Summary:

This paper examines the relationship between index fund (passive) ownership and it's involvement in monitoring activities, thereby deducing the impact of the increase of passive ownership on the firm's governance. The authors present a lot of statistically significant findings to claim that increase in index fund ownership leads to decreased monitoring of the corporates which might have negative effects on the corporate governance. They find no evidence that index funds engage with the firm management to alter their proposals, either privately or publicly. Put together, increase in index fund ownership shifts the power from shareholders to firm management.

Importance of the paper:

This paper has important policy implications as it shows that the increase in index fund ownership need not necessarily be good for retail shareholders and the firm value in general. Given the rate at which the index fund ownership is increasing this could have an adverse effect on the governance of corporates and their performance, which could have an economy-wide impact. The question addressed in the paper is even more important given the results are against everyone's priors and have economic significance.

Comments:

(1) *Non-random assignments/Selection bias*: The authors use a new approach developed by the Russell group to pick the constituents for their indices, and employ Heckman correction model. The approach creates an upper and lower band around the rank-cutoff used to decide constituents of Russell 1000 and 2000 indices. The bands are calculated as

+/- 2.5% of the total market capitalization of the Russell 3000E index. This is kind of a random assignment and stocks within these bands do not switch indexes.

But in Heckman correction model, the authors select potential switchers as the firms +/- 100 ranks around the upper and lower band. It's not clear why they used 100 instead of 50 or 200.

(2) *Endogeneity issues:*

The authors use fixed effects to control for unobserved idiosyncratic and time-varying aggregate shocks. But they could also control for time-varying observable factors like firm-characteristics and local market (geographical) conditions, as they can induce risk-taking behavior and affect governance.

(3) *Benchmarking the monitoring behavior*:

The authors use active funds as the benchmark for monitoring behavior and compare index funds with them in these terms. But the authors do an aggregate fund-type level analysis. Instead they could perform a fund-level analysis by comparing funds with similar characteristics but fall into different buckets of active and index funds, investing in the same firm. Then we would be able to say precisely after controlling for observed and non-observed effects, how index fund ownership is impacting corporate governance.

(4) *Alternative proxies for corporate governance*:

The authors could also go a step further and look at how firm's risk-taking behavior has changed following the increase in index fund ownership. They could look at financial risk ratios like leverage ratio, interest coverage ratio etc. or credit ratings of the firm.

(5) The authors could also test how the fund managers' personal fund investment is affecting it's monitoring activities. If possible, look for any conflicts of interest on Form-ADV.