Why an Active Approach to Corporate Governance is Important in Today's Market

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Modern stock market investors take a variety of forms. Unfortunately, some of the largest investors on Wall Street (*i.e.*, hedge funds, high frequency traders, and passive index funds) may have among the smallest incentives to address failures in corporate governance. This stands in stark contrast to public pension plans that, for years, have led the charge against executive wrongdoing. The lack of incentives to spur these private funds to address corporate governance is a problem that affects everyone. Recently, certain market participants and commentators have recognized the risk of falling into a "cartoon version of market capitalism," where some of the largest private shareholders have essentially given up trying to monitor the companies in which they invest.[1] As a result, it remains as important as ever for public pension plans to remain active and vigilant.

Today's Wall Street is substantially influenced by large, private investment firms.[2] It has also been defined by a decades-long shift towards passive investment strategies, such as index funds.[3] However, there is real doubt that many of these private funds are properly incentivized to monitor and ensure good corporate governance. Index funds seek only to match the performance of a broad index or other specific benchmark, and therefore lack a strong financial incentive to ensure that any individual company is well-run.[4] Similarly, hedge funds and day traders, who often trade on volatility or proprietary algorithms, may quickly trade in and out of companies, or have closed their positions long before the fallout from corporate misdeeds.[5]

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According to a report published by *The Wall Street Journal* on February 27, 2024, a market dominated by those with little incentive to engage in corporate oversight could lead to share prices disconnected from corporate profitability.[6] It also risks ensuring the best allocation of capital — one of the primary goals of our market system.[7] What's more, the failure to enforce good governance harms long-term investors, like public pension funds, who will be around to suffer the consequences of corporate wrongdoing. The situation is concerning enough that some large equity investors have begun to realize what many public pension plans have known for years: that institutional investors cannot freeride on the efforts of others to ensure that corporate misconduct is appropriately addressed.

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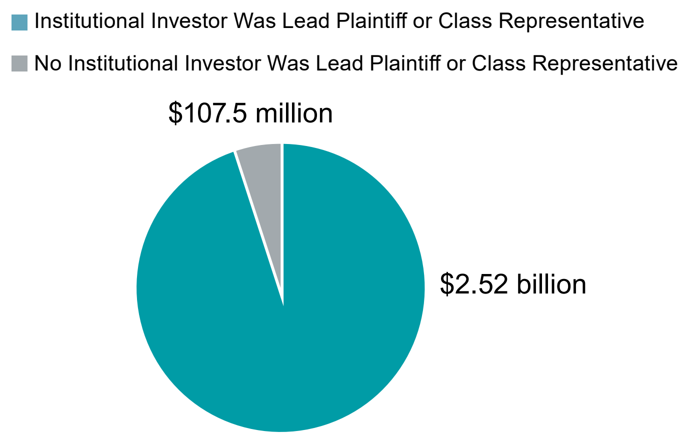
As Nicolai Tangen, the Chief Executive Officer of Norway's Government Pension Fund Global, told *The Wall Street Journal*, "[n]ot everyone can just be passive" and investors should not "free ride on a well-functioning market."[8] Mr. Tangen explained that taking an active approach in corporate governance is not based on trying to be a "global policeman," but rather a "shrewd capitalist" investor that aims to "enhance future long-term returns."[9]

Total Settlement Funds of Top 10 U.S. Securities Class Action Settlements of 2023



Note: nine of the ten largest securities class actions of 2023 involved an institutional investor as lead plaintiff or class representative.

Taking an active approach to corporate governance, however, is not new or uncommon for many public pension funds, who often take the lead in securities class actions against companies — the "ultimate way shareholders enforce control of big business," according to *The Wall Street Journal*.[10] Indeed, in 2023, institutional investors (including public pension plans) served as lead plaintiff or class representative in nine of the ten largest securities class action settlements and a number of successful derivative actions.[11]

In short, recent market commentary indicates that an active approach to corporate governance remains necessary to ensure the integrity of the market and maximize returns. This understanding is consistent with how public pension plans have acted for years, as they have led the way in achieving significant results in improving corporate governance practices and recovering plan assets through litigation. By continuing to take an active role in these matters, trustees and staff can help maximize asset values, work toward ensuring the integrity of the market, and keep corporate executives in check. ◆

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Endnotes:

[1] Mackintosh, James, *Why We Risk a Cartoon Version of Capitalism*, THE WALL STREET JOURNAL (Feb. 27, 2024), https://www.wsj.com/finance/investing/why-we-risk-a-cartoon-version-of-capitalism-83d8e7d4.

[2] Kardashian, Kirk, Why Institutions Should Be Active Investors, TUCK SCHOOL OF BUSINESS (May 16, 2018), https://www.tuck.dartmouth.edu/news/articles/why-institutions-should-be-active-investors.

[3] Id.

[4] Shapiro Lund, Dorothy, *The Case Against Passive Shareholder Voting*, at 2, COASE-SANDOR WORKING PAPER SERIES IN LAW AND ECONOMICS 829 (2017), https://chicagounbound.uchicago.edu/law_and_economics/846.

[5] See THE WALL STREET JOURNAL, supra note i.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Largest Securities-Related Class Action Settlements of 2023*, ISS SCAS (Jan. 18, 2024), https://insights.issgovernance.com/posts/the-largest-securities-related-class-action-settlements-of-2023/#:~:text=2023%20delivered%20a%20banner%20year,also%20up%2018%25%20from%202022.