TOO BIG TO BE ACTIVIST

JOHN D. MORLEY*

Big investment managers, such as Vanguard and Fidelity, have accumulated an astonishing amount of common stock in America's public companies—so much that they now have enough corporate votes to control entire industries. What, then, will these big managers do with their potential power?

This Article argues that they will do less than we might think. And the reason is paradoxical: the biggest managers are too big to be activists. Their great size creates intense internal conflicts of interest that make aggressive activism extremely difficult or even impossible.

The largest managers operate hundreds of different investment funds, including mutual funds, hedge funds, and other vehicles that all invest in the same companies at the same times. This structure inhibits activism, because it turns activism into a source of internal conflict. Activism by one of a manager's funds can damage the interests of the manager's other funds. If a BlackRock hedge fund invests in a company's equity, for instance, at the same time a BlackRock mutual fund invests in the company's debt, then any attempt by either fund to turn the company in its favor will harm the interests of the other fund. The hedge fund and mutual fund might similarly come into conflict over the political and branding risks of activism and the allocation of costs and profits. Federal securities regulation and poison pills can create even more conflicts, often turning activism by a hedge fund into serious legal problems for its manager's entirely passive mutual funds. A big manager, in other words, is like a lawyer with many clients: its advocacy for one client

*. Professor of Law, Yale Law School. E-mail: john.morley@yale.edu. I thank Mark Andriola, Aslihan Asil, Eli Jacobs, John Jo, and Alex Resar for excellent research assistance. For helpful conversations and comments, I thank Vince Buccola, Florian Ederer, Marcel Kahan, Roy Katzovicz, Chuck Nathan, Roberta Romano, Dorothy Shapiro, Robert Zack, and workshop participants at the American Law and Economics Association Annual Meeting, Northwestern University Law and Economics Workshop, NYU Institute for Corporate Governance and Finance Corporate Governance Roundtable, UCLA Law School, and the Wharton School Department of Legal Studies and Business Ethics.

can harm the interests of another.

The debate about horizontal shareholding and index fund activism has ignored this truth. Research on horizontal ownership tends to treat a manager and its funds as though they were a single unit with no differences among them. Traditional analyses of institutional shareholder activism tend to go the opposite direction, treating mutual funds as though they were totally independent with no connection to other funds under the same management.

By introducing a subtler understanding of big managers' structures, I can make sense of shareholder activism more clearly. Among other things, I show why aggressive activism tends to come entirely from small managers—that is, from the managers whose potential for activism is actually the weakest.

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INTRODUCTION

The future of American capitalism belongs to a handful of giant investment managers. Registered investment companies such as mutual funds collectively hold stocks, bonds, and other assets worth $22.5 trillion,[1] enough to give them 31 percent of the outstanding common stock of America's public companies.[2] And of this amount, fully 50 percent—or $12.2 trillion—belongs to just four massive investment management firms: BlackRock, Vanguard, State Street, and Fidelity.[3] BlackRock alone has more than $6 trillion in assets under management,[4] and Vanguard more than $5 trillion.[5] These giants are growing much faster than their smaller competitors. In 2006, the four biggest investment managers held 51 percent of all assets in mutual funds;[6] by 2015, they held 68 percent.[7] Vanguard's growth has been especially impressive. Between 2014 and 2016, Vanguard took in more mutual fund assets than all four thousand other firms in the mutual fund industry combined.[8]

With so much wealth under management, the biggest investment managers hold enormous potential for influence. Vanguard, BlackRock, and State Street hold so many shares in America's public companies that they each control one of the five largest stakes in at least twenty-four of the twenty-five largest U.S. corporations.[9] If we combined the holdings of

1. INV. CO. INST., 2018 INVESTMENT COMPANY FACT BOOK, at ii (58th ed. 2018), http://www.lexissecuritiesmosaic.com/gateway/sec/testimony/pdf_2018_factbook.pdf.

2. *Id.* at 39.

3. N. TR. ASSET MGMT., ASSET MANAGEMENT RANKING HIGHLIGHTS 1 tbl.1 (2015), https://www.northerntrust.com/documents/white-papers/asset-management/rankings-investmgr.pdf.

4. *History*, BLACKROCK, INC., https://www.blackrock.com/corporate/about-us/blackrock-history (last visited Sept. 7, 2019).

5. *Fast Facts About Vanguard*, VANGUARD GROUP, https://about.vanguard.com/who-we-are/fast-facts (last visited Sept. 7, 2019).

6. INV. CO. INST., *supra* note 1, at 34 fig.2.1 (indicating that in 2006, assets in mutual funds totaled $11.1 trillion); *The World's Largest Managers*, PENSIONS & INV. (Oct. 1, 2007, 1:00 AM), https://pionline.com/article/20071001/INTERACTIVE/70927004/the-worlds-largest-managers/W (indicating that the four biggest managers held $5.7 trillion in 2006).

7. INV. CO. INST., *supra* note 1, at 34 fig.2.1 (indicating that all mutual fund managers held $18.1 trillion); Gregg A. Runburg, *Table: The World's Largest Money Managers*, PENSIONS & INV. (Oct. 31, 2016, 1:00 AM), www.pionline.com/article/20161031/INTERACTIVE/161029928 (indicating that the top four managers held $12.3 trillion in 2015).

8. Landon Thomas Jr., *Vanguard Is Growing Faster Than Everybody Else Combined*, N.Y. TIMES (Apr. 14, 2017), https://www.nytimes.com/2017/04/14/business/mutfund/vanguard-mutual-index-funds-growth.html.

9. Based on publicly available shareholder data for each of the top twenty-five U.S. public companies by market capitalization, taken from the Thomson ONE database (data on file with author). The only firm that did not have each of the big three among its top five shareholders was Amazon, only because T. Rowe Price, another large fund manager, edged out State Street for the fifth-largest shareholder spot.

Vanguard, BlackRock, and State Street, they would collectively be the largest shareholder in 88 percent of all firms on the S&P 500.[10] BlackRock and Vanguard manage one of the ten largest stakes in 65 percent of all publicly traded firms, State Street in 35 percent, and Fidelity in 28 percent.[11] As of March 2016, BlackRock was the beneficial owner of 5 percent or more of the stock of 2,632 different companies—more than half of all publicly listed companies in the United States.[12] Vanguard and Fidelity controlled 5 percent or more of 1,855 and 1,309 publicly listed companies, respectively.[13] At least twelve other investment managers beneficially owned 5 percent or more of more than two hundred companies.[14]

The immense power of these big investment managers has inspired equally immense fear—and hope—that they will use their influence to change the way companies do business. Academics in both law and economics have generated a tidal wave of research—much of it in the last two or three years—contemplating what this consolidation in corporate ownership will mean. What is at stake are both the hopeful possibilities that big managers will improve shareholder oversight of corporate boards,[15] and also the darker possibility that these managers will launch vast programs of political influence or destroy the delicate balance of power between shareholders and directors.[16] Antitrust scholars and economists have written in especially prolific and worrisome terms about "horizontal" or "common" ownership—the possibility that a handful of big investment managers might become de facto monopolists or oligopolists by gaining control over every company in a given industry.[17]

10. Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 298 (2017).

11. Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives* 40 tbl.3B (Ross Sch. of Bus., Working Paper No. 1328, 2016), http://ssrn.com/abstract=2802332.

12. Fichtner et al., *supra* note 10, at 312.

13. *Id*.

14. *Id*.

15. *See, e.g.*, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1149 (2015).

16. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1279 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 599 (2006); Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 1 (Univ. of Cal., L.A. Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 05-20, 2005), http://ssrn.com/abstract=796227.

17. To be clear, these commentators have not suggested that big managers are self-consciously causing companies to collude with one another over prices, but they do suggest that big managers might have little incentive to encourage competition when they possess large stakes in every company in an industry. *See generally* José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (arguing that common ownership diminishes incentives for competition); Martin C. Schmalz, *Common-Ownership Concentration and Corporate Conduct*, 10 ANN. REV. FIN. ECON. 413 (2018)

(same); Miguel Antón et al., *supra* note 11 (same); Joseph J. Gerakos & Jin Xie, *Institutional Horizontal Shareholdings and Generic Entry in the Pharmaceutical Industry* (Tuck Sch. of Bus., Working Paper No. 3285161, 2019), https://ssrn.com/abstract=3285161 (same); Katherina Lewellen & Michelle Lowry, *Does Common Ownership Really Increase Firm Coordination?* (Tuck Sch. of Bus., Working Paper No. 3336343, 2019), https://ssrn.com/abstract=3336343 (same); Miguel Antón et al., Innovation: The Bright Side of Common Ownership? (June 21, 2018) (unpublished manuscript) (available at https://ssrn.com/abstract=3099578) (same); José Azar, Portfolio Diversification, Market Power, and the Theory of the Firm (Aug. 23, 2017) (unpublished manuscript) (available at http://dx.doi.org/10.2139/ssrn.2811221) (same); José Azar et al., Ultimate Ownership and Bank Competition (May 4, 2019) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252) (same); Omesh Kini et al., Common Institutional Ownership and Product Market Threats (Aug. 11, 2019) (unpublished manuscript) (available at https://ssrn.com/abstract=3301998) (same); Oz Shy & Rune Stenbacka, Common Ownership, Institutional Investors, and Welfare (Apr. 15, 2019) (unpublished manuscript) (available at http://dx.doi.org/10.2139/ssrn.3302078) (same); Mohammad Torshizi & Jennifer Clapp, Price Effects of Common Ownership in the Seed Sector (Apr. 22, 2019) (unpublished manuscript) (available at http://dx.doi.org/10.2139/ssrn.3338485) (same). Other commentators have addressed the legal implications of hiorizontal shareholding. *See generally* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, 3 COMPETITION POL'Y INT'L ANTITRUST CHRON., June 2017, at 36 (proposing solutions to the antitrust problems purportedly posed by common ownership); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291–92 (2016) [hereinafter Elhauge, *Horizontal Shareholding*] (same); C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE. L.J. (forthcoming 2020) (same); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026 (2018) (same); Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017) (same); Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors* (N.Y. Univ. Law & Econ. Research Paper No. 17-23, 2017), http://dx.doi.org/10.2139/ssrn.2998296 (same); Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (N.Y. Univ. Law & Econ. Research Paper No. 17-05, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2925855 (same); Einer Elhauge, How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It (Aug. 2, 2019) (unpublished manuscript) (available at https://ssrn.com/abstract=3293822) (same); Einer Elhauge, New Evidence, Proofs, and Legal Theories on Horizontal Shareholding (Jan. 4, 2018) (unpublished manuscript) (available at https://ssrn.com/abstract=3096812) (same). Other authors have critiqued the common ownership hypothesis. *See generally* Erik P. Gilje et al., *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, J. FIN. ECON. (forthcoming) (criticizing the common ownership hypothesis); Keith Klovers & Douglas H. Ginsburg, *Common Ownership: Solutions in Search of a Problem*, *in* FRÉDÉRIC JENNY: STANDING UP FOR CONVERGENCE AND RELEVANCE IN ANTITRUST, LIBER AMICORUM (Nicolas Charbit et al. eds., forthcoming 2019) (same); Douglas H. Ginsburg & Keith Klovers, *Common Sense About Common Ownership*, CONCURRENCES REV., No. 2, 2018 (same); Menesh S. Patel, *Common Ownership, Institutional Investors, and Antitrust*, 82 ANTITRUST L.J. 279 (2018) (same); Lucian Bebchuk & Scott Hirst, *The Misguided Attack on Common Ownership* (Harvard Pub. Law Working Paper No. 19-10, 2018), http://dx.doi.org/10.2139/ssrn.3298983 (same); Thomas A. Lambert & Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms* (Univ. of Mo. Sch. of Law, Legal Studies Research Paper No. 2018-21, 2018), https://ssrn.com/abstract=3173787 (same); Ittai Paldor, *The Perils of Institutional Investors' Diversification: Defying the Myth* (Hebrew Univ. of Jerusalem, Legal Research Paper No. 19-06, 2019), https://dx.doi.org/10.2139/ssrn.3316111 (same); David I. Walker, *Common Ownership and Executive Incentives: The Implausibility of Compensation as an Anticompetitive Mechanism* (Bos. Univ. Sch. of Law, Law & Econ. Research Paper No. 19-3, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3345120 (same); Patrick Dennis et al., Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry (Aug. 12, 2019) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3063465) (same).

What, then, will these big managers actually do with all of their potential power? The answer, I argue, is that they will do much less than we might think. And the reason is paradoxical: the biggest managers are actually too big to be activists. Their great size creates intense internal conflicts of interest that render aggressive activism extremely difficult or even impossible.

Large investment managers attain their great size by simultaneously managing money on behalf of many different clients. In a large investment management firm, the clients can number in the hundreds or even thousands and may include a wide array of separately incorporated hedge funds, private equity funds and mutual funds, each with a distinct legal existence, a distinct set of owners, and a distinct investment strategy. Thus, when we think of how many shares a big manager holds in a particular company, we should be aware that those shares are spread across many different clients. Even if the aggregate ownership of all of a manager's clients amounts to, say, 10 percent of the outstanding shares of Delta Airlines, those shares will be spread so thinly among so many different funds that no individual fund may hold more than a sliver of a percent.

The basic claim of this Article is that this fragmentation of ownership inside an investment management complex creates intense conflicts of interest over shareholder activism. Because a manager and each of its various funds have separate owners, the manager and each of its funds are separate sites of fiduciary duty. Activism can thus place a manager in an extremely difficult position. Activism often brings a manager's various funds into conflict with one another, damaging some of a manager's funds even as it helps others.

Some of the conflicts over activism are economic. If a BlackRock hedge fund invests in a company's equity at the same time that a BlackRock mutual fund invests in the company's debt, then any attempt by either fund to influence the company's affairs will damage the interests of the other fund. Similar conflicts can arise over the political and branding risk created by activism, the resources required to fund activism, the profits generated by activism, and the preferred strategies for engaging corporate managers.

Other conflicts are legal. Many legal rules have a tendency to combine an investment manager and its various funds into a single unit for purposes of the law. Those kinds of rules include poison pills and section 13(d) and section 16 of the Securities Exchange Act,[18] The lumping together of a

18. 15 U.S.C. §§ 78m(d), 78p(b) (2018).

manager and its clients into a single unit has the odd effect of forcing all of the various funds to bear each other's legal burdens. The problem is intense, because the spillage of legal rules from one fund to another often makes the rules operate in odd and unpredictable ways. Activism by one fund can thus do grave legal damage to the other funds, even if the other funds remain passive.

These conflicts over activism tend to grow more severe as a manager grows larger and its activism grows more aggressive. A manager may engage in activism so long as the manager remains small or the activism remains mild. But once an investment manager becomes very large, the most aggressive forms of activism become nearly impossible.

This connection between a manager's internal structure and its capacity for activism has never been appreciated before. Though I have written previously about the logic of an investment manager's internal structure, the subtleties of this structure have been widely ignored by research on shareholder activism.[19] Recent work on horizontal ownership almost always treats a manager and its various funds as though they were a single unit.[20] Researchers often speak of BlackRock, for instance, as though it "owns" a massive stake in various companies. But in reality, BlackRock does not own much of anything—its funds do. By collapsing the distinction between BlackRock and its many funds, the horizontal ownership literature has glossed over profound internal conflicts that limit BlackRock's influence.

Opposite the horizontal ownership literature sits a more conventional body of research on corporate governance that tends to go to the other extreme. Most analyses of institutional investor behavior tend to treat each of a manager's funds as though it were an independent, stand-alone operation. Many commentators, for example, have analyzed the incentives of index mutual funds, almost always concluding that such funds have little incentive to engage in activism.[21] In so doing, these researchers have focused

19. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1228 (2014) [hereinafter Morley, *The Separation of Funds and Managers*] (describing the separation of funds and managers). *See generally* John Morley, *Why Do Investment Funds Have Special Securities Regulation?*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS 9 (William A. Birdthistle & John Morley eds., 2018) [hereinafter Morley, *Why Do Investment Funds Have Special Securities Regulation?*] (arguing that this pattern is the best explanation for why mutual funds are subject to distinctive securities regulation).

20. *See supra* note 17.

21. *See, e.g.*, Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 90 (2017) ("[I]ndex funds have especially poor incentives to engage in stewardship activities that could improve governance and increase value."); Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 32, 41 (Jennifer G. Hill & Randall S. Thomas eds., 2015); Ronald J. Gilson & Jeffrey N. Gordon,

on the incentives of the funds acting alone. But this ignores the positioning of these funds inside of large families of funds that could coordinate and act together. Although a BlackRock S&P 500 index fund may not be able to profit from activism, for example, one could imagine it using its votes to support a BlackRock hedge fund that actually could profit from activism. Indeed, precisely because such a BlackRock hedge fund could rely on the support of so many BlackRock index mutual funds, a BlackRock activist hedge fund could, in theory at least, become the world's most powerful corporate governance juggernaut. The question of why BlackRock and other large managers never start activist hedge funds—leaving hedge fund activism to small managers instead—is thus a deep puzzle. To my knowledge, no one has ever even identified the puzzle before, let alone convincingly solved it.

This Article thus turns our focus to the only fact about the world that can solve this puzzle and many others like it: the internal structure of big investment managers. By paying attention to the nuances of how and why a big manager's clients conflict, I can explain why big managers tend to be passive, why small managers tend to be activist, and why the forms of activism in which big managers do engage tend to be relatively mild.

This Article proceeds as follows. First, I explain how large investment managers are structured and how they come to contain so many conflicts. I then show how activism inflames those conflicts and makes them more intense as a manager grows bigger and activism becomes more aggressive. I consider other possible explanations for large investment managers' passivity and show how an awareness of conflicts makes more sense than these alternatives. I conclude by contemplating the implications for legal reform.

I. INVESTMENT MANAGERS AND CORPORATE INFLUENCE

To understand the conflicts over shareholder activism in large investment managers, we first have to understand how investment managers come to take on so many different obligations to so many different clients in

The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863, 894 (2013); Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 497 (2018) (arguing that index mutual funds should not be allowed vote their shares because they lack adequate incentives to inform themselves); Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 363–87 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018). *But see* Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U PA. L. REV. (forthcoming 2019) (arguing that index mutual funds have incentives to improve corporate governance in order to attract investors away from actively managed mutual funds).

the first place.

A. THE INVESTMENT MANAGEMENT INDUSTRY

Investment managers adopt a distinctive pattern of organization that I have elsewhere called the "separation of funds and managers."[22] This pattern accounts for much of what makes investment managers and their funds unusual and it creates many of the most interesting problems in investment management regulation and contracting. The conflicts of interest that plague activism by big investment managers are a product of this distinctive pattern.

Fundamentally, the business of an investment manager is to invest other people's money. Individuals and institutions entrust their money to an investment manager in the hope that the manager will earn a better investment return at less cost and inconvenience. In exchange for this service, the investment manager charges a fee, often as a percentage of the assets under management and sometimes as a percentage of investment returns. An investment manager invests money in a variety of ways, but the most common—and the one that has the greatest effect on corporate governance—is to buy stocks, bonds, and other securities of public companies. An investment manager might invest its clients' money, for example, in the common stock of General Motors, IBM, or Microsoft.

Sometimes an investment manager might hold its clients' money directly, as when a client opens a brokerage account to invest its money. More often, however, an investment manager will aggregate its clients' money into various corporations, trusts and other legal entities known as "funds." Investment funds can take a variety of different regulatory forms. *Mutual funds* are often the largest types of funds. They are registered with the SEC under the Investment Company Act of 1940 and may accept investments from the general public. *Hedge funds* and *private equity funds* are not registered with the SEC and may accept investments only from wealthy institutions and individuals.

The modern investment managers who account for the bulk of the industry's assets tend to be large corporate firms with diversified financial businesses. Examples include Fidelity, BlackRock, Goldman Sachs, and the Teachers Insurance and Annuity Association of America-College Retirement Equities Fund ("TIAA-CREF"). Crucially, the benefits of the

22. Morley, *The Separation of Funds and Managers*, *supra* note 19, at 1238–68 (describing the separation of funds and managers); Morley, *Why Do Investment Funds Have Special Securities Regulation?*, *supra* note 19, at 18 (citation omitted) (arguing that this pattern is the best explanation for why mutual funds are subject to distinctive securities regulation).

investment management industry's growth have not been equally distributed among all of these firms. A handful of the very largest management firms have grown astonishingly quickly in recent years, with the effect that the industry's assets are becoming increasingly concentrated among the very biggest firms, such as BlackRock, Vanguard, State Street, and Fidelity.[23]

One of the key facts about a large investment manager is that it does not work for just one client.[24] A large manager like Fidelity or BlackRock works simultaneously for many different investment funds, each with its own investment strategy, its own owners, and its own distinct corporate existence.[25] The accumulation of all these different clients is part of what accounts for a big investment manager's great size. Fidelity, for example, is best known for managing mutual funds, and it operates nearly a hundred of these funds, including the Fidelity Magellan Fund, the Fidelity 500 Index Fund, and the Fidelity Ohio Municipal Income Fund.[26] These funds attract a variety of investors, including individuals saving for retirement and institutions seeking returns on their endowments. In addition to these mutual funds, Fidelity could also manage (and many large managers *do* also manage) an array of private equity and hedge funds. Fidelity further manages thousands of so-called separately managed accounts, which are individualized accounts, similar to bank accounts, that each contain the assets of only a single investor. Fidelity also runs a trust company, which invests the money of donative trusts of the kind that grandparents commonly establish for their grandchildren.[27] The net effect of all these investment funds, individual accounts, and trusts is to give Fidelity and similar large investment managers a huge number of distinct clients, possibly reaching into the tens of thousands.

Crucially, each of Fidelity's many investment funds relies on Fidelity for its operations. Each fund has a contract with Fidelity that specifies the terms of Fidelity's authority and the fee the fund will pay to Fidelity. Very often, Fidelity will have almost total discretion regarding how to manage a fund. The fund will have no employees of its own, and only minimal mechanisms of corporate governance. A Fidelity fund is effectively

23. Fichtner et al., *supra* note 10, at 299.

24. I use the term "client" to refer both to an investment fund and to an individual investor who opens a "separately managed account," which is an individual investment account distinct from an investment fund.

25. Morley, *The Separation of Funds and Managers*, *supra* note 19, at 1239.

26. *All Fidelity Investment Funds*, MORNINGSTAR, INC., http://quicktake.morningstar.com/fundfamily/fidelity-investments/0C00001YR0/fund-list.aspx (last visited Sept. 7, 2019).

27. *Fidelity's Personal Trust Services*, FIDELITY INV., https://www.fidelity.com/managed-accounts/personalized-portfolios/personal-trust-services (last visited Sept. 7, 2019).

controlled and dominated by Fidelity.[28]

It is thus easy to conflate Fidelity with its various clients, but we must nevertheless keep them conceptually distinct, because the clients of an investment manager are not all pooled together, and their assets do not formally belong to the manager. Each Fidelity investment fund is a separate legal entity with a separate group of shareholders and a separate set of investments. The stocks and other investment assets of the fund legally belong to the fund, and not to Fidelity or to Fidelity's other clients.[29]

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

The proliferation of these sites of fiduciary duty does not stop with the manager's investment management clients. Investment management is often just one of many different lines of business in a much larger financial conglomerate. Goldman Sachs, for instance, operates a huge investment management business that includes mutual funds, hedge funds, private equity funds, and separately managed investment accounts. But Goldman is best known for its many other financial services businesses, including investment banking, commercial lending, securities underwriting, consulting, and derivatives underwriting. Goldman also has its own proprietary investing operation, in which it invests its own money for its own benefit. A large investment manager thus has to balance not only the interests of its many investment management clients, but also the interests of customers in its many other business lines—not to mention the manager's own shareholders.

Balancing all of these loyalties can be difficult, because an investment manager often holds extensive discretion. It often has total authority to make decisions about matters as basic as how to invest the money and what to do

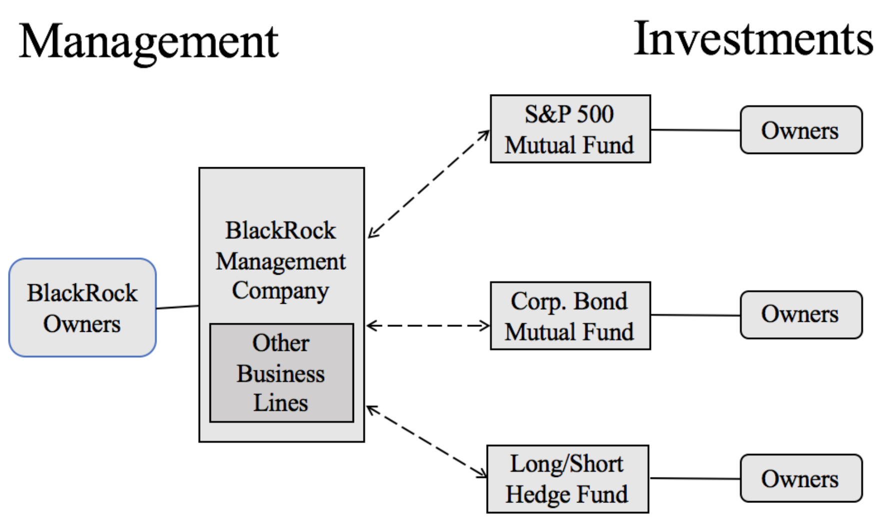
28. Morley, *The Separation of Funds and Managers*, *supra* note 19, at 1232.

29. Some investment management clients, such as the ones who set up separately managed accounts, may not formally own the investment assets in their portfolios in separate legal entities. Instead, the assets will formally belong to the manager, with the client merely having a contractual claim against the manager. Although this ownership formality is important for purposes of creditors' rights, it is not important for purposes of fiduciary duties. Whether or not a client holds separate title to its investments, each client is a separate site of fiduciary duty.

with it.[30] This system of delegating total authority makes sense for reasons I have described elsewhere.[31] But it nevertheless forces a manager to make difficult decisions with extensive implications for fiduciary duties.

Figure 1 illustrates the structure of a large investment management company. By way of example, Figure 1 shows an investment manager with just three different funds, although in reality, of course, a big manager would have hundreds of funds. Figure 1 shows the management company and the funds as separate corporate entities with separate owners, united only by the contracts (represented by dashed lines) that bind the various funds to the manager. In addition, the manager has other business lines beyond fund management that the manager runs inside of a larger corporate conglomerate.

FIGURE 1. Structure of a Large Investment Management Complex



B. THE POSSIBILITY OF HEDGE FUND ACTIVISM

Could a large manager with this organizational structure ever unite its clients' holdings into a single, focused program of shareholder activism? To date, research on corporate governance has failed not only to answer the question, but even to acknowledge it. Research on big institutional investors has focused overwhelmingly on the incentives of individual mutual funds, rather than the larger investment management complexes of which they are

30. Morley, *The Separation of Funds and Managers*, *supra* note 19, *passim*.
31. *Id*.

a part. Economists and lawyers have argued, basically, that the various funds on the right side of Figure 1 tend not to engage in activism because they do not find activism profitable.[32] There are many reasons. One is that the "mom-and-pop" investors who buy shares in ordinary mutual funds are not excited enough about activism to pay the high fees necessary to cover the costs of activism. Another reason is that the index investing strategies used by mutual funds makes activism unprofitable, because if an index fund spends money on activism to improve a company's stock price, the benefits of the increase will be shared by all of the fund's competitors who invest in the same company and the same index, even though none of them paid any of the costs of the activism.[33]

These explanations for why mutual funds do not find activism profitable are surely correct, but they miss the real heart of the problem. They examine the incentives of mutual funds individually, but not the incentives of the larger complex of which the funds are a part. The right unit of analysis, however, might be the complex as a whole. Instead of looking at individual funds, perhaps we should look instead at a manager and all of its funds as though they were a single unit.

This way of thinking is implicit in the rapidly growing literature on horizontal shareholding. This line of research worries that big managers turn into de facto monopolists by controlling every company in a given industry.[34] Without self-consciously thinking about it, the horizontal shareholding literature has implicitly treated management complexes as though they were unitary things. In the eyes of the horizontal shareholding literature, the key actor in corporate governance is not a fund, but the group of funds controlled by the fund's manager.

Consider, then, the possibility that the large manager depicted in Figure 1 might unite its various funds in a program of shareholder activism by adding to its various offerings an activist hedge fund. This possibility appears in Figure 2.

32. *See supra* note 21 and accompanying text.
33. Lund, *supra* note 21, at 520–23.
34. *See supra* note 17 and accompanying text.

FIGURE 2. Large Investment Management Complex with Activist Hedge Fund

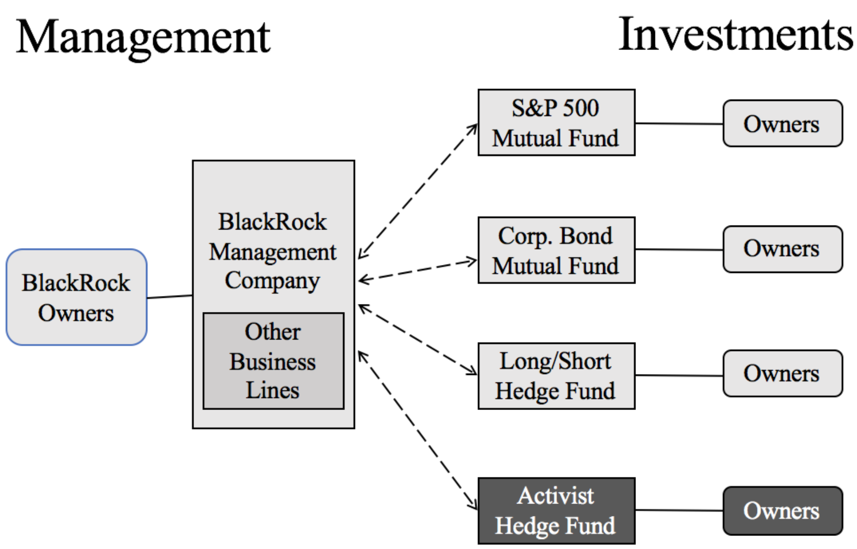


Figure 2 is important, because it tells us that even if *mutual funds* do not find activism profitable, a manager's other funds very well might. We know that hedge funds can turn a profit with activism, because for decades now, the market for hedge fund activism has been booming.[35] And because a large manager already tends to offer a wide variety of different funds, it seems plausible that an activist hedge fund might reasonably number among them.

Indeed, it would seem on first impression that a large investment manager ought to be the very best kind of manager to run an activist hedge fund, because a large manager could theoretically support an activist hedge fund by bolstering it with the voting power of the many other funds in the management complex that surround it. A large manager, in other words, could direct its various mutual funds to support its activist hedge funds.

35. Ajay Khorana et al., *The Evolving Shareholder Activist Landscape (How Companies Can Prepare for It)*, 29 J. APPLIED CORP. FIN., Summer 2017, at 8, 8 (showing that 2015 was a record year for hedge fund activism); Anna L. Christie, *Hedge Fund Activism and the Market for Corporate Quasi-Control* 2 (Univ. of Cambridge Faculty of Law Legal Studies Research Paper Series, Paper No. 51/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3066877 (showing that hedge fund activism has been increasing).

If a large manager were ever to try this strategy, the result could be an activist shareholder of unprecedented power. Whereas Pershing Square, a small manager with a prominent activist hedge fund, has only two funds and about $9 billion under management,[36] Fidelity, the investment management giant, has hundreds of funds and about $2.5 trillion under management.[37] If Fidelity ever added a $9 billion activist hedge fund to its stable of other clients, then Fidelity could form a voting bloc several orders of magnitude larger than Pershing Square. Fidelity could make the bloc especially huge by directing its other funds not only to *vote* alongside its activist fund, but also to *invest* alongside it as well. With more than $2 trillion under management, Fidelity could theoretically accumulate controlling majority ownership stakes in dozens and maybe even hundreds of America's largest companies.

It seems plausible that large investment managers could consolidate the voting of their various funds, because most of them already do it. In off-the-record interviews, I spoke with about a dozen current and former lawyers and executives at several of America's largest investment management firms and asked them how their firms voted their clients' shares. Their responses all indicated a degree of centralized control over the voting of each of their various clients.[38]

In one common pattern, a senior executive of a management company leads a dedicated department whose job is to formulate voting policy for the entire firm. This central voting office decides how to vote all of the shares of the manager's different clients on each matter presented in each portfolio company. If a hedge fund, a mutual fund, and a separately managed account each own shares in Delta Airlines, for example, the centralized voting office decides how all three clients will vote and casts all of their votes the same way. The central voting office might, on occasion, give the portfolio manager of a particular fund the right to vote the fund's shares differently from the rest of the firm. But for most large managers, such freedom tends to be exercised only very rarely.

Some firms are less centralized than this. Some firms place

36. Scott Deveau, *Ackman's Pershing Square's Assets Fell 20 Percent in* 2017, BLOOMBERG, https://www.bloomberg.com/news/articles/2018-01-29/ackman-s-pershing-square-s-total-assets-fell-20-percent-in-2017 (last updated Jan. 29, 2018, 3:01 PM).

37. *Fidelity by the Numbers: Corporate Statistics*, FIDELITY INV., https://www.fidelity.com/about-fidelity/fidelity-by-numbers/corporate-statistics (last visited Aug. 13, 2019).

38. The account I offer here finds support in the empirical evidence of Ryan Bubb and Emiliano Catan, who tally the corporate voting of individual mutual funds and find, among other things, that funds that share a manager all tend to vote almost exactly the same way. Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds 29 (Feb. 14, 2018) (unpublished manuscript) (available at https://ssrn.com/abstract=3124039).

responsibility for the initial decisionmaking about voting directly in the hands of the portfolio managers of individual funds. If three different funds each hold shares in Delta Airlines, the managers of each different fund may make the decision about how to vote the shares independently without any central guidance. Such a decentralized firm will, nevertheless, almost always have a central voting office with a small staff whose purpose is to safeguard the reputation of the firm as a whole. The office will not allow an individual portfolio manager to issue a public statement on a sensitive corporate governance dispute unless the firm's central voting office agrees to take the same position as well. In this way, even investment managers with relatively decentralized voting operations show both the willingness and the capacity to coordinate voting among their clients.

C. THE CONTINUUM OF MANAGER SIZE AND INTENSITY OF ACTIVISM

It seems possible, then, that a large manager might start an activist hedge fund and use a centralized voting office to direct its other clients to support the fund. But what exactly would it mean for the hedge fund to be an "activist"? The answer is complex, and I will say much more about exactly what I mean later, in Part IV. For now, though, I wish to make it clear that activism exists along a continuum of aggressiveness and that the sorts of conflicts between clients that I am concerned about tend to be most serious at the more aggressive end of the continuum. Mild forms of activism tend to be relatively unproblematic.

Some large investment managers, such as T. Rowe Price, for example, tend to think of themselves, even now, as being seriously committed to activism. They sometimes vote in support of smaller managers' activist hedge funds and they occasionally meet with corporate executives to talk about how the companies are faring.[39] As we will see in a moment, the mildness of these forms of activism ensures that they create comparatively few conflicts within a management complex.

The forms of activism that concern me most here are more aggressive. They involve not merely voting for someone else's nominees to a corporate board, but actually nominating candidates directly. They also include things like running proxy contests on mergers and publicly pushing for changes to a company's capital structure. Again, for reasons that will become clear, these more aggressive kinds of activism are where conflicts between clients

39. Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2912 (2016) (describing how big investment managers often hold nonpublic meetings with corporate executives).

become truly debilitating.

II. LEGAL CONFLICTS

Let us turn, then, to the heart of the matter by examining the nature of the conflicts that activism can generate. Conflicts over activism tend to come from two sets of sources, one legal and one practical. We begin with the legal conflicts. Activism poses a host of legal challenges and they tend to make it difficult for any shareholder to become an activist. But for a large manager, the legal challenges of activism are greatly aggravated by their tendency to spill from one client to another. Legal rules governing shareholder activism often treat an investment manager and its various clients as a single unit, with the effect that the activism of one client can damage the regulatory status of every other client.

A. EXCHANGE ACT SECTION 13(d)

The first problem is section 13(d) of the Securities Exchange Act of 1934.[40] Roughly speaking, section 13(d) requires anyone who "beneficially own[s]" more than 5 percent of any class of a company's equity securities to file a report with the Securities and Exchange Commission within ten days after the acquirer crosses the 5 percent line.[41] The contents of the report can vary—more on this in a moment—but the report must generally disclose the extent and character of the owner's investment and the owner's intentions for future voting and control. The purpose of section 13(d) is to let an issuer and other shareholders know when a potential controlling shareholder is amassing a big interest.[42]

Section 13(d) is a headache for anyone who attempts to influence a public company, but it is especially painful for a large investment manager with many clients. The special problem for a big investment manager is that section 13(d) and its administrative rules combine a manager and all of its various clients into a single legal unit. If Fidelity has one hundred different clients that each own stock in Delta Airlines, for example, Fidelity becomes a "beneficial owner" of the shares of every one of these many clients for purposes of section 13(d) reporting. Hence, even if each of Fidelity's one hundred clients owns only 0.06 percent of Delta's common stock, so that

40. 15 U.S.C. § 78m(d) (2018).

41. *Id*.

42. Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58 (1975) ("The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding the qualifications and intentions of the offering party.").

none of them would cross the 5 percent threshold individually, all of these holdings will nevertheless be added together and attributed to Fidelity, bringing the total to 6 percent. Fidelity will thus have to file a Schedule 13D in its own name reporting its beneficial ownership. The lesson is that as a manager and its clients get bigger, the 5 percent threshold becomes easier and easier to cross.

The reason a manager and its clients get aggregated in this way is that regulations under section 13(d) define the term "beneficial owner" very broadly. Rule 13d-3(a) says that the term "beneficial owner" of a security includes anyone who has the "power to *vote*" or the "power to *dispose*" of the security.[43] This broad definition clearly reaches most investment managers, because the essence of an investment management contract is to give a manager discretionary authority to *vote* and *dispose of* a client's securities. Thus, the beneficial owner for purposes of section 13(d) in most investment management relationships is not only the fund that owns the shares, but also the manager that decides how to vote them.

Managers and their clients face a further risk of aggregation through the concept of a "group."[44] For purposes of the 5 percent threshold, section 13(d)(3) can combine together even persons who count as distinct beneficial owners so long as the persons act together as a "group for the purpose of acquiring, holding or disposing of securities of an issuer . . . ."[45] Thus, if two hedge funds work together to acquire 2 percent and 3 percent of an issuer's securities, respectively, then even if they are distinct "beneficial owners," their holdings can nevertheless be added together to total 5 percent, because they are working together as a group. Both hedge funds must then comply with section 13(d) and report each other's shares as their own.[46]

The definition of a group has been elaborated extensively by the courts, and the inquiry is highly fact-specific, making the resolution of particular cases very hard to predict.[47] But we can nevertheless say with confidence that if two clients have both given over control of their portfolios to the same investment manager and that manager directs them to both acquire shares in the same company, the clients will be at grave risk of being treated as a group

43. 17 C.F.R. § 240.13d-3 (2019).

44. 15 U.S.C. § 78m(d)(3).

45. *Id.* § 78m(d).

46. Note that if the two hedge funds are combined under the "group" definition—rather than having their ownership attributed to their manager under the definition of "beneficial owner"—then it is technically the funds, rather than the manager, who bear the burden of compliance.

47. *E.g.*, Hemispherx Biopharma, Inc. v. Johannesburg Consol. Invs., 553 F.3d 1351, 1366 (11th Cir. 2008) (holding that in order to be a member of a group, a person must be a beneficial owner of a security).

if the manager has not already been treated as the beneficial owner of both funds' securities under Rule 13d-3(a).

The logic of the group concept and the broad definition of beneficial ownership is to prevent clever strategies for avoiding the reporting obligation in 13(d).[48] In the absence of these aggregation rules, an investor could easily subvert the 5 percent limit by simply spreading its investment across multiple subsidiary entities. A shareholder could allocate 2 percent of a company's shares to each of five different entities that the shareholder controls, and thereby gain 10 percent of the company's shares without ever having to report a 5 percent ownership stake under section 13(d). The aggregation rules prevent this kind of gamesmanship.

There was a time when the 5 percent threshold of section 13(d) was high enough to allow large managers to purchase all the shares they liked for their many clients without running into problems. But as the biggest investment managers have grown, the 5 percent threshold has come to sweep in a huge number of investment positions for large investment managers. As of March 2016, BlackRock was the beneficial owner of 5 percent or more of the stock of 2,632 different publicly listed companies, or more than one half of all such companies in the United States.[49] Vanguard held a similar position in 1,855 companies and Fidelity did so in 1,309 companies.[50] At least twelve other investment managers beneficially owned 5 percent or more of more than two hundred companies.[51]

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

Consider, for example, what may happen if a client of a large investment manager tries to execute a so-called *quiet acquisition* of shares in a public company. In a quiet acquisition, an investor slowly accumulates up to 4.9 percent of the target company's shares and then buys as many

48. H.R. Rep. No. 90-1711, at 7 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2818 (making it clear that the goal of section 13(d)(3) is to "prevent a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns more than [five] percent of the securities").

49. Fichtner et al., *supra* note 10, at 312.

50. *Id.*

51. *Id.*

shares as it can over a period of ten days after crossing the 5 percent threshold. Quiet acquisitions are a common strategy for governance activists, because section 13(d) gives an investor a grace period of ten days after crossing the 5 percent threshold before the investor has to disclose its ownership publicly.[52] Quiet acquisitions are controversial—Hillary Clinton threatened to crack down on them when she was a candidate for president[53]—but virtually everyone seems to agree that they are central to both the success and the profitability of an activism strategy.

What makes a quiet acquisition so useful is that it offers an activist its best opportunity to buy shares at a low price before the public learns about the activist's plan and the price moves upward. Once the public knows the activism campaign is coming, the activist's opportunity to buy at a low price will disappear. Quiet acquisitions are delicate affairs, because the act of acquiring shares can tip off other investors of the impending campaign. Leaks of information are a constant problem, and an activist manager's acquisitions are watched extremely carefully.

Quiet acquisitions thus face a host of obstacles, but, for a large manager, by far the largest is the way section 13(d) brings various clients into conflict with one another. When a client of a large investment manager attempts a quiet acquisition, the client cannot actually buy 5 percent of the target company's stock before it crosses the 5 percent threshold and has to report its shares, because the client is part of a "beneficial ownership" unit that may already hold several percent of the target company's stock even before the client buys its first share. Imagine, for example, that an activist hedge fund wishes to buy 10 percent of Netflix, Inc. (as an activist fund managed by Carl Icahn did in 2012[54]). For a fund like Icahn's that works independently of a large management group, 10 percent is a fairly attainable goal. The fund can buy 4.9 percent slowly and quietly and then buy another 5.1 percent over a 10-day period of rapid acquisition before making its actions public in a Schedule 13D. By contrast, for a fund managed by a large manager such as T. Rowe Price, acquiring 10 percent would be much harder. As of year-end 2015, T. Rowe Price clients collectively owned 3 percent of Netflix.[55] Hence, if T. Rowe Price started an activist hedge fund, the fund could only buy 2

52. 15 U.S.C. § 78m(d)(1) (2018).

53. Tory Newmyer, *Hillary Clinton: Capitalism is Out of Balance, Needs a Reset*, FORTUNE (July 24, 2015), http://fortune.com/2015/07/24/hillary-says-capitalism-needs-a-reset.

54. Liyan Chen, *Here's How Carl Icahn Made $2 Billion on Netflix [Chart]*, FORBES (June 24, 2015, 4:01 PM), https://www.forbes.com/sites/liyanchen/2015/06/24/heres-how-carl-icahn-made-2-billion-on-netflix-charts/#34499c0113d9.

55. T. Rowe Price Assocs., Inc. Amendment No. 6 to Statement of Acquisition of Beneficial Ownership by Individuals (Schedule 13G/A) (Dec. 31, 2015).

percent of Netflix's stock before the 10-day clock would begin ticking, rather than 4.9 percent. Things would be harder still if, instead of being managed by T. Rowe Price, this hedge fund were managed by BlackRock or Vanguard. At year-end 2015, BlackRock and Vanguard clients already owned 5.7 percent[56] and 5.6 percent of Netflix,[57] respectively. As a result, if BlackRock or Vanguard were ever to start an activist fund, the fund would have to disclose its acquisitions almost immediately any time it purchased an additional 1 percent of Netflix's shares.[58]

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

The problem is that aggressive forms of activism can change a manager's obligations under section 13(d). Most large investment managers, it turns out, do not actually file reports under section 13(d). Instead, they file under section 13(g).[59] Section 13(g) imposes a 5 percent disclosure requirement similar to the requirement in section 13(d), but the contents of the disclosure are much less demanding than under section 13(d). Under section 13(d), the form prescribed for disclosure, which is known as Schedule 13D, has to be updated every time a beneficial owner's holdings change by more than 1 percent of the target company's stock.[60] And each time the form is filed or updated, the beneficial owner has to disclose all trades made 60 days prior to the time the schedule is filed or updated.[61] In addition, the filer has to disclose its intentions for its shares, including any intentions that might affect the control of the company.[62] In contrast to this demanding set of requirements in Schedule 13D, Schedule 13G only has to be updated once a year, does not require disclosure of prior trades, and requires no mention of the acquirer's intentions.

Eligibility for the lighter requirements of Schedule 13G turns on an

56. BlackRock, Inc., Amendment No. 1 to Statement of Acquisition of Beneficial Ownership by Individuals (Schedule 13G/A) (Dec. 31, 2015).

57. Vanguard Grp., Amendment No. 4 to Statement of Acquisition of Beneficial Ownership by Individuals (Schedule 13G/A) (Dec. 31, 2015).

58. *See* 17 C.F.R. § 240.13d-2 (2019).

59. *Id.* § 240.13d-1; U.S. SEC. & EXCH. COMM'N, SCHEDULE 13G TEMPLATE, https://www.sec.gov/Archives/edgar/data/1021917/000091228202000355/madsen13g.htm (last visited Sept. 7, 2019).

60. 17 C.F.R. § 240.13d-2(a).

61. *Id.* § 240.13d-101, item 5(c).

62. *Id.* § 240.13d-101, item 4.

investor's intentions for control. An investor who intends to exercise control must file on Schedule 13D; an investor who does not intend to exercise control can file on Schedule 13G.[63] The definition of "control" under section 13(d) and Rule 13d-1 is difficult to pin down precisely, because the statute and rule contain no express definition and the SEC's guidance prescribes only a multifactor inquiry that depends on the specifics of a given circumstance.[64] Nevertheless, it is clear that even fairly modest forms of influence can qualify. According to guidance provided by the SEC, examples of control include "engag[ing] with the issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors."[65] Similarly, Item 4 of Schedule 13D requires a shareholder to disclose its intentions with respect to a very broad array of activities that likely qualify as "control," including any intention to affect an extraordinary corporate transaction, a sale or transfer of a material amount of assets of the issuer, a change in the board of directors, a material change in capitalization, a change in the charter or bylaws, or "[a]ny other material change in the issuer's business or corporate structure . . . ."[66]

The small investment managers who operate activist hedge funds often do things that count as control within this convoluted definition, because activist hedge funds commonly nominate directors, demand dividends, and run proxy contests in support of sales and mergers—all of which are clearly named as indicia of control. Bigger managers, by contrast, almost never cross the threshold into 13d-1 control. Though they often vote in support of smaller managers' efforts at "control," they will almost never engage in control themselves.

The reason is that, whatever the meaning of "control," the analysis of whether a person has engaged in control applies at the level of the *beneficial owner*, which, in the case of an investment manager, is the manager itself, including all of its clients. Thus, for a manager to file on Schedule 13G, not only the manager but also *each and every one of its various clients* must avoid exercising control. If just one activist hedge fund exercises control

63. *Id.* § 240.13d-1(b)(1)(i).

64. *See generally* Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2854 (Jan. 16, 1998) (to be codified at 17 C.F.R. pt. 240) (amending the beneficial ownership rules in conjunction with expanding section 13(g) reporting eligibility for certain investors).

65. *Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, U.S. SEC. & EXCHANGE COMM'N, https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm (last updated July 14, 2016).

66. 17 C.F.R. § 240.13d-101, items 4(b)–(g).

over an issuer within the meaning of section 13(d), then the *entire investment management complex*—including the hundreds of mutual funds, hedge funds, trusts, and individual accounts the manager might manage—will tip from Schedule 13G to Schedule 13D status.

A fall from 13G to 13D status would do major damage to the manager and its various clients. Every professional I spoke with in the investment management industry insisted that the distinction between Schedules 13G and 13D was by far the most important problem they worried about when they considered the possibility of influencing a portfolio company. The biggest challenges, they say, are technical. The prompt updating and prior trade disclosure requirements of Schedule 13D—which are absent from Schedule 13G—are exceedingly costly for a large investment manager. The technical difficulties of constantly updating filings and adding prior trade information multiply exponentially with the number and diversity of the manager's clients. Regular reporting is difficult when a manager has many clients, because the clients' portfolios change constantly, as does the size of mutual funds whose shareholders can constantly withdraw and add money. If, for instance, a large manager operated a large S&P 500 index fund, an activist hedge fund, and a few thousand individual client accounts, the manager's holdings could easily increase or decrease by more than 1 percent—the threshold for filing an update—over the course of a single day. And it could happen day after day. A manager could thus be required to update its holdings in a company at a level of maddening frequency.

Updating all of the reports for a large number of clients and issuers would be difficult enough by itself, but it becomes especially difficult when it is added to the 60-day trade reporting requirement. Though trades that occur on the same day within one dollar of each other can be consolidated on a single line, the number of trades that might have to be tracked and consolidated could be enormous—numbering, perhaps, in the hundreds of millions.[67]

Even if the technical challenges of consolidating millions of trades could be overcome, a responsible manager would still worry about the huge privacy breach involved in doing so. If a manager were to disclose every one of its trades over the 60-day periods required by regular updates to Schedule 13D, it would end up giving away a huge amount of information about its transacting habits, which other traders could then use to front-run and otherwise game the manager's future trades. And the cost of this intrusive

67. *Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, *supra* note 65.

disclosure would not be borne exclusively—or even mainly—by the one client that triggered the obligation. The activist hedge fund that tripped the 13D trigger would only be just one of many clients that would have to throw open their trading histories.

Of course, one might argue that many of these problems under section 13(d) could be avoided if a manager just restricted its efforts at control to a few companies on behalf of just a few clients. But this is easier said than done. As noted above, a large investment management firm serves so many clients that many of them will inevitably want to invest in the same companies, making it impossible to limit the number of clients that accumulate holdings in a particular company. Further, even if a manager were able to focus its influence on just a few companies for just a few clients, it would simply prove my point, which is that a large manager cannot influence anything more than a small number of companies for a small number of clients. Turning the holdings of many clients into a focused program of corporate influence in major companies is tremendously difficult.

B. EXCHANGE ACT SECTION 16

Section 13(d) is just one of many legal rules that aggregate an investment manager and its clients for purposes of a regulatory ownership threshold. Another one is section 16 of the Exchange Act.[68] Section 16(b) requires a certain kind of investor known as a "statutory insider" to disgorge profits on trades it makes within six months of each other. A purchase of Facebook stock at $100 and a sale four months later at $105, for example, can be matched together under section 16(b) to produce a $5 profit, which the trader must then disgorge to Facebook.[69] Section 16(b) creates an express private right of action in any holder of the issuer's securities to sue for disgorgement, and plaintiffs' lawyers often use this right of action in the hope that they can take a portion of the settlement as a legal fee for themselves.[70] In addition to requiring disgorgement of profits, section 16(b) has a companion provision in section 16(a) that requires a statutory insider to disclose its ownership on forms known as Form 3 and Form 4.[71] The statutory insiders covered by the statute include officers, directors, and—

68. 15 U.S.C. § 78p(b) (2018).

69. Smolowe v. Delendo Corp., 136 F.2d 231, 234 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

70. Section 16(b) is a common cause of action in reported securities cases**.** Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2091 (1994).

71. 15 U.S.C. § 78p(a).

most important for my purposes—shareholders who own more than 10 percent of an issuer's equity securities.

The 10 percent ownership threshold could theoretically cover a large number of the positions of big investment managers. As of March 2016, Fidelity was the beneficial owner of 10 percent or more of the outstanding stock of 506 companies.[72] For BlackRock, the number was 375 companies and for Vanguard it was 163 companies.[73]

The purpose of section 16(b) is to serve as a prophylaxis against insider trading. By categorically prohibiting all profits on short-swing trading by the kinds of people who are most likely to have private information about an issuer, section 16(b) reduces the odds that any of these people will trade while they actually possess private information. Because section 16(b) only applies to certain high-risk categories of statutory insiders, it does not require a plaintiff to prove that an insider actually possessed private information at the time of its trade. The mere fact of the insider's insider status is enough to trigger disgorgement if the insider makes a qualifying trade over a short period of time.

For a large investment manager, section 16(b) creates conflicts over activism for the same reasons as section 13(d): it lumps a manager and its clients together for purposes of determining an ownership threshold. Under section 16, the relevant threshold is 10 percent, which is when a shareholder becomes a statutory insider. Exchange Act Rule 16a-1(a)(1) expressly borrows the aggregation framework of section 13(d) by defining a beneficial owner for purposes of determining statutory insider status to mean any person who is deemed to be a beneficial owner under section 13(d) and its implementing rules.[74]

Section 16 softens this act of combination by providing a special provision for an investment adviser who has become a beneficial owner of securities merely by virtue of managing the securities for the account of a client.[75] This special provision has the practical effect of exempting a large investment manager from section 16(b), even if its clients own more than 10 percent of a company. The implementing rules under section 16 further soften the aggregation rules by providing that persons are liable for disgorgement under section 16(b) only if they have a pecuniary interest in

72. Fichtner et al., *supra* note 10, at 312.
73. *Id*.
74. 17 C.F.R. § 240.16a-1(a)(1) (2019).
75. *See id.* § 240.16a-1(a).

the traded securities.[76] Thus, whenever two entities are combined for purposes of determining 10 percent ownership, these entities may nevertheless be broken apart for purposes of matching trades under the disgorgement requirement if they do not have a pecuniary interest in each other's trades.[77] Thus, even if section 16 were to aggregate an investment adviser with its clients to obtain a combined ownership total of more than 10 percent, the adviser would only have to disgorge profits on its own trades, and not on the trades of its clients.

This softening provision for investment advisors prevents section 16(b) from being completely unworkable, but—crucially for present purposes—it stops working if a manager or its client becomes an activist. The exemption only applies to an investment manager and its client if the client has bought its shares "in the ordinary course of business" and "without the purpose or effect of changing or influencing control of the issuer . . . ."[78] "Control" here has the same hair-trigger definition as in section 13(d), meaning that if a manager's client solicits proxies in connection with a board election, the exemption that stops a manager's trades from being combined with those of its client would cease to work, and both the manager and the client could run afoul of section 16(b). Activism by one client could send shrapnel flying toward the manager itself.

Complying with the short-swing trading restrictions of section 16(b) would be catastrophic for a manager that has its own internal trading operation. Every time such a manager or its activist client bought and sold within a six-month period, they would have to disgorge their profits to the issuer. This would be a challenge for many managers, in addition to their clients, because many investment managers run proprietary trading operations—or market-making operations that function like proprietary trading operations—in which they invest their own money.[79] These trading operations could have to disgorge profits on every short-swing trade as a result of some stray hedge fund's activism. A large manager might also have to disgorge profits on trades by the private funds it manages. Many large investment managers, such as Goldman Sachs and BlackRock, operate dozens of hedge funds, and the operating agreements in these funds

76. *Id.* § 240.16a-1(a)(2); *see also* Feder v. Frost, 220 F.3d 29, 33–34 (2d Cir. 2000) (explaining that the pecuniary-interest-based definition in Rule 16a-1(a)(2) "comes into play for purposes of the reporting and short-swing profit provisions of Section 16").

77. 17 C.F.R. § 240.16a-1(a)(2).

78. *Id.* § 240.16a-1(a)(1).

79. Francine McKenna, *How a Goldman Sachs Trader Can Make $100 Million in the Volcker Rule Era*, MARKETWATCH, (Oct. 20, 2016, 10:21 AM), https://www.marketwatch.com/story/how-a-goldman-sachs-trader-can-make-100-million-in-the-volcker-rule-era-2016-10-20.

commonly require the manager to own a certain percentage of the fund in order to align its interests with those of the fund's investors. A big manager may thus own stakes in dozens of hedge funds at any given time. Under section 16(b), if any of these funds buys shares in a company with regard to which the manager has to comply with section 16(b), then the manager would have to disgorge not only the profits from the manager's own proprietary trades in the company, but also its proportionate share of any profits from trades by the hedge fund in which the manager owns a stake.[80] In other words, if a hedge fund's activism forces a manager to disgorge profits on trades in General Electric and then another one of the manager's hedge funds makes a short swing trade in General Electric, the manager will have to disgorge its share of the profits on the trade by the hedge fund. If the manager owns 5 percent of the limited partnership interests of this other hedge fund, then the manager has to disgorge 5 percent of the fund's profits on its trade. To keep track of the trades of hundreds of hedge funds in this way would be a logistical nightmare, to say nothing of the direct financial costs.

Worse still, a manager and its clients could find themselves getting aggregated with one another as a "group," which is a concept that the rules under section 16 borrow from section 13(d). The definition of a group under section 13(d) combines any two or more persons who work together for the purpose of acquiring, holding, or disposing of a security.[81] Thus, if an advisor operates two funds, one of which owns 7 percent of an issuer and another of which owns 4 percent, and one of the funds seeks to influence control, the two funds and the manager could end up getting lumped into a group of 11 percent simply by virtue of the funds having the same manager.[82] Getting classified as a group would be especially disastrous, because each member of the group—the funds and the manager alike—would have to disgorge their short-swing profits.[83]

To summarize: the only thing that keeps section 16(b) from becoming catastrophic for a big manager is the softening exemption for investment

80. 17 C.F.R. § 240.16a-1(a)(2)(ii)(B)–(C).

81. 15 U.S.C. § 78m(d)(3) (2018).

82. Though it is possible that the two funds could be classified as a group even without an attempt to influence control, simply by virtue of having the same manager and absent the attempt to influence control the advisor would likely be exempt and thus would not be classified as part of the group, lessening the deleterious consequences of the designation. The attempt to influence control is further harmful in that it makes it appear more likely that the acquisition of shares was part of a deliberate plan to work together, increasing the chances of group designation.

83. Note that they only have to disgorge profits on their own trades under Rule 16a-1(a)(2)2. 17 C.F.R. § 240.16a-1(a)(2).

advisors. But this exemption goes away when a manager's client starts to exercise control over an issuer. Like the control determination that distinguishes section 13(d) from section 13(g), the control determination in section 16(b) is jointly applied to a manager and each of its clients. The antics of just one client can force the manager into section 16(b) obligations.

C. POISON PILLS

The problems do not stop with sections 13(d) and 16(b). Poison pills also combine a manager with its clients for purposes of calculating a legal ownership threshold. A poison pill, which may be more formally known as a shareholder rights plan, is an antitakeover device that a company's board can use to prevent a potential acquirer from accumulating too large a stake in the company without the board's permission.[84] A poison pill dilutes the ownership of any shareholder who acquires shares in excess of a certain percentage specified by the company's board. If the acquirer buys more than the specified percentage, then all of the company's other shareholders—not including the acquirer—get the right to buy new shares in the company at a deeply discounted price. The result is to decrease the acquirer's ownership of the issuer in terms of both value and percentage, and to increase the ownership of everyone else. Although few companies maintain a poison pill on a regular basis, a company's directors can adopt a pill at a moment's notice if ever they perceive a threat.[85]

Like sections 16(b) and 13(d), a poison pill triggers its obligations upon the crossing of a certain ownership threshold. The exact threshold varies from company to company and pill to pill, but it often hovers between ten and twenty percent. Because "ownership" is so difficult to define, poison pills commonly borrow the conceptual apparatus of section 13(d) to determine ownership and police avoidance. Most poison pills thus define "beneficial ownership" by express reference to the definition in section 13(d) and its implementing rules, sometimes defining "security" and "ownership" even more expansively than section 13(d) for good measure.[86] Much like section 13(d), a poison pill usually says that an investment manager and all of its various clients form a single beneficial owner.

Because the limits imposed by a poison pill put a cap on the combined

84. WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 541–46 (5th ed. 2016).

85. *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 277 (2000).

86. Marcel Kahan & Edward B. Rock, *Anti-Activist Poison Pills* 27 (N.Y. Univ. Sch. of Law, Law & Econ., Research Paper No. 17-08, 2017), https://ssrn.com/abstract=2928883.

ownership of a manager and all of its various clients, the effect of a poison pill is similar to the effects of sections 13(d) and 16(b): if any one client acquires too many shares, the resulting obligations will be felt equally by all clients. Hence, an acquisition by one client is a potential poison pill problem for every other client.

Many of the resulting difficulties are obvious. The most basic is that, like the limit on quiet acquisitions implicit in section 13(d), the poison pill prevents an activist hedge fund from buying as many shares as it might like. If the poison pill is triggered at 10 percent, and a manager's index mutual funds already own 6 percent, the most the manager's activist hedge fund can acquire is another 3.99 percent. This naturally limits how much profit the activist fund can make.

The problems are even more profound for the manager itself. Many investment managers, such as Goldman Sachs Asset Management, are part of larger financial conglomerates that buy and hold securities in connection with various parts of their far-flung businesses. Goldman, for instance, does a major business in derivatives underwriting. As part of this business, Goldman sells large quantities of swaps and options on other companies. Goldman might agree with some third-party hedge fund, for example, to sell a swap on the stock of Delta Airlines, which requires Goldman to pay the fund the value of any increases in Delta's stock price and requires the fund to pay Goldman the value of any decreases in Delta's stock price. Goldman regards this kind of transaction as a financial service, rather than an investment decision, and so it commonly offsets the risk of changes in Delta's stock price by buying or selling Delta's shares or economically similar derivatives.[87] This ensures that Goldman will have the ability to meet any obligations on the swap as they come due.

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

87. Goldman might also buy options on the securities, which would clearly qualify as "equity security[ies]" under section 13(d). 17 C.F.R. § 240.3a11-1.

This problem is not lost on issuers, and they have generally tried to help their passive shareholders by using a device known as a "two-tier" poison pill.[88] Borrowing once again from the conceptual apparatus of section 13(d), a two-tier poison pill rewards passive investors and punishes activist investors by applying a lower triggering threshold to Schedule 13D filers than to Schedule 13G filers. Because a 13G filer, by definition, does not intend to exercise control, accumulations of shares by a 13G filer pose less threat to an incumbent board than accumulations by a 13D filer. Netflix thus responded to the activism campaign by Carl Icahn by adopting a pill with a 10 percent threshold for 13D filers and a 20 percent threshold for 13G filers.[89]

Under a two-tier poison pill like this one, a large and diverse manager like Goldman Sachs usually has no problem, because it does not intend to exercise control and files only on Schedule 13G. But imagine if a client of Goldman (or BlackRock, or Vanguard, or any other large manager) began trying to exercise control. The manager and all of its various clients would flip from 13G to 13D status, thus lowering the trigger point for the poison pill. If, for example, Goldman's derivative desk and asset management clients together owned 13 percent of Netflix, then Goldman would have no problem under Netflix's 20 percent pill threshold, so long as all of the asset management clients remained passive enough to permit Goldman to file ownership reports on Schedule 13G. But if just one Goldman hedge fund owning just 0.5 percent of Netflix's common stock solicited a proxy for a Netflix board election, Goldman's entire operation would suddenly tilt into Schedule 13D status, and Goldman would find itself on the wrong side of Netflix's 10 percent poison pill threshold for 13D filers.

Poison pills have recently become even more problematic by virtue of their expanded scope. Poison pills often go further than section 13(d) in consolidating beneficial owners and defining the kinds of securities that they cover. Section 13(d), for instance, only covers "voting securities" and so arguably does not count synthetic equities (which do not carry a right to

88. Ronald Barusch, *Dealpolitik: Will Third Point Lawsuit Invalidate Sotheby's Poison Pill?*, WALL ST. J., (Mar, 26, 2014, 2:02 PM), https://blogs.wsj.com/moneybeat/2014/03/26/dealpolitik-will-third-point-lawsuit-invalidate-sothebys-poison-pill; *see also* Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, 2014 Del. Ch. LEXIS 64, at *33 (Del. Ch. May 2, 2014); Spencer Klein et al., *Poison Pills with Lower Ownership Thresholds for Activist Investors Come Under Attack*, MORRISON & FOERSTER LLP (Apr. 22, 2014), http://media.mofo.com/files/uploads/Images/140422-Poison-Pills-Under-Attack.pdf.

89. Klein et al., *supra* note 88.

vote).[90] Poison pills, however, cover synthetic equities almost routinely.[91]

The lesson, once again, is that in a large investment management firm, everything is connected. The activism of just one client can potentially damage an entire firm.

III. PRACTICAL CONFLICTS OF INTEREST

The conflicts of interest are not limited to legal rules. Conflicts can also appear from practical and economic sources.

A. OTHER BUSINESS LINES

One source of conflicts is the damage a client's activism can do to a manager's other business lines beyond investment management. As we have seen, investment management is rarely the only thing that a large investment manager does. In addition to managing investments, Goldman Sachs, for instance, also runs business lines in commercial banking, investment banking, securities underwriting, and derivatives underwriting. Other investment managers also operate diverse businesses. Vanguard, Fidelity, and TIAA-CREF each run a business as an administrator of 401(k) accounts for big employers.[92] Fidelity administers the 401(k) plan for Microsoft, for example, keeping track of each Microsoft employee's monthly contributions and withdrawals and providing a web site and phone number that Microsoft employees can call for customer service.[93] Fidelity profits from this role both by charging Microsoft a fee to administer the employee accounts and by charging each employee a fee when he or she chooses to invest her 401(k)

90. CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 546 (S.D.N.Y. 2008) (holding that the definition of a voting security under section 13(d) "does not confine itself to the mere possession of the legal right to vote . . . securities, but looks instead to all of the facts and circumstances to identify situations in which one has even the ability to influence voting, purchase, or sale decisions of its counterparties by legal, economic, or other[] means." (brackets in original) (citation omitted) (internal quotation marks omitted)), *aff'd in part, vacated in part*, 654 F.3d 276, (2d Cir. 2011); LLOYD S. HARMETZ, MORRISON & FOERSTER LLP, FREQUENTLY ASKED QUESTIONS ABOUT SECTION 13(d) AND SECTION 13(g) OF THE SECURITIES EXCHANGE ACT OF 1934, at 13 (2017), https://media2.mofo.com/documents/faqs-schedule-13d-g.pdf.

91. MARK D. GERSTEIN ET AL., LATHAM & WATKINS LLP, THE RESILIENT RIGHTS PLAN: RECENT POISON PILL DEVELOPMENTS AND TRENDS 7 (July 2014), https://www.lw.com/thoughtLeadership/2014-poison-pill-developments-and-trends; Kahan & Rock, *supra* note 86, at 26.

92. Rasha Ashraf et al., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANTITATIVE ANALYSIS 567, 578 (2012); Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 554 (2007).

93. Andrea Davis, *Microsoft Boosts Employer Match in its 401(k) Plan*, BENEFIT NEWS (Jan. 5, 2016, 9:06 AM), https://www.benefitnews.com/news/microsoft-boosts-employer-match-in-its-401-k-plan.

savings in a Fidelity mutual fund, which Fidelity may promote to Microsoft employees as part of its administrative activities. An investment manager might also hope to include its funds in the portfolio of offerings available through a 401(k) account even if the manager does not directly manage the account. Even though Fidelity is the manager in control of the Microsoft 401(k), for example, TIAA-CREF can lobby Microsoft to have its funds included in the investment menu.

The trouble with lines of business beyond investment management is that they can be hurt by activism. Activism is dangerous to a financial conglomerate's brand. Consider, for example, investment banking. The investment banking division of Goldman Sachs sells a variety of professional and financial services to big companies, including loans, securities underwriting, and advice on mergers and acquisitions. If Goldman Sachs' asset management unit started an activist hedge fund, the fund's antics might easily damage Goldman's client relationships in its investment banking unit. If the fund went around terrorizing the CEOs of S&P 500 companies, how many of these CEOs would hire Goldman for merger and acquisition advice? Fidelity might face a similar problem if one of its hedge funds became aggressively active. Fidelity's 401(k) business serves the human resources departments of many of America's big companies, and an activist hedge fund that attacked these companies might complicate Fidelity's efforts to build relationships with them. The same would be true even if Fidelity did not manage a company's 401(k). Fidelity's desire to have its funds included in the 401(k) menu that another manager assembles for the company would expose Fidelity to the risk of retaliation by the company.

The conflicts between an investment manager's various business lines has appeared before in the ongoing controversies over analyst reporting. Analysts affiliated with investment banks often sell research reports on public companies that advise investors on whether they should buy or sell the stock of these companies. In the early 2000s, these analysts generated a raft of lawsuits when plaintiffs' lawyers alleged that the analysts were writing inaccurately positive reports in order to curry favor with companies so that those companies might later hire the analysts' banks to provide financial services.[94]

Just recently, evidence has surfaced of similar conflicts between analysts and their banks' investment management units. Many public

94. Randall Smith et al., *Wall Street Firms Settle Charges Over Research in $1.4 Billion Pact*, WALL ST. J., https://www.wsj.com/articles/SB105154298989636300 (last updated Apr. 29, 2003, 11:08 AM).

companies permit the clients of some investment managers to speak to the companies' senior executives, and investment managers sometimes earn money by charging clients for this privilege. Walmart, for instance, might give certain preferred clients of Goldman Sachs the right to speak directly with Walmart executives. Many companies like Walmart, however, have a policy of only permitting an investment manager to grant this kind of access if the manager's analysts have written positive reports about the company.[95] If a Goldman analyst writes a bad report on Walmart, the access of Goldman's investment management clients may be cut off.

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

B. Differing Tastes for Activism

Activism can also bring an investment manager's clients into conflict because it can affect each of the clients differently. Because of their investing strategies, histories, and tax situations, the same kinds of activism might hurt one client even as they help another.

The preferences of a manager's clients might diverge for any number of reasons. The most obvious is the conflict between debt and equity. If a manager operates both a debt fund and an equity fund, and they both invest in the same company, how should the manager vote its holdings if the company becomes distressed? The interests of the debt and equity holders will be in direct opposition to one another, because every dollar given to a debt holder is a dollar not given to an equity holder. For this manager to actively influence the outcome of a bankruptcy bargaining process is thus a profound conflict of interest. No law firm would take on such a conflict of interest, and neither would a big investment manager.

Debt and equity can also come into conflict long before a company becomes insolvent. One of the most common tactics of activist hedge funds is to show up at a company and clamor for a distribution of capital to equity holders. Because this kind of distribution pulls money out of the company, it reduces the resources available to debt holders and therefore reduces the value of the debt. A passive fund that holds debt can thus be hurt by the

95. Serena Ng & Thomas Gryta, *New Wall Street Conflict: Analysts Say 'Buy' to Win Special Access for their Clients*, WALL St. J., https://www.wsj.com/articles/new-wall-street-conflict-analysts-say-buy-to-win-special-access-for-their-clients-1484840659 (last updated Jan. 19, 2017, 11:31 AM).

activism of a hedge fund that holds the company's equity even if the company remains technically solvent.

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

Or imagine that one fund is focused on socially responsible investing and another is not. Should the manager use its influence to make a portfolio company more responsible at the cost of reducing its profitability? Or what if one fund holds stock in Apple and another in Huawei? Since Huawei makes super cheap smart phones that are undermining Apple's core business, Apple and Huawei are competitors—and so are the funds that invest in them. So as between Apple and Huawei, where should the manager devote its activist time and energy?

The usual answer for a manager when the interests of clients point in opposite directions is to vote each client's holdings in that client's best interests, ignoring the interests of the other client. A manager who operates both a debt and an equity fund might vote the debt fund's holdings in the interests of debt, and the equity fund's holdings in the interests of equity, even if that means voting the two funds' holdings in opposite ways. This strategy works fine in most cases, but it only proves my point. By voting its clients' holdings in opposite directions, a manager effectively gives up on the prospect of turning its various clients' holdings into a single, unified bloc. To vote clients' holdings in opposite directions is effectively to adopt a strategy of uncoordinated passivity, not coordinated activism.

C. Differing Strategies for Engagement

A further problem is that even if every one of a manager's various clients agrees on the need to influence a portfolio company, they might prefer different time horizons and strategies for implementing that influence. Compare, for example, the different preferences of an index mutual fund and an activist hedge fund. An index mutual fund's investment strategy is to hold the stocks that appear on an index, which is a list of securities compiled by a third party. Examples of popular indices include the S&P 500 and the Russell 2000. Index funds have grown enormously in recent years and they now account for more than a quarter of the assets of all equity mutual funds.[96]

Index funds tend to prefer less assertive forms of activism than other kinds of funds. Indexers like quiet, closed-door meetings with company executives more than aggressive public contests. The reason is that an index fund cannot sell its shares in a company if its relationship with the company's executives turns sour. An index fund has to hold the stocks listed on its index, no matter how bad the fund's relationship with the company's board becomes. This makes an index fund conservative in the way it relates to a board. An index fund will tend to want to make peace with the managers in the hopes of maintaining a productive long-term relationship.

The preferences of an activist hedge fund stand in sharp contrast. If an activist hedge fund tries to change a company and fails, the activist can just sell the shares and move on to another company, leaving the buyers of the shares to develop a more positive relationship with the company's directors. Thus, even if an activist hedge fund and an index fund have identical beliefs about the direction of a company and the need for activism, they will have different preferences for how the activism is carried out.

These differing preferences come into conflict because they cannot be acted out independently. If both funds are operated by the same manager, then the reputational consequences of one fund's actions will inevitably spill over onto the other fund. In interviews, investment management professionals insist that when a corporate voting officer from Fidelity shows up in the boardroom of an operating company like Delta Airlines, Delta's directors will presume that the Fidelity officer speaks on behalf of *all* Fidelity clients, not just a single client. If a Fidelity officer showed up representing an activist hedge fund, anything she said would therefore be attributed to Fidelity's index mutual funds. If the activist fund came in with guns blazing, it seems highly unlikely that the index fund would ever again be able to get a quiet, closed-door meeting with the company's executives.

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

96. INV. CO. INST., *supra* note 1, at 75.

D. COST AND PROFIT ALLOCATION

Further conflicts arise in allocating the costs and profits of activism. Activism is expensive. If a manager wants to influence the operations of a portfolio company, it has to pay investment analysts to identify the company and then develop a plan for improving it. The manager also has to pay lawyers to strategize about how to beat takeover defenses and figure out how to comply with securities regulations and corporate laws that burden activists. The manager will also have to pay proxy solicitors to send out mailings and recruit investors to vote.

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

Perhaps more difficult than the allocation of costs is the allocation of profits. The profits from activism are inherently scarce because an investment manager can only buy so many shares in a target company before the opportunities to buy them at a low price disappear. If a manager buys too many shares on behalf of too many clients, the supply of shares will run dry, or the manager's intentions will become obvious, and the share price will go up. A manager may thus be unable to buy as many shares in a target company as each of its many clients might want. How then should the manager allocate the opportunity to buy shares? The answer involves a conflict of interest.

E. POLITICAL RISK

A big manager also faces conflicts over the risk of regulatory and political interference. The actions of a single activist hedge fund can damage the political and regulatory standing of a manager's other clients and business lines.

The risk of political and regulatory interference is real, because corporate governance activism is deeply unpopular in certain circles. In her 2016 campaign for president, Hillary Clinton promised to "reset" American capitalism by reigning in activist hedge funds.[97] Bernie Sanders likewise spoke constantly of his frustration with big banks.[98] This hostility to big financial institutions is nothing new. Anger towards Wall Street is a longstanding driver of American financial and antitrust regulation and a large part of what accounts for the uniquely diffuse ownership of American industry.[99]

This hostility limits all corporate investors, but it limits large investment managers more than others. One obvious reason is large managers' size. The American public has always been suspicious of big institutions and big managers are growing astonishingly big. Another reason is the diversity of a large manager's business. A small activist hedge fund manager like Pershing Square or ValueAct Capital tends to run only a single and very narrow kind of business—activist hedge fund investing—and so it faces little regulation outside of the Securities Exchange Act[100] and the Investment Advisers Act.[101] A larger manager like Goldman Sachs, by contrast, runs so many different businesses that it faces regulation not only under the Exchange Act and the Advisers Act, but also under the Investment Company Act, various banking statutes, state trust laws, systemic risk regulations, the Commodity Exchange Act, and the regulations of the Consumer Financial Protection Bureau. If Goldman Sachs sent an activist hedge fund to antagonize a favored corporate patron of a powerful senator, the senator would have a wide array of regulatory arrows to fire. The results could be catastrophic, not just for the hedge fund, but also for Goldman's derivatives underwriting business, its private equity fund management business, its commercial banking business, and its investment banking business. A large manager is a very big target for a political attack.

97. Newmyer, *supra* note 53.

98. *See, e.g.*, Chris Cillizza, *This New York Daily News Interview Was Pretty Close to a Disaster for Bernie Sanders*, WASH. POST. (Apr. 5, 2016), https://www.washingtonpost.com/news/the-fix/wp/2016/04/05/this-new-york-daily-news-interview-was-pretty-close-to-a-disaster-for-bernie-sanders/?noredirect=on&utm_term=.e179c112fd38.

99. *E.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 28 (1994); Barak Orbach & Grace Campbell Rebling, *The Antitrust Curse of Bigness*, 85 S. CAL. L. REV. 605, 648 (2012).

100. 15 U.S.C. §§ 78a–78qq (2018).

101. *Id.* §§ 80b-1 to -21.

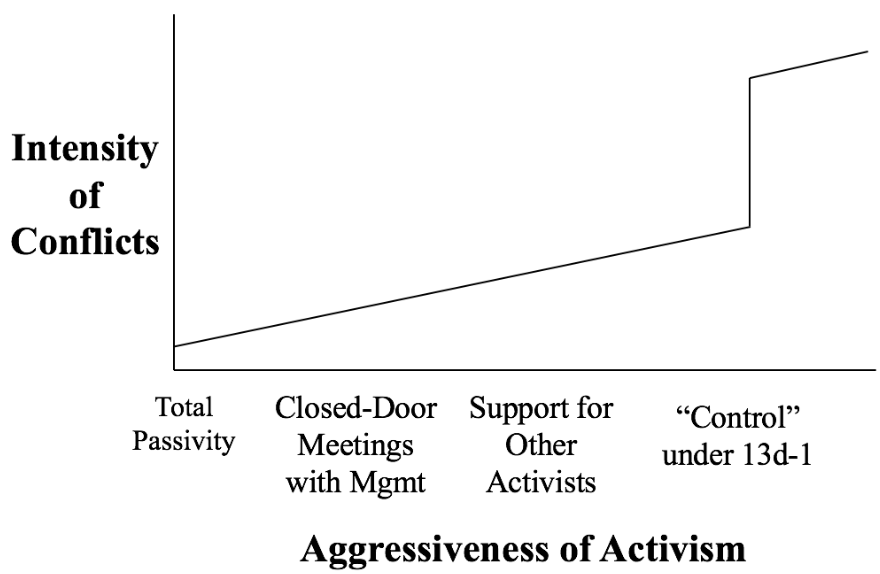
IV. THE CONTINUUM OF MANAGER SIZE AND INTENSITY OF ACTIVISM

Now that we know how activism can deepen a manager's conflicts, we can see more precisely how conflict, activism, and size relate. As noted above, the relationship between conflicts, activism, and size is not binary; it is more in the nature of a continuum.[102] Conflicts grow more intense as (1) activism becomes more aggressive and direct; and (2) a manager takes on larger stakes in individual companies and grows more internally complex. This continuum is worth exploring in more detail because it makes sense not only of the passivity of big investment managers, but also of the aggressive activism of other kinds of institutional investors.

A. AGGRESSIVENESS OF ACTIVISM

The first dimension of conflict is the aggressiveness of activism: conflicts grow more intense as activism becomes stronger and more direct. Figure 3 expresses this relationship graphically.

FIGURE 3. Aggressiveness of Activism and Intensity of Inter-Client Conflict



At the weak end of the continuum lies what may be the most ubiquitous form of activism: simple passivity, in which a manager just does nothing, or

102. *See supra* Section I.C.

at least nothing very meaningful. A manager and its clients might hold a large stake in a company, and yet never use their power to speak to the company's executives or become involved in the company's governance in a meaningful way. This kind of passivity can function as a form of activism because it entrenches the status quo. It acts as a tacit approval of whatever the company's executives are then doing and soaks up the voting power an activist would need to produce change. This kind of negative influence figures prominently in the recent tsunami of academic research about horizontal shareholding,[103] which suggests that when a large manager holds shares in all of the major companies in a given industry, it might diminish competition among the companies by simply failing to encourage competition.[104]

Doing nothing (or doing very little) is indisputably a popular strategy,[105] and its popularity is consistent with my thesis about the high cost of conflicts, because doing nothing tends to generate few conflicts. Doing nothing never counts as "control" under Rule 13d-1 and it has very little salience to a manager's brand or political position. This means, therefore, that the widespread concern about horizontal shareholding is basically consistent with my thesis about the importance of inter-client conflicts. My thesis does, however, imply a kind of upper bound to how directly a big manager can discourage competition. If a big manager like State Street or Fidelity ever tried to discourage competition by nominating candidates to a board of directors or exercising other forms of direct control, it would become a controller under section 13(d), a violator of fiduciary duties, and a tempting target for political and regulatory attack. All of these consequences would come in addition to the penalties of antitrust law.

Other forms of activism lie further up on the continuum of intensity. One is a strategy of quiet, behind-the-scenes engagement. An investment manager might meet with the directors and senior executives of a company and talk about what the investment manager thinks the company should be doing.[106] Another is a strategy of supportive activism. A large manager might vote in favor of an activist's proposal without ever making any proposals of its own.[107]

103. *See generally* Hemphill & Kahan, *supra* note 17 (identifying the various ways in which large investment managers might discourage price competition among their portfolio companies).

104. Elhauge, *Horizontal Shareholding*, *supra* note 17, at 1269.

105. Bebchuk et al., *supra* note 21, at 110.

106. McCahery et al., *supra* note 39, at 2912.

107. Jessica Toonkel & Soyoung Kim, *Activist Investors Find Allies in Mutual, Pension Funds*, REUTERS (Apr. 9, 2013, 4:11 AM), https://www.reuters.com/article/us-funds-activist-idUSBRE9380DU20130409. A whole industry of proxy advisers has popped up to tell large institutional investors how

Both of these forms of activism are fairly popular among large investment managers because both of them are mild enough that they generate no debilitating conflicts.[108] Neither of these forms of activism risks being defined as "control" under Rule 13d-1. Figure 3 shows these forms of activism generating slightly more conflicts than total passivity, however, because, even if they do not pose serious legal conflicts, they can pose significant practical conflicts. If one of a manager's funds invests in a company's equity and another invests in the company's debt, then even mild forms of activism will have a tendency to privilege one fund over the other. These forms of activism can also damage a manager's brand. As we have seen, Goldman Sachs cannot vote its mutual funds in support of an activist hedge fund at a company without torching the bank's investment banking relationship with the company's executives.

The next level of intensity in activism is where conflicts begin to become truly prohibitive for a large manager. Figure 3 shows a sudden vertical increase in the level of conflict when a manager does something that counts as "control" for purposes of section 13(d) and Rule 13d-1 of the Securities Exchange Act of 1934.[109] This is why we see a limit to how aggressive large managers will become. A large manager might talk with company executives behind closed doors or vote for smaller managers' director nominees, but a large manager will almost never directly nominate candidates to a board of directors, run a proxy contest on an extraordinary corporate transaction, attempt to materially change a company's business or corporate structure, or do anything else that counts as control under Rule 13d-1. It could only do so if the stars aligned in an unusual way that happened to avoid conflicts.[110]

B. SIZE AND COMPLEXITY

After the aggressiveness of activism, the next dimension of conflict is a manager's size. Conflicts grow more intense as a manager gets bigger. A manager's size may be measured in many different ways, but for purposes of conflicts over activism, there are two that matter most. The first is the

to vote in activism campaigns run by activist hedge funds. *See, e.g.*, Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 871 (2010) (assessing the degree of influence proxy advisers have on shareholder voting).

108. McCahery et al., *supra* note 39, at 2907–08; Toonkel & Kim, *supra* note 107.

109. 15 U.S.C. § 78m(d)(1)(C), (d)(5) (2018); 17 C.F.R. § 240.13d-1(b)(1)(i), (e) (2019).

110. For example, the company might be so small and obscure that only one or two of the manager's clients own stakes and the stakes happen not to be at odds with one another. The manager might also have to have the sort of brand that is consistent with activism and might not operate other business lands whose political or branding position would be hurt by activism.

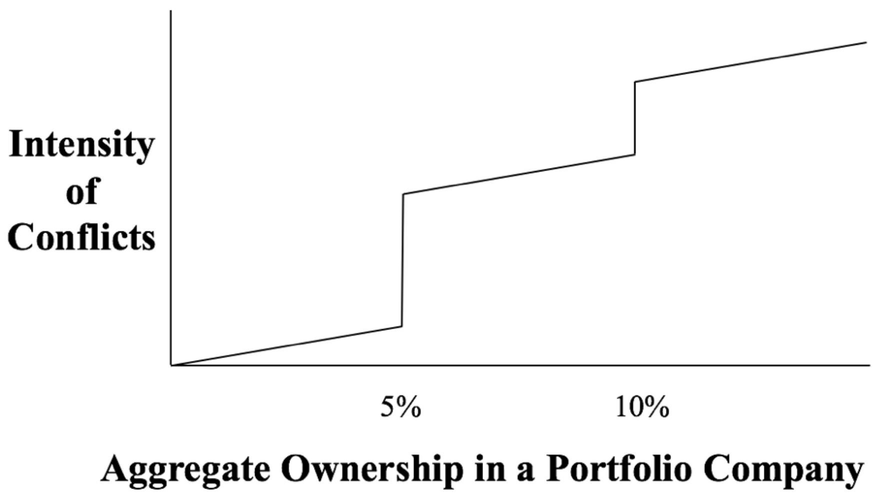
aggregate size of the investment a manager and its clients have made in a given company. If the manager and its clients collectively hold a large stake in a particular company, conflicts over activism will tend to be more intense than if the manager and its clients hold a smaller stake.

Note that this measure of size—the size of a manager's aggregate investment in a given company—is different from a manager's total assets under management. I am not talking about the total value of all the assets a manager invests on behalf of all of its various clients, but about the percentage of equity ownership a manager and its various clients have amassed in a particular public company. The two measures are distinct, because even a manager with a very large amount of assets under management might have little investment in a particular company if none of the manager's clients have invested their assets in that company. Nevertheless, the amount of total assets a manager has under management and the percentage of ownership a manager has accumulated in a given public company will tend to be highly correlated, because a manager with more assets will eventually have to invest more of them in individual companies. One of the side effects of having a larger pool of assets to invest is that a manager will have to invest more assets in individual companies. This is how the number of public companies in which BlackRock controlled 5 percent or more of the stock increased from 1,800 in 2011 to 2,632 in 2016.[111] The increase was not a product of any deliberate strategy by BlackRock to accumulate control stakes; it was an unintentional byproduct of BlackRock's success in accumulating more total assets in its funds.

Figure 4 charts how the size of a manager's stake in a given company relates to the intensity of conflict over activism. Figure 4 shows that conflict over activism increases as a manager's aggregate investment in a company increases. The positive slope reflects the tendency of greater ownership to increase a manager's potential for influence and therefore the potential consequences of activism. The vertical increases at 5 percent and 10 percent reflect the legal conflicts generated by Exchange Act sections 13(d), which kicks in at 5 percent, and 16(b), which kicks in at 10 percent. We might also include a vertical increase further up on the continuum (for example, at 15 percent or 20 percent) where a company's poison pill kicks in.

111. Fichtner et al., *supra* note 10, at 312.

FIGURE 4. Aggregate Ownership and Intensity of Inter-Client Conflict



In addition to looking at the number of shares a manager and its clients own in a particular public company, another way to measure a manager's size is to examine the manager's internal complexity. As a manager takes on more assets, it tends also to take on more clients and business lines with greater variety and difference. Complexity matters because the more complex a manager is, the more conflicts it tends to face over activism. A manager with only a single client will face almost no conflicts over activism, because there are no other clients with whom that client's preferences can conflict. A manager with many clients might also face few conflicts if all of the clients invest in and desire the same things. If all of the manager's funds invest only in equity, then activism will not generate any conflicts between equity and debt. But if a manager has some funds invested in equity and others in debt and then tacks on a large investment bank that writes credit default swaps on the side, the potential for conflict becomes much larger.

The relationship between internal complexity and conflict over activism appears in Figure 5. Figure 5 shows that as the number and diversity of a manager's clients and business lines increase, so too does the intensity of conflict over activism. Of course, like the other figures plotting the seriousness of conflict over activism, Figure 5 is only a rough approximation. The main point of Figure 5 is simply to show that conflict over activism increases with a manager's internal complexity.

FIGURE 5. Internal Complexity and Intensity of Inter-Client Conflict

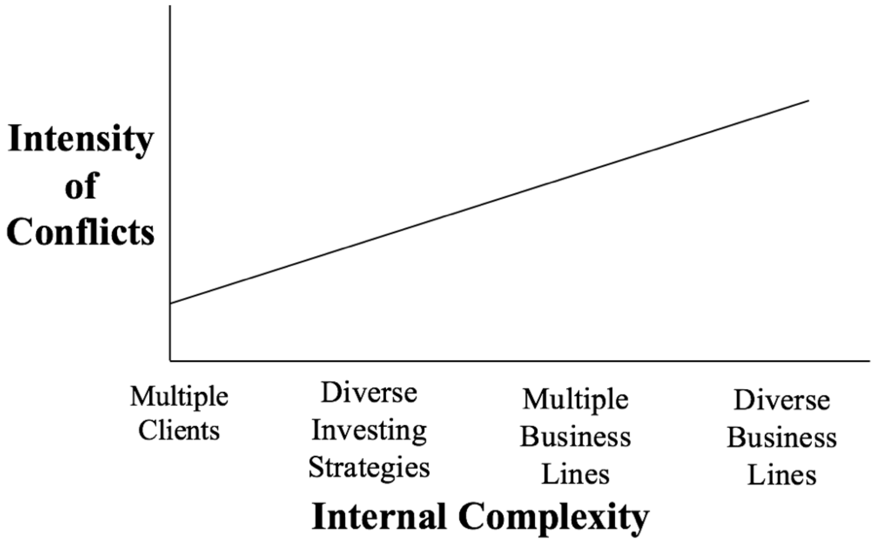


Figure 5 is useful because it does not just explain the passivity of large investment managers; it also explains the activism of other types of institutional investors, including private equity funds, pension funds, and hedge funds with small managers.[112] Consider private equity funds. When a private equity fund buys a private company, it tends to own a majority or even an entirety of the company's shares, usually exercising the power to appoint all of the company's directors and to dictate every aspect of the company's business and affairs. This is "activism" in the extreme. So why does it not trigger the conflict of interest problems that plague large managers invested in public companies? One reason is that the companies in private equity portfolios are not public—hence the term "private" equity—and so are not regulated by sections 13(d) and 16(b) of the Exchange Act. A second reason is that private equity managers avoid the complexity depicted in Figure 5. Private equity managers tend not to permit more than one of their funds to invest in a given company at the same time, and if they do, they tend to police the conflicts with acute sensitivity.[113]

112. Bainbridge, *supra* note 16, at 11.

113. *See, e.g.*, William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 82 (2009); William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249, 286–88

In addition to private equity funds, pension funds also sometimes become aggressive activists.[114] They occasionally collaborate with hedge funds on the nomination of candidates to corporate boards, initiate proxy contests and practice other forms of activism that clearly cross the line into "control" within the meaning of section 13(d). The California State Teachers Retirement System Pension, for instance, recently considered an "engagement fund" to press executives at underperforming companies,[115] and it openly collaborates with activist hedge funds in the nomination of director candidates.[116] Pension funds become activist in this way despite sometimes being very large. The California Public Employees Retirement System pension fund, or CalPERS, ended the 2017 fiscal year with about $326 billion under management.[117]

The explanation for pension funds' comparative assertiveness is that pension fund managers do not divide their loyalties. Unlike hedge funds, private equity funds, and mutual funds, pension funds internalize their management. A pension fund manager works only for the fund that employs him or her and no one else. Pension funds do not adopt the separation of assets and management. Because pension fund managers have just one client, they have no conflicts in making the client into an activist.[118]

The last category of highly activist investor is hedge funds operated by small managers. The reason hedge fund activism appears only among small managers should by now be clear: these managers have simple internal structures. Although they too might have significant quantities of assets under management, they tend to spread them across only a handful of funds which all have highly similar investing strategies. They also tend to avoid investment banking and other complicated business lines that might conflict

(2017).

114. DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER 131 (2018) (describing how pension funds have begun engaging in direct activism over social and environmental causes in addition to investor welfare).

115. Randy Diamond, *CalSTRS Considering New Engagement Push*, PENSIONS & INV. (May 1, 2017, 1:00 AM) (citation omitted), http://www.pionline.com/article/20170501/PRINT/305019983/calstrs-considering-new-engagement-push.

116. *Id.*; Randall Smith, *Some Big Public Pension Funds Are Behaving Like Activist Investors*, N.Y. TIMES (Nov. 28, 2013, 8:48 PM), https://dealbook.nytimes.com/2013/11/28/some-big-public-pension-funds-are-behaving-like-activist-investors (describing how the California State Teachers Retirement System pension fund co-sponsored a proposal with an activist hedge fund to break up a company).

117. CAL. PUB. EMP.'S RET. SYS., 2016–2017 ANNUAL INVESTMENT REPORT (2017), https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2017.pdf.

118. Things can be more complicated if a large pension fund hires an outside manager, like BlackRock or Fidelity, to manage a portion of its portfolio. The degree of conflict faced by the outside manager might depend on whether the outside manager has the discretion to vote the pension fund's shares.

with activism. This is why every high-profile activist hedge fund—think of Pershing Square, Third Point, ValueAct, and Trian—is managed by a small firm with only a single client, or, occasionally, two or three clients.

V. OTHER THEORIES OF PASSIVITY IN PERSPECTIVE

Once we properly understand it, the risk of internal conflict can go a long way toward explaining the nuances of the market for activism by institutional investors. But I nevertheless acknowledge that the possibility of conflict is not the only force shaping institutional investor activism. Decades of research on corporate governance has identified other forces as well. Nevertheless, an understanding of conflicts fills a number of gaps that other explanations for large investors' passivity have left open. Although researchers have come up with many partially accurate explanations for why large investors tend to be passive, none of these explanations is complete without an understanding of the importance of conflicts.

The first common explanation for why large investment managers shy away from activism is that activism does not attract many investors. A manager cannot find enough investors willing to pay a fee to managers who will try to influence portfolio companies. This argument usually focuses on mutual funds and on their investors' lack of sophistication. Mutual fund investors, it is said, cannot assess the value of activist investing strategies, and so they will not pay the high fees required to cover the costs of activism.

This theory certainly has real merit, but it also has serious problems. The most obvious problem is that investors quite clearly *do* have an appetite for activism. This is evident in the success of activist hedge funds in recent years. Pershing Square Capital, for instance, at one point raised more than $18 billion dollars for a hedge fund that invests in corporate governance activism and the last two decades have witnessed a boom in activism by hedge funds.[119] So although *mutual fund* investors may have no appetite for activism, *hedge fund* investors clearly do.

Of course, investors' appetite for activism may be fairly small, but large managers are not above offering niche products for small groups of investors. The appetite for investment in corporate influence is probably no more limited than the appetite for Tennessee municipal debt—and yet one can find several large investment managers that offer funds specifically devoted to Tennessee municipal debt.[120] The same is true of other niche funds, from

119. Deveau, *supra* note 36.

120. *MFS Tennessee Municipal Bond Fund*, MFS, https://www.mfs.com/en-us/individual-investor/product-strategies/mutual-funds/MTNLX-mfs-tennessee-municipal-bond-fund.html (last visited Sept. 14

airline funds to oil funds, to high-frequency trading funds.[121] So why shouldn't a large investment manager start a niche fund focused on activism? The answer, of course, is conflicts of interest.

Another common explanation for why large managers tilt toward passivity is that the Investment Company Act of 1940 and its associated tax provisions prohibit mutual funds from buying large stakes in portfolio companies. The argument is that if a mutual fund wants to avoid corporate-level taxation, then it cannot buy securities in any one issuer in excess of certain limits in the tax code.[122] This argument was first made by Mark Roe,[123] and it has since become popular with other academic commentators.[124]

This argument is true as far as it goes, but it, too, has a number of serious limitations. First, it only applies to mutual funds. It does not apply to hedge funds. So, there is no reason why the restrictions on mutual funds should stop a large manager from setting up an activist hedge fund. Additionally, the Investment Company Act and its tax rules apply to mutual funds individually and not as part of a group under common management. The unit of legal regulation is a fund, not a family of funds managed by a single adviser. Thus, even if the law prohibited the Fidelity Magellan fund from owning more than 10 percent of the stock of a company like Delta Airlines, there is no reason why the Magellan fund could not combine with Fidelity's Stock Select Large Cap Value, S&P 500 Index, Select Transportation, Growth Company, Mega Cap Stock, and Air Transportation funds to cross the threshold of 10 percent.

Moreover, even when applied to individual funds, the Investment Company Act and its tax rules are not very restrictive.[125] The tax code's limits on a fund's concentration in a particular portfolio company are

2019); *Nuveen Tennessee Municipal Bond Fund*, NUVEEN, https://www.nuveen.com/mutual-funds/TN (last visited Aug. 16, 2019).

120. *Fidelity Select Air Transportation Portfolio*, FIDELITY INV., https://fundresearch.fidelity.com/mutual-funds/summary/316390798 (last visited Sept. 14, 2019); *New Era Fund*, T. ROWE PRICE, https://www3.troweprice.com/fb2/fbkweb/objective.do?ticker=PRNEX (last visited Sept. 14, 2019); SUSQUEHANNA INT'L GRP., https://sig.com (last visited Sept. 14, 2019).

121. Fidelity alone offers more than 500 different mutual funds. *Fidelity by the Numbers: Corporate Statistics*, FIDELITY INV., https://www.fidelity.com/about-fidelity/fidelity-by-numbers/corporate-statistics (last visited Sept. 14, 2019).

122. *See* 26 U.S.C. § 851 (2018).

123. Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1479 (1991).

124. *E.g.*, Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 997–98 & n.50 (1993).

125. 26 U.S.C. § 851.

complicated, but in application, they permit a mutual fund to invest in as few as twelve different companies, owning up to 10 percent of the outstanding equity of each the first ten, 49 percent of the eleventh, and 100 percent of the twelfth.[126] This is at least as much concentration and control as an activist hedge fund would typically take—and possibly even more.

A related argument for why large managers are not interested in influence is that mutual funds require too much liquidity. Because a mutual fund permits its investors to withdraw their money every day,[127] the fund needs to be able to raise cash quickly to pay withdrawals. Such liquidity needs are arguably incompatible with a large investment in a single issuer, because a large investment in a single issuer can be difficult to sell. This argument is also true as far as it goes, but it has the same limitations as the argument about regulation of portfolio composition. The need for liquidity does not apply to hedge funds and other private vehicles that can restrict redemptions. And the need for liquidity can be addressed by spreading a holding across many different funds in a larger management company. Though liquidity needs may prevent *one* fund from accumulating a massive stake, they need not prevent *many* funds from each holding a small stake that aggregates into a massive stake.

VI. POLICY IMPLICATIONS

What then does the interactive effect of size, activism and conflicts mean for legal reform? Should we allow large managers to be activists? And *could* we allow them be activists? Is there any set of legal reforms that could make it possible for large managers to become activists, and would those reforms make the world a better place?

To these questions, I can offer no definitive answers. The debate about the merits of corporate governance activism is so vast that I cannot hope to resolve it here. Instead, I am content to point out that in certain ways, at least, the debate has been seriously misinformed. Whether activism by large investment managers turns out to be good or bad, it is only ever likely to happen if we understand exactly why it remains so rare. My analysis of the legal sources of inter-client conflicts of interest suggests that if we do indeed want to encourage activism by large investors, then we will need major reforms to poison pills and to sections 13(d) and 16(b) the Exchange Act.

126. John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341, 358 (2012).

127. The Investment Company Act only requires a mutual fund to pay redemptions every seven days, but in practice most mutual funds process redemptions daily. 15 U.S.C. § 80a-22 (2018).

But even these reforms might not be enough, because legal reforms cannot eliminate the many practical conflicts that large investment advisers face. No changes to the wording of section 13(d) can eliminate the fundamental conflict between equity and debt, or between taxable and nontaxable investors. These conflicts are not legal accidents—they are facts of life. And whether they could ever be eliminated is by no means certain.

My insights do offer some certainty, however, about the ever-growing debate about horizontal shareholding. Though the possibility of quiet, unintentional influence is quite real, there is an upper bound to just how much influence a large investment manager can wield. It cannot influence a company so directly that it triggers debilitating conflicts.

At bottom, the insights I have offered here remain important, because they tell us how the debate about corporate governance activism should proceed in the future. We can now see when activism is realistically likely, and where we must focus our energies if we ever want to make it more or less likely in the future. I cannot resolve the debate about the desirability of corporate governance activism, but I can at least show how the debate could be more realistic.

CONCLUSION

The paradox at the heart of this Article is that as an investment manager gets bigger, its capacity for corporate influence gets smaller. As an investment management firm grows, it eventually becomes too big and complex to be an activist. The constraints on a big investment manager come from a variety of conflicts of interest that appear in both business strategy and law. Each of these conflicts is driven by the fact that everything in an investment management complex is connected. The actions of every client can influence the welfare of every other client—as well as the manager itself. Activism by one client can send legal and economic shrapnel flying into every corner of a manager's business.

Together, these conflicts place serious constraints on a large investment manager's ability to influence public companies. Though a large manager can exercise a degree of influence, the risk of conflicts places an upper bound on how assertive that influence can be. Although the growth of big investment managers raises immense questions, the numerous conflicts these managers face will inevitably limit both the promise and the peril they can bring to the future of corporate governance.