (noting that hedge funds do not generally seek to acquire majority control of their targets). In a fascinating twist, there is evidence that venture capital funds are beginning to encroach on the turf previously controlled by buyout funds. See Rebecca Buckman, *Venture Capital Goes Big*, WALL ST. J., Oct. 5, 2007, at C1 (reporting that some venture capital funds, in search of profitable investments, have begun acquiring shares in “private and public companies with established revenues and profits”).

181. See Robert Berner, *The Next Warren Buffett?*, BUS. WK., Nov. 22, 2004, at 144, 144–46 (noting, as part of a cover story on fund manager Eddie Lampert, that ESL’s acquisitions of large retailers include not only Sears Roebuck and Kmart, but also AutoZone and AutoNation, as well as long-distance telecom MCI); *In the Wake of Wal-Mart*, ECONOMIST, Nov. 20, 2004, at 64, 64–65 (reporting that ESL had acquired a 53% stake in Kmart and a 13.5% stake in Sears).

Once control is established, private equity funds frequently cause management to take actions that favor shareholder interests, thus reducing agency costs.¹⁸² These include trimming operating costs, monetizing underutilized assets, and changing corporate culture.¹⁸³ Indeed, accountability to shareholder interests is ratcheted up to an almost unbearable degree.¹⁸⁴ According to one study, seventy-four percent of the top managers of buyout targets were eventually replaced due to poor performance.¹⁸⁵ The long-term investment strategy of private equity funds also allows their targets to avoid some of the costs associated with the short-term outlook that is so prevalent among public company managers.¹⁸⁶

Private equity funds, in other words, do not earn their outsized returns through superior stock-picking acumen. Rather, they do so by attempting to improve the performance of the companies in which they invest. They are, in fact, engaged in a firm-specific market for good corporate governance.¹⁸⁷ They vie with one another not to recognize potential targets that suffer from few inefficiencies, but to eliminate agency costs from those with many.

The activist investment strategy pursued by private equity funds can be distinguished from that pursued by public equity funds. Mutual funds and public pension funds generally do not make investments with the goal of influencing individual firm policy.¹⁸⁸ Rather, they market themselves as aggregators of capital. Their primary function is to provide the benefits of

182. See Brav, Jiang, Thomas & Partnoy, *supra* note 51, at 37 (finding that hedge fund activism can reduce agency costs by increasing managerial discipline).

183. See, e.g., Thornton, *supra* note 164, at 40 (“With financial conditions so tight, buyout chiefs’ best shot at generating strong returns in the U.S. lies in their ability to make the companies they control more profitable—slashing costs, boosting sales in global markets, and paying down debt.”).

184. See *id.* at 41 (“Private equity firms expect their CEOs to succeed on two fronts. They must make the smart and aggressive moves needed to yield quick financial improvements. And they must radically alter corporate psychology so that the changes they make stick.”).

185. *Id.* (citing a study by Ernst & Young of LBOs of companies that were sold or taken public in 2006).

186. See, e.g., Theo Francis, *HCA Chief Enjoying the Private Life*, WALL. ST. J., Jan. 7, 2008, at B1 (Jack O. Bovender, the CEO of HCA, stated: “Being a private company gives you a chance to retool yourself on a much longer-term basis without worrying about quarter-to-quarter blips in your earnings because you’ve made these decisions for the long term.”).

187. Industry insiders generally articulate this concept by noting that private equity funds compete based upon four factors: their access to deals, their access to leverage, their ability to manage costs, and their ability to pick deals. Considered from the light of corporate governance, however, it seems clear that at least the first and last of these factors, and probably the third as well, are actually just aspects of the broader competition to minimize agency costs. In other words, the term “deal” in this formulation must really be interpreted more narrowly as meaning “deal that presents the opportunity to identify and minimize agency costs.” Thus, competition among private equity funds in actuality revolves around the fund managers’ ability to access and select (and then manage) investment opportunities that present an excess of agency costs. See, e.g., DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 245 (2000) (noting that “private equity managers with the ability to facilitate operating improvements [in targeted companies] possess unusual skills, for which they and their partners receive outsized compensation.”).

188. See Kahan & Rock, *supra* note 163, at 1069 (“Mutual fund and public pension fund activism, if it occurs, tends to be incidental and ex post.”).

diversification to investors with relatively small portfolios.¹⁸⁹ Moreover, when they do become engaged in activist monitoring, it is generally aimed at structural or systemic change.¹⁹⁰ CalPERS, the influential California state pension fund, for example, led an effort in the mid-1980s to induce firms to remove antitakeover protections from their charters.¹⁹¹ The goal of this effort was not to increase firm-specific profitability, but to improve the overall health of the market for corporate control.

Private equity fund activism can also be distinguished from the oversight strategy envisioned by early proponents of institutional investor monitoring. For scholars like Black, for example, the proper goal of institutional investors is not control but “voice.”¹⁹² They view expanded monitoring as merely incremental change, whereby public equity funds would exercise greater influence through shareholder proxy proposals, coordinated voting efforts, and private negotiations with management.¹⁹³ Perhaps anticipating Bainbridge’s concern regarding who will watch the watchers, they stop short of proposing that institutional investors acquire actual con-

189. See Allan F. Conwill, *Blight or Blessing? The Wharton School Study of Mutual Funds*, 18 BUS. LAW. 663, 667 (1963) (“[A]n investor of moderate means cannot achieve the diversification provided by most funds by individual investment in selected stocks. Unless he has substantial funds available, he cannot buy each of the one hundred or more securities which are in the portfolio of the typical mutual fund. Thus, the mutual fund provides the modest investor with an easy and convenient vehicle for achieving diversification.”); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, J. ECON. PERSP., Spring 2004, at 161, 180 (“Mutual funds give investors the benefit of diversification and, if the fund is actively managed, professional money management.”); Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 18–27 (1997) (arguing that the primary purpose of institutional investors is to shield their customers from undue risk via diversification).

190. See Black, *supra* note 6, at 834–35 (“Institutional shareholders can’t and shouldn’t watch every step a manager takes. . . . [S]hareholders have stronger incentives to take an active interest on issues for which scale economies will partly offset the incentives for passivity created by fractional ownership.”); Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293, 294–95 (1999) (finding that heavily indexed pension funds are more likely to pursue activist strategies that are aimed at boosting the performance of the overall economy); Gilson & Kraakman, *supra* note 29, at 867 (arguing that institutional investors hoping to increase the value of their portfolio must focus on “improving the corporate governance system rather than by attempting to improve the management of particular companies”).

191. See Philip C. English II, Thomas I. Smythe & Chris R. McNeil, *The “CalPERS Effect” Revisited*, 10 J. CORP. FIN. 157, 159 (2004); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 231 (1996) (“During the 1987 and 1988 proxy seasons CalPERS targeted firms based primarily on their corporate governance structures.”).

192. See, e.g., Black, *supra* note 6, at 816 (“Institutional voice means a world in which particular institutions can easily own 5–10% stakes in particular companies, but can’t easily own much more than 10%; in which institutions can readily talk to each other and select a minority of a company’s board of directors, but can’t easily exercise day-to-day control or select a majority of the board.”). Under some circumstances, the term “shareholder voice” may also include informal means of communication between shareholders and corporate managers occurring outside of the formal voting and proxy system but aimed at and supported by the corporate franchise. See Black, *supra* note 17, at 522 n.3.

193. Indeed, Kahan & Rock’s recent study of hedge fund activism focused on funds acquiring stakes of between 5% and 10%, suggesting their continued interest in a non-controlling role for institutional monitors. See Kahan & Rock, *supra* note 163, at 1088.

trol of public companies. For them, institutional investor monitoring is intended more as a gentle prod than a painful bite.

As the above discussion demonstrates, private equity funds engage in control acquisitions with the intent to pressure management to adhere more closely to shareholder interests. Companies that are the subject of leveraged buyouts or other private equity transactions exchange a diverse and individually toothless mass of anonymous shareholders for a single, dominant master. When performance lags, executives are sacked, assets are monetized, operations are streamlined, and companies are merged to realize economies of scale. Much to the delight of investors—and the chagrin of inefficient managers—private equity funds seek to enrich themselves by squeezing agency costs out of bloated and underperforming companies.¹⁹⁴ Thus, under the watchful eye of their new shareholder-disciplinarians, corporate managers should in theory seek to adhere more closely to the goal of profit maximization. In fact, as described in the following subpart, private equity fund monitoring appears in practice to succeed admirably in this respect.

B. The Evidence

In practice as well as in theory, the activist oversight strategy pursued by private equity funds appears to accomplish its goal of improving corporate performance and reducing net agency costs.¹⁹⁵ Certainly, there have been some spectacular failures, especially among traditional hedge funds.¹⁹⁶ A number of funds have also failed or suffered setbacks in the

194. See *supra* note 187.

195. See Jensen, *supra* note 157, at 65 (arguing that post-buyout companies, with their close monitoring, have an incentive structure that is superior to that of public corporations); see also ROBERT F. BRUNER, APPLIED MERGERS AND ACQUISITIONS 56 (2004) (summarizing several empirical studies that found increased value in transactions where managers had more at stake, including leveraged buyouts); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 924 (1992) (noting the existence of “substantial evidence suggesting that [leveraged buyouts] often led to improved corporate performance, at least up through about 1986”); William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.–Oct. 1990, at 70, 82 (arguing that institutional investors can have a positive impact on the long-term performance of American companies).

196. The most notorious of these was of course the sudden collapse of Long-Term Capital Management (LTCM) in the fall of 1998. The events leading up to the \$3.6 billion loss of LTCM are chronicled in colorful fashion in ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000). Another lesser-known but nonetheless significant collapse involved Amaranth Advisors, which lost over \$3 billion in a few short weeks in 2006. See Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, at C1 (attributing the fund's decline to a fall in natural gas prices). Despite such newsworthy failures, however, most funds close because of lackluster performance, not disastrous implosion. *Hedge Podge: Despite Mixed Results, Hedge Funds Earn a Little Respect*, ECONOMIST, Feb. 16, 2008, at 83, 83 (“For every Bear Stearns ‘enhanced-leverage’ fund that loses all of its value, there are five or six funds that shut after a fall of a few percentage points.”).

wake of the ongoing subprime mortgage crisis.¹⁹⁷ However, overall returns on private equity investments consistently surpass market averages.¹⁹⁸ Indeed, one study found an average 235% annualized return among buyout funds during the period from 1980 to 1986.¹⁹⁹ Moreover, for the moment at least, many private equity funds appear to have avoided the worst of the fallout from the collapse of the subprime mortgage market.²⁰⁰ Certainly, they have not required the type of bailout granted to Wall

197. In hindsight, in fact, the onset of the current liquidity crisis appears closely tied to the disintegration in 2007 of two hedge funds associated with Bear Stearns, a development that led directly to the 84-year-old firm's first ever quarterly loss and the ouster of its CEO. See Kate Kelly, *Cayne to Step Down As Bear Stearns CEO*, WALL ST. J., Jan. 8, 2008, at A1; Jennifer Levitz & Kate Kelly, *Bear Faces First Loss, Fraud Complaint*, WALL ST. J., Nov. 15, 2007, at C1. Several months later, the venerable firm was sold to J.P. Morgan Chase for a fraction of its pre-crisis value of over \$170 per share. See Andrew Ross Sorkin, *In Sweeping Move, Fed Backs Buyout and Wall Street Loans*, N.Y. TIMES, Mar. 17, 2008, at A1. Meanwhile, others in the industry continue to be hit. See, e.g., Jenny Strasburg & Gregory Zuckerman, *June Is Cruel to Big Names as Prentice, Tosca Get Hit*, WALL ST. J., July 11, 2008, at C1; Landon Thomas Jr., *Tight Credit, Tough Times for Buyout Lords*, N.Y. TIMES, Mar. 8, 2008, at C1. More recently, as stock market indices have been pummeled by the credit meltdown, a number of funds have suffered setbacks as well. See, e.g., Story, *supra* note 158, at C7 ("In recent weeks, several funds have closed, most notably a fund run by Ospraie Management. Rumors about troubled hedge funds like Atticus Capital have unsettled the broader markets."); Peter Lattman, Craig Karmin & Pui-Wang Tam, *Private Equity Draws the Cold Shoulder*, WALL ST. J., Nov. 4, 2008, at C1 (reporting that the storied private equity fund, Kohlberg Kravis Roberts & Co., announced that it would delay its planned IPO until 2009).

198. See, e.g., GEORGE P. BAKER & GEORGE DAVID SMITH, *THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 207-09* (1998) (reporting returns of 13.8% to 40.2% on a portfolio of leveraged buyout investments); MERCER REPORT, *supra* note 12, at 86 (finding that "annual returns range from 0% to more than 30%, with an average of 10% to 20%, far surpassing the 9% to 10% average returns historically realized by common stock investors"); Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, J. APPLIED CORP. FIN., Spring 1989, at 35, 39 (testifying to Congress that returns on successful leveraged buyouts ranged from 40% to 56%); Greg Ip & Henny Sender, *Private Money: The New Financial Order*, WALL ST. J., July 25, 2006, at A1 (reporting that buyout funds had average annual returns of 24% in 2004 and 2005, triple the return of the S&P 500). In 2006, the nation's highest paid hedge fund manager posted a 44% return, net of fees, while the second and third posted returns of around 30% and 24.5%, respectively. Taub, *supra* note 130, at 42-43.

199. Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 236-37 (1989); see also Chris J. Muscarella & Michael R. Vetsuypens, *Efficiency and Organizational Structure: A Study of Reverse LBOs*, 45 J. FIN. 1389, 1389 (1990) (finding that, consistent with theory, "LBOs create real wealth gains and improvements in operating performance, perhaps because of a more efficient ownership structure and allocation of residual claims under private ownership"). But see Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1791-92 (2005) ("On average, LBO fund returns net of fees are slightly less than those of the S&P 500; VC fund returns are lower than the S&P 500 on an equal-weighted basis, but higher than the S&P 500 on a capital weighted basis."). The more recent vintage of this study raises the possibility that buyouts and other private equity transactions have been historically profitable, but that changing economic conditions are making them less so. Cf. Anne Tergesen, *Time to Hedge on Hedge Funds?*, BUS. WK., Sept. 13, 2004, at 104, 104-06 (reporting on research that shows sliding returns among hedge funds).

200. See, e.g., Gregory Zuckerman, *Hedge Funds Bounce Back—In a Big Way*, WALL ST. J., Nov. 19, 2007, at C1 (quoting one fund manager stating: "Everyone got nervous over the summer, but now the good managers are taking advantage of the market's volatility."). Notably, the worst-hit funds are those whose investment strategies are tied most closely to the health of the overall economy. Story, *supra* note 158, at C7 ("The worst hit are funds that bet on events like mergers, companies' stock prices, bonds and those that missed the turn in the price of oil."). Moreover, private equity

Street's major investment banks, and 2007, which witnessed the onset of the credit meltdown, was a banner year for many in the industry.²⁰¹ This model of activist investing has thus proven profitable for investors. This much was predicted by the findings in Part II.C. But what is the impact of private equity funds on their targets?

In 1989 Michael Jensen forecasted that the once-dominant public corporation would soon be eclipsed by "LBO Associations," at least with respect to old-economy companies.²⁰² Though his prediction has proven exaggerated (or at least premature), the past two years witnessed nine of the ten largest leveraged buyouts in history.²⁰³ Thus, the question remains pressing: Have private equity funds indeed proven themselves adept at monitoring corporate agency costs, or are their superior returns merely the result of misappropriating value from other corporate constituents?²⁰⁴

Economists and other experts in corporate finance have conducted a number of empirical studies over the past two decades in an attempt to determine the impact of leveraged buyouts and other private equity investments on target companies. In general, they have found that the model does work. Buyouts create shareholder value.²⁰⁵ Not only do private equity funds prosper from their activist investment strategy, but so too do the other shareholders of their targets.

The most obvious technique for measuring the impact of leveraged buyouts is to compare the market value of target firms pre- and post-acquisition.²⁰⁶ Using this methodology, Steven Kaplan found a 77% increase in median value (adjusted for market returns) among buyout targets

funds, though hurting as a group, have nonetheless continued to outperform Wall Street. Gregory Zuckerman & Cassell Bryan-Low, *More Pressure on Hedge Funds*, WALL ST. J., Oct. 17, 2008, at C3 ("As a group, [hedge] funds were down 5.4% in September and 10.1% for the year, beating the Standard & Poor's 500, which fell 20% over the same period.").

201. For example, the nation's twenty-five top hedge fund managers "earned, on average, \$892 million in 2007, up from \$532 million in 2006." Stephen Taub, *The Kings of Cash*, ALPHA, Apr. 2008, at 36. Given that the managers' fees were based in large part on a percentage of their funds' annual earnings, these incredible compensation packages suggest equally incredible financial performances on behalf of investors. Similarly, though many funds have suffered in 2008, commodities and financial futures funds like Clive and Bluetrend are up by as much as 34% through November 2008. Matthew Goldstein & David Henry, *The Hedge Fund Contagion*, BUS. WK., Nov. 3, 2008, at 36.

202. See Jensen, *supra* note 157, at 68 (describing the LBO Association as a cooperative arrangement among fund sponsors, company managers, and institutional investors).

203. See Andrew Ross Sorkin, *The Money Binge*, N.Y. TIMES, Apr. 4, 2007, at H1 (reporting on record-setting leveraged buyouts, including the proposed \$45 billion buyout of TXU, the \$33 billion buyout of HCA, and the proposed \$29 billion buyout of First Data).

204. Accord Kahan & Rock, *supra* note 163, at 1026 (asking whether hedge funds represent "the 'Holy Grail' of corporate governance" or "darker forces").

205. See generally BRUNER, *supra* note 195, at 30-65 (summarizing research regarding the circumstances under which M&A transactions turn profitable). For a general discussion of how leveraged buyouts are structured and executed, see generally *id.* at 393-423; GAUGHAN, *supra* note 60, at 291-329.

206. More precisely, because markets react to the public announcement of a transaction, the studies must consider the target's pre-announcement value, not its pre-deal value.

from 1980 to 1986.²⁰⁷ This represented a median market-adjusted return of 37% for pre-buyout shareholders and a median market-adjusted return of 28% for post-buyout investors.²⁰⁸ In a separate study, Gregor Andrade and Steven Kaplan determined that highly leveraged transactions earned significantly positive market-adjusted returns, even in instances where they subsequently encountered financial distress.²⁰⁹ A number of additional studies also support the conclusion that leveraged buyouts result in gains of 15%–40% for a target company's pre-buyout shareholders.²¹⁰

More important for corporate governance purposes than market price, however, is the impact that buyouts have on operating performance. To determine this, Phillip Phan and Charles Hill surveyed managers at 214 completed buyouts and found improvements in “goals, strategy, and structure . . . as demonstrated by increases in productivity and profitability.”²¹¹ Frank Lichtenberg and Donald Siegel, using a different methodology, found that manufacturing plants involved in leveraged buyouts had significantly higher rates of productivity growth than non-targeted plants in the same industry.²¹² Moreover, although several early studies failed to find measurable improvements in post-buyout performance, a statistical study by Scott Smart and Joel Waldfogel supported the conclusion that management-led buyouts yield significant improvements in overall performance.²¹³

207. Kaplan, *supra* note 199, at 219 (the mean value increase was 96%).

208. *Id.*

209. Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443, 1447 (1998) (studying thirty-one highly leveraged transactions that became financially distressed, meaning that the target company subsequently (1) “default[ed] on a debt payment” or (2) “attempted to restructure its debt”).

210. See, e.g., Harry DeAngelo, Linda DeAngelo & Edward M. Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367, 389, 400 (1984) (finding that target shareholders experienced an average wealth increase of 30% from among a sample of seventy-two leveraged buyouts during the period 1973–1980); Kenneth Lehn & Annette Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FIN. 771, 775–76 (1989) (finding average cumulative abnormal returns for target shareholders of 20% during a forty-day window from among a sample of 244 leveraged buyouts during the period 1980–1987); Laurentius Marais, Katherine Schipper & Abbie Smith, *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155, 156, 159, 175 (1989) (finding that holders of target senior securities, including both convertible and non-convertible preferred stock, experienced significant positive abnormal returns from within a sample of 290 leveraged buyouts during the period 1974–1985).

211. Phillip H. Phan & Charles W. L. Hill, *Organizational Restructuring and Economic Performance in Leveraged Buyouts: An Ex Post Study*, 38 ACAD. MGMT. J. 704, 704, 730 (1995) (studying the impact of leveraged buyouts occurring between 1986 and 1989); see also Margarethe F. Wiersema & Julia Porter Liebeskind, *The Effects of Leveraged Buyouts on Corporate Growth and Diversification in Large Firms*, 16 STRATEGIC MGMT. J. 447, 450–51 (1995) (examining all leveraged buyouts occurring at the one thousand largest “manufacturing firms between 1980 and 1986 for which line of business data [was] available”).

212. Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165, 191–92 (1990) (using large longitudinal establishment and firm-level Census Bureau data sets for manufacturing plants involved in leveraged buyouts from 1981 to 1986).

213. See Scott B. Smart & Joel Waldfogel, *Measuring the Effect of Restructuring on Corporate*

This result was also supported by separate studies undertaken by Tim Opler, Harbir Singh, and Abbie Smith, among others.²¹⁴

Admittedly, there is some question regarding the longevity of any buyout-related gains. For example, François Degeorge and Richard Zeckhauser found that although operating profits improved significantly following a leveraged buyout, they tended to fall shortly after the company returned to public ownership, perhaps due to insiders' superior knowledge regarding the company's (poor) future prospects.²¹⁵ In another study, however, William Long and David Ravenscraft found that any decrease in performance among whole-company leveraged buyouts was delayed until at least three years following the target's return to public ownership, thereby suggesting causal factors unrelated to the buyout.²¹⁶ Moreover, given that research by Kaplan found that buyout targets remained private for a median period of almost seven years, it is clear that overall increases in operating performance were anything but short-lived.²¹⁷

Paradoxically, however, the most instructive study regarding the impact of leveraged buyouts may be one that found negative results. According to Philippe Desbrières and Alain Schatt, leveraged buyouts in France result in *decreased* performance.²¹⁸ They posit, however, that differences

Performance: The Case of Management Buyouts, 76 REV. ECON. & STAT. 503, 511 (1994) (finding "large positive increases in the ratio of operating income to sales after the [management] buyout"). But see DAVID J. RAVENSCRAFT & F. M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY 102-03, 193 (1987) (finding no measurable improvement); Dennis C. Mueller, *Mergers and Market Share*, 67 REV. ECON. & STAT. 259, 266-67 (1985) (same); David J. Ravenscraft & F. M. Scherer, *Life After Takeover*, 36 J. INDUS. ECON. 147, 154-55 (1987) (same).

214. Tim C. Opler, *Operating Performance in Leveraged Buyouts: Evidence from 1985-1989*, FIN. MANG., Spring 1992, at 27, 31 (finding an industry-adjusted average increase of 11.6% in operating profits—and 40.3% in per employee operating profits—among forty-four leveraged buyouts between 1985 and 1989); Harbir Singh, *Management Buyouts: Distinguishing Characteristics and Operating Changes Prior to Public Offering*, 11 STRATEGIC MANG. J. 111, 111, 125-26 (1990) (finding abnormal positive growth in both sales and operating profits among sixty-five management-led buyouts between 1980 and 1987); Abbie J. Smith, *Corporate Ownership Structure and Performance: The Case of Management Buyouts*, 27 J. FIN. ECON. 143, 149 tbl.1, 150 (1990) (finding an industry-adjusted average increase of 71% in cash flows per employee among fifty-eight management-led buyouts between 1977 and 1986).

215. See François Degeorge & Richard Zeckhauser, *The Reverse LBO Decision and Firm Performance: Theory and Evidence*, 48 J. FIN. 1323, 1323-24 (1993) ("In the year after the offering, however, reverse LBOs disappoint. Their performance worsens dramatically in the first public year, falling by about three points, which is ten points below the change in their own previous year and four points below their public comparison firms.").

216. See William F. Long & David J. Ravenscraft, *The Financial Performance of Whole Company LBOs* 23-27 (Ctr. for Econ. Studies, U.S. Census Bureau, Working Paper No. 93-16, 1993), available at http://www.ces.census.gov/index.php/ces/cespapers?detail_key=100211 (finding that a statistically significant increase among whole-company leveraged buyouts in industry-adjusted operating income, as compared to sales, persisted for three years following the target companies' return to public status).

217. Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287, 290, 311 (1991) (finding that typical leveraged buyouts are "neither short-lived nor permanent," but represent "a transitory organizational form" between "periods of public ownership").

218. Philippe Desbrières & Alain Schatt, *The Impacts of LBOs on the Performance of Acquired Firms: The French Case*, 29 J. BUS. FIN. & ACCT. 695, 722-23 (2002).

between U.S. and French financial markets are such that leveraged buyouts in France are conducted under the very opposite conditions as in the U.S. Pre-buyout French companies tend to be already highly concentrated in ownership, for example, and take on less debt as part of the transaction.²¹⁹ Most importantly, the targets of French buyouts tend to be those with the best performance, not the worst.²²⁰ Thus, opportunities for the acquiring fund to improve performance through the elimination of unnecessary agency costs are absent in the French model. We therefore again see a strong connection between the privatization of *underperforming* companies and the elimination of agency costs.

A number of studies have also attempted to measure the impact of hedge funds on the economy. Unfortunately, such studies tend to focus on those hedge funds that pursue quantitative or macroeconomic strategies, rather than those that behave more akin to traditional private equity funds.²²¹ Their usefulness for purposes of this Article is therefore minimal.

However, several studies of hedge fund activism have focused on the impact of investments that fall short of control. Thomas Briggs, for example, uncovered data that suggest that even relatively small hedge fund investments result in pressure on their targets to improve their governance structures.²²² In a similar study of non-controlling acquisitions, William Bratton found that target companies both improved their governance structures and outperformed the market.²²³ Finally, Alon Brav, Wei Jiang, Randall Thomas, and Frank Partnoy found that low-level hedge fund activism resulted in improved operating performance, higher dividend payments, increased CEO turnover, and decreased CEO compensation, among other positive gains.²²⁴ Because these studies involve hedge funds

219. *Id.* at 722 (“LBOs in France are mostly used when they involve a transfer of or a succession in family businesses.”).

220. *Id.* (“By and large, MBO operations in France are carried out on firms whose financial situation is better than that of the other companies in the same sector of activity.”).

221. *See, e.g.*, Carl Ackerman, Richard McEnally & David Ravenscraft, *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833, 846–53 (1999) (examining the returns earned by a large sample of hedge funds from 1988 to 1995); Stephen J. Brown, William N. Goetzmann & Roger G. Ibbotson, *Offshore Hedge Funds: Survival and Performance, 1989–95*, 72 J. BUS. 91 (1999) (examining the performance of off-shore hedge funds); Bing Liang, *Hedge Fund Performance: 1990–1999*, FIN. ANALYSTS J., Jan.–Feb. 2001, at 11, 12–13 (reporting above-market returns for hedge funds by category of investment strategies).

222. Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 722 (2007) (finding that “the pressure [hedge funds] bring is forcing managements far beyond those of the few specific companies directly affected to come up with their own good ideas or, in Martin Lipton’s words, to ‘[r]eview basic strategy’” (second alteration in original)).

223. *See* Bratton, *supra* note 175, at 1418–22 (examining the performance of a hypothetical portfolio comprised of targets of hedge fund activism).

224. *See* Brav, Jiang, Thomas & Partnoy, *supra* note 51, at 2–6 (examining data of hedge fund activism from 2001 to 2006).

that do not engage in traditional private equity investments, however, their results offer clues, but not answers, to the questions asked by this Article.

The impact of venture capital investing is particularly difficult to quantify given the steep growth curve of most successful start-ups and the many changes that one would expect to occur as part of their natural development. However, it is probably safe to assume that many if not most venture capital backed start-ups would not have found (affordable) financing but for the availability of these funds.²²⁵ In this respect, the impact of venture capital on the overall economy has been enormously positive. The success of Silicon Valley is, without exaggeration, the envy of financiers the world over.²²⁶ Inflows into American venture capital funds reached \$105 billion annually in 2000, with such monies fueling the development of storied companies such as Microsoft, Apple, and Intel.²²⁷ Moreover, by concentrating their investments in industries characterized by significant levels of uncertainty and market variability, venture capital funds fuel innovation and encourage risk-taking.²²⁸ Venture capitalists, in other words, will go where banks and other more risk-averse sources of capital will not. Indeed, numerous studies have concluded that the availability of venture funding has a strong positive impact on an economy's overall level of innovation.²²⁹

Surely one final, but non-scientific, measure of the success of private equity must be the continued demand for such investments expressed by wealthy and sophisticated investors who could easily choose to invest elsewhere. Indeed, the overall private equity market continues to be both vibrant and growing. Private equity funds raised \$215.4 billion during 2006, an increase of 33% over the prior year and far above the record \$177.1 billion raised in 2000.²³⁰ In total, the industry is estimated to actively manage as much as \$3 trillion in investment capital.²³¹ Given that access to such funds is limited to highly wealthy investors with access to

225. See LERNER, HARDYMON & LEAMON, *supra* note 169, at 4–5 (arguing that neither individual investors nor traditional banks have the expertise and flexibility necessary to finance high-risk ventures); Dent, *supra* note 170, at 1032.

226. See Timothy J. Sturgeon, *How Silicon Valley Came to Be*, in UNDERSTANDING SILICON VALLEY, *supra* note 173, at 15, 15 (“The rise of Silicon Valley has garnered worldwide attention because it seemed to offer the possibility that a region with no prior industrial history could make a direct leap to a leading-edge industrial economy.”).

227. See GOMPERS & LERNER, *supra* note 135, at 1.

228. See *id.* at 3.

229. See, e.g., *id.* at 273–307. Gompers and Lerner concluded that “venture capital accounted for 8 percent of industrial innovations in the decade ending in 1992.” *Id.* at 306.

230. Tennille Tracy, *Moving the Market: Private-Equity Firms Raked in Record Amounts Last Year*, WALL ST. J., Jan. 11, 2007, at C6. Of this \$215.4 billion, approximately \$25 billion, or 11% of the total, went to venture capital funds, while \$149 billion, or 69% of the total, went to leveraged buyout funds. *Id.*

231. See Henny Sender, *Investors Riding the “Cash” Rapids*, WALL ST. J., Jan. 2, 2007, at C1 (citing data provided by J.P. Morgan Securities).

any number of other investment opportunities, this is truly a mark of success.²³²

At least in traditional financial terms, then, there appears to be a strong body of evidence suggesting that the investment strategies pursued by private equity funds yield significantly positive results, both for fund investors and for target company shareholders. To the extent such strategies result from the governance structure of private equity funds, it is therefore a governance structure worthy of emulation. By closely aligning the interests of managers and investors, private equity funds have developed a highly effective means for reducing agency costs. The carried interest, when coupled with a hurdle rate and a direct equity stake that subjects managers to a portion of the downside risk, forces fund managers to pay close attention to the performance of their portfolio companies and to take active and firm-specific steps to constantly improve such performance. The monitoring strategy engaged in by private equity funds therefore successfully reduces agency costs at both the fund level and the level of the fund's target companies.

C. Fostering a Market for Good Corporate Governance

As I mentioned earlier in this Article, there are essentially only two strategies for reducing agency costs. On the one hand, the agent's interests can be made to better coincide with the interests of its principal, thus reducing agency costs directly. On the other hand, an outside monitor can be enlisted to discipline the agent on behalf of its principal. The problem with monitors, of course, is that they are themselves agents who suffer from their own set of agency costs. Thus, reform efforts aimed at increased monitoring must inevitably return full circle to the problem of aligning interests.²³³ Otherwise, agency costs are not reduced, they are simply relocated.

Part II of this Article focused on the first half of the equation. In it, I demonstrated that, although the governance structure of both corporations and public equity funds are poorly designed to reduce agency costs, private equity fund compensation creates a tight alignment of interests. The first two subparts of Part III then focused on the second half of the equa-

232. In order to remain exempt from the registration requirements of the Investment Company Act, private equity funds with more than one hundred investors must bar individuals with less than \$5 million actively invested in the markets, as well as entities with less than \$25 million actively invested. See 15 U.S.C. §§ 80a-2(a)(5)(A), -3(c)(7) (2006). Thus, the money being invested in private equity markets comes from highly sophisticated investors.

233. See Bratton, *supra* note 73, at 1581 ("If the economics of corporate governance teach us anything, it is that agency problems will not be solved unless actors have an incentive to solve them.").

tion. In those subparts, I argued that private equity fund monitoring effectively reduces agency costs at the corporate level as well.

Thus, this Article suggests that the promise of private equity fund compensation arises from its ability to combine these two governance strategies, thereby resolving the defects in both. The carried interest, coupled with a hurdle rate and direct investment by the fund managers, tightly aligns the interests of private equity fund managers with those of investors. At the same time, the need to justify large fees—as well as the opportunity to earn such fees—causes the managers to become active and effective corporate monitors. Their profits come not from picking the winners, but from improving the performance of the losers.

Having thus explored the promise of private equity fund governance, it is now possible to return to this Article's initial question: Would it be beneficial to imbue public equity funds with significant monitoring abilities?²³⁴ The answer is an emphatic but conditional yes. Public equity funds could become excellent corporate monitors, but only if they are permitted to adopt the governance structure of a private equity fund. The result would be to better align managerial and investor interests, while simultaneously fostering an expanded market for good corporate governance.

Before concluding, however, it is worth considering what such a regime might look like. An assumption underlying the work of most corporate governance scholars is that institutional investor monitoring, were it to occur, would be limited to one of two forms. The first form—call it the American model—would be akin to the concept of shareholder voice espoused by proponents such as Black.²³⁵ Under this model, public equity funds would continue to hold relatively small, dispersed stakes of five percent or less, but would combine their efforts and use their increased access to management's proxy to advocate for systemic governance reforms.²³⁶ Institutional investors would have influence over the direction of future governance decisions, but would not exercise control over firm-specific policy.

The alternative form that many scholars fear would result—call this the European or Asian model—would be characterized by relatively static securities markets in which banks and other financial intermediaries own a

234. Of course, in light of the material discussed in this Article, one could just as easily ask the opposite question: If private equity funds are so well suited to monitoring, why not expand *their* influence by allowing retail investors to purchase direct equity stakes in such funds? In short, the answer is that investors in public equity funds are protected by a host of other regulations that make public equity funds much safer investment vehicles than hedge funds and other private equity funds. These include detailed reporting and fraud standards, as well as diversification requirements. *See, e.g.*, sources cited *infra* notes 255–58 and accompanying text. Thus, from a regulatory standpoint, it would be a far narrower—and thus safer—reform to deregulate public equity fund compensation than to remove eligible investor standards from hedge funds and other private equity funds.

235. *See supra* note 192 and accompanying text.

236. *See Black, supra* note 6, at 816.

majority of the stock of most large industrial enterprises. Under this scenario, were they actually empowered as powerful monitors, institutional investors would seek to exercise permanent dominion over corporate America. Seen in this light, the potential for agency costs to proliferate at the monitoring level seems glaringly real.

I doubt, however, that either model would be the likely result of deregulating American public equity fund compensation. As Mark Roe has demonstrated, a country's particular form of corporate governance is influenced to a large degree by its unique politics and culture.²³⁷ Therefore, it is unlikely that any one set of economic circumstances will lead inexorably to a particular governance system. Indeed, Coffee has pointed out that the existing legal constraints on U.S. public equity funds are not dissimilar to those impacting European and Japanese institutional investors, and yet the results are quite distinct.²³⁸ Cultural expectations and investment outlook, in other words, matter a great deal.

An important benefit of using private equity funds as exemplars of good governance is that the model has truly American roots. Although private equity markets are beginning to flourish outside the U.S., their early development has been closely tied to American culture and experience.²³⁹ There is therefore every reason to believe that, if American public equity funds were governed like American private equity funds, they would behave like American private equity funds, not like European banks or Japanese *keiretsu*.²⁴⁰ In fact, one can imagine public equity funds, under such circumstances, competing to recruit the same talent as private equity funds, and perhaps even attempting to poach their managers. They would, in other words, be the same people but with the additional resource of a vast pool of retail investment savings.

237. See generally MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* (2003).

238. Coffee, *supra* note 27, at 1286 (arguing that "a close comparative analysis demonstrates that the actual limitations placed by American law on financial institutions as investors are not significantly more restrictive than, for example, the applicable laws in Japan and certain other comparable economies" in Europe).

239. See PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 12, at 61. A good deal has been written on the American origins of the private equity industry. See, e.g., DOERFLINGER & RIVKIN, *supra* note 173 (tracing venture capital's impact over time on the development of various American industries); THE FIRST VENTURE CAPITALIST: GEORGE DORIOT ON LEADERSHIP, CAPITAL, & BUSINESS ORGANIZATION (Udayan Gupta ed., 2004) (chronicling the life of the founder of ARD, America's first professional venture capital fund); Kenney & Florida, *supra* note 173 (tracing the parallel histories of the development of the venture capital industry and of the Silicon Valley region of California).

240. Large Japanese companies are frequently organized into groups, called *keiretsu*, which are characterized by overlapping share-ownership. As a result, ownership of such companies is mostly static. Many large Korean companies are similarly organized into *chaebol*. See generally Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 345-46 (2005).

Certainly, even if they were permitted to charge a carried interest, many public equity fund managers would see their brightest future in continuing to offer low-risk, low-reward investments. After all, a substantial portion of any investment portfolio must always be retained in relatively conservative products.²⁴¹ It is also doubtful that there would be a sufficiently deep pool of monitoring talent for all fund managers to suddenly become activist.²⁴² In other words, not everyone would change their fee structure or investment strategy in response to deregulation.

However, it is likely that many public equity fund managers would prefer to join their private equity counterparts in a market for good corporate governance. Given the chance to become truly activist, they would compete to identify and streamline companies that underperform their potential or suffer from an excess of agency costs.²⁴³ Indeed, just such a cultural shift occurred in the late 1970s when new Department of Labor regulations clarified that pension funds could invest in private equity funds.²⁴⁴ It also happened in the 1980s when bond markets were liberalized.²⁴⁵ In both cases many previously staid market players eagerly jumped at the chance to play in more profitable—albeit also more risky—markets. Thus, given the history of Wall Street, it is difficult to imagine that the opportunity to earn twenty percent fees would long be ignored by the majority of fund managers.

In fact, one can already observe tentative efforts to expand the market for good corporate governance by combining aspects of public and private equity funds. Pension funds, for example, as mentioned above, have for

241. Modern portfolio theory suggests that prudent investors will seek to balance their holdings so as to include a range of investments with varying risk profiles. Thus, despite the fact that private equity funds hold the promise of greater returns, few rational investors would allocate more than a modest portion of their capital to such high-risk ventures. Instead, the bulk of their portfolio will be spread among a variety of investments, including many that are considered “safe.” See generally ZVI BODIE, ALEX KANE & ALAN J. MARCUS, *ESSENTIALS OF INVESTMENTS* 161–200 (6th ed. 2007) (discussing methods for constructing efficient portfolios composed of the optimal level of risk).

242. See MEYER & MATHONET, *supra* note 135, at 15–16 (discussing the impact that high-quality managers have on the results of a given investment portfolio).

243. See Illig, *supra* note 2, at 231–32.

244. Indeed, many industry watchers attribute the rise of professional venture capital firms to changes in the Department of Labor’s interpretation of ERISA’s “prudent investor” standard. LERNER, HARDYMON & LEAMON, *supra* note 169, at 2. Prior interpretations had left uncertain whether pension funds could safely invest in “venture capital or other high-risk asset classes.” *Id.* However, in 1979, the Department of Labor issued a release that clarified the standard to permit such investments. *Id.* Another factor may have been the rise of limited partnerships, which—unlike Small Business Investment Companies—were not restricted in investment options, and which made possible performance-based fee arrangements. *Id.*; see also MERCER REPORT, *supra* note 12, at 85.

245. See LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* 1–5 (1991) (describing the transformation of financial markets that took place in the 1970s and 1980s in response to Federal Reserve Board Chairman Paul Volcker’s announcement that interest rates, and hence bond prices, would no longer be fixed); Boyer, *supra* note 47, at 1000 (“After Volcker’s speech . . . the bond market was transformed from a backwater into a casino.”) (alteration in original) (quoting MICHAEL LEWIS, *LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET* 35–36 (1989)).

many years invested a portion of their assets in venture capital, while a number of mutual funds have been formed in recent years with the express purpose of doing likewise.²⁴⁶ Conversely, several private equity funds have recently sought public financing, thereby morphing themselves into a sort of quasi-public equity fund.²⁴⁷ Thus, the lines separating public and private equity have begun to blur as the two camps seek to emulate one another's strengths.²⁴⁸ Private equity funds have begun to tap the deep pool of retail dollars now available only to public equity funds, while public equity funds seek to garner a share of the profits to be made from active monitoring.

Fee deregulation, however, is unlikely to result in a static system of bank domination of the industrial economy. This is because funds that elect to charge a carried interest could do so successfully only so long as they achieve above-average returns. In other words, if a newly active fund did not significantly outperform its more traditional rivals, it would be unable to justify its high level of fees and so would begin to lose investors.

In practice, this means that once a fund has squeezed the agency costs out of a particular portfolio company, it would need to liquidate such investment because of the opportunity cost involved with its retention. In this way, an enhanced market for good corporate governance would be likely to preserve the cyclical character of private equity markets. Control over a given corporation would be maintained for only a few years at a time.²⁴⁹ Thus, the market would not entail the relatively permanent acquisition of control along the lines of that seen in Europe or Japan.²⁵⁰ Rather,

246. With respect to pension funds, see *supra* note 244 and accompanying text. With respect to mutual funds, see Eleanor Laise, *Mutual Funds Delve Into Private Equity*, WALL ST. J., Aug. 2, 2006, at D1.

247. During 2007, several prominent private equity advisers, most notably Kohlberg Kravis Roberts and Blackstone Group, either sold subscriptions to the general public or announced that they would soon do so. See Jenny Anderson & Michael J. de la Merced, *Kohlberg Kravis Plans to Go Public*, N.Y. TIMES, July 4, 2007, at C1; Michael J. de la Merced & Jenny Anderson, *Hedge Funds Continue Public Path*, N.Y. TIMES, July 3, 2007, at C1; Gregory Zuckerman & Henny Sender, *Blackstone's Green Day*, WALL ST. J., June 22, 2007, at C1. These offerings will enable the funds to partially tap the retail dollars currently available only to public equity funds and to use them as an important additional source for the financing of corporate monitoring. Their aim—like that of the reforms considered in this Article—is convergence: joining retail dollars to the fight for improved corporate discipline.

248. The SEC, meanwhile, appears to be headed in the opposite direction, at least with respect to hedge funds. A recent proposal to increase the financial qualification requirements for certain hedge fund investments appears to be aimed at limiting the ability of retail investors to participate in private equity funds. See Nathan J. Greene, *The SEC's Latest Hedge Fund Rulemaking: More than 600 Comment Letters Later*, BANKING & FIN. SERVICES POL'Y REP., July 2007, at 4, 5–7; J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 812–13 (2007).

249. See Kaplan, *supra* note 217, at 290, 311 (finding that typical leveraged buyouts are neither short-lived nor permanent, but represent a transitory organizational form between periods of public ownership).

250. See, e.g., Coffee, *supra* note 27, at 1294–1306 (describing the corporate governance systems in Japan and Germany, both of which are characterized by relatively permanent bank domination of

control would be temporary and recurring, with an endless cycle wherein the poorest performers always become targets, only to be replaced by others as their efficiency improves due to the impact of outside oversight. The result would be a near-continuous refreshing process, wherein bottom-tier companies are acquired, refurbished, and then resold as middle- or top-tier companies. Those that were previously in the middle would by then have fallen to the bottom, converting them into the next most likely targets.

Although an expanded market for good corporate governance would primarily target the poorest performers, its impact would be felt in the middle ranks as well. Managers at the margin would suddenly have more to fear as money became available for acquisitions of companies whose talent is only slightly below the average. Additionally, above-average managers whose performance is solid, but not stellar would find themselves forced to compete with the improved efforts of their formerly sub-par competitors. Increased demand for activist monitoring would therefore drive all corporate managers to more closely pursue shareholder interests in order to keep up with the overall improved performance of the marketplace.

However, fee deregulation would be worth the risk even if it does not result in a vibrant market for good corporate governance. This is because it ultimately relies on market forces, not governmental intervention, to bring discipline to corporate America. Money would become available for activist monitoring strategies only to the extent there are in fact agency costs to squeeze. Fee deregulation, in other words, would not be synonymous with compulsory oversight. Rather, the market itself would serve as a test of our understanding of agency costs. If it turns out that no such costs exist—or that they are vastly exaggerated by those on the left—then fee deregulation would have no impact, positive or negative. However, a powerful myth would have been dispelled at no cost to the economy. If, on the other hand, corporate America is as rife with agency costs as some believe, then the market will prosper so long as monitoring remains profitable. Additional managerial oversight, in other words, would lead to greater economic prosperity.

In fact, we might expect such a market to eventually mature as agency costs begin to disappear. By constantly seeking to reform the poorest companies, activist investors would raise the performance of the market overall. Profitable ventures, however, would become scarcer and require greater effort to bring to fruition. Over time, returns from passive investments would improve, while returns from monitoring would decline.

Though such a result might be unfortunate for any given fund manager, it would be a boon for the overall economy.

Admittedly, the feeble nature of the hostile takeover market would place some check on the foregoing. Managers have at their disposal a host of anti-takeover devices and could presumably block most uninvited attempts to impose discipline upon them.²⁵¹ One of the beauties of the private equity markets, however, is that they are generally not premised on hostile deals. Rather, most private equity transactions currently operate with the blessing and encouragement of current management. On the other hand, if the takeover wars were re-ignited as a result of fee deregulation, it is not at all clear that the outcome would be the same as in the 1980s. This is because, unlike in the 1980s when the defenders of the corporate bastion had resources that vastly exceeded those of their challengers, it would be the challengers who had the deeper pockets.²⁵²

Critics might also be concerned that, by incentivizing public equity fund managers to engage in leveraged buyouts and other control acquisitions, policy makers would be exposing retail investors to excessive risk. In fact, modern portfolio theory suggests that the real danger to investors arises not from how aggressive a fund's investment strategy is, but whether its investors are sufficiently diversified.²⁵³ The exemptions that permit wealthy and sophisticated investors to freely acquire interests in private equity funds are based in part on the notion that such investors understand the benefits of diversification and will bet only a portion of their portfolios on riskier ventures. For a retail investor whose portfolio is too small to adequately diversify, however, there is a real possibility that she will invest the entirety of her savings in a single public equity fund (or fund family).²⁵⁴ Thus, there is a danger that retail investors would become overly speculative, whether purposefully, due to a high risk tolerance, or through ignorance.

The regulatory framework that governs mutual funds and pension funds already accounts for the risks posed by too little diversification, however, and so the danger is relatively small. Pension fund managers, for example, are required by ERISA to diversify their investments "so as to minimize the risk of large losses."²⁵⁵ Securities regulations similarly require most mutual funds to devote seventy-five percent of their assets to investments that are diversified, both with respect to the size of the fund and the size of the target company.²⁵⁶ Moreover, for those mutual funds

251. See *supra* text accompanying notes 20–21.

252. See *supra* note 1 and accompanying text.

253. See, e.g., Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 89 (1952).

254. See Roe, *supra* note 30, at 20 ("Mutual funds are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund's portfolio.").

255. 29 U.S.C. § 1104(a)(1)(C) (2000).

256. 15 U.S.C. § 80a-5(b)(1) (2006) (prohibiting "diversified" mutual funds from using 75% of

that are not so limited, subchapter M of the Internal Revenue Code effectively bars them from investing more than fifty percent of their assets in non-diversified investments.²⁵⁷ In fact, this is one of the reasons that public equity funds are so well suited for the job of activist monitoring. Therefore, in terms of investor protections, even if public equity funds were permitted to engage in private equity-style control acquisitions, it is likely that they would remain adequately diversified.²⁵⁸

The money that is pouring into private equity markets is doing so because no other investment option is more successful at limiting agency costs. Investors, in other words, are craving investments that offer low agency costs and a tight alignment of interests. What this suggests, then, is that the expansion of private equity-style compensation would be welcomed by the investment community. Were public equity funds permitted to charge a carried interest—subject to a hurdle rate and coupled with a mandatory direct equity investment by the fund managers—such a shift would both realign the incentives of their managers and convert them into powerful corporate disciplinarians. The result would be to foster the expansion of the market for good corporate governance.

CONCLUSION

From an academic standpoint, the 1990s may be considered the decade of the institutional investor. According to contemporary scholars, institutional ownership of U.S. stocks had risen to over 45% by 1989.²⁵⁹ In dol-

their assets to acquire more than 10% of the voting securities of any one company or to acquire an interest in a single company that would exceed 5% of the fund's total assets).

257. See I.R.C. § 851(b)(3)(A)(ii) (2000) (providing pass-through tax treatment for “regulated investment compan[ies]” that set aside 50% of their portfolio for investments that do not exceed 10% of the voting securities of any one company or 5% of the fund's total assets). But for the pass-through treatment provided by § 851, dividends earned by mutual funds would be taxed three times—once at the portfolio company level, again at the level of the mutual fund, and a third time when distributed to the mutual funds' investors. See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1478–80 (1991).

258. Some finance textbooks state that as few as eight stocks can be sufficient to provide reasonable diversity. See Gerald D. Newbould & Percy S. Poon, *The Minimum Number of Stocks Needed for Diversification*, FIN. PRAC. & EDUC., Fall/Winter 1993, at 85, 85–86 (surveying the recommendations of twelve prominent finance textbooks). The idea is that firm-specific risks will be minimized, or even eliminated, in a balanced portfolio of stocks whose risks are negatively correlated, leaving only market-wide risks. For a classic example, assume that high oil prices will be good for oil stocks but bad for airline stocks. Presumably, the changes in the price of the two stocks will offset one another. A sagging economy, by contrast, will be bad for both. See generally John L. Evans & Stephen H. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761 (1968) (arguing, based on empirical analysis, that there are doubts as to whether increasing portfolio diversity beyond ten securities is economically justified).

259. Rock, *supra* note 27, at 447 n.3 (citing the NEW YORK STOCK EXCHANGE INSTITUTIONAL INVESTOR FACT BOOK 4 (1990)). Because of the difficulty associated with compiling accurate data regarding fund activities, and because definitions sometimes vary, estimates as to size also frequently vary. Thus, according to another contemporary source, institutional investor holdings represented 38% of all U.S. markets in 1981 and approximately 53% percent in 1990. CAROLYN KAY BRANCATO &

lar terms, the total value of institutional holdings in 1996 exceeded \$11 trillion.²⁶⁰ As a result, considerable scholarly attention was devoted to the oversight potential of institutional investors, with reformers seeking to make the legal landscape more hospitable for fund activism.²⁶¹ Public pension funds, in particular, were viewed as a white knight that could finally bring accountability to corporate America.²⁶²

As the first decade of the twenty-first century nears its close, however, the tide has shifted, and we are now witnessing the rise in importance of private equity.²⁶³ Today, it is estimated that hedge funds account for over half of the daily trading volume of the New York Stock Exchange, while leveraged buyout and venture capital funds account for a substantial portion of the nation's M&A activity.²⁶⁴ Meanwhile, the returns on private equity investments consistently surpass those earned by other institutional investors, usually by a considerable degree.²⁶⁵ Interest in the monitoring potential of traditional institutional investors may therefore be waning, to be replaced by the promise of hedge fund oversight.

Progressive legal scholars, however, have generally been slow to embrace the kind of activist monitoring conducted by private equity funds—that which rises to the level of outright control. Roe, for example, highlights the impact of America's long-standing distrust of accumulated capital.²⁶⁶ Meanwhile, Black and others advocate for the expansion of institu-

PATRICK A. GAUGHAN, THE GROWTH OF INSTITUTIONAL INVESTORS IN U.S. CAPITAL MARKETS tbl.10 (1991 update).

260. Hamilton, *supra* note 14, at 354 & n.8 (noting that institutional holdings had grown from around \$673 billion in 1970 to over \$11 trillion by the mid-1990s—a sixteen-fold increase in under a generation) (citing a series of reports subtitled “Institutional Investment Reports” published in 1998 by the Global Research Council of the Conference Board).

261. See, e.g., Black, *supra* note 6; Black, *supra* note 17; Coffee, *supra* note 35; Coffee, *supra* note 27; Gilson & Kraakman, *supra* note 29; Gordon, *supra* note 28; Rock, *supra* note 27.

262. See, e.g., Coffee, *supra* note 27, at 1336–37.

263. See *supra* notes 230–31 and accompanying text; see also Fleischer, *supra* note 147, at 80 (predicting that “the 21st century will be the golden age of private equity”).

264. See Steven M. Davidoff, *Do Retail Investors Matter Anymore?*, N.Y. TIMES DEALBOOK, Jan. 17, 2008, <http://dealbook.blogs.nytimes.com/2008/01/17/do-retail-investors-matter-anymore/> (noting estimates that trading by hedge funds may exceed “60 percent of the daily trading volume on the [New York Stock Exchange] and Nasdaq”); Jessica Hall, *U.S. Mergers Hit New Record, But Lag Europe*, REUTERS, Dec. 19, 2007, <http://www.reuters.com/article/businessNews/idUSN1961973720071220> (reporting that, according to data supplied by Thompson Financial, private equity funds accounted for 41% of all M&A activity during the first half of 2007, and 15% during the second half when money was more expensive to borrow); see also Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds 2* (Swedish Inst. for Fin. Research Conf. on the Econ. of Private Equity Mkts., Working Paper, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=996334 (reporting that buyout funds are responsible for approximately 25% of “global M&A activity”).

265. See *supra* notes 198–99 and accompanying text.

266. See Roe, *supra* note 30, at 11 (“Opinion polls show Americans mistrust large financial institutions with accumulated power and have always been wary of Wall Street controlling industry.”); see also Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 89–90 (1990). But see Coffee, *supra* note 27, at 1280 (arguing that “the populist image of a domineering J.P. Morgan seems to have been forever erased from the public’s mind” and that bank weakness, not bank strength, is the greater concern).

tional investor voice, but stop short of recommending that public equity funds increase their holdings beyond the traditional five percent threshold.²⁶⁷

This hesitation may indeed reflect the true thinking of these scholars. Still, I wonder whether there may be an element of political calculation in their judgments. Proposing legal reform in the business arena can be tricky. Not only do reformers face the quite reasonable argument that the economy is too large—and too important—to be tinkered with lightly, but any serious restructuring is certain to encounter the wrath of entrenched business interests. Incrementalism, as a result, is generally both safer and more likely to be enacted.

One of the major advantages of using hedge funds and other private equity funds as exemplars of good governance, however, is that the solution is a market-based one. By relaxing the legal constraints that generally prohibit mutual funds and public pension funds from charging incentive-based fees, policy makers can foster competition among would-be corporate monitors. Public equity funds, in addition to private ones, would compete to identify and acquire underperforming companies in the hope that they can be turned around. The monitoring of corporate agency costs would therefore continue only to the extent such costs can be remediated profitably.

A second significant advantage to be derived from drawing lessons from hedge fund governance is that the model is a uniquely American one. Thus, rather than attempt to make historical or cross-cultural comparisons, we can learn from a contemporary industry with its roots and development tied to the American experience. In this way, the vagaries of time, culture, language, politics, and regulatory environment are all removed. In other words, the best way to understand how incentive compensation would impact American public equity funds is to consider how it currently operates within American private equity funds.

The governance structure of hedge funds and other private equity funds is clearly superior to those of corporations and traditional institutional investors. The use of a carried interest, when combined with a hurdle rate and direct investment in the fund by its managers, results in a close alignment of interests between the fund's managers and investors. Moreover, the need to justify their outsized fees—plus the opportunity to earn such fees—provides strong incentives for private equity fund managers to closely monitor the conduct of their portfolio of investments.

Policy makers, as a result, should repeal or narrow the rules that currently prohibit most forms of incentive compensation for public equity

267. See Black, *supra* note 6, at 815 (“I believe that there is a strong case for measured reform that will facilitate joint shareholder action *not directed at control*, and reduce obstacles to particular institutions owning stakes *not large enough to confer working control*.”).

fund managers. Furthermore, they should consider coupling such reform with the requirement that any incentive compensation arrangements be subject to a hurdle rate and be accompanied by a mandatory direct equity investment by the fund managers. Their fees thus deregulated, the managers of mutual funds and public pension funds would then be free to behave more like their private equity counterparts. The result would be to reduce agency costs while simultaneously deputizing an effective new monitor of corporate wrongdoing. Institutional investors would thus become powerful and efficient players in an enhanced market for good corporate governance.