GCGC 2019

Bebchuk & Hirst

"Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy"

discussion by:

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University of Virginia
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Columbia Law Review (forthcoming)

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Winner
Working Paper
Law Series
2019

The **2019 Cleary Gottlieb Steen Hamilton Prize** for the Best Paper in the ECGI Law Working Paper Series has been awarded to:

Lucian Bebchuk (Harvard Law School, NBER, CEPR and ECGI), **Scott Hirst** (Boston University, Harvard Law School) for their paper:

"Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy" (ECGI Law Working Paper 433/2018).

U.S. "paradigm" of corporate ownership: publicly-listed companies with dispersed anonymous investors (Berle and Means (1932))

… separation of ownership and control => agency costs between owners/investors ("principals") and managers ("agents")

… Grossman and Hart (1980): "free-rider" problem

Change #1: Rise of collective investment vehicles (ex: mutual funds)

… Shleifer & Vishny (1986): large investors => monitoring by "voice" or "exit"?

… Gilson & Gordon (2019): delegation => double-agency problems?

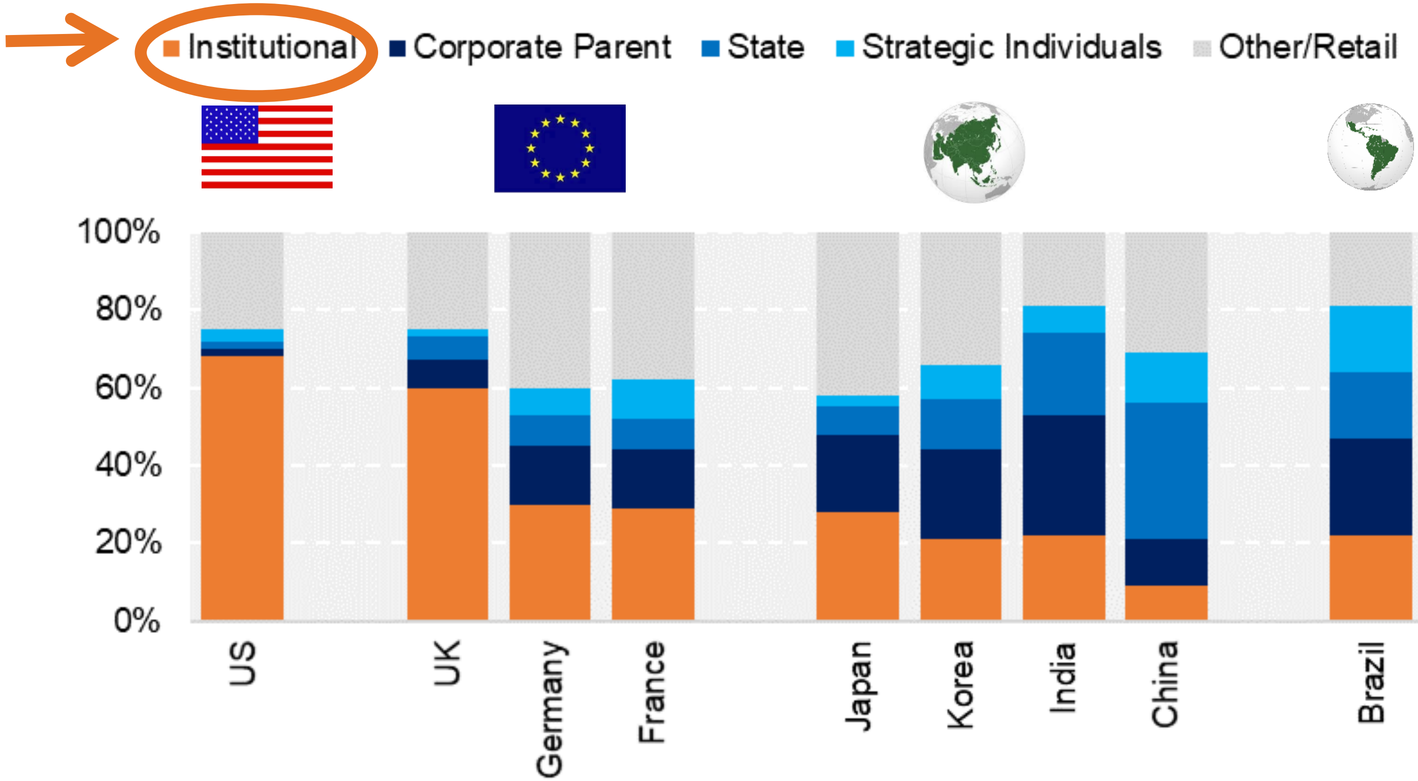
Change #2: Rise of "passive" investing (ex: index funds and ETFs)

… modern portfolio theory & scale economies in passive management => increased concentration of ownership with re-formation of block-ownership?

-> this paper: very timely study of "Index Funds and the Future of Corporate Governance"!

Change #1: The Rise of Institutional Investors

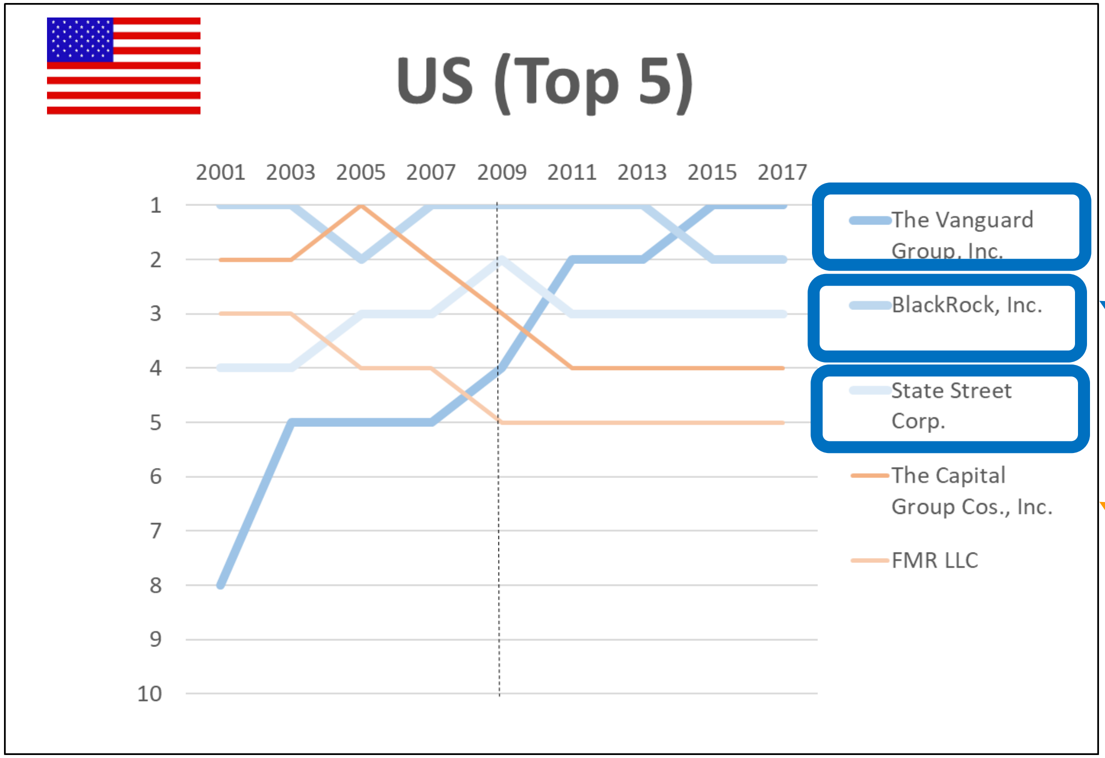
Average Share Ownership(100 largest listed companies, end-of-2017)



Source: Table 4 - OECD Equity Markets Review ASIA 2018
(based on data from FactSet Ownership)

*-> **institutional investors** dominant in U.S. but less concentrated ownership (vs. insider blockholders in other markets)*

Change #2: Rise of "Top 3" Institutional Owners



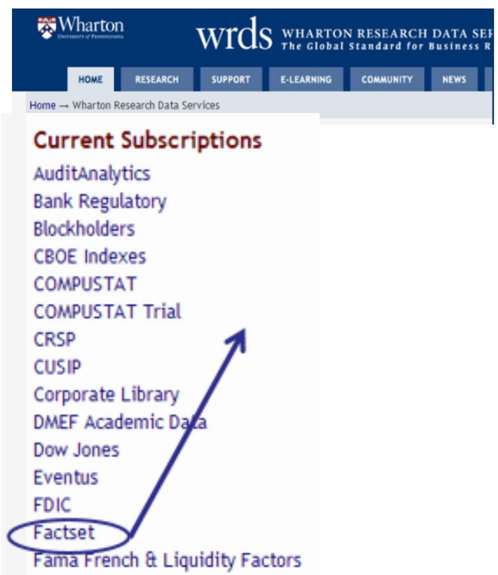
Top 3: "index"/ "passive"/ "universal"

"active"

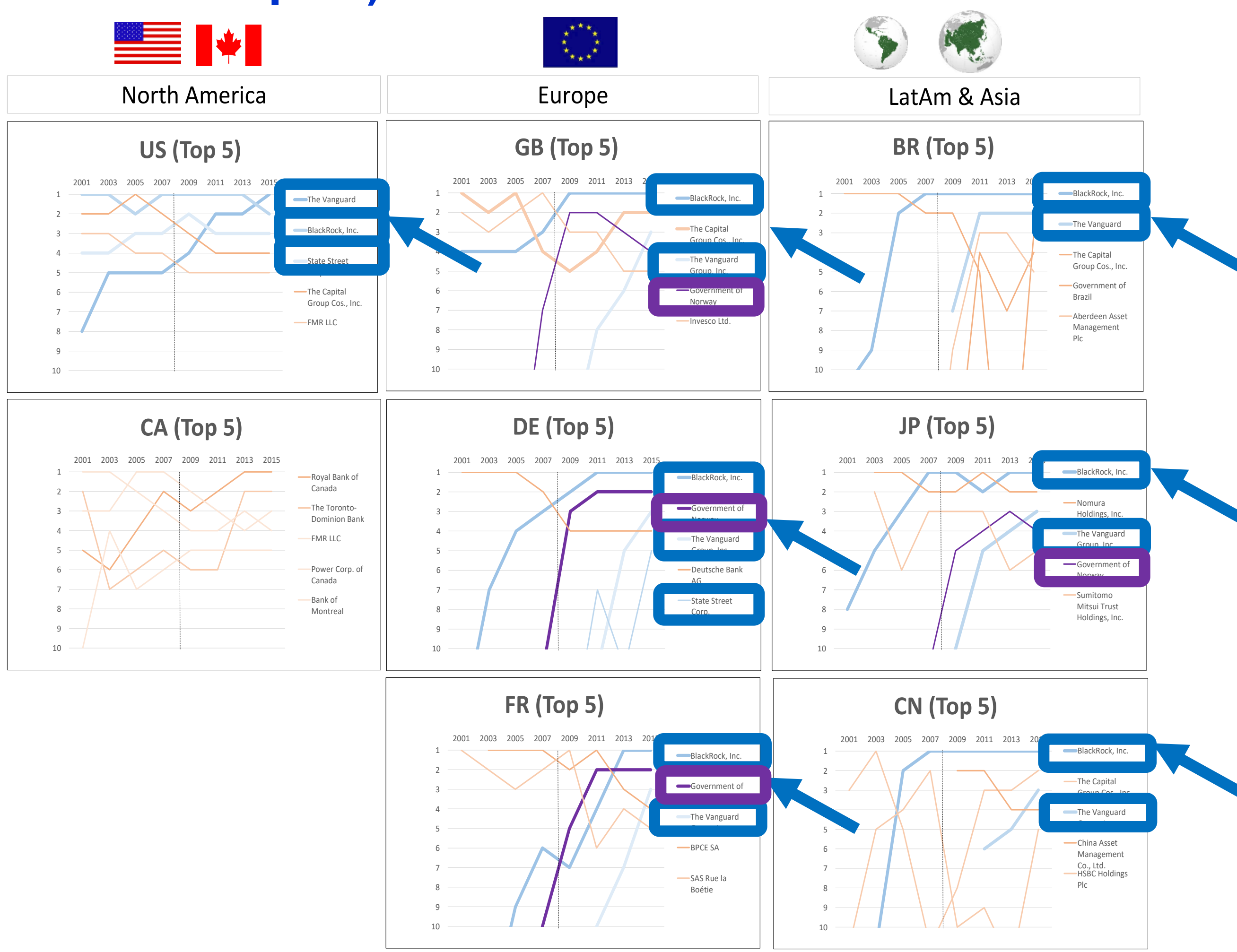
-> institutional ownership becoming more concentrated in "Top 3 index" in U.S. since the global financial crisis!

Is Change #2 (the Rise of the "Top 3") a Global Phenomenon?

Data: Factset Ownership (old LionShares)

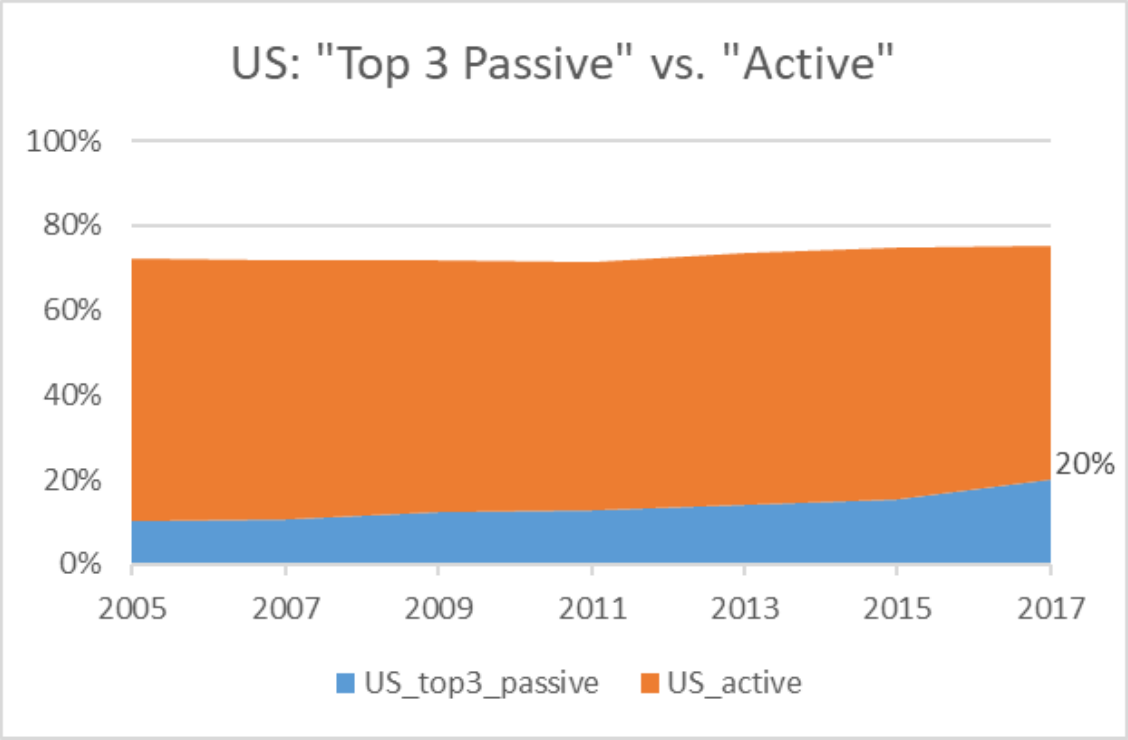


http://wrds-web.wharton.upenn.edu/wrds/ds/factset/holdingsbyfirmmsci/index.cfm



-> Top 3 "universal owners": BLK, Vanguard and SSgA top institutional holders worldwide! … or Top 4: NBIM?

Is Change #2 (the Rise of the "Top 3") a Global Phenomenon?



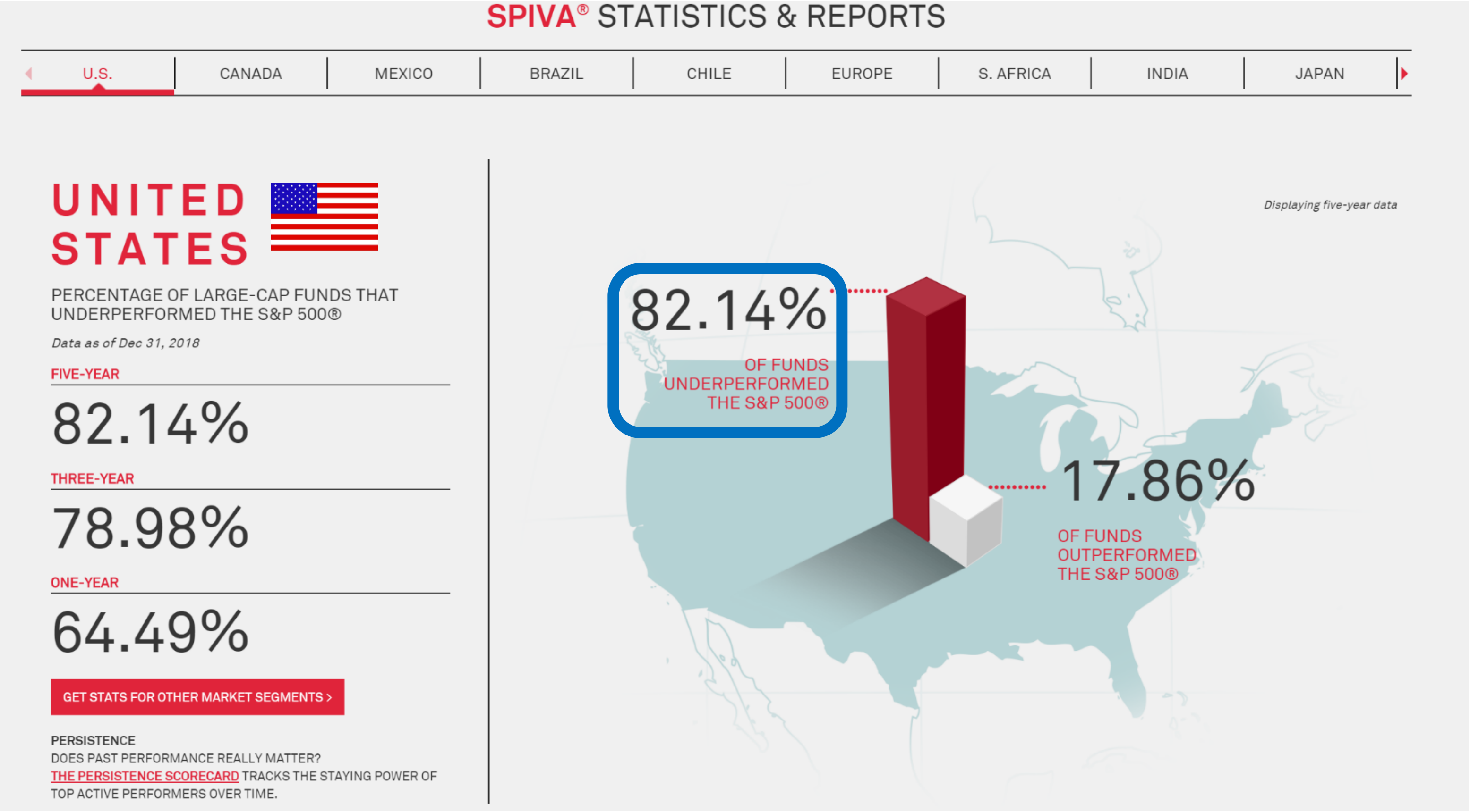
-> US: Top 3 ownership = 20% (2017) … costs vs. benefits?

Is Change #2 (the Rise of the "Top 3") a Global Phenomenon?

	Dec 2015: Total Institutional ownership	*Dec 2015:* Top3_passive (BlackRock + Vanguard + State Street)
Global:	42% of global market cap (US$ 25.4 trln)	8% (US $4.6 trln)
US:	75% (US$ 16.8 trln)	15% (US$ 3.5 trln)
Non-US:	22% (US$ 8.5 trln)	3% (US$ 1.2trln)

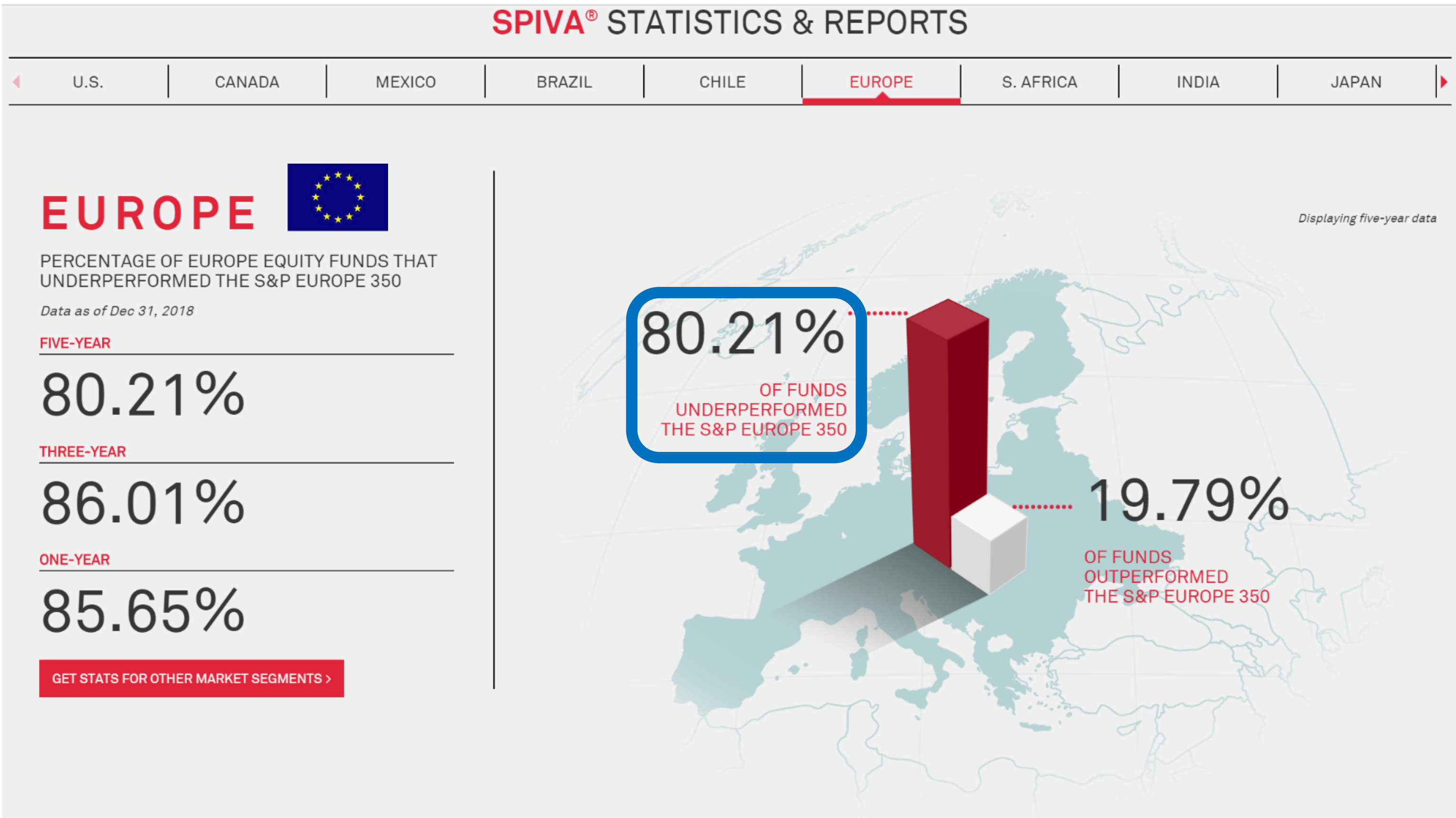
-> Non-US: Top 3 ownership = 3% (2015) ... still low!

Taking a Step Back: What's Behind this Change?



https://us.spindices.com/spiva/#/reports

What’s Taking a Step Back: What’s Behind this Change? (2)



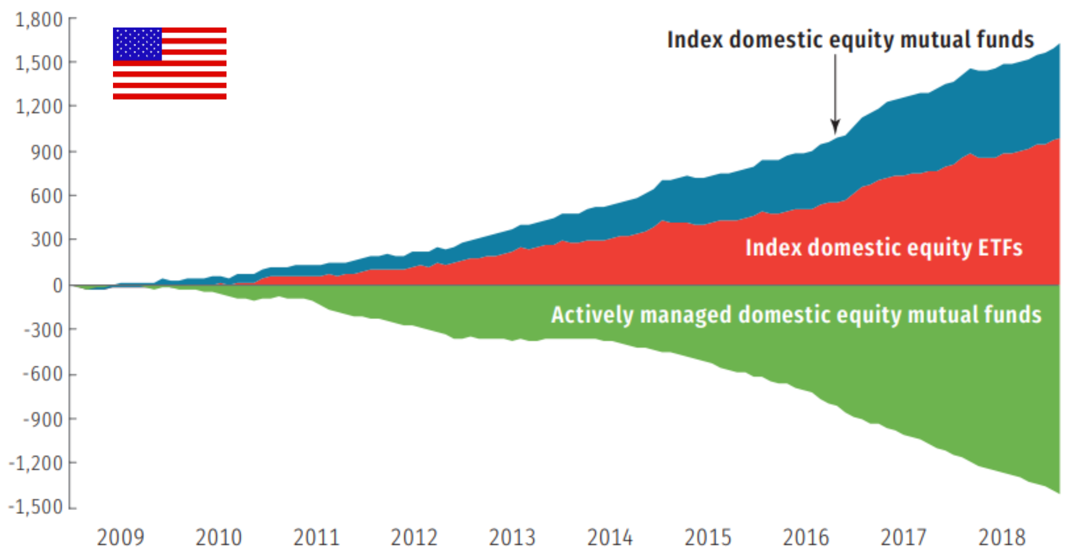
https://us.spindices.com/spiva/#/reports

Taking a Step Back: What's Behind this Change? (3)

FIGURE 3.14

Some of the Outflows from Domestic Equity Mutual Funds Have Gone to ETFs

Cumulative flows to domestic equity mutual funds and net share issuance of index domestic equity ETFs;* billions of dollars, monthly



*Prior to October 2009, index domestic equity ETF data include a small number of actively managed domestic equity ETFs.

Note: Mutual fund data include net new cash flow and reinvested dividends; ETF data for net share issuance include reinvested dividends.

https://www.ici.org/pdf/2019_factbook.pdf

This Paper: I. Theory on "index" fund stewardship:

THE "GOOD"

(The "promise"):

+ universal owners

+ large stakes

+ no "exit" option

+ long-term / near-permanent

-> Appel et al. "Passive Investors, not Passive Owners" (2016), "Standing on the Shoulders of Giants" (2019), Fisch et al. (2018) …

THE "BAD"

(The "agency costs"):

- Incentive to under-invest (low fees)

- deferential to corporates (business ties, avoid 13(d), fears of backlash)

-> Bebchuk, Cohen and Hirst (2017), Brav, Jiang and Li (2018) …

THE "UGLY"

Common ownership

-> Azar, Schmalz, Tecu (2018), …

II. Evidence on “index” fund stewardship

II. A. Under-Investment

	Blackrock	Vanguard	SSgA
Stewardship team	33	21	11
Personnel $	$9.9 mln	$6.3 mln	$3.3 mln
as % of AUM	0.00029%	0.00018%	0.00018%
as % of Fees	0.12%	0.18%	0.11%

-> <u>small</u> but relative to other institutions? (next slide)

II. Evidence on “index” fund stewardship

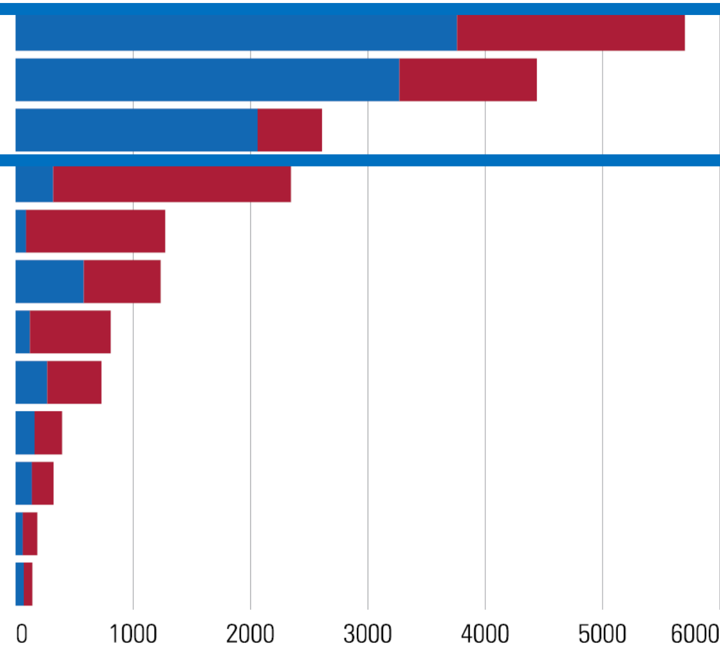
II. A. Under-Investment

MORNINGSTAR **Passive Fund Providers Take an Active Approach to Investment Stewardship**

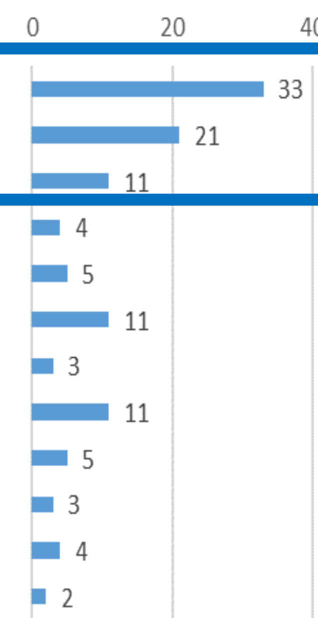
Morningstar Manager Research
December 2017

Exhibit 2 Surveyed Manager AUM Split Into Passive and Active ($ Billion)

Asset Manager	Passive	Active
BlackRock	3,762	1,938
Vanguard	3,270	1,170
SSGA	2,062	548
Fidelity Investments	319	2,027
Amundi	89	1,185
LGIM	580	655
Deutsche AM	121	687
UBS AM	270	460
Nomura AM	162	233
Schwab	139	183
Nikko AM	61	123
Lyxor	71	71



Stewardship team (2017):



Source: Asset managers. Data as of 30 June 2017.

II. Evidence on “index” fund stewardship

II. A. Under-Investment

II. Evidence on "index" fund stewardship

II. A. Under-Investment

II. Evidence on "index" fund stewardship

II. B. Private Engagement

	Blackrock	Vanguard	SSgA
# Engagements	*1,480?*	*817?*	*611?*
% Portfolio Cos. w/ Engagement	10.7%	17.2%	9.6%

-> # and % vs. other institutions? (next slide)

II. Evidence on “index” fund stewardship

II. B. Private Engagement

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Amundi	89	1,185	481
LGIM	580	655	500
Deutsche AM	121	687	37
UBS AM	270	460	120
Nomura AM	162	233	200
Schwab	139	183	0
Nikko AM	61	123	1,000
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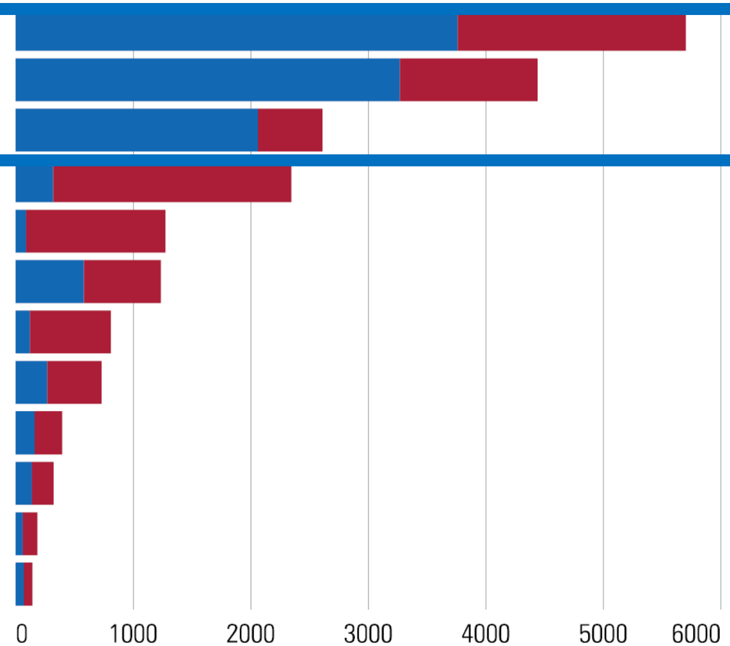

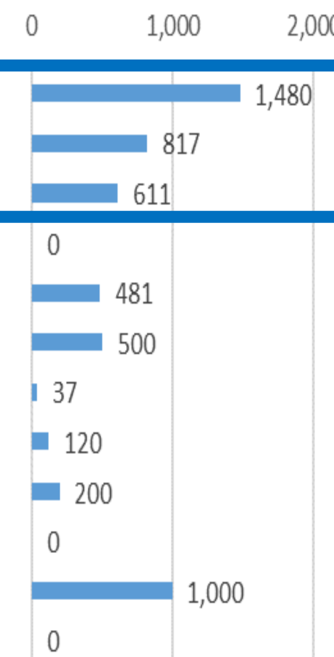

Source: Asset managers. Data as of 30 June 2017.

II. Evidence on "index" fund stewardship

II. B. Private Engagement

BlackRock Investment Stewardship

2018 Annual Report

August 30, 2018

Appendix: Engagements

Vanguard

2018

Investment Stewardship Annual Report

?

STATE STREET GLOBAL ADVISORS

Stewardship 2017

Appendix

List of Companies Engaged by Topic

II. Evidence on “index” fund stewardship

II. C. Limited Attention to Performance

- No engagement cases motivated by financial underperformance (most focus on governance)

-> agreed, but may support hedge fund activists?

II. Evidence on “index” fund stewardship

II. D. Proxy voting

	Blackrock	Vanguard	SSgA
% “No” Votes on Say-on-Pay	2.3%	2.4%	4.9%

-> <u>low</u> but vs. other institutions? (next slide) … and vs. ISS / Glass Lewis?

II. Evidence on “index” fund stewardship

II. D. Proxy voting

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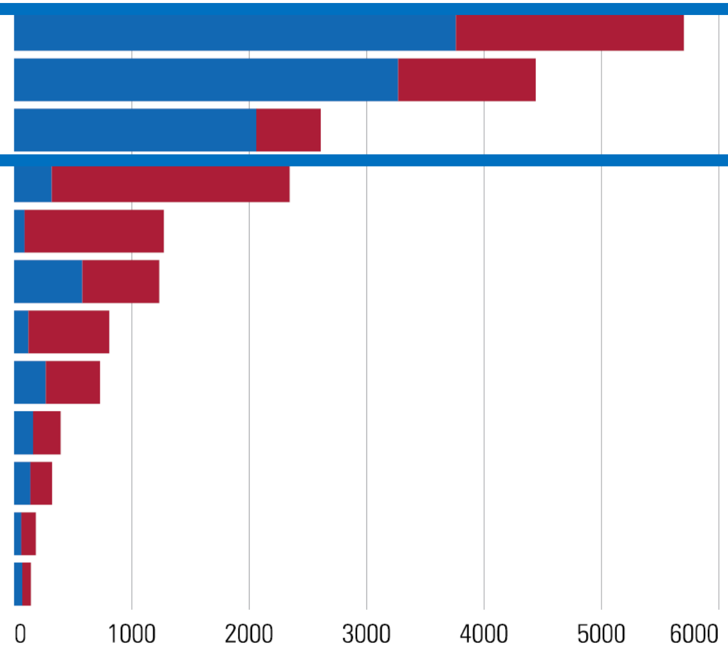
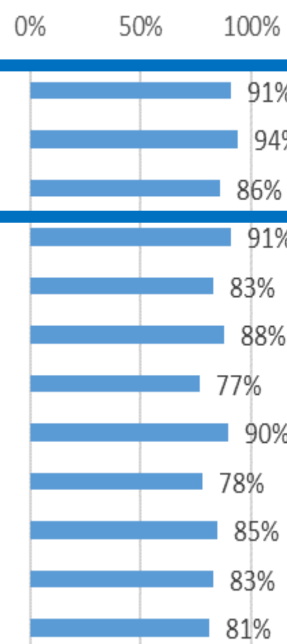


% Votes “For” (2016/17):



Source: Asset managers. Data as of 30 June 2017.

II. Evidence on “index” fund stewardship

II. E. Director Selection

- No director nominations
- Would require 13(d) filing

-> agreed but vs. other institutions? (could not find data?)

II. Evidence on “index” fund stewardship

II. F. Shareholder Proposals

- No shareholder proposals

-> <u>agreed</u> but vs. other institutions? (next slide)

II. Evidence on “index” fund stewardship

II. F. Shareholder Proposals

MORNINGSTAR® **The Proxy Process**
Raising the Investor Voice to Address New Risks

Morningstar Manager Research
8 February 2019

Exhibit 7 Large Asset Manager Support for Shareholder Resolutions in Broad E&S Category Groupings

Category	Asset Managers	2016 #	2016 %	2017 #	2017 %	2018 #	2018 %
Climate Change	BlackRock	66		56	4	40	8
	BNY Mellon	57	4	46	4	33	36
	Fidelity (ex. Geode)	65	4	56	33	41	30
	Fidelity (Geode)	65		54	11	40	48
	State Street	65	38	55	33	40	45
	Vanguard	66		56	4	39	15
Environment	BlackRock	25		26	4	16	13
	BNY Mellon	20	10	22	14	12	42
	Fidelity (ex. Geode)	25	7	26	14	16	38
	Fidelity (Geode)	25		26	19	16	50
	State Street	25	32	26	38	16	25
	Vanguard	25		26		16	19
Gender: Diversity and Pay Equit	BlackRock	18		29	21	19	26
	BNY Mellon	14	7	24	13	18	17
	Fidelity (ex. Geode)	18	21	29	38	19	79
	Fidelity (Geode)	17		29	3	19	42
	State Street	18	22	29	7	19	32
	Vanguard	18		29	21	19	16

Source: Morningstar Proxy Voting Data as of Dec. 31, 2018. Support is calculated as the percentage of the resolutions supported by funds within fund groups offered by each of the asset managers.

II. Evidence on "index" fund stewardship

II. G. Corporate Governance reforms

	Blackrock	Vanguard	SSgA		*CalPERS*	*CalSTRS*
% Comments on SEC Proposed Rules (25% most commented)	5%	10%	10%		*55%*	*35%*

-> agreed but other lobbying efforts [ex: exclusion of dual-class stocks from indices - see Kim, Matos and Xu (working paper) @ ECGI Riga]

II. Evidence on “index” fund stewardship

II. H. Securities Litigation

- No lead plaintiff positions

-> agreed but vs. other institutions?

III. Public Policy:

III. A. Encouraging Investment in Stewardship

III.B. Limit Business Relationships

III. C. Transparency to Private Engagements

III.D. Size Limits

III. E. The Debate on Cross Ownership *-> "crowding out" effect?*

III. F. The Debate on Hedge Fund Activism

-> other policy options: new (stewardship codes) or old (anti-trust)?
-> also, any policy should be weighted vs. societal benefits of low-cost indexation

Columbia Law Review (forthcoming)

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