Global Corporate Governance Colloquia 2019

7-8 June 2019

House of Finance

Goethe University Frankfurt

7th June 2019

Protocol – Session 2
Index Funds and The Future of Corporate Governance: Theory, Evidence, And Policy

Speaker: Lucian Bebchuk
Discussant: Pedro Matos

Lucian Bebchuk is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School; a Fellow of the American Academy of Arts and Sciences; and a Research Associate of the NBER. Holding doctorates in both economics and law from Harvard, Bebchuk is the author of more than one hundred research papers, and has been ranked by SSRN as first among legal academics of all fields in terms of citations to his work in each of the past five years.

Pedro Matos is the Academic Director of Richard A. Mayo Center for Asset Management, holds the John G. Macfarlane Family Chair in Business Administration and is a Professor of Business Administration (Finance) at the University of Virginia Darden School of Business. His research focuses on the growing importance of institutional investors in financial markets worldwide. His work has been published in top academic journals and featured in the press, including in The Economist, Financial Times, New York Times, Washington Post, Fortune, and Forbes. He is a Research Associate at ECGI and his work has received numerous research grants and awards.

Protocol of Session 1, Friday 7 June (11.30 a.m. – 12.30 a.m.)

In the first part of this session, the paper by Lucian Bebchuk on "Index Funds and The Future of Corporate Governance" is presented. In this paper, an agency-cost theory of index fund stewardship decision is developed with the final goal to identify a range of policy implications. The paper builds on the analytical framework introduced in Bebchuk, Cohen & Hirst (2017). Supplemental empirical evidence on the rise of the Big Three is presented. According to the presenter, stewardship decisions are made not by the fund`s beneficial investors but by investment fund managers, which might result in agency problems. Agency problems are the first-order-driver of stewardship decision index funds and that understanding these problems can help to identify approaches to limit/ reduce their costs. There are two types of incentive problems: Index funds have i) incentives to under-invest in stewardship and ii) incentives to be excessively deferential to corporate managers (both relatively to what would be optimal for beneficial investors). Each of the Big Three has hundreds of large scale positions in portfolio companies which could justify multiple professionals dedicating a substantial part of their time to monitoring and interacting with such a portfolio company. Afterwards, evidence of the full range of stewardship activities that index funds do and do not undertake is presented. The paper documents that Big Three stewardship focuses on the existence of deviations from their governance principles. Such deviations serve the private interests of the Big Three by enabling economies of scale that reduce required investments in stewardship. The presenter points to the limited attention to performance as evidence for what the Big Three fail to do. The body of evidence presented is shown to be consistent with and can be explained by the agency-costs analysis. Finally, it is argued that this analysis should reorient important ongoing debates regarding common ownership and hedge fund activism. The presenter describes that as the Big Three hold positions in many companies, wide-scale governance reforms could significantly benefit their portfolios. However, the hand-collected evidence shows a pattern of limited involvement. It is found that to less than 10% of the rules, comments were filed by the Big Three. This limited involvement of the Big Three in both SEC comments and amicus views is consistent with the agency-cost views.

In the second part, the discussant Pedro Matos focusses on the evidence part of the paper. Therefore, the US paradigm of corporate ownership regarding the separation of ownership and control is briefly discussed. Furthermore, changes are discussed: i) The rise of collective investment vehicles as well as ii) the rise of passive investing. The discussant provides empirical evidence for both changes by referring to the Factset Ownership Database. The top 3 US passive investors have rising shares to about 20% in 2017. In other non-US-countries, the percentage amounts to only 3%. Afterwards, the discussant analyzes what is behind this change (in the US). One of the reasons is that investors are more aware of the costs in the aftermath of the financial crisis. In a next step, the discussant briefly discusses the theory of the paper, i.e. the theory on index fund stewardship, more precisely the good (e.g. the promise, universal owners…), the bad side (e.g. the agency costs, the incentive to overinvest…), and the ugly side (common ownership). Subsequently, the discussant analyzes the empirical results of the paper w.r.t. Under-Investment. He compared the results from the paper (i.e., the Big Three) with empirical results from the non-Big Three and the stewardship teams. Furthermore, the discussant also analyzes the empirical findings regarding private engagements and again compares the findings to those from non-Big-Three institutions. Finally, the discussant points to the empirical evidence on proxy voting and compares to the Non-Big Three companies showing that these companies have higher outcomes for No-Votes on Say on Pay. During the last 5 minutes, an open discussion with all participants of the paper takes place. The topics covered include i) Firm-Specific Governance Intervention; ii) Systemic stewardship.