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

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November 2019

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We have also received helpful comments from participants in presentations at the American Law and Economics Association Annual Meeting, the NYU/Penn Law and Finance Conference, the Global Corporate Governance Colloquia, and a Federal Trade Commission hearing, as well as at Bar-Ilan University, Boston University School of Law, Harvard Law School, New York University, and the University of California, Berkeley. We have also benefited from conversations with many members of the institutional investor and corporate governance advisory communities; and from invaluable research assistance by Jordan Figueroa, Aaron Haefner, David Mao, Matthew Stadnicki, Wanling Su, and Zoe Piel. Finally, we gratefully acknowledge financial support from Harvard Law School and Boston University School of Law.

Abstract

Index funds own an increasingly large proportion of American public companies. The stewardship decisions of index fund managers—how they monitor, vote, and engage with their portfolio companies—can be expected to have a profound impact on the governance and performance of public companies and the economy. Understanding index fund stewardship, and how policymaking can improve it, is thus critical for corporate law scholarship. In this Article we contribute to such understanding by providing a comprehensive theoretical, empirical, and policy analysis of index fund stewardship.

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

We then provide an empirical analysis of the full range of stewardship activities that index funds do and do not undertake. We analyze four dimensions of the Big Three's stewardship activities: the limited personnel time they devote to stewardship regarding most of their portfolio companies; the small minority of portfolio companies with which they have any private communications; their focus on divergences from governance principles and their limited attention to other issues that could be significant for their investors; and their pro-management voting patterns.

We also empirically investigate five ways in which the Big Three could fail to undertake adequate stewardship: the limited attention they pay to financial underperformance; their lack of involvement in the selection of directors and lack of attention to important director characteristics; their failure to take actions that would bring about governance changes that are desirable according to their own governance principles; their decision to stay on the sidelines regarding corporate governance reforms; and their avoidance of involvement in consequential securities litigation. We show that this body of evidence is, on the whole, consistent with the incentive problems that our agency-costs framework identifies.

Finally, we put forward a set of reforms that policymakers should consider in order to address the incentives of index fund managers to underinvest in stewardship, their incentives to be excessively deferential to corporate managers, and the continuing rise of index investing. We also discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism.

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

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

JEL Classifications: G23, G34, K22

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INDEX FUNDS AND THE FUTURE OF CORPORATE GOVERNANCE: THEORY, EVIDENCE, AND POLICY

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In the course of our work on this Article and our larger project we have accumulated significant debts that we wish to acknowledge. We have benefitted from valuable suggestions from—and discussions with—many individuals, including Ian Appel, Michal Barzuza, Bernie Black, Alon Brav, John Coates, Alma Cohen, Stacey Dogan, Asaf Eckstein, Einer Elhauge, Luca Enriques, Jill Fisch, Jesse Fried, Steve Fraidin, Stavros Gadinis, Wendy Gordon, Assaf Hamdani, Henry Hu, Keith Hylton, Marcel Kahan, Louis Kaplow, Kobi Kastiel, Dorothy Shapiro Lund, Pedro Matos, Mike Meurer, Stephen O'Byrne, Elizabeth Pollman, Edward Rock, Mark Roe, Eric Roiter, Martin Schmalz, Bernard Sharfman, Steve Shavell, Ted Sims, David Skeel, Steven Davidoff Solomon, Holger Spamann, Leo Strine, Roberto Tallarita, Andrew Tuch, Fred Tung, David Walker, and David Webber.

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ABSTRACT

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

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We also empirically investigate five ways in which the Big Three could fail to undertake adequate stewardship: the limited attention they pay to financial underperformance; their lack of involvement in the selection of directors and lack of attention to important director characteristics; their failure to take actions that would bring about governance changes that are desirable according to their own governance principles; their decision to stay on the sidelines regarding corporate governance reforms; and their avoidance of involvement in consequential securities litigation. We show that this body of evidence is, on the whole, consistent with the incentive problems that our agency-costs framework identifies.

Finally, we put forward a set of reforms that policymakers should consider in order to address the incentives of index fund managers to underinvest in stewardship, their incentives to be

excessively deferential to corporate managers, and the continuing rise of index investing. We also discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism.

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

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INTRODUCTION

Index funds—investment funds that mechanically track the performance of an index[1]—hold an increasingly large proportion of the equity of U.S. public companies. The sector is dominated by three index fund managers—BlackRock, Inc. (BlackRock), State Street Global Advisors, a division of State Street Corporation (SSGA), and the Vanguard Group (Vanguard), often referred to as the "Big Three."[2] In a recent empirical study, *The Specter of the Giant Three*, we document that the Big Three collectively vote about 25% of the shares in all S&P 500 companies;[3] that each holds a position of 5% or more in a large number of companies;[4] and that the proportion of equities held by index funds has risen dramatically over the past two decades and can be expected to continue growing strongly.[5] Furthermore, extrapolating from past trends, we estimate in that article that the average proportion of shares in S&P 500 companies voted by the Big Three could reach as much as 40% within two decades and that the Big Three could thus evolve into what we term the "Giant Three."[6]

The large and steadily growing share of corporate equities held by index funds, and especially the Big Three, has transformed ownership patterns in the U.S. public market. How index funds make stewardship decisions—how they monitor, vote in, and engage with portfolio companies—has a major

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1. For a more detailed definition of index funds, see infra section I.A.1.

2. The term "Big Three" has been used in reference to Vanguard, SSGA, and BlackRock (or, prior to 2009, Barclays Global Investors, which BlackRock acquired in that year) for more than a decade. For early uses of the term in the financial press, see Rebecca Knight, Irresistible Rise of the Flexible Fund, Fin. Times (Apr. 19, 2006) (on file with the *Columbia Law Review*). For the academic study that seems to have been the first to introduce the term to the academic literature, 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, 19 Bus. & Pol. 298, 298 (2017).

3. See Lucian A. Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. 721, 736 (2019) [hereinafter Bebchuk & Hirst, Specter of the Giant Three]. That article substantially expands on the evidence regarding the "bigness" of the Big Three that Fichtner et al., supra note 2, provided by, among other things, analyzing past trends, expected future trends in the growth of the Big Three, and the key factors likely to lead to their continued dominance of the industry. See Bebchuk & Hirst, Specter of the Giant Three, supra, at 723–24.

4. Bebchuk & Hirst, Specter of the Giant Three, supra note 3, at 735 (presenting evidence that the Big Three held, in aggregate, 1,118 positions of 5% or more at S&P 500 companies in 2017).

5. Id. at 732–40.

6. Id. at 737–40.

impact on the governance and performance of public companies and the economy. Understanding these stewardship decisions, as well as the policies that can enhance them, is a key challenge for the field of corporate governance. This Article contributes to such an understanding.

Leaders of the Big Three have repeatedly stressed the importance of responsible stewardship and their strong commitment to it. For example, then-Vanguard CEO William McNabb stated that "[w]e care deeply about governance" and that "Vanguard's vote and our voice on governance are the most important levers we have to protect our clients' investments."[7] Similarly, BlackRock CEO Larry Fink stated that "our responsibility to engage and vote is more important than ever" and that "[t]he growth of indexing demands that we now take this function to a new level."[8] The Chief Investment Officer of SSGA stated that "SSGA's asset stewardship program continues to be foundational to our mission."[9]

The Big Three leaders have also stated both their willingness to devote the necessary resources to stewardship and their belief in the governance benefits that their investments in stewardship produce. For example, Vanguard's McNabb has said, of governance, that "[w]e're good at it. Vanguard's Investment Stewardship program is vibrant and growing."[10] Similarly, BlackRock CEO Larry Fink has stated that BlackRock "intend[s] to double the size of [its] investment stewardship team over the next three years. The growth of [BlackRock's] team will help foster even more effective engagement."[11]

The stewardship promise of index funds arises from their large stakes and their long-term commitment to the companies in which they invest. Their large stakes provide these funds with significant potential influence and imply that by improving the value of their portfolio companies they can help bring about significant gains for their portfolios. Furthermore, because index funds have no "exit" from their positions in portfolio companies while those companies remain in the index, they have a long-term perspective and are not

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[7]. Bill McNabb, The Ultimate Long-Term Investors, Vanguard (Jul. 5, 2017), https://global.vanguard.com/portal/site/institutional/nl/en/articles/research-and-commentary/portfolio-construction/ultimate-long-term-investors-uk [https://perma.cc/76PC-AV8P].

[8]. Larry Fink, 2018 Letter to CEOs: A Sense of Purpose, BlackRock (Jan. 16, 2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (on file with the *Columbia Law Review*).

[9]. State St. Glob. Advisors, Annual Stewardship Report 2016 Year End 3 (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf [https://perma.cc/Z3BE-RMQ4] [hereinafter State St. Glob. Advisors, Annual Stewardship Report 2016].

[10]. McNabb, supra note 7.

[11]. Fink, supra note 8.

tempted by short-term gains at the expense of long-term value. This long-term perspective has been stressed by Big Three leaders[12] and applauded by commentators.[13] Jack Bogle, Vanguard's founder and the late elder statesman of index investing, has stated that index funds "are the . . . best hope for corporate governance."[14]

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

In particular, the Article seeks to make three contributions. The first contribution is to provide an analytical agency-cost framework for understanding the incentives of index fund managers. Our analysis demonstrates that index fund managers have strong incentives to (i) underinvest in stewardship and (ii) defer excessively to the preferences and positions of corporate managers. The incentive analysis builds on, and further develops, the analytical framework put forward in *The Agency Problems of Institutional Investors*, a 2017 article we coauthored with Alma Cohen.[15]

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

The third contribution is to explore the policy implications of the incentive problems of index fund managers that we identify and document. We put forward a number of policy measures to address these incentive

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[12]. See infra notes 39–40 and accompanying text.

[13]. See, e.g., Martin Lipton, Engagement—Succeeding in the New Paradigm for Corporate Governance, Harvard Law Sch. Forum on Corp. Governance & Fin. Regulation (Jan. 23, 2018), https://corpgov.law.harvard.edu/2018/01/23/engagement-succeeding-in-the-new-paradigm-for-corporate-governance/ [https://perma.cc/NBP4-GNXG] [hereinafter Lipton, New Paradigm for Corporate Governance] ("[T]he BlackRock letter is a major step in rejecting activism and short[-]termism . . . ."). For a detailed account by one of us of the appeal that "long-termism" has had to corporate law scholars and practitioners, see generally Lucian A. Bebchuk, The Myth That Insulating Boards Serves Long-Term Value, 113 Colum. L. Rev. 1637, 1646–51 (2013) [hereinafter Bebchuk, Long-Term Value].

[14]. Christine Benz, Bogle: Index Funds the Best Hope for Corporate Governance, Morningstar.com (Oct. 24, 2017), http://www.morningstar.com/videos/830770/bogle-index-funds-the-best-hope-for-corporate-gove.html (on file with the *Columbia Law Review*).

[15]. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, The Agency Problems of Institutional Investors, 31 J. Econ. Persp. 89 (2017) [hereinafter Bebchuk et al., Agency Problems of Institutional Investors].

problems and explain why some other measures do not merit serious consideration. We also explain how recognition of these incentive problems should inform and influence important ongoing debates, such as those on common ownership and hedge fund activism.[16]

This Article's analysis is organized as follows. Part I develops our agency-costs theory of index funds stewardship. We begin by discussing the nature of index funds and stewardship. We proceed to discuss the features of index funds, such as large stakes and long-term perspectives, that have given rise to high hopes for index fund stewardship. We then explain that these hopes are founded on the premise that the stewardship decisions of index fund managers are largely focused on maximizing the long-term value of their investment portfolios and that agency problems are thus not a key driver of those decisions. We contrast this "value-maximization" view with an alternative "agency-costs" view that we put forward.

In the agency-costs view, because the stewardship decisions of index funds are not made by the index funds' own beneficial investors (to whom

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[16]. The research that is most closely related to this Article consists of four current or recent works that focus on index fund stewardship but differ considerably from this Article in terms of scope, methodology, approach, and normative position.

To begin, a study by John C. Coates also focuses on the increasing concentration of ownership in the hands of a small number of institutional investors. See generally John C. Coates, The Future of Corporate Governance Part I: The Problem of Twelve (Harvard Pub. Law Working Paper No. 19-07 2018), https://ssrn.com/abstract=3247337 (on file with the *Columbia Law Review*). However, unlike this Article, Coates's study seems to be concerned that these investors will exercise too much power, rather than underinvest in stewardship and be excessively deferential to corporate managers; see infra note 269 and accompanying text and see generally Coates, supra.

In addition, studies by Jill E. Fisch, Assaf Hamdani, and Steven Davidoff Solomon, and by Edward B. Rock and Marcel Kahan, take issue with our analysis and view index fund stewardship much more favorably than we do. But as we explain in various places below (see infra notes 58, 60, 65–66, 69-70, 87, 108, 126, 134–136, 139, 143, 162, 172–174, 179, 183–187, 192, 196, 199–200, 210, 289, 293 and accompanying text), each of these studies fails to recognize some of the major problems with the stewardship that our analysis identifies. See generally Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, U. Pa. L. Rev. (forthcoming 2019), https://ssrn.com/abstract=3192069 (on file with the *Columbia Law Review*); Marcel Kahan & Edward B. Rock, Index Funds and Corporate Governance: Let Shareholders Be Shareholders (N.Y. Univ. Law & Econ. Research Paper No. 18-39, 2019), https://ssrn.com/abstract=3295098 (on file with the *Columbia Law Review*).

Finally, a study by Dorothy Shapiro Lund shares our concerns about how little the Big Three invest in stewardship, but it differs substantially from our incentive analysis, empirical investigation, and policy recommendations. See generally Dorothy Shapiro Lund, The Case Against Passive Shareholder Voting, 43 J. Corp. L. 493 (2018); see also infra notes 109, 223–230 and accompanying text.

These four studies, as well as our own work, build on the substantial earlier body of literature on institutional investors discussed in note 17, infra.

we refer below as the "index fund investors"), but rather by their investment advisers (whom we label "index fund managers"), the incentives of index fund managers are critical. The remainder of Part I is devoted to developing the elements of the agency-costs theory. In particular, we analyze two types of incentive problems that push the stewardship decisions of index fund managers away from those that would best serve the interests of index fund investors.

The first type is *incentives to underinvest in stewardship*. Stewardship that increases the value of portfolio companies will benefit index fund investors. Index fund managers, however, are remunerated with a very small percentage of their assets under management and thus would capture a correspondingly small fraction of such increases in value. They therefore have much more limited incentives to invest in stewardship than their beneficial investors would prefer. Furthermore, if stewardship by an index fund manager increases the value of a portfolio company, rival index funds that track the same index (and investors in those funds) will receive the benefit of the increase in value without any expenditure of their own. As a result, an interest in improving financial performance relative to rival index fund managers does not provide *any* incentive to invest in stewardship. In addition, we explain that competition with actively managed funds cannot be expected to address the substantial incentives to underinvest in stewardship that we identify.

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

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

substantial risk of regulatory backlash.[17]

Although we focus on understanding the structural incentive problems that afflict the stewardship decisions of index fund managers, we stress that in some cases, fiduciary norms, or a desire to do the right thing, could lead well-meaning index fund managers to take actions that differ from those suggested by a pure incentive analysis. Furthermore, index fund managers also have incentives to be perceived as responsible stewards by their beneficial investors and by the public—and thus, to avoid actions that would make salient their underinvestment in stewardship or their deference to corporate managers. These factors could well constrain the force of the problems that we investigate. However, the structural incentive problems that we identify should be expected to have significant effects, and the evidence we present in Part II demonstrates that this is, in fact, the case.

As with any other theory regarding economic and financial behavior, the test for which of the value-maximization view or the agency-costs view is valid is the extent to which those views are consistent with and can explain the extant evidence. Part II, therefore, puts forward evidence on the stewardship decisions of the Big Three. We provide a detailed picture of what they do, how they do it, and what they fail to do. We combine hand-collected data and data from various public sources to piece together this broad and detailed picture. We describe in detail the data sources used in the various empirical analyses of Part II in this Article's Appendix.

The first half of Part II considers four dimensions of the stewardship that the Big Three actually undertake and how they do so. First, we examine *actual stewardship investments*. Our analysis provides estimates of the stewardship personnel, in terms of both workdays and dollar cost, devoted to

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[17]. In analyzing the incentives of index funds, our work, as well as other current writings on index fund stewardship, builds on a substantial body of earlier literature on institutional investors and their potential benefits and agency costs. For well-known early works that analyze the potential benefits and limitations of institutional investors as monitors of portfolio companies, see generally Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811 (1992) [hereinafter Black, Agents Watching Agents]; Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990) [hereinafter Black, Shareholder Passivity Reexamined]; John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445 (1991).

For recent works in this literature, see generally Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013); Leo E. Strine, Jr., Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, 114 Colum. L. Rev. 449 (2014); Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 Bus. Law. 1 (2010) [hereinafter Strine, One Fundamental Corporate Governance Question].

particular companies. Whereas supporters of index fund stewardship have focused on recent increases in the stewardship staff of the Big Three, our analysis examines personnel resources in the context of the Big Three's assets under management and the number of their portfolio companies. We show that the Big Three devote an economically negligible fraction of their fee income to stewardship and that their stewardship staffing levels enable only limited and cursory stewardship for the vast majority of their portfolio companies.

Second, we consider *behind-the-scenes engagements*. Supporters of index fund stewardship view private engagements by the Big Three as explaining why they refrain from using certain other stewardship tools available to shareholders. However, we show that the Big Three engage with a very small proportion of their portfolio companies, and only a small proportion of portfolio companies have more than a single engagement in any year. Furthermore, refraining from using other stewardship tools also has an adverse effect on the small minority of cases in which private engagements do occur. The Big Three's private engagement thus cannot constitute an adequate substitute for the use of other stewardship tools.

Third, we describe the Big Three's *focus on divergence from governance principles*. Our review of the proxy voting guidelines and engagements of the Big Three demonstrates that they largely focus on the existence or absence of divergences from governance principles. But value-maximizing stewardship decisions would require also paying attention to additional company-specific information, including information about financial performance or the suitability of particular directors up for election.

Fourth, we discuss *pro-management voting*. We focus on votes cast by the Big Three on matters of central importance to managers, such as executive compensation and proxy contests with activist hedge funds. We show that the Big Three's votes on these matters reveal considerable deference to corporate managers. For example, the Big Three very rarely oppose corporate managers in say-on-pay votes and do so significantly less frequently than other large investment fund managers.

In the second half of Part II, we analyze in turn five dimensions of stewardship activities that the Big Three *fail* to undertake adequately. First, we examine their *limited attention to business performance*. Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance. While portfolio company compliance with governance best-practices serves the interests of index fund investors, those investors would also benefit substantially from stewardship aimed at identifying, addressing, and remedying financial underperformance.

Second, we analyze how the Big Three pay *limited attention to some*

important characteristics of directors and to the choice of individual directors. Index fund investors could benefit if index fund managers communicated with the boards of underperforming companies about replacing or adding certain directors. However, our examination of director nominations and Schedule 13D filings over the past decade indicates that the Big Three have refrained from such communications.

Third, we explain that the Big Three fail to *adequately bring about improvements favored by their own governance principles*. Shareholder proposals have proven to be an effective stewardship tool for bringing about governance changes at large numbers of public companies. Many of the Big Three's portfolio companies persistently fail to adopt the governance best-practices that the Big Three support. Given these failures, and the Big Three's focus on divergences from governance principles, it would be natural for the Big Three to submit shareholder proposals to such companies aimed at addressing such failures. But our examination of shareholder proposals over the last decade indicates that the Big Three have completely refrained from submitting such proposals.

Fourth, we analyze the frequent tendency of the Big Three *to stay on the sidelines of governance reforms*. Index fund investors would benefit from involvement by index fund managers in corporate governance reforms—such as supporting desirable proposed changes and opposing undesirable changes—that could materially affect the value of many portfolio companies. We therefore review the comments submitted to the Securities and Exchange Commission (SEC) from 1995 through 2018 with respect to proposed rulemaking regarding corporate governance issues. We also examine amicus briefs filed from 2007 through 2018 in precedential litigation regarding corporate governance issues. We find that the Big Three have contributed very few such comments and no amicus briefs during the periods we examine, and were much less involved in such reforms than asset owners with much smaller portfolios.

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

Taken together, this body of evidence is difficult to reconcile with the value-maximization view. On the whole, however, the documented patterns

are consistent with, and can be explained by, the agency-costs view put forward in Part I.

Part III turns to the policy implications of our theory and evidence. In section III.A we put forward for consideration five measures for addressing the incentive problems of index fund managers and discuss measures that we believe would be counterproductive—in particular, prohibiting index funds from voting or having index fund investors determine funds' votes. The set of approaches that we consider includes measures designed (i) to encourage stewardship investments; (ii) to address the distortions arising from business ties between index fund managers and public companies; (iii) to bring transparency to the private engagements conducted by index fund managers and their portfolio companies; and (iv) to redesign the rules governing the disclosure of stakes of 5% or more in portfolio companies.

We further discuss placing limits on the fraction of equity of any public company that could be managed by a single index fund manager. The expectation that the proportion of corporate equities held by index funds will continue to rise[18] makes it especially important to consider the desirability of the Big Three's continued dominance. For instance, we explain that if the index fund sector continues to grow and index fund managers come to control 45% of corporate equity, having each of the "Giant Three" holding 15% would be inferior to having each of a "Big-ish Nine" holding 5%.

Section III.B discusses the significant implications of our analysis for two important ongoing debates. First, we consider the debate over influential but controversial claims that the rise in common ownership patterns—whereby institutional investors hold shares in many companies in the same sector—can be expected to have anticompetitive effects. We explain that our analysis indicates that these claims are unwarranted and that focusing regulatory attention on them would be counterproductive.[19]

With respect to the debate on hedge fund activism, our analysis also

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[18]. See infra notes 26–28 and accompanying text.

[19]. We were invited by the Federal Trade Commission (FTC) to discuss the implications of our work for the common ownership debate at an FTC hearing on the subject. The slides of our presentation are available in Lucian Bebchuk & Scott Hirst, The Misguided Attack on Common Ownership (Harvard Pub. Law Working Paper No. 19-10, 2018), https://ssrn.com/abstract=3298983 (on file with the *Columbia Law Review*) [hereinafter Bebchuk & Hirst, Misguided Attack on Common Ownership].

For recent attempts by a leading critic of common ownership to engage with the arguments regarding common ownership made in this Article, see Einer Elhauge, The Causal Mechanisms of Horizontal Shareholding 49–58 (2019) (unpublished manuscript), https://papers.ssrn.com/abstract=3370675 (on file with the *Columbia Law Review*) [hereinafter Elhauge, The Causal Mechanisms of Horizontal Shareholding]; Einer Elhauge, How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It 48–70 (Aug. 2, 2019) (unpublished working paper), https://ssrn.com/abstract=3293822 (on file with the *Columbia Law Review*).

undermines claims by opponents of such activism that index fund stewardship is superior to—and should replace—hedge fund activism; rather, the incentive problems of index fund managers make the role of activist hedge funds especially important.

Part III concludes by highlighting another way in which we hope our analysis could contribute to improving index fund stewardship. Because index fund managers have an interest in having their stewardship viewed favorably by their investors and others, increased recognition of the agency problems of index fund managers could by itself induce such managers to reduce divergences from value-maximizing stewardship decisions. Although the policy measures we put forward would improve matters, the problems that we identify and document can be expected to remain an important element of the corporate governance landscape. Acquiring a full understanding of these problems is thus essential for policymakers and the field of corporate governance.

We have been fortunate to receive reactions and responses to our work from many academics, both in their writings and in various fora in which earlier versions of this Article were presented, as well as from practitioners, including index fund officers. Throughout our analysis, we attempt to engage with and respond to comments, objections, and arguments raised by such commentators.[20]

Before proceeding, we would like to clarify the nature of our normative claims. First, we do not argue that index fund stewardship produces worse outcomes for the governance of the economy's operating companies than the outcomes that would occur if the shares of the index funds were instead held by dispersed individual investors. On the contrary, we believe that, despite the problems we identify and document with index fund stewardship, the concentration of shares in the hands of index funds produces substantially better oversight than would result from the shares currently held through index funds instead being owned directly by dispersed individual investors. The evolution from the dispersion of ownership highlighted by Adolf Berle and Gardiner Means[21] to the concentration of ownership among institutional investors created the potential for improved oversight. Our interest is in realizing that potential to the fullest extent possible.

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[20]. For examples of our engagement with arguments or counterarguments related to our work that have been raised by others, see, e.g., infra notes 58, 60–62, 65–66, 69–71, 87, 108–109, 115–117, 119–120, 126, 134–141, 143, 145, 162–164, 172–174, 179, 183–187, 192, 196, 199–200, 205, 210, 215, 217, 222–225, 227–229, 231, 269, 278–279, 289, 293 and accompanying text.

[21]. For the classic work documenting and lamenting the dispersion of ownership prior to the rise of institutional investors, see generally Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

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

Instead, we focus on comparing the current stewardship decisions of index fund managers with the stewardship decisions that would best serve the interests of index funds' investors. We believe that comparing current stewardship decisions to this benchmark can improve our understanding of the shortcomings of current stewardship decisions, the nature and significance of these shortcomings, and the best ways to address them. If agency problems are indeed a first-order driver of stewardship decisions, as we argue, then the agency-costs framework can substantially contribute to a fuller understanding of stewardship decisions. Furthermore, the agency-costs framework can provide a basis for putting forward arrangements to limit the agency costs we identify and improve index fund stewardship. These improvements would, in turn, serve the interests of the index fund investors and contribute to the performance of the public companies in which they hold shares.

I. AN AGENCY-COSTS THEORY OF INDEX FUND STEWARDSHIP

This Part develops our agency-costs theory of index fund stewardship. We start by explaining the nature of index funds and the stewardship activities they undertake in section I.A. We describe views that have been expressed about the significant promise that the nature of index funds holds for stewardship in section I.B. We explain that this is the basis for the "value-maximization view" of index fund stewardship, and we put forward our competing "agency-costs" view in section I.C. We then develop the agency-costs view, showing how this view indicates that index fund managers will have incentives to underinvest in stewardship in section I.D, as well as incentives to be excessively deferential to managers of portfolio companies

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[22]. For analyses of these substantial problems, see Bebchuk et al., Agency Problems of Institutional Investors, supra note 15, at 95–104; Lucian Bebchuk & Scott Hirst, Are Active Mutual Funds More Active Owners than Index Funds?, Harv. L. Sch. F. on Corp. Harvard Law Sch. Forum on Corp. Governance & Fin. Regulation (Oct. 3, 2018), https://corpgov.law.harvard.edu/2018/10/03/are-active-mutual-funds-more-active-owners-than-index-funds/ [https://perma.cc/G6FQ-EDG7] [hereinafter Bebchuk & Hirst, Active Mutual Funds].