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

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Lucian Bebchuk and Scott Hirst

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What We Do

- Develop an agency-cost theory of index fund stewardship decisions.
- Put together hand-collected and public data to piece together evidence on the full range of stewardship activities of the Big Three.
- Find that the evidence is consistent with the agency-costs view.
- Identify a range of policy implications.

Part of a Larger Project on the Agency Problems of Institutional Investors

- Related Work:
  - We build on the analytical framework for analyzing institutional investor agency problems introduced in Bebchuk, Cohen & Hirst (2017), The Agency Costs of Institutional Investors, *Journal of Economic Perspectives*.
  - We provide supplemental empirical evidence on the rise of the Big Three, estimating that the Big Three could well cast as much as 40% of the votes in S&P 500 companies within two decades, in Bebchuk & Hirst (2019), The Specter of the Giant Three, *Boston University Law Review*.

The Agency-Costs View of Investment Fund Stewardship

- Stewardship decisions are made not by the fund's beneficial investors but by investment fund managers ⇨ agency problems.
- The benchmark is the decisions that would be optimal for beneficial investors.
  - We do not argue that index fund stewardship necessarily produce worse governance outcomes compared to a state of the world in which the shares were instead held by individual investors and/or active funds.
- We argue that :

  (i) agency problems are a **first-order driver** of stewardship decisions of index funds, and

  (ii) understanding these problems can help identify ways to **limit/reduce** their costs.

Two Types of Incentive Problems.

- Index funds (as well as active funds) have incentives **to under-invest in stewardship**

  (relative to what would be optimal for beneficial investors).

- Index fund (as well as active funds) have incentives **to be excessively deferential** to corporate managers

  (relative to what would be optimal for beneficial investors).

Investments in Stewardship

- Each of the Big Three has hundreds of $1 billion+ positions in portfolio companies.
  ⇨ This could justify multiple professionals dedicating substantial part of their time to monitoring and interacting with such a portfolio company.
- Whereas supporters of index fund stewardship have focused on recent increases in stewardship staff, we estimate the personnel resources (hours and cost) devoted to each portfolio company.

Investments in Stewardship Relative to Equity Investments and Estimated Fees

	BlackRock	*Vanguard*	*SSGA*
Stewardship Personnel	45	21	12
Stewardship Investment as % of Estimated Fees			
Estimated Stewardship Investment ($m)	$13.5	$6.3	$3.6
Estimated Fees & Expenses ($m)	$9,107	$3,467	$2,625
Stewardship as % of Fees & Expenses	0.15%	0.18%	0.14%

Stewardship per Portfolio Company

	BlackRock	*Vanguard*	*SSGA*
Stewardship Time (Person-Days)			
Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)	1.00	0.40	0.25
Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company	2.17	1.03	0.68
Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide	3.71	1.36	1.94
Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies	3.81	1.57	1.77

Investments in Stewardship

- 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 business performance of the company;
  - 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; and
  - Assessments of the directors' performance.
- However, the stewardship staffing of the Big Three enables only limited and cursory review 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:
  - e.g., Vanguard stated that private engagement is the "perhaps more important … component of [Vanguard's] governance program"; "engagement is where the action is."

Private Engagement (2)

Average Proportion of Companies Engaged, 2017-2019

	BlackRock	*Vanguard*	*SSGA*	*Average*
Portfolio Companies with No Engagement	88.9%	94.2%	94.5%	92.5%
Portfolio Companies with Engagement:				
Portfolio Companies with a Single Engagement	7.2%	3.5%	5.0%	5.2%
Portfolio Companies with Multiple Engagements	3.9%	2.3%	0.6%	2.3%
Total Portfolio Companies with Engagement	11.1%	5.8%	5.5%	7.5%

Private Engagement (3)

- Thus, each of Big Three had no engagement with the great majority of companies:
  - ⇨ For these companies private engagement cannot serve as substitute for the use of other stewardship tools.

Governance-Principles-Based Stewardship

- We document that Big Three stewardship focus on the existence of deviations from their governance principles.
- Serves the private interests of the Big Three:
  - Enables economies of scale that reduce required investments in stewardship; and
  - Makes the potential power of the Big Three less salient.
- **But** does not take advantage of potential benefits from stewardship based on attention to business performance and/or individual director qualifications
  - (More on this below)

Pro-Management Voting

Average Big Three vs. Average Active Manager "Against" Votes on Say-on-Pay

	Big Three	*Largest 3 Active*	*Largest 10 Active*
2012	3.9%	13.7%	10.2%
2013	2.4%	11.5%	11.2%
2014	3.7%	9.2%	8.1%
2015	2.4%	6.3%	7.2%
2016	2.8%	7.8%	8.7%
2017	4.0%	7.7%	8.9%
2018	2.5%	6.9%	9.4%
Average	3.1%	9.0%	9.1%

- Although these patterns are, at most, suggestive, they are consistent with deference incentives

Limited Attention to Performance

- Financial performance is important to investors:
  - ⇨ Index fund investors would benefit significantly from having index funds:
    - (i) monitoring financial underperformance, and
    - (ii) examining what personnel or other changes could address identified underperformance.

Limited Attention to Performance (2)

- Examining the many examples of behind-the-scenes engagements in Big Three Stewardship Reports, we find **no** cases in which engagement was motivated by financial underperformance.
- Examining the proxy voting guidelines of each of the Big Three for deciding whether to withhold support from director/s, we find that **all** focus on governance aspects and **do not** include financial underperformance as relevant criterion.

Limited Attention to Performance (3)

- Could it be argued that this is because the Big Three "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 should not be taken as **given** – it is an endogenous choice made by index fund managers:
  - Index fund managers have the resources and could improve their ability to identify and remedy financial underperformance if they had incentives to do so.

Little Attention to Many Important Director Characteristics

- How well a given director suits a board may depend **not just** on governance dimensions (are they independent? chosen through an appropriate governance process?)
- **But also** on various individual & company specific characteristics (e.g., how much and what kind of experience a director has in the company's industry? what talents, tools, and education they have?).
- However, we provide evidence that, outside the small number of activist proxy fight, the Big Three pay little attention to such characteristics.

No Submission of Shareholder Proposals for Changes Desired by the Index Funds

- Proposals submitted by shareholders that receive majority support (including consistent support from the Big Three) have led to considerable improvements in numerous companies (e.g., with respect to annual elections, majority voting, elimination of supermajority provisions)
- However, we document that, among the almost 1,500 corporate governance proposals submitted during 2014-2018, including among the **large** subset of proposals supported by the Big Three, **none** was submitted by the Big Three.

No Submission of Shareholder Proposals for Changes Desired by the Index Funds (2)

- Can avoidance of shareholder proposal submission be explained on grounds that the Big Three don't need to submit proposals for governance changes they desire because other (smaller) investors are doing so?
- **No**.
  - Because of the limited resources of smaller investors, proposals for many changes that the Big Three would favor are not submitted at all, or are submitted only after many years of delay.
  - As a result, we document that a large proportion of the Big Three's portfolio companies lack governance arrangements they themselves favor.
  - ⇨ Submission of shareholder proposals on those issues by one of the Big Three would likely have significant positive effects for their beneficial investors.

Staying on the Sidelines of Corporate Governance Reforms

- Because the Big Three hold positions in many companies, wide-scale governance reforms (even with a small effect per company) could significantly benefit their portfolios.
- But the evidence we hand-collect shows a pattern of limited involvement.

Staying on the Sidelines of Corporate Governance Reforms (2)

- We examine all comment letters submitted on 80 SEC proposed rule changes regarding corporate governance during 1995-2018:
- With over 20% of corporate equities, one could expect the Big Three to state regularly whether the proposed rule is (i) desirable, (ii) undesirable, or (iii) not practically important and worthy of SEC attention.
- However, each of the Big Three submitted comments regarding 10% (or less) of (i) the set of all proposed rules , as well as (ii) the set of proposals getting most attention.
- We also examine the dockets of ten cases of precedential litigation that attracted many amicus “friend-of-the-court” briefs. We find that none of the Big Three filed a single amicus curiae brief.

Policy Implications

- Part III of our paper discusses several policy measures that should be considered, and some that should not be considered, for addressing the incentive problems we identify.
- We consider measures with respect to:
  - Encouraging investments in stewardship;
  - Business relationships with public companies;
  - Transparency of private engagements;
  - Rethinking Rule 13D; and
  - Size limits.

Implications for 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.

Implications for Hedge Fund Activism (2)

- But hedge fund activism is not a substitute for index fund stewardship:
  - We argue that the hedge funds-index funds combination cannot generally address effectively corporate governance failures.

1. Hedge fund activism requires the support of index fund managers (against their deference incentives).

   ⇨ Insufficient support by index fund managers may impede or discourage hedge fund activist engagement (Brav, Jiang & Li, 2018).

2. Activist hedge funds will only engage if they expect to make large and rapid returns.

   ⇨ They will ignore many opportunities for smaller gains whose realization would be valuable for index fund investors.

Implications for the Common Ownership Debate

- We argue that common ownership criticism are counterproductive:
  - The first-order concern is that the Big Three do too little and have too little influence;
  - Not that they do too much and have too much influence.
  - So the push for greater scrutiny of index fund stewardship would likely produce counterproductive effects.

(For further details on the implications of our work for common ownership, see Lucian Bebchuk & Scott Hirst, *The Misguided Attack on Common Ownership*, our presentation at an FTC hearing on the subject)

Recognition and Reality

Index fund managers have significant incentives to be perceived as responsible stewards.

⇨ Greater recognition by beneficial investors and the public of the incentive problems we identify can by itself lead to improved stewardship.

⇨ We hope that our work will contribute to bringing about such changes!

Conclusion

- The evidence we have collected is consistent with the agency-costs view of investment fund stewardship that we put forward.
- Given the rise of investment fund ownership, the two agency problems that we have identified deserve the close attention of policymakers, market participants, and corporate governance scholars.

Thank you!