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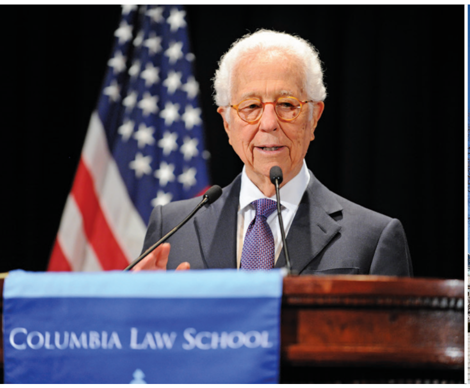

10th Year Anniversary Essay

“The Changing Landscape of the Capital Markets”

COLUMBIA LAW SCHOOL

About the Essay

This essay is part of a series written for the Millstein Center's 10-year anniversary. Each of the essays explores a topic or issue that the Center has addressed over its past decade of work. The essays' authors have all been on the front lines of the changes addressed and were often directly engaged in the Center's activities.

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The Changing Landscape of the Capital Markets

By Barbara Krumsiek

Much has been made of the rise of activist hedge funds over the past five years. But the shifts in the makeup of the investor community run much deeper than that, impacting both capital formation and capital deployment.

From the proliferation of hedge funds and the emergence of SRI and other new investment strategies, to the massive shift of funds to passive investors, the intermediation of the investment chain, and the concentration of ownership in the largest institutional investors, understanding the trend lines in the capital markets is integral to understanding where governance and the performance of public corporations goes from here.

This essay will explore those elements of those trends and the implications for how we think about public corporations and the capital markets going forward.

The Winds of Change

The winds of change often start out as gentle breezes. And so it is across the landscape of the capital markets. In 1975 the first equity index mutual fund portfolio was launched as part of the Vanguard Index Trust, with $11 million in assets under management.[1] ETF's, Exchange Traded Funds, were unheard of at that point. In 1986, Calvert mutual funds, advised by Calvert Group, a leading sustainable and responsible investment (SRI) firm, filed a shareholder resolution on labor-management relations, becoming the first investment firm to sponsor a shareholder resolution tied to a social issue.[2] Hedge funds, after fits and starts of performance and asset gathering success in the 1970's and 1980's, stood at $39 B in assets in 1990.[3]

Fast forward to the present. Assets in passively managed equity index funds are $2.7 trillion as of December, 2016, 25% of the reported total of $8.5 trillion in equity fund assets.[4] In March 2017, Proxy Preview reported that 430 social and environmental shareholder resolutions had been filed to date, with Environment and Political Activity at the top of the list of issue.[5] And hedge fund assets reached a reported $3.2 trillion in assets in June 2017, with an estimated 5,000 institutional investors allocating some of their assets to hedge funds.[6]

The growth of indexation versus active management, the emergence of environmental, social and governance (ESG) factors as material to investors, and the surge in activism through hedge funds vehicles, may have started out as breezes. With increasing force however, they can now be characterized as gale force winds.

The impact on the corporate boardroom of these three trends is magnified by the increased concentration of assets in fewer proxy-voting "hands". For example, the five largest mutual fund and ETF complexes represented 32% of all mutual fund assets in 2000, but by 2016 represented 47% of the $19.2 trillion in mutual fund and ETF assets,[7] a majority of which are in equity funds. Index mutual and exchange-traded fund investors are often called "universal owners," holding all stocks included in the index being tracked. Proxy voting has become a critical tool for these investors, as they typically do not have the option within these strategies of selling or divesting to express dissatisfaction with company performance.

The SEC's adoption of rule amendments in 2003 requiring mutual funds and other registered management investment companies to disclose their proxy voting procedures and actual votes cast[8] has brought all mutual funds into the arena of actively voting proxies. Rather than disclosing to the public, including their own investor base, that they are taking a "cookie cutter" approach to proxy voting—often deferring to management's recommendation—many investment advisors and fund complexes have established or expanded their in-house governance teams to analyze the issues and vote proxies.

These three distinct trends—growth in power and influence of indexation investment strategies, growth in power and influence of SRI, and growth in power and influence of activist hedge funds—can be viewed and analyzed in isolation, but they also must be understood as forces that can align to magnify their boardroom impact. SRI shareholder advocacy activists increasingly partner with major state and municipal pension funds and labor unions to open dialogue with corporations and jointly file shareholder resolutions if those talks cannot be concluded successfully.

Activist hedge funds have had their successes reaching out to the largest asset managers, including index fund asset managers, to solicit support for their proposals. The recent flurry of adoption of proxy access proposals, allowing for corporate director nominations from shareholders under certain conditions, demonstrates the power of alignment between asset owners, financial activists, SRI firms, and a broad range of asset managers.

Reshaping the Landscape of Board Governance

These trends are having a profound effect in the Boardroom, challenging Boards to weigh the demands of shareholders with varying time frames for achieving results. Hedge fund activism in particular might be driving short-term behaviors counter to the interest of longer-term or universal investors. Board expectations of management are amplified in terms of strategy development. With the rise in financial, environmental, social and governance activism, Boards now expect that management will infuse these considerations throughout corporate strategy, rather than reacting as issues surface.

Boards need to be well-informed regarding matters that drive the activists. They need to deepen their understanding of sustainability, for example, as companies are pressed to provide transparency and improved reporting in these areas. Audit Committees will need to become more conversant in the work of the Sustainability Accounting Standards Board, SASB, with regard to the materiality of ESG factors in their respective sectors. And as the SASB initiative gathers momentum, we may well see SASB stand beside the Financial Accounting Standards Board (FASB) as a driver of required corporate disclosures.

Importantly, there is good reason for Boards to consider a proactive plan for dealing with activists by asking management for insights, and identification of issues and vulnerabilities sooner rather than later in order to address them before being surprised by a contentious situation. Committee Charters and Committee composition should be reviewed to assure thorough and continuous coverage of key issues. If necessary, Committees Charters may need to be re-written; Committee composition may need to be re-structured to assure that the necessary experience and expertise is represented on the Committee; and in some cases a new Committee could be added.

Another notable Boardroom impact is the step-up in Board and shareholder direct engagement during proxy season, particularly when proxy advisors and activist shareholders present positions that management opposes. But why wait until proxy season? Are there not better times to engage? Board members need to know and understand their leading shareholders, listen to them, and anticipate with whom they might align with on controversial issues.

A Permanent Transformation?

The investment of management and Board time and energy in understanding and addressing these trends is worthwhile. The growth in index funds, the alignment of the financial sector with the corporate responsibility movement, and the growth in activist hedge funds are fast evolving beyond mere trends to become permanent fixtures on the Boardroom landscape.

The governance influence and power of index asset owners and managers is a direct function of the volume of assets they control. While nothing in the markets is a safe bet, the influence of passive investments is here to stay, and may even grow. Even in the event there is improved performance from active funds, and reduced fees to improve competitiveness, the fundamental dynamic won't shift. But how much more influence the passive funds achieve is the critical question. Could the influence of index asset owners and managers become even greater? It is likely there will be a "tipping point" in terms of the percent of asset owner funds that are directed to index or passive ETF funds and managers. Savvy investment professionals will increasingly move to develop strategies to manage against that outsized commitment to companies based solely on their presence in a popular index. As referenced earlier, using mutual funds as a proxy for all investable assets of publicly traded companies, we have now reached a minimum of 25% of equity assets under passive index management. There may be some room for some further growth in this percentage, perhaps even close to 50%, but there ultimately will be a ceiling.

The past decade has also seen growing alignment between the financial sector and the corporate responsibility movement. There is the very real prospect that this alignment will accelerate the integration of ESG factors in the mainstream investment process, as it becomes increasingly clear that these issues are material to corporate performance and therefore shareholder value. A meta-study of almost 200 sources published by Arabesque Asset Management and the University of Oxford in 2014, entitled "From the Stockholder to the Stakeholder", found that 80% of reviewed sources demonstrate a link between robust sustainability practices and positive investment performance.[9] Sustainability in the Boardroom, and in the corporate C-Suite, is here to stay.

The focus on ESG is currently centered on risks, including liabilities, costs, and reputational damage. In the future, however, management and Boards will increasingly view ESG factors from the perspective of opportunity. The growing global demand for renewable energy, for example, is far from simply a risk assessment for those companies that are in, or who serve, the energy and utility sectors. There is a clear growth opportunity.

As understanding grows of the material relevance of ESG factors, and as the quality and level of sustainability data increases, so too will innovation in how ESG information is used to generate financial performance. Indeed, we are already seeing the rise of ESG Quant funds, which integrate sustainability criteria into quantitative investment models. By systematically utilizing ESG data in combination with state of the art quantitative technology, a powerful new tool is becoming available to investors. And as it gains momentum, we can expect more capital to flow to companies that have truly embedded ESG issues into their strategies. Boards should take note.

With regard to the future of the third trend, growth in activist hedge funds, there will certainly continue to be an "activist" investor base in asset management as there has been for decades. Boards are therefore well served to develop response processes for the future. However, the source of activism in the future may not be activist hedge funds. The impact of the CalPRS and NYCERS decisions (among other pension funds) to eliminate hedge funds from their investment allocation mix due to complexity, high costs, and disappointing performance is not yet clear.

Activist hedge funds cite their performance advantage to date over equity hedge funds overall, but whether this outperformance will persist, and blunt the decisions of major pension investors to decrease their commitment, is unknown. The growth trajectory for hedge funds overall, and activist hedge funds in particular, may indeed slow or turn negative. Activism has surfaced in many forms over the decades, and will likely emerge from other directions as activist hedge funds as an asset allocation category face challenges from their current and prospective client base.

As these winds of change re-shape forces affecting the capital markets, company Boards are increasingly facing a new and dramatically different landscape; one which some are inevitably embracing more proactively than others. And in the life cycle of our capital markets, it is those nimble and adaptive corporations, and their Boards, that are more likely to succeed for the benefit of all stakeholders.

ENDNOTES

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[8] Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies; Release Nos. 33-8188, 34-47304, IC-25922 (2003), www.sec.gov/rules/final/33-8188.htm (last visited Aug 23, 2017).

[9] Gordon L Clark, Andreas Feiner & Michael Viehs, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance 42–48 (2015).

About the Author

Barbara Krumsiek: Barbara Krumsiek is an experienced Trustee and Director, having served on public company, private company, and mutual funds boards. Ms. Krumsiek's qualifications include her financial knowledge and her experience with issues of corporate governance, mergers and acquisitions, compensation, risk assessment and technology.

A globally recognized leader in sustainable investing, Ms. Krumsiek's professional background spans four decades in the asset management field, including most recently as the President, CEO and Chair of Calvert Investments, Inc. During her tenure as CEO of Calvert from 1997 to 2014, Ms. Krumsiek served on the Board of Calvert Mutual Funds and the Calvert Foundation, and served as the Chair of the Board of Acacia Mutual Life Insurance Company from 2008-2012.

Her prior board service includes a nine-year tenure (2007-2016) as Independent Director on the board of Pepco Holdings, Inc. (PHI). In 2016, Ms. Krumsiek was appointed an Independent Director of Arabesque Asset Management, London. In 2015, Ms. Krumsiek was named Senior Industry Fellow at Georgetown University's Women's Leadership Institute in the McDonough School of Business. Also in 2016, Ms. Krumsiek was appointed an Advisor to the Robert Wood Johnson Foundation Investment Committee.

Ms. Krumsiek was awarded the Lifetime Achievement Award from the Mutual Fund Industry Awards in March 2016. She received Columbia University Business School's Botwinick Prize in Business Ethics in 2012 and is a Washington Business Hall of Fame Laureate. She was named in Ethisphere's 2015 list of the 100 Most Influential in Business Ethics.

Graduating Phi Beta Kappa with University Honors and Honors in Mathematics from Douglass College at Rutgers University, Ms. Krumsiek holds a Master of Science in Mathematics from New York University's Courant Institute of Mathematical Sciences.

Ms. Krumsiek and her husband, Bart Leonard, reside in Washington, DC. They have two daughters.

About the Millstein Center for Global Markets and Corporate Ownership

The mission of the Millstein Center for Global Markets and Corporate Ownership is to bring world class scholarship, research and academic rigor to the vital task of restoring and strengthening long-term financing of innovative and durable public corporations, which are the underpinning of economic growth.

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