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

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Our Focus

- We focus on the stewardship decisions of index funds
  - How they monitor, vote in, and engage with portfolio companies
- This has a major impact on the governance and performance of public companies and the economy
- We provide a systematic theoretical, empirical and policy analysis of index fund stewardship
Theory

• We describe two competing theories of index fund stewardship:
  1. No-agency-costs view
  2. Agency-costs view
     ⇒ Suggests that index funds managers have strong incentives to:
        (i) under-invest in stewardship; and
        (ii) defer excessively to corporate managers
Evidence

• We provide the first comprehensive evidence of the full range of stewardship choices made by index fund managers, especially the Big Three

• The evidence is, on the whole, consistent with the agency-costs view
Policy

• We explore the policy implications of the incentive problems of index fund managers
  – We put forward a number of policy measures to address these
  – We explain how these problems shed light on important ongoing debates
Theory
The Big Three’s Stewardship Aspirations

Big Three executives have repeatedly stressed the importance of responsible stewardship, and their strong commitment to it:

– Vanguard’s CEO: “We care deeply about governance.”

– Blackrock’s CEO: “Our responsibility to engage and vote is more important than ever” and “the growth of indexing demands that we now take this function to a new level.”

– SSGA’s CIO: “SSGA’s asset stewardship program continues to be foundational to our mission.”
The Big Three’s Stewardship Aspirations (2)

• Big Three executives have also stated both their willingness to devote the necessary resources to stewardship, and their belief in the governance benefits that this produces:
  – Vanguard’s CEO: “We’re good at [governance]. Vanguard’s Investment Stewardship program is vibrant and growing.”
  – BlackRock’s CEO: BlackRock “intends to double the size of [its] investment stewardship team over the next three years. The growth of [BlackRock’s] team will help foster even more effective engagement.”
The Promise of Index Fund Stewardship

The Big Three and supporters of index fund stewardship focus on three characteristics that give the Big Three potential advantages as stewards:

1. Large stakes in each portfolio company
   - Provide the Big Three with significant potential influence
   - Means that their portfolio captures significant gains from improving the value of a given portfolio company
The Promise of Index Fund Stewardship (2)

2. Lack of “exit” option from positions in portfolio companies (while they remain in the index)
   ⇒ Protecting/improving value is their only option

3. Holding shares for the long term gives them a long-term perspective
   ⇒ BlackRock’s CEO: “BlackRock cannot express its disapproval by selling the company’s securities … [a]s a result, our responsibility to engage and vote is more important than ever.”

⇒ SSGA and Vanguard’s CEOs refer to their funds as “near-permanent capital” or “permanent shareholders.”
The No-Agency-Costs View

• The premise of the Big Three leaders and supporters of index fund stewardship (e.g., Fisch, Hamdani & Davidoff Solomon 2018) is that index funds maximize the value of their portfolios
  – i.e., Their decisions do not substantially diverge from the decisions that would best serve index fund beneficial investors

• This view does not view agency problems as a first-order determinant of stewardship decisions
  ⇒ We refer to this view as the no-agency-costs view
The Agency-Costs View

• We suggest that the private interests of index fund managers create agency problems that are a first-order driver of stewardship decisions
  – Stewardship decisions for an index fund are made by the index fund manager, not the index fund’s beneficial investors

• Two types of incentive problems push the stewardship decisions of index fund managers away from those that would be best for index fund investors
Incentives to Under-Invest in Stewardship

• Assume (initially) that stewardship has no effect on assets under management or on fees
• Consider an investment in stewardship that will materially increase the expected value of a portfolio company
• The index fund manager will capture only a very small fraction of the produced gains in terms of increased fees
  – Likely less than 1%
  ⇒ Has an incentive to under-invest
Incentives to Under-Invest in Stewardship (2)

• e.g.: Consider a $1 bn position in a portfolio company held by an index fund
  – (Each of the Big Three has hundreds of $1 bn+ positions)
  – Assume a certain stewardship investment would produce a modest expected increase in value of 0.1%
    ⇨ The no-agency costs benchmark calls for making stewardship investments up to $1m
  – Assume that the index fund manager charges fees of 0.5%
    ⇨ The manager has an incentive to spend no more than $5,000
Incentives to Under-Invest in Stewardship (3)

Can an interest in expanding assets or increasing fees provide extra incentives to invest in stewardship?

• Investments in stewardship that increase the value of a portfolio company increase index fund performance

• But rival index funds tracking the same index get the benefit of the increase in value without any expenditure of their own

⇒ Stewardship investments will not enable index funds to attract additional funds or increase fees
Incentives to be Excessively Deferential

- For any given investment level, index fund managers face qualitative stewardship decisions
  - Be more/less deferential to corporate managers?
- Index fund managers bear private costs from nondeference (or capture private benefits from deference)
  - Private incentives to be excessively deferential
Private Interests Served by Deference

1. Maintaining/developing existing or potential business relationships between index fund managers and their portfolio companies

Index fund managers have incentives to adopt principles, policies, and practices that defer to corporate managers to avoid frictions that could undermine business development.
Private Interests Served by Deference (2)

2. Avoiding the Costs of 13D Filings and Poison Pills
   – Where the Big Three have positions of 5% or more, nondeference may trigger 13D disclosure obligations or poison pill imposition
     ⇒ This would impose substantial additional (private) costs on the index fund manager
3. Reducing the Risks of Political Backlash
   - Given the growing power of the Big Three, and recalling reactions to past episodes of concentrated power in the hands of financial interests, Big Three leaders have reasons to worry about regulatory backlash

\[ \Rightarrow \text{Non-deference would likely encounter significant resistance from corporate managers, and increase the salience of Big Three power, increasing the risk of regulatory backlash} \]
Constraints on the Effects of Agency Problems

- Fiduciary norms or a desire to do the right thing
  - Might lead index fund managers to take actions that differ from those suggested by a pure incentive analysis
- Incentives to be perceived as responsible stewards by their beneficial investors and by the public
  - Might avoid actions that would make salient their under-investing in stewardship and their deference to corporate managers
- This might limit the force of the structural problems we identify
- But they should not be expected to eliminate the problems, as is suggested by the evidence we present
Evidence
Investments in Stewardship

• Given the size of their portfolio positions, the no-agency-costs view would predict that index fund managers would make significant stewardship investments
  – An expected 0.1% increase in a $1bn position would justify up to $1m investment in stewardship
  ⇒ This could justify multiple professionals dedicated to monitoring and interacting with each such portfolio company

• Supporters of index fund stewardship have focused on recent increases in stewardship staff of the Big Three

• We estimate the personnel resources (hours and cost) devoted to each portfolio company
## Stewardship Personnel and Portfolio Companies

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stewardship Personnel</strong></td>
<td>33</td>
<td>21</td>
<td>11</td>
</tr>
<tr>
<td><strong>Portfolio Companies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Worldwide)</td>
<td>17,309</td>
<td>18,900</td>
<td>17,337</td>
</tr>
<tr>
<td><strong>Portfolio Companies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(U.S.)</td>
<td>4,084</td>
<td>3,946</td>
<td>3,762*</td>
</tr>
</tbody>
</table>

* Estimated
### Stewardship Investments Relative to Equity Investments and Estimated Fees

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stewardship Personnel (2017)</strong></td>
<td>33</td>
<td>21</td>
<td>11</td>
</tr>
<tr>
<td><strong>Stewardship Investment as % of Equity AUM</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated Stewardship Investment ($m)</td>
<td>$9.9</td>
<td>$6.3</td>
<td>$3.3</td>
</tr>
<tr>
<td>Equity AUM ($m)</td>
<td>$3,364,184</td>
<td>$3,507,649</td>
<td>$1,835,917</td>
</tr>
<tr>
<td>Stewardship as % of Equity AUM</td>
<td>0.00029%</td>
<td>0.00018%</td>
<td>0.00018%</td>
</tr>
<tr>
<td><strong>Stewardship Investment as % of Estimated Fees</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated Stewardship Investment ($m)</td>
<td>$9.9</td>
<td>$6.3</td>
<td>$3.3</td>
</tr>
<tr>
<td>Estimated Fees &amp; Expenses ($m)</td>
<td>$8,410</td>
<td>$3,508</td>
<td>$2,937</td>
</tr>
<tr>
<td>Stewardship as % of Fees &amp; Expenses</td>
<td>0.12%</td>
<td>0.18%</td>
<td>0.11%</td>
</tr>
</tbody>
</table>
## Stewardship Per Portfolio Company

<table>
<thead>
<tr>
<th>Stewardship Time (Person-Days)</th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)</strong></td>
<td>0.48</td>
<td>0.28</td>
<td>0.16</td>
</tr>
<tr>
<td><strong>Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company</strong></td>
<td>1.52</td>
<td>1.00</td>
<td>0.55</td>
</tr>
<tr>
<td><strong>Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide</strong></td>
<td>2.45</td>
<td>1.50</td>
<td>1.50</td>
</tr>
<tr>
<td><strong>Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies</strong></td>
<td>3.17</td>
<td>1.84</td>
<td>1.69</td>
</tr>
</tbody>
</table>
## Stewardship Per Portfolio Company (2)

<table>
<thead>
<tr>
<th>Stewardship Investment ($)</th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)</strong></td>
<td>$572</td>
<td>$333</td>
<td>$190</td>
</tr>
<tr>
<td><strong>Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company</strong></td>
<td>$1,818</td>
<td>$1,197</td>
<td>$658</td>
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<tr>
<td><strong>Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide</strong></td>
<td>$2,943</td>
<td>$1,796</td>
<td>$1,797</td>
</tr>
<tr>
<td><strong>Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies</strong></td>
<td>$3,805</td>
<td>$2,213</td>
<td>$2,025</td>
</tr>
</tbody>
</table>
Investments in Stewardship (2)

Evaluating the governance and performance of a public company requires evaluating hundreds of pages of documents (or more):

- The company’s annual report and proxy statement
- The performance of the company with respect to long-term plans
- The company’s executive pay arrangements
- Management proposals and shareholder proposals up for a vote
- The views of the company’s directors on these matters
- Assessments of the directors’ performance
Investments in Stewardship (3)

Conclusions: Consistent with the agency-costs view:
- The Big Three devote an economically negligible fraction of their fee income to stewardship
  - Their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies
Private Engagement

• The Big Three have stressed that private engagement is a central and superior tool that allows them to avoid using other shareholder tools:
  – Vanguard: Private engagement is the “perhaps more important … component of [Vanguard’s] governance program”; “engagement is where the action is.”
  – BlackRock: “[M]eetings behind closed doors can go further than votes against management.”
• We look at the proportion of portfolio companies that the Big Three engage with, and have more than one conversation with
## Private Engagement (2)

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Portfolio Companies with No Engagement</strong></td>
<td>89.3%</td>
<td>82.8%</td>
<td>90.4%</td>
</tr>
<tr>
<td><strong>Portfolio Companies with Engagement:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portfolio Companies with Engagement Limited to a Single Conversation</td>
<td>7.2%</td>
<td>10.3%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Portfolio Companies with Engagement Including More Than a Single Conversation</td>
<td>3.5%</td>
<td>6.9%</td>
<td>0.7%</td>
</tr>
<tr>
<td><strong>Total Portfolio Companies with Engagement</strong></td>
<td>10.7%</td>
<td>17.2%</td>
<td>9.6%</td>
</tr>
</tbody>
</table>
Private Engagement (3)

• Each of Big Three had no engagement in the great majority of companies
  ⇒ For these companies private engagement be a substitute for the use of other stewardship tools
• Where private engagement does occur its effectiveness is reduced by the Big Three’s reluctance to use other stewardship tools
Limited Attention to Performance

- Financial performance is important to investors
  - Index fund investors would benefit from fund managers focusing on the financial performance of portfolio companies

\Rightarrow In the no-agency-costs benchmark, index funds would monitor financial underperformance and examine what personnel or other changes could address it
Limited Attention to Performance (2)

- But Big Three stewardship focuses on governance best practices, with limited attention to underperformance, or to remedying it
  - SSGA: Seeks to provide “principles-based guidance”
  - BlackRock: Engages where a company lags behind its peers on environmental, social, or governance matters, or in sectors with thematic governances issues
  - Vanguard: Focuses on board composition issues, governance structures, executive compensation, and risk oversight
Limited Attention to Performance (3)

• We examine the many examples of behind-the-scenes engagements in Big Three Stewardship Reports:
  ⇒ No cases in which engagement was motivated by financial underperformance

• We examine the proxy voting guidelines of each of the Big Three for withholding support from directors
  ⇒ All focus on governance aspects and none include financial underperformance
Limited Attention to Performance (4)

- Supporters of index fund stewardship argue that they “lack the expertise and access to information to identify operational improvements … to improve the performance of companies in their portfolio.” (Fisch, Hamdani & Davidoff Solomon, 2018)
- But lack of in-house expertise is not a given, it is a choice made by index fund managers
  - Index fund managers have the resources to could improve their ability to identify and remedy financial underperformance
Limited Attention to Performance (5)

• Could index fund managers rationally avoid doing so because “activist hedge fund are already doing it” and thus it is unnecessary for them to do it?

• Not a valid justification because:
  – Activist hedge funds will only engage where underperformance is very large and can be fixed quickly
  – Activist hedge funds may take some time to arrive
Pro-Management Voting

• In proxy fights, index funds voted in favor of managers more often than did other investment funds
  To an extent that is economically and statistically significant (Brav, Jiang, and Li, 2018)

• We gather data on the say-on-pay votes of index fund managers
“No” Votes in S&P 500 Say-on-Pay Votes

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
<th>Avg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>2.5%</td>
<td>3.6%</td>
<td>3.1%</td>
<td>3.1%</td>
</tr>
<tr>
<td>2013</td>
<td>2.3%</td>
<td>2.1%</td>
<td>4.2%</td>
<td>2.9%</td>
</tr>
<tr>
<td>2014</td>
<td>2.3%</td>
<td>2.9%</td>
<td>6.4%</td>
<td>3.9%</td>
</tr>
<tr>
<td>2015</td>
<td>1.0%</td>
<td>1.8%</td>
<td>4.5%</td>
<td>2.4%</td>
</tr>
<tr>
<td>2016</td>
<td>2.0%</td>
<td>1.8%</td>
<td>5.1%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2017</td>
<td>3.6%</td>
<td>3.3%</td>
<td>5.9%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Avg.</td>
<td>2.3%</td>
<td>2.4%</td>
<td>4.9%</td>
<td>3.2%</td>
</tr>
</tbody>
</table>
Pro-Management Voting (2)

- The Big Three *rarely* oppose say-on-pay votes
- Pro-management voting is consistent with the agency-costs view
Avoiding Shareholder Proposals

- Proposals submitted by shareholders under Rule 14a-8:
  - Have improved shareholder rights at many companies
  - In ways that the Big Three supports
    (e.g., Majority voting, annual elections, proxy access)
- Use of shareholder proposals would be natural for index funds:
  - Focus on conformity with governance best practices
  - Numerous portfolio companies aren’t in compliance
- 3,912 shareholder corporate governance proposals were submitted from 2008 to 2017
# Submission of Shareholder Proposals

<table>
<thead>
<tr>
<th>Year</th>
<th>Shareholder Proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>409</td>
</tr>
<tr>
<td>2009</td>
<td>477</td>
</tr>
<tr>
<td>2010</td>
<td>456</td>
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<tr>
<td>2011</td>
<td>310</td>
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<tr>
<td>2012</td>
<td>359</td>
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<td>2013</td>
<td>344</td>
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<td>2014</td>
<td>300</td>
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<tr>
<td>2015</td>
<td>396</td>
</tr>
<tr>
<td>2016</td>
<td>322</td>
</tr>
<tr>
<td>2017</td>
<td>261</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,912</strong></td>
</tr>
</tbody>
</table>
Avoiding Shareholder Proposals (2)

- *None* of these proposals were submitted by any of the Big Three.
- Avoiding shareholder proposals is consistent with the agency-cost view.
Avoiding Shareholder Proposals (3)

Can their avoidance of shareholder proposals be justified on grounds that the Big Three don’t need to submit proposals because others (smaller) investors are doing so?

- Because of the limited resources of smaller investors, proposals that the Big Three would support are not submitted at all, or are submitted only after many years delay
- e.g., A large proportion of the Big Three’s portfolio companies lack annual elections, proxy access, or majority voting, which the Big Three support
  - Had any of the Big Three submitted shareholder proposals on those issues they are likely to have had significant practical effects.
Avoiding Involvement in Director Selection

• A portfolio company’s directors may not be well suited to the needs of the company
  ➞ Index fund investors would benefit from index fund managers facilitating desirable changes in the directors on the board
• We examine whether the Big Three ever nominate director candidates
• We find 2,373 total director nominations from 2008 to 2017
# Actual and Proposed Director Nominations

<table>
<thead>
<tr>
<th>Year</th>
<th>Director Nominations</th>
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<tbody>
<tr>
<td>2008</td>
<td>255</td>
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<tr>
<td>2009</td>
<td>235</td>
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<tr>
<td>2010</td>
<td>190</td>
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<td>2011</td>
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<td>2012</td>
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<td>2015</td>
<td>266</td>
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<tr>
<td>2016</td>
<td>195</td>
</tr>
<tr>
<td>2017</td>
<td>209</td>
</tr>
<tr>
<td>Total</td>
<td>2,373</td>
</tr>
</tbody>
</table>
Avoiding Involvement in Director Selection (2)

• *None* of these nominations were made by any of the Big Three
• Index fund investors would benefit from communications to companies re individuals that should be added to / removed from the board
• We review engagements described in the Big Three’s Stewardship Reports
  ⇒ No mention of private communications to influence choice of directors
Avoiding Involvement in Director Selection (3)

- We gather data on 5% positions held by the Big Three 2008-2017
- Blackrock had 2,455 positions, Vanguard 1,839, SSGA 221
- Suggestions re director selection by a 5% holder would require a Schedule 13D filing
- The Big Three did not file any Schedule 13Ds 2008-2017
## Big Three Positions of 5% or More

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Vanguard</th>
<th>SSGA</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>1,175</td>
<td>31</td>
<td>83</td>
<td>1,289</td>
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<tr>
<td>2009</td>
<td>1,383</td>
<td>83</td>
<td>71</td>
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<td>2012</td>
<td>1,629</td>
<td>833</td>
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<tr>
<td>2013</td>
<td>1,818</td>
<td>992</td>
<td>173</td>
<td>2,983</td>
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<tr>
<td>2014</td>
<td>1,926</td>
<td>1,283</td>
<td>210</td>
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<td>2015</td>
<td>2,038</td>
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<td>3,677</td>
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<td>2016</td>
<td>2,281</td>
<td>1,631</td>
<td>200</td>
<td>4,112</td>
</tr>
<tr>
<td>2017</td>
<td>2,454</td>
<td>1,839</td>
<td>221</td>
<td>4,514</td>
</tr>
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</table>
Avoiding Involvement in Director Selection (3)

• Suggestions re director selection by a 5% holder would require a Schedule 13D filing
• The Big Three did not file any Schedule 13Ds 2008-2017
• Avoidance of involvement in the selection of particular directors is consistent with the agency-cost view
  ➞ Would require significant stewardship investment
  ➞ Would involve non-deference to corporate managers
Avoiding Involvement in Director Selection (4)

Can the Big Three simply free-ride on activist hedge funds?

• The Big Three’s preferred directors may differ from those that activist hedge funds nominate (e.g., SSGA criticizing agreements with activist hedge funds)

• The Big Three could communicate with its portfolio companies about which directors would be best for the company
Limited Involvement in Corporate Governance Reforms (1)

• The Big Three could serve their investors’ interests by seeking to facilitate desirable corporate governance rule changes.

• Because they hold positions in many companies, wide-scale governance reforms could significantly benefit the portfolio if they have even a small positive effect in each company.

• We examine comment letters submitted on 80 SEC proposed rule changes regarding corporate governance.
# Involvement in SEC Proposed Rules Regarding Corporate Governance

<table>
<thead>
<tr>
<th></th>
<th>BlackRock</th>
<th>Index Fund Managers</th>
<th>Large Asset Owners</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>SSGA</td>
<td>Total</td>
</tr>
<tr>
<td>Most Commented 25% of Proposed Rules (20)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Total Comments Submitted</td>
<td>1</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Comments per Proposed Rule</td>
<td>0.05</td>
<td>0.20</td>
<td>0.10</td>
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<tr>
<td>Proposed Rules Commented On</td>
<td>1</td>
<td>2</td>
<td>2</td>
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<tr>
<td>Proportion of Proposed Rules Commented On</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Remaining 75% of Proposed Rules (60)</td>
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<tr>
<td>Total Comments Submitted</td>
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<td>4</td>
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<tr>
<td>Comments per Proposed Rule</td>
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<td>0.07</td>
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<td>1</td>
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<tr>
<td>Proportion of Proposed Rules Commented On</td>
<td>3%</td>
<td>7%</td>
<td>2%</td>
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</tbody>
</table>
Limited Involvement in Corporate Governance Reforms (2)

• Each of the Big Three submitted comments on many fewer proposals than large asset owners
• We examine submission of amicus briefs in ten important cases regarding investor protection (2008-17) in which the Council of Institutional Investors submitted amicus briefs.
# Amicus Curiae Briefs, 2008–2017

<table>
<thead>
<tr>
<th>Case</th>
<th>Amicus Briefs</th>
<th>Briefs by Two Largest Asset Owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Enterprise Fund v. Public Company Accounting Oversight Board, 537 F.3d 667 (D.C. Cir. 2008)</td>
<td>22</td>
<td>**</td>
</tr>
<tr>
<td>New York State Teachers’ Retirement System v. The Mercury Pension Fund Group, 618 F.3d 988 (9th Cir. 2010)</td>
<td>1</td>
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<tr>
<td>Business Roundable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011)</td>
<td>6</td>
<td>**</td>
</tr>
<tr>
<td>New Jersey Carpenters Health Fund v. RALI Series 2006-QO1 Trust, 477 Fed. Appx. 809 (2d Cir. 2012)</td>
<td>6</td>
<td>**</td>
</tr>
<tr>
<td>Corre Opportunities Fund, LP v. Emmis Communications Corp., 792 F.3d 737 (7th Cir. 2015)</td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>

✓✓ Briefs filed separately by both of asset owners  
** Brief filed by both of the asset owners, jointly with CII
Limited Involvement in Corporate Governance Reforms (2)

- The two largest public pension funds filed or joined amicus briefs in 5 of 10 cases, alone or jointly with another party, despite being many times smaller than the Big Three.
- None of the Big Three filed a single amicus curiae brief in any of these ten precedential litigations.
Limited Involvement in Corporate Governance Reforms (3)

- The limited involvement of the Big Three in both SEC comments and amicus briefs is consistent with the agency-costs view
  - Explicitly supporting pro-shareholders reforms would not be deferential to company managers
  - Explicitly opposing reforms reduces the salience of their deference
→ Private interests might be best served by staying on the sidelines
Avoiding Lead Plaintiff Positions

• The Private Securities Litigation Reform Act looks to institutional investors with the most “skin in the game” to be lead plaintiffs
  ⇒ They have an incentive to monitor class counsel and ensure optimal settlements (including corporate governance reforms)
• We examine the lead plaintiffs in securities class actions 2008-2017 settled for more than $10m
• 219 cases such cases
# Securities Class Action Cases

<table>
<thead>
<tr>
<th>Year</th>
<th>Cases Settled for over $10m</th>
<th>Total Recovery in Cases Settled for over $10m (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>58</td>
<td>$6,913</td>
</tr>
<tr>
<td>2009</td>
<td>38</td>
<td>$6,542</td>
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<tr>
<td>2010</td>
<td>20</td>
<td>$1,971</td>
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<td>20</td>
<td>$1,300</td>
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<td>2013</td>
<td>15</td>
<td>$497</td>
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<td>2014</td>
<td>29</td>
<td>$4,633</td>
</tr>
<tr>
<td>2015</td>
<td>11</td>
<td>$463</td>
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<td>2016</td>
<td>7</td>
<td>$383</td>
</tr>
<tr>
<td>2017</td>
<td>1</td>
<td>$40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>219</strong></td>
<td><strong>$24,453</strong></td>
</tr>
</tbody>
</table>
Avoiding Lead Plaintiff Positions (2)

• The Big Three did not serve as a lead plaintiffs in any securities class action 2008-2017

• Serving in lead plaintiff positions in many cases:
  – Would require material expenditures, and
  – Would require non-deferential action against portfolio company managers

\[\Rightarrow\text{Avoiding such positions is consistent with the agency-costs view.}\]
Policy
Policy Implications

- Policymakers should recognize the incentives of index fund managers to under-invest in stewardship and defer to corporate managers.
- We discuss a number of potential policy measures. We highlight the need for a policy reexamination of the legal rules in this area, with an openness to fresh ideas.
- We consider the implications of our analysis for important ongoing debates.
Potential Policy Measures

The policy measures that we consider as potential solutions are:

• Encouraging investment in stewardship
• Limiting or disclosing index fund manager relationships with portfolio companies
• Bringing transparency to private engagements
• Size limits for investment fund families
Encouraging Investment in Stewardship

- Policymakers should explore ways to encourage index fund managers to increase levels of stewardship investment, including:
  - Charging Stewardship Costs to the Index Fund.
  - Sharing Outside Research Services
  - Making Stewardship Expenses Mandatory
Business Relationships with Portfolio Companies

- Policymakers should explore measures to address problems resulting from index fund managers’ business relationships with portfolio companies, including:
  - Limits on Business Relationships
    - e.g., prohibiting investment administration of 401(k) plans
    - Determine whether efficiencies from combining businesses outweighs the adverse effects on incentives
  - Requiring detailed disclosure of business relationships with portfolio companies
Bringing Transparency to Private Engagements

• BlackRock and Vanguard currently do not disclose details of the companies they engage with or the nature of those engagements.

• Transparency would provide all investors with material information, including:
  – Commitments by companies to make changes
  – The changes that the Big Three desire at particular companies

• Transparency would lead to more meaningful engagement
  – The Big Three would be motivated because their investors could assess the effectiveness of their private engagements.
Bringing Transparency to Private Engagements (2)

- Regulation FD could be interpreted to require disclosure of engagements, as they may be material
- If it does not, it could be amended to do so
- Would transparency make private engagements more difficult or less effective?
  - SSGA already discloses its engagements, without any apparent chilling effect
  - Fear of disclosure of failures to engage would motivate company managers
  - Disclosing index funds’ requests to companies may make them more likely to follow those requests
Size Limits

Should the Big Three be permitted to continue growing freely?

• As a thought experiment, suppose that:
  – The proportion of U.S. equity in index funds grows to 45%
  – The Big Three become the “Giant Three,” each with 15% of the shares of each large public company; and
  – Regulation could prevent investment fund managers from managing more than 5% of any particular company

⇒ Holdings would be divided among nine index fund managers—the “Big-ish Nine”—each holding about 5%

• We explain that there are good reasons to prefer the Big-ish Nine scenario over the Giant Three scenario.
The Debate on Common Ownership

- Index funds increase common ownership, whereby an investment manager holds positions in all the companies in a given sector of the economy.
- Some scholars have claimed that common ownership has substantial anti-competitive effects.
- Those scholars fail to take account of index manager incentives:
  - No incentives to engage in stewardship focused on the operations of particular companies.
Implications for Ongoing Debates

We consider the implications of our analysis for the following debates

• The debate on common ownership
• The debate on hedge fund activism
The Debate on Common Ownership (2)

• Alarmism over common ownership has negative consequences:
  ⇨ It may push index fund managers to be even more deferential
  ⇨ Common ownership is a red herring for anti-trust officials, who should focus on the decisions of corporate managers rather than index fund managers
The Debate on Hedge Fund Activism

• Opponents of hedge fund activism view “long-termist” index fund stewardship as a preferable substitute for the “short-termist” activist hedge funds

• Our analysis shows that index fund stewardship cannot serve as an effective substitute.

• Because of the incentive problems of index fund managers, hedge fund activism has a critical role in stewardship
  – Hedge fund managers do not have incentives to underspend or to be excessively deferential
  – Hedge fund managers invest substantially in stewardship, focus on underperformance, and use the full toolkit of shareholder powers
The Debate on Hedge Fund Activism

• But hedge fund activism is not a complete substitute for index fund governance

• It requires the support of index fund managers (against their deference incentives)

• Lack of index fund manager support may discourage hedge fund activist engagement (Brav, Jiang & Li, 2018)

• Activist hedge funds will only engage if they expect to make large and rapid returns
  ⇒ They will ignore many opportunities for smaller gains will be ignored
Recognition and Reality

The Big Three have significant incentives to be perceived as responsible stewards

⇒ Greater recognition by investors and the public of the incentive problems of index fund managers can lead to improved stewardship by the Big Three
  – e.g., Recognition of their relatively small stewardship budgets ⇒ pressure to increase investments in stewardship
  – e.g., Recognition of their failure to use valuable stewardship tools ⇒ pressure to use such tools
Conclusions

• The evidence that we have collected is consistent with the agency-costs view of index funds stewardship that we put forward.

• The agency problems and policy implications that we have identified deserve the close attention of policymakers, market participants, and corporate governance scholars.
Questions?