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

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Index funds own an increasingly large proportion of American public companies, currently more than one fifth and steadily growing. Understanding the stewardship decisions of index fund managers—how they monitor, vote, and engage with their portfolio companies—is critical for corporate law scholarship. In a study that we recently placed on SSRN—Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy—we seek to 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 the incentives of index fund managers. Our agency-costs analysis shows that index funds have strong incentives to (i) under-invest in stewardship, and (ii) defer excessively to the preferences and positions of corporate managers.

We then provide the first comprehensive and detailed evidence of the full range of stewardship activities that index funds do and do not undertake. This body of evidence, we show, is inconsistent with a no-agency-costs view but can be explained by our agency-cost analysis.

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

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

Below is a more detailed account of our study:

Index funds—investment funds that mechanically track the performance of an index—hold an increasingly large proportion of the equity of U.S. public companies. The sector is dominated by three index fund managers—BlackRock, State Street Global Advisors (SSGA), and Vanguard, often referred to as the "Big Three". The Big Three manage over $5 trillion of U.S. corporate equities, collectively vote about 20% of the shares in all S&P 500 companies, and each holds a position of 5% or more in a vast number of companies. The proportion of assets in index funds has risen dramatically over the past two decades, reaching more than 20% in 2017, and is expected to continue growing substantially over the next decade.

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. It has also been attracting increasing attention to index fund stewardship.

Leaders of the Big Three have repeatedly stressed the importance of responsible stewardship, and their strong commitment to it. For example, Vanguard's then-CEO William McNabb stated that "We care deeply about governance", and that "Vanguard's vote and our voice on governance are the most important levers we have to protect our clients' investments." Similarly, BlackRock's CEO Larry Fink stated that "our responsibility to engage and vote is more important than ever" and that "the growth of indexing demands that we now take this function to a new level." The Chief Investment Officer (CIO) of SSGA stated that "SSGA's asset stewardship program continues to be foundational to our mission."

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

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

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

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

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

Our third contribution is to explore the policy implications of the incentive problems of index fund managers that we identify and document. We put forward a number of policy measures to address these incentive problems. These measures should be considered to improve index fund stewardship—and thereby, the governance and performance of public companies. We also explain how these incentive problems shed light on important ongoing debates about common ownership and hedge funds.

Our analysis is organized as follows. Part I discusses the features of index funds that have given rise to high hopes for index fund stewardship. The views of Big Three leaders and supporters of index fund stewardship, we explain, are premised on a belief that index fund decisions can be largely understood as being focused on maximizing the long-term value of their investment portfolios, and that agency problems are not a key driver of those decisions.

By contrast to this "no-agency-costs" view, Part II puts forward an alternative "agency-costs" view. Stewardship decisions for an index fund are not made by the index fund's own beneficial investors, which we refer to as the "index fund investors," but rather by its investment adviser, which we label the "index fund manager." As a result, the incentives of index fund managers are critical. We identify two types of incentive problems that push the stewardship decisions of index fund managers away from those that would best serve the interests of index fund investors.

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

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

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

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

As with any other economic theory, the test for whether the no-agency-costs view or the agency-costs view are valid is the extent to which they are consistent with and can explain the extant evidence. Part III therefore puts forward evidence on the actual stewardship activities that the Big Three index funds do and do not undertake. We combine hand-collected data and data from various public sources to piece together a broad and detailed picture of index fund stewardship. In particular, we investigate eight dimensions of stewardship:

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

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

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

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

5. *Avoiding Shareholder Proposals*. Shareholder proposals have proven to be an effective stewardship tool for bringing about governance changes at broad groups of public companies. Many of the Big Three's portfolio companies persistently fail to adopt the best governance practices that the Big Three support. Given these failures, and the Big Three's focus on governance processes, it would be natural for the Big Three to submit shareholder

proposals to such companies aimed at addressing such failures. However, our examination of shareholder proposals over the last decade indicates that the Big Three have completely refrained from submitting such proposals.

6. Avoiding *Engagement Regarding Companies' Nomination of Directors*. Index fund investors could well benefit if index fund managers communicated with the boards of underperforming companies about replacing or adding certain directors. However, our examination of director nominations and Schedule 13D filings over the past decade indicates that the Big Three have refrained from such engagements.

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

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

Taken together, the body of evidence that we document is difficult to reconcile with a "no-agency-cost" view under which stewardship choices are made to maximize the value of managed portfolios. Rather, the evidence is, on the whole, consistent with, and can be explained by, the agency-costs view and its incentive analysis described in Part II.

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

In Part IV we consider the policy implications of our theory and evidence. We begin by examining several approaches to address the incentives of index fund managers to under-invest in stewardship and defer excessively to corporate managers. In particular, we consider measures to encourage stewardship investments, as well as to address the distortions arising from business ties between index fund managers and public companies. We also examine measures to bring transparency to the private engagements conducted by index fund managers and their portfolio companies—transparency that, we argue, is necessary to provide material information to investors, and can provide beneficial incentives to those engaged in such engagements.

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

Part IV also discusses the significant implications of our analysis for two important ongoing debates. One such debate concerns influential claims that the rise in common ownership patterns—whereby institutional investors hold shares in many companies in the same sector —can be expected to have anticompetitive effects and should be a focus of antitrust regulators. Our analysis indicates that these claims are not warranted. The second debate concerns activist hedge funds. Our analysis undermines claims by opponents of hedge fund activism that index fund stewardship is superior to—and should replace—hedge fund activism. We show that, to the contrary, the incentive problems of index fund managers that we identify and analyze make the role of activist hedge funds especially important.

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

Our study is available here. Comments would be most welcome.