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

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July 2019

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We have also benefitted from the comments of participants in workshops, presentations, and roundtables at Bar-Ilan University, Boston University School of Law, Harvard Law School, New York University, the University of California, Berkeley, a Federal Trade Commission hearing at New York University; at the American Law and Economics 2019 Annual Meeting; from conversations with many members of the institutional investor and corporate governance advisory communities; and from invaluable research assistance by Jordan Figueroa, Aaron Haefner, David Mao, Matthew Stadnicki, and Zoe Piel. Finally, we gratefully acknowledge financial support from Harvard Law School and the Boston University School of Law.

Abstract

Index funds own an increasingly large proportion of American public companies, currently more than one fifth and steadily growing. The stewardship decisions of index fund managers—how they monitor, vote, and engage with their portfolio companies—can be expected to have a profound impact on the governance and performance of public companies and the economy. Understanding index fund stewardship, and how policy-making can improve it, is critical for corporate law scholarship. This Article contributes to such understanding by providing a comprehensive theoretical, empirical, and policy analysis of index fund stewardship.

We begin by putting forward an agency-costs theory of index fund incentives. Stewardship decisions by index funds depend not just on the interests of index fund investors but also the incentives of index fund managers. Our agency-costs analysis shows that index funds have strong incentives to (i) under-invest in stewardship, and (ii) defer excessively to the preferences and positions of corporate managers. We then provide the first comprehensive and detailed evidence of the full range of stewardship activities that index funds do and do not undertake. This body of evidence, we show, is consistent with and can be explained by our agency-costs analysis.

We next put forward a set of policy reforms that should be considered in order to encourage index funds to invest in stewardship, to reduce their incentives to be deferential to corporate managers, and to address the concentration of power in the hands of the largest index fund managers. Finally, we discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism. The policy measures we put forward, and the beneficial role of hedge fund activism, can partly but not fully address the incentive problems that we analyze and document. These problems are expected to remain a significant aspect of the corporate governance landscape, and should be the subject of close attention by policymakers, market participants, and scholars.

Keywords: Index funds, passive investing, institutional investors, corporate governance, stewardship, engagement, monitoring, agency problems, shareholder activism, hedge fund activism

JEL Classifications: G23; G34; K22

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ABSTRACT

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We begin by putting forward an agency-costs theory of index fund incentives. Stewardship decisions by index funds depend not just on the interests of index fund investors but also the incentives of index fund managers. Our agency-costs analysis shows that index funds have strong incentives to (i) under-invest in stewardship, and (ii) defer excessively to the preferences and positions of corporate managers.

We then provide the first comprehensive and detailed evidence of the full range of stewardship activities that index funds do and do not undertake. This body of evidence, we show, is consistent with and can be explained by our agency-costs analysis.

We next put forward a set of policy reforms that should be considered in order to encourage index funds to invest in stewardship, to reduce their incentives to be deferential to corporate managers, and to address the concentration of power in the hands of the largest index fund managers. Finally, we discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism.

The policy measures we put forward, and the beneficial role of hedge fund activism, can partly but not fully address the incentive problems that we analyze and document. These problems are expected to remain a significant aspect of the corporate governance landscape, and should be the subject of close attention by policymakers, market participants, and scholars.

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INTRODUCTION

Index funds—investment funds that mechanically track the performance of an index[1]—hold an increasingly large proportion of the equity of U.S. public companies. The sector is dominated by three index fund managers—BlackRock, State Street Global Advisors (SSGA), and Vanguard, often referred to as the "Big Three."[2] In an empirical study of the rise of indexing in general and the Big Three in particular, we document that the Big Three collectively vote about 25% of the shares in all S&P 500 companies,[3] and each holds a position of 5% or more in a vast number of companies;[4] that the proportion of equities held by index funds has risen dramatically over the past two decades and can be expected to continue growing substantially;[5] and that the average proportion of shares in S&P 500 companies voted by the Big Three could reach as much as 40% within two decades.[6]

The large and steadily growing share of corporate equities held by index funds, and especially the Big Three, has transformed ownership patterns in the U.S. public market. How index funds make stewardship decisions—how they monitor, vote in, and engage with portfolio companies—has a major impact on the governance and performance of public companies and the economy. Understanding these stewardship decisions, as well as the policies that can enhance them, is a key challenge for the field of corporate governance. This Article contributes to such an understanding by providing a systematic theoretical, empirical, and policy analysis of index fund stewardship.

Leaders of the Big Three have repeatedly stressed the importance of responsible stewardship, and their strong commitment to it. For example, Vanguard's then-CEO William McNabb stated that "We care deeply about governance," and that "Vanguard's vote and our voice on governance are the

[1] For a more detailed definition of index funds, see Subsection I.A.1, *infra*.

[2] For an account of the dominant role of the Big Three, see Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUSINESS AND POLITICS 298 (2017).

[3] Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. LAW REVIEW 721, 736 (2019) (forthcoming) (presenting evidence that the Big Three cast 25.4% of votes, on average, at annual meetings of S&P 500 companies in 2017).

[4] *Id.* at 735 (presenting evidence that the Big Three held, in aggregate, 1,118 positions of 5% or more at S&P 500 companies in 2017).

[5] *See Id.* at 724 (providing evidence on past growth and expected future changes).

[6] *Id.* at 740 (extrapolating from past trends and estimating that the combined voting stake of the Big Three at S&P 500 companies is likely to rise to about 41% by 2038).

most important levers we have to protect our clients' investments."[7] Similarly, BlackRock's CEO Larry Fink stated that "our responsibility to engage and vote is more important than ever" and that "the growth of indexing demands that we now take this function to a new level."[8] The Chief Investment Officer (CIO) of SSGA stated that "SSGA's asset stewardship program continues to be foundational to our mission."[9]

The Big Three leaders have also stated both their willingness to devote the necessary resources to stewardship, and their belief in the governance benefits that their investments produce. For example, Vanguard's McNabb has said, of governance, that "We're good at it. Vanguard's Investment Stewardship program is vibrant and growing."[10] Similarly, BlackRock's Fink has stated that 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."[11]

The stewardship promise of index funds arises from their large stakes and their long-term commitment to the companies in which they invest. Their large stakes provide these funds with significant potential influence, and imply that by improving the value of their portfolio companies they can help bring about significant gains for their portfolios. Furthermore, because index funds have no "exit" from their positions in portfolio companies as long as the companies remain in the index, they have a long-term perspective, and are not tempted by short-term gains at the expense of long-term value. This long-term perspective has been stressed by Big Three leaders,[12] and applauded by commentators.[13] Vanguard's founder, the late elder statesman of index investing, has said that "index funds are the … best hope for corporate governance."[14]

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[7] William McNabb, *The ultimate long-term investors*, Vanguard Blog for Advisors (Jul. 6, 2017), https://vanguardadvisorsblog.com/2017/07/06/the-ultimate-long-term-investors/.

[8] *See, e.g.* Letter from Larry Fink, Annual Letter to CEOs (Jan. 16, 2018).

[9] *See, e.g.* State Street Global Advisors, *Annual Stewardship Report 2016 Year End* 3 Mar. 7, 2017 [hereinafter, State St. Global Advisors, *Annual Stewardship Report*].

[10] McNabb, *supra* note 7 (emphasis in original).

[11] *See, e.g.*, 2017 Letter from Fink, *supra* note 8.

[12] *See* notes 37 to 38, *infra*, and accompanying text.

[13] *See, e.g.*, Martin Lipton, *Engagement—Succeeding in the New Paradigm for Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2018), https://corpgov.law.harvard.edu/2018/01/23/engagement-succeeding-in-the-new-paradigm-for-corporate-governance/ ("the BlackRock letter is a major step in rejecting activism and short- termism"). For a detailed account by one of us of the appeal that "long-termism" has had to corporate law scholars and practitioners, see Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013)

[14] Christine Benz, *Bogle: Index Funds the Best Hope for Corporate Governance*, Morningstar.com (Oct. 24, 2017), http://www.morningstar.com/videos/830770/bogle-index-

Will index funds deliver on this promise? Do any significant impediments stand in the way? How do the legal rules and policies affect index fund stewardship? Given the dominant and growing role that index funds play in the capital markets, these questions are of first-order importance, and are the focus of our Article.

In particular, we seek to make three contributions. First, we provide an analytical agency-cost framework for understanding the incentives of index fund managers. Our analysis demonstrates that index funds managers have strong incentives to (i) under-invest in stewardship and (ii) defer excessively to the preferences and positions of corporate managers.[15]

Our second contribution is to provide the first comprehensive evidence of the full range of stewardship decisions made by index fund managers, especially the Big Three. We find that this evidence is, on the whole, consistent with the incentive problems that our analytical framework identifies. The evidence thus reinforces the concerns suggested by this framework.

Our third contribution is to explore the policy implications of the incentive problems of index fund managers that we identify and document. We put forward a number of policy measures to address these incentive problems. These measures should be considered to improve index fund stewardship—and thereby, the governance and performance of public companies. We also explain how recognition of these incentive problems should inform and influence important ongoing debates, such as those on common ownership and hedge fund activism.[16]

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funds-the-best-hope-for-corporate-gove.html.

[15] In providing this contribution, we build on, and further develops, the analytical framework put forward in our 2017 article with Alma Cohen, Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

[16] The works by others that are most closely related to our project and contributions are four current or recent works that focus on index fund stewardship but differ considerably from this Article in terms of scope, methodology, approach, and positions. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, SSRN Scholarly Paper ID 3247337 (Social Science Research Network), Mar. 14, 2019 focuses on the increasing concentration of ownership in the hands of a small number of institutional investors and, unlike us, seems to be concerned that these investors will exercise too much power rather than under-investing in stewardship and being excessively deferential to corporate managers. Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, U. PA. L. REV. (2019) (forthcoming), and Edward B. Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, SSRN Scholarly Paper ID 3295098 (Social Science Research Network), Apr. 6, 2019 view the current stewardship activities of index funds favorably but, as we note in various places below, fail to recognize important considerations developed in our analysis. Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101 (2018), shares our concerns about how little the Big Three spend on stewardship, but otherwise overlaps little with our

Our analysis is organized as follows. Part I.A discusses the features of index funds that have given rise to high hopes for index fund stewardship. The views of Big Three leaders and supporters of index fund stewardship, we explain, are premised on a belief that index funds holding significant stakes for a long period of time can be expected to perform well relative to many other institutional investors in terms of stewardship.[17] In this view, the stewardship decisions of index fund managers can be largely understood as being focused on maximizing the long-term value of their investment portfolios, and agency problems are not a key driver of those decisions.

By contrast to this "value-maximization" view, the remainder of Part I.C puts forward an alternative "agency-costs" view. Stewardship decisions for an index fund are not made by the index fund's own beneficial investors, which we refer to as the "index fund investors," but rather by its investment adviser, which we label the "index fund manager." As a result, the incentives of index fund managers are critical. We identify two types of incentive problems that push the stewardship decisions of index fund managers away from those that would best serve the interests of index fund investors.

Incentives to Under-Invest in Stewardship. Stewardship that increases the value of portfolio companies will benefit index fund investors. However, index fund managers are remunerated with a very small percentage of their assets under management (AUM) and thus would capture a correspondingly small fraction of such increases in value. They therefore have much more limited incentives to invest in stewardship than their beneficial investors would prefer. Furthermore, if stewardship by an index fund manager increases the value of a portfolio company, rival index funds that track the same index (and investors in those funds) will receive the benefit of the

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incentive analysis, empirical investigation, or policy recommendations. These works, as well as our work, build on the earlier and large literature on institutional investors discussed in note 17, *infra*.

[17] Our work, as well as other current writings on index fund stewardship, build on an earlier and substantial body of literature on institutional investors in general and their potential benefits and agency costs. For early and well-known works in this literature, see, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991–1992) [hereinafter, Black, *Agents Watching Agents*]; John C.Jr. Coffee, *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); and Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1990–1991). For recent works in this literature, see, e.g., Leo E. Strine, *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1 (2010); Leo E.Jr. Strine, *Can We Do Better by Ordinary Investors; A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law Essay*, 114 COLUM. L. REV. 449 (2014); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

increase in value without any expenditure of their own. As a result, an interest in improving financial performance relative to rival index fund managers does not provide any incentive to invest in stewardship. Furthermore, we explain that competition with actively managed funds cannot be expected to address the substantial incentives to under-invest in stewardship that we identify.

Incentives to be Excessively Deferential. When index fund managers face qualitative stewardship decisions, we show that they have incentives to be excessively deferential—relative to what would best serve the interests of their own beneficial investors—toward the preferences and positions of the managers of portfolio companies. This is because the choice between deference to managers and nondeference not only affects the value of the index fund's portfolio, but could also affect the private interests of the index fund manager.

We then identify and analyze three significant ways in which index fund managers could well benefit privately from such deference. First, we show that existing or potential business relationships between index fund managers and their portfolio companies give the index fund managers incentives to adopt principles, policies, and practices that defer to corporate managers. Second, we explain that, in the many companies where the Big Three have positions of 5% or more of the company's stock, taking certain nondeferential actions would trigger obligations that would impose substantial additional costs on the index fund manager. Finally, and importantly, the growing power of the Big Three means that a nondeferential approach would likely encounter significant resistance from corporate managers, which would create a significant risk of regulatory backlash.

We focus on understanding the structural incentive problems that motivate index fund managers to under-invest in stewardship and defer to corporate managers, thereby impeding their ability to deliver on their governance promise. We stress that in some cases, fiduciary norms, or a desire to do the right thing, could lead well-meaning index fund managers to take actions that differ from those suggested by a pure incentive analysis. Furthermore, index fund managers also have incentives to be perceived as responsible stewards by their beneficial investors and by the public—and thus, to avoid actions that would make salient their under-investing in stewardship and deferring to corporate managers. These factors could well constrain the force of the problems that we investigate. However, these structural problems should be expected to have significant effects; the evidence we present in Part II demonstrates that this is, in fact, the case.

As with any other theory regarding economic and financial behavior, the test for whether the value-maximization view or the agency-costs view are valid is the extent to which they are consistent with and can explain the extant evidence. Part II therefore puts forward evidence on the stewardship decisions of the Big Three. We provide a detailed picture of what they do, how they do it, and what they fail to do. We combine hand-collected data and data from various public sources to piece together this broad and detailed picture. We first discuss four dimensions of the stewardship the Big Three actually undertake, and how they do so:

1. Actual Stewardship Investments. Our analysis provides estimates of the stewardship personnel, both in terms of workdays and dollar cost, devoted to particular companies. Whereas supporters of index fund stewardship have focused on recent increases in stewardship staff of the Big Three,[18] our analysis examines personnel resources in the context of the Big Three's assets under management and their number of portfolio companies. We show that the Big Three devote an economically negligible fraction of their fee income to stewardship, and that their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies.

2. Behind-the-Scenes Engagements. Supporters of index fund stewardship view private engagements by the Big Three as explaining why they refrain from using certain other stewardship tools available to shareholders.[19] However, we show that the Big Three engage with a very small proportion of their portfolio companies, and only a small proportion of these engagements involve more than a single conversation. Furthermore, refraining from using other stewardship tools also has an adverse effect on the small minority of cases in which private engagements do occur. The Big Three's private engagement thus cannot constitute an adequate substitute for the use of other stewardship tools.

3. Focusing on Divergence from Governance Principles. Our review of the proxy voting guidelines of the Big Three demonstrates that their voting decisions are based exclusively on the existence or absence of certain divergences from best governance practices using objective and easily-obtained information. Value-maximizing voting decisions would require consideration of additional company-specific information, including information about financial performance or the suitability of particular directors up for election.

4. Pro-Management Voting. We examine data on votes cast by the Big Three on matters of central importance to managers, such as executive compensation and proxy contests with activist hedge funds. We show that the Big Three's votes on these matters reveals considerable deference to corporate managers. For example, the Big Three very rarely oppose corporate managers in say-on-pay votes, and are less likely than other investors to oppose managers in proxy fights against activists.

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[18] See notes 83 to 85, *infra*, and accompanying text.

[19] See notes 97 to 101, *infra*, and accompanying text.

We then consider five dimensions of stewardship activities that the Big Three *fail* to undertake:

1. Attention to Performance. Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance. While portfolio company compliance with governance best practices serves the interests of index funds investors, those investors would also benefit substantially from stewardship aimed at identifying, addressing, and remedying financial underperformance.

2. Influencing Choice of Directors and Rule 13D Status. Index fund investors could well benefit if index fund managers communicated with the boards of underperforming companies about replacing or adding certain directors. However, our examination of director nominations and Schedule 13D filings over the past decade indicates that the Big Three have refrained from such engagements.

3. Bringing About Improvements in Corporate Governance Arrangements. Shareholder proposals have proven to be an effective stewardship tool for bringing about governance changes at broad groups of public companies. Many of the Big Three's portfolio companies persistently fail to adopt the best governance practices that the Big Three support. Given these failures, and the Big Three's focus on governance processes, it would be natural for the Big Three to submit shareholder proposals to such companies aimed at addressing such failures. However, our examination of shareholder proposals over the last decade indicates that the Big Three have completely refrained from submitting such proposals.

4. Staying on the Sidelines of Governance Reforms. Index fund investors would benefit from involvement by index fund managers in corporate governance reforms—such as supporting desirable changes and opposing undesirable changes—that could materially affect the value of many portfolio companies. We therefore review all of the comments submitted on proposed rulemaking regarding corporate governance issues by the Securities and Exchange Commission (SEC), and the filing of amicus briefs in precedential litigation. We find that the Big Three have contributed very few such comments and no amicus briefs over the past decade, and were much less involved in such reforms than asset owners with much smaller portfolios.

5. Involvements in Securities Litigation. Legal rules encourage institutional investors with "skin in the game" to take on lead plaintiff positions in securities class actions; this serves the interests of their investors by monitoring class counsel, settlement agreements and recoveries, and the terms of governance reforms incorporated in such settlements. We therefore examine the lead plaintiffs selected in the large set of significant class actions over the past decade. Although the Big Three's investors often have significant skin in the game, we find that the Big Three refrained from taking on lead plaintiff positions in any of these cases.

Taken together, the body of evidence that we document is difficult to reconcile with a value-maximization view under which stewardship decisions are made to maximize the value of managed portfolios. Rather, the evidence is, on the whole, consistent with, and can be explained by, the agency-costs view and its incentive analysis described in Part I.C.

In the course of examining the evidence on index fund stewardship, we consider the argument that some types of stewardship activities are outside the "business model" of the Big Three. This argument raises the question of *why* this is the case. The "business models" of the Big Three and the stewardship activities they choose to undertake are not exogenous; rather, they are a product of choices made by index fund managers, and thus they follow from the incentives we analyze.

In Part III we consider the policy implications of our theory and evidence. We begin by putting forward for consideration five measures for addressing the incentives of index fund managers to under-invest in stewardship and defer excessively to corporate managers. We also discuss measures that we believe would be counterproductive—in particular, prohibiting index funds from voting, or having index funds' beneficial investors determine funds' votes. The set of approaches that we consider includes measures designed to encourage stewardship investments; to address the distortions arising from business ties between index fund managers and public companies; to bring transparency to the private engagements conducted by index fund managers and their portfolio companies—transparency that, we argue, is necessary to provide material information to investors, and can provide beneficial incentives to those engaged in such engagements; and to redesign the rules governing the disclosure of stakes of 5% or more in portfolio companies.

We further discuss placing limits on the fraction of equity of any public company that could be managed by a single index fund manager. The expectation that the proportion of corporate equities held by index funds will keep rising makes it especially important to consider the desirability of continuing the Big Three's dominance. For instance, we explain that if the index fund sector continues to grow and index fund managers control 45% of corporate equity, having a "Giant Three" each holding 15% would be inferior to having a "Big-ish Nine" each holding 5%.

Part III then proceeds to discuss the significant implications of our analysis for two important ongoing debates. One such debate concerns influential claims that the rise in common ownership patterns—whereby institutional investors hold shares in many companies in the same sector—can be expected to have anticompetitive effects and should be a focus of antitrust regulators. Our analysis indicates that these claims are not warranted.[20]

A second important debate concerns activist hedge funds. Our analysis undermines claims by opponents of hedge fund activism that index fund stewardship is superior to—and should replace—hedge fund activism. We show that, to the contrary, the incentive problems of index fund managers that we identify and analyze make the role of activist hedge funds especially important.

Part III concludes by highlighting another way in which we hope our analysis could contribute to improving index fund stewardship. Because index fund managers would like their stewardship to be viewed favorably by their beneficial investors and by the public in general, our evidence and analysis of index fund incentive problems could itself lead to recognition these problems by investors and the public, an in turn, to investor and public pressure for index fund managers to reduce divergence from value-maximizing stewardship decisions.

Although the policy measures we put forward would improve matters, they should not be expected to eliminate the incentive problems that we identify. Similarly, although activist hedge funds make up for some of the shortcomings of index fund stewardship, we explain that they do not and cannot fully address these shortcomings. The problems that we identify and document can be expected to remain an important element of the corporate governance landscape. Obtaining a clear understanding of these problems—to which this Article seeks to contribute—is therefore critical for policy makers and market participants.

Before proceeding, we would like to clarify the nature of our normative claims. First, we do not argue that index fund stewardship produces worse outcomes for the governance of the economy's operating companies than the outcomes that would occur if the shares of the index funds were instead held by dispersed individual investors. On the contrary, we believe that, despite the problems we identify and document with index fund stewardship, the concentration of shares in the hand of index funds produces better oversight than would result from the shares currently held through index funds instead

[20] We were invited by the Federal Trade Commission (FTC) to discuss the implications of our work for the common ownership debate in a FTC hearing on the subject. The slides of our presentation are available in Lucian Bebchuk & Scott Hirst, *The Misguided Attack on Common Ownership* (Social Science Research Network), Dec. 2018. For recent attempts to engage with the arguments regarding common ownership made in this Article by a leading critic of common ownership, see Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—and Why Antitrust Law Can Fix It*, SSRN Scholarly Paper ID 3293822 48–70 (Social Science Research Network), Nov. 30, 2018 and Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, SSRN Scholarly Paper ID 3370675 49–58 (Social Science Research Network), Apr. 13, 2019.

being owned directly by dispersed individual investors. The evolution of the capital markets from the dispersed ownership described by Adolph Berle and Gardiner Means[21] created the potential for improved oversight. Our interest is in contributing to realizing that potential to the fullest extent possible.

Similarly, we do not claim that index fund stewardship produces worse outcomes than those that would occur if the shares currently held by index funds were instead held by active mutual funds. Our ongoing research about the agency problems afflicting active mutual funds indicates that these problems are also substantial.[22] We do not view the stewardship decisions of index funds as generally inferior to those of active mutual funds, and we do not advocate measures to favor active funds over index funds.

Instead, we focus on comparing the current stewardship decisions of index fund managers, with optimal stewardship decisions, i.e., those that would best serve the interests of index funds' beneficial investors. We seek to provide an understanding the shortcomings of current stewardship decisions, and the nature and significance of the divergence of current stewardship decisions from optimal stewardship decisions. This as understanding can help improve the stewardship of index funds, with their large and growing positions in modern corporations.

A valuable conceptual paradigm was provided to the corporate governance field four decades ago by Jensen and Meckling's foundational article on the agency problem between corporate insiders and their shareholders.[23] Jensen and Meckling focused on how the decisions of corporate insiders that do not own 100% of the shares can be expected to diverge from those that would occur if the corporate decision-makers owned 100% of the shares. They labeled the value losses from these divergence as agency costs. Jensen and Meckling and subsequent authors recognized that agency costs are inevitable where control of corporate assets is separated from ownership. The agency framework and the sole-owner benchmark have proven valuable for identifying and explaining the corporate governance problems that occur when control and ownership are separated, and for

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[21] For the classic work documenting and lamenting the dispersion of ownership prior to the rise of institutional investors, see ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[22] This ongoing research builds on the analysis of the agency problems of active mutual funds contained in Bebchuk et al., *supra* note 15, and is summarized by Lucian Bebchuk & Scott Hirst, *Are Active Mutual Funds More Active Owners than Index Funds?*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Oct. 3, 2018), https://corpgov.law.harvard.edu/2018/10/03/are-active-mutual-funds-more-active-owners-than-index-funds/.

[23] See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)..

suggesting arrangements that would limit the costs of these problems.[24]

Similarly, we believe that the agency analysis we put forward in this Article can provide a useful benchmark and framework for analyzing the decisions of index fund managers. If agency problems are a first-order driver of stewardship decisions, as we believe, then the agency framework can contribute to a fuller understanding of stewardship decisions. Furthermore, the agency framework can provide a basis for putting forward arrangements to limit the agency costs we identify, and to improve index fund stewardship. These improvements would, in turn, serve the interests of the beneficial investors in index funds, and contribute to the performance of the public companies in which they hold shares.

I. AN AGENCY-COSTS THEORY OF INDEX FUND STEWARDSHIP

This Part develops our agency-costs theory of index funds stewardship. We start by explaining the nature of index funds and the stewardship activities they undertake (Section A). We describe views that have been expressed about the significant promise that the nature of index funds holds for stewardship (Section B). We explain that this is the basis for the "value-maximization view" of index fund stewardship, and set out our competing "agency-costs" view (Section C). We explain how our agency costs view leads to two predictions regarding index fund stewardship—that index fund managers will have incentives to under-invest in stewardship (Section D), and to be excessively deferential to managers of portfolio companies (Section E). Finally, we consider two potential limits on the forces of these incentives (Section F).

A. Index Funds and Stewardship

1. Index Funds

Index funds are a special type of investment fund. Investment funds pool the assets of many individuals and entities and invest those assets in diversified portfolios of securities. Actively managed investment funds buy and sell securities of companies in accordance with their views about whether those companies are under- or overvalued.[25] By contrast, index funds invest

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[24] The article is one of the most cited in the history of financial economics and corporate governance, with more than 77,000 citations. *See* Google Scholar, https://scholar.google.com/scholar?cites=4986983958447029005.

[25] *See, e.g.*, Fidelity Investments, Active and Passive Funds: The Power of Both, https://www.fidelity.com/viewpoints/investing-ideas/power-of-active-and-performance.

in portfolios that attempt to track the performance of specified benchmark indexes, such as the S&P 500, or the Russell 3000.[26] The term *index fund* encompasses both mutual funds and exchange traded funds (ETFs), or any other investment vehicle that mechanically tracks an index.[27] Well-known examples of index funds include the Vanguard S&P 500 Mutual Fund, SSGA's SPDR S&P 500 ETF, and BlackRock's iShares Core S&P 500 ETF. Some index funds also track indexes of debt securities, however we focus on those that invest in equity securities.

The index fund sector is heavily concentrated, and is dominated by the Big Three.[28] This concentration is to be expected: because index funds currently track indexes, they provide a commodity product, and there are no substantial opportunities for new entrants to improve on the offerings of incumbents by using strategies that are difficult to imitate. The dominant incumbents have significant advantages because of the economies of scale of operating index funds, the funds' branding, and—in the case of ETFs—the liquidity benefits for funds with large asset bases.

2. Stewardship

In the literature on institutional investors, *stewardship* refers to the actions that investors can take in order to enhance investments in companies that they manage on behalf of their own beneficial investors.[29] Most advanced economies now have stewardship principles or codes that seek to provide guidance to institutional investors.[30] We focus here on stewardship that aims to enhance the value of the company.[31] Stewardship by institutional investors,

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[26] *See, e.g.*, Vanguard 500 Index Fund, Prospectus (Form N-1A) 6 (2017).

[27] For a discussion of the rules governing mutual funds and ETFs, see LOIS YUROW ET AL., MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK, § 4:1 (2017); William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 72 (2008).

[28] *See, e.g.* BlackRock, *BlackRock Global ETP Landscape* Dec. 2016 6 (reporting that, as of December 2016, BlackRock had 36.9% of the exchange-traded products market, Vanguard had 18.5%, and SSGA had 15.4%). For an analysis of and evidence on the structural

[29] *See, e.g.*, *The Investment Stewardship Ecosystem* (BlackRock Viewpoint), Jul. 2018 6 (defining stewardship as "engagement with public companies to promote corporate governance practices that are consistent with encouraging long-term value creation for shareholders in the company").

[30] For recent efforts in the United Kingdom and the United States, see Financial Reporting Council, UK Stewardship Code (2012).; Institutional Stewardship Group, About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance (2018), https://isgframework.org/.

[31] Some institutional investors—for instance socially responsible funds—might have goals other than enhancing value. We do not discuss this type of stewardship in this Article.

including by the index funds that are the focus of this Article, includes three components: monitoring, voting, and engagement.

Monitoring involves evaluating the operations, performance, practices, and compensation and governance decisions of portfolio companies. It provides the informational basis for the voting and engagement decisions of index funds.

Voting at shareholder meetings is a key function of index fund managers and other shareholders. Shareholders vote on the election of directors to manage the corporation, as well as charter and bylaw amendments; mergers, dissolutions, and other fundamental changes in the corporation; and advisory votes on executive compensation and shareholder proposals.[32] Index funds (along with other investment funds) are required to vote on these matters, and index fund managers determine how their funds vote. These decisions can have significant influence on the actions of public companies.[33]

Engagement refers to interactions between index fund managers and their portfolio companies in ways other than voting—for example, by submitting shareholder proposals, nominating directors, and undertaking proxy contests. Among other forms of engagement, index fund managers (and other shareholders) can communicate publicly or privately with managers and directors of their portfolio companies, which can be proactive and initiated by the investor, or reactive, as when an investor responds to contact from a portfolio company or other investors.

In our analysis the remainder of this Part I we will distinguish between two types of decisions that index fund managers must make regarding stewardship activities. One type of decision is quantitative: determining the level of investment that the index fund manager will make on stewardship activities. The other type of decision is qualitative: determining the level of deference that the index fund manager will give to the corporate managers that lead particular portfolio companies. In Sections D and E, below, we discuss the value-enhancing benchmarks with respect to each of these two types of decisions respectively.

For a discussion of such stewardship by one of us, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 222 (2017–2018). We also note that some investors in indexed products seek to screen out some companies from the portfolio in which they invest, and index fund managers therefore also manage portfolios that follow such exclusions. Investor demands for exclusion of certain investments, and the impact they might have on corporate behavior, are outside the scope of this Article, as we focus on the stewardship decisions of index fund managers with respect to those companies that are included in managed portfolios.

[32] For the classic treatment of shareholder voting, see Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 THE JOURNAL OF LAW AND ECONOMICS 395 (1983).

[33] *See* Interpretive Bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines, 29 C.F.R. §§ 2509.2016-01 (Dec. 29, 2016).

B. The Promise of Index Fund Stewardship

The leaders of the Big Three, and supporters of index fund stewardship, have expressed the view that such stewardship can be expected to produce significant benefits. They have based this view on three characteristics of index funds, and especially the Big Three: (i) their large and growing stakes in publicly traded companies; (ii) their inability to exit poorly-performing companies, rather than trying to fix their governance problems; and (iii) their long-term focus. Below we discuss each of these factors in turn, and consider how they can be expected to contribute to the quality of index fund stewardship.

Large and Growing Stakes. The substantial and growing stakes held by each of the Big Three give them significant influence over the outcomes of corporate votes. This influence leads, in turn, to their substantial influence over the decisions of corporate managers, even before matters come to a vote.

A priori, we would expect the large stakes that each of the Big Three holds in their portfolio companies to motivate them to maximize the value of those companies. In the standard corporate free-rider problem, the benefits of improving corporate value are shared with other investors.[34] A very large investor like a Big Three index fund family will capture a larger fraction of these benefits than a smaller investor. For instance, an index fund manager that manages 5% of the shares of a particular company will capture ten times as much from an increase in the value of that company than a smaller investment manager holding 0.5% of the same company.

No Exit. If other types of investors are dissatisfied with the performance of their portfolio companies they can make the "Wall Street walk" and simply sell their shares.[35] By contrast, because index funds replicate their benchmark index, they are unable to exit from a particular portfolio company while it remains in the index. Indeed, SSGA's CIO has referred to SSGA as representing "near-permanent capital,"[36] and Vanguard's then-CEO William McNabb has described Vanguard's index funds as being "permanent

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[34] For a well-known discussion of the free-rider problem, see ROBERT C. CLARK, CORPORATE LAW 389–400 (1986).

[35] For an excellent review of the financial economics literature on exit, see Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. OF FIN. ECON. 23, 28–32 (2014).; Alex Edmans & Clifford G. Holderness, *Blockholders: A Survey of Theory and Evidence*, *in* HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017). As Edmans has highlighted, exit decisions by other investors can affect corporate behavior. For surveys of his and others' work on exit decisions and governance, see Edmans, *supra*.

[36] State Street Global Advisors, *supra* note 9, at 3.

shareholders."[37] The lack of an exit option increases the relative importance of stewardship and engagement. BlackRock's CEO Larry Fink has stated that "BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever."[38]

Long-term Perspective. A third characteristic of index funds that is potentially attractive to supporters of their stewardship is their long investment horizon. BlackRock has stated that "index investors are the ultimate long-term investors."[39] There is significant debate in the literature about the extent to which the presence of investors with short-term horizons has adverse effects on corporate governance.[40] The long-term investment horizons of index funds obviates any such concerns and therefore makes stewardship by index fund managers especially attractive to commentators that are concerned about short-termism.[41] Consistent with this view, SSGA states that they "actively engage with [their] portfolio companies to promote the long-term value of [their clients'] investments," and Vanguard states that its "emphasis on investment outcomes over the long term is unwavering."[42]

Can the large stakes of index funds, their lack of exit options, and their long-term perspective combine to enable them to deliver on the promise they hold for corporate of governance? In subsequent parts of this Article we analyze the impediments to such delivery.

C. The Value-Maximization and Agency-Costs Views

In highlighting the above characteristics, index fund leaders and supporters of index fund stewardship implicitly assume that the managers of

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[37] William McNabb, *Getting to Know You: The Case for Significant Shareholder Engagement*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Jun. 24, 2015), https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/. Vanguard's Annual Stewardship Report also states that Vanguard's index funds are "structurally permanent holders of companies." Vanguard, *Investment Stewardship 2017 Annual Report* 3 Aug. 31, 2017 [hereinafter, Vanguard, *Annual Stewardship Report*].

[38] 2017 Letter from Fink, *supra* note 8.

[39] *See, e.g.*, 2017 *Id.*.

[40] For an exchange on this subject between one of us and Chief Justice Leo Strine, Jr., see Bebchuk, *supra* note 13 and Strine, *supra* note 17.

[41] For instance, Martin Lipton has stressed that "BlackRock, State Street and Vanguard have continued to express support for sustainable long-term investment". Martin Lipton, *Activism: The State of Play*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Sept. 23, 2017), https://corpgov.law.harvard.edu/2017/09/23/activism-the-state-of-play/. For a detailed review by one of us of the many academics, practitioners, and public officials that express short-termism concerns, see Bebchuk, *supra* note 13.

[42] State Street Global Advisors, *supra* note 9, at 3.

index fund families largely act to maximize the long-term value of the portfolios they manage; we therefore refer to this view as the "value-maximization" view of index fund stewardship. This view attaches limited significance to potential agency problems within index funds and does not view such problems as first-order drivers of stewardship decisions.

Below we put forward an alternative to the value-maximization view. Because stewardship decisions are made by investment managers, we believe that it is critical to assess their incentives regarding stewardship. Examining these incentives, and the evidence we put forward regarding their stewardship decisions, indicates that agency problems are a first-order driver of the stewardship decisions of index fund managers, and that these decisions cannot be properly understood without recognizing these agency problems.

Before examining the incentives of index fund managers, it is useful to recognize several characteristics of index fund managers that play an important role in our theory.

Index funds are generally structured as corporations or statutory trusts, with their own directors or trustees. However, these directors or trustees have a very limited set of responsibilities, and the key decisions in operating index funds are made by the fund's investment advisor.[43] We use the term *index fund managers* to refer to these investment advisors of index funds that make key decisions, including BlackRock, Vanguard and SSGA.[44] It is the incentives and decisions of index fund managers that are our focus in this Article.[45]

The economies of scale in investment management mean that most investment managers now manage dozens or hundreds of investment funds, often referred to collectively as "fund complexes" or "fund families." While some investment fund families consist predominantly of actively managed funds, each of the Big Three fund families consists predominantly of index

[43] For a discussion of the governance of index funds, see Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1, 18 (2016).

[44] BlackRock is a public company, and SSGA is an operating unit of a public company, so it is reasonable to assume that they both seek to maximize their profits and, in turn, the value of their index fund management business. In contrast, Vanguard is owned by its investment funds. *See* Vanguard, Why Ownership Matters at Vanguard, https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters/. Vanguard appears to operate by constraining its fees to the point that leaves its business with no profit. This raises the interesting question of which objectives the business leaders of Vanguard maximize. It is reasonable to assume that, subject to their chosen constraint, they try to be successful by expanding the scale of their business. Our analysis in this part is consistent with this assumption.

[45] For early writing stressing the need to consider the incentives of institutional investors, see Rock, *supra* note 17, at 453; Jill E. Fisch, *Relationship Investing: Will It Happen--Will It Work*, 55 OHIO ST. L. J. 1009, 1039 (1994); Black, *supra* note 17, at 595–96.

funds.[46]

For the Big Three, as with many other investment managers, the key stewardship decisions are centralized in a dedicated stewardship department of the index fund manager.[47] An important component of the stewardship decision making of the index fund manager relates to the level of resources it devotes to this department, as well as to the qualitative decisions that the department makes.

The remainder of this Part develops an analytical framework for understanding the incentives of index fund managers. Sections D and E below analyze how the fact that investment managers manage other people's money incentivizes them to diverge from this benchmark in two important ways. In particular Section D examines the index fund managers' incentives to under-invest in stewardship compared to the value-maximizing level. Section E focuses on the qualitative stewardship decision of how deferential to be toward corporate managers, and shows that index fund managers have incentives to be excessively deferential. Finally, Section F discusses some constraints that limit the force of the distorted incentives that we identify.

D. Incentives to Under-Invest in Stewardship

In this Section we consider index fund managers' incentives with respect to the first dimension of stewardship decisions we identified in Section A, the level of investment in stewardship activities. Section 1 discusses the value-maximization benchmark—that is, the investment level that would best serve the interests of index funds' beneficial investors. Section 2 discusses the investment-level decisions that index fund managers will make, assuming, for simplicity, that both the fee levels that index fund managers charge and the size of their investment portfolio are fixed. Section 3 relaxes this assumption and considers how the possibility of a competitive benefit from stewardship could affect index fund manager incentives.

1. The Value-Maximization Benchmark for Investment Level

In order to assess the investment-level decisions of index fund managers, it is first necessary to define a benchmark for desirable stewardship decisions.

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[46] As of June 2017, the proportion of assets invested in index funds was 79% for SSGA, 73% for Vanguard, and 66% for BlackRock. In contrast, only 14% of Fidelity's assets under management were invested in index funds. Hortense Bioy et al., *Passive Fund Providers Take an Active Approach to Investment Stewardship* 4 Dec. 5, 2017.

[47] *See, e.g.*, State Street Global Advisors, *supra* note 9, at 7 ("All voting and engagement activities are centralized within the Asset Stewardship Team."). *See also* Fichtner et al., *supra* note 2, at 317 (documenting highly consistent voting within fund families by each of the Big Three as evidence of the impact of centralized stewardship departments).

The benchmark for value-enhancing stewardship decisions made by the investment managers are those that would be best for investors in the index funds. These are also the stewardship decisions that would be made if there were no agency separation between the index fund manager and the investors in the index fund—that is, in a "sole-owner" benchmark, in which the index fund's portfolio had a sole owner that managed the portfolio and was expected to make all of the stewardship decisions that would enhance its value.

Investment in a certain stewardship activity will be desirable only if it produces, on an expected value basis, an increase in the value of the portfolio companies that are the subject of the activity. Clearly, stewardship activity should not be undertaken if it is not expected to produce such a gain. However, for stewardship investments to be worthwhile that gain must also exceed the cost of the activity. To formalize our analysis, we refer to the investment in the stewardship activity as the *stewardship investment*, and to the value increase created by that investment in stewardship on an expected value basis as the *expected gain from stewardship investment*. We denote the cost of stewardship investment as C_{SI} and the expected gain from stewardship investment by ΔV_{SI}. From the perspective of the beneficial investors in the index fund, a stewardship investment is desirable if and only if $C_{SI} < \Delta V_{SI}$—that is, if the cost of the stewardship investment is less than the expected gain from it.

This condition could well call for substantial investments in stewardship. For instance, if an index fund manager holds a stake of $1 billion in a portfolio company and stewardship is expected to increase the value of the company by 0.1%, it would be desirable to invest up to $1 million in such stewardship. Even if the expected gain were as little as 0.01% it would be desirable to invest up to $100,000 in stewardship. Each of the Big Three has positions of $1 billion or more in numerous companies, with an average value of $4 billion for such positions. BlackRock, Vanguard, and SSGA held positions of $1 billion or more in 353, 427, and 242 S&P 500 companies, respectively, as of the end of 2017.[48] From the perspective of a beneficial investor in a Big Three index fund, substantial investments in stewardship are therefore likely to be value enhancing in many cases.

2. The Tiny Fraction of Value Increases Captured

Let us first assume that index fund managers take their assets under management and fee structures as given. This simplifying assumption highlights a key driver of the gap between the interests of index fund managers and those of beneficial investors in their funds. Index fund

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[48] These calculations are based on ownership data from FactSet Ownership.

managers generally cover the cost of investments in stewardship from the fee income that they receive from investment funds. However, the increased fee revenue they receive as a result is only a tiny fraction of the expected value increase from stewardship.

Given our assumption that stewardship does not affect assets under management, the private benefits to index fund managers from stewardship come only from the increased fees that would result from an increase in the value of the index funds' given assets. Under existing arrangements, index fund managers charge their investors fees that are usually specified as a fixed percentage of assets under management.[49] As a result, increasing the value of the portfolio increases the present value of these fees. Index fund managers have an incentive to undertake stewardship if its cost is not only less than the expected gain to the portfolio, but also less than that gain multiplied by the (very small) fractional fee.

Formally, if the fraction of portfolio value charged as a fee is θ and a stewardship investment of C_{SI} produces an increase in value of ΔV_{SI}, then an index fund manager has an incentive to undertake the stewardship if and only if $C_{SI} < \theta \times \Delta V_{SI}$. In Subsection 1 we explained that the stewardship investment is value-maximizing if and only if its cost, C_{SI}, is less than ΔV_{SI}. Thus, the range in which value-maximizing stewardship investments are not in the interests of index fund managers is defined as

$$\theta \times \Delta V_{SI} < C_{SI} < \Delta V_{SI}.$$

What is the practical significance of this problem? In assessing this critical question, it is important to recognize the very small quantum of the fees that index funds charge. The average expense ratios for the Big Three—the combined fees and expenses that they receive for their services as a percentage of assets under management—are 0.25%, 0.10%, and 0.16% for BlackRock, Vanguard, and SSGA, respectively. Because these figures also include expenses, the fractional fee is likely even lower than these figures suggest.[50] These tiny fee percentages are an attractive feature of index funds that has driven their phenomenal growth. However, as the analysis above has demonstrated, the tiny fraction of expected gains captured by index fund managers through these fees gives them a correspondingly tiny incentive to

[49] Amounts that investment managers charge to investors also include certain expenses, such as legal expenses and expenses related to custody of portfolio assets. These are all included in the annual fund operating expenses that investment funds are required to disclose (see 17 C.F.R. § 274.11A, Item 3), which are calculated as a percentage of investment, and commonly referred to as the "expense ratio." When we refer to fees charged to investors we include all amounts included in the expense ratio.

[50] *See* Patricia Oey, *U.S. Fund Fee Study* 10 Apr. 26, 2018 (based on Morningstar data as of December 31, 2017).

invest in stewardship.

Recall the example of an index fund with a $1 billion position in a company where stewardship would generate a modest gain of 0.1%. Even though the level of the expected gain is small, given the size of its position, it would be value maximizing for the index fund to invest up to $1 million in such stewardship to achieve the gain. That is, the index fund should employ a team of professionals that would dedicate significant time to stewardship at that particular company. However, if the index fund's fractional fee is 0.5%, the index fund manager's interests would not be served by any stewardship investments exceeding $5,000.

More generally, the highest level of stewardship that would serve the private interest of the index fund manager is 0.5% of the level at which stewardship investment would be value maximizing for index fund investors. Thus, the index fund manager would *not* have an incentive to employ a team of professionals to spend significant time on stewardship for that company, even though such stewardship would be value maximizing. The $5,000 investment in stewardship that would serve the index fund manager's interests could fund only a small fraction of a single person's annual time. Consider now a situation where the expected gain is a mere 0.01%. In this case, it would be value maximizing to invest up to $100,000 in stewardship to bring about this gain. However, if the fractional fee is again 0.5%, the index fund manager would have no incentive to invest more than $500 in stewardship.

3. The Limited Effects of Competition for Funds

So far our analysis has assumed that index fund managers take their assets under management and fees as given. We now relax this assumption and examine how the competition to attract assets affects index fund managers' incentives to invest in stewardship. We first discuss competition with other index funds and then competition with actively managed funds.

Competition with Other Index Funds. An index fund manager's most obvious source of competition is other index fund managers.[51] An investor in a given index fund could choose to invest instead in an index fund run by another manager that tracks the same or similar index. Index fund managers thus have an incentive to make their funds as attractive as possible, and to perform as well as possible, relative to other index funds.

Competition with other index funds gives index fund managers precisely zero additional incentive to invest in stewardship for any of their portfolio

[51] For studies stressing performance relative to peer fund managers, see Fisch, *supra* note 45, at 1020–21; and Keith C. Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. OF FIN. 85, 85 (2012).

companies. If the index fund manager invests in stewardship that increases the value of a particular portfolio company, the increase will be shared with all other investors in the company, including rival index funds that replicate the same index. These rival index funds will capture the same benefit even though they have not themselves made any additional investment in stewardship. An index fund manager's investment in stewardship will therefore not result in any increase in the fund's performance compared to that of its rivals, and will not allow the fund to attract investments from its rivals or to increase its fee levels.

The index fund manager cannot even increase its fees or expenses to cover the cost of the investment in stewardship: since its gross returns are the same as those of rival index fund managers, if it increases its fees or expenses, its net returns will be *below* those of its rivals. Stewardship will therefore not provide any competitive benefits to index fund managers and will not give them any incentive to ameliorate their under-investment in stewardship from the level described in Section C.2.

Finally, while the above analysis has assumed implicitly that index fund investors care exclusively about the financial return from their investment, some index fund investors might well have a preference for investing with an index fund manager whose stewardship activities they view favorably, or at least not unfavorably, and expect index fund managers with which they invest to be good stewards. The more widely held are such preferences, the stronger the incentives that index fund managers will have to be perceived as good stewards. However, incentives to be *perceived* as good stewards are quite different from incentives to make desirable stewardship decisions. Investors may not recognize certain deviations from optimal stewardship decisions, in which case accommodating their preferences would not discourage such sub-optimal stewardship. Although the interest of index fund managers in being perceived as good stewards cannot eliminate such deviations, it can be expected to affect index fund manager behavior, in a way that we will return to in Section F, below.

Competition with Actively Managed Funds. Professors Fisch, Hamdani, and Davidoff Solomon have recently offered support for index fund stewardship, arguing that index fund managers compete for funds "not only with each other but also with active funds," and that this competition provides them with "the incentive to use their governance rights to target underperforming companies in their portfolio."[52] According to this view, by improving the governance of public companies, index fund managers may eliminate potential advantages that actively managed funds might have—advantages that might otherwise provide those funds with opportunities to outperform index funds. However, as we explain below, this argument

[52] *See* Fisch et al., *supra* note 16, at 10.

provides little basis for expecting index fund managers to have significant incentives to invest in stewardship.

A key driver of the movement from active funds to index funds has been the understanding, backed by empirical evidence in the financial literature, that actively managed funds significantly underperform index funds on average. To the extent that this understanding leads investors to switch from active funds to index funds, the relevant competition for any given index fund manager is other index funds that track the same or similar indexes.

Of course, substantial assets under management are still invested in actively managed funds; this is mainly because, even though actively managed funds underperform (on average) whichever index they use as a benchmark, some do outperform these indexes.[53] Fisch, Hamdani, and Davidoff Solomon acknowledge this, giving the example of active manager Oakmark International Investor, which attracted $9.7 billion in new assets in 2017, leading it to close to new investors in 2018.[54]

Even if index fund stewardship increases value in some or all of their portfolio companies, some actively managed funds will still outperform their benchmark indexes. The constituent companies in any given index can be expected to perform very differently, depending on their industry and the success of their strategies, services, and products. Active managers that disproportionately hold positions in companies that outperform the index will outperform index funds that track that index.

Indeed, to the extent that stewardship by index fund managers brings about expected governance gains in a subset of portfolio companies, those active managers that disproportionately hold those companies in their portfolios will outperform the index. As a result, an interest in lowering the performance of actively managed funds relative to index funds should not be expected to provide index fund managers with substantial incentives to undertake value maximizing stewardship.[55]

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[53] For studies by financial economists on such occasional outperformance, see, e.g., Jonathan B. Berk & Jules H. van Binsbergen, *Mutual Funds in Equilibrium*, 9 ANN. REV. OF FIN. ECON. 147 (2017); Hyunglae Jeon et al., *Precision about Manager Skill, Mutual Fund Flows, and Performance Persistence*, 40 THE NORTH AMERICAN JOURNAL OF ECONOMICS AND FINANCE 222 (2017).

[54] *See* Fisch et al., *supra* note 16, at 11, fn. 64, citing Greg Carlson, *Oakmark International Announces Soft Close*, 178, Morningstar.com (Jan. 30, 2018), http://www.morningstar.com/articles/845771/oakmark-international-announces-soft-close.html.

[55] For additional criticisms of the argument that the desire to compete with actively managed funds encourages stewardship by index funds, see J.B. Heaton, *All You Need is Passive: A Response to Professors Fisch, Hamdani, and Davidoff Solomon*, SSRN Scholarly Paper ID 3209614 (Social Science Research Network), Jul. 7, 2018.

E. Incentives to be Excessively Deferential

Section D discussed one key dimension of stewardship decisions: the choice of how much to spend on stewardship investments and the incentives that index fund managers have to under-invest in stewardship. In this Section we turn to a second key dimension: the choice between deference to corporate managers and nondeference. As we show, the private interests of index fund managers are likely to be affected by their deference/nondeference choices in ways that could well distort these choices. Below we first discuss this problem in general; we then proceed to discuss three significant ways in which the private interests of index fund managers, and especially the Big Three, could be served by being excessively deferential.

1. The Value-Maximization Benchmark for Deference Levels

The other important dimension, which is qualitative in nature, is the level of deference that index fund managers give to the views and preferences of the managers of their portfolio companies.[56] Such "deference/nondeference" decisions include whether to vote for or against a company's say-on-pay proposal; whether to vote for or against a company's director slate in a proxy fight against an activist; whether to support or withhold support from the directors on the company slate in uncontested elections; whether or not to vote against shareholder proposals opposed by the managers of a company; and whether or not to submit shareholder proposals to a company. Deference/nondeference decisions may also involve the choice of general principles, policies, or practices that apply to a wide range of situations, such as proxy voting guidelines.

Some deference/nondeference decisions—such as voting—are purely qualitative; they will involve the same resource cost regardless of the level of deference chosen. For other decisions—such as submitting a shareholder proposal—the nondeferential choice requires greater resources. While there is thus some interaction between the choice of investment level and the choice between deference and nondeference, we discuss the two choices separately for the sake of conceptual clarity. Similarly, for simplicity of exposition, we discuss deference/nondeference as a binary decision, but the insights from our analysis are equally applicable to situations where the level of deference involves a range of choices.

What is the deference/nondeference decision that would be value-

[56] We note that, in taking issue with our agency-costs view of index fund stewardship, Fisch et al., *supra* note 16, and Rock & Kahan, *supra* note 16, focus on the incentives of index fund managers to invest in stewardship, and pay little attention to the dimension of deference. As explained in this Article, however, this dimension is critical for assessing the agency costs of index fund managers.

maximizing for index fund investors? In many cases, the positions preferred by corporate managers would be viewed independently as value-enhancing by the index fund manager. In some cases, the index fund manager may be uncertain, but may rationally conclude that deferring to the views of corporate managers would likely be value-enhancing because of the corporate managers' superior information. However, in some other cases deferring to corporate managers may not be value-enhancing. Nondeference will be value-enhancing if and only if its expected effect on the value of the index fund's position in the portfolio company would be positive. Formally, denoting the expected gain from nondeference as ΔV_{ND}, nondeference will be value-enhancing if and only if $\Delta V_{ND} > 0$.

Where an index fund manager faces a binary choice between deference and nondeference to a particular portfolio company's managers, value-maximizing stewardship calls for nondeference whenever the expected value effect from nondeference is positive and for deference whenever the expected value effect from nondeference is negative. However, the choice between deference and nondeference may also affect the interests of the index fund manager in other ways, some of which we discuss in Subsections 2 to 4. Let us suppose that the expected gain to the portfolio from nondeference, which we denote by ΔV_{ND}, is positive, so nondeference would be desirable for the beneficial investors in the index fund, but that nondeference imposes costs of C_{ND} on the index fund manager. The index fund manager captures only the fractional fee (θ) of the expected gain from nondeference: $\theta \times \Delta V_{ND}$. Even though nondeference is value-maximizing it does not benefit the index fund manager where $C_{ND} > \theta \times \Delta V_{ND}$. Thus, costs to index fund managers from nondeference create a distortion: value-enhancing nondeference would *not* serve the interests of index fund managers if and only if

$$0 < \Delta V_{ND} < C_{ND} / \theta.$$

It is useful to note the role that the fractional fee (θ) plays in determining the range of situations in which the index fund manager will have distorted incentives. Rearranging the inequality above, desirable nondeference will be against the interests of index fund managers whenever $0 < \Delta V_{ND} < C_{ND} / \theta$. Because the value of θ is likely to be very small for index fund managers, C_{ND} / θ will likely be higher, and the range of distorting situations will likely be wider. Because the fractional fee (θ) is likely to be very small, the expected gain from nondeference (ΔV_{ND}) figures less prominently in the calculus of index fund managers' incentives, and is thus more likely to be outweighed by given private costs from nondeference.

To illustrate, consider again the index fund with a $1 billion position, where the expected gain from nondeference is 0.1% (i.e., $1 million) and the index fund manager's fractional fee is 0.5%. Nondeference will be against the interests of the index fund manager if the cost of nondeference exceeds $5,000.[57]

The practical significance of distortions from private costs of nondeference depends on the extent of those costs. Below we consider the significance of three sources of costs: business ties with public companies (Subsection 3); legal requirements that nondeferential index fund managers file Schedule 13D disclosure (Subsection 4); and the risk that, by "stepping on the toes" of corporate managers, the Big Three could trigger a managerial and regulatory backlash (Subsection 4).

2. Business Ties with Corporate Managers

Index fund managers, including the Big Three, have a web of financially-significant business ties with corporate managers, so they may pay close attention to how corporate managers perceive them. One important source of such investment manager revenue that has received considerable attention relates to defined contribution plans, commonly referred to as "401(k) plans".[58] The assets under management in 401(k) plans were over $4.7 trillion in 2015,[59] most which came from employees of public companies. Over 60% of 401(k) assets were held in mutual funds.[60] Index fund managers derive a substantial proportion of their revenues from 401(k) plans[61] in two ways: (i) by providing administration services to such plans,[62] and (ii) by having their index funds included in the menu of investment options available to plan participants.[63]

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[57] In the second example used in Section I.D, where the expected gain is only 0.01%, nondeference is against the interests of the index fund manager if the cost of nondeference is greater than $500.

[58] 401(k) plans are so-called for the section of the Internal Revenue Code that governs the tax treatment of "qualified cash or deferred arrangement," which is how these plans are structured. *See* Internal Revenue Code, 26 U.S. § 401(k).

[59] Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2015*, 22 ICI RES. PERSP. 2 (2016).

[60] *See Id.*

[61] According to *Pensions & Investments*, the proportion of U.S. client assets under management for each of the Big Three that came from 401(k) plans in 2017 was 14%, 20%, and 17%, for BlackRock, Vanguard, and SSGA, respectively.

[62] As of December 31, 2016, Vanguard ($444 billion in plan assets) was the third-largest plan provider, after Fidelity and TIAA. *See* Plansponsor, 2017 Recordkeeping Survey 3 (Jun. 25, 2017), https://www.plansponsor.com/research/2017-recordkeeping-survey/. Plansponsor's data is based on a survey of data from each provider. Plansponsor estimates that the providers that responded to the survey comprise 85% of the total defined contribution plan market. *See Id.* at 5.

[63] An index fund that provides administration services is also more likely to have its funds appear on the menus for 401(k) investments. For evidence, see Veronika Pool et al., *It*

Index fund managers can reasonably expect that the extent to which corporate managers view them favorably might influence their revenues from 401(k) plans. In public companies, a committee of employees often chooses the plan administrator and the menu of investment options.[64] Although these choices are subject to fiduciary duties, the decision makers often have a number of reasonable choices, and in such cases the views and preferences of corporate managers could influence the decision of these employees. Furthermore, the incentives discussed below arise even if decisions are often not influenced by the preferences of corporate managers, so long as index fund managers *believe* that such influence might sometimes have an effect.

Turning to analyze how business ties provide incentives for deference, we would like to distinguish two types of effects of business ties on deference/nondeference decisions. The first type of effect, "client favoritism," has received significant attention in the literature,[65] however, we view it as less important. Index fund managers may be more deferential to managers of particular companies with which they have (or hope to have) business ties than they are to managers of other companies. For example, an index fund manager may have incentives to support the say-on-pay proposal of a company that is a current or potential client, even if that index fund manager would vote against such a proposal at other companies.

Indeed, there is evidence suggesting that such favoritism has an effect on voting decisions. In particular, empirical studies have documented that the volume of business that investment managers receive from corporate pension funds is associated with their voting more frequently in support of corporate managers on shareholder proposals, as well as on executive compensation matters.[66] Furthermore, a recent study by Dragana Cvijanović, Amil

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Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans, 71 J. OF FIN. 1779, 1786 table 1 (2016).

[64] For smaller companies, the plan fiduciary is a staff member in the company's human resources or finance department. STEPHEN DAVIS ET AL., WHAT THEY DO WITH YOUR MONEY: HOW THE FINANCIAL SYSTEM FAILS US AND HOW TO FIX IT 104 (2016).

[65] For work discussing this type of effect, see, e.g., Gerald F. Davis & Tracy A. Thompson, *A Social Movement Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141, 161–62 (1994); John Brooks, *Corporate Pension Fund Asset Management*, *in* TWENTIETH CENTURY FUND, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS (1980); Coffee, *supra* note 17, at 1321; Rock, *supra* note 17, at 469.; Black, *supra* note 17, at 597.

[66] For studies providing such empirical evidence, *see* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007) (voting on shareholder proposals); Rasha Ashraf et al., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 567 (2012) (voting on executive pay); Assaf Hamdani & Yishay Yafeh, *Institutional Investors as*

Dasgupta, and Konstantinos Zachariadis finds that investment managers are more likely to vote in support of portfolio company managers on closely-contested proposals when the investment manager has significant business ties to the portfolio company.[67]

Responding to concerns about client favoritism problems, some investment fund managers, including the Big Three, have put in place internal "walls" separating stewardship personnel from the individuals who maintain and cultivate business ties. For example, SSGA publishes "Conflict Mitigation Guidelines" that explain how SSGA's stewardship team is insulated from others within the organization whose role is to develop and maintain business ties with corporate managers.[68] However, even fully assuming that internal walls should be expected to completely eliminate the problem of client favoritism by the Big Three and some other major index fund managers, such walls cannot eliminate another key channel through which business ties produce incentives to be deferential. It is that channel—setting stewardship principles, policies, and practices that are more deferential to companies in general—that we believe to be most important in incentivizing deference.

Although client favoritism has thus far received the most attention, we believe that another key channel is the most important in incentivizing deference. Setting general principles, policies, and practices more deferentially enhances the likelihood that corporate managers will view the index fund manager more favorably, and does so without producing any inconsistency in the treatment of clients and non-clients. For example, rather than tending to vote at particular companies that are clients in ways that managers of those companies are likely to prefer, an index fund manager can set its general principles, policies, and practices so as to enhance the likelihood of supporting management in votes across *all* portfolio companies. This reduces the likelihood that current or potential clients would receive negative votes and therefore view the index fund manager unfavorably.

The problem of excessively deferential principles, policies, and practices is difficult for outsiders to measure empirically. Existing studies do not test for, and so cannot detect, this problem, because they focus on differential treatment of clients and non-clients.

Of greater importance, excessively deferential principles, policies, and practices could make an index fund manager's stewardship more deferential

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Minority Shareholders, 17 REV. OF FIN. 691 (2013).

[67] Dragana Cvijanović et al., *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. OF FIN. 2933 (2016).

[68] State Street Global Advisors, 2018 SSGA Conflict Mitigation Guidelines (Mar. 16, 2018), https://www.ssga.com/na/us/institutional-investor/en/our-insights/viewpoints/2018-ssga-conflict-mitigation-guidelines.html.

than desirable *outside* of the subset of companies that are current or potential clients. Such excessively deferential principles, policies, and practices will affect that index fund manager's stewardship decisions with respect to public companies in general. The breadth of this effect strengthens concerns about distortions of the deference/nondeference decisions of index fund managers.

3. Avoiding Section 13(d) Filer Status

We now turn to a substantial cost of nondeference for the Big Three that arises from the very large number of companies in which they hold stakes of 5% or more: 2,454 companies (BlackRock), 1,839 companies (Vanguard), and 221 companies (SSGA).[69] For all of these companies, the Big Three have incentives to avoid any nondeference that would require filing on Schedule 13D.[70]

Under Section 13(d) of the Securities and Exchange Act, an investor that obtains more than 5% of a public company is required to make certain disclosures, either on Schedule 13D or on Schedule 13G.[71] The criterion for whether the investor must make detailed disclosure on Schedule 13D, rather than more limited disclosure on Schedule 13G, is whether the investor makes the acquisition "with the purpose [or] the effect of changing or influencing the control of the [portfolio company]."[72] A number of stewardship activities by index fund managers could be viewed as having such a purpose, including making proposals to sell or restructure the portfolio company, or engaging with the portfolio company to propose or facilitate the appointment of particular individuals as directors.

Schedule 13D filings are more frequent and much more extensive than Schedule 13G filings. Schedule 13D must be filed within ten days after every acquisition and subsequent change in holdings, compared to once-per-year for Schedule 13G. Schedule 13D filings also require particularized disclosure of each acquisition, entity-by-entity, compared to disclosure of aggregated

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[69] *See* Section II.B.2 and Table 7, *infra*. Calculations are based on data from FactSet Ownership, as of December 31, 2017.

[70] For early discussions of the possibility that Section 13(d) could deter stewardship, see Alfred F. Conard, *Beyond Managerialism: Investor Capitalism Symposium: Issues in Corporate Governance*, 22 U. MICH. J.L. REFORM 117, 162 (1988–1989); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 26 (1991).

[71] *See* 15 U.S.C. § 78m(d) (2012); 15 U.S.C. § 78m(g) (2012); 17 C.F.R. § 240.13d-1(b) (2017). For an analysis of the law and economics of blockholder disclosure co-authored by one of us, see Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39 (2012).

[72] *See* 17 C.F.R. § 240.13d-1(b) (2017). For a general discussion of the rules governing Section 13(d), see ARNOLD S. JACOBS, THE WILLIAMS ACT -- TENDER OFFERS AND STOCK ACCUMULATIONS ch. 2 (2018).

positions for Schedule 13G.[73] Schedules 13D and 13G apply not just to the index funds managed by the index fund manager but to all the investments they manage, including active funds, and separate client accounts.

Given the frequency of trades in the Big Three's portfolios, making the additional extensive disclosures that Schedule 13D requires would be incredibly costly and time consuming. If a Big Three index fund manager has a position of 5% or more in a company, nondeference that would require filing Schedule 13D would impose significant costs, which would be borne by the index fund manager rather than by the index fund. Such nondeference would therefore be against the interests of the index fund manager, even though it is desirable for the index fund.

4. Fears of Backlash

Finally, we turn to what we believe to be an especially strong factor inducing the Big Three to be excessively deferential to corporate managers—their substantial and growing power puts them at risk of public and political backlash that might constrain index fund managers in ways they would find detrimental.[74] As explained below, deference could reduce the risk of such backlash.

The Big Three's dominance of the ever-growing index fund market puts them in a very desirable position. The economies of scale and first-mover advantage that they enjoy provide substantial protection for the dominance of their firms in the index fund marketplace. Are there any clouds on the horizon? Is there anything major that could go wrong for the leaders of the Big Three?

The most significant risk is likely to be that of a backlash reaction to the growing power of the Big Three. Business history suggests that the concentration of power over "Main Street" companies in the hands of large "Wall Street" interests can lead to a backlash. Referring to the current period as a "new era of financial capitalism," scholars have compared it to a chapter in American history a century ago in which Wall Street interests, led by J.P. Morgan, wielded substantial power.[75] However, this earlier chapter of finance capitalism ended with a strong regulatory backlash. As Mark Roe's well-

[73] *Compare* 17 C.F.F. § 240.13d-102 (2017) (regarding Schedule 13G) *with* 17 C.F.F. § 240.13d-101 (2017) (regarding Schedule 13D).

[74] On the concept of backlash in economic and legal systems generally, and on how the risk of backlash affects decision making, see Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217, 217 (1998).

[75] *See* Gerald F. Davis, *A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States*, 5 EUR. MGMT. REV. 11, 12 (2008); Fichtner et al., *supra* note 2, at 299.

known work has documented, vested interests were able to mobilize popular sentiments against the concentrated power of Wall Street financiers, leading to an array of legal rules that curtailed the power of financial blockholders and their ability to intervene on Main Street for decades.[76]

Perhaps most telling for the purposes of our analysis is a more recent chapter of business history that took place in the eighties and nineties in during which the rise of hostile takeovers led to a backlash, which in turn produced legislation protective of managers. The possibility of hostile takeovers was viewed by various scholars as potentially beneficial, by facilitating the replacement of some underperforming management teams and by facing management teams in general with a disciplinary threat that could provide incentive to be attentive, to shareholder interests.[77] However, the possibility of hostile takeovers presented a threat to incumbent managers and detrimental to their interests.

As Mark Roe, Roberto Romano, and others have carefully documented, management interests played an important and active role in bringing about a wave of antitakeover legislation in a large majority of U.S. states that produced severe impediments to hostile takeovers and provided incumbents with substantial insulation from such threats.[78] Pressures from advisers affiliated with incumbents also seem to have played a role in encouraging the Delaware courts to develop doctrines that provided incumbents with power to impede hostile takeovers.[79] Thus, it is natural for this of leaders of the Big Three to take into account the risk that stewardship activities by them that would pose a substantial threat to incumbents' power and interests could lead to a regulatory backlash.

Let us consider how the approach of the Big Three may influence the

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[76] For an influential work providing the historical account of backlash against Wall Street, see Roe, *supra* note 70, at 27–28.

[77] For articles discussing the potential benefits of hostile takeovers, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. OF POL. ECON. 110 (1965); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1980–1981); Lucian Bebchuk, *The Case against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

[78] Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE (Margaret Blair ed., 1993); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988–1989).

[79] For a discussion of the evolution of Delaware law in the direction favored by managers, see Roe, *supra* note 78. In a famous memo issued by Martin Lipton, Partner, Wachtell, Lipton, Rosen & Katz, to clients (Nov. 3, 1988) (on file with authors), Lipton threatened that companies may reincorporate out of Delaware in light of the Delaware Chancery Court's decision in City Capital Assocs. Ltd. P'Ship v. Interco Inc., 551 A.2d 787 (Delaware Ch. 1988). The Delaware Supreme Court subsequently overruled the decision and adopted a position far more protective of incumbents. Interco Inc. v. City Capital Assocs. Ltd. P'Ship, 556 A.2d 1070 (Delaware 1988).

prospect of public or political backlash. Consider a hypothetical *interventional strategy* as part of which the Big Three would seek to improve the value of portfolio companies by (i) making executive compensation incentives more tightly linked to performance, (ii) eliminating anti-takeover defenses, (iii) monitoring the business performance of CEOs very closely, and (iv) forcing out CEOs who do not meet a relatively high standard of performance. Let us further assume that the interventional strategy would be expected to enhance the value of the Big Three portfolios by about 5%, and that the Big Three know of this expected beneficial effect.

Of course, it might be argued that the interventional strategy would be value decreasing rather than value enhancing. However, our focus here is not on debating the merits of the interventional strategy but rather on showing that the Big Three would have incentives to avoid the strategy even under the assumed scenario in which the strategy is expected to be beneficial for their portfolios, and the Big Three know this to be the case.

This interventional strategy would create a significant risk of a backlash. Even though the interventional strategy would be expected to enhance value, managers of portfolio companies would have strong incentives to resist it and mobilize against the Big Three because of the strategy's adverse effect on their power and private interests. Because managers control the massive resources of Main Street companies, they are a formidable foe in the political arena.[80]

Furthermore, management interests could be expected to receive substantial public support. Even though we have stipulated that the interventional strategy is expected to enhance value, this fact would not be incontestable, or necessarily salient to the public. To the contrary, corporate managers, and the groups, advisors and researchers associated with them, would be expected to argue forcefully that the interventional strategy would destroy value. They may claim that the Big Three would be excessively micromanaging or second-guessing the business decisions of well-informed managers, creating distraction, or pressuring them toward short-termism. Indeed, business history suggests that public opinion would view with suspicion any substantial concentration of power over Main Street companies by financial decision makers.

Thus, pursuing any such strategy whereby the Big Three used their power in ways that adversely affect corporate managers would have a significant risk of backlash. Such backlash could lead to the imposition of considerable legal constraints on the power and activities of large index funds and thereby

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[80] For a study of the subject in a historical context, see Roe, *supra* note 70, at 46. For a formal analysis of this issue co-authored by one of us, see Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, 23 REV. FIN. STUD. 1089, 35 (2010).

have substantial adverse effects on the Big Three. Their leaders therefore have significant interest in reducing the risk of such backlash.

The Big Three can reduce the risk of a backlash by limiting the extent to which their stewardship constrains the power, authority, compensation, and other private interests of corporate managers. Indeed, a strategy of deference would likely convert corporate managers into quiet allies rather than foes. With such a strategy, corporate managers could be expected not to resist the increasing equity concentration in the hands of the Big Three but, rather, to view such concentration as favorable to their own interests.

Deference also reduces the salience of the Big Three's power and, with it, potential concerns from those parts of the public that are resistant to large concentrations of financial power. Even when interventions by the Big Three in portfolio companies would maximize value, such interventions would make salient their influence on economic decision making at many Main Street companies. Thus, even though a strategy of nondeference would not serve the financial interests of Big Three fund investors, it would benefit the Big Three managers by reducing opposition to their power not only from corporate managers but also from parts of the public that are resistant to concentrations of power, and thus also decreasing the risk of regulatory backlash.

F. Limits on the Force of Distorting Incentives

Thus far we have focused on the significant incentives that index fund managers, and especially the Big Three, have to under-invest in stewardship and to defer excessively to corporate managers. We conclude this Part with some comments on two factors that may limit the force and the potentially damaging consequences of these distorting incentives.

1. Fiduciary Norms

To begin, in addition to their economic incentives, fiduciary norms and individuals' desire "to do the right thing" may well have a significant influence on index fund managers.[81] These may lead to behavior that is more desirable for their investors than that suggested by a pure incentive analysis. Analyzing the strength of such motivations is beyond the scope of this Article, but we wish to stress that these motivations might have a significant effect on behavior. However, they should not be expected to eliminate the agency problems we identify, for two reasons.

First, fiduciary norms regarding beneficial investors may sometimes be

[81] In our own interactions with individuals working for index funds, we have often encountered what impressed us as an interest of those individuals in "doing the right thing."

in tension with fiduciary norms regarding shareholders. Some index fund managers (including two of the Big Three) are public companies. Fiduciary norms call for executives of those index funds to maximize the value of the fund management company. For the reasons we have explained in this Part, the value of the fund management company might be maximized by the index fund manager under-investing in stewardship and displaying deference to the managers of portfolio companies.

Second, and most importantly, the premise underlying most corporate governance arrangements is that incentives matter. If we could rely exclusively on fiduciary norms many key corporate law arrangements would be unnecessary. To illustrate, if fiduciary norms were sufficient to induce desirable behavior by managers then there would be no reason to adopt executive pay arrangements aimed at generating incentives. The voting guidelines of index fund managers encourage such executive pay arrangements, and give significant consideration to the incentives they create in determining how to cast say-on-pay votes. Thus, even fully accepting that fiduciary norms and a desire to do the right thing play a role in shaping behavior, it remains important to carefully analyze the incentives of index fund managers.

2. Perceptions of Stewardship Quality

As we have noted, index fund managers might care about how their stewardship is perceived, not just by the managers of their portfolio companies but also by their current and potential customers.

While some index fund investors will choose their index fund manager solely on the basis of financial considerations, other current and potential investors—such as public pension funds, endowments, and individuals with non-financial preferences—might also base their choices among index fund managers on non-financial considerations. In particular, such investors might base their choice partly on non-financial considerations, such as their perceptions regarding the stewardship quality of the index fund managers they use or are considering.

To the extent that some investors disfavor investing with index fund managers that they believe to be inferior stewards, even where the investors' returns are the same as from other index fund managers, then index fund managers will have an incentive to avoid being perceived as inferior stewards. Thus, index fund managers will have an incentive to emphasize their commitment to stewardship in their public communications. This might also lead index fund managers to take positions on subjects that they expect to appeal to such investors, such as gender diversity on boards and climate change disclosure.

These incentives are also likely to discourage behavior on the part of index fund managers that would make more salient their incentives to under-invest in stewardship, or to be deferential to corporate managers. However, as we have stressed above, most investors are unlikely to have sufficient expertise or resources to evaluate the many stewardship decisions made by index fund managers. As a result, incentives to avoid being perceived as inferior steward cannot be expected to eliminate the many non-salient ways that the incentives described by the agency cost view affect the behavior of index fund managers.

Finally, we note that this discussion carries significant implications for the potential value of this Article. To the extent that our analysis serves to inform investors with preferences for stewardship quality, it could contribute to reducing deviations from desirable stewardship decisions. We return to this issue in Section III.C below.

II. EVIDENCE

In this Part we turn from theory to evidence. We combine data from various providers with hand-collected data to put forward substantial evidence regarding the stewardship activities that index fund managers do and do not undertake. Our comprehensive empirical analysis covers a wide range of stewardship activities along a number of dimensions, analyzing what index funds do, how they do it, and what they fail to do. We focus on the Big Three, because they manage most of the index assets under management by investment managers, and because their stewardship reports enable an empirical assessment of their stewardship activities.

Section A examines what the Big Three do in terms of stewardship, and how they do it. The four stewardship activities we examine are: level of investments in stewardship (Subection A.1); private engagements (Subsection A.2); the focus on divergence from governance principles (Subsection A.3); and the Big Three's voting decisions (Subection A.4).

In Section B we analyze various the stewardship activities that the Big Three *do not* undertake. The five activities on which we focus are: their attention to business performance (Subsection B.1); influencing director identity and taking on 13D status (Subsection B.2); submission of shareholder proposals to facilitate changes favored by the index fund's governance principles (Subsection B.3); active contribution to corporate governance reforms by filing comments to SEC rulemaking and amicus briefs in precedential litigation (SubsectionB.4); and taking on lead plaintiff positions in securities cases (Subsection B.5).

On the whole, the empirical patterns we document in this Part are inconsistent—or at least in tension—with the value-maximizing view. As we explain below, these empirical patterns are consistent with—and can be explained by—the predictions generated by the agency-costs view: that index fund managers have considerable incentives to both underinvest in stewardship and defer excessively to corporate managers.

A. What the Big Three Do, and How They Do It

1. Stewardships Budgets and Personnel

In recent years, the Big Three have substantially increased the resources they devote to stewardship.[82] Vanguard's "team has doubled in size since 2015,"[83] and BlackRock has announced its intent "to double the size of [its] investment stewardship team over the next three years."[84] The Big Three have also noted the significant numbers of stewardship personnel that they employ, the number of corporate meetings at which they vote, and the number of companies with which they engage.[85] Supporters of index fund stewardship have viewed these figures as reassuring and promising.[86]

However, any assessment of the Big Three's stewardship activities must consider both the vast number of portfolio companies they invest in and the many such companies where they have substantial stakes with significant monetary value. We conduct such an assessment below and find that it raises significant concerns that the Big Three substantially under-invest in stewardship.[87]

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[82] Bioy et al., *supra* note 46, at 19, Exhibit 10 (reporting the results of a survey of investment fund managers conducted in October 2017 showing that from 2014-2015 to 2017, the number of stewardship team members (excluding environmental, social, and governance (ESG) analysts and portfolio managers of investment teams) increased from 20 to 33 at BlackRock, from 10 to 21 at Vanguard, and from 8 to 11 at SSGA).

[83] *See, e.g.*, Vanguard, *supra* note 37, at 2.

[84] 2017 Letter from Fink, *supra* note 8.

[85] For instance, Vanguard's McNabb stated that Vanguard's investment stewardship team "held more than 950 engagements with company leaders" in 2017.Vanguard, *supra* note 37, at 1.

[86] For discussions by supporters of index fund stewardship that favorably cite the Big Three's statements on the scale of their activities, see Fisch et al., *supra* note 16, at 25–26; and Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, SSRN Scholarly Paper ID 3194605 44 (Social Science Research Network), Jun. 12, 2018.

[87] Tables and other data referred to in this Section are based on data from Bioy et al., *supra* note 46, at 19, Exhibit 10 (regarding stewardship personnel, as of October 2017); BlackRock, *Investment Stewardship Report: 2017 Voting and Engagement Report* Jul. 15, 2017 [hereinafter, BlackRock, *Annual Stewardship Report*]; Vanguard, *supra* note 37; andState Street Global Advisors, *supra* note 9 [hereinafter, collectively, the "Big Three Stewardship Reports"] (regarding numbers of portfolio companies and engagements); Pensions & Investments' 2018 survey of money managers [hereinafter, "Pensions and Investments Database"] (regarding equity assets under management); and Oey, *supra* note 50, at 10 (regarding average expense ratios).

(a) Current Levels of Stewardship Investments. Table 1 below uses data from Morningstar and the most recent stewardship reports of the Big Three to present the number of stewardship personnel that each manager employs, and the number of portfolio companies that each manages in the United States and abroad.

Table 1. Stewardship Personnel and Portfolio Companies

	BlackRock	*Vanguard*	*SSGA*
Stewardship Personnel	33	21	11
Portfolio Companies (Worldwide)	17,309	18,900	17,337
Portfolio Companies (U.S.)	4,084	3,946	3,762*

* *Estimated*

We next estimate the total investment in stewardship by each of the Big Three. We assume, conservatively, that the cost of each stewardship staff member (including benefits and payroll loading rates) is $300,000 per year. Table 2 shows the estimated cost of each of the Big Three's stewardship departments and the fraction they represent of (i) equity assets under management (AUM), and (ii) the estimated fees from managing these assets. As the Table shows, the estimated investment in stewardship by BlackRock and Vanguard is below $10 million each, and that of SSGA is below $5 million. All three stewardship budgets are less than 0.0003% of AUM. Perhaps most tellingly, stewardship accounts for less than one-fifth of 1%—only 0.02%—of the estimated fees that each of the Big Three charge for managing equity assets. Thus, although the Big Three stress the importance of stewardship, their stewardship budgets are not economically significant in the context of their operations and the fees they charge.

In addition to the personnel spending calculated above, the total stewardship spending of the Big Three would also include the payments each of the Big Three makes to proxy advisors (including ISS and Glass Lewis) for their services. However, these payments are unlikely to affect the economic significance the Big Three's stewardship spending. Furthermore, whereas the Big Three's stewardship operations likely make some use of the materials issued by the proxy advisory firms, Big Three officers regularly stressed that they do not defer to proxy advisor conclusions, but rather make their own decisions,[88] and financial economists have empirically confirmed

[88] *See, e.g.*, Barbara Novick, *BlackRock Makes Its Own Proxy-Voting Choices*, WALL ST. J., Sept. 27, 2018, https://www.wsj.com/articles/blackrock-makes-its-own-proxy-voting-

that institutional investors with large assets under management such as the Big Three often do not follow the recommendations of proxy advisors.[89]

Table 2. Stewardship Investments Relative to Equity Investments and Estimated Fees

	BlackRock	*Vanguard*	*SSGA*
Stewardship Investment as % of Equity AUM			
Estimated Stewardship Investment ($m)	$9.9	$6.3	$3.3
Equity AUM ($m)	$3,364,184	$3,507,649	$1,835,917
Stewardship as % of Equity AUM	0.00029%	0.00018%	0.00018%
Stewardship Investment as % of Estimated Fees			
Estimated Stewardship Investment ($m)	$9.9	$6.3	$3.3
Estimated Fees & Expenses ($m)	$8,410	$3,508	$2,937
Stewardship as % of Fees & Expenses	0.12%	0.18%	0.11%

Another important dimension for assessing the levels of investment in stewardship is the amount of personnel time each of the Big Three dedicates to particular portfolio companies. To estimate this amount, we assume (conservatively) that each stewardship team member works on all weekdays other than federal holidays (i.e., they take no vacation or sick days), for a total of 250 workdays per year. We also assume (again conservatively) that stewardship personnel spend 100% of their time on "pure" stewardship and no time at all on other activities, such as administration, training, and reporting.

To estimate the amount of personnel-time devoted to a given company we must make assumptions regarding how the Big Three allocate their stewardship time among their portfolio companies. We examine four different potential allocation scenarios. Scenario 1 assumes that the Big Three

choices-1538075415. *See also* BlackRock, *Proxy Voting and Shareholder Engagement FAQ* Feb. 2019 3 ("We do not follow any single proxy advisor's voting recommendations").

[89] For evidence that many large investment managers do not follow the recommendations of proxy advisors ISS or Glass Lewis, see Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds*, SSRN Scholarly Paper ID 3124039 13 (Social Science Research Network), Feb. 14, 2018; Novick et al., *supra* note 29, at 10–11.

divide their stewardship resources equally among all of their portfolio companies. Because our focus is on understanding the quality of corporate governance in U.S. public companies, Scenario 2 assumes (conservatively) that the Big Three spend 75% of their stewardship resources on U.S. portfolio companies (even though those companies constitute less than 25% of each manager's total portfolio companies). Because index fund managers are likely to allocate more stewardship time to portfolio companies where their investments are larger, Scenario 3 calculates how much time and investment the Big Three make for each $1 billion equity position in their worldwide portfolios, and Scenario 4 calculates the stewardship time and investment for each $1 billion equity position in U.S. public companies (again assuming that the Big Three devote 75% of their stewardship resources to U.S. companies).

For each of these four scenarios Table 3 provides estimates of the amount of personnel time and the dollar cost of this personnel time that the Big Three allocate to stewardship. Table 3 indicates that, no matter the scenario, each of the Big Three spends very limited resources on stewardship—either in personnel time or in dollar cost—per portfolio company, including for positions of significant monetary value. Even under the most conservative assumptions, each of the Big Three spends less than 3.5 person-days each year, and less than $4,000 in stewardship costs, to oversee each billion-dollar investment.

To be sure, it is possible to conceive of many other scenarios for allocating personnel time among portfolio companies. These could include scenarios in which the Big Three devote more time to companies that are the target of hedge fund activists and correspondingly less time to the (many more) companies that are not targeted by hedge fund activists, scenarios in which the Big Three devote more time to companies that have been afflicted by scandals, or that have experienced poor financial performance, and correspondingly less time to the (many more) companies that haven't experienced such troubles. While these scenarios would obviously involve shifting personnel time from some companies to others, they would not affect the aggregate personnel resources devoted to stewardship by each of the Big Three reported above. The question we consider is whether these aggregate resources are sufficient for effective stewardship.

Table 3. Stewardship Per Portfolio Company

	BlackRock	*Vanguard*	*SSGA*
Stewardship Time (Person-Days)			
Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)	0.48	0.28	0.16
Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company	1.52	1.00	0.55
Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide	2.45	1.50	1.50
Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies	3.17	1.84	1.69
Stewardship Investment ($)			
Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)	$572	$333	$190
Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company	$1,818	$1,197	$658
Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide	$2,943	$1,796	$1,797
Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies	$3,805	$2,213	$2,025

(b) Assessing Stewardship Investment Levels. Recall the factors that provide the Big Three with incentives to under-invest in stewardship relative to what would be desirable for their beneficial investors. Given that each of the Big Three holds positions of about 5% or more in a very large proportion of U.S. companies,[90] with many of these positions worth more than $1 billion, it would be in the interest of index fund investors for those portfolio companies to receive significant time and attention from the Big Three's stewardship personnel.

Recall the example, discussed in Subsection I.D.1, of an index fund portfolio with a sole owner-manager and a $1 billion investment in a particular portfolio company. In that case it would be value-maximizing to spend up to $1,000,000 if such spending could bring about a 0.1% increase in value. However, as we discussed in Section I.D, an index fund manager that has a fractional fee of 0.5% of assets under management would have an incentive to spend up to $5,000 on stewardship. The concerns raised by this analysis are reinforced by the evidence presented in Table 3. The levels of

[90] See Table 7, *infra*.

stewardship described in Table 2 and Table 3 would enable only limited and cursory attention to a large majority of the Big Three's portfolio companies, including those where they hold positions of significant monetary value.

In assessing these concerns, we note that evaluation of the governance and performance of each public company requires reviewing hundreds of pages of documents, at a minimum. These include (i) the annual report and proxy statement, (ii) the company's long term plans and performance; (iii) executive compensation arrangements; and (iv) management proposals and shareholder proposals going to a vote. Investors with large stakes may also want to review other materials, such as analyst reports and proxy advisory assessments.

We consider two possible responses to the above concerns. First, it could be argued that our analysis of per-company personnel time assumes that a certain amount of time must be spent with respect to every portfolio company, whereas in fact many portfolio companies—such as those that do not face a crisis, a performance problem, or a governance failure—may not require any attention or investment in personnel time. The time saved by ignoring these companies could be devoted to those companies that are facing a crisis, underperformance, or a corporate governance failure.[91] We take a different view, that managers of a large stake in a public company should reasonably follow the activities of the company, and take informed actions with respect to the company, even when no obvious problems with the company, its performance, or its governance have come to light. Relying on others to identify problems with the company means that many problems with portfolio companies may go undiscovered. This is especially the case since the Big Three will generally be among the largest shareholders in the company, and so would have to rely on smaller and potentially less-well-resourced shareholders to identify these problems.

Second, it could be argued that the economies of scale from dealing with many portfolio companies with similar problems allows the Big Three to spend much less time on any individual company.[92] When the stewardship staff of a Big Three manager studies an issue that arises in numerous companies, so the argument goes, the staff can apply their conclusions to all of those many companies, thereby spreading the cost of their study. However, even with the use of some generally applicable insights, effective stewardship also requires considering detailed, company-specific information, and using it to make adjustments to general policies.

Consider decisions whether to vote in favor or against a company's

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[91] We are grateful to Mark Roe for stressing the need to respond to this objection.

[92] For versions of this argument, *see, e.g.*, Eckstein, *supra* note 86, at 29; Fisch et al., *supra* note 16, at 7; Rock & Kahan, *supra* note 16, at 35.

executive compensation arrangements at the company's annual meeting.[93] Clearly, researching compensation arrangements at many companies gives index fund manager staff members experience and expertise that might reduce the average time they require need to make each individual voting decision. However, an effective voting decision with respect to a compensation arrangement requires staff members to first obtain and assess information about the details of the company's financial performance and compensation arrangements from the company's disclosure documents, and possibly to compare them to the compensation arrangements of relevant peer companies.

Alternatively, consider index fund managers' decisions regarding whether companies have appropriate mechanisms for dealing with various legal and compliance risks. According to one supporter of index fund stewardship, Assaf Eckstein, these decisions offers a good example of an activity that involves substantial economies of scale, and could therefore be effectively and inexpensively carried out by a Big Three manager holding positions in many companies.[94] However, the monitoring necessary for these decisions cannot be effectively carried out based only on cursory examinations using general principles. Instead, it would require obtaining and assessing detailed company-specific information.[95]

We agree that for the Big Three it would be optimal for their beneficial investors for them to undertake such activities for the vast number of companies in which they have positions worth hundreds of millions of dollars or more. However, our analysis above which indicates how little time per company these investors devote to stewardship indicates that they cannot undertake such activities, or undertake them in more than a perfunctory fashion, for such a large number of companies.

We do not doubt that some stewardship activities of the Big Three may produce benefits in a large number of companies for a small per company cost, producing a relatively large impact for the amount spent. For example, the Big Three's proxy voting guidelines, and their materials expressing their

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[93] We are grateful to John Coates for suggesting that we consider the presence of economies of scale in making these decisions.

[94] For such an argument, see Eckstein, *supra* note 86, at 29.

[95] For examples of what such stewardship activities would be necessary in the context of the Foreign Corrupt Practices Act, see *Id.* (listing the steps necessary to "make sure that companies have adopted policies and procedures designed to prevent prohibited conduct", including, for pharmaceutical companies, "the establishment of a system to monitor transactions with members of the healthcare community, an improved anti-corruption training program, a third-party due diligence program, independent control functions, creating an office charged with addressing reports of misconduct and a dedicated Global Compliance Audit group; as well as improved mechanisms to ensure that no illegal influence will be made through means that seem to be legitimate such as marketing events, educational seminars and medical studies." [Footnotes omitted].)

general views on certain corporate governance matters could affect many companies for a limited per company cost. However, many other valuable stewardship activities require the steward to go beyond general principles and to make significant investments in acquiring and assessing company-specific information.

Unfortunately, the personnel resources that index fund managers currently allocate to stewardship do not enable them to devote more than a limited and cursory attention to obtaining company-specific information in most cases. As a result, the Big Three are likely to under-invest in such company-specific stewardship. The evidence about current investment levels is therefore consistent with the concerns about incentives to under-invest suggested by the agency-costs view.[96]

2. Private Engagements

Later in this Part we discuss valuable stewardship tools that are widely used by other investors, and we present evidence that index funds largely refrain from using those tools. Before doing so, however, we examine the argument that "behind-the-scenes" engagement with portfolio companies is an effective substitute for these other stewardship tools. This Subsection therefore presents and analyzes evidence on private engagement by the Big Three. Our analysis shows that, even if private engagement by the Big Three is likely to have benefits where it occurs, it cannot serve as a substitute for other stewardship tools or justify avoiding their use.

Big Three executives have stressed the central role that private engagement plays in their stewardship. For example, writings by senior officers of BlackRock state that "[t]he key to effective engagement is constructive and private communication;"[97] and that "[e]ngaging with boards and firm executives … can bring about change through incremental, non-

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[96] To take issue with the agency-costs view we put forward, Rock & Kahan, *supra* note 16, at 33–34, 42–44, argue that index fund managers have material incentives to invest in acquiring company-specific information and engage in company-specific analysis. However, they fail to engage with the evidence we provide regarding how little such managers actually invest (in terms of personnel time or monetary resources) in such activities on a per-portfolio-company basis. Rock & Kahan, *supra* note 16, also argue that index fund managers can be expected to be especially effective with respect to "recurring governance issues" that arise similarly with respect to a large number of companies in their portfolios. However, the evidence we put forward in Sections II.B.3 and II.B.4 below regarding shareholder proposals and involvement in corporate governance reforms indicates that index fund managers take surprisingly little advantage of significant opportunities to address problems that recur in a large number of companies.

[97] *See, e.g.*, BlackRock, *supra* note 87, at 2.

confrontational means."[98] Furthermore, and importantly, Big Three executives have stressed their view that private, behind-the-scenes engagement is a *superior* stewardship tool.

Vanguard's senior officers referred to private engagement as the "perhaps more important … component of [Vanguard's] governance program," indicating that it "provides for a level of nuance and precision that voting, in and of itself, lacks," and that "engagement is where the action is."[99] Similarly, a senior BlackRock officer has stated that "meetings behind closed doors can go further than votes against management."[100] Supporters of index fund governance have also asserted the significance of the private engagement channel.[101]

However, even fully accepting the views of Big Three executives and index fund stewardship supporters regarding the paramount benefits of private engagement where it occurs, any assessment of the significance of the private engagement channel requires an evaluation of the scale and nature of those private engagements undertaken by the Big Three. The Big Three Stewardship Reports indicate that these managers conduct private communications with hundreds of companies, and supporters of index fund stewardship have highlighted these absolute numbers.[102] However, the number of companies with which the Big Three privately engage should be examined in relation to the very large number of the Big Three's portfolio companies.

Table 4 reports the percentage of their portfolio companies with which each of the Big Three companies had zero engagement in the one-year period covered by their Stewardship Reports:[103] 89% for BlackRock, 83% for Vanguard, and 90% for SSGA. Table 4 also indicates that, for the small minority of portfolio companies with which the Big Three did undertake private engagement, most of those engagements were limited to a *single* conversation during the year. In only a very small percentage—3.5% of portfolio companies for BlackRock, 7% for Vanguard, and less than 1% for SSGA—did the engagement include more than a single conversation. Thus,

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[98] *See, e.g.,* Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 392, 396 (2015–2016).

[99] Glenn Booraem, *Passive Investors, Not Passive Owners*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (May 10, 2013), https://corpgov.law.harvard.edu/2013/05/10/passive-investors-not-passive-owners/.

[100] Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J., Oct. 24, 2016, http://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101.

[101] *See, e.g.,* Fisch et al., *supra* note 16, at 25.

[102] For writings stressing the absolute number of engagements, see, e.g., Eckstein, *supra* note 86, at 44–45.

[103] BlackRock's and Vanguard's Annual Stewardship Reports are for the year ended June 30, 2017; SSGA's Annual Stewardship Report is for the 2016 calendar year.

for the large majority of cases in which there was no engagement, private engagement cannot be argued to have provided a substitute for the use of other stewardship tools.

Table 4. Private Engagement

	BlackRock	*Vanguard*	*SSGA*
Portfolio Companies with No Engagement	89.3%	82.8%	90.4%
Portfolio Companies with Engagement:			
Portfolio Companies with Engagement Limited to a Single Conversation	7.2%	10.3%	8.9%
Portfolio Companies with Engagement including more than a single conversation	3.5%	6.9%	0.7%
Total Portfolio Companies with Engagement	10.7%	17.2%	9.6%

Furthermore, even in those cases in which private engagement does occur, there are reasons for concern that the effectiveness of such private engagement is reduced by the Big Three's reluctance to use other stewardship tools. For example, private communication by a Big Three manager in favor of a given change—either a strategic change, or a governance change like moving to majority voting or annual elections—would make clear to corporate managers that a substantial shareholder supported the change. However, if corporate managers expected that failing to make the change would cause the Big Three manager to nominate director candidates or submit a shareholder proposal they would presumably be more likely to make the change.

Conversely, current expectations that the Big Three manager will not take such actions if corporate managers fail to make such a change (as we discuss below) makes private engagement less effective than it could be. Thus, not only can private engagement not be a substitute for other tools, given the small minority of cases in which it takes place, but refraining from using other tools can also be expected to weaken the effectiveness of the private engagements that do take place.

3. Focusing on Divergence from Governance Principles

This Subsection focuses on the substantial extent to which the Big Three's stewardship activities diverge from governance principles. The practice of comparing the practices and arrangements of portfolio companies with general governance principles is commonly referred to as "check-the-box" governance.[104] As we explain below, focusing on divergence from governance principles serves certain private incentives of index fund managers. To be sure, it may sometimes be desirable for investors to make decisions based on how company activities vary from general governance principles. However, as we explain below, some value-maximizing stewardship decisions require additional company-specific information that goes beyond check-the-box stewardship.

Consider the proxy voting guidelines that the Big Three follow in determining whether to support incumbent directors standing for reelection or to withhold their support. Each of the Big Three's guidelines lists situations and conditions that would lead to a withhold vote. Our review of these guidelines indicates that, for each of the Big Three, the important decision whether to support a director or withhold support is based exclusively on the existence or absence of certain divergences from best governance practices.

For example, Vanguard's proxy voting guidelines call for withholding votes from one or more directors, if, among other things:

- A majority of directors are not independent;
- Members of the audit, compensation, nominating and governance are not independent;
- A director who is also a named executive officer sits on more than one outside public company board;
- A director serves on five or more public company boards;
- For non-controlled companies, management's proposed slate does not result in a majority board independence;
- Key committees are not 100% independent;
- The board proposes the reappointment of a director who failed to receive majority support;
- Unilateral board actions have meaningfully limited shareholder rights;
- Egregious pay practices arise, or there has been low say on pay support without meaningful improvements to executive compensation;
- The board has not adequately responded to shareholder proposals that received majority support;

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[104] For uses of such a label, see, e.g., Martin Lipton, *Corporate Governance: The New Paradigm*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 11, 2017), https://corpgov.law.harvard.edu/2017/01/11/corporate-governance-the-new-paradigm/; Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 908, 918 (2006–2007); Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 134 (2016); ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 172 (2011).

- Directors who have failed to address material risks and business practices under their committee's purview;
- Where non-audit fees exceed audit-related fees;
- Where there have been multiple years of material accounting misstatements or audit weaknesses without sufficient remedies; or
- A director has attended less than 75% of the previous year's board/committee meeting, absent extenuating circumstances.[105]

BlackRock and SSGA's approaches differ in some details but are similarly based on comparison with best governance practices.[106]

The Big Three Stewardship Reports indicate that the Big Three's private, behind-the-scenes engagements—when they do occur—also focus on companies that diverge significantly from desirable governance principles. For example, SSGA indicates that its engagement seeks to provide "principles-based guidance."[107] BlackRock indicates that its engagement might occur when a company lags behind its peers on environmental, social, or governance matters; when it is in a sector with a thematic governance issue material to value; or for other reasons that do not include financial underperformance.[108] Vanguard in turn states that its stewardship focuses on board composition issues, governance structures, executive compensation, and risk oversight.[109]

In assessing this focus on divergence from governance principles, we do not question the relevance of such divergences for voting or engagement decisions. It is clearly valuable to take information regarding such divergences into account. However, in our view, value-maximizing decisions on these matters would also require consideration of other types of information. As we discuss in Subsections B.1 and B.2 below, value-maximizing voting and engagement decisions would also incorporate detailed information about the business performance of the portfolio company and the qualifications, expertise, and experience of its directors.

Importantly, the proxy voting guidelines of the Big Three call for consideration of detailed company-specific information regarding business performance and the characteristics of particular directors in the case of proxy contests involving an outside challenger. For example, in contested director

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[105] *See* Vanguard, *Vanguard's Proxy Voting Guidelines*.

[106] *See* BlackRock, *Proxy Voting Guidelines for U.S. Securities* (2018); State Street Global Advisors, *2018 Proxy Voting and Engagement Guidelines: North America* Mar. 2018.

[107] *See, e.g.*, State Street Global Advisors, *supra* note 9, at 3.

[108] BlackRock, *supra* note 87, at 3.

[109] Vanguard Annual Stewardship Report, *supra* note 20, at 7.

elections, Vanguard's proxy voting guidelines call for a "case-by-case" decisions based on considerations including "[h]ow has the company performed relative to its peers," and the extent to which the incumbent directors are "well-suited to address the company's needs" compared with the directors proposed by the challenger.[110]

Although focusing divergence from governance principles may not be value-maximizing for an index fund's beneficial investors, we note that it could well serve the private interests of the index fund's managers that we analyzed in Part I, for two reasons. First, The focus on divergence from governance principles enables an index fund manager to avoid focusing significantly on issues such as business performance and the individual characteristics of directors. Assessing these issues would require detailed company-specific information. Focusing on governance principles thus serves the interests of the Big Three in limiting investments in stewardship. For instance, a single staff member can assess compliance or divergence relative to governance principles at dozens—or hundreds—of portfolio companies. Second, focusing on compliance or divergence relative to governance principles that enjoy broad support avoids the need to make many discretionary decisions or contestable judgements. Instead, the Big Three's decision making is supported by governance best practices that are broadly supported. This makes their use of their power less salient, and thus reduces the risk of backlash.

4. Voting Decisions

Our analysis in Part II raises concerns that the Big Three index fund managers have incentives to be excessively deferential to corporate managers when they vote, especially with respect to issues affecting managers' authority and private interests. This Subsection reviews the Big Three's voting record on these issues.[111] We show that it is consistent with, and can be explained by, the theoretical predictions of our agency-costs view.

We consider voting on two issues that are likely to be closest to the hearts of corporate managers: executive compensation and proxy fights. Starting with compensation, Table 5 provides evidence of the incidence of "no" votes

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[110] Vanguard, *supra* note 105, at 5–6.

[111] The results we presented here are consistent with three current papers on mutual fund voting more generally. *See* Bubb & Catan, *supra* note 89; Patrick Bolton et al., *Investor Ideology*, SSRN Scholarly Paper ID 3119935 (Social Science Research Network), Feb. 7, 2018; and Davidson Heath et al., *Passive Investors Are Passive Monitors*, SSRN Scholarly Paper ID 3259433 (Social Science Research Network), Oct. 26, 2018. Consistent with our results, those papers find that index fund managers are more likely to vote with management than other mutual funds.

by each of the Big Three in say-on-pay votes at S&P 500 companies in each full year since the 2011 adoption of a say-on-pay mandate in the Dodd-Frank Act.[112] As Table 5 indicates, each of the Big Three very rarely opposed such votes, doing so in only 3.2% of cases on average.

Table 5. Big Three "No" Votes in S&P 500 Say-on-Pay Votes

	BlackRock	*Vanguard*	*SSGA*	*Avg.*
2012	2.5%	3.6%	3.1%	3.1%
2013	2.3%	2.1%	4.2%	2.9%
2014	2.3%	2.9%	6.4%	3.9%
2015	1.0%	1.8%	4.5%	2.4%
2016	2.0%	1.8%	5.1%	3.0%
2017	3.6%	3.3%	5.9%	4.3%
Avg.	2.3%	2.4%	4.9%	3.2%

Of course, this pattern is only suggestive and does not provide irrefutable evidence of excessive deference. It could be argued that the general support by index fund managers for say-on-pay proposals reflects the optimality of executive pay arrangements in the vast majority of S&P 500 companies. At a minimum, however, index funds' general support for executive pay in the vast majority of these companies is consistent with the deference predictions of the agency-costs view.

Another voting decision of significant importance to incumbents is whether to support the company's slate of directors in contested elections.[113] A recent study by finance Professors Brav, Jiang, and Li finds that index funds voted against hedge fund dissidents more often than did other types of investment funds, to an extent that is economically and statistically significant.[114] This evidence is also consistent with, and could be explained by, the deference predictions of our incentive analysis.

[112] Dodd–Frank Wall Street Reform and Consumer Protection Act § 951 (2010) (adding to the Securities Exchange Act of 1934 § 14A, 15 U.S.C. § 78n–1 (2018)). Table 5 is based on say-on-pay data from the Proxy Insight database (accessed July 27, 2018) [hereinafter, "Proxy Insights"] and S&P 500 constituent data from Compustat.

[113] Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests*, SSRN Scholarly Paper ID 3101473 35, figure 1A (Social Science Research Network), Dec. 8, 2017.

[114] *Id.* at 19.

B. What the Big Three Fail to Do

1. Attention to Business Performance

Enhancing the financial returns of portfolio companies is an important objective for index fund investors. Those investors would benefit from stewardship that identifies underperforming portfolio companies, analyzes changes that could improve their performance, and uses the substantial voting power of the Big Three to bring about such changes. In discussing his view that index funds offer "the best hope for corporate governance," Vanguard's founder Jack Bogle stressed that "the new index fund rule is that if you don't like the management, fix the management because you can't sell the stock."[115] However, as we discuss in this Subsection, in the vast majority of companies in which a hedge fund activist is not agitating for change, the Big Three pay little attention to the extent of financial or business underperformance or how such underperformance could be remedied. As Bogle explained, when an investor cannot sell the stock, remedying such underperformance by "fix[ing] management" is the natural route for the investor.

Consider the important decisions that index funds make in the vast number of companies that hold uncontested elections in any given year—whether to vote for the incumbent directors up for election, or to withhold votes. As we explained in Subsection **Error! Reference source not found.**, e ach of the Big Three's proxy voting guidelines makes the decision to withhold votes conditional entirely on certain specified divergence from governance principles. Importantly, our review of the Big Three's guidelines indicates that none of them lists financial underperformance, no matter how severe or persistent, as a basis for withholding votes from directors.

Similarly, as we discussed in Subsection A.2, the Big Three Stewardship Reports indicate that the Big Three's private, behind-the-scenes engagements—in those relatively infrequent cases in which they do occur—focus on addressing significant divergence from desirable governance principles. Importantly, these private engagements do not target or focus on business underperformance. We reviewed all of the examples of behind-the-scenes engagements described in the Big Three Stewardship Reports. We found *zero* cases where engagement was motivated by financial underperformance. To be sure, some Big Three engagements follow interventions by activist hedge funds seeking to improve performance and focus on those interventions.[116] However, in those cases the Big Three did not themselves identify underperformance, but merely reacted to activist

[115] Benz, *supra* note 12.
[116] Vanguard, *supra* note 37, at 7.

hedge funds doing so and proposing to address it.

Writers supportive of index fund stewardship seek to justify their limited attention to financial underperformance by arguing that index fund managers "generally lack the expertise and access to information to identify operational improvements that should be implemented to improve the performance of companies in their portfolio."[117] However, because such arguments take such lack of "in-house expertise" as a given, they fail to recognize that it is a product of the decisions made by index fund managers. Index fund managers have the resources to obtain or develop any in-house expertise that they might consider desirable.

Indeed, given the hundreds of companies in which the Big Three hold positions of $1 billion or more, the interests of their beneficial investors could be well served by adding in-house personnel with financial expertise. Adding a sufficient number of such personnel could allow the Big Three to identify severe or persistent underperformance at particular portfolio companies. Once such underperformance is identified, those personnel could generate proposals for improving performance through changes in corporate leadership or strategy, and they could facilitate those changes using the Big Three's power and influence. Why then do the Big Three not employ such personnel on the significant scale that their holdings warrant? The lack of such personnel is consistent with, and can be explained by, the agency-costs view of index fund stewardship.

Some could argue that index fund managers do not need to pay attention to financial underperformance as they can count on activist hedge funds to bring such underperformance to the attention of other investors, and to initiate proposals for improving performance.[118] However, companies often underperform for several years before an activist emerges to push for change.[119] The interests of index fund investors are therefore not served by ignoring underperformance in the hope that an activist hedge fund may one day address it.

Furthermore, as we discuss in Subsection III.B.2, activist hedge funds

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[117] Fisch et al., *supra* note 16, at 15, fn. 76. *See also* Charles M. Nathan, *Institutional Investor Engagement: One Size Does Not Fit All*, The Conference Board (Jul. 18, 2018), https://www.conference-board.org/blog/postdetail.cfm?post=6826 (explaining that the Big Three's stewardship teams "are principally focused on big picture environmental, social, and governance (ESG) issues [and they] lack the skill-sets and manpower necessary to deal in depth with company specific issues of strategy design and implementation, capital allocation, M&A opportunities, and operational and financial performance.")

[118] For one such argument, see Gilson & Gordon, *supra* note 17, at 897–98.

[119] A study co-authored by one of us shows empirically that activist targets underperform significantly during the three years prior to the emergence of an activist hedge fund, see Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1125 (2015).

have incentives to engage only when performance problems are very large and can be fixed quickly. The interests of index fund investors would be served by having other performance problems addressed as well. Thus, while the work of activist hedge funds often provides benefits to index fund investors, it cannot fully substitute for work that index fund managers could do themselves to address financial underperformance. Index fund managers largely avoid such work at the moment, even though it could provide index fund investors with significant additional benefits.

2. Influencing Director Identity and Taking on Rule 13D Status

Directors matter. Their characteristics, background, and experience have considerable influence on the governance and performance of companies. The Big Three's governance principles impact the selection of directors, such as by discouraging the selection of directors who did not consistently attend past board meetings, and encouraging gender diversity among directors. However, among the very many potential directors that would comply with the Big Three's principles, some candidates would clearly be better choices than others given the particular portfolio company's circumstances and needs.

A board with governance processes that accord completely with the Big Three's standards may sometimes select one or more individuals who are not well suited to the company's needs, or fail to select individuals likely to improve board performance. When the Big Three hold large stakes in such a company, their beneficial investors would be served by the index fund managers identifying when changes to the individuals on the board are desirable and facilitating those changes. Those changes might not require the index fund manager to be represented on the board—adding or removing one or more independent directors could be sufficient.[120]

In this Subsection we therefore examine whether the Big Three do in fact seek to influence the selection of directors of their portfolio companies. We examine both (i) formal nominations of directors, and (ii) mere communications to portfolio companies suggesting that particular directors be added or removed. We find that the Big Three appear to avoid both types of activities.

We begin by gathering data on director nominations. Table 6 shows that there were approximately 2,400 director nominations at U.S. companies from

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[120] For evidence that activist hedge funds often seek to improve value in their portfolio companies by introducing new independent directors, see Lucian A. Bebchuk et al., *Dancing with Activists*, SSRN Scholarly Paper ID 2948869 (Social Science Research Network), Apr. 1, 2017.

2008 to 2017.[121] Our review of these nominations indicates that *not a single nomination* was made by any of the Big Three.

Table 6. Actual and Proposed Director Nominations

Year	*Director Nominations*
2008	255
2009	235
2010	190
2011	177
2012	206
2013	198
2014	229
2015	266
2016	195
2017	209
Total	2,373

Even though the Big Three did not formally nominate any directors it is possible that they may have suggested that particular directors be added or removed. To evaluate whether this was the case we reviewed the examples of engagements described in their Stewardship Reports. Our review indicates that such communications were not part of any of the numerous engagements with named companies and examples of engagements with unnamed companies in the Stewardship Reports.

We examine this issue more systematically by gathering data on positions of 5% or more held by the Big Three in Russell 3000 companies from 2008 to 2017.[122] As Table 7 indicates, the incidence of Big Three positions of 5% or more was large and increasing throughout the period, reaching more than 4,500 such positions in 2017.

[121] Table 6 is based on S&P Dow Jones Indices data from Compustat and director nomination data from SharkRepellent.net.

[122] Table 7 is based on institutional ownership data from FactSet Ownership, investment manager rankings data from the Pensions & Investments 2018 Survey of Money Managers (accessed July 11, 2018) [hereinafter, "Pensions & Investments"], Russell US Index constituent data from FTSE Russell; data on S&P Dow Jones Indices from Compustat, and data on Schedule 13D filings from SharkRepellent.net.

Table 7. Big Three Positions of 5% or More

	BlackRock	*Vanguard*	*SSGA*	*Total*
2008	1,175	31	83	1,289
2009	1,383	83	71	1,537
2010	1,464	176	82	1,722
2011	1,495	438	107	2,040
2012	1,629	833	153	2,615
2013	1,818	992	173	2,983
2014	1,926	1,283	210	3,419
2015	2,038	1,489	150	3,677
2016	2,281	1,631	200	4,112
2017	2,454	1,839	221	4,514

As we discussed in Section I.E, an index fund manager with a block of 5% or more must file on Schedule 13D if its activities have the purpose or effect of influencing the identity of the individuals serving on the board.[123] We therefore gathered data on Schedule 13D filings over the same period.

We find that none of the Big Three made a single Schedule 13D filing from 2008 to 2017 even though they held thousands of positions of 5% or more in portfolio companies. This evidence supports our analysis in Subsection I.E.3 concerning the Big Three's incentives to avoid filing on Schedule 13D. Furthermore, this evidence indicates that the Big Three refrain from communications about particular individuals who they believe should be added to or removed from boards of directors in the vast number of cases where one or more of the Big Three had positions of 5% or more in portfolio companies.

It could be argued that the Big Three do not need to engage with companies about adding or removing particular directors because activist hedge funds take on this role. However, the Big Three's views on optimal board members likely differ from those of activist hedge funds. For example, SSGA has criticized portfolio companies that reach settlement agreements with activist hedge funds to add directors favored by activists without consulting other investors.[124] The best way for the Big Three to increase the likelihood that underperforming companies would make director additions

[123] 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1(b) (2017).

[124] *See* State Street Global Advisors, Protecting Long-Term Shareholder Interests In Activist Engagements (2016).

that are consistent with their views regarding value-maximization would be for a Big Three manager itself to communicate with its portfolio companies about the particular directors they believe would be best for the company.

The Big Three's reluctance to be involved in selecting directors is difficult to reconcile with the value-maximization view. However, it is consistent with, and can be explained by, our incentive analysis and the agency-costs view. Identifying directors who should be added or removed requires significant time and resources. Avoiding such actions is consistent with the Big Three's incentives to under-invest in stewardship, and with the limited resources they actually allocate to stewardship at particular portfolio companies. Furthermore, deference to corporate managers on the choice of directors (assuming general process requirements are met) is also consistent with the incentives that we identified for index funds to be excessively deferential to corporate managers.

3. Bringing about Improvements in Company Governance Arrangements

A widely used shareholder tool for improving corporate governance is the submission of shareholder proposals to be voted on at the company's annual meeting, generally using shareholders' rights under Securities Exchange Act Rule 14a-8.[125] Shareholder proposals advocating governance changes that receive majority support commonly lead to companies adopting such changes.[126] When governance changes are widely viewed by investors as best practice, shareholder proposals advocating such changes have been very successful in bringing those changes about in companies that have not yet implemented them. For example, shareholder proposals have led a large number of public companies to adopt majority voting, annual elections, and, most recently, proxy access—all governance arrangements that have received broad support from investors.[127] As Table 8 indicates, almost 4,000 shareholder proposals were submitted between 2008 and 2017 to companies in the Russell 3000 index.[128]

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[125] 17 C.F.R. 240.14a-8 (2017).

[126] For empirical evidence, see Yonca Ertimur et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 54 (2010).

[127] For empirical evidence, see *Id.* (regarding majority voting); Emiliano Catan & Michael Klausner, *Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Value?*, SSRN Scholarly Paper ID 2994559 2 (Social Science Research Network), Sept. 1, 2017 (regarding declassification); and Tara Bhandari et al., *Governance Changes through Shareholder Initiatives: The Case of Proxy Access*, SSRN Scholarly Paper ID 2635695 22 (Social Science Research Network), Jan. 17, 2017 (regarding proxy access).

[128] Table 8 is based on Russell 3000 constituent data from FTSE Russell and shareholder proposal data from SharkRepellent.net. We exclude social responsibility proposals, and proposals that are part of proxy contests.

Table 8. Submission of Shareholder Proposals

Year	*Shareholder Proposals*
2008	409
2009	477
2010	456
2011	310
2012	359
2013	344
2014	300
2015	396
2016	322
2017	261
Total	3,912

The Big Three have consistently supported shareholder proposals to adopt governance arrangements that they view as beneficial, and they continue to do so. For example, each of the Big Three has consistently voted for shareholder proposals seeking to replace staggered boards with annual elections.[129] The Big Three's voting guidelines also indicate that they will generally vote in support of proposals to introduce annual elections, majority voting, and proxy access.[130]

Many of the Big Three's portfolio companies have not yet adopted these arrangements. Given that the Big Three focus on governance arrangements in general, their support for these arrangements in particular, and the effectiveness of shareholder proposals in obtaining such arrangements, it would be natural to expect them to make extensive use of shareholder proposals at those companies.

Do they do so? Table 8 shows the number of shareholder proposals submitted to companies in the Russell 3000 index between 2008 and 2017.[131] Our review of these almost-4,000 shareholder proposals did not identify a single proposal submitted by any of the Big Three.

[129] For evidence of such support, see Catan & Klausner, *supra* note 127, at 2.

[130] *See* BlackRock, *supra* note 106, at 2–6; Vanguard, *supra* note 105; State Street Global Advisors, *supra* note 106, at 2–4.

[131] Table 8 is based on Russell 3000 constituent data from FTSE Russell and shareholder proposal data from SharkRepellent.net. We exclude social responsibility proposals, and proposals that are part of proxy contests.

It might be argued that the Big Three have no need to submit shareholder proposals because all the proposals that would serve the interests of their beneficial investors are already being submitted by others. However, many shareholder proponents have much more limited resources than the Big Three. As a result, many proposals that the Big Three would support are not submitted at all, or are submitted only after a delay of many years.

To illustrate, a large proportion of the Big Three's portfolio companies that lack annual elections, majority voting, or the ability for shareholders to call special meetings—all arrangements called for by the Big Three's voting guidelines[132]—have yet to receive shareholder proposals calling for such arrangements. Any of the Big Three submitting proposals advocating those changes would likely have led to their adoption by many companies.

The Big Three's practice of voting consistently for shareholder proposals advocating certain changes yet never initiating such proposals is difficult to reconcile with the value-maximization view. However, this reactive-not-proactive approach is consistent with, and can be explained by, the agency-costs view. Whereas corporate managers have come to expect and accept the Big Three voting reactively for shareholder proposals advocating changes consistent with governance best practices, corporate managers might view the proactive submission of proposals as adversarial or even confrontational.

By refraining from submitting shareholder proposals, the Big Three enable many portfolio companies to maintain governance arrangements that are inconsistent with the Big Three's governance principles. As a result, consistent with the agency-costs view, the Big Three's stewardship activities serve their beneficial investors significantly less than they could.

4. Staying on the Sidelines of Corporate Governance Legal Reforms

The Big Three's beneficial investors would benefit from having their index fund managers contribute to corporate governance reforms that are likely to have a material effect on their portfolio companies. The Big Three could serve their investors' interests by either facilitating desirable rule changes or impeding undesirable changes. Commentators have long observed that index fund investors have an especially keen interest in rule changes that could enhance the value of a large number of companies, even by a small amount.[133] Indeed, given the Big Three's focus on governance practices,

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[132] *See* note 130, *supra*, and accompanying text.

[133] *See, e.g.*, Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 867 (1990–1991) ("indexed institutional investors should seek a corporate governance system that … can improve the performance of all companies.").

supporters of index fund stewardship have argued that the Big Three are well-positioned to contribute in this way.[134]

In this Subsection we provide empirical evidence about two key ways in which institutional investors can seek to influence legal rules regarding public companies: by commenting on SEC proposed rules regarding corporate governance, and by filing amicus curiae briefs in significant precedential litigation in this field. We find that the Big Three have participated very little in either of these activities. Instead, our analysis reveals what can be viewed as a pattern of the Big Three systematically staying on the sideslines on those decisions and generally avoiding expressing any position or preference with respect to SEC proposals and judicial precedential decisions under consideration. We explain that systematic staying on the sidelines does not serve the interests of the beneficial investors in index funds, but is consistent with the private incentives of index fund managers.

(a) SEC Comment Letters. By submitting comments on proposed SEC rules, commenters can influence SEC rulemaking. Under the value-maximization view, since the Big Three hold more than 20% of corporate equities, they should be expected to frequently express their views on proposed SEC rules. Clearly, when a Big Three manager views a proposed SEC rule as desirable or undesirable, submitting a comment would help increase the value of portfolio companies, or avoid value decreases. Furthermore, even if the index fund manager viewed a proposed rule as practically insignificant for investor interests, expressing this view could still benefit the manager's beneficial investors by directing the SEC's limited resources and attention to changes with greater potential to benefit investors.

We hand-collected (from the SEC website) and reviewed all comments on SEC proposed rules regarding corporate governance (80 proposed rules in total). As Table 9 indicates, each of the Big Three submitted comments on only one or two of the 20 proposed rules that attracted the most comments.[135] By comparison, the largest two asset owners, CalPERS and CalSTRS, whose assets are largely indexed but very small compared to those managed by the Big Three, submitted comments on 7 (CalPERS) and 11 (CalSTRS) proposed rules.

A similar picture emerges when we examine the larger set of proposed rules that received relatively less attention. Of those 60 proposed rules, each of the Big Three submitted comments with respect to no more than four rules

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[134] *See, e.g.*, Fisch et al., *supra* note 16, at 15; Eckstein, *supra* note 86, at 42.

[135] Table 9 is based on an analysis of comments collected from the webpages of proposed SEC rules, Securities and Exchange Commission, Proposed Rules, https://www.sec.gov/rules/proposed.shtml. (accessed July 13, 2018). Totals for asset owners are less than the sum of comments by CalPERS and CalSTRS as several comments were submitted jointly.

(less than 10%). In contrast, CalPERS and CalSTRS submitted comments with respect to between 8 and 16 rules.

It could be argued that another explanation for our findings is that the Big Three consider filing comments with the SEC to be a futile exercise, since they may expect them to have little effect on the SEC's decisions. In this view, the submission of many comments by others, rather than the infrequent submission of comments by the Big Three, should be viewed as surprising or irrational.[136] However, even if we accept that the average comment submitted by investors would have limited effect on SEC decisions, that is unlikely to be the case for a comment filed by one of the Big Three. Instead, if one or more Big Three manager took a clear position on proposed SEC rule, the trillions of dollars of their equity investments, and the breadth of their investments across all significant public companies, would likely give substantial weight to their comment, and cause the SEC to give it significant attention. We note that views expressed by the Big Three on corporate governance matters commonly attract substantial attention and commentary from prominent advisory firms, the media, and other institutional investors.

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[136] We are grateful to Steven Davidoff Solomon and Stephen Fraidin for suggesting that we respond to this potential objection.

Table 9. Involvement in SEC Proposed Rules Regarding Corporate Governance

	Index Fund Managers				*Asset Owners*		
	BlackRock	*Vanguard*	*SSGA*	*Total*	*CalPERS*	*CalSTRS*	*Total*
Most Commented 25% of Proposed Rules (20)							
Comments	1	4	2	7	16	11	26
Comments per Proposed Rule	0.05	0.20	0.10	0.35	0.80	0.55	1.30
Proposed Rules Commented On	1	2	2	5	11	7	17
Proportion of Proposed Rules Commented On	5%	10%	10%	25%	55%	35%	85%
Remaining 75% of Proposed Rules (60)							
Comments	2	4	1	7	10	11	20
Comments per Proposed Rule	0.03	0.07	0.02	0.12	0.17	0.18	0.33
Proposed Rules Commented On	2	4	1	7	9	8	16
Proportion of Proposed Rules Commented On	3%	7%	2%	12%	15%	13%	27%

(b) Amicus Curiae Briefs in Precedential Litigation. Supporters of index fund stewardship have claimed that "institutional investors now regularly file amicus briefs",[137] noting an amicus brief that BlackRock filed on the issue of marriage equality for same-sex couples.[138] However, although the subject of same-sex marriage is clearly important, it does not involve a corporate governance issue. We therefore examine the submission of amicus briefs in cases important for protecting and enhancing the value of index fund portfolios. Table 10 presents data from 2008 to 2017 on the ten cases of precedential litigation regarding investor protection that the Council of

[137] Fisch et al., *supra* note 16, at 27.

[138] *Id.* at 28, fn. 160 (citing a blog post as "reporting that BlackRock signed an amicus brief to the U.S. Supreme Court arguing for marriage equality for same sex couples").

Institutional Investors identified as sufficiently important to warrant the filing of an amicus curiae brief.[139] We reviewed the filings in each of these cases to identify all of the briefs submitted. Eight of the ten cases gathered a significant number of amicus curiae briefs, with six of the ten drawing between 10 and 30 briefs.

Reviewing the filed briefs, we find that the two largest asset owners, CalPERS and CalSTRS, filed their own briefs or joined the Council of Institutional Investors' brief in five of the ten cases. Their assets are largely indexed, although less than 5% of those assets under management held by the largest of the Big Three. However, none of the Big Three filed a single amicus curiae brief in any of these ten cases of precedential litigation. In these cases, the voices of the Big Three, which represent more than 20% of corporate equities, were not heard.

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[139] We are grateful to the General Counsel of the Council of Institutional Investors for providing us with this list.

Table 10. Amicus Curiae Briefs, 2008–2017

Case	*Amicus Briefs*	*Briefs by Two Largest Asset Owners*
Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008)	29	✓✓
Free Enterprise Fund v. Public Company Accounting Oversight Board, 537 F.3d 667 (D.C. Cir. 2008)	22	**
Free Enterprise Fund v. Public Company Accounting Oversight Board, 561 U.S. 477 (2010)	17	**
Merck & Co. v. Richard Reynold, 559 U.S. 633 (2010)	15	
New York State Teachers' Retirement System v. The Mercury Pension Fund Group, 618 F.3d 988 (9th Cir. 2010)	1	
Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011)	13	
Business Rountdable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011)	6	**
New Jersey Carpenters Health Fund v. RALI Series 2006-QO1 Trust, 477 Fed. Appx. 809 (2d Cir. 2012)	6	
Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 13 (2014)	25	**
Corre Opportunities Fund, LP v. Emmis Communications Corp., 792 F.3d 737 (7th Cir. 2015)	2	

✓✓ Briefs filed separately by both of the asset owners
** Brief filed by both of the asset owners, jointly with CII

Thus, although supporters of index fund stewardship have argued that the Big Three are well positioned to contribute to legal reforms affecting public companies, our evidence indicates that their activities in this regard are very modest. Indeed, the Big Three have collectively contributed fewer comments on SEC proposed rules regarding corporate governance, and fewer amicus briefs in precedential litigation, than the two largest asset owners, which have corporate equities with a value of approximately 5% of that of the largest of the Big Three.

Under the value-maximization view, more involvement should be expected from investors that collectively hold more than $5 trillion in corporate equities. However, the reluctance of the Big Three to contribute to corporate governance reforms is consistent with, and can be explained by, the incentives identified by the agency-costs view described in Part I.C. The incentives of the Big Three to defer to corporate managers discourage them from supporting reforms that strengthen shareholder rights, and their interest in reducing the salience of their deference gives them incentives not to oppose such reforms. Thus, the interests of the Big Three are likely served by generally staying on the sidelines and not lending their influential support either in favor of or against such reforms.

5. Involvement in Securities Litigation

Securities litigation provides an important instrument for deterring misconduct by corporate insiders, and for compensating investors if such misconduct occurs. The "lead plaintiff" that is selected in any securities class action plays a significant role in navigating the litigation. The lead plaintiff selects and sets compensation incentives for class counsel and oversees the terms of any settlement, including monetary recovery and prospective corporate governance changes required as part of the settlement.

Since the adoption of the Private Securities Litigation Reform Act (PSLRA) in 1995, securities law has followed a presumption that the plaintiff with the largest financial interest in a class action should be the lead plaintiff.[140] This reflects a view that it is advantageous for investors to have an institutional investor with significant "skin in the game" to play the role of lead plaintiff, because such investors have the greatest incentive and ability to monitor the litigation and ensure that it is conducted in the interest of investors.[141]

With over $5 trillion in corporate equities, the Big Three's beneficial investors have significant monetary interests in the outcome of many securities class actions. The legal rules and policies of the PSLRA suggest that the interests of these investors are best served by having the Big Three—institutional investors with very substantial skin in the game—play the role of lead plaintiffs in significant securities class actions. As lead plaintiffs the Big Three could help to ensure that the outcome of those actions would best serve investors. Among other things, they could ensure that class counsel has adequate incentives and that corporate governance reforms are part of any settlement where they are necessary. However, as we show below, the Big Three have also chosen to "stay on the sidelines" with respect to the leadership of securities litigation.

To identify the decisions made by the Big Three in this area, we examine the extent to which the Big Three served as lead plaintiffs in significant

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[140] Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(a)(3)(B)(iii).

[141] For an influential article written during the debate leading to the passage of the PSLRA that advocated having institutional investors serve as lead plaintiffs, see Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

securities cases between 2008 and 2017. Table 11 presents data that we gathered regarding the incidence of securities class actions over that period.[142] To avoid marginal cases that are more likely to be frivolous we focus on cases settled for more than $10 million, and the subset of those cases settled for more than $100 million. These cases can be expected to be brought regardless of who serves as lead plaintiff. As they are likely to take place in any event, there are significant benefits for investors from having the litigation overseen by a lead plaintiff with substantial skin in the game. Table 11 shows that 219 class actions settled for more than $10 million from 2008 to 2017, with total recovery of $24.5 billion. Of these 219 cases, 47 settled for more than $100 million, with total recovery of $18.7 billion.

Table 11. Securities Class Action Cases

Year	*Cases Settled for over $10m*	*Total Recovery in Cases Settled for over $10m ($m)*	*Cases Settled for over $100m*	*Total Recovery in Cases Settled for over $100m ($m)*
2008	58	$6,913	18	$5,282
2009	38	$6,542	7	$5,636
2010	20	$1,971	4	$1,340
2011	20	$1,711	6	$1,194
2012	20	$1,300	3	$755
2013	15	$497	1	$116
2014	29	$4,633	5	$3,979
2015	11	$463	1	$142
2016	7	$383	2	$235
2017	1	$40	0	$0
Total	219	$24,453	47	$18,679

For the reasons discussed above, the Big Three's beneficial investors could well have benefited from having their fund managers serve as lead plaintiff in some of these significant securities class actions. However, our review of the data indicates that *none* of the Big Three served as lead plaintiff in *any* of these securities class actions during the ten-year period that we

[142] Table 11 is based on securities class action settlement data from Institutional Shareholder Services' Securities Class Action Database (accessed July 16, 2018) [hereinafter, "SCAS"].

examined.

The avoidance of any lead plaintiff positions by the Big Three is in tension with the value-maximization view. However, this pattern is consistent with, and can be explained by, the agency-costs view and its incentive analysis.[143] First, the empirical pattern is consistent with the incentive to under-invest in stewardship. If an index fund manager serving as lead plaintiff in a significant class action would increase portfolio value by $1 million, doing so is efficient if it costs less than $1 million. However, if the index fund manager has a fractional share of 0.5%, serving as lead plaintiff position is not in the manager's interests if the cost exceeds $5,000.

Similarly, the avoidance of any lead plaintiff positions is also consistent with the Big Three's deference incentives. Being an effective lead plaintiff may require taking strong positions against certain corporate managers, which corporate managers may view unfavorably. At the same time, because decisions made in securities class actions are public, lead plaintiffs' decisions can be scrutinized. For a Big Three lead plaintiff to be excessively deferential toward corporate managers would make that deference more salient to outsiders. Avoiding lead plaintiff positions allows index fund managers to avoid both frictions and undesirable perceptions.

In response to our analysis it could be argued that it is not surprising that index fund managers avoid service as lead plaintiffs because serving as a lead plaintiff would not be economically worthwhile for them. However, this is exactly our point: avoiding such positions is indeed consistent with the cost-benefit analysis of the index fund manager from the index fund manager's private economic perspective, even when taking such a position would serve the interests of the index fund's beneficial investors. It is for this reason that the avoidance of lead plaintiff positions, like the other patterns documented in this Part, is consistent with the agency-costs view of index fund stewardship.

III. POLICY

Our analysis in the preceding Parts has identified the incentives of index fund managers to under-invest in stewardship and defer to corporate managers, and has put forward empirical evidence consistent with the significant influence of these incentives. In this Part we turn to the policy implications of our analysis.

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[143] For a related discussion of why large investment managers do not become lead plaintiffs, see David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907 (2013–2014) and David H. Webber, *Shareholder Litigation without Class Actions*, 57 ARIZ. L. REV. 201 (2015)

Section A discusses a number of regulatory measures that could be used to address these incentive problems, as well as some that should not be used for this purpose. In each case, we do not aim to provide a comprehensive analysis of each measure or give a blueprint for its implementation; rather, we wish to put these measures on the table for subsequent discussion as partial solutions to the considerable problems that we have identified. Our aim is also not to present an exhaustive identification of approaches that should be considered, but to highlight the availability of a range of measures for consideration and the potential benefits of reforms in this area.

We begin (in Subsection A.1) by explaining why precluding index funds from voting or requiring them to adopt "pass-through" voting should not be considered as a solution for the problems we identify. We then focus on five types of measures that should be considered, either individually or in combination: measures to encourage the use of stewardship tools by index fund managers (Subsection A.2); measures to address problems arising from business relationships (Subsection A.3); measures to bring transparency to private engagements (Subsection A.4); rethinking Rule 13D and its application to index funds (Subsection A.5); and measures to limit the scale of assets managed by each index fund manager (Subsection A.6).

In Section B we turn to the significant implications that our analysis holds for two important ongoing debates in the corporate law field. We discuss the heated debates on common ownership (Subsection B.1) and on hedge fund activism (Subection B.2). In both cases, we explain how our analysis undermines claims made in the debates, introduces new issues into the debates, and calls for revision of positions taken in those debates.

Finally, in Section C, we comment on a more direct avenue through which our analysis could impact stewardship. We argue that because index fund managers care about how their stewardship is viewed and wish to be perceived as good stewards, this is an area in which the mere recognition of incentive problems by the public might have an effect on index fund manager behavior. In particular, public recognition of the problems we analyze can induce index fund managers to make changes that would reduce the force of the problems we identify.

A. Regulatory Reforms

1. Letting Index Fund Managers Vote

Before discussing regulatory reforms that would be worthwhile for policy makers to consider, we would like to dismiss two approaches that are not worthy of further consideration. Given our analysis of the agency problems with the stewardship decisions of index fund managers, a natural response may be to suggest eliminating or reducing the power of index fund managers to make stewardship decisions.[144] In particular, we discuss below two suggestions in this direction made in current discussions: one is to "disenfranchise" index funds by precluding them from affecting the outcome of corporate votes; and the second is to require index funds to adopt pass-through voting that would enable decisions to be made by beneficial investors rather than index fund managers. We explain below in turn why we view each of these measures as unwarranted and indeed counterproductive.

(a) *Taking away the voting power of index funds*: Dorothy Shapiro Lund has made a provocative proposal to address problems with index fund stewardship by precluding index fund managers from voting.[145] Under one version of this approach, the votes associated with shares held by index funds would not count at all, which would result in an increase in the power of corporate insiders that could adversely affect all public investors. Under an alternative version designed to address this pro-insider bias, the votes associated with the shares held by index funds would be voted in the same way and in the same proportions as the votes cast by shareholders other than index funds and corporate insiders. In this version, the voting power of index funds would essentially pass to those shareholders that are not index funds or corporate insiders, who we refer to as the "non-indexed public investors".

We do not support such a transfer of voting power from index funds to non-indexed public investors. Although this Article has focused on the problems with index fund stewardship, the existence of these problems does not imply that the voting decisions of non-indexed public investors are, on the whole, superior to those of index funds. Although supporters of this approach oppose index fund voting on the grounds that index funds are insufficiently informed,[146] they fail to consider the problems with voting by non-indexed public investors. However, most individual retail investors are likely to have considerably weaker incentives to acquire information about the consequences of upcoming votes than index funds, and as a result are likely to be considerably less informed. Furthermore, we explain elsewhere that a careful comparison of the incentives of active mutual funds managers and those of index fund managers does not suggest that active mutual fund managers are generally likely to invest more in informing themselves about votes decisions index fund managers.[147] We therefore oppose taking away

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[144] *See, e.g.*, Lund, *supra* note 16.

[145] The proposal was put forward in *Id.*, as well as in a subsequent op-ed article, M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J., Jun. 22, 2017, Opinion.

[146] *See* Lund, *supra* note 16, at 137. *See also Id.* at 121 (arguing that the "low-cost, unthinking approach to governance" of index fund managers will risk doing "more harm than good.")

[147] For our analysis of this issue, *see* Bebchuk & Hirst, *supra* note 22.

voting power from index funds.

(b) *Taking votes away from investment managers.* As an alternative to taking voting power from index funds, several authors have suggested taking voting power from the *managers* of index funds. These authors advocate "pass-through" requirements that would enable the beneficial investors of index funds to determine how the votes associated with the shares held by the index funds will be cast.[148] We view this alternative as also unwarranted, for three reasons.

First, implementing full pass-through arrangements would involve substantial practical difficulties and expense.[149] Consider an individual who is a beneficial investor in an S&P 500 index funds. The individual would be asked each year to make voting decisions on all the proposals that will come up at the annual meeting of each of the hundreds of companies in the S&P 500, which would likely amount to thousands of proposals each year.[150] Even putting aside the costs of informing oneself about those proposals, merely communicating thousands of decisions each year would not be feasible for most of the index fund's individual beneficial investors.

Second, even if these individual beneficial investors could hypothetically determine their preferences with respect to each of a vast number of votes without substantial effort or expense, the voting decisions of index funds produced by this process would likely be based on very little information. The great majority of individual beneficial investors would have no or negligible information about the thousands of proposals on which the index fund would have to cast votes. Essentially, the problem is that having decisions made in a centralized fashion for the portfolio as a whole produces large economies of scale compared with the pass-through approach. By forgoing these economies, the pass-through approach would produce a

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[148] For articles proposing such pass-through as a required or at least default arrangement, *see, e.g.*, Lund, *supra* note 16, at 138–39*;* Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, SSRN Scholarly Paper ID 3365222 34 (Social Science Research Network), Mar. 1, 2019*;* Sean J. Griffith, Opt-In Stewardship: Toward an Optimal Default Rule for Mutual Fund Voting (Unpublished Manuscript) 33–43 2019.

[149] For an earlier version of this objection to pass-through voting by one of us, see Hirst, *supra* note 31, at 237.

[150] Some authors suggest pass-through voting arrangements where instead of reporting preferences on each decision, beneficial investors could give general principles in advance, or designate an agent to choose their preferred vote. *See, e.g.*, Griffin, *supra* note 152, at 34. However, beneficial investors could not fully specify how they would prefer that investment managers vote on every possible matter that may arise for a vote, which would leave significant discretion to the investment manager. If a beneficial investor were asked to choose an agent for selecting their preferred voting decision, this would require the investor to inform themselves sufficiently regarding the agent, which would require additional effort on the part of the investor.

process that would be both costly and uninformed.

Finally, a pass-through approach with respect to voting would not permit index funds to use their substantial voting power to produce benefits through engagement. If an index fund manager did not have the power to determine how to cast the votes associated with shares held by the fund then portfolio companies would have little incentive to listen to the index fund manager, and the index fund manager would have commensurately little ability to influence the company through such engagement. At the same time, the dispersed nature of the beneficial investors that would determine how votes are cast means that they are unable to effectively communicate or engage with portfolio companies. Thus, a pass-through arrangement would eliminate any potential benefits from stewardship activities other than voting.

2. Encouraging Investment in Stewardship

We now turn to regulatory reforms that in our view *should* be considered. The evidence that we presented in Part II shows that, consistent with our incentive analysis, the Big Three make investments in stewardship that are very small relative to the number of their portfolio companies and the value of their equity assets: each allocates to stewardship less than 0.0003% of the value of assets under management and devotes, on average, only a few thousand dollars in stewardship costs to large positions. These levels of stewardship are likely to be less than optimal from the collective perspective of index fund investors, who would be better off if all index fund managers increased their investments in stewardship and passed the costs on to their beneficial investors.

Policymakers should explore ways to encourage index fund managers to move towards these higher levels of stewardship investment. As we explain below, because current stewardship budgets are economically negligible relative to the fee income of the Big Three, pressure from investors and from the public alone could lead the Big Three to raise their stewardship budgets considerably. Given the importance of increasing investment in stewardship, it would also be worthwhile for policy makers to consider measures to encourage such investment. We suggest that they consider three possible measures.

(a) *Charging Stewardship Costs to the Index Fund.* One way to respond to the identified incentive problems is to facilitate the ability of index fund managers to charge stewardship costs directly to the index fund so they are borne by the index fund investors that also capture the gains from stewardship activity. This would mean that index fund managers would no longer have to bear the cost of stewardship investments while capturing only a tiny benefit of the gains such investments generate.[151]

As we explained above, the stewardship efforts of index fund families are generally undertaken by a centralized department on behalf of all the funds in the fund family. A significant impediment to charging stewardship costs to index fund investors is the difficulty of allocating centralized stewardship costs to the index funds in the fund family without risking litigation. Regulators could help alleviate this problem. One solution could be for the SEC to adopt a safe harbor that would allow fund families that have a central stewardship unit to allocate its costs to the different funds in the family, and to do so proportionately to the value of the portfolio of each fund.[152]

(b) *Sharing Outside Research Services.* As Section II.A.3 explained, it would be desirable for index fund managers to monitor portfolio companies to identify underperformance, to assess the characteristics and fit of their directors, and—when appropriate—to identify which directors should be added or removed. Such stewardship activities require close attention to the particular circumstances of individual companies and, are therefore costly. However, such information acquisition could serve more than one index fund manager. Policymakers should thus facilitate the pooling of research, including having such research be undertaken by outside organizations on behalf of multiple index fund managers.[153]

Consider the following thought experiment. Suppose that there were three substantial organizations that monitored each company in the major indexes to reveal underperformance and identify changes—including choices of directors—that could improve performance. Suppose also that the Big Three and other index fund managers shared the costs of these organizations and received reports from them to inform their stewardship decision-making. In our view such pooling of resources, which already takes place in Europe,[154]

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[151] *See also* Assaf Hamdani et al., *Incentive Fees and Competition in Pension Funds: Evidence from a Regulatory Experiment*, 2 LFA 49, 54 (2017) (advocating performance fees for retirement savings funds as an alternative approach).

[152] For example, the safe harbor could provide a precise formula, such as dividing the cost proportionately to portfolio value at the end of each quarter.

[153] For recent policy discussions about pooling of resources by institutional investors, see Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163 (2015–2016), as well as Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, SSRN Scholarly Paper ID 3157708 36 (Social Science Research Network), Apr. 1, 2018.

[154] In the United Kingdom some pooling of stewardship is done through the Investor Forum. *See* Investor Forum, About The Investor Forum (2018), https://www.investorforum.org.uk/about. For a discussion of this approach, see Andrew F. Tuch, *Why Do Proxy Advisors Wield So Much Influence? Insights From U.S.-U.K. Comparative Analysis*, SSRN Scholarly Paper ID 3384264 (Social Science Research

could also improve index fund stewardship in the United States. Policy makers should facilitate such pooling by making it clear that such resource sharing would not create a group for the purposes of Section 13(d).[155] We note that the European Securities and Market Authority provides a safe harbor for certain collective efforts by shareholders.[156]

(c) *Making Stewardship Expenses Mandatory.* A third measure for policymakers to consider is to require each index fund manager to invest an amount in stewardship that is above a specified minimum fraction of its indexed assets under management. Consider, as a thought experiment, a requirement that all index fund managers allocate for stewardship an amount equal to at least 0.0005% or 0.001% of their indexed equity assets under management. Although this investment would remain an economically negligible fraction of total index fund manager fee revenue, it would lead to a substantial increase in stewardship budgets.

Of course, as with any such mandate, a difficult issue would be the specific investment requirement. However, as long as the required investment was held to a multiple of existing stewardship investments, the risk of overshooting the desirable stewardship level would remain relatively low compared to the economic benefit from reducing under-investment. Indeed, even if policymakers did not adopt such a mandate, merely considering it would likely encourage index fund managers to increase their stewardship.

3. Business Relationships with Public Companies

As Section I.E explained, index fund managers' business relationships with public companies provide significant incentives for them to be excessively deferential to corporate managers. Below we put forward two alternative measures that could be considered to address this problem: limits on business relationships and disclosure requirements.[157]

(a) *Limits on Business Relationships.* One natural approach for regulators is to constrain or prohibit business relationships between index fund managers (and potentially some other investment managers) and their

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Network), May 7, 2019.

[155] For a review of these rules, see JACOBS, *supra* note 72, ch. 2

[156] European Securities and Markets Authority, *Information on Shareholder Cooperation and Acting in Concert under the Takeover Bids Directive – 1st Update* Jun. 20, 2014.

[157] For early discussions of regulatory responses to problems arising from business relationships, see Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 885 (1991–1992), and Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 887–88 (2008–2009).

portfolio companies. Their substantial assets under management should give index fund managers sufficient scale that they can operate solely as investment managers without engaging in other business activities. Put another way, there would not appear to be substantial efficiency gains from investment managers also operating such other businesses, so precluding them from doing so would not have significant social costs.[158]

For example, public officials should consider prohibiting investment managers from administering 401(k) plans for employers. This is a business that inherently places index fund managers into meaningful conflicts of interest with a significant number of portfolio companies over which they conduct stewardship. As explained earlier, empirical evidence suggests that these conflicts of interest distort investment managers' stewardship incentives. More broadly, policy makers should review investment managers' range of business relationships with portfolio companies and compare (i) the efficiencies that result from combining these businesses with (ii) the adverse effects of these businesses on the incentives of investment managers.

(b) *Disclosure Requirements*. A more moderate approach would be to require index fund managers to disclose their business relationships with portfolio companies with particularity. Index fund managers currently provide some information about their policies and practices with respect to conflicts of interest, but they do not provide particularized information about the actual cases where potential conflicts arise. Disclosure alone would not preclude business relationships between index fund managers and their portfolio companies, but it would shed light on those relationships, enabling outsiders to assess how they affect stewardship decisions. Such scrutiny may help offset the undesirable incentives of index fund managers and thus have positive effects on their stewardship activities. Transparency would also provide a basis for regulators to make informed decisions regarding the desirability of substantive restrictions on business relationships.

4. Bringing Transparency to Private Engagements

As we have discussed, the leaders of the Big Three consider private engagements with portfolio companies as the major channel through which they conduct stewardship. We have presented evidence that private engagement takes place with a very small minority of portfolio companies. Nonetheless, used effectively, private engagement by index fund managers could have a powerful influence on portfolio companies. Our analysis

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[158] Indeed, public officials may also wish to consider whether index fund managers should also manage active funds, as the Big Three currently do. We leave detailed consideration of this question to future work.

suggests that it would be desirable for index fund managers to provide much more detailed disclosure regarding their private engagements.

BlackRock and Vanguard currently provide very little information about the companies with which they engage privately and what transpires in those engagements. Each of the Big Three publishes an annual stewardship report with the number of its engagements, and the illustrative topics they covered. But this is insufficient to determine the vast majority of companies with which BlackRock and Vanguard engaged. SSGA is somewhat more transparent about its engagements, disclosing the companies with which it engaged[159] and the general categories of each engagement.[160] In this Section we propose bringing greater transparency to this important component of fund stewardship for all index fund managers.

(a) *The Value of Transparency*. We believe that making index fund engagements more transparent would be desirable for two reasons. First, transparency would provide all investors with material information. Companies are already required to disclose any engagements with activist hedge funds. We believe that the marketplace should similarly be informed about engagements with index funds that have large stakes in the company.

Private engagements involve both information flows from public companies to index fund managers, and vice versa.[161] Index fund managers seek information that they view as useful for their voting decisions: For instance, during Vanguard's engagements with two companies on climate risk disclosure, corporate managers made commitments to improve disclosure that caused Vanguard to vote against a shareholder proposal requesting such disclosure.[162] In BlackRock's engagements, it "seek[s] to better understand how boards assess their performance and the skills and expertise needed to take the company through its future … multi-year strategy" and "continue[s] to engage companies to better understand their progress on improving gender balance in the boardroom."[163] If either BlackRock or Vanguard receive information that it deems material for its voting decisions, such information is also likely to be material to the voting

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[159] State St. Global Advisors, Annual Stewardship Report, *supra* note 7, at Appendix, 41-53.

[160] For example, for SSGA's reporting on companies with which it had engagements focused on executive compensation concerns, see *Id.* at 34.

[161] *See* Mallow & Sethi, *supra* note 98, at 393 (an article by senior officers of BlackRock explaining that "[e]ngagement could take the form of consultation for the purpose of enhancing two way information flow between shareholders and management." [Footnote omitted]).

[162] Vanguard, *supra* note 37, at 12.

[163] *See*, *e.g.* BlackRock, *BlackRock Investment Stewardship Engagement Priorities for 2018* Mar. 2018 3.

decisions of other investors.

Private engagements also involve index fund managers communicating their views that portfolio companies should change their governance practices in certain ways. For example, SSGA provided feedback to Qualcomm Inc. regarding its compensation plans, as a result of which the company made the desired changes to those plans.[164] Private engagement by the Big Three is predicated on the belief that such communications increase the likelihood that requested changes will occur. Information that the Big Three have made such requests would thus be material for other investors.

The second reason why transparency would be desirable is that it should lead to more meaningful engagement by index fund managers. Thus far, we have taken the stewardship decisions of index fund managers as given. However, transparency is likely to affect stewardship decisions in desirable ways. Once investors are informed about the companies with which engagements took place and the subjects of those engagements, they will be better able to assess the effectiveness of such engagements. This would motivate index fund managers to achieve more significant outcomes from their private engagements.

The SEC's Regulation FD requires companies to disclose material information that they provide to some investors. In our view, it would be reasonable to interpret Regulation FD as requiring companies to disclose the existence and contents of all of their engagements. That Vanguard believes information from its private engagements with a company to be material is highly suggestive that other investors would regard it as material as well, and the information should therefore also be considered material to the company. Vanguard knows what demands it has communicated and how the company has responded; Regulation FD should require the disclosure of this information to all investors. Counsel to public companies and to the SEC should consider whether Regulation FD already requires companies to disclose the existence and contents of their engagements with index fund managers, as they do for engagements with activist hedge funds.

If the SEC does not consider such disclosure to be currently required under Regulation FD, it should consider amending Regulation FD or adopting other rules to require such disclosure, either by companies or by investment managers. In designing such disclosure rules, the SEC should aim to place other investors on an equal informational footing with the index fund manager undertaking the engagement. Such disclosure may include the engagements that took place, their duration, whether they were by phone or in person, the main topics discussed, the positions that the index fund manager expressed, and the company's responses. Were investors aware of this information, they could assess how effectively index fund managers

[164] State St. Global Advisors, Annual Stewardship Report, *supra* note 7, at 26.

wield their considerable power.

(b) *Objections to Transparency?* It might be argued by index fund managers and supporters of index fund stewardship that the disclosure we suggest could chill private engagement: companies might not be willing to engage privately with index fund managers if they know their communications would be disclosed. We do not believe this to be a realistic concern. Companies are unlikely to reject conversations with their largest shareholders. SSGA has disclosed the identity and nature of its engagements since 2014 without any apparent effect on its ability to engage.[165] Indeed, if disclosure included whether particular companies declined to engage, the possibility of such disclosure alone would likely discourage any companies from declining engagement with index fund managers.

In addition, it could also be argued that disclosure would make engagements less effective in producing results. Companies may be more willing to accept private requests because they would prefer not to appear susceptible to outside pressure. However, any promise to accede to or seriously consider a request is even more likely to be material and therefore subject to Regulation FD. If an engagement involves only a request by the index fund manager, it is debatable whether disclosing the request would make the company less likely to heed it. Following a long-term investor's request may be positively regarded. The willingness of companies to implement precatory shareholder proposals that receive majority support demonstrates that the visibility of shareholder pressure is generally not a barrier to management responsiveness. While these costs should be considered, they do not appear sufficient to maintain the lack of engagement transparency.

5. Rethinking Rule 13D

The analysis of the preceding two Parts took as given the application of Rule 13D, which requires certain extensive disclosures in the event an investor crosses the 5% threshold with the purpose of influencing the control of the portfolio company. In Subsection I.E.3 we explained that this rule deters the Big Three, each of which holds a very large number of 5%-plus positions, from engaging in activities that could be regarded as seeking to influence corporate decision-making. Furthermore, in Subsection II.B.2 we presented evidence consistent with this deterrence effect being quite strong: we documented that, despite having each a vast number of 5% plus positions, the Big Three have not filed a single Schedule 13D in the past decade, presumably by avoiding any of the influence-seeking activities that could trigger Rule 13D obligations. While the above analyses took Rule 13D as

165 State Street Global Advisors, *Annual Stewardship Report 2014 Year End* (2015).

given, they suggest that it would be worthwhile to reconsider the design of Rule 13D or at least its application to index funds.

To begin, although Rule 13D might be regarded as a disclosure requirement aimed at bringing certain information to the market, our analysis makes clear that the application of Rule 13D to index funds has thus far not provided any material information to the market. Whereas the application of Rule 13D to activist hedge funds has led to the filing of hundreds of Schedule 13Ds providing the market with information, we have documented that the application of Rule 13D to index funds has not resulted in any filing of and 13Ds by index funds.

To the extent that the application of Rule 13D to index funds has had any practical effect, it has been by deterring index funds from taking certain potentially influence-seeking activities. Thus, in assessing the current operation of Rule 13D with respect to index funds, we should consider not whether providing some information to the market in certain circumstances would be desirable, but whether deterring index funds from engaging in activities that would trigger disclosure obligations under the current design of Rule 13D is desirable. Our analysis raises concerns that such deterrence effects might be undesirable.

Furthermore, a main policy goal underlying the adoption of Rule 13D, and Section 13(d) of the Williams Act on which it is based, and the disclosure required thereby, is to alert the market before an investor that seeks to influence corporate decision rapidly acquires a substantial stake.[166] Clearly, the application of Rule 13D to the case of an activist hedge fund could reduce the risk that the fund would rapidly accumulate a large stake rapidly. However, index funds can be expected to increase their stakes in individual portfolio companies only gradually as funds flow to the index fund over time, so there is no risk of the rapid accumulation of a large stake.

A detailed analysis of the optimal redesign of Rule 13D, or at least its application to index funds, is beyond the scope of this Article. However, we note that our analysis does suggest considerations that should be examined in any such redesign. In particular, such considerations should include (i) the chilling effect that the current application of Rule 13D to index funds has on stewardship activities by index funds; (ii) the potential value of such stewardship activities for the beneficial investors of index funds; and (iii) the reasonable expectations, grounded in the *modus operandi* of index funds, that an index fund would increase its position in a particular portfolio company only gradually and slowly over time. A reconsideration of the current application of Rule 13D to index funds, taking into account these issues, is in our view warranted.

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[166] For a discussion of the legislative history and policy goals of Rule 13D, see Bebchuk & Jackson, *supra* note 71.

6. Size Limits

As we show in Section I.A, the Big Three already owns 5% or more of a vast number of companies. Furthermore, as we document in detail in an empirical study supplementing this Article, the index fund sector is expected both to grow and to continue to be dominated by the current three dominant players, and the Big Three could be estimated to cast as much as 40% of the votes in S&P 500 companies on average within two decades.[167] We argue in this Subsection that this growing concentration of equity in the hands of three large players raises significant policy concerns, and that policymakers should consider measures to limit or reverse this trend.[168]

Measures to limit or discourage large financial stakes are not unknown in the U.S. regulatory framework. Long-standing tax rules deter investment funds from holding more than 10% of any portfolio company.[169] However, these rules apply only to individual funds and do not prevent investment managers from advising fund complexes that cross these thresholds in the aggregate. We believe that policy makers should consider measures to prevent or deter investment fund managers from managing investment funds that cross certain thresholds in the aggregate, whether through fiat, tax penalties, or otherwise.

Such an approach would have an important effect on the trajectory of index fund growth. For concreteness, let us suppose that the proportion of U.S. equity in index funds is expected to grow to 45%. As the Big Three can be expected to continue to dominate the sector if there is no regulatory intervention, suppose that the Big Three become a "Giant Three," each owning approximately 15% of each large public company. Compare a regulatory approach that would prevent investment fund managers from managing funds holding, in the aggregate, more than 5% of any company.[170] Suppose also that this would lead the sector being divided equally among nine index fund managers—the "Big-ish Nine"—each holding about 5% of each large public company.

In our view, policymakers should consider whether the Big-ish Nine scenario is preferable to the Giant Three scenario. Having the sector in the hands of three players rather than nine is unlikely to result in significant incremental economies of scale. Each of the Big-ish Nine would be expected to be managing more than a trillion dollars, so each would have substantial

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[167] For the empirical study providing such evidence, see Bebchuk & Hirst, *supra* note 3.

[168] *See also* Coates, *supra* note 16 (expressing concerns about the rising concentration of corporate equity in the hands of a small number of players).

[169] For an account and discussion of these rules, see Roe, *supra* note 70, at 20–21.

[170] Since our aim is to put this general idea on the table for discussion, we do not discuss the design and implementation issues it would entail; instead, we focus on the basic conceptual question of whether this regulatory direction is worth pursuing.

scale economies, similar to those of the Big Three at the moment. Thus, assessing the two scenarios requires close attention to their consequences for stewardship.

Because each of the Giant Three would capture a larger fraction of generated governance benefits than would each of the Big-ish Nine, each of the Giant Three would have a somewhat greater incentive to invest in stewardship. Precluding the Giant Three scenario would forgo the benefits of such increase. At the same time, however, the Giant Three scenario would involve three significant costs, which precluding the Giant Three scenario would reduce.

First, incentives to be excessively deferential would be greater in the Giant Three Scenario than in the Big-ish Nine scenario. In the Giant Three scenario, each of the index fund managers would be continually apprehensive that its 15% block would raise concerns about its power and legitimacy, triggering demand for regulatory intervention to impose size limits or break them up. By contrast, in the Big-ish Nine scenario, with reasonable size limits already in place and voting power divided among the nine players holding, the index fund managers would have significantly less concern about additional regulatory intervention.

Second, since their blocks would not exceed 5%, none of the Big-ish Nine could be required to file on Schedule 13D, so they would not be discouraged from interventions that would require Schedule 13D filing if they held more than 5%. These factors would substantially reduce the incentives of the Big-ish Nine managers to be deferential to corporate managers, thereby allowing them to be more effective stewards of the interests of index fund investors.

Third, having nine decision makers rather than three would substantially reduce risks, and concomitant legitimacy problems. Consider what would happen if one of the Giant Three were to make a stewardship decision in a reasonable, good-faith expectation of increasing portfolio value that nonetheless turned out to be detrimental to their portfolio companies. The consequences would be large, because there is no feedback mechanism to correct such a decision: that manager's index funds would perform no worse than those of any rival index fund manager, so they would have no incentive to avoid or ameliorate their mistake.

There is also no market mechanism that rewards index fund managers for good judgment about stewardship for their portfolio companies. The financial success of index fund managers depends on their prowess at operating funds that mechanically track an index at low cost. Thus, there is no necessary association between this ability and judgment with respect to the stewardship of portfolio companies.

Clearly, precluding or discouraging a Giant Three scenario would represent a major step in the regulatory intervention into the distribution of control in the economy, a step that should not be taken lightly. However, the challenge posed by the Giant Three scenario is unusual in its economic significance and merits the consideration of such measures.

B. Implications for Key Debates

1. The Debate on Common Ownership

A significant body of recent academic work has expressed serious concern about one of the consequences of the rise of index funds: increases in common ownership, whereby an investment manager holds positions in all the companies in a given sector of the economy.[171] These authors argue that a rise in common ownership, whether from index funds or otherwise, can be expected to produce substantial anti-competitive effects that are detrimental to the economy.[172] This view has led prominent legal scholars and economists—including Professors Elhauge, Hovenkamp, Posner, Scott Morton, and Weyl—to propose strong measures to constrain the rise of common ownership. Such measures include limiting investment managers to holding only one company in each economic sector, and having anti-trust regulators scrutinize the behavior of index funds and other similar investors.[173]

The reform proposals put forward by the common ownership critics were significantly motivated by, and have substantially relied on, recent empirical work that claimed to find evidence that increases in common ownership bring about anti-competitive effects and, in particular, higher market prices.[174] However, other empirical studies have contested the findings and conclusions of this empirical work and argued that it does not provide a solid empirical basis for the concerns of the common ownership critics.[175] Putting aside the

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[171] For a review of this literature, see Martin C. Schmalz, *Common Ownership, Concentration and Corporate Conduct*, SSRN Scholarly Paper ID 3165340 (Social Science Research Network), Feb. 26, 2018.

[172] *See* José Azar et al., *Anti-Competitive Effects of Common Ownership*, 73 J. OF FIN. 1513 (2018).

[173] *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669 (2017); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026 (2018).

[174] For the influential empirical study on the airline industry that has received most attention, see Azar et al., *supra* note 176. For another empirical study that claims to obtain similar findings for the banking industry, see José Azar et al., *Ultimate Ownership and Bank Competition*, SSRN Scholarly Paper ID 2710252 (Social Science Research Network), Jul. 23, 2016.

[175] For such empirical studies, see, e.g., Pauline Kennedy et al., *The Competitive Effects*

debate on whether the empirical hypothesis of the common ownership critics is consistent with the available empirical evidence, an important question is whether, on a conceptual level, it is reasonable to expect that an increase in common ownership in general, and such an increase due to a rise of index fund ownership in particular, should be expected to bring about anti-competitive effects. Our analysis questions the plausibility of this key theory.

We agree that, in a hypothetical world without any agency costs between index funded and their beneficial investors (or more generally between investment fund managers and their beneficial investors), a rise in common ownership could have anti-competitive effects. Suppose hypothetically that the Big Three could be expected to make stewardship decisions as if they each had a sole owner acting to maximize the value of its portfolio. In this hypothetical scenario, it would be reasonable to be concerned that three large sole owners with large stakes in all significant public companies would have incentives to encourage anti-competitive effects. However, as Parts I and II have shown, the world we inhabit is very far from such a hypothetical scenario.

In our world, the real worry is not that index funds might do too much, but that they might do too little.[176] This Article identifies significant incentives of index fund managers, that common ownership critics fail to take into account. In particular, as Parts I and II have shown, index fund managers have inadequate incentives to engage in stewardship aimed at enhancing the value of particular companies,[177] and they have significant incentives to defer to the preferences of corporate managers. Thus, contrary to the concerns of common ownership scholars, index fund managers should not be expected to

of Common Ownership: Economic Foundations and Empirical Evidence, SSRN Scholarly Paper ID 3008331 (Social Science Research Network), Jul. 24, 2017; Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less than We Think*, SSRN Scholarly Paper ID 2922677 (Social Science Research Network), Feb. 23, 2017; Matthew Backus et al., *Common Ownership in America: 1980-2017*, Working Paper 25454 (National Bureau of Economic Research), Jan. 2019; Matthew Backus et al., *The Common Ownership Hypothesis: Theory and Evidence*, BROOKINGS Feb. 5, 2019; Jacob Gramlich & Serafin Grundl, *Estimating the Competitive Effects of Common Ownership*, SSRN Scholarly Paper ID 2940137 (Social Science Research Network), Apr. 21, 2017; Jacob Gramlich & Serafin Grundl, *The Effect of Common Ownership on Profits: Evidence from the U.S. Banking Industry*, SSRN Scholarly Paper ID 3269120 (Social Science Research Network), Oct. 3, 2018.

[176] For a somewhat more detailed discussions of our view on this subject than in the current section, see the presentation we prepared for the Federal Trade Commission hearings period, supra note 20.

[177] For an empirical examination confirming our analysis, see Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged* Sept. 2018.

push corporate managers to engage in business strategies that they would not wish to pursue on their own.

Indeed, we believe that the alarmism over common ownership, and the scrutiny that it brings, may have two important negative consequences. First, it may push index fund managers to act even more deferentially than they have to date, in which case such alarmism could move stewardship even further in the wrong direction. The problem with index fund stewardship is not that it pushes corporate managers too much but that it pushes them too little.

Furthermore, common ownership alarmism might push anti-trust officials in the wrong direction. There is evidence that concentration in many markets and the associated increases in markups have been on the rise in recent decades.[178] Dealing with such concentration requires antitrust regulators to focus their attention on the decisions of corporate managers. Common ownership concerns are a red herring that distracts anti-trust officials by unnecessarily refocusing their attention on ownership patterns and the stewardship of index fund managers.

2. The Debate on Hedge Fund Activism

The past decade has witnessed a heated debate over the merits of hedge fund activism and how it should be governed.[179] Supporters of hedge fund activism contend that it brings about value-enhancing changes in activism targets, and that it exerts a disciplinary force that induces incumbents to be more attentive to shareholder interests.[180] Opponents of hedge fund activism claim that it pushes public companies to improve short-term outcomes at the expense of long-term value, which is detrimental to investors in those companies, as well as to the economy.[181] This has led these opponents to

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[178] *See* Gustavo Grullon et al., *Are U.S. Industries Becoming More Concentrated?*, SSRN Scholarly Paper ID 2612047 (Social Science Research Network), Aug. 31, 2017.

[179] For articles focusing on arguments for and against activist hedge funds, see Leo E.Jr. Strine, *Who Bleeds When the Wolves Bite: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. [i] (2016–2017); Bebchuk et al., *supra* note 119.

[180] For works supportive of hedge fund activism, see, e.g., Bebchuk & Jackson, *supra* note 71; Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUNDATIONS AND TRENDS® IN FINANCE 185 (2009).

[181] For examples of works in opposition to hedge fund activism, see Strine, *supra* note 183; John C. Coffee, *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality*, SSRN Scholarly Paper ID 3058319 (Social Science Research Network), Oct. 24, 2017; Martin Lipton, *The Threat to the Economy and Society from Activism and Short-Termism*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Jan. 22, 2015), https://corpgov.law.harvard.edu/2015/01/22/the-threat-to-the-economy-and-

advocate for various measures to constrain activist hedge funds.[182]

Our analysis has significant implications for the ongoing debate on hedge fund activism. As explained below, our analysis has implications for understanding the interaction between index funds and activist hedge funds and its expected consequences. We make two main points in this regard. First, the emergence of index funds in general, and the big three as key players in particular, cannot substitute for the important role that activist hedge funds play in the corporate governance system. Second, while activist hedge funds play a beneficial role, their presence cannot fully make up for the significant problems that we identify with index fund stewardship, since these problems mean that the combination of index funds and activist hedge funds cannot fully address common corporate governance failures.

(a) The Inability of Index Fund Stewardship to Substitute for Activist Hedge Funds. Given the long-term focus of index funds, opponents of hedge fund activism view index fund stewardship as a preferable substitute for the activities of activist hedge funds and have urged index fund managers to support companies against activist hedge funds.[183] However, the analysis in this Article suggests that understanding the stewardship incentives and behavior of index fund managers should lead to support for hedge fund activism rather than opposition. The shortcomings of index fund stewardship that we identify mean it cannot be a substitute for hedge fund activism. To the contrary, these shortcomings mean that hedge fund activism has a critical role in stewardship.

The incentives of hedge fund managers differ from those of the index fund managers that we have analyzed in three key ways. First, whereas index fund managers capture a tiny fraction of the governance gains that they produce, the so-called "2-and-20" compensation arrangements of hedge fund managers enable them to capture a meaningful proportion of any governance gains they bring about.

In addition, whereas index fund managers hold the same portfolios as

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society-from-activism-and-short-termism/; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010); Bill George & Jay W. Lorsch, *How to Outsmart Activist Investors*, HARVARD BUSINESS REVIEW, May 1, 2014.

[182] For review of such measures proposed by opponents of hedge fund activism, see Bebchuk et al., *supra* note 119, at 1088.

[183] For example, Martin Lipton, a well-known opponent of hedge fund activism, has stated that "[BlackRock CEO Larry Fink's 2018 Letter to CEOs] is a major step in rejecting activism and short- termism", and that "BlackRock, State Street and Vanguard have continued to express support for sustainable long-term investment." Lipton, *supra* note 13; Lipton, *supra* note 41.. For a review of the opposition to hedge fund activism co-authored by one of us, see Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1093–96 (2015).

rival managers tracking the same indexes and thus cannot improve performance relative to rivals by bringing about governance gains, activist hedge funds have concentrated portfolios, and governance gains in their main portfolio companies can thus greatly enhance their performance relative to rivals. Third, hedge fund managers generally do not have other business relationships with their portfolio companies, so they lack the other types of incentives that we have identified as inducing index fund managers to be excessively deferential to corporate managers.

The different incentives of hedge fund managers cause them to invest substantial amounts in the stewardship of their portfolio companies.[184] Hedge fund managers closely follow the particular business circumstances of those companies and identify ways to remedy underperformance. They can also use the full toolkit of shareholder powers—including nominating directors—vis-à-vis companies that they identify as underperforming.

Given these substantial differences in incentives and consequent stewardship behavior, index fund stewardship cannot substitute for hedge fund activism, especially with respect to remedying the underperformance of portfolio companies. The work of activist hedge funds in targeting and remedying underperformance can partially address the substantial gap left by the lack of stewardship by index fund managers, and thereby benefit index fund investors. Conversely, opposition to hedge fund activism would be contrary to the interests of index fund investors.

(b) Index Fund Stewardship and the Limits of Hedge Fund Activism. Although hedge fund activism can partially substitute for the shortcomings of index fund stewardship that we identify, it cannot fully make up for such stewardship shortcomings. In a well-known and influential article, Ronald Gilson and Jeffrey Gordon express a more optimistic view on this subject and argue that the current interaction of index funds and activist hedge funds works very well to address corporate governance problems at portfolio companies.[185] In the view of Gilson and Gordon, the actions of the two types of players complement each other well: hedge funds identify target companies in which changes would enhance value, and index funds (and other mutual funds) provide the activist hedge funds with support in those cases where changes would be value-enhancing. The assistance of these investment managers thus enable the hedge fund activists to bring about these value-enhancing changes. However, our analysis indicates that the combination of activist hedge funds and index funds cannot fully address

[184] For a more detailed analysis of why agency problems afflict the stewardship decisions of activist hedge funds to a lesser extent than they affect the stewardship decisions of index funds and other mutual funds, see Bebchuk et al., *supra* note 15, at 104–6.

[185] Gilson & Gordon, *supra* note 17, at 897–900.

corporate governance problems in the way that Gilson and Gordon hope, for three reasons.

First, an activist hedge fund can be successful at a company only if that company's management expects index fund managers to support the activist hedge fund.[186] However, as we have explained, index fund managers have incentives to be excessively deferential to corporate managers.[187] To the extent that index fund managers are expected not to support some value-enhancing changes that activist hedge funds would like to bring about, activist hedge funds would likely be unable to bring about such changes themselves.

Second, not only do activist hedge funds require the support of index funds to succeed in engagements that they undertake, but a lack of index fund support might discourage them from engaging with companies in the first place. A recent study by Alon Brav, Wei Jiang, and Tao Li shows that activists are less likely to engage with an underperforming company when institutional investors are less likely to vote for activist nominees.[188]

Third, activist hedge funds have incentives to undertake stewardship activities only where such activities could result in very large increases in value. Hedge funds invest substantial resources in stewardship and take on considerable risks in their activities, including liquidity risk and the risk of unsuccessful engagements. To compensate, activist hedge funds' own beneficial investors demand higher returns, which must sustain first paying the substantial 2-and-20 fees charged by the hedge fund manager. As a result, activist hedge fund managers will take on engagements only where they would likely bring about large returns, sufficient to compensate their investors on a risk-adjusted basis after the manager's high fees. There will be many opportunities for smaller gains from stewardship—say, of approximately 5% to 10% —that activist hedge funds will ignore but that would significantly benefit index fund investors if they were realized.

For these three reasons, activist hedge funds can be only a limited substitute for the lack of stewardship by index fund managers. Consequently, the problems with index fund stewardship identified in this Article remain of substantial concern, even if activist hedge funds are allowed to continue to operate without the impediments sought by their opponents.

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[186] *See, e.g.*, Bebchuk & Jackson, *supra* note 71, at 52; Gilson & Gordon, *supra* note 17, at 987.

[187] For recent empirical evidence regarding index fund managers' support for activist hedge funds, see Brav et al., *supra* note 113, at 3.

[188] *Id.* at 24–25.

C. Recognition and Reality

Recognition by policymakers and the public of the problems that we have analyzed in this Article would be necessary to bring about significant reforms in this area. Sections A.2 to A.6 of this Part have put forward several measures that policymakers should consider to improve the stewardship of index fund managers. Before we conclude this Part, we wish to note that this is an area in which improved understanding of problems can also directly contribute to their solution.[189] Thus, we can hope that improving the understanding of current problems can by itself contribute to improving index fund stewardship.

As we explained in Section I.F, the Big Three have significant incentives to be perceived as responsible stewards. A public perception that they are otherwise might adversely affect their flow of funds or increase the risks of backlash. The Big Three thus have reason to communicate in ways that portray their stewardship in a favorable light, and to make stewardship decisions that reduce the salience of their under-investment in stewardship and their excessive deference to corporate managers. Therefore, recognition by investors and the public of the incentive problems of index fund managers could, by itself, lead to improved stewardship by the Big Three.

In particular, recognition of the extent of the Big Three incentives to under-invest in stewardship might counteract their incentives to under-invest. Similarly, recognition of the extent of the deference incentives of index fund managers might constrain such deference.

To illustrate, the evidence that we have provided regarding the scale of the Big Three's investments in stewardship could contribute to public pressure on the Big Three to increase their investments in stewardship. Discussions of Big Three investment levels by Big Three leaders and supporters of index fund stewardship have thus far paid close attention to the significant increases in personnel in the Big Three's stewardship departments in recent years. This discussion has looked favorably on the number of people currently employed in these departments.[190] However, our analysis in Subsection II.A.1 shows that, notwithstanding the increases in personnel in recent years, the Big Three's investments in stewardship currently enable them to devote limited resources to stewardship in the great majority of the companies in which they hold positions of significant monetary value.

[189] For a discussion of another context in which recognition of flawed incentives by investors and the public can have a profound effect on reality, and where academic work highlighting the problems can usefully contribute to this recognition, see LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION ch. 16 (2004), Ch. 16.

[190] For such comments, see notes 10 and 11, supra, and associated discussion.

Introducing this point could be salient for public discussions.

To take another example, the evidence we provide in Section II.B regarding the Big Three's failure to use certain potentially valuable stewardship tools could increase investor and public pressure on the Big Three to use these tools. In particular, our analysis in Subsection II.B.3 showed that the Big Three have generally avoided any submission of shareholder proposals of the type that they generally support and that could bring about governance changes that the Big Three's own governance principles consider valuable; public recognition of these findings could contribute to investor and public pressure on the Big Three to consider active submission of shareholder proposals to bring about these governance reforms. Similarly, our analysis in Subsection II.B.4 showed that the Big Three have commonly chosen to remain on the sidelines in cases of SEC consideration of proposed rules and precedential litigation; these findings could thus lead to investor and public pressure on the Big Three to increase their involvement in such activities.

Thus, this is an area in which recognition of problems might by itself contribute to improving matters. We therefore hope that this Article, and the analysis and empirical evidence that we provide, will contribute to investor and public recognition of the problems afflicting index fund stewardship.

CONCLUSION

With index funds owning a large and steadily increasing fraction of the equity capital of all significant American public companies, understanding the stewardship decisions of index fund managers—and how they can be improved—is of critical importance for all interested in the governance and performance of public companies. In this Article we have sought to contribute to this understanding by providing a comprehensive theoretical, empirical, and policy analysis of index fund stewardship.

The Article has put forward an analytical framework for understanding the incentives of index fund managers. Our framework has enabled us to identify and analyze two types of incentives that could adversely affect the stewardship decisions of index fund managers: incentives to under-invest in stewardship and to defer excessively to the preferences and views of corporate managers.

The Article has also provided the first comprehensive and detailed empirical account of the full range of stewardship activities that index fund managers do and do not undertake. We show that this evidence is consistent with the predictions of our incentive analysis and reinforces the concerns raised by our analysis.

Finally, the Article has considered the significant policy implications of the incentives problems that we identify analytically and document empirically. We propose a set of significant measures that policy makers should consider to address the concerns that our analysis and evidence have highlighted. We also show that our analysis undermines the arguments that critics have made against common ownership by institutional investors and activism by hedge funds, thereby contributing to these important policy debates.

We hope that the framework we have developed, the empirical evidence we have provided, and the policy proposals we have put forward for consideration, will all prove useful for policy makers and market participants in considering the opportunities and challenges posed by the rise of index funds. How well those policy makers and market participants assess and respond to these opportunities and challenges will have profound effects on the governance and performance of public companies and, in turn, on the prosperity of investors and the success of the American economy.

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