

Index Funds and Corporate Governance: Let Shareholders be Shareholder

Law Working Paper N° 467/2019

August 2019

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Abstract

Index funds and indexed ETFs managed by the “Big Three” – BlackRock, Vanguard and State Street – have grown to be the largest investors in the capital markets and have become the presumptive “deciders” of corporate law controversies. With this prominence has come controversy. Commentators have bemoaned their lack of financial incentives to ensure that the companies in their portfolios are well run and have suggested that index funds should not be allowed to vote the shares of the companies in their portfolio or should be subjected to special regulations. In this article, we provide a systematic and differentiated analysis of the incentive and information structure within which advisers to index funds operate. Overall, the Big Three have among the strongest direct financial incentives to become informed. These incentives derive from their enormous scale and scope. This is important in several ways. First, scale increases the likelihood that their decisions will be pivotal. Second, even at a low percentage fee, their share of increases in firm value will be larger than almost any other shareholder. Third, they benefit from economies of scope in setting market wide governance standards. Fourth, the scale generates reputational incentives to be seen as responsible stewards, both for marketing and to forestall regulation. On the other hand, unlike advisers to active funds, advisers to index funds do not have indirect, flow-based incentives and have lesser access to company-specific information generated by analysts in the context of their investment activities. The differences between advisers to active and advisers to index funds have different implications for the three core areas of engagement: high profile proxy contests between activist shareholders and boards; broad market wide governance standards; and monitoring of portfolio company governance and performance. With regard to the highest profile contests that will likely affect firm value, the strong direct incentives should assure that the Big Three will vote intelligently. With regard to market wide governance standards, the Big Three are better positioned than any other shareholders to set the standards: they enjoy economies of scope and analysts-generated information is generally not important. With regard to company specific monitoring of governance, the Big Three are similarly well positioned. By contrast, with regard to company specific performance – for which analyst-generated information tends to be important – hedge funds and advisers to large actively managed funds will often be in a better position to become engaged than advisers to index funds. On the whole, our corporate governance world would be poorer if index funds could not vote their shares and proposals singling out index funds for regulation are unwarranted.

Keywords: Index funds, passive investing, active funds, institutional investors, corporate governance, monitoring, agency problems, shareholder activism, corporate law, hedge fund activism, mutual funds, public pension funds, shareholder voting, incentives to become informed, dispersed shareholders

JEL Classifications: K22, G23, G28, G20

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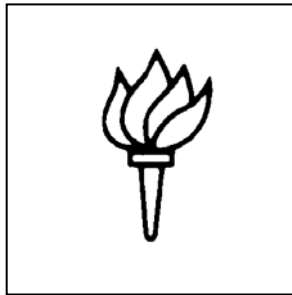
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Abstract

Index funds and indexed ETFs managed by the “Big Three” – BlackRock, Vanguard and State Street – have grown to be the largest investors in the capital markets and have become the presumptive “deciders” of corporate law controversies. With this prominence has come controversy. Commentators have bemoaned their lack of financial incentives to ensure that the companies in their portfolios are well run and have suggested that index funds should not be allowed to vote the shares of the companies in their portfolio or should be subjected to special regulations.

In this article, we provide a systematic and differentiated analysis of the incentive and information structure within which advisers to index funds operate. Overall, the Big Three have among the strongest direct financial incentives to become informed. These incentives derive from their enormous scale and scope. This is important in several ways. First, scale increases the likelihood that their decisions will be pivotal. Second, even at a low percentage fee, their share of increases in firm value will be larger than almost any other shareholder. Third, they benefit from economies of scope in setting market wide governance standards. Fourth, the scale generates reputational incentives to be seen as responsible stewards, both for marketing and to forestall regulation. On the other hand, unlike advisers to active funds, advisers to index funds do not have indirect, flow-based incentives and have lesser access to company-specific information generated by analysts in the context of their investment activities.

The differences between advisers to active and advisers to index funds have different implications for the three core areas of engagement: high profile proxy contests between activist shareholders and boards; broad market wide governance standards; and monitoring of portfolio company governance and performance. With regard to the highest profile contests that will likely affect firm value, the strong direct incentives should assure that the Big Three will vote intelligently. With regard to market wide governance standards, the Big Three are better positioned than any other shareholders to set the standards: they enjoy economies of scope and analysts-generated information is generally not important. With regard to company specific monitoring of governance, the Big Three are similarly well positioned. By contrast, with regard to company specific performance – for which analyst-generated information tends to be important – hedge funds and advisers to large actively managed funds will often be in a better position to become engaged than advisers to index funds. On the whole, our corporate governance world would be poorer if index funds could not vote their shares and proposals singling out index funds for regulation are unwarranted.

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Introduction

Index funds and indexed ETFs managed by the “Big Three” – BlackRock, Vanguard and State Street – have grown to be the largest investors in the capital markets and have received disproportionate attention. Do they do too little? Too much? Or just the right amount? Are their incentives sufficiently aligned with the interests of their investors to whom they owe fiduciary duties? Should they be suppressed in favor of more active, undiversified shareholders like activist hedge funds or actively managed mutual funds? These questions lie at the heart of current corporate governance debates.

Long the darling of finance scholars,¹ index funds offer investors the benefit of a diversified portfolio, and escape from the impossible task of outperforming the market, at extraordinarily low cost. Embracing the academic research supporting index investing, Vanguard built a huge business on the simple promise of a high degree of diversification and low fees – made possible in part by the fact that index investing does not require a fund to employ analysts who try to identify undervalued stock.² Because index funds charge lower fees than actively managed funds,³ and because the conventional wisdom that it is difficult to outperform the market has proven correct,⁴ index funds often have better net (post-fee) performance than active funds. The market has caught on, with many other fund families offering index funds and indexed ETFs and with such vehicles constituting a growing share of the investment company sector. As of today, a large majority of the equities managed by the Big Three are in index funds and other pools of assets using index strategies.⁵

¹ Burton G. Malkiel, *A Random Walk Down Wall Street* (New York: Norton 1999) (advocating indexing as investment strategy).

² Leslie P. Norton, Jack Bogle, Vanguard Founder and Legendary Index Fund Inventor, Dies at 89, *Barron's*, Jan 17, 2019, available at <https://www.barrons.com/articles/jack-bogle-legendary-index-fund-inventor-dies-at-89-51547679373>.

³ 2018 Investment Company Factbook at 126 (showing respective expense ratios of 7 and 78 basis points for equity funds), available at https://www.ici.org/pdf/2018_factbook.pdf.

⁴ John Bogle, *The Little Book on Common Sense Investing*, (noting that the average U.S. equity fund compounded at 10 percent from 1980 through 2005, while the Vanguard 500 Index Fund made 12.3 percent).

⁵ See Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk at 7, *Business and Politics*, April 2017. As John Bogle pointed out, the firms that manage pension funds have, in substance, merged with the firms that manage mutual funds, with essentially all managing both mutual fund and pension funds, although the relative weight varies substantially. According to Bogle, as of around 2007, “Only 4% of the U.S. equities overseen by State

With this prominence has come controversy. To be sure, there have always been critics who have argued that index funds are the end of capitalism.⁶ But more recently, the criticisms have sharpened. Index funds, according to some commentators, are passive do-nothings and know-nothings, “freeloaders”⁷ who lack financial incentives to ensure that the companies in their portfolios are well run,⁸ whose increased power has “ominous”⁹ implications for corporate governance, and who blindly support management.¹⁰ Pursuing this line of reasoning further, commentators like Dorothy Lund, Todd Henderson, and Dick Weil have suggested that index funds should not be allowed to vote the shares of the companies in their portfolio.¹¹ Not far behind, Lucian Bebchuk and Scott Hirst, in what they call the “Agency Cost Theory of Index Fund Stewardship”, point out that index funds have substantially lower incentives than a sole owners holding the same stake and document that they do much less than such an owner would be expected to do.¹² While Bebchuk and Hirst want index funds to retain their voting rights, they advocate a set of policy reforms designed to make index funds into better corporate monitors.¹³

In this article, we argue that these criticisms rest on a flawed understanding of the current corporate governance landscape and of the nature of institutional investing. Properly

Street, for example, are held in mutual funds, compared to a whopping 97% for Vanguard.” John Bogle, Reflections on “Toward Common Sense and Common Ground?”, 33 J. Corp. L. 31, 32 (2007).

⁶ See, e.g., Luke Kawa, Bernstein: Passive Investing Is Worse for Society Than Marxism, available at <https://www.bloomberg.com/news/articles/2016-08-23/bernstein-passive-investing-is-worse-for-society-than-marxism>.

⁷ Dick Weil, Passive Investors, Don’t Vote, Wall St. J., Mar. 8, 2018, available at <https://www.wsj.com/articles/passive-investors-dont-vote-1520552657>

⁸ Dorothy Shapiro Lund, The Case Against Passive Shareholder Voting, The Case Against Passive Shareholder Voting, 43 Journal of Corporation Law 101 (2018).

⁹ Dorothy Shapiro Lund, The Case Against Passive Voting, CLS Blue Sky Blog, available at <http://clsbluesky.law.columbia.edu/2017/08/02/the-case-against-passive-shareholder-voting/>. In the same vein, see John C. Coates, The Future of Corporate Governance Part I: The Problem of Twelve (September 20, 2018), available at <https://ssrn.com/abstract=3247337>; Lucian Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. __ (forthcoming 2019).

¹⁰ Jordon Wathen, A billionaire’s warning on index funds , CNN Money, Mar. 15, 2015, available at <http://money.cnn.com/2015/03/31/investing/investing-index-funds-warning/index.html>; Todd Henderson and Dorothy Shapiro Lund, Index Funds Are Great for Investors, Risky for Corporate Governance, Wall St. J., June 6, 2017, available at <https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623>; Lucian Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy, forthcoming, 119 Colum. L. Rev. __.

¹¹ See, e.g., Lund, supra note 8; Henderson and Lund, supra note 10, Weil, supra note 7.

¹² See Bebchuk & Hirst, supra note 9.

¹³ Id. at __.

viewed, index funds in general – and the Big Three in particular – are valuable corporate citizens that make substantial and positive contributions through their current role in corporate governance. To be sure, the investment advisory firms that run index funds – and that are in charge of voting and other governance decisions – have incentives that differ from those of ordinary shareholders.¹⁴ But the reason for that is simple: they are *not* the owners of the stock held in the mutual fund portfolios.¹⁵ Comparing advisory firms to regular shareholders owning the same stake – a comparison in which advisory firms will necessarily fare poorly – is a category mistake that does not take account of the underlying economic ownership structure of our capital markets and public corporations.

This article first provides a systematic and differentiated analysis of the incentive and information structure under which advisers to index funds operate. Our analysis shows that, of all real-life shareholders in public corporations, the Big Three – which act as advisers to the bulk of assets held in index funds¹⁶ – actually have among the *best* incentives to acquire information, to engage, and to vote intelligently. Their incentives are multiple orders of magnitude higher than those of mutual fund investors – the economic owners of the stocks held in index funds – and superior to those of virtually all retail shareholders and most other institutional investors.

Our analysis then proceeds by analyzing the incentives of the Big Three in the three main areas of shareholder engagement. We show that the Big Three’s incentives in the small number of high profile contests with the greatest impact of share value – proxy contests between activist shareholders and company management over corporate strategy and contested merger votes – are more than adequate to encourage them to devote substantial

¹⁴ See, e.g., Marcel Kahan & Edward Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1050-51 (2007) (noting limited incentives of mutual funds); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445 (1991) (same).

¹⁵ See, e.g., John Morley, The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation, 123 YALE L. J. 1228 (2014) (explaining structure of investment advisers). For that reason, the criticisms by another group of commentators who have argued that common ownership of public companies by diversified investors such as index funds is anticompetitive and has, e.g., resulted in airline ticket prices that are as much as 10% higher than they otherwise would have been,¹⁵ is also mistaken. See José Azar, Martin C. Schmalz & Isabel Tecu, Anti-Competitive Effects of Common Ownership, 73 J. FIN. 1513 (2018); José Azar, Sahil Raina & Martin Schmalz, Ultimate Ownership and Bank Competition (July 23, 2016) (unpublished manuscript), ssrn.com/abstract=2710252; Einer Elhauge, Horizontal Shareholding, 129 HARV. L. REV. 1267 (2016); Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, A Proposal to Limit the Anticompetitive Power of Institutional Investors, 81 ANTITRUST L.J. 669 (2017).

¹⁶ See Fichtner et al., *supra* note 5, at ___.

resources to deciding between the competing camps. With regard to the second major category of corporate governance engagement – market-wide governance standards (e.g., staggered board, in force poison pill, majority voting, CEO/Chair separation, ESG disclosure, board diversity) – the Big Three benefit from their massive scale and scope, and the spillover knowledge that comes with it. Finally, with regard to the third major area of engagement – company-specific governance and performance issues – their incentives are mixed. With respect to governance issues – the focus of the Big Three’s engagement with portfolio firms – they are able to leverage their market wide expertise. By contrast, with regard to company-specific performance issues, the Big Three play a minimal role. Some actively managed mutual funds and activist hedge funds, however, have strong and targeted incentives to take the lead, and have the ability to convert a company-specific performance issue into a proxy contest that, if not resolved, will become the focus of the Big Three’s attention.

Our analysis shows that the relative incentives and capacities of the firms managing the largest index funds are vastly better than the those of individual shareholders and most other institutional investors. Our corporate governance world would be poorer if index funds could not vote their shares and proposals singling out index funds in order to make them into better corporate citizens are unwarranted.

We proceed as follows. In Part I, we review the current corporate governance landscape, the structure of investment advising and the resulting incentives of investment advisers. In Part II, we consider advantages that investment advisers derive from “spill-over knowledge” and distortions generated by short-term investment horizons. Then, in Part III, we consider a variety of conflicts associated with investment advisers, including the long recognized conflict that result from asset management competing for corporate business as well as less appreciated conflicts that can arise from the “heft” that a large index fund can provide to a fund family’s actively managed portfolios. We close with a brief conclusion.

I. Understanding the Structure and Incentives of Investment Advisers

While it was once reasonable to think of U.S. corporate governance as a bilateral relationship between dispersed shareholders and firms, the decades-long rise of institutional investors, combined with the more recent emergence of activist hedge funds, has transformed corporate governance. Ron Gilson and Jeff Gordon have argued that this results in a very different model in which activist hedge funds identify problem companies, propose fixes, and if managers resist, the largest institutional investors decide.¹⁷ This is accurate, as far as it goes, but captures only one part of the current reality.

Today's corporate governance landscape is more complex and more interesting. There are three principal focuses of engagement between shareholders and firms. Type A engagements are the small number of high profile proxy contests that capture so much attention, such as Trian's effort to elect Nelson Peltz to the Procter & Gamble board.¹⁸ These contests illustrate the Gilson and Gordon model of hedge funds versus managers with the largest institutional investors determining the outcome. Typically, between ten and twenty proxy contest per year come to a vote.¹⁹

Type B issues involve market wide governance standards such as staggered boards, in-force poison pills, majority voting, board diversity. These issues are sometimes raised by shareholder proposals but the decisive influences are the proxy voting guidelines of the largest institutional investors and the voting recommendations by ISS and Glass Lewis, the two leading proxy advisers.

Type C engagements are the oversight of individual companies on governance and performance. Company-specific governance is the focus of the largest institutional investors' engagement with portfolio firms. By contrast, company-specific performance is largely

¹⁷ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism*, 113 *Colum. L. Rev.* 863 (2013).

¹⁸ See Thomas Heath, *P&G Announces It Narrowly Wins Proxy Fight against Activist Peltz*, *Wash. Post*, Oct. 10, 2017 (describing campaign).

¹⁹ In 2018, 34 proxy contests were launched against Russell 3000 companies. Of those, 21 settled, 3 were withdrawn and 10 went to a vote, with dissidents winning at 2 companies. Matteo Tonello, *Conference Board, Proxy Voting Analytics (2015-2018)*, available at <https://corpgov.law.harvard.edu/2018/11/26/shareholder-voting-in-the-united-states-trends-and-statistics-on-the-2015-2018-proxy-season/>

monitored by analysts and portfolio managers at actively managed mutual funds, activist hedge funds looking for targets, and, more generally, by sell-side and buy-side analysts.²⁰

When a hedge fund or an actively managed mutual fund engages with a firm on performance issues and proposes changes – a Type C performance issue – all parties understand that, in the absence of a negotiated resolution, the issue can become a Type A contest in which the largest shareholders will ultimately cast the decisive votes. The ability of determined activists to convert a Type C issue into a Type A issue has transformed the landscape. “Activism defense” has become an important legal and banking practice. Leading practitioners have often worked at the largest institutional investors or proxy advisory firms and are thus in a position to explain how large investors are likely to view a particular contest.²¹ Increasingly, these specialists are called in before an activist emerges in order to help boards anticipate and address the issues that an activist would focus on, with the goal of preventing the company from becoming a target.

In understanding the incentives of the large index funds in corporate governance, it is necessary to consider whether their incentives are adequate for the roles that they play.

A. The Relationship between Funds and Advisers

The current framing of the discussion in terms of “index funds” is fundamentally misleading. “Index funds,” like “actively managed funds,” are a collective of assets that perform no real functions that are of interest from a corporate governance perspective. Thus, the relevant discussion should be framed in terms of “investment advisers” rather than in terms of “funds.”

Funds are separate legal entities with their own boards of directors. The board’s role, however, is not to manage the fund but to retain (and monitor) “management” which is

²⁰ Michael J. Jung, M.H. Franco Wong and X. Frank Zhang, Buy-Side Analysts and Earnings Conference Calls, 56 J. Accounting Research 913-52 (2018); Anne Heinrichs, Jihwon Park and Eugene F. Soltes, Who Consumes Firm Disclosures? Evidence from Earnings Conference Calls, The Accounting Review, 10.2308/accr-52223, 94, 3, (205-231), (2019). “Buy-side” analysts work for institutional investors and advise on what to buy. “Sell-side” analysts work for brokerage firms and, as the name suggests, have an incentive to sell shares to clients of the firm.

²¹ Edward Rock, Institutional Investors in Corporate Governance, The Oxford Handbook of Corporate Law and Governance (edited by Jeffrey Gordon and Wolf-Georg Ringe) (2018)

provided externally by an “investment adviser” that owes fiduciary duties to the advised fund.²² It is the investment adviser – and portfolio managers hired by the investment adviser – that “manages” the assets in the fund, whether actively or by reference to an an index.²³ An investment adviser often manages multiple funds that employ different strategies and have different sets of investors; in addition, some advisers also separately manage assets on behalf of other clients such as pension funds, insurance companies, endowments, and high net worth individuals.²⁴

Investment advisers are often identified with the fund family.²⁵ Thus, FMR Inc. (FMR) is the investment adviser for most Fidelity funds and Vanguard Group Inc. (VGI) is the investment adviser for most Vanguard funds. The Fidelity Contrafund, the Vanguard Primecap Fund, and the Vanguard 500 Index Fund are all examples of mutual funds.²⁶

In active funds, the portfolio managers assigned to a fund typically have significant discretion with respect to the fund’s investment decisions. But at least as an initial matter, even with respect to shares held by active funds, most voting decisions are made at the investment adviser level.²⁷ In small advisers, the voting decisions may be made by the same

²² See Morley, *supra* note 15, at 1252 (explaining role of board).

²³ See generally Investment Company Institute, *Frequently Asked Questions About Mutual Fund Directors*, available at https://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.idc.

²⁴ See John Morley, *Too Big to Be Activist*, forthcoming __ So. Cal. L. Rev. __.

²⁵ Funds in the same fund family generally have identical board members. Thus, for example, the board composition of the Vanguard Primecap Fund is identical to the board composition of the Vanguard 500 Index Fund.

²⁶ Investment advisers must periodically disclose, in Forms 13F, the U.S. equity securities over which they exercise investment power and indicate whether they have voting power of these securities. Unlike individual funds, however, investment advisers do not disclose how they vote the shares over which they have voting power. The Forms 13F filed by FMR and VGI will aggregate the holdings of all funds advised by these companies as well as other holdings managed outside of the fund. Sometimes, funds that bear a name of a fund family are advised by a different adviser. The Vanguard Primecap Fund, for example, is advised by the Primecap Management Co. and Fidelity index funds are advised by Geode Capital Management. In such cases, the holdings of the funds may be included in the 13F of the family (as in the case of the Vanguard Primecap Fund) or in the 13F of the fund adviser (as in the case of the Fidelity index funds).

²⁷ See Steve Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Election*, 3 *Harvard Business Law Review* 35 (2013) (finding that funds in the same fund family typically vote shares the same way). When a fund in a family is advised by an outside adviser, initial responsibility for voting sometimes resides with the outside adviser (in its proxy voting group, if it has one, or elsewhere) and sometimes resides with the proxy group of the in-house adviser. This information, again, is not always directly disclosed but can often be deduced from the disclosed portfolio holdings and votes. Thus, although the Vanguard Primecap Fund is advised by Primecap and its shares are not included in the VGI Form 13F, until recently it voted its shares like other Vanguard funds and unlike other Primecap funds. See Thomas Franck, *Vanguard to Surrender some of its Corporate Voting Power to External Fund Managers*, CNBC, Apr. 25, 2019, available at

individuals who determine the investment strategy; many smaller advisers also have a policy of following the voting recommendations of a proxy adviser on virtually all votes.²⁸ By contrast, large investment advisers typically centralize the voting function in a “stewardship” or “proxy voting” group.²⁹ The members of the proxy voting group are responsible for making sure that shares are voted and have significant influence over how these shares are voted. But the proxy group can ask portfolio managers or stock analysts (who, like the proxy voting group, are employees of the investment adviser) for their views on how certain shares should be voted or portfolio managers and analysts can volunteer their input. Moreover, portfolio managers sometimes can vote the shares held by the funds they advise differently from the way shares held by other funds in the family are voted.³⁰

In sum, the investment adviser plays a central role with regard to voting. This role is particularly pronounced with regard to voting of shares held in index funds. Voting decisions for these shares will be made by the adviser’s proxy group, sometimes with input of portfolio managers for active funds or analysts.

Unlike funds, however, investment advisers do not pursue strategies – such as indexed or active – and thus cannot always be neatly categorized along these dimensions. Because of the disjunction between the level at which voting decisions are made (largely the adviser level) and the level at which strategy is determined (the fund level), it is therefore misleading to discuss governance activities of index funds. But it can also be misleading to ignore the role of portfolio managers for active funds in the structure of large investment advisers – and the

<https://www.cnbc.com/2019/04/25/vanguard-to-give-up-some-of-its-voting-power-to-external-fund-managers.html> (describing change in Vanguard’s policy to let outside advisers vote shares in Vanguard funds managed by that adviser). By contrast, Fidelity index funds advised by Geode frequently vote differently from other Fidelity funds, indicating that Fidelity’s proxy group does not make de jure or de facto voting decisions for these funds.

²⁸ See Choi et al., supra note 27.

²⁹ See, e.g., Vanguard Investment Stewardship Commentary, What We do. How We Do It. Why It Matters., April 2019, available at https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf (describing approach to voting and engagement by Vanguard’s stewardship group).

³⁰ The extent to which they do so varies among fund families and across issues and can be observed in the voting disclosures filed by funds. See Choi et al. supra note 27, at 48; Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds (2018), available at <https://ssrn.com/abstract=3124039>; see also Fichtner et al., supra note 5.

potential divergence of views and interests among portfolio managers employed by the same investment advisers.³¹

B. The Incentive Structure

Voting shares – determining how to vote shares and ensuring that all shares are voted – is an expense for investment advisers. To understand the incentives as to voting, one must therefore look at the overall strategy profile of the funds managed by an adviser. In actively managed funds, the fund adviser adopts a strategy that, *ex ante*, is expected to increase the value of assets under management (AUM). In exchange, the investment adviser receives a fee that is typically a percentage of AUM. The fund adviser can thus benefit in two ways from the success of the strategy: fees go up because the value of the portfolio increases (direct incentives); and fees go up if superior performance attracts additional investment into the fund (indirect or flow-based incentives).

By contrast, index fund assets are invested according to a pre-determined formula, typically seeking a market value weighted portfolio that tracks the performance of an “index” such as the S & P 500 index. Index funds compete on tracking error, cost and customer service but *not* on stock picking skills, as they do not pick stocks. Because index funds do not choose individual stocks, or adopt other specific strategies, their expenses are much lower than those of actively managed funds. Vanguard’s S & P 500 Index fund charges individual investors as little as 4 basis points per year (.04 percent of invested assets). By contrast, Fidelity’s Contrafund Fund, a large actively managed mutual fund with \$122 billion under management, charges 82 basis points.³²

This structure – higher fees for active funds than for index funds, potential additional benefit from fund flows for active funds – create complex incentives for investment advisers that manage both actively managed and indexed assets. Suppose that a fund family has one

³¹ See Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, forthcoming __ Yale L. J. __ (discussing implications of conflicts of interests).

³² Fidelity Contrafund Fact Sheet, available at <https://fundresearch.fidelity.com/mutual-funds/fundfactsheet/316071109>

actively managed fund, “Active,” for which it charges 82 basis points and one index fund, “Index,” that charges 4 basis points per year. A fund family’s annual fees will thus be

$$\text{Fees} = 0.0082 * \text{AUM (Active)} + 0.0004 * \text{AUM (Index)}.$$

This very simple example shows that AUM in actively managed funds are much more valuable to an adviser than assets in index funds. In the above example, assets in the active fund generate more than 2050% more fees than assets in the index fund. To be sure, running an active fund also entails greater costs. But because many of these greater costs are fixed and because index funds are essentially commodities – little distinguishes one family’s S&P 500 fund from its counterpart at another family³³ – it is likely that marginal profits per dollar invested are higher for active than for index funds. This provides an obvious incentive for fund families to encourage investors to shift investments from funds pursuing index strategies to funds pursuing active strategies.

Why then run index funds at all? There are several reasons. Some investors have a strong preference for index funds and would otherwise invest in a fund from a different family. Perhaps more importantly, having index funds as part of the product platform may generate economies of scope that may make it profitable to offer index funds even if the adviser earns no profits from managing the fund itself. Fidelity, for example, recently introduced a zero-fee index fund.³⁴ While this fund may generate some income to Fidelity from securities lending which conceivably could cover the expenses of running the fund, we would guess that operating this fund is unprofitable on a stand-alone basis.³⁵ But because it is substantially

³³ While this accurately describes retail “buy and hold” investors, the choice of index fund may be more complicated for institutional investors for whom greater liquidity is important and for whom greater liquidity may justify higher fees. BlackRock’s institutional index funds have historically charged fees in the range of 45 basis points because of the greater liquidity provided.

³⁴ Marketwatch, Fidelity Announces Zero-Fee Funds, in a Big Milestone for the Industry, Aug. 1, 2018, available at <https://www.marketwatch.com/story/fund-fees-hit-milestone-as-fidelity-announces-products-charging-0-2018-08-01>

³⁵ After all, Vanguard, which supposedly operates on a zero-profit margin, enjoys very large economies of scale charges as low as 4 basis points for its S&P 500 index fund. At Vanguard, any net income from securities lending is paid to the fund for the benefit of its shareholders and not retained by VGI. We do not have sufficient information to determine how any net income from securities lending retained by Fidelity compares to the fees charged by Vanguard on its index funds.

easier for investors to move investments among funds within a mutual fund family than between funds from different families, Fidelity may benefit by keeping investors seeking an index fund in-house, and attracting new customers to its index funds, in the expectations that such investors are more likely to invest in Fidelity's higher-fee active funds or purchase other services from Fidelity in the future.³⁶

Relatedly, depending on how a fund family structures its proxy voting process, indexed assets may increase the power of the portfolio managers of actively managed funds in their interactions with portfolio companies. BlackRock's \$3.9 trillion in indexed assets may open doors for its portfolio managers who advise its \$538 billion in actively managed assets for retail investors and \$1,080 billion for institutional investors.³⁷ This additional heft can be important when those portfolio managers ask questions, make suggestions, express views, object to corporate action, or seek individual meetings with management.

Importantly, mutual fund families differ significantly in the strategy profile of their managed funds. Other than the "Big Three", most larger fund families have a relatively small percentage of their AUM in index funds and these assets contribute an even smaller percentage to the families' total fee income. T. Rowe Price, for example, is mainly an actively managed house: of its \$564 billion in equity assets under management, only \$29 billion is in index funds.³⁸ Among the Big Three, almost all of State Street's equity assets are in indexed funds.³⁹ Vanguard and BlackRock, by contrast, have only about 80% of their equity assets in index funds.⁴⁰ Despite this similarity, Vanguard and BlackRock differ in important respects. First, even actively managed Vanguard funds charge a relatively low management fee.⁴¹ Thus, index funds will contribute a larger percentage of total fees to Vanguard than to BlackRock. Second,

³⁶ Similarly, investors' preferences and the desire to keep investors in-house may explain why Vanguard, the pioneer in index investing, has sponsored some actively managed funds.

³⁷ BlackRock, Inc., Form 10-K, Dec. 31, 2018, at 12/31/2017 10K at p. 4., available at <http://www.sn1.com/Cache/c396926153.html>.

³⁸ T. Rowe Price 12/31/2017 10K at p. 25 (\$564.1 billion in equity assets under management); T. Rowe Price Equity Index 500 Fund (\$28.8 billion in assets), available at <https://www3.troweprice.com/fb2/fbkweb/snapshot.do?ticker=PREIX>.

³⁹ Fichtner et al, *supra* note 5 (97%).

⁴⁰ *Id.*

⁴¹ For example, Vanguard's Primecap Fund has an expense ratio of 0.38%. See Vanguard PrimeCap Fund Investor Shares, Overview, available at <https://investor.vanguard.com/mutual-funds/profile/VPMCX>.

most of the active equity funds in the Vanguard family are managed or co-managed by outside advisers, such as Primecap Management Co which advises the Vanguard Primecap Fund.⁴² Thus, a portion of the additional fee income that accrues when an actively managed Vanguard fund does well accrues to the benefit of the outside adviser, not to Vanguard. Third, Vanguard Group Inc. – the legal entity that earns the management fees – is owned by the shareholders of the various Vanguard mutual funds and is not meant to make profits. By contrast, BlackRock’s active funds resemble more closely – in fee, management structure, and style – standard active funds and BlackRock itself is a publicly traded company separate from its funds and thus is expected to make profits from its investment advisory business.⁴³

Considering this overall structure, we now examine in greater detail how fund management fees provide a financial incentive for fund advisers to cast an informed vote. First, we consider the incentives to improve absolute returns that result from the fact that higher returns directly result in a higher value of assets under management which directly result in higher fees. Second, we consider the effect of returns on net flows into funds.

Although many commentators assume that management fees provide an incentive to increase the value of *actively* managed assets, some have suggested that the advisers to *index* funds have *no* incentives to do so.⁴⁴ As we show below, this is incorrect; in fact, investment advisers who manage the bulk of assets in index fund assets have substantial incentives to increase portfolio value. Indeed, the incentives of the Big Three are among the largest incentives of any shareholders, superior to those of most other institutional investors and of all but the largest individual investors.

⁴² Id.

⁴³ See BlackRock, History, available at <https://www.blackrock.com/corporate/about-us/blackrock-history> (noting that BlackRock had its initial public offering in 1999).

⁴⁴ See, e.g., Lund, *supra* note 8, at 119 (“Because a passive fund seeks only to match the performance of a market index—not outperform it—the fund lacks a financial incentive to ensure that the companies in their portfolio are well run.”); id. (“A passive fund that invests in governance, therefore, would improve the performance of all rival passive funds in equal measure. Moreover, investing in governance would also benefit active funds—in fact, active funds are able to reap even greater benefits from the passive fund’s investment because they can overweight the target company upon learning about the intervention. In other words, any investment in governance would benefit competitor funds while simultaneously driving up the passive fund’s costs. Therefore, unless the intervention were costless, it would be certain to harm the passive fund’s relative performance.”)

1. Direct Incentives

Advisers to index funds, like advisers to any other mutual funds, directly benefit if the portfolio companies held by the fund do well. Advisers' fees depend on the value of fund assets.⁴⁵ As the value of fund assets increases, fees increase proportionally.

To be sure, in percentage terms, index fund fees are low – substantially lower than the fees of actively managed funds. According to the Investment Company Institute, the average asset-weighted fee on equity index funds in 2017 was 9 basis points (that is 9/100 of 1% of the fund's assets). The corresponding average fee for actively-managed funds was 78 basis points.⁴⁶

Even these low fees, however, generate incentives in the context of voting that compare favorably to those of most other shareholders. The reason is that the assets managed by the principal advisers to largest equity index funds are extraordinarily large. Take, for example, Vanguard Group Inc. ("Vanguard"). The average annual fee for the five largest Vanguard funds is just 0.064% per year.⁴⁷ But the aggregate value of the shares in Vanguard administered portfolios is huge, as are its investments in portfolio companies. For example, at the end of the first quarter of 2019, Vanguard had around \$2.5 trillion of equities under management.⁴⁸

In the context of voting and of stewardship engagement more generally, portfolio size is important for two distinct reasons. First, the dollar amount that a fund family has invested in a certain company determines the base for any incremental fee income from an increase in portfolio value. Thus, consider Vanguard's incentives in 2017, the year in which Trian launched its proxy contest at Procter & Gamble.⁴⁹ In 2017, Vanguard held about 185 million shares of

⁴⁵ See 2018 Investment Company Factbook, *supra* note 3, at 112 (explaining that funds charge fees in the form of expense ratios as a percentage of AUM).

⁴⁶ *Id.* at 126

⁴⁷ Fund fee data were supplied to us by Professors Ryan Bubb and Emiliano Catan.

⁴⁸ Vanguard Group Inc., Form 13F Information Table, March 31, 2019, available at <https://www.sec.gov/Archives/edgar/data/102909000114420419026247/0001144204-19-026247-index.htm>

⁴⁹ As of the end of June, 2017, Vanguard held 180,730,770 shares of P & G. Vanguard Group Inc., Form 13F Information Table, June 30, 2017, available at https://www.sec.gov/Archives/edgar/data/102909/000095012317007433/xslForm13F_X01/form13fInfoTable.xml. At that time, P & G was trading for around \$87 per share. See Yahoo Finance, The Procter & Gamble Co., Historical Prices, available at <https://finance.yahoo.com/quote/PG/history?period1=1496264400&period2=1501534800&interval=1d&filter=history&frequency=1d>.

P&G with a market value of about \$17 billion.⁵⁰ If P&G's stock rises by 1% as a result of a voting outcome, the value of the Vanguard positions in P&G would increase by \$170 million and Vanguard's annual fees, applying the 0.064% rate, would increase by about \$109,000.⁵¹ Assuming that Vanguard expects to earn these annual fees for 10 more years before its investors withdraw funds, its additional fees would amount to about \$1.1 million. This is about the same dollar amount as the gain to an individual stockholder with \$110 million in P&G stock.

But Vanguard's monetary incentives to cast a value-increasing vote are substantially stronger than those of an individual shareholder with \$110 million in P&G stock. Because Vanguard administers about 150 times as many shares, its vote is much more likely to be outcome-determinative than the vote of such an individual shareholder. Assume, for simplicity, that the likelihood that a vote is outcome-determinative is proportional to the number of votes cast – an assumption that probably substantially *understates* the relative likelihood that the vote of large funds is outcome-determinative. In that case, Vanguard's direct financial incentives would be equivalent to those of an individual shareholder who owns about 1/12 of the number of shares held by Vanguard.⁵² For P&G, this implies that Vanguard's financial incentives to cast an informed vote are equivalent to the incentives of an individual shareholder with a staggering \$1.3 billion investment.⁵³

Note that the fact that P&G is one of the largest companies⁵⁴ affects only the dollar magnitude of the incentives, not the *relative* incentives of Vanguard compared to other

⁵⁰ See Table 2 below. Ownership figures are based on year-data filings and were converted in market value at the year-end market price of \$91.88 per share.

⁵¹ In fact, since Peltz's addition to the board of P & G on March 1, 2018, P & G stock has increased from \$79.50 to \$111.74 (June 20, 2019), a gain of 40%. See P&G Historical Prices, available at <http://www.pginvestor.com/Historic-Prices>.

⁵² Let p_v be the likelihood that Vanguard's vote is outcome determinative and normalize Vanguard's position to 1. Vanguard's benefit from becoming informed is thus $p_v * 0.64% * p_v * B$ where B is the percentage effect on the vote outcome on company value assuming that Vanguard earns additional fees of 0.064% for 10 years (assuming a 0% discount rate). For an individual investor with stake $1/s_i$, the equivalent benefit is $p_v/s_i * 1 * p_v/s_i * B$. An individual investor will obtain a benefit equivalent to Vanguard's if $0.64% = 1/s_i^2$ which is approximately true for $s_i = 12$.

⁵³ For comparison, Trian, when it launched the proxy contest at Procter & Gamble, had a \$3.5 billion stake. Michael Flaherty, Trian takes \$3.5 billion stake in Procter & Gamble, Reuters, Feb. 14, 2017, available at <https://www.reuters.com/article/us-procter-gamble-stake-trian-fund-idUSKBN15T2WR>

⁵⁴ Procter & Gamble is number 45 in the list of Fortune 500 companies. See Fortune 500, available at <http://fortune.com/fortune500/>.

shareholders. If Vanguard expects to earn its 0.064% fees on the increased stock value for 10 years, and if the likelihood that a vote is outcome-determinative is proportional to the number of votes cast, it will have incentives equivalent to those of an individual shareholder with 1/12 of its stake regardless of the dollar value of its position. And even if the Vanguard expected to earn its 0.064% fee on the increased stock value for only 2 years, its incentives would correspond to those of an individual shareholder with 1/28 of its stake. Because of Vanguard's size, its incentives will thus be substantially stronger than those of virtually all individual shareholders.

The bulk of assets in equity index funds are held in funds advised by the Big Three.⁵⁵ But the same logic applies to investment advisers who largely manage index funds but are smaller than the Big Three. Consider, for example, Charles Schwab, a smaller investment adviser that specializes in index funds. As of December 31, 2017, Charles Schwab held P&G stock worth "only" about \$1.2 billion and charges fees of about 0.04%.⁵⁶ Given the same assumptions that we used before, its incentives would be equivalent to those on an individual investor who held 1/16 of the stock held by Charles Schwab, or about \$74 million in P&G stock. Because even small investment advisers to index funds have incentives that are substantially stronger than those of most real-life individual shareholders, we strongly disagree with proposals by the various commentators who are argued that incentives of index funds are so trivial that index funds should lose their right to vote.⁵⁷

To be sure, Vanguard's incentives are substantially lower than the incentives of an individual shareholder who held a stake in P&G of the same size as Vanguard's – about 1/12 the size assuming Vanguard earns fees for 10 years.⁵⁸ Bebchuk and Hirst attribute this differential to the what they call "Agency Cost Theory of Index Fund Stewardship" and advocate a set of policy reforms designed to make passive investors into better corporate citizens.⁵⁹

⁵⁵ See Fichtner et al., *supra* note 5, at ___.

⁵⁶ See Table 2 below. Ownership figures were converted in market value at the year-end market price of \$91.88 per share.

⁵⁷ See *supra* notes 7 and 8.

⁵⁸ See Kahan & Rock, *supra* note 14, at 1050.

⁵⁹ See Bebchuk & Hirst, *supra* note 10, at 17 – 19 (calculating incentives assuming annual fees are earned for only one year). Perhaps ironically, one reason why Vanguard's incentives are not higher is that its fees are so low. If Vanguard charged fees equivalent to those of active funds, its incentives, assuming 10 year holdings, would be only

We believe that the Bebchuk and Hirst analysis misses the point. The reason why advisers to index fund (or, for that matter, advisers to other types of mutual funds) do not have incentives equivalent to those of true owners is that they are not the owners of the stocks in the portfolios they advise.⁶⁰ Rather, economically, the owners are the mutual fund investors.

The question to ask is therefore whether, given the underlying economic ownership structure, the agency, collective action and free-rider costs associated with publicly traded companies would be lower if the present-day index fund investors held shares directly (rather than through funds). Because the incentives of Vanguard and other index fund advisers are multiple orders of magnitude higher than the incentives that the shareholders of Vanguard or other index funds would have given their actual stake, the answer is obvious.⁶¹ Looking at incentives from this perspective, in our view, is not a question is whether the glass is half-empty or half-full. Vanguard's relative incentive are so much higher than the incentives of individual shareholders that the relevant metaphor is to a glass that is more than 99% full. Put differently, index funds like Vanguard's are a solution (albeit an imperfect one) to the costs of dispersed ownership, rather than a cause of these costs. And given the underlying economic ownership structure, the costs of dispersed ownership are virtually baked into the system and do not lend themselves to be reduced through easy fixes.⁶²

1/12 of those of an individual holder with a stake equivalent to Vanguard. The fact that Vanguard charges low fees is of course beneficial to its investors, and not a reflection of agency costs.

⁶⁰ See Rock, *supra* note 14, at 469 ("Institutional investors are intermediaries: the investment and voting decisions are made by someone other than the beneficiaries")

⁶¹ In an intriguing article, Sean Griffith argues that mutual funds should devolve voting rights to their investors on issues where investors lack a common purpose, such as some environmental and social issues. See Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Default Rule for Mutual Fund Voting*, forthcoming, __Texas L. Rev. __. We agree with Griffith's assessment that voting on issues where investors lack a common purpose of maximizing returns is conceptually distinct from other voting. But because mutual fund investors often have very low stakes in portfolio companies and soliciting their votes entail expenses, we doubt whether devolution of such votes is cost-effective.

⁶² The various proposals made by Bebchuk and Hirst to reduce the agency costs of index fund stewardship are thus, in our view, not likely to be effective. See Bebchuk & Hirst, *supra* note 10, at 56-58, 59-62. In particular, bringing transparency to private engagements (*id.* at 56-58) would raise the costs to engagements and could reduce their effectiveness, thus resulting in fewer engagements; facilitating the charging of stewardship costs to funds (*id.* at 56-57) is not needed as funds could (and, in effect, do) contract with advisers to provide stewardship; having outside organizations conduct research on behalf of advisers (*id.* at 57) would aggravate the incentive problem as outside organizations would have fewer incentives that advisers presently do and, in any case, outside organizations that do so – ISS and Glass Lewis in particular – already exist; and making stewardship expenses mandatory, even if unwanted by fund investors (*id.* at 58), would not seem to be an effective way to address agency costs arising between fund investors and advisers.

Perhaps individual shareholders are not the right comparison group. Individual shareholders have notoriously poor incentives to cast an informed vote. Saying that Vanguard's or Schwab's incentives are superior to those of individual shareholders, even ones who hold stock worth double-digit millions of dollars, may be more of a reflection on the poor incentives of individuals than those of advisers to index funds.

Perhaps the better inquiry is then how Vanguard's incentives compare to those of actively managed mutual fund families. With respect to direct incentives,⁶³ index funds differ from actively-managed funds in three important respects. First, active funds charge higher annual fees. As noted, the average fee for an active fund in 2017 was 78 basis points, compared to 9 basis points for index funds.⁶⁴ Higher fees generate correspondingly better incentives to cast informed votes for active funds.

Second, actively managed funds are likely to have more concentrated portfolios. Almost by definition, actively-managed funds will tend to invest in fewer companies than broad-based index funds and their largest investments will tend to constitute a greater percentage of their net assets than the corresponding investments for index funds. Thus, for example, as of December 31, 2017, the 10 largest holdings of the Fidelity Contrafund, the largest active fund, constituted 38.1% of its net assets;⁶⁵ the 10 largest holdings of the Vanguard S&P 500 Index fund constituted only 20.9% of its assets.⁶⁶

Looking at stock concentration at the individual fund level, however, overstates stock concentration at the fund *family* level. As illustration, consider Table 1 below which provides, for the six companies with the largest dollar stakes held by the Fidelity Contrafund, the holdings in the company as a percentage of total domestic equity holdings for the Contrafund, the S&P 500 Index fund, and FMR (the adviser for Fidelity's non-index funds). For each company, FMR's relative holdings were below the Contrafund's relative holdings; and for the 6 companies

⁶³ Other differences, including the fact that actively-traded funds have stronger flow-based incentives, are discussed further below.

⁶⁴ See *supra*, text accompanying note 46.

⁶⁵ See Fidelity Contrafund, Form N-CSR, Dec. 31, 2017, available at <https://www.sec.gov/Archives/edgar/data/24238/000137949118000849/filing706.htm#350158510>

⁶⁶ See Vanguard Index Funds, Form N-CSR, Dec. 31, 2017, available at https://www.sec.gov/Archives/edgar/data/36405/000093247118005288/indexfunds_final.htm

combined, FMR’s relative holdings were similar to those of the S&P Index Fund. At the fund family level, holdings by advisers to actively managed funds – in particular large advisers like Fidelity that manage multiple active funds – will thus tend to be less concentrated than holdings of particular funds.

Table 1: Fidelity Contrafund – Largest Holdings (as of December 31, 2017)

	Contrafund	S&P Index Fund	FMR
Alphabet	6.7	2.7	3.7
Amazon	5.1	2.0	2.4
Apple	3.2	3.8	2.4
Berkshire H.	5.2	1.7	1.4
Facebook	7.2	1.8	2.5
Microsoft	3.1	2.9	1.9
Combined	30.5	14.9	14.3

Third, active funds and index fund may differ in the number of years over which they earn the higher fees. The number of years over which a fund will earn higher fees if the value of stock in its portfolio increases depends on the period of time for which the fund investors will keep owning the fund.⁶⁷ To illustrate, if all fund investors withdraw all their funds after one year, the fund will earn the higher annual fees for one year only; if they all withdraw all their funds only after ten years, they will earn the higher annual fees for ten years.⁶⁸

How long fund investors retain their investment depends on the investors’ liquidity needs, and investors’ proclivity to move assets actively among investment vehicles. While we see no strong reason why investors in index funds would have systematically different liquidity

⁶⁷ Specifically, funds will earn higher fees for as long, and to the extent, their voting and engagement raises the amount of their AUM. Assuming that index fund performance does not affect the amount of new inflows into index fund, see infra TAN, this period will be a function of the lengths of time for which existing investors keep holding the fund and the degree to which withdrawals are higher because fund value increased (e.g. because existing investors seek to liquidate their entire investment rather than withdraw a specific amount from a fund for a specific purpose). By contrast, the fund’s portfolio turnover rate will not per se affect the amount of AUM.

⁶⁸ Withdrawals will affect marginal fee income if the amount of withdrawals from the fund depends on its net asset value (for example, if investors want to withdraw all their investments, rather than just a specific amount independent of their total investment). To the extent, withdrawals will proportionally reduce marginal future fee income. To the extent withdrawals of the same amount would have taken place in any case, they will have no effect on marginal future fee income.

needs than investors in active funds, there are reasons to believe that they will have a lesser proclivity to shift investments among investment vehicles. One reason for such a shift is that investors attempt to play the mutual fund market – that is, to sell under-performing funds and buy funds that they believe will out-perform the stock market. Plausibly, investors who buy index funds – funds designed to hold the market and not to try to identify under-valued *stocks* deemed likely to out-perform other stocks – are less inclined themselves to try to identify *funds* that are deemed likely to out-perform other funds. To that extent, index funds would expect to earn their annual fees for more years than actively-managed funds do.

To derive a ballpark estimate of the relative direct incentives, we examined some of the largest institutional owners of P&G that advise mutual funds. For each adviser, we calculated the fees by multiplying the dollar value of the shares owned by the average fees of that adviser’s five largest funds. We also assumed, conservatively, that index funds and active funds do *not* differ in the number of years over which they would earn the fees and that the likelihood that a vote is outcome determinative is proportional to the adviser’s stake. Table 2 below shows each adviser’s direct incentives to cast an informed an informed vote *relative to* Vanguard’s direct incentives. As the table shows, the relative incentives of BlackRock, Vanguard and State Street are the highest in the industry.

BlackRock, Vanguard and State Street’s incentives, for that matter, also compare favorably to those of public pension funds. Assuming that index funds expect to earn fees for ten years and the public pension fund incentives are equivalent of those of an individual owner holding the same number of shares, even the largest public pension funds have incentives that are far below those of BlackRock, Vanguard or State Street’s and none that are as high as BlackRock’s. Most of the other public pension funds, which number in the thousands, would have even lower incentives.

Table 2: Largest Holders of Procter &Gamble- 2017

Adviser	Shares (in 000)	Relative Incentive
VANGUARD GROUP, INC.	185,434	1.00
BLACKROCK	164,446	1.97
STATE STR CORPORATION	114,721	0.85

CAPITAL WORLD INVESTORS	35,132	0.35
NORTHERN TRUST CORP	34,388	0.25
MELLON BANK NA	28,288	0.30
GEODE CAPITAL MGMT, L.L.C.	27,189	0.014
FIDELITY MGMT & RESEARCH CO	22,463	0.10
STATE FARM MUT AUTOMOBILE INS	20,546	0.08
GOLDMAN SACHS & COMPANY	16,001	0.09
YACKTMAN ASSET MANAGEMENT LP	15,163	0.10
CHARLES SCHWAB	12,850	0.003
WELLINGTON MANAGEMENT CO, LLP	8,212	0.009
T. ROWE PRICE ASSOCIATES, INC.	7,067	0.015
FRANKLIN RESOURCES INC	6,110	0.013
CREDIT SUISSE SECS (USA) LLC	4,984	0.017
NEW YORK STATE COMMON RET SYS	7,233	0.24
CALIFORNIA PUBLIC EMP' RET SYS	6,652	0.20
CALIFORNIA STATE TEACH' RET SYS	4,798	0.10
NEW YORK STATE TEACH' RET SYS	4,260	0.08
STATE NJ COMMON PENSION FD D	2,189	0.02

Based on 13F filings for December 31, 2017

P&G, of course, is only one company. But the share ownership structure of P&G is reasonably representative. As the Big Three, together with Fidelity, are by far the largest institutional investment advisers,⁶⁹ they are among the largest shareholders in most companies.⁷⁰

As the preceding analysis shows, among mutual fund advisers, the most important factor by far in determining how much a fund adviser stands to gain from being informed is the size of the holdings. Because the most prominent investment advisers that focus on index funds, Vanguard, State Street and BlackRock, are also the largest investment advisers period, they stand to gain the most from casting informed votes. To the extent that they also provide active management for some of their clients, their incentives – already substantial – are even

⁶⁹ See Fichtner et al., supra note 5.

⁷⁰ See Miguel Anton, Florian Ederer, Mireia Gine & Martin Schmalz, *Common Ownership, Competition, and Top Management Incentives* (European Corporate Governance Institute, Finance Working Paper No. 511/2017, 2017), available at <http://papers.ssrn.com/abstract=2802332> (showing that as of 2013, Blackrock, Vanguard and State Street were among the largest 10 shareholders in the largest percentage of companies).

higher. Thus, as between Vanguard, State Street and BlackRock, the fact that BlackRock is an adviser to relatively more higher-fee active funds increases its relative incentives.

Advisers who specialize in index funds other than the big three – advisers like Geode, which manages and votes the Fidelity index votes, or Charles Schwab – of course have lower incentives. But their incentives are still superior to those of many smaller active fund advisers not included in the table, those of many public pension funds, and those of almost all individual investors.

The analysis we have offered in this section is consistent with an argument frequently made about the competitive incentives of index funds. That argument runs largely as follows. Because the product offered by different index funds – matching an index and shareholder services – is almost identical, funds attract investors by charging low fees. Index funds, however, gain no competitive advantage over other index funds by casting informed votes. Even if their voting increases portfolio value, other competing index funds will obtain a corresponding increase and the fund who invested in casting an informed vote will obtain no competitive advantage. Because of the competitive structure, and because investment in voting by one fund would benefit a competing index fund, index funds who charge higher fees in order to cover the additional expense of investment in voting may be at a competitive disadvantage.⁷¹

None of these observations, however, affect the analysis we have offered. Our analysis does not turn on index funds deriving any *competitive advantage* from casting an informed vote. Rather, it depends solely on the fact that *advisers* to index funds (and other funds), *through their annual fees*, obtain an economic stake – albeit a small one in percentage terms – in the value of the stocks in their portfolio. The advisers of index funds thus have incentives to cast informed votes because these votes may raise the dollar amount of fees they obtain, regardless of any competitive advantage (or lack thereof) they obtain.

To make this concrete, consider again Trian’s proxy contest at Procter & Gamble. Since Nelson Peltz’s addition to the board of Procter & Gamble on March 1, 2018, the company’s

⁷¹ See Lund, *supra* note 8, at ___; Bebchuk & Hirst, *supra* note 10, at 4, 19-20 (“Competition with other index funds gives index fund managers precisely zero additional incentive”).

stock has increased from \$79.50 to \$111.74 (June 20, 2019), a gain of 40%.⁷² The value of Vanguard's position on March 1, 2018 was approximately \$ 14.7billion,⁷³ and has thus increased by \$5.9 billion, resulting in increased management fees (applying the 0.064% rate) of around \$3.76 million per year. Even leaving aside Vanguard's fiduciary duty to vote the shares it controls intelligently, this provides a significant economic incentive to invest the resources necessary to decide intelligently between Trian's arguments and the opposing arguments by the Procter & Gamble board.

This is an example of what Mancur Olson called the "exploitation of the great by the small."⁷⁴ Because the advisers to the largest index funds, by virtue of their huge size, *independently* have incentives to cast informed votes (thereby reducing the classic problems of rational apathy and free riding), other shareholders benefit without bearing any of the cost. The importance of this cannot be overstated. It is this basic alignment of interests of the huge fund families with individual firm value, driven by their huge size, the makes them peculiarly well suited to play the "decider" role in corporate governance.

2. Indirect Incentives: The Impact on Fund Flows

a. Actively-Managed Funds

Managers of actively-managed funds care about their performance not only because an increase in the value of the stock in their portfolio directly increases fees but also because such an increase may result in larger net inflows into the fund. Net inflows, in turn, further increase fees. These indirect incentives – the benefits from casting an informed vote that result from the effect on net inflows – are often seen as a substantial difference between the incentives of index funds and of actively managed funds.⁷⁵

⁷² See supra note 51.

⁷³ Vanguard Group Inc., Form 13F Information Table, March 31, 2018, available at <https://www.sec.gov/Archives/edgar/data/102909000095012318005610/0000950123-18-005610-index.htm>.

⁷⁴ Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2d ed. 1971) at 29 (footnote omitted). For further discussion, see Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *Geo. L. J.* 445, 461-62 (1991).

⁷⁵ See, e.g., Lund, supra note 8; Bebchuk & Hurst, supra note 10.

As to such flow-based incentives, it is important to distinguish between the investment adviser's incentives overall – sometimes implemented through a centralized proxy voting group -- and the incentives of the individual portfolio managers charged with managing a specific fund. As we have explained, both the voting group and portfolio managers can have input into votes, and the degree of input varies across families and within families across issues. One therefore needs to consider both sets of incentives separately.

Empirical evidence has shown that relative fund performance, rather than absolute performance, affects fund flows.⁷⁶ But this implies that attracting future fund flows generates *no incentives* for a portfolio manager to cast an informed vote to increase the value of stock in which a fund is *underweight* relative to competing funds or the benchmark. To the contrary, funds could improve their relative performance if shares of firms in which they are underweight *declined*.

Even for stocks in which a fund is overweight, relative performance will only improve *to the extent* a fund is overweight. If the benchmark weight of a stock is 0.2% and the weight in the portfolio of a fund is 0.22%, only the 0.02% excess weight will contribute to the fund's relative performance. In sum, from the perspective of a portfolio manager, improving relative fund performance will generate no incentives to invest in information as to some stocks in the portfolio and only attenuated incentives as to all other stocks.

From the perspective of a fund family, the effect on incentives is likely to be even further attenuated. As we have seen, fund family portfolios resemble the market more closely than the portfolios of individual funds.⁷⁷ To get a sense of the extent to which fund family portfolios differ from market portfolios, we randomly selected 20 domestic stocks listed on the 13F filed by T. Rowe Price Associates, one of the largest advisers of actively-managed funds,

⁷⁶ The seminal article is Ippolito, R. 1992. Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry. *Journal of Law and Economics* 35:45–70. Other important contributions include: Chevalier, J., and G. Ellison. 1997. Risk-Taking by Mutual Funds as a Response to Incentives. *Journal of Political Economy* 105:1167–1200; Berk, J., and R. Green. 2004. Mutual Fund Flows and Performance in Rational Markets. *Journal of Political Economy* 112:1269–95; Frazzini, A., and O. Lamont. 2008. Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns. *Journal of Financial Economics* 88:299–322; Sensoy, B. 2009. Performance Evaluation and Self-Designated Benchmark Indexes in the Mutual Fund Industry. *Journal of Financial Economics* 92:25–39.

⁷⁷ See *supra* Table 1.

and compared their weight in the T. Rowe Price portfolio to the weight of these stocks in the 13F report filed by the Vanguard Group, as a proxy for the market.⁷⁸ For 15 of the 20 stocks, T. Rowe Price was underweight relative to the market. For the other five stocks, T. Rowe Price was overweight relative to the market, by 11%, 31%, 88%, 201% and 413% respectively. In these stock, for flow-based incentives to be equivalent to the direct incentives discussed before, each \$1 in excess performance (relative to the benchmark) generated by an informed vote would have to result in net inflows to the fund family of \$10.09, \$4.23, \$2.13, \$1.49 and \$1.24, respectively.⁷⁹

A recent working paper by Lewellen and Lewellen examined the effect of performance on fund family flows.⁸⁰ It estimated a fund family flow-to-performance sensitivity of 1.29%. That is, for a 1% performance above the benchmark, a fund family would obtain a net inflow (over several years) of an additional 1.29% of assets. Placed into perspective, for a stock in which the fund family is underweight (relative to the benchmark), flow-based incentives are negative; for a stock in which the family is overweight by less than 77.5% (i.e., its holdings are above the benchmark but less than 77.5% above it), flow-based incentives are positive, but lower than direct incentives; and for stock in which the family is overweight by more than 77.5%, flow-based incentives are larger than direct incentives.

For fund families with highly concentrated holdings, flow-based incentives may dominate direct incentives. Such families exist, but most such families are on the small side. Thus, Lewellen and Lewellen found that institutions in the bottom 25% of assets under management invested on average 3.50% (value weighted) of their portfolio in a given firm, compared to a benchmark weight of 0.29%. These institutions are thus about 1,100%

⁷⁸ T. Rowe Price., Form 13F Information Table, Dec. 31, 2017, available at https://www.sec.gov/Archives/edgar/data/80255/000008025518001796/xslForm13F_X01/infotable.xml and Vanguard Group Inc., Form 13F Information Table, Dec. 31, 2017, available at https://www.sec.gov/Archives/edgar/data/102909/000095012318002112/xslForm13F_X01/form13finfoTable.xml

⁷⁹ Consider the stock in which T. Rowe Price is weighted at 111% of the market portfolio. To generate \$1 in excess performance, the value of T. Rowe Price's holdings have to increase by $\$1 * 111/11 = \10.09 . An increase of \$10.09 generates direct benefits in the amount of $\$10.09 * \mu$ where μ is a function of the fees and the investor holding period in the fund. To generate equivalent flow-based incentives, the \$1 increase would have to generate net inflows in the amount of \$10.09. The other figures were calculated in an equivalent manner.

⁸⁰ Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentives to be Engaged at 12 (Working Paper 2018).

overweight, with flow-based incentives much 20% larger than direct incentives. But because assets under management by these institutions are very low (average AUM of \$1.2 billion in 2011-2015), total incentives remained very low.⁸¹

In comparison, the quartile of the largest institutions (average AUM of \$736.4 billion) invested just 0.52% in a given firm compared to a benchmark weight of 0.4% – i.e., they were overweight by 30%. For those institutions, direct incentives were more than three times higher than flow-based incentives – and overall incentives that dwarf those of the smallest quartile.⁸²

For individual fund portfolio managers, enhancing relative performance may, on one level, be more important than it is for fund families: individual fund holdings are likely to be more concentrated, making fund performance more sensitive to the performance of individual stocks than fund family performance; and net fund flows are likely to be more sensitive to fund performance than net fund family flows.⁸³ On the other hand, of course, size matters for flow-based incentives as well. At larger fund families, individual funds generally hold many fewer shares than fund families do. Thus, the degree to which they are overweight – measured in the *number* of shares by which they are overweight – and the degree to which performance by an individual stock will affect relative performance – measured in *dollar* amounts – will tend to be small in comparison to fund families. Moreover, unless a portfolio manager is able to persuade the entire fund family to cast its votes a certain way, the comparatively small holdings by an individual fund will make it relatively unlikely that its votes will be outcome determinative. To the extent that fund portfolio managers do not expect to influence the voting outcome, they

⁸¹ Id. at 15, Figure 2.

⁸² Id. (finding gains from a certain percentage increase in portfolio firm value to be 14 times as high).

⁸³ As to fund flows, the empirical evidence to date would suggest that indirect effects are of a comparatively small magnitude. The evidence is a bit hard to interpret. Several of the studies on the effect of performance on fund flows examine the performance ranking – for example, whether a fund’s performance places it in the top decile or top quarter of funds with a similar objective – rather than the fund’s relative performance in terms of excess returns. Moreover, the effect of performance on flows is not linear, but is concentrated on the top-performing funds. See *infra* note 88. This being said, a recent paper in the Review of Financial Studies derives a linear estimate of the effect of CAMP Alpha on fund flows. Brad M. Barber, Xing Huang & Terrance Odean, Which Factors Matter to Investors/Evidence from Mutual Fund Flows, 29 Rev. Fin. Stud. 2600 (2016). (The price impact of votes that turn on company-specific information should be reflected in alpha to the extent a fund is over- or underweight in the stock of the company.) The study arrives at a point estimate of 0.474 – that is, a 1% increase in alpha generates 0.474% in net inflows. Even for the stock of the company in our sample in which T. Rowe Price was the most overweight, and even assuming that all the net inflow is coming from outside the fund family, indirect effects in that magnitude would amount to only roughly 2/5 of the direct effects.

will have very low incentives to acquire information related to voting that goes – beyond information that they would acquire in any case related to their investment decisions (an issue we address in the next Part).

Overall, then, for the bulk of investments held by actively-managed funds, flow-based incentives will be irrelevant or of a lower magnitude than direct incentives. However, for some companies in which an adviser to actively managed fund, or a portfolio manager for a particular fund, is substantially overweight, flow-based incentives may dominate direct incentives.

b. Index Funds

In accordance with conventional wisdom,⁸⁴ our discussion has so far assumed that managers of index funds have no incentives to enhance their relative performance in order to obtain net inflows. In a recent paper, however, Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon (FHDS) have argued that index funds have indirect incentives similar in nature to those of active funds.⁸⁵ Their argument is basically the flip-side of the argument for active funds: just as active funds can generate inflows by superior performance relative to the index, index funds can generate inflows by improving index funds performance relative to active funds.⁸⁶ Thus, FHDS argue that index funds would benefit – through improving the performance of index funds relative to active funds – by improving governance at underperforming companies.⁸⁷

⁸⁴ See supra note 71.

⁸⁵ Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon, *Passive Investors* (June 29, 2018) available at <http://ssrn.com/abstract=3192069>. A similar point was made by Bernie Black in 1992, Bernard Black, *Agents Watching Agents*, 39 UCLA L. Rev. 811, 879-881 (1992) (noting that index funds compete with active funds and non-equity investments).

⁸⁶ FHDS further claim that these indirect incentives induce index funds to improve poorly-managed firms, in which active funds are underinvested. But there is no reason to believe actively managed funds tend not to own shares in companies that under-performed the market. If they did, then actively managed funds as a whole would systematically outperform index funds – which they do not. Moreover, stock performance is not closely related to good management. The assessed quality of management will be reflected in the market price and increase the share price, but that does not mean that these shares will therefore be attractive to actively managed funds. Actively-managed funds try to buy shares that will increase in value, not shares that are already highly valued. That is, they will buy shares in companies where they believe management is better than the market believes it is, and for many other reasons unrelated to management quality.

⁸⁷ FHDS further argue that index funds can benefit by increasing transparency, such as by improving the quality of disclosed financial information, and thereby reducing mispricing. To be sure, mispricing can enable some investors – those who have ferreted out the mispricing -- to beat the market. But it is far from clear than active funds systematically benefit from mispricing at the expense of index funds or that index funds can do much about this by voting or engaging with portfolio companies.

For index funds, however, the relationship between firm performance and fund flows is at best highly tenuous; to the limited extent any relationship exists, there is no evidence that it affects index fund advisers' voting or engagement policies. First, although empirical evidence shows that performance is related to fund flows, this relation is not linear. Thus, Erik Sirri and Peter Tufano found that for the three bottom-quartile of funds, fund flows are not significantly related to performance. The relationship is only significant for the top quartile of funds.⁸⁸ Since index funds are unlikely to ever be in the top quartile of performers relative to their benchmark, this study implies that flows to index funds would be relatively insensitive to performance.

Second, as discussed, index funds would improve their relative performance if the price of a portfolio company increases only if, and only to the extent that, the index fund is overweight in the portfolio company. To determine whether an S&P 500 index fund is overweight in any company relative to active funds, the adviser would have to collect information about holdings in that company by all active funds. This would require the aggregation of large amounts of data that is released quarterly and with a 45-day lag.⁸⁹ Then, for the stratagem to work, active funds could not substantially increase the weight in the stock from the time as of which their stakes were disclosed until the time the index funds efforts

First, although mispricing can enable some investors (informed investors) to beat the market, they do so at the expense not of shareholders at large but only of investors who engage in trading. Investors who engage in trading may stand on the losing side of the trade with informed investors and informed trading in general reduces liquidity and increases the bid-ask spread. Thus, it is likely that the bulk of the costs of informed trading is borne by other active funds that engage in substantial trading activity. Buy-and-hold investors and investors that trade little, such as large index funds, will not bear much of the costs. It is thus unclear whether active funds as a group benefit from mispricing. Indeed, one could plausibly argue that hedge funds have a comparative advantage over actively managed mutual fund in detecting mispricing and that the main effect of mispricing is to benefit hedge funds at the expense of actively managed fund. From that perspective, mispricing could easily enhance the performance of index funds relative to actively managed funds.

Second, even to the extent that actively managed fund systematically benefit from mispricing, it is unclear what index fund can do, and what they in fact do, to reduce mispricing by voting their shares or engaging with portfolio companies. To be sure, index fund advisers may favor rules like Regulation FD that are designed to reduce the degree of asymmetric information held by investors. But the kind of issues that shareholders vote on – directors, say-on-pay, shareholder proposals – and the topics that arise in engagements meeting have no clear impact on the pricing of a company's securities.

⁸⁸ Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. Fin. 1589 (1998).

⁸⁹ Although 13Fs are released quarterly, they may not be useful for this purpose since they aggregate information of holdings for funds that do not have a comparable strategy as the index fund.

come to fruition and the stock price increases. These requirements greatly complicate efforts by index funds to enhance their relative performance.

Third, even if index funds were to do all of this, the strategy proposed by FHDS is unlikely to contribute much to index fund relative performance. For one, there is an inherent upper limit on the degree to which an index funds can be “overweight” in any particular stock. Indeed, relative to the index benchmark, index funds should not be overweight in any stock. Index funds could only be “overweight” if active funds shun certain stocks. Plausibly, active funds in the aggregate may be underweight by 20% or 33% relative to the index, making index funds overweight (relative to active funds) by 25% or 50%. But as we have shown above, flow-based incentives are very sensitive to the degree to which a fund or adviser is overweight in a stock. Being overweight by 25% or 50% would not contribute much to aggregate incentives. Moreover, while actively managed funds are in control over the degree to which they are overweight in certain stock, the degree to which an index fund is overweight is completely out of its control. The companies in which index funds may find themselves overweight may not lend themselves to improvement in value, and the companies that lend themselves to improvements may not be the ones in which index funds are overweight. Finally, index funds are highly diversified and invest in a large number of shares. As a result, superior performance of a single or a few shares will contribute little to the overall performance of the fund.

We doubt that the stewardship groups at index funds advisers are even aware whether they are overweight or underweight in a company relative to active funds taken as a whole. We are also not aware of any evidence that would suggest that index fund advisers structure their votes or their engagement based on whether they are so overweight. To the contrary, the evidence as to voting suggests that it is often governed by published policies that apply equally to all companies – both ones where funds are overweight or underweight. As to flow-based incentives of index funds, we therefore believe that the conventional wisdom is correct: such incentives are irrelevant.

3. Reputational Incentives

BlackRock, Vanguard, and State Street – the sponsors of the largest index funds – are also the largest U.S. asset management companies.⁹⁰ In 2017, their combined assets under management exceeded \$10 trillion. As regulated financial institutions of enormous size, these companies stand in the public eye. They have strong reputational interests to be perceived – by investors, regulators, and politicians – as responsible actors who are a force for the good.

In this regard, the annual letters that BlackRock’s CEO Larry Fink sends to portfolio company CEOs have become a widely-followed window into the thinking of the largest investor, and are covered with the attention previously only given to Warren Buffett’s annual shareholder letter.

The January 2017 letter focused on BlackRock’s engagement with companies:

BlackRock engages with companies from the perspective of a long-term shareholder. Since many of our clients’ holdings result from index-linked investments – which we cannot sell as long as those securities remain in an index – our clients are the definitive long-term investors. As a fiduciary acting on behalf of these clients, BlackRock takes corporate governance particularly seriously and engages with our voice, and with our vote, on matters that can influence the long-term value of firms. With the continued growth of index investing, including the use of ETFs by active managers, advocacy and engagement have become even more important for protecting the long-term interests of investors.

As we seek to build long-term value for our clients through engagement, our aim is not to micromanage a company’s operations. Instead, our primary focus is to ensure board accountability for creating long-term value. However, a long-term approach should not be confused with an infinitely patient one. When BlackRock does not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect our clients’ long-term economic interests, we do not hesitate to exercise our right to vote against incumbent directors or misaligned executive compensation.⁹¹

In his January 2018 letter, “A Sense of Purpose,”⁹² Fink seemingly aligned BlackRock with those calling on companies to pay more attention to environmental, social and governance concerns (ESG):

⁹⁰ See Fichtner et al. *supra* note 5.

⁹¹ Akin Oyedele, Here is the letter the world's largest investor, BlackRock CEO Larry Fink, just sent to CEOs everywhere, Business Insider, Jan. 29, 2017, available at <https://www.businessinsider.com.au/blackrock-larry-fink-letter-to-ceos-2017-1>

⁹² BlackRock, Larry Fink’s 2019 Letter to CEOs, Purpose & Profit, available at <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

As a fiduciary, BlackRock engages with companies to drive the sustainable, long-term growth that our clients need to meet their goals. . .

To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

These letters can be understood as directed to several audiences beyond the CEOs of the companies in BlackRock's portfolio. First, as the largest institutional investor, BlackRock faces "political risk." Given the U.S.'s historical suspicion of concentrated economic power,⁹³ BlackRock's CEO must worry about the prospect of regulation. The best way to avoid regulation is to be viewed by relevant audiences as responsible stewards. The emphasis on long term value creation addresses these concerns. Similarly, the more recent discussion of purpose, of making a positive contribution to society, and of benefiting all stakeholders, can be understood as responding to the concern (triggered in part by the UK vote on "Brexit" and the election of Donald Trump) that large portions of the electorate feel left out. Given BlackRock's prominence, it makes perfect sense that its CEO will address these matters of public concern.

Second, BlackRock, like any business in a competitive market, will compete on both price and non-price dimensions. Price competition among index funds, led by Vanguard which is owned by its investors and thus acts rather like a nonprofit, has been fierce. Forced to meet Vanguard's low management fees, competition may be shifting from price to non-price elements. Customer service is one dimension of non-price competition. Embracing ESG concerns may be another. In a world in which index funds are largely indistinguishable on price

⁹³ For how this has shaped corporate governance, see Mark Roe, *Strong Managers, Weak Owners* (1996).

and tracking error, BlackRock may gain additional assets by portraying itself as a responsible investor and thereby appealing to investors with a “taste” for socially responsible investment. Consider, for example, a university investment committee that is being pressured by student activists to invest in a more environmentally conscious and sustainable way. If BlackRock can establish itself as the environmentally conscious index fund, it will likely attract assets from such committees, especially if BlackRock’s fees and performance are competitive.

The scale of these large asset managers means that even large percentage increases in governance capacity may be justifiable on “reputational” grounds. In his 2018 letter, Fink announced that, over the next three years, BlackRock would double the size of its investment stewardship group, already the largest in the industry. This huge increase in capacity solidifies BlackRock’s stewardship group as the industry leader, and can easily be justified as an effort to control political risk and/or as a marketing expense.

Does it matter whether BlackRock is “sincere” in its efforts to be a responsible investor or whether it is simply responding to pressure to act “as if” it is? Yes and no. A desire to maintain or develop a reputation for responsible stewardship – whether driven by legal, political or market pressures – provides substantial incentives to acquire information, especially with respect to high profile votes. DuPont’s 6.8% stock price drop after it repelled a proxy challenge by Trian with the support of BlackRock, Vanguard, and State Street⁹⁴ may have caused some raised eyebrows. As to DuPont, Trian achieved its goal – a breakup of the company and a merger with Dow Chemical – despite its ballot box defeat, when investors lost confidence in the board. DuPont’s CEO left, Trian’s strategy was embraced, and the stock price recovered.⁹⁵ But multiple high-profile votes that result in price drops over the short and the long term would surely be detrimental to the image of BlackRock, Vanguard, and State Street and could induce investors in these funds to seek alternate vehicles.

On the other hand, avoiding regulatory scrutiny, generating positive PR, and appealing to the taste of a segment of the investing public is not the same as increasing returns for fund

⁹⁴ Tom Hals, DuPont wins board proxy fight against activist investor Peltz, Reuters, Mar. 13, 2015, available at <https://www.reuters.com/article/us-dupont-trian/dupont-wins-board-proxy-fight-against-activist-investor-peltz-idUSKBN0NY1JI20150513>

⁹⁵ Michelle Celanier, DuPont-Dow merger pays off for steady hedgies, NY Post, Dec. 12, 2015, available at <https://nypost.com/2015/12/12/dupont-dow-merger-pays-off-for-steady-hedgies/>

holders. The reputational incentives of investment advisers are thus to some extent aligned with the interests of fund holders and to some extent independent of these interests, as will be discussed in Part IV.

II. Economies of Scope, Spill-Over Knowledge and Short-Term Trading Horizons

In this Part, we place incentives to become informed and engaged in the broader context of the structure of investment advisers. We make three points. First, investment advisers often enjoy economies of scope: information that is relevant to one a vote in one of their portfolio companies may also be relevant to a vote in another economy. Second, in the course of their investment activities, active funds may generate spill-over knowledge – information that was acquired for trading purposes but that can also be helpful for voting purposes.⁹⁶ Spill-over knowledge is likely to be relevant for a subset of issues and, for those issues, may lead to relatively more informed actions by advisers with access to such knowledge. Third, active funds may be subject to possible voting distortions generated by short-term trading horizons.

Before turning to the specifics, it is worth recalling that the largest institutional investors vote on an extraordinary number of matters per year. For example, according to BlackRock’s 2017 voting report, it voted on 163,461 matters at 17,309 meetings around the globe, including 33,835 proposals at 4,048 meeting in the U.S.⁹⁷ Most of these votes have, individually, no significant effect on firm value. But because of the vast number of these votes, their collective impact may be substantial. In the much smaller number of consequential issues, significant governance controversies are typically between activist hedge funds and management, with the largest institutional shareholders playing the role of “decider” or referee. These are the most important individual votes that merit the most specific attention. With regard to the

⁹⁶ See, e.g. Lund, *supra* note 8, at ___ (noting that active funds generate information about firm performance as a byproduct of investing).

⁹⁷ BlackRock INVESTMENT STEWARDSHIP REPORT: 2017 VOTING AND ENGAGEMENT REPORT July 1, 2016 – June 30, 2017 at p. 5. [UPDATE WITH 2019 REPORT WHEN IT COMES OUT AT THE END OF AUGUST], available at <https://www.blackrock.com/corporate/about-us/investment-stewardship/voting-guidelines-reports-position-papers#engagement-and-voting-reports> .

remaining votes, each proxy voting group will have a triage system in place that discriminates between the run of the mill issues that can be decided with reference to the voting guidelines, and the significant issues that demand more specific attention.

How many potentially consequential individual votes are there? It is a little hard to tell because of settlements before a proxy contest comes to a conclusion but the number is most likely a two-digit figure (and likely in the low two-digits). For example, in 2018, 34 proxy contests were launched against Russell 3000 companies.⁹⁸ Of these, 21 were settled, 3 withdrawn and 10 went to a vote, with activists prevailing in 2 and management in 8.⁹⁹

The central question raised by the critics of index funds, then, becomes whether the investment advisers who manage index funds have adequate capacity and incentives to vote intelligently in the 10 to 20 votes per year that are potentially consequential and to develop proper voting guidelines for the bulk of other votes, and how their incentives compare to those of other shareholders.

A. Company-Specific versus Issue-Specific Information

The information required to cast an informed vote can be roughly divided into two categories: company-specific information and issue-specific information. Company-specific information is information related to the company. Company-specific information is relevant for votes cast with respect to the company, and not for votes cast on any issue with respect to another company. Issue-specific information, by contrast, is relevant only for votes cast with respect to a certain issue (but is relevant for the same issue at several companies), and not for votes cast with respect to another issue.

Thus, for example, if X is nominated to the board of companies A, B and C, information that pertains to X's service on all of these boards is issue-specific, while information that

⁹⁸ Matteo Tonello, Conference Board, Proxy Voting Analytics (2015-2018), available at <https://corpgov.law.harvard.edu/2018/11/26/shareholder-voting-in-the-united-states-trends-and-statistics-on-the-2015-2018-proxy-season/>; Sullivan & Cromwell, Review and Analysis of 2018 U.S. Shareholder Activism, at 32 (proxy contests that went to a vote: 17 (2018); 17 (2017); 15 (2016); 26 (2015); 14 (2014))(March 14, 2019)(not limited to the Russell 3000).

⁹⁹ Id.

pertains only to X's nomination to the board of A (and perhaps other directors' nominations to the board of A) is company-specific.

For most matters on which shareholders vote, both company- and issue-specific information is at least somewhat relevant. However, the degree of importance of these types of information varies by item. In particular, some voting issues arise only with respect to a single company such as the election of director-nominee Y who is nominated only to the board of a single company. Other issues arise so frequently – such as a vote on a resolution to eliminate a staggered board – that it is unlikely that any specific company is uniquely situated with respect to that issue.¹⁰⁰

The distinction between company-specific and issue-specific information is highly relevant in determining incentives to become informed. While incentives to obtain company-specific information derive primarily from one's holdings *in a single company*, incentives to obtain issue-specific information derive from one's holdings *in all companies* where a vote on the issue has to be cast.

B. Economies of Scope

Investment advisers whose assets under management include shares in a large number of companies benefit the most from the economies of scope related to issue-specific information. These economies may explain why mutual fund families have developed detailed voting guidelines (guidelines that are far more detailed than necessary to satisfy legal obligations)¹⁰¹ on many recurring issues, such as votes on precatory resolutions to de-stagger the board. Because investment advisers face these votes regularly, they will already have examined issue-specific information bearing on the vote; if such issue-specific information is sufficiently clear, it may not pay to consider any additional company-specific information; and,

¹⁰⁰ We do not mean to say that a staggered board is necessarily good or bad for all companies, just that it is likely to be good or bad for certain types of companies, and thus that the only relevant company-specific information is what type of company it is.

¹⁰¹ Rock, *supra* note 21.

with detailed voting guidelines, voting can be delegated to a relatively junior person or even programmed into the voting software.¹⁰²

The extent to which investment advisers have incentives to develop company-specific and issue-specific expertise will depend on both the size of the adviser and the mix between actively managed funds and index funds. Although all mutual fund families benefit from the economies of scope generated by issue-specific information, those with a more widely dispersed portfolio are likely to benefit more than fund families that invest in a smaller set of companies. Because investment advisers concentrating on index funds tend to provide advice with respect to more widely dispersed portfolios, they tend to benefit more from economies of scope generated by issue-specific information. Fund families weighted towards active strategies with more concentrated portfolios will tend to have relatively stronger incentives to develop company-specific information.

C. Spill-Over Knowledge

A second important factor is whether information that investment advisers obtain in the course of making their investment decisions is relevant for, and incorporated in, their voting decisions. Index funds, of course, do not acquire significant information to execute their investment strategy. Rather, for index funds, the strategy will be dictated by composition of the index the fund is trying to match. By contrast, stock-pickers advising actively-managed funds obtain information in the course of their investment activities that can be material on some of the issues that come up for a vote. This comparative information advantage may assist active funds when it comes to voting.¹⁰³ But in a world in which few pure fund families exist, and in which the mix of active and passive strategies varies, the argument should not be overstated. Moreover, the significance of spill-over knowledge from stock picking to voting will depend on the specific issue voted upon and, to a lesser extent, on a fund's investment strategy.

¹⁰² See, e.g., Vanguard Funds, Proxy voting guidelines for U.S. portfolio companies, effective April 1, 2019, available at https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf (explaining, for example, that Vanguard will vote against overboarded directors and in favor of proposals to declassify a staggered board).

¹⁰³ Lund, *supra* note 8, at 118-128.

The information that is material to a vote on any particular issue consists of some mix of issue-specific information, company-specific information that stock-pickers would often obtain, and other company-specific information that stock-pickers would not normally obtain. The relevance of each information type will differ by issue. Thus, corporate governance arrangements, say-on-pay votes, and uncontested director elections may turn largely on issue-specific information (such as whether cumulative voting is generally desirable), on company-specific information that is either not the focus of stock-pickers (such as how incentive compensation should be designed or whether a director nominee is independent and regularly attends meetings), or on company-specific information that is easily observable and programmable (such as company size, industry, and stock price performance) – rather than on, or in addition to, company-specific information to which only stock-pickers are privy (such as internal cash flow projections and in-depths assessments of managerial quality).

As to issue-specific information and company-specific information that is not the focus of stock-pickers, a different type of spill-over knowledge may confer an advantage to index funds. Because index funds tend to invest in a larger number of companies and tend to hold stock over longer periods of time than actively-managed funds, advisers of index funds may have obtained information *in the course of their other votes* (either prior votes at the same company or votes at different companies) that is material to a current vote they are asked to cast.¹⁰⁴ That is, when voting on the election of a new nominee A to the board of X, an index fund adviser may have information about A from prior votes on the election of A to the board Y. An adviser of an active fund that does not hold stock of Y would have encountered A for the first time.

By contrast, to the extent that company-specific information that stock-pickers are privy to is relevant, voting groups at families with actively managed funds can benefit by obtaining such information as a by-product of the investment activities at little or no additional

¹⁰⁴ Such spillover-knowledge is conceptually distinct from the economies of scope discussed in the prior section. Economies of scope arise when an adviser invests more in acquiring this information because it knows that certain information is relevant to multiple votes. Spillover knowledge arise because an investment adviser (or a stock-picker) happens to have acquired information for a different vote or purpose than is now relevant to a vote at hand.

expense.¹⁰⁵ Perhaps the clearest case where such information is important is a vote on a proposed merger, where stock-pickers may have an assessment of the fundamental value of the merging companies independent of the market price that would be helpful in deciding how to vote. To be sure, even such a vote will turn on additional factors, such as regulatory risks, whether the company used a process designed to get the best terms, or the specific provisions of the merger agreement. But at least some of these factors, although not already known, may be ones that stock-pickers would investigate, independent of any vote, for investment purposes.

Contested director elections also involve information that stock-pickers obtain in the course of their investment activities. In particular, some stock-pickers may have an assessment of the quality of incumbent management and whether management is pursuing an optimal strategy. But contested director elections also involve a high degree of information related to the quality and proposed strategy of the activist challenger. And as to such information, fund families with dispersed portfolios may have had experiences with activist challengers in general and a specific activist in particular in a prior contest. Thus, the net advantage to actively-managed funds from spill-over knowledge is less clear cut. On the whole, therefore, the significance of spill-over knowledge – and the relative informational benefits such knowledge confers on actively-managed funds compared to index funds – will vary both from issue to issue and from adviser to adviser.

That spill-over knowledge from stock-pickers is of little importance to many votes is also indicated by the fact that advisers to many actively-managed fund families follow the recommendations of proxy advisers, like ISS and Glass Lewis. Proxy advisers supply voting-related information and voting recommendations to their clients. Importantly, proxy advisers do not employ stock-pickers, so their information and recommendation does not rely on investment-related spill-over knowledge.¹⁰⁶ That a large number of families with actively-managed funds obtain information from proxy advisers, and that many of them rarely deviate

¹⁰⁵ Even to the extent that stock-pickers have relevant information, it will only affect fund voting if such information is communicated to those in charge of voting decisions. In fund families with separate voting groups, such communication may not occur for the many votes that individually have no material price impact.

¹⁰⁶ Like index funds, they may develop spill-over knowledge in the course of their other votes, e.g., from prior votes involving the same director.

from the voting recommendations supplied by the advisers,¹⁰⁷ indicates that they do not regard such spill-over knowledge as all that important.

Notably, although the Big Three may also use information supplied by proxy advisers as input, none of them closely follow their recommendations. Rather, they base their votes on their own, in-house, analysis.¹⁰⁸ That proxy advisers have more influence over actively-managed funds than over the Big Three is consistent with our assessment that fund family size generates incentives for advisers to make independent assessments of how to vote on an issue.¹⁰⁹

Even as to issues where spill-over knowledge is important, several factors mitigate the handicap under which index fund advisers operate. First, most advisers to index funds also manage some active funds. One leading manager of index funds – BlackRock – actively manages very substantial assets. As a result, BlackRock enjoys both the economies of scale and scope from running large index funds and access to spill-over knowledge from trading generated by its active management.¹¹⁰

Vanguard's situation is more complicated. Several large actively-managed funds carry the Vanguard name and generally vote the same way as the Vanguard index funds. But several of them are exclusively advised by an outside adviser (such as Barrow Hanley Mewhinney & Strauss and Primecap);¹¹¹ others are managed or co-managed by Vanguard's Quantitative Equity Group, which mostly follows computer-driven and other quantitative strategies.¹¹² Vanguard's in-house Quantitative Equity Group and the affiliation by Vanguard with outside advisers to actively-managed funds¹¹³ may provide the respective voting groups for the index

¹⁰⁷ See Choi et al., supra note 27.

¹⁰⁸ See Bubb & Catan, supra note 30.

¹⁰⁹ See supra Section I.B.1; see also Choi et al., supra note 27.

¹¹⁰ To be sure, BlackRock is likely to hold stock of companies in its indexed portfolio that it does not hold in its actively-managed portfolio. However, the scope of BlackRock's active management operations is extensive. Moreover, as part of their investment activities, stock-pickers not only obtain company-specific information if they own company stock, but also for covered companies the stock of which they decide not to own.

¹¹¹ Barrow Hanley Mewhinney & Strauss LLC is one of the outside managers of the Selected Value Fund; Primecap manages, among others, the Vanguard Primecap fund.

¹¹² In total, the domestic equity of all funds managed and co-managed by this group are about 7% of Vanguard's domestic equity assets.

¹¹³ Geode, which advises Fidelity's index funds, has a similar affiliation with an active fund and also has an active management operation. See Geode Capital Management, available at <https://www.geodecapital.com> ("Geode offers both alpha-generating and beta-tracking strategies.")

funds with some access to information from the stock-pickers for the active funds, especially on issues where such information is particularly valuable. Thus, albeit to a lesser extent than BlackRock, Vanguard may be able to tap into some company-specific information learned by active funds in the course their investment activities.

Finally, even fund families that have no significant actively managed equity funds, such as State Street, can develop a view based on public information and industry contacts if the matter is sufficiently important. Indeed, when company-specific information is particularly valuable, active fund advisers have incentives to share information they consider pertinent to a vote, both through formal and informal channels.¹¹⁴

This leads to a second mitigating factor, namely, that on many matters on which company specific information is valuable – e.g., votes on mergers and in contested director elections – a significant amount of company-specific information and analysis will be publicly disclosed in proxy statements and other campaign materials. This lessens the informational advantage of stock-pickers. To be sure, stock-pickers are still likely to know additional company-specific information that is pertinent to the vote and may have a comparative advantage in analyzing publicly-disclosed information. On the other hand, advisers to index fund may have developed expertise in analyzing such information through their prior votes.

D. Voting Distortions from Short-Term Trading Horizons and Other

Whether stock prices reflect fundamental values, what accounts for any deviations, and how easy it is to detect deviations are subjects of major controversy.¹¹⁵ One prominent camp

¹¹⁴ Alex Sherman, Dell's VMware deal may hinge on how the companies split up value from Dell's tracking stock, CNBC, Mar. 23, 2018, available at <https://www.cnbc.com/2018/03/23/dell-vmware-deal-may-hinge-on-how-they-split-dells-tracking-stock.html> (reporting that T Rowe Price opposes Dell-VMware merger; Barry Burr, Pension funds divided on Dell deal, Pensions & Investments, July 22, 2013, available at <http://www.pionline.com/article/20130722/PRINT/307229983/pension-funds-divided-on-dell-deal> (reporting opposition to Dell LBO by several institutional investors).

¹¹⁵ See, e.g., Donald C. Langevoort, Theories, Assumptions, And Securities Regulation: Market Efficiency Revisited, 140 U. Penn. L. R. 851 (1992); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003); Joseph A. Grundfest, Damages And Reliance Under Section 10(B) Of The Exchange Act., 69 Bus. Law. 307, n. 45 ("The decision of the Nobel Prize committee to divide the 2013 award in economics among Eugene Fama, an ardent advocate of the efficient market hypothesis, Robert Shiller, one of the theory's most articulate critics, and Lars Peter Hansen, developer of statistical techniques applied in testing the theory's validity, underscores the current unsettled state of the efficient market hypothesis among professional economists.")

of commentators subscribes to the efficient market hypothesis – the notion that stock prices accurately reflect all public information about the company’s fundamental value and that it is not possible to arrive at a superior estimate without access to non-public information.¹¹⁶ Others disagree, some fervently.¹¹⁷

To be sure, even if the market is not fully efficient, changes in a company’s long-term value will ultimately be reflected in the stock price or in the company’s payouts to its shareholders. But in inefficient markets, the shareholders who benefit from such changes may not be those who were shareholders when the changes took place or were announced, but those who became shareholders at a later point, when the effects on value became apparent. In inefficient markets, in other words, a shareholder’s trading horizons – the length of time a shareholder expects to hold on to stock of a company before it is sold – matter.

The length of time a mutual fund holds on to stock of a company before it is sold is a function of three factors: involuntary sales due to liquidations or mergers; voluntary portfolio changes (selling one stock to buy another); and redemptions by shareholders of mutual fund in excess of inflows that force a fund to sell stock in order to make payments to its investors.

These factors affect active funds and index funds differently. While both types of funds are affected by involuntary sales, they differ with respect to the other two factors. Index funds make portfolio changes only if the composition of the underlying index changes (as, e.g., when a firm enters or leaves the S & P 500 index) and, if needed, will sell a proportional amount of assets to meet redemption demands. Active funds, by contrast make voluntary portfolio changes in response to changed assessments of their stock-pickers and may change their portfolio in response to redemptions.

¹¹⁶ See, e.g., Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 383, 416 (1970) (reviewing theoretical and empirical literature on the efficient markets model and concluding that the model holds well).

¹¹⁷ See, e.g. Donald Langevoort, [*Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*](#), 97 NW. U. L. REV. 135, 140-43 (2002) (discussing evidence against market efficiency); Justin Fox, *The Myth Of The Rational Market* (2009).

Historically, and intrinsically, therefore, index funds have had a much lower portfolio turnover rate than active funds.¹¹⁸ The average turnover rate – defined as the lesser of stock purchases and sales divided by average stock portfolio value – of the 10 largest non-index funds was 34.2%; the average turnover rate of the 10 largest index funds was a mere 3.5%. For funds with no net flows, these turnover rates imply an average holding period of 28.5 years for the index funds and of 2.9 years for the active funds.¹¹⁹

Index funds thus rationally ought to expect to hold stock in portfolio companies for the long term. And as long as index funds expect to hold stock for a long term, it matters little to their voting whether stock markets are efficient. Whether or not reflected immediately in the stock price, index funds ought to base their vote on the effect on the fundamental value of the company.

Actively-managed funds are different. The very rationale for the existence of an actively-managed fund is that deviations between fundamental value and stock price occur, can be detected by its stock-pickers, and are common and significant enough to warrant running an active fund designed to exploit them. Deviations can, in principle, be due to two causes: the failure of the stock price to reflect some positive or negative elements of fundamental value; or the incorporation by the stock price of elements that do not bear on fundamental value. The foundation of most active investing is to buy stock at a time when some positive elements of fundamental value are not incorporated or some irrelevant elements depress the stock price – *and* when the mispricing will be corrected soon enough to make a stock acquisition worthwhile *now*.¹²⁰

Stock-pickers may or may not be right in their assessment that a stock is undervalued and that the undervaluation will be corrected within a certain time frame. But whether they

¹¹⁸ See Investment Company Factbook, supra note 45, at 124 (“index funds’ portfolios tend not to change frequently, and therefore have low turnover rates”).

¹¹⁹ Holding periods are calculated by dividing one by the turnover rate.

¹²⁰ Our argument that short-term trading horizons can cause voting distortions applies to most actively-managed mutual funds. By contrast, activist hedge funds, unlike most actively-managed mutual funds, do not try to exploit market inefficiencies; they try to generate value through their activist interventions. Rejection of the efficient market hypothesis, in other words, is not part of the DNA of activist hedge funds. While activist hedge fund managers have limited trading horizons, and while they may not subscribe to the efficient market hypothesis, there is no a priori reason to assume that they believe that deviations between fundamental value and stock price are common and significant and orient their investment towards exploiting these inefficiencies.

are is, for our purposes, irrelevant. Rather, what is relevant is that stock-pickers believe that they are right. Stock-pickers, in giving their views on a vote, will thus tend to *give no weight* to its effects on fundamental value if *they believe* that it will not be reflected in stock price by the time they will sell the stock; and will *give weight* to its effect on irrelevant elements if *they believe* it will still be reflected in the stock price by the time they sell the stock. To the extent that stock-pickers affect the vote, the shorter-term trading horizons of active funds in conjunctions with the efforts to exploit market inefficiencies may result in voting distortions.

As may be apparent by now, voting distortions generated by stock-pickers are the flip-side of spill-over knowledge generated by stock-pickers. Just like stock-pickers obtain spill-over knowledge from their investment activities that can be beneficial in inducing votes that increase the stock price, stock-pickers can induce deviations from value-maximizing votes to the extent that they believe – *as they must* – that stock prices do not always fully reflect fundamental values.

E. How Incentives and Spillover Knowledge Stack Up

For the “Big Three”, we now consider how incentives, economies or scope, spillover knowledge and voting distortions stack up for the three categories of engagements that characterize contemporary corporate governance: Type A issues in which votes are likely to have a material impact on the value and stock price of an individual company, such as votes in proxy contests and contested votes on mergers; Type B issues involving market wide governance standards, including board structure, director election votes that turn on such standards (e.g., overboarding) and say-on-pay votes that turn on the structure of executive compensation; and Type C issues that relate to company-specific performance (including strategy and management performance and director election and say-on-pay votes that turn on performance) and company-specific governance standards.

a. Type A: Market-Moving Votes

In the 10-20 high profile proxy contests or merger votes that shareholders must decide each year, there is very substantial lobbying by each side, with management and activists both

producing detailed presentations, and meeting as frequently as possible with each of the large holders. Because these votes are likely to have a price impact on the market price and on the value of portfolio companies (Procter & Gamble stock has increased by 40% since Peltz went on the board), and because the Big Three, due to their large stakes, often stand to cast the deciding vote, the Big Three have material incentives to acquire and analyze information that is specific to the vote at issue, and to cast their votes with care. In fact, to the extent – as is often the case – that the Big Three hold larger stakes in the portfolio company at issue than advisers to active funds, their incentives to acquire such information may well be superior to those of such advisers. If there is a problem with the Big Three’s incentives, it is not with regard to this small number of market-moving votes.

To be sure, advisers to active funds will often benefit from spillover knowledge from the analyst side. Such spillover knowledge decreases the need to acquire information just for voting purposes. And although the Big Three, in particular BlackRock, also run an active business, the centralized voting groups at the Big Three may have less access to or pay less attention to spillover knowledge from the analyst side than some advisers to active funds do. On the other hand, the voting groups at the Big Three will benefit from spillover knowledge from past contested votes, including past contested votes that may have involved some of the same activists, and will be less subject to voting distortions associated with actively managed funds.

Because advisers to index funds and advisers to active funds base their votes to some extent on differing sets of information, they may approach market-moving votes from somewhat different perspectives. Advisers to active funds, such as T. Rowe Price Advisers, may rely more on portfolio managers with deep knowledge of portfolio companies and may focus more on how well, or how poorly, the company did before the activist became involved. The Big Three may rely more on voting personnel to accumulate and analyze information, may have better information about past campaigns by the activist at issue, may obtain more information specifically for the purpose of voting in the campaign at hand, and may have a longer-term orientation but are likely to have less information about the company’s prior problems.

But while their initial perspectives may differ, each set of advisers will have some access to the perspective of the other set: the Big Three run their own, or are affiliated with other advisers that run, actively managed funds; advisers to active funds can obtain information about the past record of the activist; the financial press, proxy advisory firms and, of course, the contestants themselves will provide information and analysis; and through personal or institutional connections, the people in charge of voting at one adviser will at least be somewhat aware of the views of those in charge of another adviser. As a result, ultimate voting decisions may not differ and, to the extent they differ, there is no a priori reason to believe that one set of advisers will make substantially better decisions than the other set

b. Type B: Recurring Governance Issues

With respect to recurrent governance issues, and the setting of market-wide governance standards (what some refer to as “corporate hygiene”¹²¹), the Big Three are likely to have incentives and information that is superior to those of advisers of actively managed funds. Their larger stakes in individual companies and the economies of scope generated by issue-specific information gives the Big Three an inherent advantage.

In comparison, the fact that actively managed funds may have superior access to spillover knowledge from stock-pickers will matter little for these types of votes. This is not because “one-size-fits-all” on these governance issues is optimal or that company-specific information is irrelevant. Rather, because stakes are low as to each individual vote, and issue-specific information will often dominate company-specific information, even advisers to actively managed funds may often not bother to obtain the relevant company-specific information from stock-pickers, much less integrate it with the issue-specific information in deciding how to vote.¹²²

¹²¹ See, e.g., Q&A with Stephanie Ashe, Stanford law School, available at <https://law.stanford.edu/2019/02/13/stanford-laws-joe-grundfest-and-mike-callahan-correct-common-misconceptions-about-corporate-governance-in-the-venture-capital-arena/>.

¹²² T. Rowe Price, for example, has developed proxy voting guidelines that address many recurrent governance issues on a one-size-fits-all basis. See T. Rowe Price, Proxy Voting Guidelines 4-5, available at https://www3.troweprice.com/usis/content/trowecorp/en/utility/policies/_jcr_content/maincontent/policies_row_1/para-mid/thiscontent/pdf_link/pdffile (providing one-size-fits-all guidelines for votes on majority voting, poison pills, and staggered boards).

c. Type C: Company-Specific Performance and Governance Issues

Advisers to actively managed funds and activist hedge funds, in contrast, are likely to be superior to index fund advisers in identifying and initially addressing company-specific performance problems, whether through engagement on these issues or through voting. To be sure, advisers to index funds could easily, and cheaply, obtain measures for company performance such as industry-adjusted accounting or stock price returns. But pinpointing the cause for low performance and recommending specific changes require a more detailed analysis. For State Street and Vanguard (albeit not for BlackRock), the scarcity of in-house analysts who become aware of performance problems in the course of stock-picking activities makes it more costly to generate such an analysis. For those advisers, it will often not pay to perform an analysis merely for the purpose of voting or engagement. In the ordinary course, therefore, rougher performance measures are unlikely to lead to engagements or votes that address company-specific performance problems.¹²³

By contrast, advisers to actively managed fund and activist hedge funds have access to their stock-pickers' or analysts' assessment of the cause of poor performance that was generated for trading purposes. Especially for a poorly performing company in which such an adviser is substantially overweight, the adviser or its portfolio managers may have sufficient incentives to engage with company management or its outside directors to address the performance issues or to cast votes that reflect their performance concerns.

Here, a division of labor that reflects the differing incentives of the different players seems to be emerging. Company-specific performance issues are addressed in the first instance by the investors with the best incentives and capacity to do so: actively managed mutual funds and activist hedge funds. If they identify a firm with problems, and develop a plausible solution, the firm may accept the suggestions or reject them. In the event that a firm resists, the active managers, if sufficiently determined, can force the issue by means of a proxy contest, thereby converting a Type C issue into a Type A issue, at which point the Big Three will get involved.

¹²³ See Bebchuk & Hirst, *supra* note 10 (adducing evidence that they do not).

Company-specific governance issues, to the extent that they do not result in inferior performance, are largely handled by the Big Three stewardship groups in their periodic engagement meetings. Here, as discussed above, the Big Three are likely to have good information and incentives, and actively managed mutual funds and hedge funds are typically uninterested.

III. Conflicts

Investment advisers to mutual funds face myriad potential conflicts of interest. Conflicts can arise between the investment adviser and mutual fund shareholders; between the mutual fund (as shareholder of a company) and other shareholders of the same company; and among funds managed by the same adviser. Since the first two sets of conflicts have been discussed at length in the prior literature, we address them only briefly.¹²⁴ We discuss the third set in more detail.

A. Adviser – Investor Conflicts

Adviser-investor conflicts are mostly generated by other business operations of an investment adviser. Many investment advisers for mutual funds are affiliated with financial institutions such as investment banks or insurance companies.¹²⁵ Such advisers may be reluctant to antagonize present or future banking or insurance clients through their voting or engagement. Many mutual fund complexes are also engaged in the management of corporate pension plans, would like to attract investments into their funds or independently manage assets of corporate defined benefit plans, or would like their funds included among the options offered by corporate defined contribution plans.¹²⁶

The reputational and marketing interests of investment advisers that we discussed earlier¹²⁷ may also give rise to conflicts. Consider, for example, the position that an adviser takes on “ESG” issues: issues such as climate change, sustainability, diversity, human rights and

¹²⁴ Edward Rock, *The Logic and (Uncertain) Significance of Institutional Investor Activism*, 79 *Geo. L. J.* 445, 468-76 (1991).

¹²⁵ Kahan & Rock, *supra* note 14 (reporting that 9 of the 20 largest mutual fund families had such affiliations).

¹²⁶ *Id.* at 1055.

¹²⁷ See *supra* Section I.B.3.

animal welfare. The famous letter by Larry Fink stressing Blackrock's commitment to ESG issues¹²⁸ may reflect a sincere belief that a greater focus on ESG will promote the long-term value of portfolio companies. But it may also have served as an effective marketing ploy or as an effort to increase Blackrock's reputation and fend off regulation. To the extent that advisers – for reputational or marketing reasons – take positions and casts votes that reduce firm value, their interests conflict with those of at least some of their fund investors.

To the extent that such conflicts arise, both competitive pressures and politics limit the degree to which fund families can deviate from pursuing goals that conflict with investor interests. On the competitive front, State Street responded to Larry Fink's letter by emphasizing that it pursues "value not values."¹²⁹ State Street, in other words, tried to appeal to investors that do not share Fink's "values" or who were not willing to sacrifice "value" to promote them. On the political front, former Senator Phil Gramm has castigated large institutional investors for using investors' money to pursue liberal goals that they have failed to achieve legislatively or from the courts.¹³⁰

B. Intra-Shareholder Conflicts

A second, long recognized source of conflicts is the desire of stock-pickers for investment advisers to maintain cordial relationship with management of their portfolio companies.¹³¹ Stock-pickers benefit from such relationships to get their questions answered in public venues and to obtain information privately that may not be legally material on its own, but helps them fill gaps in their understanding of the firm's operations.¹³² They may use this access to make better predictions of stock price movements and hence for the benefit of fund

¹²⁸ See supra text accompanying note 91.

¹²⁹ Cyrus Taraporevala, Index Funds Must be Activists to Serve Investors, Financial Times 7/24/2018("We are creating long-term value; not imposing values."); Ron O'Hanley, Foreward, BCG, Total Societal Impact: A New Lens for Strategy (October 2017).

¹³⁰ Phil Gramm and Mike Solon, Keep Politics out of the Boardroom, WSJ July 18, 2018, available at <https://www.wsj.com/articles/keep-politics-out-of-the-boardroom-1531952912>.

¹³¹ See, e.g., Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts, 88 Iowa L. Rev. 1035, 1054-56 (2003) (noting conflicts from securities analysts attempting to maintain their standing with or curry favor from sources of information);

¹³² There is evidence suggesting that companies sometimes retaliate against analysts by avoiding their questions in conference calls. Susan Pulliam, Analysts to Tell Congress that Skepticism Gets Them Abuse, Wall St. J., Mar. 19, 2002, at C1.

shareholders. But to the extent they maintain such access by not casting votes against management when voting against management would enhance firm value, they do so at the expense of shareholders-at-large.

C. Fund Family Conflicts

There are additional conflicts that are quite specific to the fund family structure.¹³³ Suppose companies A and B propose merging. Suppose further that an investment adviser believes that the two companies are worth more together than apart but that the price that A is offering for B is too low.¹³⁴ This creates conflicts of interest between funds that are equally weighted in A and B (for whom the price is irrelevant) and other funds that may be overweight in B (for whom the price is a reason to oppose the merger) or overweight in A (for whom the price is a reason to support the merger). In such situations, the fiduciary duties that investment advisers owe to investors in particular funds lead at least some investment advisers to push the voting decision down to the fund level (i.e., to allow the portfolio managers who manage the specific fund's assets to make the voting decision).¹³⁵

More fundamentally, the presence of both passive and active strategies within a single fund family can produce opportunities for conflicts of interest as well as the synergies discussed above. Recall that active AUM are more valuable because the fees are so much higher. If the added heft of passive assets increases the returns in an active fund, it may seem to be a win-win: increased fees from the active funds without disadvantaging the passive funds in their competition with other passive funds over cost, tracking error and customer service.¹³⁶

¹³³ See Morley, *supra* note 24 (discussing conflicts among funds managed by the same adviser); Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017); Fisch, Hamdani & Davidoff Solomon, *supra* note 85 do so as well at 33-36.

¹³⁴ As was arguably the case with the 2002 Hewlett Packard-Compaq merger and the 2007 CVS-Caremark merger.

¹³⁵ In contested merger contexts like HP-Compaq or CVS-Caremark, Vanguard is on record as having voted some shares in favor and some against. In both cases, the consensus was that the companies were worth more together than apart although many raised concerns about the magnitude of the premium. Because of concerns over the premium, Vanguard delegated the decision to the fund level where some funds were overweight on one side or the other. For the 500 Index Fund, all shares of both companies were voted in favor of both deals, but for other funds, different decisions were made.

¹³⁶ So why, then, would a fund family dominated by active strategies like Fidelity delegate the voting of index fund shares to Geode, an independent firm? Wouldn't the assets in Fidelity's 500 Index Fund, a \$150 billion index fund, be valuable support when a portfolio company board considers the views of a Fidelity Contrafund portfolio manager? The history is interesting. Geode was, originally, part of Fidelity and was used to experiment with

Although unlikely to have any effects on the competition with other index funds, using the heft of the passive funds to amplify the voice of the active managers may nonetheless pose substantial conflicts of interest because sometimes maximizing the value of a given portfolio firm will not maximize the value of each fund in the family. Consider an extreme example raised Amazon's recent acquisition of PillPack, an online pharmacy. The acquisition sent the shares of pharmacy stocks like CVS, Walgreens and Rite Aid plummeting.¹³⁷ Suppose that an active fund in a fund family with a large index fund is overweight in Amazon and its portfolio manager would like to use the heft of the passive assets to support the acquisition of PillPack. Because the active fund is underweight in CVS, Walgreens and Rite Aid, the fact that the acquisition will predictably cause those stocks to decline is a matter of indifference (or even joy) to its portfolio manager. But the index fund will, of course, hold all those shares, and investors in that fund will suffer from the price drop.

Note the subtlety of the problem: while Amazon's acquisition of PillPack might hurt investors in the index fund, it will have no effect on the *relative* performance of the index fund vis a vis competing index funds – and thus will not hurt the management company in its index fund competition – but it will improve the relative performance of the active fund vis a vis other active funds. Moreover, because the fees for actively managed assets are so much higher than the fees for passive strategies, the direct losses in fees from the decline in the index fund could be more than offset by the direct gain in fees from the value of the active fund even if the aggregate value of AUM declined.

higher risk computer trading strategies. See John Hechinger, Fidelity Spins Off Geode Unit; Could Allay Fears of Conflict, Wall St. J., Aug. 5, 2003, available at <https://www.wsj.com/articles/SB106003396490241400>. These "experiments" raised concerns that Fidelity might be betting against its own investors in its funds. To assuage these concerns, Geode was spun off in 2003. Post spinoff, Geode's CEO was a Fidelity veteran, Jacques Perold, who had run Geode at Fidelity and, as part of those responsibilities, had overseen Fidelity's \$28 billion in index funds. In what the WSJ described as a "coup" for Geode's CEO, Geode took the index funds with it. "Fidelity, which prefers to stress stock-picking, said it doesn't consider indexing a 'core business.'" (Interestingly, Perold left Geode in 2009 to return to Fidelity Asset Management Inc. as president. See Bloomberg Executive Profile, Jacques Pierre Perold, available at

<https://www.bloomberg.com/research/stocks/private/person.asp?personId=26166622&privcapId=10903390>)

¹³⁷ Matt Levine, Profiting from Disruption Trades, Bloomberg, June 29, 2018, available at

<https://www.bloomberg.com/view/articles/2018-06-29/profitting-from-disruption-trades>; Sharon Terlep, Amazon Buys Online Pharmacy PillPack for \$1 Billion, Wall St. J., June 28, 2018, available at

<https://www.wsj.com/articles/amazon-to-buy-online-pharmacy-pillpack-1530191443>

These conflicts of interest raise substantial fiduciary duty concerns, as the investment advisers owe fiduciary duties to the investors of each fund managed.¹³⁸ There are two basic ways to handle these conflicts: case by case or structural. One can, for example, delegate the voting decisions to the managers of individual funds when conflicts arise, as in the merger example discussed above. This is how Vanguard handled the potential conflicts of interest among its funds in the HP-Compaq and CVS-Caremark mergers. Alternatively, one can delegate the voting of index fund shares to an independent company, as in the case of Fidelity and Geode.

For fund families with large index funds, the Vanguard approach would seem to be better than the Fidelity approach. As we showed above, shareholders as a group benefit from the presence of fund managers with direct incentives to vote intelligently, and the “heft” of the fund families’ total assets increases those incentives by increasing the likelihood that their votes will be decisive. By contrast, the conflicts, while real, do not arise very often, and can be handled case-by-case when they do.

D. Conflicts and Voting Rights

Mutual fund investment advisers, of course, are not the only shareholders to face potential conflicts. Public pension funds, for example, face political constraints and conflicts of interests that may bias their voting, including pressure from groups that pursue aims other than increasing firm value.¹³⁹ Union-affiliated pension funds may pursue a labor agenda.¹⁴⁰ Managers and other employees of the firm who are stockholders may vote their shares to maintain their job security and improve the terms of their employment, rather than to increase the stock price. Controlling shareholders, whether or not employees, may vote to preserve their private benefits of control by opposing measures that dilute such control (such as issuance of additional voting stock), or hamper the effective exercise of control (such as the election of independent-minded directors to the board), even if such measures enhance firm value. Hedge

¹³⁸ John Morley, *supra* note 24.

¹³⁹ Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 Va. L. Rev. 1347, 1416-18 (discussing conflicts).

¹⁴⁰ Kahan & Rock, *supra* note 58.

fund managers, though well-incentivized to maximize the value of their funds,¹⁴¹ sometimes pursue complex investment strategies that can drive a wedge between what is best for the fund and what is best for other company shareholders.¹⁴²

The pervasive potential for conflicts of interests are yet another reason why one should be reluctant to deprive some shareholders of voting rights because their incentives to cast an informed vote are lower than those of other shareholders. The shareholders with superior incentives to cast an informed vote may have conflicts of interest that distort their incentives to vote for the outcome that maximizes company value. Thus, for example, advisers to index funds without access to stock-pickers may lack access to useful spillover knowledge that comes from stock picking; but advisers to actively managed funds with access to such spillover knowledge may be conflicted due to their desire to retain good relationships between fund analysts and fund portfolio managers on one hand and management of portfolio companies on the other hand – conflicts that are not present for index funds. In a world where incentives to become informed and conflicts of interest are a matter of degree – and where virtually the only group of shareholders without conflicts, retail investors, is also the group that has the least overall incentives to become informed – trying to fine-tune to voting system is not likely to lead to superior outcomes. While we see room for some modest measures designed to reduce conflicts of interest – such as enhanced disclosure requirements of business relationships between advisers and portfolio companies¹⁴³ – we are skeptical about the merits of some broader schemes.¹⁴⁴

Conclusion

With the ever-increasing institutional holdings of shares, power in the governance of U.S. corporations has shifted significantly from managers to shareholders. In the highest profile

¹⁴¹ Id. at 1066-68.

¹⁴² Id. at 1072-77.

¹⁴³ See Bebchuk & Hirst, *supra* note 10, at 59 (proposing such requirements).

¹⁴⁴ For example, Bebchuk and Hirst also propose prohibiting investment managers from administering 401(k) plans for employers. Id. But the assets of 401(k) plans are inherently invested in mutual funds and investment advisers will thus continue to have an interest in attracting investments from 401(k) plan participants.

contests between hedge funds and managers, the largest institutional investors are often the presumptive “deciders.” And in the determination of market wide governance “best practices” – e.g., the choice between annually elected and classified boards, the number of boards that directors may serve on, or board diversity – the largest institutional investors, along with the proxy advisory firms, act as standard setters.

With this new-found power has come a vast increase in scrutiny as well as a significant dose of paranoia, as one would expect given the history of U.S. finance. The Big Three – BlackRock, Vanguard, and State Street – have been buffeted with suggestions as to what they should do, what they should not do, how they should do it, and how many people they should hire. Some have even suggested that they be broken up or forced to choose between abandoning their business model and committing to complete governance passivity.

But someone has to decide key corporate governance issues. Corporate voting is highly imperfect. It entails severe collective action problems and low-to-moderate conflicts of interest are widespread. Most publicly traded corporations have few individual shareholders with a sufficient stake to become informed without also suffering from severe conflicts of interest.

Investment advisers in general, and investment advisers that mostly or exclusively manage index funds in particular, are not perfect voters. But in the world of corporate voting, perfection is not a realistic goal. Rather, the question is whether some shareholders are better (or worse) than others in making voting decisions and whether they are so to such an extent and reliably enough to warrant a change via regulation or private ordering.

We do not believe that such a case has been made. Advisers to index funds – including, in particular, the Big Three, which manage the bulk of index fund assets – compare favorably to advisers of active funds in some respects and unfavorably in others. Small individual shareholders have among the worst incentives but are also least likely to have conflict of interests. Identifying and grading conflicts of interest – which depend on the specific shareholder-company relationship and the specific issue to be voted on – is difficult. If different investors have different conflicts, eliminating some of the conflicts may not, in fact, generate a better voting outcome. Moreover, conflicts of interests are endogenous to the legal system

and a change in voting rules is likely to cause shareholders that gain more voting power to develop stronger conflicts.

Radical proposals, such as depriving index funds of their right to vote or devolving voting rights from funds to fund shareholders – will likely result in inferior outcomes. More modest proposals are likely to be costly and ineffective. Until and unless there is a proposal that would significantly improve matters, we should just let shareholders be shareholders.

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