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“Index Funds and Corporate Governance: Let Shareholders be Shareholders”

by

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Note: It is expected that you will have reviewed the speaker’s paper before the seminar.

Index Funds and Corporate Governance: Let Shareholders be Shareholders

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Abstract

The largest institutional investors have become the de facto “deciders” of corporate law controversies. In this article, we take a close look at the financial incentives of the largest institutional investors with regard to the three core areas of shareholder involvement: high profile proxy contests between activist shareholders and boards; broad market wide governance standards; and routine monitoring of portfolio companies through “engagement.”

With regard to the highest profile contests that will likely affect firm value, the managers of the three largest index funds – BlackRock, Vanguard and State Street – have direct financial incentives to vote intelligently that are typically larger than any other shareholder, with the occasional exception of very large actively managed mutual funds. With regard to market wide governance standards, the Big Three are better positioned than any other shareholders to set the standards. With regard to routine monitoring, hedge funds and large actively managed funds will often be in a better position to monitor because of their firm-specific knowledge.

The Big Three’s financial incentives to become involved in corporate governance 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, their scope generates “spillover knowledge” that is valuable 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. For a variety of reasons, flow-based incentives are unlikely to be significant.

Although the Big Three’s scale and scope produce financial incentives to be responsible and informed “deciders,” their incentives and capacity to engage in general monitoring of portfolio companies are not as strong because of their business model and organizational structure. With regard to this sort of monitoring, hedge funds that seek out underperforming companies and large actively managed mutual funds with a pool of analysts and portfolio managers who pick stocks are both better positioned to identify firm-specific problems.

In light of the significant incentives that the Big Three have to play their current roles in corporate governance responsibly, we largely disagree with critics who would prevent them from voting or who view their involvement in corporate governance as reflecting significant agency costs.

Introduction

The largest institutional investors are at the center of the corporate governance debates. Do they do too little? Too much? Just the right amount? Are their incentives sufficiently aligned with the interests of their investors to whom they owe fiduciary duties? With the goals of corporate law to be trustworthy stewards? Recently, index funds managed by the “Big 3” – BlackRock, Vanguard and State Street – have grown to be the largest investors in the capital markets and have received disproportionate attention. Are the Big 3 a force for good or evil? Should they be suppressed in favor of active, undiversified shareholders like activist hedge funds or actively managed mutual funds?

With the decline of the small “retail” shareholders,¹ shareholders of U.S. publicly held companies are mostly a combination of corporate defined benefit pension funds, state and local public pension funds, insurance companies, endowments, hedge funds and, the sector that now attracts the most attention, open-ended mutual funds and their close cousins, exchange traded funds. Within this category, the funds that have grown the most are index funds.

Long the darling of finance scholars, 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. Because index funds charge lower fees than actively managed funds, and because the conventional wisdom that it is difficult to outperform the market has proven correct, index funds often have better net (post-fee) performance. The market has caught on, with many other fund families offering index funds and with index funds constituting a growing share of the fund sector. As of today, the majority

¹ Brian G. Cartwright, Gen. Counsel, SEC, Address at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007) (transcript available at <http://sec.gov/news/speech/2007/spch102407bgc.htm>).

of the equities held by the three largest investment advisors – BlackRock, Vanguard and State Street – are in index funds and other pools of assets using passive strategies.²

With this prominence has come controversy over whether this has been a positive or negative development. Historically, this has been viewed as a positive development, holding the potential to control management agency costs and to bring responsible stewardship of portfolio companies.³ For some, these “middle of the plate” investors hold the potential to be a stabilizing force in turbulent times.⁴

But there have always been critics some of whom have argued that index funds are the end of capitalism.⁵ More recently, the criticisms have sharpened, with one group of commentators arguing that index funds do too little, blindly supporting management rather than supporting hedge funds or voting “no” on “say on pay” resolutions.⁶ This has led some to argue that widely diversified shareholders’ do not have adequate incentives to increase firm value and therefore should not be allowed to vote their shares.⁷

At the same time, another group of commentators have argued that index funds do too much and that common ownership of public companies by these widely diversified investors is anticompetitive and has, e.g., resulted in airline ticket prices that are as much as 10% higher

² 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 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).

³ Edward Rock, Institutional Investors in Corporate Governance, Oxford Handbook of Corporate Law and Governance (Jeffrey Gordon & Georg Ringe, eds.)(OUP 2018)

⁴ Leo Strine, Securing Our Nation’s Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in the United States, 71 Bus. Lawyer – (2018)..

⁵ See, e.g., Luke Kawa, Bernstein: Passive Investing Is Worse for Society Than Marxism, <https://www.bloomberg.com/news/articles/2016-08-23/bernstein-passive-investing-is-worse-for-society-than-marxism>.

⁶ Dick Weil, Passive Investors, Don’t Vote, WSJ 3/8/18 <https://www.wsj.com/articles/passive-investors-dont-vote-1520552657> ; Jordon Wathen, A billionaire's warning on index funds , CNN Money 3/31/15 <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, WSJ 6/22/2017 <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, Available at SSRN: <https://ssrn.com/abstract=3282794>.

⁷ See, e.g., Lund, supra note 6.

than they otherwise would have been.⁸ Building on this research, others now argue that the current distribution of shareholding is illegal under Section 7 of the Clayton Act and that these firms should be forced to divest or to end all involvement in corporate governance.⁹

Institutional investors can be forgiven for wondering what they are supposed to do with their new found prominence and power, if anything. At the center of this swirling debate are several linked issues: what are the financial incentives of the largest institutional investors? How do their incentives compare to other shareholders' incentives? What, if any, connection should there be between investors' incentives and their legal and governance roles in corporate governance? In this article, we look closely at the incentive structure within which the largest institutional investors operate.

These questions must be addressed in the context of the current corporate governance landscape. The highest profile contests in corporate governance today are the proxy contests between activist shareholders and company management, in which the activists typically nominate several directors in an attempt to shift firm strategy (and raise the stock price). In these contests, the largest institutional investors – prominent among them the Big 3 -- hold the decisive votes and are the de facto “deciders.” In 2018, 34 proxy contests were launched against Russell 3000 companies. Of these, 21 were settled, 3 withdrawn and 10 went to a vote, with activists prevailing in 2 and management in 8.¹⁰ What are the Big 3's incentives to vote intelligently in these 10 or so contests per year? Does anyone have better incentives than they do?

The second category of corporate governance engagement involves market wide governance standards (e.g., staggered board, in force poison pill, majority voting, CEO/Chair separation, ESG disclosure, board diversity, etc.). For these issues, the Big 3 proxy voting

⁸ 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 At some points, AST adopt both views, that by doing too little, widely diversified funds “crowd out” active, undiversified shareholders who would push for hard competition.

⁹ 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).

¹⁰ Matteo Tonello, Conference Board, Proxy Voting Analytics (2015-2018).

<https://corpgov.law.harvard.edu/2018/11/26/shareholder-voting-in-the-united-states-trends-and-statistics-on-the-2015-2018-proxy-season/>

guidelines and the proxy advisory firms' recommendations are close to binding. What are the Big 3 incentives on these sorts of issues?

Finally, there are a variety of firm-specific issues. This can be divided into two subcategories: monitoring the performance of individual companies, where the Big 3 do little and activist hedge funds and actively managed mutual funds take the lead; and oversight of firm-specific governance decisions (including whether boards understand their role, are diverse across the various dimensions important to a firm's business, and have the right set of skills) where the Big 3 take the lead and the active managers do little.

This structure has important interaction effects. Because no firm wants to be targeted with a high profile proxy contest, the ten or so decided proxy contests a year have given birth to a new practice area of "activism defense" involving both lawyers and bankers. In preparing firms, advisers often invite directors to "think like an activist," to anticipate (and undertake) changes they might make if confronted with an activist, and to consider what the Big 3 would think were the firm in a contested situation.¹¹ One effect of this interaction effect is that the activists' "playbook," and the Big 3's perceived views, have a substantial influence on companies *not* targeted by activists, and lead to changes that the Big 3 often have not considered.

A key question that arises from the current debate is whether the Big 3 are well equipped to play the roles they currently perform in the corporate governance ecosystem. A separate question is whether they should be encouraged or forced to take on additional roles such as firm specific monitoring of performance¹² or as the arbiter of management compensation.¹³

As we will show below, the biggest investors neither fit the mold of conspirators against the public good that need to be restrained nor of shareholders with large voting power and without any information. Rather, the structure of the investment advising business, combined with the vast amounts of assets under management, provide the decision-makers for index funds with material incentives to cast fund votes that increase the value of the shares in their

¹¹ Advisory firms have hired numerous "graduates" of the Big 3 stewardship groups to provide this sort of insight.

¹² See Bebchuk and Hirst.

¹³ Gretchen Morgenson, *Your Mutual Fund Has Your Proxy, Like It or Not*, NYTimes Sept. 23, 2016.

portfolio, especially in their central roles as the de facto “deciders” of corporate law controversies and with regard to market-wide governance policies. Indeed, because of the massive scale of the largest index funds – a scale that can make their votes decisive in many of the most important controversies – the expected value of investing in voting is larger for these funds than for all but the largest individual shareholders and most active money managers. On the other hand, investment advisors that largely run index funds are unlikely to address company-specific performance problems proactively.

Of course, the heterogeneity of financial incentives that we find among today’s largest institutional investors and between money managers that mostly advise index funds and money managers that mostly advise active funds is simply an example of the heterogeneity of financial incentives that has always characterized shareholders, institutional and otherwise. In our view, this heterogeneity is a strength of capital markets, not a weakness.

This is for two reasons. For one, different kinds of shareholders have different competencies and accordingly serve different functions. Currently, for example, activist hedge funds specialize in searching for companies that would benefit from a change in strategy; when the hedge fund and management cannot agree on a new strategy, the large diversified investors are the de facto deciders.¹⁴ When institutional investors are acting as “deciders”, especially in the small number of controversies with significant implications for firm value, the evaluation of their incentives and capacities are both fundamentally different than with regard to routine and continuous “stewardship” of portfolio firms. Even if traditional investment advisors are not well-equipped to perform the tasks of activist hedge funds or to provide significant, ongoing monitoring of portfolio companies,¹⁵ they have comparatively strong incentives to invest sufficient resources in deciding the outcome when hedge funds and management disagree. Similarly, as we will argue, traditional investment advisors have comparatively strong incentives, with regard to market-wide governance policies. In particular, index funds’ broad diversification and indefinitely long time horizon are potentially significant

¹⁴ Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, __ B.U. L. Rev. __ (forthcoming 2019); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism ... of Governance Rights*, 113 *Columbia Law Review* 863 (2013).

¹⁵ Bebchuk & Hirst, *supra* note 6, at 17-18.

advantages vis a vis other shareholders and can mitigate distortions caused by short-term trading horizons and other factors. Just as there are some issues in which “firm specific” information is required, there are other issues for which market wide expertise is more valuable.

Most importantly, there are no “pure” shareholders. Incentive problems and conflicts of interest arise for every category of shareholder. A plurality of investing strategies undergirds a plurality of approaches, and there are strong reasons to think that investors benefit from both active and passive management, from highly active hedge funds, as well as from other sorts of hedge funds that pay no attention at all to governance.¹⁶

From this perspective, there is no need or justification for corporate law to privilege or penalize any particular approach. Capital markets are large enough, and diverse enough, to support both active and passive investing strategies, and investors of different shapes and sizes. Specifically, calls to deprive one group of investors – advisors to index funds – of voting rights or to subject them to more burdensome regulation because their information or incentives are systematically worse than that of other shareholders are unwarranted.¹⁷

We proceed as follows. In Part I, we review the structure of investment advising, and describe the various ways in which fund investment and voting is structured. In Part II, we turn to the question of fund family incentives and how these incentives interact with the balance between active and passive management. We then turn to the direct incentives of the largest fund families. We show that the largest institutional investors have better financial incentives than just about anyone else. This is a function of both the role that they play and the massive scale of assets under management. By contrast, we are dubious that the indirect incentives from competing for fund flows plays a significant role. Moreover, direct incentives are complemented by reputational or marketing incentives from being perceived as reliable stewards of investors’ funds. In Part III, we consider the advantages that large fund families derive from “spill-over knowledge” and a long-term trading horizon that can mitigate

¹⁶ Robert Stambaugh, *Investment Noise and Trends*, *Journal of Finance* (2014): 1415–1453; Lubos Pastor and Robert Stambaugh, *On the Size of the Active Management Industry*, *Journal of Political Economy* (2012): 740–781.

¹⁷ Elsewhere, Rock & Rubinfeld argue against the claims that widely diversified investors have an anticompetitive effect on product markets and should be forced to divest or to be passive in corporate governance. Edward Rock and Daniel Rubinfeld, *Antitrust for Institutional Investors*, 82 *Antitrust L. J.* 221 (2018).

distortions generated by short-term pressures. Then, in Part IV, we consider a variety of conflicts that can arise including the long recognized conflict between asset management and competing for corporate business as well as less well-appreciated conflicts that can arise from the “heft” that a large index fund can provide to a fund family’s actively managed portfolios. We then consider how the largest investors’ conflicts compare to conflicts faced by other types of shareholders and how conflicts are handled under Delaware’s case by case, ex post treatment of conflicted voting in the context of the extent to which a shareholder vote will be viewed as a “cleansing act” that can ratify a conflict of interest transaction. We close with a brief conclusion.

I. The Structure of Investment Advising: Funds, Fund Families, and Investment Advisors

The current framing of the discussion in terms of whether “index funds” do too little of the right things or too much of the wrong things when they vote is fundamentally misleading. “Index funds,” like “actively managed funds,” are essentially inert: each fund is a separate entity, the holders of which are the investors in that fund.¹⁸ Although each such fund has a board, the board’s role is not to manage the fund but to retain (and monitor) “management” which is provided externally by an “investment advisor” that owes fiduciary duties to the investors in the fund that it advises. It is the investment advisor that manages the assets in the fund, thereby bringing it to life. Portfolio managers, who select stock for actively managed funds, will be employees of the investment advisor, and not of the fund itself (which will have directors but no employees).¹⁹ Many funds identify by name the individual portfolio managers – specific employees of the advisor – who are in charge of making the investment decisions for the fund. An investment advisor often manages multiple funds with different strategies and different investors and may also manage assets not held through such funds on behalf of other clients (pension funds, insurance companies, endowments, high net worth individuals and families, etc.). A multi-fund complex managed in the main by a single advisor is referred to as a “Fund Family.” The corporate governance incentives of mutual funds – whatever their strategy

¹⁸ Investors invest in an open-ended mutual fund by buying shares in the fund at its net asset value (NAV). It is “open-ended” because the fund stands ready to buy the shares back at NAV.

¹⁹ See generally https://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.idc.

– can only be understood in the context of the governance structure and the incentives of the Fund Family/Investment Advisor to which the fund belongs.

The Fidelity Contrafund, the Vanguard Primecap Fund, and the Vanguard 500 Index Fund are all examples of mutual funds. It is the mutual fund that is either indexed or actively managed, with the Fidelity Contrafund and the Vanguard Primecap Fund being examples of actively managed funds and the Vanguard 500 Index Fund being an example of an indexed fund. Mutual funds must periodically disclose their portfolio holdings and the votes they cast. The Fidelity Contrafund is a part of the Fidelity family, the Vanguard Primecap Fund and the Vanguard 500 Index Fund are part of the Vanguard family. 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.

Investment advisors are often identified with the Fund Family. Thus, FMR Inc. (FMR) is the investment advisor for most Fidelity funds and Vanguard Group Inc. (VGI) is the investment advisor for most Vanguard funds. The ownership structure of investment advisors varies. Some advisors are privately held (e.g., FMR), some are owned by the investors in the mutual funds (e.g., VGI), and some are publicly traded (e.g., BlackRock). Investment advisors must also 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 advisors 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. However, funds in a family sometimes are advised by a different entity. 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 advisor (as in the case of the Fidelity index funds).

In active funds, the fund investment decisions are made on a decentralized basis by the fund's portfolio managers. At least as an initial matter, most voting decisions are made at the

investment advisor/fund family level. In small fund families, the voting decisions may be made by the same individuals who determine the investment strategy. Large investment advisors typically centralize the voting function in a “stewardship” or “proxy voting” group. 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. This may be the case even if the investment advisor claims, in its Form 13F, not to have any voting authority. Thus, for example, VGI disclaims legal voting authority over most of the shares listed on its Form 13F. Yet, Vanguard funds vote synchronously in virtually all instances, indicating that de facto voting decisions are made on a centralized basis. Fund families that do not have a large in-house proxy voting group often follow the voting recommendations by proxy advisors, such as ISS.

There are, however, a number of complexities. First, although the proxy group, when there is one, will be influential, portfolio managers (who, like the proxy voting group are employees of the investment advisor) are often involved in deciding how shares should be voted and sometimes can vote the shares that they are responsible for differently from the way shares of other funds in the family are voted. 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.²⁰ In addition, the proxy group can ask portfolio managers or stock analysts for their views on how certain shares should be voted, or portfolio managers and analysts can volunteer their views. In some fund families, the corporate governance specialist will present issues to a committee of portfolio managers who will make the final voting decision. The extent to which this happens also presumably varies among families and across issues, but cannot easily be observed.²¹

Second, when a fund in a family is advised by an outside advisor, initial responsibility for voting sometimes resides with the outside advisor (in its proxy voting group, if it has one, or elsewhere) and sometimes resides with the proxy group of the in-house advisor. This information, again, is not always directly disclosed but can often be deduced from the disclosed

²⁰ See Stephen Choi, Jill Fisch & Marcel Kahan, Who Calls the Shots in Director Elections, 3 Harv. Bus. L. Rev. 35, 48 (2013); see also 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 Business and Politics, April 2017, DOI: 10.1017/bap.2017.6

²¹ Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds (February 14, 2018). Available at SSRN: <https://ssrn.com/abstract=3124039> or <http://dx.doi.org/10.2139/ssrn.3124039>

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, it votes its shares like other Vanguard funds and unlike other Primecap funds. 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.

Third, managers of mutual funds also typically manage funds on behalf of non-mutual fund clients. Although those shares will typically be included in the advisor's 13F form when, for example, the advisor has dispositive power over the shares, no publicly available information is available on how those shares were voted. As a legal matter, an advisor may have sole voting power, shared voting power, or no voting power over these shares. As a practical matter, clients may be able to influence the voting of these shares even if the advisor has sole voting power and advisors may influence the voting of these shares even if they lack any voting power.

In sum, there is substantial variation in practice that is only imperfectly revealed in the Form 13F filings that form the basis for many assertions about institutional investor behavior and power.

II. Incentives

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

By contrast, passive funds – index funds – invest 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, because they do not pick stocks. Because index funds do not choose individual stocks, or adopt other specific strategies, their costs are much lower than actively managed funds. Vanguard’s S & P 500 Index fund charges individual investors as little as 4 basis points (.04 percent per year of invested assets). By contrast, Fidelity’s Contrafund Fund, a large actively managed mutual fund with \$98 billion under management, charges 74 basis points.²²

This structure – higher fees for active funds than for passive funds, potential additional benefit from fund flows for active funds – create complex incentives for investment advisors that manage both actively and passively managed assets. Suppose that a fund family has one actively managed fund Active for which it charges 74 basis points per year and one passively managed fund Passive that charges 4 basis points per annum. A fund family’s annual fees will thus be

$$\text{Fees} = .74 * \text{AUM (Active)} + .04 * \text{AUM (Passive)}.$$

This very simple example begins to uncover a great deal of the complexity in understanding the incentive structure of mutual fund families. It shows that AUM in actively managed funds are much more valuable to a sponsor than assets in passively managed funds. In the above example, assets in the active fund generate more than 17 times the fees for investments than assets in the passive 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 family’s²³ – it is likely that marginal profits per dollar invested are higher for active than

²² <https://fundresearch.fidelity.com/mutual-funds/fees-and-prices/316184100>

²³ 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.

for passive funds. This provides an obvious incentive for fund families to encourage investors to shift funds from passive to active strategies.

Why then run index funds at all? There are several reasons. Some investors have a strong preference for index funds and even at the lower fees, advising index funds may generate profits to an advisor. 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 as a loss leader. Fidelity, for example, recently introduced a zero-fee index fund.²⁴ Even though this fund may generate some income to FMR from securities lending, we would guess that operating this fund is not profitable on a stand-alone basis. After all, Vanguard, which supposedly operates on a zero-profit margin, enjoys very large economies of scale and can also earn income from securities lending, charges 4 basis points for its S&P 500 index fund. But because investors find it substantially easier to move funds within a mutual fund family than between mutual fund families, and record keeping is substantially simpler, Fidelity may benefit by keeping investors seeking an index fund in-house, and attract new customers to its index funds, in the expectations that such investors are more likely to invest in its higher fee active funds or purchase other services from Fidelity. Similarly, investors' preferences and the desire to keep investors in-house may explain why Vanguard, the pioneer in index investing, has always had some actively managed funds.

Relatedly, depending on how a fund family structures its proxy voting process, passively managed assets may increase the power of the PMs of actively managed fund managers in their interactions with portfolio companies. BlackRock's \$3.1 trillion in passively managed equity assets may open doors for its portfolio managers who manage its \$311 billion in actively managed equity assets.²⁵ This can be important when those PMs ask questions, make suggestions, express views, object to corporate action, or seek individual meetings with management. This is a benefit of running an index fund within a multi-fund family, separate and apart from the management fees earned.

²⁴ <https://www.marketwatch.com/story/fund-fees-hit-milestone-as-fidelity-announces-products-charging-0-2018-08-01>

²⁵ BlackRock 12/31/2017 10K at p. 32..

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’ 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.²⁶ Among the “big three”, almost all of State Street’s assets are in indexed funds.²⁷ State Street, as well as some smaller families that focus on index funds, thus resemble an investment advisor that exclusively runs passive funds. Vanguard and BlackRock, by contrast, have only about 90% of their equity assets under management in passive funds. Despite this similarity, however, Vanguard and BlackRock differ in important respects. First, even actively managed Vanguard funds charge a relatively low management fee. Second, most of the active equity funds in the Vanguard family are managed or co-managed by outside advisors, such as Primecap Management Co. 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 advisor, not to Vanguard. And lastly, the small Vanguard in-house active equity management group pursues a quantitative strategy. By contrast, BlackRock’s active funds resemble more closely – in fee, management structure, and style – standard active funds.

Considering this overall structure, we now examine in greater detail how fund management fees provide a financial incentive for fund advisors to cast an informed vote. First, we consider the incentives to improve absolute returns that result from the fact that higher return directly results in higher assets under management which directly results 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 suggest that the advisors to *index* funds have *no* incentives to do so. As we show below, this is incorrect and, in fact, investment advisors who manage the bulk of assets in index fund assets have substantial incentives to increase portfolio value. Indeed,

²⁶ 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) <https://www3.troweprice.com/fb2/fbkweb/snapshot.do?ticker=PREIX>.

²⁷ Fichtner et al, *supra* note 20 (97%).

their incentives are among the largest incentives of any shareholders, superior to those of most other institutional investors and of all but the largest individual investors.

A. Direct Incentives

As we explained, advisers to index funds, like advisors to any other mutual funds, directly benefit if the portfolio companies held by the fund do well. Advisors' fees depend on the value of fund assets. As the value of fund assets increases, other things being equal, 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.²⁸

Even these low fees generate incentives in the context of voting that compare favorably to those of most other shareholders because the principal advisors to equity index funds are very large. Take, for example, Vanguard Group Inc. ("Vanguard"). The average annual fee for of the five largest Vanguard funds is 0.064% per year. But the aggregate value of the shares in Vanguard's portfolio is huge. For example, at the end of 2013, Vanguard's shares in Procter & Gamble, the target of a recent proxy contest by Trian, had a value of about \$13 billion.

In the context of voting, 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, if P&G's stock rises by just 1% as a result of a voting outcome, the value of Vanguard position in P&G would increase by 1% of its \$13 billion position (\$130 million) and Vanguard's annual fees, applying the 0.064% rate, would increase by about \$83,000 per year. 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 \$830,000. This is about the same dollar amount as the gain to an individual stockholder with \$83 million in P&G stock.

²⁸ https://www.ici.org/pdf/2018_factbook.pdf at 126

But Vanguard's monetary incentives to cast a value-increasing vote are substantially stronger than those of an individual shareholder with \$83 million in P&G stock. Because Vanguard owns 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.²⁹ 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 \$1.06 billion investment.³⁰

Note that the fact that P&G is one of the largest companies affects only the dollar magnitude of the incentives, not the *relative* incentives of Vanguard compared to an individual shareholder. 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.

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 1/150

²⁹ 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 $s_i = 12$.

³⁰ Trian, in launching a proxy contest at Procter & Gamble, had a \$3.5 billion stake.
<https://www.reuters.com/article/us-procter-gamble-stake-trian-fund-idUSKBN15T2WR>

the size assuming Vanguard earns fees for 10 years.³¹ But they are multiple orders of magnitude higher than the incentives that the shareholders of Vanguard mutual funds would have given their actual stake. 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 and less than 1% empty.

The bulk of assets in equity index funds are held in funds advised by the "big three." But the same logic applies to investment advisors who largely manage index funds but are smaller than Vanguard. Consider, for example, Charles Schwab, another investment advisor that specializes in index funds. Charles Schwab held P&G stock worth "only" \$552 million and charges fees of about 0.04%. 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 Schwab, or about \$35 million in P&G stock.

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 advisors to index funds.

How do Vanguard's incentives compare to most actively managed mutual fund families? With respect to direct incentives,³² 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. These higher fees generate correspondingly better incentives to cast informed votes.

³¹ See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1050 (2007); Bebchuk & Hirst, *supra* note **Error! Bookmark not defined.**, 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 1/12 of those of an individual holder with a stake equivalent to Vanguard. It is an open question whether, in the absence of free-rider problems, mutual fund holders would gladly buy these higher fees for the benefits obtained from the superior incentives for investment advisors.

³² Other differences, including the fact that actively-traded funds have stronger flow-based incentives, are discussed further below.

Second, actively managed fund families 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, as of December 31, 2017, the 10 largest holdings of the Fidelity Contrafund, the largest active fund, constituted 38.1% of its net assets;³³ the 10 largest holdings of the Vanguard S&P 500 Index fund constituted only 20.9% of its assets.³⁴

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 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 advisor 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 combined, FMR’s relative holdings were similar to those of the S&P Index Fund. Nevertheless, in particular for smaller fund families, families with mainly active funds are likely to invest in fewer companies, and to hold more concentrated stakes in these companies, than families consisting mostly of index funds.

Table 1: Fidelity Contrafund – Largest Holdings

	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

³³ <https://www.sec.gov/Archives/edgar/data/24238/000137949118000849/filing706.htm#350158510>

³⁴ https://www.sec.gov/Archives/edgar/data/36405/000093247118005288/indexfunds_final.htm

of stock in its portfolio increase depends on the average period of time for which *fund investors* will keep owning the fund (as opposed to the fund's portfolio turnover rate). To illustrate, if all fund investors withdraws 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. How long fund investors retain their investment depends on the investors' liquidity needs as well as on 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 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 will out-perform the stock market. Plausibly, investors who buy index funds – funds designed to hold the market and not try to identify under-valued *stock* likely to out-perform the market – are less inclined themselves to try to identify *funds* that are likely to out-perform over funds. To that extent, index funds would expect to earn their (smaller) annual fees for more years than actively-managed funds do.

To derive a ballpark estimate of the relative direct incentives, we examined the largest institutional owners of P&G that advise mutual funds. For each advisor, we calculated the fees by multiplying the dollar value of the shares owned by the average fees of that advisor'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 advisor's stake. The table below shows each advisor's direct incentives to cast an informed an informed vote relative to Vanguard's. As the Table shows, the relative incentives of BlackRock, Vanguard and State Street are the highest in the industry. Geode, another large index fund advisor, has incentives just below the top 10.

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 five years and the public pension fund incentives are equivalent of those of an individual owner holding the same number of shares, only the two largest public pension funds have incentives that are in the range of Vanguard's and State Streets. The Pennsylvania Public Schools

Employee fund, the 20th largest public fund in terms of ownership of P&G stock, only has relative incentives of 0.00403, about 1/250's of BlackRock's incentives and 1/3 of Geode's. Most of the other public pension funds, which number in the thousands, would have even lower incentives.

Table 2: Largest Holders of P&G

Advisor	Shares	Relative Incentive		
BLACKROCK	154,087,387	2.843		
VANGUARD GROUP, INC.	144,499,854	1.000		
STATE STR CORPORATION	122,654,225	1.599		
FIDELITY MGMT & RESEARCH CO	59,674,582	1.173		
NORTHERN TRUST CORP	41,801,881	0.602		
CAPITAL WORLD INVESTORS	40,110,000	0.756		
MELLON BANK NA	37,658,809	0.889		
T. ROWE PRICE ASSOCIATES, INC.	37,560,238	0.682		
YACKTMAN ASSET MANAGEMENT LP	25,808,953	0.495		
WELLINGTON MANAGEMENT CO, LLP	21,061,730	0.093		
GEODE CAPITAL MGMT, L.L.C.	20,591,553	0.014		
STATE FARM MUT AUTOMOBILE INS	20,372,600	0.133		
GMO LLC	19,470,736	0.214		
MFS INVESTMENT MANAGEMENT	15,666,652	0.134		
COLLEGE RETIRE EQUITIES	13,757,793	0.038		
PNC FINL SERVICES GROUP INC	13,461,032	0.119		
DEUTSCHE BK AKTIENGESELLSCHAFT	13,055,091	0.122		
UBS GBL ASSET MGMT(AMERICAS)	10,877,625	0.090		
GOLDMAN SACHS & COMPANY	10,366,572	0.063		
CREDIT SUISSE SECS (USA) LLC	9,822,267	0.109		
FRANKLIN RESOURCES INC	9,384,637	0.050		
CALIFORNIA PUBLIC EMP' RET SYS	8,665,763	1.124		
NEW YORK STATE COMMON RET SYS	8,173,882	1.000		
NEW YORK STATE TEACH' RET SYS	5,698,832	0.486		
CANADA PENS PLAN INVESTMENT BD	5,630,889	0.475		
CALIFORNIA STATE TEACH'RET SYS	4,962,300	0.369		

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 advisors, they are among the largest shareholders in most companies.

The preceding analysis shows that, among mutual fund advisors, the most important factor by far in determining how much a fund advisor stands to gain from being informed is the size of the holdings. Because the most prominent investment advisors that focus on index funds, Vanguard, State Street and BlackRock, are also the largest investment advisors 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 – will be increased. Thus, as between Vanguard, State Street and BlackRock, the fact that BlackRock is an advisor to relatively more higher-fee active funds increases its relative incentives. Advisors who specialize in index funds other than the big three – advisors 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 advisors not included in the table, such as those of Parnassus Investments (relative incentive 0.008) or Janus Capital (0.007), 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 funds. 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 fund who charge higher fees in order to cover the additional expense of investment in voting may be at a competitive disadvantage.³⁵

None of these observations, however, affect the analysis we have offered in this section. 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 index funds (and other funds), through their annual fees, obtain a direct economic stake – albeit a small one in percentage

³⁵ See Bebchuk & Hirst, *supra* note **Error! Bookmark not defined.**, at 4, 19-20 (“Competition with other index funds gives index fund managers precisely zero additional incentive”).

terms – in the value of the stocks in their portfolio. The managers 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.

This is an example of what Mancur Olson called the “exploitation of the great by the small.”³⁶ Because the managers of the largest index funds, by virtue of their huge size, *independently* have incentives to cast informed votes (thereby avoiding 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, that makes them peculiarly well suited to play the “decider” role in corporate governance.

B. Indirect Incentives: the impact of 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 their 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 benefit from casting an informed vote that derive from the effect on net inflows – is often, though in our view inaccurately, seen as a substantial difference between index fund and actively managed fund incentives.³⁷

As to indirect incentives, it is important to distinguish between the investment advisor’s incentives overall – sometimes implemented through a centralized proxy voting group -- and the incentives of the PM charged with managing a specific fund. Both the voting group and portfolio managers can have input into votes, and the degree of input can vary across families and within families across issues. One therefore needs to consider both sets of incentives separately.

³⁶ M. 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).

³⁷ See, e.g., Lund, *supra* note 6; Bebchuk & Hurst, *supra* note 6.

First, although empirical studies show that fund performance affects fund flows, it is relative performance, rather than absolute performance, that affects fund flows.³⁸ But this implies that attracting future fund flows generates *no incentives* for a portfolio managers 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 *decline*. 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 0.3%, only the 0.1% 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 more attenuated. As we have seen, fund family portfolios resemble the market more closely than the portfolios of individual funds. 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 advisor of actively-managed funds and compared their weight to the one of these stocks in the 13F filed by the Vanguard Group, as a proxy for the market.³⁹ For 15 stocks, accounting for 37% of the dollar value in T. Rowe Price's 20 stock portfolio, T. Rowe Price was underweight relative to the market. For the other 5 stocks, T. Rowe Price was overweight by 11%, 31%, 88%, 201% and 413% respectively. In these stock, for indirect incentives to be equivalent to the direct incentives discussed before, each \$1 in excess

³⁸ 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.

³⁹ https://www.sec.gov/Archives/edgar/data/80255/000008025518001796/xslForm13F_X01/infotable.xml
https://www.sec.gov/Archives/edgar/data/102909/000095012318002112/xslForm13F_X01/form13fInfoTable.xml

performance (relative to the benchmark) generated by an informed vote would have to result in net inflows to the fund family of \$10.90, \$4.23, \$2.13, \$1.49 and \$1.24, respectively.

Second, most empirical studies focus on *fund* flows. Fund flows are probably the dominant consideration for portfolio managers. But, from the fund family perspective, the dominant consideration is likely to be whether relative performance increases net flows to the family. To some extent, flows into or out of a fund are due to investors shifting investments from an under-performing fund on one family to a higher-performing fund *in the same family*. Flows from one fund to another fund in the same family do not systematically increase or decrease the aggregate fees for a fund family.

A recent working paper by Lewellen and Lewellen examined the effect of performance on fund family flows.⁴⁰ 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 fund family that is underweight (relative to the benchmark) in a particular stock, flow-based incentives are negative; for a family that is less than 77.5% overweight in a particular stock (i.e., its holdings are above the benchmark but less than 77.5% above), flow-based incentives are positive, but lower than direct incentives; and for family that is more than 77.5% overweight in a particular stock, flow-based incentives are larger than direct incentives.

For fund families with relatively concentrated holdings, flow-based incentives may dominate direct incentives. Such families exist, but most of them are on the small side. Thus, Lewellen and Lewellen found that institutions in the bottom 25% of assets under management invested on average 3.82% (value weighted) of their portfolio in a given firm, compared to a benchmark weight of 0.32%. These institutions are thus about 1,100% overweight, with flow-based incentives much larger than direct incentives. But because assets under management by these institutions is low (\$117 million in 2011-2015), total incentives remain low.

In comparison, “large” institutions (top 25% of assets under management) invested just 0.51% in a given firm – i.e., are overweight by 59%. For those, direct incentives were higher than flow-based incentives. When divided by value-weighted quartiles (rather than by quartiles

⁴⁰ Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentives to be Engaged (Working Paper 2018).

with the same number of institutions), Lewellen and Lewellen find that the quartile of smallest institutions has direct and flow-based incentives in about equal size and the quartile of largest institutions have direct incentives that are about 4 times as high as flow-based incentives – and overall incentives that dwarf those of the smallest quartile.

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 new fund flows are likely to be more sensitive to fund performance than fund family flows.⁴¹ On the other hand, of course, size matters for flow-based incentives as well. Because individual funds will hold many fewer shares than fund families do, 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 managers is able to persuade the entire fund family to cast its votes a certain way, the comparatively small holdings by individual funds will make it less likely that the votes will be outcome determinative. To the extent that fund portfolio managers do not expect to influence the voting outcome, they 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).

⁴¹ 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 __. 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.

Overall, then, although fund-flow incentives often will not be strong, there is no doubt that, for some value-relevant issues, some of the largest actively managed funds will have substantial direct and fund-flow incentives to vote intelligently, especially when they are significantly overweight. This is consistent with their active involvement in some of the most significant controversies.

b. Index Funds

In accordance with conventional wisdom, our discussion so far has 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.⁴² Their argument is basically the flip-side of the argument for active funds: just like 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.⁴³ Thus, FHDS argue that index fund would benefit – through improving the performance of index funds relative to active funds – by improving governance at underperforming companies and by reducing the incidence of mispricing by increasing transparency.

At the outset, we note that only investment advisors that derive the bulk of their fee income from index funds would benefit if funds flow from active funds to index funds. Even advisors such as BlackRock, that have the bulk of their AUM in index funds but obtain about half of their fee income from active funds, may derive no significant benefits from a flow of investments from actively managed to index funds.

⁴² Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon, *Passive Investors* (June 29, 2018) available at <http://ssrn.com/abstract=3192069>

⁴³ 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.

Turning to the specific arguments made by FHDS, we are skeptical that they point to material incentives for investment advisors to acquire information or to engage with portfolio companies. For index funds, the relationship between firm performance and fund flows is at best highly tenuous and, to the extent any exists, there is no evidence that it affects the index fund advisors' voting or engagement policies. First, although empirical evidence shows that performance is related to fund flows, this relation is not linear. Thus, Sirri and Tufano find 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. 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 advisor 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.⁴⁴ 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 come to fruition and the stock price increases.

Third, it is unlikely that advisors to index funds are substantially overweight in any particular stock. The bulk of index fund assets are in broad based funds and broad-based funds invest in a large number of shares – such that the weight of any stock in an index fund is relatively low. For example, the weight of SBA Communications, the median company in the S&P 500 index, is 0.0914%.⁴⁵ This is even more true from the perspective of large index fund advisors, such as Vanguard and State Street. The weight of a company in the portfolio of an index fund advisor is the theoretical *upper bound* of the degree to which the advisor is overweight in the company. But it is of course highly unlikely that no actively managed fund

⁴⁴ 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.

⁴⁵ <https://www.slickcharts.com/sp500>

owns shares of any company. For example, the top mutual fund holders of SBA Communications include, besides several index funds, active funds like the Principal (3.21%), the Mid Cap Fund Professionally Managed Portfolio -Akre Focus Fund (2.12%), and the American Century Growth Fund (0.74%).⁴⁶ As a result, the actual degree to which an advisor to index funds is overweight in a company is likely to be much lower than this upper bound.

Moreover, while actively managed funds are in control over the degree to which they are over- or under-weight in certain stock, the degree to which an index fund is so overweight is completely out of the control of the index fund. Their portfolio is dictated by the index they are trying to match, and whether they are overweight is a function of the portfolio choices of actively managed funds, not their own choices. 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.

We doubt that the stewardship groups at index funds advisors are even aware whether they are overweight or underweight in a company relative to active funds. We are also not aware of any evidence that would suggest that index fund advisors 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.

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 that 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.

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

⁴⁶ <https://finance.yahoo.com/quote/SBAC/holders?p=SBAC>

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 advisors 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.

C. Reputational Incentives

BlackRock, Vanguard, and State Street – the largest sponsors of index funds – are also three of the four largest asset management companies.⁴⁷ In 2017, their combined assets under management exceeded \$[10] trillion. As regulated financial institutions of such 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.

⁴⁷ <http://www.ioandc.com/wp-content/uploads/2017/11/7-WYW-Top-500-report.pdf>

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.

In his January 2018 letter, "A Sense of Purpose,"⁴⁸ Fink seemingly aligned BlackRock with those calling on companies to pay more attention to environmental, social and governance concerns (ESG):

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.

⁴⁸ <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

The letters can be understood as directed to several different audiences. First, as the largest institutional investor, BlackRock faces “political risk.” Given the U.S.’s historical suspicion of concentrated economic power,⁴⁹ 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 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 will double the size of its investment stewardship group, already the largest in the industry. This huge increase in capacity solidifies

⁴⁹ For how this has shaped corporate governance, see Mark Roe, *Strong Managers, Weak Owners* (XXXX).

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. Du Pont's 6.8% stock price drop after it repelled a proxy challenge by Trian with the support of BlackRock, Vanguard, and State Street⁵⁰ may have caused some raised eyebrows. As to Du Pont, 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. Du Pont's CEO left, Trian's strategy was embraced, and the stock price recovered.⁵¹ 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 holders. The reputational incentives of investment advisors 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.

III. Spill-Over Knowledge and Short-Term Trading Horizons

In this part, we discuss two additional factors that relate to the role of fund families in corporate governance. The first section will discuss spill-over knowledge, that is, the ability to use of information gleaned from investment activities for voting. The second section will discuss the possible voting distortions generated by short-term trading horizons. As we explain,

⁵⁰ <https://www.reuters.com/article/us-dupont-trian/dupont-wins-board-proxy-fight-against-activist-investor-peltz-idUSKBN0NY1JI20150513>

⁵¹ <https://nypost.com/2015/12/12/dupont-dow-merger-pays-off-for-steady-hedgies/>

both of these factors are of particular significance for actively-managed investment vehicles and, in some respect, represent flip-sides of each other.

Before turning to the specifics, it is worth recalling the different issues that shareholders now vote on. Some are specific to a given company: the election of directors; approval of certain significant decisions and transactions; non-binding votes on compensation. Other issues are more general: whether directors should be elected annually; whether directors should be elected by a plurality or a majority; whether the position of board chair and the position of CEO should be held by the same person; whether, and under what circumstances, should shareholders be able to nominate directors on the corporate proxy “ballot.” In addition to these questions, there are large numbers of shareholder proposals that have only a tangential relation to firm governance or strategy.⁵² In 2018, JP Morgan Chase shareholders were asked to vote on a proposal recommending that the board adopt a policy prohibiting the vesting of equity based awards for senior executives who enter government service (Proposal 7) and to report on investments tied to genocide (Proposal 8).

When all these matters are combined, from all the jurisdictions in which they invest, 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.⁵³ Most of these matters 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 consequential individual votes that merit the most specific attention. Each proxy voting group will have a triage system in place that discriminates

⁵² For an overview, see <https://corpgov.law.harvard.edu/2018/02/28/an-overview-of-u-s-shareholder-proposal-filings/>.

⁵³ BlackRock INVESTMENT STEWARDSHIP REPORT: 2017 VOTING AND ENGAGEMENT REPORT July 1, 2016 – June 30, 2017 at p. 5. [UPDATE WITH 2018 REPORT WHEN OUT], available at <https://www.blackrock.com/corporate/about-us/investment-stewardship/voting-guidelines-reports-position-papers#engagement-and-voting-reports>.

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 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 likely a two-digit figure (and likely in the low two-digits).

The central question raised by the critics of index funds, then, becomes whether the investment advisors who manage index funds have adequate capacity and incentives to vote intelligently in the 10 to 100 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 only for votes cast with respect to the company (but is relevant for several voting items 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 service on all of these boards is issue-specific, while information that pertains only to X's nomination 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.⁵⁴

The distinction between company- 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.

Investment advisors 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)⁵⁵ on many recurring issues, such as votes on precatory resolutions to de-stagger the board. Because fund families 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, with detailed voting guidelines, voting can be delegated to a relatively junior person or even programmed into the voting software.

The extent to which fund families have incentives to develop firm specific and issue specific expertise will depend on both the size of the Fund Family 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, fund families with a more widely dispersed portfolio are likely to benefit more than fund families that invest in a smaller set of companies. Because fund families concentrating on index funds tend to have more widely dispersed portfolios, they tend to benefit from economies of scope generated by issue-specific information. Fund families weighted towards active strategies will tend to have stronger incentives to develop firm-specific information.

⁵⁴ 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 is what type of company it is.

⁵⁵ Rock Oxford Handbook chapter at X.

B. Spill-Over Knowledge

A second important factor is whether information that fund families obtain in the context of making their investment decisions is relevant for, and incorporated in, their voting decisions. Index funds, of course, do not need to 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, actively-managed funds will base their investment decisions, at least to some degree, on information about the company. This comparative information deficit, it is argued, will hamper index funds when it comes to voting.⁵⁶

There is certainly some merit to this argument. Stock pickers advising actively-managed funds obtain information in the course of their investment activities that is material on some of the issues that come up for a vote. 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.

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. 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) or 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 that is easily observable (such as company size, industry, and stock price performance) – rather than on, or in addition to, company-specific information that traders are concerned about (such as cash flow projections and managerial quality). Moreover, to the extent that such arrangements will be in effect for

⁵⁶ Lund, *supra* note 6, at 118-128.

long periods of time, information about *current* cash flow projections and managerial quality may be of even lesser importance.

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, advisors 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. That is, when voting on the re-election of an incumbent board member to the board of X, an index fund advisor may have information obtained in the prior votes on the election of that director to the board of X and information on the election of that director to the boards of Y and Z. An advisor of an active fund that just acquired stock of X last year and does not hold stock of Y and Z would encounter that director for the first time.

By contrast, to the extent that company-specific information that traders are concerned about is relevant, voting groups at families with actively managed funds will benefit by obtaining such information as a by-product of the investment activities at little or no additional expense. Perhaps the clearest case where such information is important is a vote on proposed merger, where stock-pickers may have an assessment of the fundamental value of the company 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, the specific provisions of the merger agreement. But 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 as well involve some information that stock-pickers obtained 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 involve a high degree of new information related to the quality and proposed strategy of the activist challenger. And as to such new information, fund families with dispersed portfolios may enjoy economies of scope: they have

more experience with activist challengers in general and may have encountered the same activist challengers in particular in a prior contest. Thus, the net advantage to actively-managed fund 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 from issue to issue and, to a lesser extent, from fund family to fund family.

In addition, even to the extent that someone at a fund family has relevant information, it will only affect fund voting to the extent that 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.

That spill-over knowledge from stock-pickers is of little importance to many votes is also indicated by the use of proxy advisors, like ISS and Glass Lewis, by many actively-managed fund families. Indeed, some actively managed funds adopt ISS's or Glass Lewis's recommendations without fail. Proxy advisors supply voting-related information and voting recommendations to their clients. Importantly, proxy advisors do not employ stock-pickers, so their information and recommendation does not rely on spill-over knowledge, at least not investment related spill-over knowledge.⁵⁷ That a large number of actively-managed funds obtain information from proxy advisors, and that many of them rarely deviate from the voting recommendations supplied by the advisors, indicates that they do not regard spill-over knowledge as all that important.

Notably, although the leading index fund advisors may also use information supplied by proxy advisors as input, none of them closely follow their recommendations. Rather, they base their votes on their own, in-house, analysis. That proxy advisors have more influence over actively-managed funds than over index funds suggests that factors other than the availability of spill-over knowledge – such as fund family size – generate incentives for fund families to make independent assessments of how to vote on an issue.

As to issues where spill-over knowledge is important, several factors mitigate the handicap for index fund advisors. First, the pure form does not exist. Even the inventor of

⁵⁷ 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.

index investing – Vanguard – has numerous actively managed funds. Another 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. 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. 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. Thus, it is likely that BlackRock would benefit from spill-over knowledge to a similar degree as an advisor for mostly active funds.

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 advisor (such as Barrow Hanley Mewhinney & Strauss and Primecap);⁵⁸ others are managed or co-managed by Vanguard’s Quantitative Equity Group, which mostly follows computer-driven and other quantitative strategies. In total, the domestic equity of all funds managed and co-managed by this group are less about 7% of Vanguard’s domestic equity assets.

Vanguard’s in-house Quantitative Equity Group and the affiliations by Vanguard and Geode with advisors to actively-managed funds may provide the respective voting groups for the index funds with some access to information from the stock-pickers for the active funds, especially on issues where such information is particularly valuable. Indeed, when such information is particularly valuable, even active fund advisors unaffiliated with index funds have incentives to share information they consider pertinent to a vote, both through formal and informal channels.⁵⁹ Thus, albeit to a lesser extent than BlackRock, Vanguard and Geode may

⁵⁸ Barrow Hanley Mewhinney & Strauss LLC is one of the outside managers of the Selected Value Fund; Primecap manages, among others, the Vanguard Primecap fund.

⁵⁹ <https://www.cnbc.com/2018/03/23/dell-vmware-deal-may-hinge-on-how-they-split-dells-tracking-stock.html> (T Rowe Price opposes Dell-VMware merger; <http://www.pionline.com/article/20130722/PRINT/307229983/pension-funds-divided-on-dell-deal> (opposition to Dell LBO);

be able to tap into some company-specific knowledge 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. In this regard, they are no worse positioned than individual investors and, because of the massive scale of their operations, have much more capacity for figuring out how to vote intelligently.

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 may still 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, large index fund advisors may have developed some expertise in analyzing such information through their prior votes.

C. How Index Strategies Mitigate Short-Term Trading Horizons and Other Voting Distortions

The extent to which stock prices reflect fundamental values, what accounts for any deviations, and how easy it is to detect deviations are subjects of major controversy. One prominent camp 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. Others disagree, some fervently.

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. 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 – matters.

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 outflows due to redemptions by shareholders of mutual fund in excess of inflows that force a fund to sell stock to redeem shares.

These factors affect active and index funds differently. While both are affected by involuntary sales, they differ with respect to the other two factors. Index funds will 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). Active funds, by contrast, may not respond to changes in the index, but will make voluntary portfolio changes in response to changed assessments of their stock pickers.

With regard to fund outflows, index funds will sell a proportional amount of assets to meet redemption demands, thereby leaving the overall market weighted portfolio unaffected. By contrast, actively managed funds may change their portfolio in response to fund outflows, especially if those outflows are caused by less than stellar performance.

Historically, and intrinsically, therefore, index funds have had a much lower portfolio turnover rate than active funds. 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 a minimum average holding period of 28.5 years for the index funds and 2.9 years for the active funds; for funds with net outflows, the implied minimum average holding period would be lower.

Because the underlying factors contributing to holding periods for index funds are not expected to change significantly – index providers are not expected to make more frequent changes in index composition, and transactions that result in firms exiting the index cannot be anticipated – index funds rationally ought to expect to hold stock in constituent 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 company value.

Actively-managed funds are different. The 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 a 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 does not bear on fundamental value. Stock-pickers at active funds thus work from a model where they try to buy stock at a time when some positive elements of fundamental value are not incorporated or some irrelevant elements depresses the stock price – *and* they believe that this mispricing will be corrected soon enough to make a stock acquisition worthwhile *now*. They will sell stock once the mispricing is sufficiently corrected to make other investments more attractive. As a corollary, it is likely that stock-pickers believe that some types of mispricing will not be corrected in a time span that makes them worthwhile to be exploited right away.⁶⁰

Stock-pickers may or may not be right in these assessments. But whether they are is, for our purposes, irrelevant. Rather, what is relevant is that stock-pickers – and perhaps the voting groups at active funds more generally – are influenced by this model. Stock-pickers, in giving 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. Beyond the difference in trading horizons, therefore, a significant difference between actively-managed funds and index funds is that the persons in charge of voting in active funds are much likely to hold, or be advised by people who hold, such beliefs than the persons in charge of voting at index funds.

⁶⁰ Our argument that short-term trading horizons can cause voting distortions applies to most actively-managed investment vehicles. Most, but not all. Activist hedge funds, unlike most other actively-managed fund, 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 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.

As may be apparent by now, the argument that the short-term trading horizons by active funds can cause voting distortions is the flip-side of the argument that active funds benefit from 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 distortions from value-maximizing votes to the extent that they believe – as they must – that the stock price does not always fully reflect fundamental value.

Indeed, the differential incentives and outlook of stock pickers at actively-traded funds may account for index fund advisors not soliciting and following their recommendation more frequently than they do. Let us assume, for the moment, that stock pickers, because of their spillover knowledge, had a much better sense than advisors to index funds of what outcome in a proxy contest would maximize company value. Stock pickers with substantial stakes would have incentives to share their knowledge with index fund advisors. They benefit not just from their own funds casting optimal votes; they want competing funds to do so as well so that the optimal vote outcome is achieved.⁶¹ Likewise, voting groups at index funds would want to tap into the superior knowledge of the stock pickers.

Why, then, do we not observe, say, Vanguard's voting group deferring to the better-informed decisions by the folks at T. Rowe Price? One possible reason is that Vanguard is concerned that T. Rowe Price's stock pickers have different and shorter term trading horizons than Vanguard does. What T. Rowe Price's stock pickers believe may be best for T. Rowe price given their trading horizon may not be best for Vanguard given its trading horizon. Vanguard may well be interested in stock pickers' views, but it wants to make the ultimate voting decision itself.

D. How Incentives and Spillover Knowledge Stack Up?

⁶¹ There are no major regulatory barriers to such an exchange. Under the securities laws, any shareholder can publicly announce how it intends to vote without becoming entangled with the federal proxy rules. 14a-1(l)(2)(iv). Because mutual funds have to disclose their vote after the fact in any case, how they vote is hardly confidential information. Form [N-PX?]. Other exceptions, including Rule 14-2(b)(1) and (2), would often permit private discussions and exchanges of information without triggering any filing obligations even such discussions and exchanges constitute solicitations.

As our discussion indicates, the amount of information an advisor will have in casting its votes will depend on the issue that is voted on. For the “Big Three”, we now consider how the incentives and the availability of spillover knowledge stack up for three generic types of issues: votes that 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; votes on recurring governance issues, such as resolutions to destagger a board or say-on-pay votes that turn on the structure of executive compensation; and votes and other forms of engagement designed to address managerial performance, such a director election votes or say-on-pay votes that turn on performance issues or in-person meetings dealing with managerial performance or strategy.

a. Market-Moving Votes

Because of their large stakes, the Big Three are, individually and collectively, likely to cast the decisive votes in many contested director elections and merger votes. How good are their incentives, in these select situations, to perform the role of de facto deciders of important corporate controversies?

In our view, the Big Three are likely to approach these votes somewhat differently than large active funds, but on the whole have incentives and information that will be equivalent. Thus, there is no reason to believe that the fact that the Big Three largely manage index funds makes them less well equipped in voting on these issues.

To start with, because these votes are likely to have a price impact on the market price and on the value of portfolio companies, the Big Three, which tend to hold large stakes in these companies, have incentives to acquire information that is specific to the vote at issue. In fact, to the extent – as is often the case – that the Big Three hold larger stakes in the portfolio company at issue, their incentives to acquire such information may be superior to those of active funds.

To be sure, advisors 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 advisors 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 activists.

As a result, advisors to active funds such as T. Rowe Price may approach these votes from somewhat different perspectives. Advisors such as T. Rowe Price, with PMs with deep knowledge of portfolio companies, may focus on how well, or how poorly, the company did before the activist became involved and how likely the activist's plans are to improve matters. The Big Three may have better information about past campaigns by the activist at issue. Both T. Rowe Price and the Big Three could be expected to assess information that is specific to the contest, though at T. Rowe Price that assessment is made mostly by analysts and portfolio managers with company-specific expertise while at the Big Three it is made by voting personnel with expertise in proxy contests.

But while their perspectives may differ, we see no a priori reason to believe that one set of funds will make substantially better decisions than the other set. This is particularly so because each set will have some access to the perspective of the other fund: the Big Three run their own, or are affiliated with other advisors that run, actively managed funds; the financial press and proxy advisory firms will provide analysis; and thorough personal or institutional connections, the people in charge of voting at one advisor will at least be somewhat aware of the views of those in charge of another advisor.

Furthermore, given the potential effects of activist intervention on firm value, both the Big Three and the largest active managers will have significant direct incentives to invest significant resources in deciding between an activist's proposals and incumbent management's performance and plans.

b. Recurring Governance Issues

With respect to recurrent governance issues, the Big Three are likely to have incentives and information that is superior to those of advisors of actively managed funds. The larger size gives the Big Three an inherent advantage. Moreover, the fact that actively managed funds

may have superior access to spillover knowledge from analysts or more concentrated portfolios will not matter much. This is not to say that “one-size-fits-all” on these governance issues and that company-specific information, which analysts may know, is irrelevant. Rather, because as to each individual vote, the stakes are low, even advisors to actively managed funds may lack the incentives to obtain the relevant company-specific information from analysts and to integrate it with the issue-specific information in deciding how to vote.

c. Addressing Company-Specific Performance Problems

Advisors to actively managed funds, in contrast, are likely to be superior to index fund advisors in directly addressing company-specific performance problems. Advisors to index funds could easily, and cheaply, obtain measures for managerial performance such as industry-adjusted returns or stock price performance. Such measures could easily influence their votes on director elections, say-on-pay, or issues like separation of the roles of CEO and board chairman. To develop more precise measures, a more detailed analysis is required. Without such analysis, it is hard to pinpoint the cause for low performance and to recommend specific changes. 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 is likely to reduce their access to such measures. From an ex ante perspective, it will often not pay to pursue an analysis just for the purpose of voting or engagement without any indication that a problem exists, that it can be remedied, and that the remedy will increase firm value. When hedge fund activists have targeted a company, such an indication would be present. But without any similar signal, advisors to index funds may not have sufficient incentives to perform it.

In the ordinary course, therefore, rougher performance measures may have some impact on votes casts by index fund advisors, but are unlikely to lead to engagements that address company-specific performance problems.⁶² We do not believe, however, that advisors to index funds compare unfavorably to most advisors to active funds. Many advisors to active funds, in particular advisors to smaller funds, follow ISS recommendations in casting their votes.

⁶² See Bebchuk & Hirst, *supra* note 6 (adducing evidence that they do not).

ISS, just like advisors to index funds, does not employ stock analysts and, unlike advisors to index funds, does not profit directly from increase in the value of portfolio companies. Advisors to active funds with smaller stakes, in particular, may also not undertake much engagement because they do not believe that they have much influence over management or because they do not want to antagonize management. Even for companies that would benefit from such engagements, we would guess that such engagements are uncommon. Overall, therefore, Vanguard and State Street's incentives may be similar to most small and mid-size advisors. And of course, through its involvement on governance issues, Vanguard and State Street will affect matters like board structure, director independence, incentive compensation and thereby indirectly address performance problems.

IV. Conflicts

Investment advisers to mutual funds face myriad potential conflicts of interest. For the potential conflicts that have been discussed at length in the prior literature, we will be brief. Other conflicts that are specific to the fund family structure will be discussed in more detail.

A. General Conflicts

Traditional conflicts basically fall into two categories: Conflicts between the investment advisor and the investors in the mutual funds advised; and conflicts between a mutual fund and its shareholders on one side and other shareholders of portfolio companies of the fund on the other side.⁶³

The first set of conflicts is mostly generated by other business operations of an investment advisor. Many investment advisors for mutual funds are affiliated with financial institution such as investment banks or insurance companies.⁶⁴ Such advisors may be reluctant to antagonize present or future banking or insurance clients with their voting activities. Many mutual fund complexes are also engaged in the management of corporate pension plans, would

⁶³ Edward Rock, *The Logic and (Uncertain) Significance of Institutional Investor Activism*, 79 *Geo. L. J.* 445, 468-76 (1991).

⁶⁴ K+R, *Activist hedge Funds at 1054* (reporting that in 2002, 9 of the 20 largest mutual fund families had such affiliations).

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.⁶⁵ Conflicts can also arise among investment vehicles managed by the same advisor. For example, a vote that increased the value of stock fund may reduce the value of bond funds managed by the same advisor.

A second, long recognized conflict is the desire of stock pickers for investment advisors to maintain cordial relationship with management of their portfolio companies. 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 in gaps in their understanding of the firm's operations. They may use this access to make better predictions of stock price movements and hence for the benefit of fund 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.

B. Fund Family Conflicts

There are other conflicts that are quite specific to the fund family structure.⁶⁶ Suppose companies A and B propose merging. Suppose further that an investment advisor believes that the two companies are worth more together than apart but that the price that A is offering for B is too low.⁶⁷ 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 advisors owe to investors in particular funds lead at least some investment advisors to push the voting decision

⁶⁵ K+R at 1055.

⁶⁶ Ann Lipton explores these conflicts in Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017); Fisch, Hamdani & Davidoff Solomon explore it as well at 33-36.

⁶⁷ As was arguably the case with the 2002 Hewlett Packard-Compaq merger and the 2007 CVS-Caremark merger.

down to the fund level (i.e., to allow the PMs who manage the specific fund's assets to make the voting decision).⁶⁸

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.⁶⁹

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 by an interesting recent transaction: Amazon's acquisition of PillPack, an online pharmacy, an acquisition that sent the shares of pharmacy stocks like CVS, Walgreens and Rite Aid plummeting.⁷⁰ Suppose that an active fund in a fund family with a large index fund is overweight in Amazon and the PM would like to use the heft of the passive assets to support the acquisition of an online pharmacy, PillPack. Because the active fund is underweight in CVS, Walgreens and Rite Aid, the fact that the acquisition will predictably cause those stocks to

⁶⁸ 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.

⁶⁹ 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 Magellan PM? The history is interesting. Geode was, originally, part of Fidelity and was used to experiment with higher risk computer trading strategies. <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, Jacques Perold, 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.

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

⁷⁰ Matt Levine: <https://www.bloomberg.com/view/articles/2018-06-29/profitting-from-disruption-trades> ; <https://www.wsj.com/articles/amazon-to-buy-online-pharmacy-pillpack-1530191443>

decline is a matter of indifference (or even joy) to the PM. But the index fund will, of course, hold all those shares, and investors in that fund will suffer from the price drop. The same sort of conflict of interest would arise if one of the actively managed portfolios had a large short position in one of the stocks in the index.

Note the subtlety of the problem: while Amazon's acquisition of PillPack or the PM's agitation around a short position might hurt the 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, and will improve the relative performance of the active fund vis a vis the index fund. Moreover, because the fees for actively managed assets are so much higher than the fees for passive strategies, the losses in fees from the decline in the index fund will likely be more than offset by the fees gained from the active fund's rise.

These conflicts of interest raise substantial fiduciary duty concerns, as the investment advisors owe fiduciary duties to the investors of each fund managed.⁷¹ 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 (even if this was not the reason Geode was spun off).

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. To adopt a structural separation is not justified by the frequency in which conflicts arise or by their magnitude.

⁷¹ John Morley, *Too Big to be Activist*, __ So. Cal. L. Rev. __ (forthcoming).

C. Conflicts between Public Relations/Marketing and Investor Value

As discussed above, stewardship activities by the largest institutional investors may result from a concern for reputation, or as a marketing device or in response to the risk of regulation. When the activities result from these considerations, they may not reliably increase firm value. Indeed, in the extreme, one might worry that they benefit index fund managers at the expense of firm value and index fund investors, and do so without hurting the fund managers competitively because relative performance will be unaffected.

Consider, for example, the position that a fund family takes on “ESG” issues. While these may, in fact, be justified based on firm value, they could also be justified as effective marketing. That is, Larry Fink’s famous letter could be viewed as a form of non-price competition designed to attract investments into what has become a commodity – index funds – on the basis of BlackRock being the “ESG compliant” index fund. Moreover, such pressure on ESG could even, in principle, result in lower firm value.

Although such conflicts are possible, and need to be acknowledged, markets and politics both limit the extent to which fund families can move too far from firm value. On the competitive front, State Street responded to Larry Fink’s letter by emphasizing that it pursues “value not values.”⁷² 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.⁷³

D. Conflicts and Voting Rights

Mutual fund investment advisors, 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. Officials at public funds, as some commentators have

⁷² 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, Foreword, BCG, *Total Societal Impact: A New Lens for Strategy* (October 2017).

⁷³ 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>.

noted, are “accountable for their decisions to politicians or the press,”⁷⁴ – groups that pursue aims other than firm value maximization. Union-affiliated pension funds may pursue a labor agenda. Managers and other employees of the firm who are stockholders may vote 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 control benefits and oppose 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 enhanced firm value. Hedge fund managers, though well-incentivized to maximize the value of their funds,⁷⁵ 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.⁷⁶

The pervasive potential for conflicts of interests should make one reluctant to deprive some shareholders of voting rights because their incentives to cast an informed vote are lower than those of other shareholders. The other shareholders, even if they have superior incentives to cast an informed vote, may have conflicts of interest that lead to inferior incentives to cast an informed vote in a manner that maximizes company value. To be sure advisors to index funds without access to stock pickers may lack access to useful spillover knowledge that comes from stock picking. But advisors to actively managed funds with access to such spillover knowledge may be conflicted due to their desire to retain good relationships with portfolio firm managers – conflicts that are not present for index fund managers. In a world where incentives to become informed and conflicts of interest are a matter of degree, and as long as smoking guns are not present, there is no prima facie basis for interfering with the basic one-share one-vote principle.

Relatedly, the presence of conflicts of interest is endogenous to the voting system. Conflicts may be affirmatively generated, enhanced, or exploited by companies. Companies may intentionally start, hold out the prospect, or hint at the withdrawal of banking business,

⁷⁴ Kevin J. Murphy & Karen Van Nuys, *Governance, Behavior, and Performance of State and Corporate Pension Funds 14* (Sept. 1994) (unpublished manuscript), available at <http://www-rcf.usc.edu/~kjmurphy/Pensions.pdf>.

⁷⁵ Kahan & Rock, *supra* note 31, at 1066-68.

⁷⁶ *Id.* at 1072-77.

insurance business, pension fund management business, access to managers, or pursuit of operations that accord with the interest of public pension fund managers *in order to* affect a vote.

In evaluating proposals to change voting rights, one therefore needs to consider the conflicts of interests present under the current voting arrangements but the conflicts of interest likely to arise under a changed system. To the extent that a change in voting rights empowers actively managed funds (e.g. by depriving index funds of their voting power), companies will have stronger incentives to develop business ties or other relationships with active fund managers in order to influence their votes. Active funds, in turn, will have stronger incentives to develop affiliations with other business lines in order to profit from such ties. Even if one could be certain that, given the present incentives to acquire information and the present conflicts of interest, active funds are reliable to cast their votes in a way that maximizes company value, this may no longer be the case once the voting rules are changed.

E. Shareholder Voting in Delaware Corporate Law

Delaware's corporate law presents an alternative approach to dealing with shareholder voting. Under Delaware corporate law, only one set of shares – those that belong to the corporation itself or to another entity that is controlled by the corporation – are deprived of all voting rights. As to all other shares, held by shareholders with varying incentives to become informed and with varying conflicts of interest, Delaware employs a multi-prong approach.

First, Delaware law requires that the board disclose information material for a vote. Although, for public companies, this requirement largely duplicates the obligations under the securities laws, it may offer additional remedies to shareholders. To the extent proxy materials fail to disclose the requisite information, the Delaware courts can – and often do – order additional disclosure and a postponement of the vote. Information disclosure, of course, lowers the costs for shareholders to become informed and thus should lead to more informed voting. Other than by requiring information disclosure, Delaware law does not openly deal with shareholder incentives to become informed. The court's sense of whether the shareholding

structure is likely to lead to an informed vote may influence Delaware doctrine in more subtle ways.

As to conflicts, Delaware adopts a qualified ex post approach. Conflicted shareholders in principle have full voting rights; however, a majority of disinterested shareholders must approve a transaction for the shareholder vote to cleanse potential breaches of fiduciary duties and, in some circumstances, the vote must be conditioned on such approval to have a cleansing effect. This approach permits Delaware to wait until after a vote is cast before resolving whether a particular shareholder was conflicted or disinterested.⁷⁷ Postponing this assessment until after the vote is cast has a major advantage. Once all votes are cast and the result is known, resolution may be moot either because a majority of disinterested shareholders failed to approve the transaction even if the questionable shareholders are disinterested or because the transaction would have received the requisite approval even if the questionable shareholders are deemed interested.

Conclusion

With the ever increasing institutional holdings of shares, power in governance of U.S. corporations has shifted significantly from the managers to the shareholders. In the highest profile contests between hedge funds and managers, the largest institutional investors are the de facto “deciders.” 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 de facto “standard setters” are the largest institutional investors.

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 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.

⁷⁷ See, e.g., CNX.

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 public traded corporations have few shareholders with a sufficient stake to become informed without also suffering from potential conflicts of interest.

Investment advisors in general, and investment advisors that mostly or exclusively manage index funds 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. Advisors to index funds compare favorably to advisors 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 to gain more voting power to develop stronger conflicts.

The present system – a combination of ex ante rules that are relatively bright-line and ex post standards that are triggered by material conflicts and that only need to be applied selectively when the vote was close – has the advantage of being easily administered. It naturally does not deliver perfect outcome. On the other hand, no proposed fix can do better. Until and unless there is a proposal that would significantly improve matters, we should just let shareholders be shareholders.