ARTICLES

INDEX FUNDS AND CORPORATE GOVERNANCE: LET SHAREHOLDERS BE SHAREHOLDERS

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ABSTRACT

Index mutual and exchange-traded funds managed by the "Big Three"—BlackRock, Vanguard, and State Street—have grown to be the largest investors in publicly traded companies and often cast the decisive votes in corporate elections. With this prominence has come controversy. Commentators have bemoaned that index funds lack financial incentives to ensure that the companies in their portfolios are well run, argued that index funds should not be permitted to vote in corporate elections, and proposed special regulations to be imposed on index funds.

In this Article, we provide a systematic analysis of the incentive and information structures within which advisers to index funds operate. We conclude that overall the Big Three have among the strongest direct financial incentives to become informed. These incentives derive from their enormous scale—the percentage of shares in a particular company that they hold—and their scope—the fact that they hold shares in a large number of different companies. Scale increases both the likelihood that an investment adviser's voting decisions will be pivotal and the magnitude of the additional fees an adviser will earn if the voting outcome results in higher corporate value. The wide scope of their holdings, in turn, enables the Big Three to apply relevant knowledge learned in the context of one company to their votes at other companies. Unlike advisers to active funds, however, advisers to index funds lack indirect, flow-based incentives to acquire information, and they benefit less from spillover knowledge gathered by analysts for the purpose of making investment decisions.

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The differences between advisers to index funds and advisers to active funds yield implications for the role of these investors in the three core categories of shareholder engagement: high profile proxy contests, market-wide governance standards, and company-specific governance and performance monitoring. Because high profile contests between activist shareholders and boards often have a significant effect on firm value, the Big Three have strong direct incentives to acquire information and vote intelligently. As to market-wide governance, the Big Three are better positioned than other investors to set standards because they enjoy economies of scope and analyst-generated spillover knowledge is typically not important. While the Big Three are reasonably well positioned to monitor governance, hedge funds and advisers to active funds—whose business model depends on stock picking—will have better incentives and more specialized expertise to monitor for and address company-specific performance problems. On the whole, our analysis shows that different investor types perform important, and often complementary, functions and that our corporate governance system would be poorer were index funds deprived of their voting rights or hampered by special regulations.

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INTRODUCTION

Index mutual funds and exchange-traded funds ("ETFs") managed by BlackRock, Vanguard, and State Street (the "Big Three") have grown to be the largest investors in publicly traded companies and have received disproportionate attention. Do they do too little? Too much? Or just the right amount? Are their incentives sufficiently aligned with the interests of their own investors to whom they owe fiduciary duties? Should index funds be curbed for the benefit of more active, undiversified shareholders such as activist hedge funds or actively managed mutual funds? These questions lie at the heart of current corporate governance debates.

Long the darling of finance scholars,[1] index funds offer investors the benefit of a diversified portfolio at low cost. Because index funds—which do not need to employ analysts—charge lower fees than actively managed funds[2] and because the conventional wisdom that it is difficult to outperform the market has proven correct,[3] index funds often have better returns than active funds. Embracing the academic research supporting index investing, Vanguard built a huge business offering low-cost index funds.[4] The market caught on; with many other fund families now offering index funds or ETFs, such vehicles constitute a growing share of the investment company sector.[5] As of October 2020, a large majority of the equities managed by the Big Three are in index funds and other asset pools using index strategies.[6]

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[1] *See generally* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE BEST INVESTMENT ADVICE FOR THE NEW CENTURY 373-86 (rev. ed. 1999) (advocating indexing as investment strategy).

[2] *See* INV. CO. INST., 2018 INVESTMENT COMPANY FACT BOOK 126 (58th ed. 2018) (showing average expense ratios of nine and seventy-eight basis points for indexed and active equity funds).

[3] *See* JOHN C. BOGLE, THE LITTLE BOOK OF COMMON SENSE INVESTING 115-16 (10th anniversary ed. 2017).

[4] *See* Leslie P. Norton, *Jack Bogle, Vanguard Founder and Legendary Index Fund Inventor, Dies at 89*, BARRON'S (Jan. 17, 2019, 10:37 AM), https://www.barrons.com/articles/jack-bogle-legendary-index-fund-inventor-dies-at-89-51547679373 [https://perma.cc/4UTG-7BHV].

[5] *Id.* (noting that index funds' share of equity fund assets increased from 4% in the 1990s to 27% in 2018).

[6] *See* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 304 (2017). As John Bogle points out, the firms that manage pension funds have, in substance, merged with the firms that manage mutual funds, with essentially all managing both mutual funds and pension funds, although the relative weight varies substantially. John C. Bogle, *Reflections on "Toward Common Sense and Common Ground?,"* 33 J. CORP. L. 31, 32 (2007). According to Bogle, as of around 2007, "[o]nly 4% of the U.S. equities overseen by State Street . . . are held in mutual funds, compared to a whopping 97% for Vanguard." *Id.*

But with this prominence has come controversy.[7] Index funds, according to some commentators, are passive do-nothings and know-nothings, "freeloaders"[8] that lack financial incentives to ensure that the companies in their portfolios are well run,[9] and blind supporters of management.[10] To these commentators, the increased power of index funds has "ominous" implications for corporate governance.[11] Pursuing this line of reasoning, commentators like Dorothy Lund, Todd Henderson, and Dick Weil have suggested that index funds should not be allowed to vote the shares of the companies in their portfolio.[12] Not far behind, Lucian Bebchuk and Scott Hirst point out that index funds have substantially lower incentives than sole owners holding the same stake and advocate a set of policy reforms designed to address this shortcoming.[13]

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[7] While there have always been critics who have argued that index funds are the end of capitalism, the criticisms have recently sharpened. *See, e.g.*, Luke Kawa, *Bernstein: Passive Investing Is Worse for Society Than Marxism*, BLOOMBERG (Aug. 23, 2016, 2:23 PM), https://www.bloomberg.com/news/articles/2016-08-23/bernstein-passive-investing-is-worse-for-society-than-marxism.

[8] Dick Weil, Opinion, *Passive Investors, Don't Vote*, WALL STREET J., Mar. 9, 2018, at A15.

[9] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 500 (2018) ("[T]he structure of the mutual fund industry creates a new collective action problem: a fund that invests in governance will bear the costs, but share the benefits with competitor funds.").

[10] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2037 (2019) [hereinafter Bebchuk & Hirst, *Index Funds*]; M. Todd Henderson & Dorothy Shapiro Lund, Opinion, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL STREET J., June 23, 2017, at A15 (discussing potential conflict of interest if funds voted against management); Jordan Wathen, *A Billionaire's Warning on Index Funds*, CNN BUSINESS (Mar. 31, 2015, 1:18 PM), http://money.cnn.com/2015/03/31/investing/investing-index-funds-warning/index.html [https://perma.cc/4KL8-HA5C] ("Scrolling through Vanguard's votes, you'll find very few occasions in which it voted against management." (citation omitted)).

[11] Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, CLS BLUE SKY BLOG (Aug. 2, 2017), http://clsbluesky.law.columbia.edu/2017/08/02/the-case-against-passive-shareholder-voting/ [https://perma.cc/MBM8-DFKX]. In the same vein, see Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 741 (2019) [hereinafter Bebchuk & Hirst, *The Specter of the Giant Three*] (concluding that Big Three might turn into "Giant Three," which would lead to even greater deference to management) and John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 17 (Harv. John M. Olin Discussion Paper Series, Discussion Paper No. 1001) (expressing concern that Big Three's dominance will cause "the majority of the 1,000 largest U.S. companies [to] be controlled by a dozen or fewer people over the next ten to twenty years").

[12] *See, e.g.*, Henderson & Lund, *supra* note 10; Lund, *supra* note 9, at 497; Weil, *supra* note 8.

[13] *See* Bebchuk & Hirst, *The Specter of the Giant Three*, *supra* note 11, at 741.

In this Article, we argue that these criticisms rest on a flawed understanding of the current corporate governance landscape and of the nature of institutional investing. Properly viewed, index funds in general—and the Big Three in particular—are valuable corporate citizens that make substantial positive contributions to the governance of their portfolio companies.

To be sure, the investment advisory firms that run index funds and are in charge of voting and other governance decisions have incentives that differ from those of ordinary shareholders.[14] But the reason for that is simple: they are *not* the owners of the stock held in mutual fund portfolios.[15] Comparing investment advisers to regular shareholders owning the same stake—a comparison in which advisers will necessarily fare poorly—is a category mistake that does not take account of the underlying economic ownership structure of public corporations and the structure of our capital markets.

This Article is the first to provide a comprehensive analysis of the incentive and information structure under which advisers to index funds operate. Our analysis shows that, of all real-life shareholders in public corporations, the Big Three—which act as advisers to the bulk of assets held in index funds—actually have among the *best* incentives to acquire information.[16] Their incentives are multiple orders of magnitude higher than those of mutual fund investors—the economic owners of the stocks held in index funds—and superior to those of virtually all retail shareholders and most other institutional investors.

We examine the incentives of the Big Three in the three main categories of shareholder engagement: high profile contests, market-wide governance standards, and company-specific engagement. We show that the Big Three's incentives in the small number of high profile contests, which tend to have the greatest impact on share value, are more than adequate to encourage them to devote substantial resources to deciding between competing positions. With regard to incentives to shape market-wide governance standards, relating to issues such as staggered boards and board diversity, the Big Three benefit from both the large size of individual holdings and the wide scope of their holdings. Finally, as to company-specific engagement, their incentives are mixed. With respect to governance issues—the focus of the Big Three's engagement with portfolio firms—they are able to leverage their influence as large holders and their market-wide expertise. With regard to company-specific performance issues, by contrast, the Big Three can only play a minimal role due to their lack of company-specific information. Some actively managed mutual funds and

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[14] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050-51 (2007) [hereinafter Kahan & Rock, *Hedge Funds in Corporate Governance*]; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-54 (1991).

[15] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1238-40 (2014).

[16] *See* Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 6, at 304 (showing that the vast majority of assets in index funds are held by the Big Three).

activist hedge funds, however, have strong and targeted incentives to take the lead on performance issues and have the ultimate ability, if a performance problem is not resolved, to wage a proxy contest that will become the focus of the Big Three's attention. On the whole, we conclude that different investor types perform important and often complementary functions and that corporate governance would be poorer if index funds were deprived of their voting rights or hampered by special regulations.

We proceed as follows. In Part I, we review the current corporate governance landscape, the structure of investment advising, and the resulting incentives of investment advisers. In Part II, we consider advantages that investment advisers derive from economies of scope and spillover knowledge as well as distortions generated by short-term investment horizons. In Part III, we examine conflicts associated with investment advisers, including long-recognized conflicts that result from asset managers competing for corporate business as well as less-appreciated conflicts among active and index funds managed by the same adviser. We close with a brief conclusion.

I. UNDERSTANDING THE STRUCTURE AND INCENTIVES OF INVESTMENT ADVISERS

The decades-long rise of institutional investors combined with the more recent emergence of activist hedge funds has transformed corporate governance. The days when most public corporations were owned by a large number of small, dispersed shareholders are gone. Nowadays, institutional investors hold sizeable but noncontrolling stakes in most corporations.[17]

As a result, today's corporate governance landscape is more complex. Before turning to specifics, it is worth recalling that the largest institutional investors hold shares in a large number of companies and cast an extraordinarily large number of votes per year. For example, in 2019, BlackRock cast 155,131 votes at 16,124 meetings worldwide, including 31,570 votes at 3896 meetings in the United States.[18] Even though most of these votes have no significant effect on firm value, some of them do, and the collective impact of individually immaterial votes may be substantial.

Within this network of holdings and votes, the engagements by institutional investors with companies can be divided into three categories. Type A engagements involve the small number of high-profile proxy contests that capture much public attention—such as Trian's effort to have Nelson Peltz elected to the Procter & Gamble ("P&G") board[19]—and are likely to affect firm

[17] *Id.* at 301-02.

[18] BLACKROCK, 2019 INVESTMENT STEWARDSHIP ANNUAL REPORT 24 (2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf [https://perma.cc/F7N6-CDKJ].

[19] *See* Thomas Heath, *P&G Announces It Narrowly Wins Proxy Fight Against Activist Peltz*, WASH. POST (Oct. 10, 2017, 3:55 PM), https://www.washingtonpost.com/business

value. These contests illustrate the dynamic that has evolved where activist hedge funds identify problem companies and propose solutions, with traditional institutional investors effectively determining the outcome when the activist fund and management cannot resolve the problem.[20] The number of potentially consequential individual contests is hard to determine because many contests settle before they come to a vote, and even some contests that eventually settle require attention by institutional investors. For example, in 2018, twenty-four of the thirty-four proxy contests that were launched against Russell 3000 companies were settled or withdrawn before the shareholder meeting.[21] But even if all settled contests are included, the number of Type A engagements is limited.

Type B engagements relate to market-wide governance standards, such as staggered boards, poison pills, majority voting, and board diversity. Proposals to change the governance provisions in a particular company are often advanced by individual shareholders as resolutions under SEC Rule 14a-8.[22] But the decisive factors in whether the resolution is adopted are the proxy voting guidelines of large institutional investors and the voting recommendations by Institutional Shareholder Services ("ISS") and Glass Lewis, the two leading proxy advisers.

Type C engagements involve the oversight of individual companies on governance and performance. This category includes engagement meetings, where representatives of investment advisers often discuss company-specific governance with the management of a portfolio company; meetings that address performance problems at individual companies; and votes cast when the underlying problem is not sufficiently addressed. Most importantly, it is well understood that, if a hedge fund or an actively managed mutual fund engages with a firm on performance issues but is dissatisfied with the company's response, it can escalate the Type C engagement into a Type A contest in which large investment advisers will ultimately cast the decisive votes.

In understanding the incentives of the large index funds in corporate governance, it is necessary to consider the extent to which their incentives are adequate for each of these categories of engagements. After providing

/capitalbusiness/pandg-announces-it-narrowly-wins-proxy-fight-against-activist-peltz/2017/10/10/0ee01bb0-add1-11e7-a908-a3470754bbb9_story.html.

[20] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 896 (2013).

[21] Matteo Tonello, *Shareholder Voting in the United States: Trends and Statistics on the 2015-2018 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 26, 2018), https://corpgov.law.harvard.edu/2018/11/26/shareholder-voting-in-the-united-states-trends-and-statistics-on-the-2015-2018-proxy-season/ [https://perma.cc/PW3W-DQVK]; *see also* SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2018 U.S. SHAREHOLDER ACTIVISM 32 (2019), https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf [https://perma.cc/3W5W-MEKY] (showing that number of proxy contests, not limited to Russell 3000 companies, that went to a vote was seventeen in 2018, seventeen in 2017, fifteen in 2016, twenty-six in 2015, and fourteen in 2014).

[22] *See* 17 C.F.R. § 240.14a-8 (2020) (governing such proposals).

background for this analysis in the remainder of Part I, we will pursue it in greater detail in Part II. Section I.A will discuss the relationship between index funds and investment advisers and explain that investment advisers of index funds, rather than the funds themselves, are the proper unit of analysis. Section I.B will analyze the incentives for index fund advisers to increase corporate value through their voting and other forms of engagement.

As we will discuss, we agree with critics of index funds that index fund advisers are not well positioned to identify company-specific performance problems. Our central dispute with these critics relates to the incentives of index fund advisers to vote intelligently in the small number of votes per year that are potentially consequential, to develop proper guidelines for voting on market-wide governance standards, and to engage on company-specific governance deficiencies. As to these matters, we will argue that the incentives of index fund advisers are superior to those of most other institutional investors.

A. *The Relationship Between Funds and Advisers*

The current framing of the discussion, which juxtaposes index funds and actively managed funds,[23] is fundamentally misleading. Funds are not the primary actors from a corporate governance perspective. Rather than distinguishing between types of funds, the relevant distinction is between investment advisers. Because investment advisers often manage both active and index funds, many advisers lie on a spectrum between active and index, rather than at the end points.

Funds are separate legal entities with their own boards of directors.[24] The board's role, however, is not to manage their fund but to retain and monitor "management," which is provided externally by an investment adviser.[25] It is the investment adviser, and portfolio managers hired by the investment adviser, who make investment decisions on behalf of the fund, whether actively or by reference to an index.[26] A single investment adviser often manages multiple funds that employ different strategies and have different sets of investors. In addition, some advisers separately manage assets on behalf of other clients, such as pension funds, insurance companies, endowments, and high-net-worth individuals.[27]

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[23] *See, e.g.*, sources cited *supra* notes 10-11.

[24] Morley, *supra* note 15, at 1232.

[25] *Id.* at 1252.

[26] *See generally Frequently Asked Questions About Mutual Fund Directors*, INV. COMPANY INST., https://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.idc [https://perma.cc/Y9EW-YU5P] (last visited Sept. 23, 2020).

[27] *See* John D. Morley, *Too Big To Be Activist*, 92 S. CAL. L. REV. 1407, 1439-40, 1449-51 (2019).

Investment advisers are often identified with the fund family.[28] Thus, FMR Inc. ("FMR") is the investment adviser for most Fidelity funds and Vanguard Group, Inc. ("VGI") is the investment adviser for most Vanguard funds. The Fidelity Contrafund, the Vanguard Primecap Fund, and the Vanguard 500 Index Fund are all examples of mutual funds.[29]

In actively managed funds, the individual portfolio managers assigned by the investment adviser to a fund typically have significant discretion with respect to

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[28] Funds in the same fund family generally have identical board members. *See, e.g.*, *Our Leaders*, VANGUARD, https://about.vanguard.com/who-we-are/our-leaders/ [https://perma.cc/3Q48-R5DG] (last visited Sept. 23, 2020) (noting that board composition of Vanguard Primecap Fund is identical to board composition of Vanguard 500 Index Fund).

[29] Investment advisers must periodically disclose, in Forms 13F, the U.S. equity securities over which they exercise investment power and indicate whether they have voting power of these securities. 17 C.F.R. §§ 240.13a-1, .13f-1 (2020). Unlike individual funds, however, investment advisers do not disclose how they vote the shares over which they have voting power. *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, 68 Fed. Reg. 6564, 6565 (proposed Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274). The Forms 13F filed by FMR and VGI will aggregate the holdings of all funds advised by these companies and any other holdings managed outside of the fund. *See, e.g.*, FMR LLC, Form 13F Information Table (Form 13F) (May 14, 2020); Vanguard Grp. Inc., Form 13F Information Table (Form 13F) (May 15, 2020). Sometimes, an investment company will sponsor a fund that is advised by a different adviser. The Vanguard Primecap Fund, for example, is advised by the Primecap Management Co., and Fidelity index funds are advised by Geode Capital Management. *See* Jackie Cook & Tom Lauricella, *Proxy Voting Adds Some Spice to Plain-Vanilla Index Investing*, MORNINGSTAR (Dec. 3, 2019), https://www.morningstar.com/articles/957393/proxy-voting-adds-some-spice-to-plain-vanilla-index-investing; *Vanguard PRIMECAP Fund Investor Shares (VPMCX)*, VANGUARD, https://investor.vanguard.com/mutual-funds/profile/VPMCX [https://perma.cc/RAB3-C4VH?type=image] (last visited Sept. 23, 2020). In such cases, the funds' holdings may be included in the sponsor's 13F (as in the case of the Vanguard Primecap Fund) or in the fund adviser's 13F (as in the case of the Fidelity index funds). *See* C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392, 1452 n.167 (2020).

Similarly, initial responsibility for voting sometimes resides with the sponsor and other times resides with the fund adviser. This information, alas, is not always directly disclosed but can often be deduced from the disclosed portfolio holdings and votes. Thus, although the shares of Vanguard Primecap Fund are not included in the VGI 13F, until recently it voted its shares like other Vanguard funds and unlike other Primecap funds. *See* Thomas Franck, *Vanguard to Surrender Some of Its Corporate Voting Power to External Fund Managers*, CNBC (Apr. 25, 2019, 2:26 PM), https://www.cnbc.com/2019/04/25/vanguard-to-give-up-some-of-its-voting-power-to-external-fund-managers.html [https://perma.cc/6UMM-HKK7]. 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. *See* Roben Farzad, *Fidelity's Divided Loyalties*, BLOOMBERG BUSINESSWEEK (Oct. 16, 2006, 12:00 AM), http://www.businessweek.com/stories/2006-10-15/fidelitys-divided-loyalties; *Proxy Voting*, FIDELITY, https://www.fidelity.com/about-fidelity/proxy-voting-overview [https://perma.cc/C373-C246] (last visited Sept. 23, 2020).

the fund's investment decisions. But even with respect to shares held by active funds, most voting decisions are made at the investment adviser level.[30] For small advisers, the voting decisions may be made by portfolio managers who also determine the investment strategy; many smaller advisers also have a policy of following the voting recommendations of a proxy adviser or ask a proxy adviser to make voting recommendations based on guidelines supplied by the investment adviser.[31] By contrast, large investment advisers typically centralize the voting function in an in-house stewardship or proxy voting group.[32] While such proxy voting groups make most voting decisions, they sometimes obtain input from portfolio managers or stock analysts (who, like the members of the proxy voting group, are employees of the investment adviser).[33] Moreover, portfolio managers can sometimes vote the shares held by funds that they advise differently from the way the proxy voting group votes the shares held by other funds in the same family.[34]

In sum, the investment adviser plays a central role with regard to voting. This role is particularly pronounced with regard to the voting of shares held in index funds since portfolio managers for index funds will generally have no strong views on how the fund's shares should be voted. Voting decisions for these shares will thus be made by the adviser's proxy voting group, occasionally with input from analysts or portfolio managers for active funds managed by the adviser.

B. *The Incentive Structure*

To understand the incentive structure bearing on an adviser, one must look at the overall strategy profile of the funds it manages. Active funds try to pick

[30] *See* Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 61-62 (2013) (finding that funds in the same fund family typically vote shares in the same manner).

[31] *See id.* at 52-53.

[32] *See, e.g.*, GLENN BOORAEM, VANGUARD, WHAT WE DO. HOW WE DO IT. WHY IT MATTERS. 2-3 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf [https://perma.cc/2NDK-VKV7].

[33] *See id.* at 11 ("In evaluating votes, the Investment Stewardship team may consider information from many stakeholders, including the company's management and board, shareholder groups, and various research and data resources.").

[34] The extent to which they do so varies among fund families and across issues and can be observed in the voting disclosures filed by funds. *See* Choi, Fisch & Kahan, *supra* note 30, at 48; Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds 6-7 (Mar. 8, 2019) (unpublished manuscript), https://ssrn.com/abstract=3124039 [https:perma.cc/3J6C-697E] ("[I]t is the investment advisor, not the fund family, to which fund voting is generally delegated, and the two organizations are often not the same.").

stocks that generate above-average returns for fundholders.[35] By contrast, index fund assets are invested according to a predetermined formula, typically seeking a market value–weighted portfolio that tracks the performance of an "index" such as the S&P 500 index.[36] Index funds compete on fees, tracking error, and customer service, but *not* on stock picking skills. Because index funds do not choose individual stocks, and hence do not need to employ analysts, their expenses are much lower than those of active funds.[37]

Funds pay advisers a fee for the services provided. That fee is typically a percentage of the fund's assets under management ("AUM"). If the AUM of a fund increase, the adviser can benefit in two ways. First, fees go up because the value of the portfolio on which the percentage fee is based increases. Second, fees may also go up if superior performance attracts additional investments into a fund.

Because running an index funds entails lower expenses than running an actively managed fund, index fund fees tend to be lower as well. Vanguard's S&P 500 Index fund charges individual investors as little as four basis points per year (.04% of invested assets).[38] By contrast, Fidelity's Contrafund Fund, a large active mutual fund with $122 billion in AUM, charges eighty-five basis points.[39]

This structure—higher fees and potential additional benefits from inflows for active funds—creates complex incentives for investment advisers that manage both active and index funds. Suppose that an adviser manages one active fund, "Active," that charges eighty-five basis points and one index fund, "Index," that charges four basis points per year. The adviser's annual fees will thus be:

$$\text{Fees} = 0.0085 * \text{AUM (Active)} + 0.0004 * \text{AUM (Index)}.$$

This simple example shows that the AUM in active funds generate more revenue to an adviser than assets in index funds. To be sure, running an active fund also entails greater costs. But because many of these greater costs are fixed,

[35] *See Index Funds vs. Actively Managed Funds*, VANGUARD, https://investor.vanguard.com/index-funds/index-vs-active [https://perma.cc/7E5D-YWVF] (last visited Sept. 23, 2020) (describing differences between index and active funds).

[36] *Id.*

[37] *See* Alicia Adamczyk, *Index Funds Are More Popular Than Ever—Here's Why They're a Smart Investment*, CNBC: MAKE IT (Sep. 19, 2019, 11:43 AM), https://www.cnbc.com/2019/09/19/why-index-funds-are-a-smart-investment.html [https://perma.cc/SNB4-WWNX].

[38] Press Release, Vanguard, World's Largest Stock and Bond Funds Lower Expense Ratios (Apr. 28, 2017), https://pressroom.vanguard.com/news/Press-Release-Vanguard-Expense-Ratio-April-2017.html [https://perma.cc/2QPL-RSU4].

[39] FIDELITY INV., FIDELITY CONTRAFUND (FCNTX) 1 (2020), https://fundresearch.fidelity.com/mutual-funds/fundfactsheet/316071109 [https://perma.cc/Q8FP-5HST].

it is likely that marginal profits per dollar invested are also substantially higher for active funds than for index funds.

Moreover, index funds are essentially commodities, with little other than fees distinguishing one S&P 500 index fund from another.[40] Competition between index funds thus drives down both fees and profits to be obtained from managing an index fund. Why then run index funds at all? There are several reasons. First, advisers may still make some small profits from running index funds. Second, having index funds as part of the product platform may generate increased profits from the adviser's active funds. Consider, for example, Fidelity, which recently introduced a zero-fee index fund.[41] While this fund may generate some revenue to Fidelity from securities lending, we would guess that operating this fund on a stand-alone basis would be unprofitable.[42] But because it is substantially easier for investors to move investments among funds within a mutual fund family than between funds from different families, Fidelity may benefit by keeping investors seeking an index fund in house or by attracting new investors to its index funds, in the expectation that such investors will invest in Fidelity's higher-fee active funds or purchase other services from Fidelity in the future.[43]

Third, a large index fund may increase the power of the portfolio managers of active funds in the same family in their interactions with portfolio companies. In particular, BlackRock's $3.9 trillion in indexed assets may open doors for its portfolio managers who advise its $1.6 trillion actively managed portfolio.[44]

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[40] Nevertheless, some index funds can charge higher fees because they offer greater liquidity, which can be important for institutional investors. For example, BlackRock's institutional index funds have historically charged fees around thirty-five basis points because of the greater liquidity provided. *See* BLACKROCK, SUMMARY PROSPECTUS 2 (2020), https://www.blackrock.com/us/individual/literature/summary-prospectus/sumpro-brindexfunds-intnatlindexfund-inv-us.pdf [https://perma.cc/7X4Q-VHJU].

[41] Ryan Vlastelica, *Fidelity Announces Zero-Fee Funds, in a Big Milestone for the Industry*, MARKETWATCH (Aug. 1, 2018, 5:23 PM), https://www.marketwatch.com/story/fund-fees-hit-milestone-as-fidelity-announces-products-charging-0-2018-08-01 [https://perma.cc/GE53-3EJM] (describing these zero-fee index funds as "essentially free to own").

[42] Vanguard, which supposedly operates on a zero profit margin and enjoys very large economies of scale, charges as low as four basis points for its S&P 500 index fund. Press Release, *supra* note 38. At Vanguard, however, any net income from securities lending is paid to the fund for the benefit of its shareholders and not retained by VGI. ANDREW S. CLARKE, VANGUARD, SECURITIES LENDING: KEY CONSIDERATIONS 6 (2016), https://personal.vanguard.com/pdf/ISGSL.pdf [https://perma.cc/6K4X-4G6F]. We do not have sufficient information to determine how any net income from securities lending retained by Fidelity compares to the fees charged by Vanguard on its index funds.

[43] Similarly, investors' preferences and the desire to keep investors in house may explain why Vanguard, the pioneer in index investing, has sponsored some active funds.

[44] BlackRock, Inc., Annual Report (Form 10-K) 4 (Feb. 28, 2019).

This additional heft can be important when those portfolio managers ask questions, make suggestions, express views, object to corporate actions, or seek one-on-one meetings with management.

Importantly, investment advisers differ significantly in the overall strategy profile of their funds. Other than the Big Three, most advisers have a relatively small percentage of their AUM in index funds, and these assets contribute an even smaller percentage to the adviser's total fee income. T. Rowe Price, for example, mainly advises active funds: of its $564 billion in equity AUM, only about $31 billion is in index funds.[45]

By contrast, the Big Three manage substantial assets in index funds. Almost all of State Street's and 80% of Vanguard's and BlackRock's equity assets are in index funds.[46] Vanguard and BlackRock, however, differ in important respects. First, even Vanguard's active funds charge a relatively low management fee.[47] Second, most of the active equity funds in the Vanguard family are managed or co-managed by outside advisers, such as Primecap Management Co., which advises the Vanguard Primecap Fund and receives a portion of the fees charged for running the fund.[48] As a result, it is likely that Vanguard derives the bulk of its fee income from index funds. Finally, Vanguard Group Inc.—the legal entity that earns the management fees—is owned by the shareholders of the various Vanguard mutual funds and is not meant to make profits.[49] By contrast, BlackRock's active funds resemble—in fees, management structure, and style—other active funds, and BlackRock itself is a separately owned, publicly traded company that is expected to make profits from its investment advisory business.[50]

Considering this overall structure, we now examine in greater detail how fund management fees provide a financial incentive for investment advisers to cast an informed vote. We first analyze incentives to improve absolute returns that result from the fact that higher returns increase the value of AUM which directly results in higher fees ("direct incentives"). Then, we examine the effect of returns on net flows into funds ("indirect" or "flow-based incentives"). Finally, we discuss reputational incentives.

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[45] T. Rowe Price Grp. Inc., Annual Report (Form 10-K) 25 (Feb. 16, 2018); *T. Rowe Price Equity Index 500 Fund*, T. ROWE PRICE, https://www.troweprice.com/personal-investing/tools/fund-research/PREIX#content-portfolio [https://perma.cc/M894-TPEW] (last visited Sept. 23, 2020).

[46] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 6, at 304.

[47] For example, Vanguard's Primecap Fund has an expense ratio of 0.38%. *Vanguard PRIMECAP Fund Investor Shares (VPMCX)*, VANGUARD, https://investor.vanguard.com/mutual-funds/profile/VPMCX [https://perma.cc/DQ3Z-3GPF?type=image] (last updated Jan. 31, 2020).

[48] *Id.*

[49] *See* CLARKE, *supra* note 42, at 6.

[50] *See History*, BLACKROCK, https://www.blackrock.com/corporate/about-us/blackrock-history [https://perma.cc/7529-3NME] (last visited Sept. 23, 2020).

1. Direct Incentives

Advisers to index funds, like advisers to any other mutual funds, directly benefit if the portfolio companies held by the fund do well. Advisers' fees depend on the value of fund assets.[51] As the value of fund assets increases, fees increase proportionally.

To be sure, in percentage terms, index fund fees are low—typically much 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 nine basis points (that is, 0.09% of the fund's assets).[52] The corresponding average fee for active funds was seventy-eight basis points.[53]

Even these low fees, however, generate incentives in the context of voting that compare favorably to those of most other shareholders. This is because assets managed by the principal advisers to equity index funds are extraordinarily large. Take, for example, Vanguard. While the average annual fee for the five largest Vanguard funds is just 0.064% per year,[54] the aggregate value of the shares in Vanguard-administered portfolios was $2.5 trillion at the end of the first quarter of 2019.[55]

In the context of voting and stewardship engagements more generally, portfolio size is important for two distinct reasons. First, the dollar amount that an adviser has invested in a given company determines the base for any incremental fee income from an increase in the stock price of a portfolio company. Thus, consider Vanguard's incentives in 2017, the year in which Trian launched its proxy contest at P&G.[56] Vanguard held about 185 million P&G shares with a value of about $17 billion.[57] If P&G's stock price rises by 1% as a result of a voting outcome, the value of the Vanguard positions in P&G would increase by $170 million, and its annual fees, applying the 0.064% rate, would increase by about $109,000.[58] Assuming that Vanguard expects to earn these

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[51] *See* INV. CO. INST., *supra* note 2, at 118.

[52] *Id.* at 126.

[53] *Id.*

[54] Fund fee data were supplied to us by Ryan Bubb and Emiliano Catan and are available upon request.

[55] Vanguard Grp. Inc., Form 13F Summary Page (Form 13F) (May 15, 2019).

[56] *See* David Benoit, *Peltz Seeks P&G Board Seat—Consumer-Products Titan Would Be Largest Company Ever To Face a Proxy Fight*, WALL STREET J., July 17, 2017, at A15.

[57] Vanguard Grp. Inc., Form 13F Information Table (Form 13F) (Feb. 14, 2018) (disclosing 2017 year-end holdings of 185,434,627 shares of P&G); *The Procter & Gamble Company (PG)*, YAHOO! FIN., https://finance.yahoo.com/quote/PG/history?period1=1512086400&period2=1517356800&interval=1d&filter=history&frequency=1d [https://perma.cc/Q8SU-SLT3] (last visited Sept. 23, 2020).

[58] In fact, from Peltz's March 1, 2018 addition to the board of P&G, P&G stock increased from $78.70 to $110.42 on June 19, 2019, a gain of more than 40%. *See The Procter & Gamble Company (PG)*, *supra* note 57.

annual fees for ten more years before its investors withdraw funds, its additional fees would amount to about $1.1 million. This is about the same dollar amount as the gain to an individual shareholder who owns $110 million in P&G stock.

But Vanguard's monetary incentives to cast a value-increasing vote are substantially stronger than those of an individual shareholder with a $110 million stake in P&G. Because Vanguard administers about 150 times as many shares, its vote is much more likely to be outcome determinative than the vote of an individual shareholder with a $110 million stake. 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 one-twelfth of the number of shares held by Vanguard.[59] For P&G, this implies that Vanguard's financial incentives to cast an informed vote are equivalent to the incentives of an individual shareholder with a staggering $1.3 billion investment in P&G.[60]

Note that the fact that P&G is one of the largest companies in the United States[61] affects only the dollar magnitude of Vanguard's incentives, not the *relative* incentives of Vanguard compared to those of other shareholders. If Vanguard expects to earn its 0.064% fees on the increased stock value for ten 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 one-twelfth of its stake *regardless* of the size of the company and the dollar value of its position.[62] Because of Vanguard's massive portfolio holdings, its incentives will thus be substantially stronger than those of virtually all individual shareholders.

[59] 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 of the vote outcome on company value assuming that Vanguard earns additional fees of 0.064% for ten years and assuming a 0% discount rate. For an individual investor with stake $1/s_I$ relative to Vanguard's, 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 $s_I = 12$.

[60] For comparison, Trian, when it launched the proxy contest at P&G, had a $3.5 billion stake. Michael Flaherty, *Trian Takes $3.5 Billion Stake in Procter & Gamble*, REUTERS (Feb. 14, 2017, 4:51 PM), https://www.reuters.com/article/us-procter-gamble-stake-trian-fund-idUSKBN15T2WR [https://perma.cc/673B-RH2U].

[61] P&G was number forty-five on the 2019 list of Fortune 500 companies. *Fortune 500*, FORTUNE, https://fortune.com/fortune500/2019/search/ (last visited Sept. 23, 2020).

[62] Even if Vanguard expected to earn its 0.064% fee on the increased stock value for only two years, its incentives would correspond to those of an individual shareholder with one twenty-eighth of its stake.

The bulk of assets in equity index funds is held in funds advised by the Big Three.[63] But the same logic applies to investment advisers that largely manage index funds but are smaller than the Big Three. Consider, for example, Charles Schwab, a smaller investment adviser that specializes in index funds. As of December 31, 2017, Charles Schwab held P&G stock worth about $1.2 billion and charged fees of about 0.04%.[64] Given the same assumptions that we used before, Charles Schwab's incentives would be equivalent to those of an individual investor who held one-sixteenth of the stock held by Charles Schwab, or about $74 million in P&G stock. As even these smaller investment advisers to index funds have incentives that are substantially stronger than those of most real-life individual shareholders, we strongly disagree with the various commentators who argue that incentives of index funds are so trivial that index funds should lose their voting rights.[65]

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.[66] Bebchuk and Hirst attribute this differential to what they call the "agency-costs theory of index fund stewardship"[67] and advocate a set of policy changes.[68]

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[63] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 6, at 304 ("[T]ogether these three firms stand for a stunning 71 percent of the entire ETF market; all other ETF providers have market shares below 3.3 percent. Data about market shares in index mutual funds are not publicly available, but it seems clear that Vanguard dominates this segment with probably at least 75 percent market share.").

[64] *See Index Funds and ETFs*, CHARLES SCHWAB, https://www.schwab.com/schwab-index-funds-etfs [https://perma.cc/ZKQ3-SVUQ] (last visited Sept. 23, 2020) (listing index fund fees ranging from 0.02% to 0.06%); *infra* Table 2 (showing ownership of 12,850,000 shares). Ownership figures were converted in market value at the year-end market price of $91.88 per share. *See The Proctor and Gamble Company (PG)*, *supra* note 57.

[65] *See, e.g.*, Lund, *supra* note 9, at 511 ("Because a passive fund seeks only to match the performance of a market index—not outperform it—the fund lacks a financial incentive to ensure that the companies in their portfolio are well run. . . . A passive fund that invests in governance, therefore, would improve the performance of all rival passive funds in equal measure. Moreover, investing in governance would also benefit active funds—in fact, active funds are able to reap even greater benefits from the passive fund's investment because they can overweight the target company upon learning about the intervention. In other words, any investment in governance would benefit competitor funds while simultaneously driving up the passive fund's costs. Therefore, unless the intervention were costless, it would be certain to harm the passive fund's relative performance.").

[66] *See* Kahan & Rock, *Hedge Funds in Corporate Governance*, *supra* note 14, at 1050-54 (examining incentives of mutual funds).

[67] Bebchuk & Hirst, *Index Funds*, *supra* note 10, at 2043-75.

[68] *See id.* at 2116-40. 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 ten year holdings, would be only one-twelfth of those of an individual

We believe that the Bebchuk and Hirst analysis misses the point. The reason why advisers to index funds (or, for that matter, advisers to other types of mutual funds) do not have incentives equivalent to those of true owners is that they are *not* the owners of the stocks in the portfolios they advise.[69] Rather, economically, the owners are the mutual fund investors.

The question therefore is how Vanguard's incentives compare to those of the actual economic owners of Vanguard's shares—the real-life investors in Vanguard's mutual funds—not how Vanguard's incentives compare to those of a hypothetical individual shareholder who holds the same stake as Vanguard. Put differently, *given the underlying economic ownership structure*, does the fact that the actual economic owners (investors in Vanguard funds) hold their shares through Vanguard, rather than directly, increase the agency costs, collective action costs, and free-rider costs associated with publicly traded companies? Because the incentives of Vanguard and other index fund advisers are multiple orders of magnitude higher than the incentives that the investors in Vanguard or other index funds would have, the answer is clearly no.[70]

Looking at incentives for index fund advisers from this perspective, index funds like Vanguard's serve to *lower* the overall costs of dispersed ownership by multiple orders of magnitude rather than contribute to these costs. Fixes to further reduce these costs are not easy to come by.[71]

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holder with a stake equivalent to Vanguard's. The fact that Vanguard charges low fees is of course beneficial to its investors and not a reflection of agency costs.

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

[70] In an intriguing article, Sean Griffith argues that mutual funds should not exercise voting authority with respect to issues in which its investors lack a common interest or issues in which they lack adequate information, such as—in Griffith's view—governance issues. *See* Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEXAS L. REV. 983, 990 (2020). We agree with Griffith's assessment that voting on issues about which investors lack a common purpose of maximizing returns is conceptually distinct from other voting. However, for the reasons we discuss below, we disagree with his argument that investment advisers lack information on governance issues relative to other shareholders.

[71] Various proposals made by Bebchuk and Hirst to reduce the agency costs of index fund stewardship are thus, in our view, not likely to be effective. *See* Bebchuk & Hirst, *Index Funds*, *supra* note 10, at 2119-27. In particular, bringing transparency to private engagements would raise the costs of engagements and could reduce their effectiveness. *See id.* at 2123-27. Facilitating the charging of stewardship costs to funds is not needed as funds could—and, in effect, do—contract with advisers to provide stewardship. *See id.* at 2120. Having outside organizations conduct research on behalf of advisers would aggravate the incentive problem as outside organizations would have fewer incentives than advisers presently have (in any case, outside organizations that do so—ISS and Glass Lewis in particular—already exist). *See id.* at 2120-21. Making stewardship expenses mandatory, even if unwanted by fund investors, would not seem to be an effective way to address agency costs arising between fund investors and advisers. *See id.* at 2121.

Perhaps individual shareholders are not the right comparison group. Individual shareholders have notoriously poor incentives.[72] Rather, perhaps the better inquiry is how Vanguard's incentives compare to those of advisers to actively managed funds.

With respect to direct incentives, index funds differ from active funds in three respects. First, active funds generally charge higher annual fees. As noted, the average fee for an active fund in 2017 was seventy-eight basis points, compared to nine basis points for index funds.[73] Higher fees generate correspondingly stronger incentives to cast informed votes.

Second, active funds tend to have more concentrated portfolios. Active funds tend to invest in fewer companies than broad-based index funds, and their largest investments tend to constitute a greater percentage of their net assets than the corresponding investments for index funds. For example, as of December 31, 2017, the ten largest holdings of the Fidelity Contrafund, the largest active fund, constituted 38.1% of its assets,[74] while the ten largest holdings of the Vanguard S&P 500 Index fund constituted only 20.9%.[75]

Looking at stock concentration in the portfolios of individual funds, however, overstates the degree of concentration at the investment adviser level. As an example, Table 1 below shows, for the six companies in which the Fidelity Contrafund has the highest investment, the investments by the Contrafund, the Vanguard S&P 500 Index fund, and FMR (the adviser for Fidelity's non-index funds) as a percentage of the respective entity's total domestic equity holdings. Although the six companies constituted a much greater percentage of the Contrafund equity holdings than of the Vanguard S&P 500 Index Fund, their share in FMR's overall holdings was similar to their share in the Vanguard S&P 500 Index Fund .[76] Holdings by advisers to active funds—in particular, holdings by large advisers, like Fidelity, that manage multiple active funds employing different strategies—are thus likely to be substantially less concentrated than holdings by individual active funds.

72 *See* Matt Egan, *Just 27% of Investors Bother to Vote*, CNN MONEY: THE BUZZ (June 12, 2014, 8:30 AM), https://buzz.money.cnn.com/2014/06/12/shareholders-dont-vote/ [https://perma.cc/6F97-NTT6].

73 *See supra* note 53 and accompanying text.

74 Fidelity Contrafund, Annual Report (Form N-CSR) (Feb. 26, 2018).

75 Vanguard Index Funds, Annual Report (Form N-CSR) (Feb. 28, 2018).

76 *See* Fidelity Contrafund, *supra* note 74; FMR LLC, Form 13F Information Table (Form 13F) (Feb. 12, 2018); Vanguard Index Funds, *supra* note 75.

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

	Contrafund	Vanguard S&P 500 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, advisers to active funds and advisers to index funds may differ in the number of years over which they earn the higher fees if the value of stock in their portfolio increases. The number of years over which a fund will earn higher fees depends on how long investors keep owning the fund. To illustrate, if all fund investors withdraw all their investments after one year, the fund will earn the higher annual fees for one year only; if they all withdraw all their investments 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 and their proclivity to move assets among investment vehicles. We see no particular reason why investors in index funds would have systematically different liquidity needs than investors in active funds. But there are reasons to believe that they will have a lesser proclivity to shift investments. Specifically, investors who buy index funds—funds that do not try to identify *stocks* likely to outperform other stocks—may be less inclined themselves to try to identify *funds* likely to outperform other funds. To that extent, advisers to index funds would expect to earn their annual fees for more years than advisers to active funds do.

To derive a ballpark estimate of the relative direct incentives of different advisers, we examined the investment advisers with the largest stakes in P&G stock. For each adviser, we calculated the fees by multiplying the dollar value of the shares owned by the average fees of that adviser's five largest funds. We also assumed, conservatively, that index funds and active funds do not differ in the number of years over which they would earn the fees and that the likelihood that a vote is outcome determinative is proportional to the adviser's stake.

Table 2 below shows each adviser's direct incentives to cast an informed vote *relative to* Vanguard's direct incentives.[77] As Table 2 shows, the relative incentives of the Big Three are by far the strongest in the industry.

The Big Three's incentives also compare favorably to those of public pension funds. Assuming that index funds expect to earn fees for ten years and the public pension fund incentives are equivalent of those of an individual owner holding the same number of shares—a highly conservative assumption—the incentives

[77] Table 2 is based on Form 13F filings with the SEC for December 31, 2017.

of even the largest public pension funds are far below those of BlackRock, Vanguard, or State Street. Most other public pension funds, which number in the thousands, would have significantly lower incentives.

Table 2. Largest Holders of Procter & Gamble in 2017.

Adviser	**Shares (in 000)**	**Relative Incentive**
Vanguard Group Inc.	185,434	1.00
BlackRock	164,446	1.97
State Street	114,721	0.85
Capital World Investors	35,132	0.35
Northern Trust	34,388	0.25
Mellon Bank	28,288	0.30
Geode	27,189	0.014
Fidelity	22,463	0.10
State Farm	20,546	0.08
Goldman Sachs	16,001	0.09
Yacktman	15,163	0.10
Charles Schwab	12,850	0.003
Wellington	8,212	0.009
T. Rowe Price	7,067	0.015
Franklin Resources	6,110	0.013
Credit Suisse	4,984	0.017
Public Pension Funds	**Shares (in 000)**	**Relative Incentive**
New York State Common Ret. Fund	7,233	0.24
CalPERS	6,652	0.20
California State Teachers Ret. Sys.	4,798	0.10
New York State Teachers Ret. Sys.	4,260	0.08
State of New Jersey Common Pension Fund	2,189	0.02

P&G, of course, is only one company. But the share ownership structure of P&G is reasonably representative. As the Big Three, together with Fidelity, are by far the largest institutional investment advisers,[78] they are among the largest shareholders in most companies.[79]

As this analysis has shown, among mutual fund advisers, the most important factor affecting the adviser's direct incentives is the size of its holdings. Because

[78] *See* Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 6, at 304.

[79] *See* Miguel Antón, Florian Ederer, Mireia Giné & Martin C. Schmalz, *Common Ownership, Competition, and Top Management Incentives* 41 (European Corp. Governance Inst., Fin. Working Paper No. 511, 2018), http://papers.ssrn.com/abstract=2802332 [https://perma.cc/26YF-55N6].

the most prominent advisers to index funds—Vanguard, State Street, and BlackRock—are also the largest investment advisers, they stand to gain the most from casting informed votes. To the extent that they also provide active management, their incentives—already substantial—are even higher. Thus, as between Vanguard, State Street, and BlackRock, the fact that BlackRock is an adviser to relatively more higher-fee active funds increases its relative incentives.

Index fund advisers other than the Big Three—advisers like Geode, which manages and votes the shares in Fidelity index funds,[80] or Charles Schwab—of course have lower incentives than the Big Three do. But their incentives are still superior to those of many smaller active fund advisers, most public pension funds, and almost all individual investors.

Critics of index funds have raised a further argument as to why index funds have low incentives. Because the product offered by different index funds—matching an index and providing shareholder services—is almost identical, the argument goes, funds attract investors by charging low fees. Index funds, however, gain no competitive advantage over other index funds by casting informed votes. Even if their voting increases portfolio value, other competing index funds will obtain a corresponding increase. The index fund that invested in casting an informed vote will thus bear costs and other index funds can free ride.[81] Rather than obtaining a competitive advantage through informed voting, a fund that invests in information will have to charge higher fees and be at a competitive disadvantage — and hence be reluctant to invest in information.[82]

While the premise of this argument is correct, the conclusion is not. Advisers of index funds have incentives to cast informed votes because these votes may raise their fees from AUM, not because they obtain a competitive advantage by doing so. An investment in informed voting, according to our analysis, will not require an adviser to raise its *percentage* fees, but will instead be financed from the additional fee income generated when informed voting results in a higher portfolio value.

To make this concrete, consider again Trian's proxy contest at P&G. Since Nelson Peltz's addition to the board of P&G on March 1, 2018, the company's stock price has increased from $78.70 to $110.42 per share on June 19, 2019, a

[80] *See supra* note 29.

[81] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 10, at 2055-57, 2118; Lund, *supra* note 9, at 513-14.

[82] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 10, at 2057 ("[C]ompetition with other index funds tracking the same index gives index fund managers precisely zero additional incentive to invest in stewardship for any of their portfolio companies."); Lund, *supra* note 9, at 500 ("[B]ecause mutual funds compete against each other on the basis of relative performance—*i.e.*, how the fund performed relative to its industry peers—those funds that invest in governance and stewardship will find themselves less desirable than their rival funds.").

40% gain.[83] The value of Vanguard's position, in turn, has increased by $5.9 billion, thereby contributing an additional $3.76 million per year to Vanguard (applying a 0.064% rate).[84] The possibility of such gains provides a significant economic incentive to invest the resources necessary to decide intelligently between Trian's arguments and the opposing arguments by P&G's board.

This is an example of what Mancur Olson called the "'exploitation' of the great by the small."[85] Because the advisers to the largest index funds, by virtue of their huge size, *independently* have incentives to cast informed votes—thereby reducing the classic problems of rational apathy and free riding—other shareholders benefit without bearing any of the cost. The fact that large advisers have incentives that align their interests with those of shareholders at large makes them well suited to play the role of decider in corporate governance disputes.

2. Indirect Incentives: The Impact on Fund Flows

a. *Actively Managed Funds*

Fund performance also matters to advisers to active funds because performance may affect net inflows into the fund. Net inflows, in turn, increase AUM and correspondingly increase management fees. That active funds have such indirect, or flow-based, incentives to cast an informed vote is often seen as a substantial difference between active and index funds.[86]

As to flow-based incentives, it is important to distinguish between the investment adviser's overall incentives—sometimes implemented through a centralized proxy voting group—and the incentives of individual portfolio managers charged with managing a specific fund. As we have explained, both the voting group and portfolio managers can have input into votes, and the degree of input varies across advisers and across funds and issues within an adviser.[87]

Empirical evidence has shown that *relative* fund performance, rather than absolute performance, affects fund flows.[88] This implies that attracting future

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[83] *See supra* note 58.

[84] Vanguard Grp. Inc., Form 13F Information Table (Form 13F) (May 15, 2018).

[85] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 29 (2d ed. 1971) (emphasis omitted) (footnote omitted). For further discussion, see Rock, *supra* note 14, at 461-62.

[86] *See, e.g.*, Lund, *supra* note 9, at 497.

[87] *See supra* Section I.A.

[88] The seminal article is Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45 (1992). Other important contributions include: Brad M. Barber, Xing Huang & Terrance Odean, *Which Factors Matter to Investors? Evidence from Mutual Fund Flows*, 29 REV. FIN. STUD. 2600, 2620 (2016) (estimating that a 1% increase in alpha generates an additional 0.474% in net inflows); Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational*

fund flows generates *no* flow-based incentives for a portfolio manager to increase the value of a company in which a fund is *underweight* relative to competing funds. If a fund is overweight in a company, relative performance will improve if the company's share price increases but only *to the extent* that a fund is overweight. For example, if the benchmark weight of a stock is 0.21% and the weight in the portfolio of a fund is 0.23%, only the 0.02% excess weight will contribute to the fund's relative performance. Thus, improving relative fund performance will generate only attenuated incentives even as to companies in which the fund is overweight. Moreover, because individual funds generally hold far fewer shares in any portfolio company than advisers do, flow-based incentives for portfolio managers to invest in information for voting purposes will tend to be low even if their fund is overweight in a particular stock.

Investment advisers hold larger stakes in portfolio companies than individual funds do. But, as we have seen, adviser portfolios resemble the market more closely than portfolios of individual funds do, thus diminishing the relative significance of flow-based incentives.[89] To get a sense of the extent to which adviser portfolios differ from market portfolios, we randomly selected twenty domestic stocks listed on the Form 13F filed by T. Rowe Price Associates, one of the largest advisers to active funds, and compared their weight in the T. Rowe Price portfolio to their weight in the Form 13F report filed by Vanguard as a proxy for the market.[90] For fifteen of the twenty stocks, T. Rowe Price was underweight relative to Vanguard. For the other five stocks, T. Rowe Price was overweight relative to Vanguard by 11%, 31%, 88%, 201%, and 413%, respectively.

A recent working paper by Jonathan Lewellen and Katharina Lewellen examined the effect of performance on net flows for all funds managed by the same adviser.[91] It estimated an adviser flow-to-performance sensitivity of 1.39%.[92] That is, for a 1% excess performance above the benchmark, a fund family would obtain a net inflow (over several years) of 1.39% of assets. Placed into perspective, for a stock in which an adviser is overweight by less than 256%, flow-based incentives are positive but lower than direct incentives; and for a

Markets, 112 J. POL. ECON. 1269, 1274-80 (2004); Judith Chevalier & Glenn Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167, 1173-82 (1997); Andrea Frazzini & Owen A. Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns*, 88 J. FIN. ECON. 299, 304-08 (2008); and Berk A. Sensoy, *Performance Evaluation and Self-Designated Benchmark Indexes in the Mutual Fund Industry*, 92 J. FIN. ECON. 25, 33-35 (2009).

[89] *See supra* Table 1.

[90] T. Rowe Price Assocs. Inc., Form 13F Information Table (Form 13F) (Feb. 14, 2018); Vanguard Grp. Inc., *supra* note 57.

[91] Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentives to Be Engaged 6-8 (Mar. 2020) (unpublished manuscript) (on file with the Boston University Law Review).

[92] *Id.* at 2.

stock in which the adviser is overweight by more than 256%, flow-based incentives exceed direct incentives.[93]

For mutual fund advisers with highly concentrated holdings, flow-based incentives will often dominate direct incentives. Such advisers exist, but most are on the small side. Lewellen and Lewellen found that, on average, institutions (excluding the Big Three and two other advisers that manage mostly index funds) in the bottom 25% of AUM invested 4.05% (value weighted) of their portfolio in a given firm, compared to a benchmark weight of 0.32%.[94] These institutions are thus about 1166% overweight, generating flow-based incentives that are 28% larger than direct incentives. But because AUM by these institutions are very low (average AUM of $1 billion), total incentives remain very low.[95]

In comparison, the quartile of the largest institutions (average AUM of $387.6 billion) invested just 0.67% in a given firm compared to a benchmark weight of 0.43%—i.e., they were overweight by merely 56%.[96] For those institutions, direct incentives were more than twice flow-based incentives, and their overall incentives dwarf those of the smallest quartile.

b. *Index Funds*

In accordance with conventional wisdom,[97] 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. However, in a recent article, Jill Fisch, Assaf Hamdani, and Steven Davidoff Solomon ("FHDS") argue that index funds have flow-based incentives similar to those of active funds.[98] Just as active funds can generate inflows by superior performance relative to the index, they reason, index funds can generate inflows by improving index fund performance relative to active funds.[99] FHDS therefore argue that index funds

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[93] Consider a stock in which the fund weight is x% of the market weight and normalize the market weight to 1. A 1% increase in the stock price directly increases portfolio value x% * 1%; a 1% increase in the stock price increases portfolio value through fund inflows by (x% - 100%) * 1.39%. The increases in portfolio value are equalized for x% = 356%, meaning that the fund is overweight by 256%.

[94] Lewellen & Lewellen, *supra* note 91, at 16.

[95] *Id.*

[96] *Id.*

[97] *See supra* note 82 and accompanying text.

[98] Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 32 (2019). Bernard Black made a similar point in 1992. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 879-81 (1992) (noting that index funds compete with active funds and non-equity investments).

[99] Fisch, Hamdani & Davidoff Solomon, *supra* note 98, at 32.

enhance their performance relative to active funds by improving governance at their portfolio companies.[100]

For index funds, however, the relationship between fund performance and fund flows is at best highly tenuous. First, although empirical evidence shows that relative performance affects fund flows, this relation is not linear. Erik Sirri and Peter Tufano have found that fund flows are significantly related to performance only for the top quintile of funds; for the four bottom quintiles of funds, the relationship is not significant.[101] Since index funds are unlikely to ever be in the top quintile of performers relative to their benchmark, this study implies that flows to index funds would be insensitive to performance.

Second, as explained, funds improve their relative performance if the price of a portfolio company increases only to the extent that a fund is overweight in the portfolio company relative to competing funds. But for index funds, there is an inherent upper limit on the degree to which an index fund can be "overweight" in any particular stock relative to active funds. Plausibly, active funds in the aggregate may be underweight by 20% or 33% in some shares relative to the index, making index funds overweight (relative to active funds) by 25% or 50%. But, as discussed, being overweight by 25% or 50% does not contribute much to aggregate incentives. Moreover, index funds are highly diversified. As a result, superior performance of a single or a few portfolio companies in which the fund is modestly overweight will barely contribute to the relative performance of the fund.

Third, the degree to which an index fund is overweight is completely out of its control. The companies in which index funds may find themselves overweight may not lend themselves to improvement in value, and the companies that lend themselves to improvements may not be the ones in which index funds are overweight.

Even to the extent that an index fund may try to enhance its relative performance as suggested by FHDS,[102] doing so is complex. To determine whether an index fund is overweight in any company relative to actively managed funds, the adviser would have to collect information about holdings in that company by all such active funds. This would require the aggregation of data that is released only quarterly and only with a forty-five day lag.[103] And for

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[100] *Id.* at 37.

[101] Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1600-05, 1618 (1998) (finding effect on flows only for funds in the top quintile of performance).

[102] Fisch, Hamdani & Davidoff Solomon, *supra* note 98, at 37-43.

[103] *See* 17 C.F.R. § 240.13f-1(a) (2020) (requiring certain investment managers to file Form 13F with SEC within forty-five days of close of each quarter). Although Form 13F reports 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. *Id.*

the strategy to work, active funds would have to stay underweight in the stock from the time their stakes were disclosed to the time when the index fund's efforts come to fruition and the stock price increased.

We doubt that the stewardship groups at index funds advisers are even aware of whether their index funds are overweight or underweight in a company relative to active funds taken as a whole. We are also not aware of any evidence suggesting that index fund advisers structure their votes or their engagement based on whether they are so overweight. To the contrary, the evidence as to voting suggests that it is often governed by published policies that apply equally to all companies—both ones where funds are overweight and ones where they are underweight.[104] As to flow-based incentives of index funds, we therefore believe that the conventional wisdom is correct: such incentives are immaterial.

3. Reputational Incentives

BlackRock, Vanguard, and State Street—the sponsors of the largest index funds—are also the largest U.S. asset management companies.[105] In 2016, their combined AUM exceeded $10 trillion.[106] As regulated financial institutions of enormous size, these companies stand in the public eye. They have strong reputational interests in being perceived—by investors, regulators, and politicians—as responsible actors and forces for good.

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. 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 longterm 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

[104] *See, e.g.*, VANGUARD, PROXY VOTING GUIDELINES FOR U.S. PORTFOLIO COMPANIES (2019) [hereinafter VANGUARD, PROXY VOTING GUIDELINES], https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf [https://perma.cc/B4LX-C6TL] (making no distinction based on weight).

[105] *See* Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 6, at 304.

[106] *Id.* at 305.

> 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' longterm economic interests, we do not hesitate to exercise our right to vote against incumbent directors or misaligned executive compensation.[107]

In his January 2018 letter, "A Sense of Purpose," 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.[108]

These letters are directed to audiences beyond the CEOs of the companies in BlackRock's portfolio. As the largest institutional investor, BlackRock faces political risk. Given the historical suspicion of concentrated economic power in the United States,[109] BlackRock's CEO must worry about the prospect of regulation. The best way to avoid regulation is to be viewed by relevant audiences as a responsible steward. Fink's emphasis on long-term value creation furthers this goal. Similarly, his more recent emphasis on corporate purpose and corporations making positive contributions to society that benefit all

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[107] Larry Fink, *Larry Fink's 2017 Letter to CEOs*, BLACKROCK (2017), https://www.blackrock.com/corporate/investor-relations/2017-larry-fink-ceo-letter [https://perma.cc/9AE8-3E63].

[108] Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (2018) (citation omitted), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/5J3R-3GEA].

[109] For how this has shaped corporate governance, see MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 26-49 (1994).

stakeholders can be understood as responding to the concern that large portions of the electorate feel left out.

In addition, Fink's letters may serve a marketing function. In a world in which funds following the same index are largely indistinguishable, BlackRock may gain additional assets by 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 make more environmentally conscious and sustainable investments.[110] Establishing itself as the environmentally conscious index fund may help BlackRock attract assets from such committees.

The size of these large asset managers also means that even large increases in governance capacity may be justifiable on reputational grounds. In 2018, Fink announced that, over the following three years, BlackRock would double the size of its investment stewardship group, already the largest in the industry.[111] This substantial increase in capacity, which solidifies BlackRock's stewardship group as the industry leader, can easily be justified as an effort to control political risk or as a marketing expense.

Does it matter whether BlackRock is "sincere" in its efforts to be a responsible investor or whether it simply wants to be perceived as one? Yes and no. A desire to maintain or develop a reputation for responsible stewardship—whether driven by political or market pressures—provides substantial incentives to acquire information, especially with respect to high-profile votes. DuPont's 6.8% stock price drop after it repelled a proxy challenge by Trian with the support of BlackRock, Vanguard, and State Street may have raised some eyebrows.[112] As to DuPont, Trian eventually achieved its goal—a merger with Dow Chemical and subsequent breakup of the company—and DuPont's stock price recovered.[113] Whatever their level of sincerity, the Big Three have reputational incentives to avoid casting high-profile votes that result in significant price drops over the short and the long term. On the other hand, avoiding regulatory scrutiny,

[110] *See, e.g.*, Kathryn Stamm, *Cornell to Effectively Divest from Fossil Fuels, Trustees Vote*, CORNELL DAILY SUN (May 22, 2020), https://cornellsun.com/2020/05/22/cornell-to-divest-from-fossil-fuels-trustees-vote/ [https://perma.cc/P3KQ-JDFE] (discussing how Cornell trustees voted to divest from fossil fuels following student protests).

[111] Fink, *supra* note 108.

[112] Tom Hals, *DuPont Wins Board Proxy Fight Against Activist Investor Peltz*, REUTERS (Mar. 13, 2015, 8:57 AM), https://www.reuters.com/article/us-dupont-trian/dupont-wins-board-proxy-fight-against-activist-investor-peltz-idUSKBN0NY1JI20150513 [https://perma.cc/N9D3-QRHD] ("DuPont won the backing of three of its largest shareholders, Vanguard Group, State Street Global and BlackRock Institutional Trust . . . . Trian won the majority of non-index institutions and would have prevailed had one of those three index funds voted differently . . . .").

[113] Michelle Celarier, *Dupont-Dow Merger Pays Off for Steady Hedgies*, N.Y. POST (Dec. 12, 2015, 1:58 AM), https://nypost.com/2015/12/12/dupont-dow-merger-pays-off-for-steady-hedgies/ [https://perma.cc/NB34-DXWN].

generating positive press, and appealing to the tastes of a segment of the investing public is not tantamount to increasing returns. The reputational incentives of investment advisers are thus to some extent aligned with the interests of fundholders and to some extent independent of these interests.

II. ECONOMIES OF SCOPE, SPILLOVER KNOWLEDGE, AND SHORT-TERM TRADING HORIZONS

In this Part, we place incentives to become informed and engaged in the broader context of the structure of investment advisers. We make three arguments. First, investment advisers often enjoy economies of scope from information that is relevant to votes in multiple portfolio companies. Second, advisers may benefit from spillover knowledge generated by information that was acquired for trading purposes but is also helpful for voting purposes.[114] Third, voting by advisers may be subject to distortions generated by short-term trading horizons.

A. *Economies of Scope*

The information required to cast an informed vote can be divided into two categories: company-specific information and issue-specific information. Company-specific information is relevant for votes cast with respect to a specific company but not for votes cast on any issue at another company. Issue-specific information, by contrast, is relevant for votes cast with respect to a certain issue at several companies and not for votes cast with respect to another issue at the same companies. For example, if X is nominated to the board of companies A, B, and C, information that pertains to X is issue specific, while information that pertains 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. On some issues, such as a vote on a merger, company-specific information is likely to dominate; on others issues, such as the elimination of a staggered board, issue-specific information is likely to be more important.[115]

The distinction between company-specific and issue-specific information is highly relevant in determining incentives to become informed. While incentives to obtain company-specific information derive primarily from one's holdings *in*

[114] *See* Lund, *supra* note 9, at 501 (noting that active funds generate information about firm performance as byproduct of investing).

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

a single company, incentives to obtain issue-specific information derive from one's holdings *in all companies* where a vote on the issue will have to be cast.[116]

Investment advisers whose AUM include shares in multiple companies benefit from the economies of scope related to issue-specific information. These economies may explain why some investment advisers have developed detailed voting guidelines on many recurring issues.[117] Because investment advisers face these votes regularly, they will already have examined issue-specific information bearing on the vote. If such issue-specific information is sufficiently clear, it may not pay to consider any additional company-specific information.[118]

The extent to which an investment adviser has incentives to acquire issue-specific information will depend on both the size of the adviser and the mix between active and index funds. Although all mutual fund families benefit from the economies of scope generated by issue-specific information, those with more widely dispersed portfolios benefit more than those that invest in a smaller set of companies. Because investment advisers concentrating on index funds tend to hold the most dispersed portfolios, they tend to benefit the most from economies of scope.

B. *Spillover Knowledge*

A second important factor bearing on the information available to investment advisers is whether information that advisers obtain in the course of making their investment decisions is relevant to, and incorporated in, their voting decisions. Managing index funds, of course, does not produce significant information relevant to voting decisions because investments are mechanically dictated by the index that a fund is trying to match.[119] By contrast, stock pickers advising active funds research companies in order to make investment decisions.[120] Voting groups at advisers to active funds may be able to obtain information that

[116] *See* Jie (Jack) He, Jiekun Huang & Shan Zhao, *Internalizing Governance Externalities: The Role of Institutional Cross-Ownership*, 134 J. FIN. ECON. 400, 403-16 (2019) (presenting empirical evidence that cross-ownership incentivizes institutional investors to play a more active monitoring role).

[117] These guidelines are far more detailed than necessary to satisfy legal obligations. *See, e.g.*, Rock, *supra* note 14, at 489-90.

[118] *See, e.g.*, VANGUARD, PROXY VOTING GUIDELINES, *supra* note 104, at 4, 16 (explaining, for example, that Vanguard will vote against overboarded directors and in favor of proposals to declassify staggered boards).

[119] *Index Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing /investing-basics/investment-products/mutual-funds-and-exchange-traded-4 [https://perma.cc/S49V-BTDL] (last visited Sept. 23, 2020).

[120] *Id.*

stock pickers learn as a by-product of the investment activities at little additional expense.[121]

This spillover knowledge from investment activities can assist advisers to active funds when it comes to voting.[122] The significance of such spillover knowledge will depend on the specific issue on which votes are cast. Perhaps the clearest case in which spillover knowledge is important is a vote on a proposed merger, when stock pickers may have an assessment of the fundamental value of the merging companies, the regulatory risks, or the likelihood that a competing bidder may offer better terms. On other issues, by contrast, company-specific information that is obtained by stock pickers may be less important. Thus, for example, say-on-pay votes may turn mostly on issue-specific information (such as the best structure to provide incentives) or on company-specific information that is not the focus of stock pickers (such as the specifics of the compensation packages).

That spillover information from stock pickers is of little importance to many votes is also reflected in the fact that advisers to many active funds follow the recommendations of proxy advisers like ISS and Glass Lewis. Proxy advisers supply voting information and recommendations to their clients.[123] Importantly, proxy advisers do not employ stock pickers, so their recommendations do not incorporate spillover knowledge. That many investment advisers to active funds rarely deviate from the voting recommendations supplied by proxy advisers[124] shows that spillover knowledge may not be relevant to many votes.[125]

Even as to issues where spillover knowledge is important, several factors mitigate the handicap under which index fund advisers operate. First, advisers to index fund advisers have some access to spillover knowledge. BlackRock, a

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

[122] Lund, *supra* note 9, at 510-20 (discussing difference in knowledge requirements used to manage active funds as compared to passive funds).

[123] Christie Hayne & Marshall Vance, *Proxy Advisers: What Is the Proper Role?*, FIN. MGMT. (Nov. 19, 2019), https://www.fm-magazine.com/news/2019/nov/role-of-proxy-advisers-201922438.html [https://perma.cc/ARS7-EKBS].

[124] *See* Choi, Fisch & Kahan, *supra* note 30, at 50-68.

[125] Notably, although the Big Three may also use information supplied by proxy advisers as input, none of them closely follow the advisers' recommendations. *Id.* at 55-63. Rather, they base their votes on their own in-house analysis. *See* Bubb & Catan, *supra* note 34, at 3-4 (discussing Big Three's tendency to deviate from recommendations of proxy advisers). That proxy advisers have more influence over advisers to active funds than over the Big Three is consistent with our assessment that adviser size generates incentives for advisers to make independent assessments of how to vote on an issue. *See supra* Section I.B.1; *see also* Choi, Fisch & Kahan, *supra* note 30, at 61-63 (charting voting decisions of large funds compared to voting decisions of proxy advisers).

leading index fund adviser, also actively manages a very substantial amount of assets. As a result, BlackRock enjoys access to spillover knowledge generated by its own stock pickers.[126] Vanguard likewise markets substantial active funds. However, Vanguard's funds are either exclusively managed by an outside adviser (such as Primecap) or managed or comanaged by Vanguard's Quantitative Equity Group.[127] Thus, albeit to a lesser extent than BlackRock, Vanguard may be able to tap into spillover knowledge generated by its in-house Quantitative Equity Group or by outside advisers affiliated with Vanguard.[128] Finally, even advisers with no significant active equity funds can obtain knowledge through newspaper articles or industry contacts.[129]

Second, in high profile contests such as contested merger votes and 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.

Third, index fund advisers may be able to compensate for their limited access to spillover information from stock pickers by a different type of spillover knowledge. Because index funds tend to hold highly diversified portfolios, an index fund adviser may have obtained information *in the course of prior votes* that is material to a current vote.[130] For example, Vanguard may have

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

[127] In total, the domestic equity of all funds managed and comanaged by this group is about 7% of Vanguard's domestic equity assets. Charles Boccadoro, *Vanguard's Quantitative Equity Group*, SEEKING ALPHA (Nov. 2, 2016, 12:37 PM), https://seekingalpha.com/article/4018236-vanguards-quantitative-equity-group [https://perma.cc/9DL6-7YZN] (discussing Quantitative Equity Group with John Ameriks, head of Group).

[128] Geode, which advises Fidelity's index funds, has a similar affiliation with an active fund and also has an active management operation. *See* GEODE CAPITAL MANAGEMENT, https://www.geodecapital.com [https://perma.cc/73R9-YUCS] (last updated June 30, 2020).

[129] Indeed, when company-specific information is particularly valuable, advisers to active funds have incentives to share information that they consider pertinent to a vote with index fund advisers, both through formal and informal channels. *See, e.g.*, Barry B. Burr, *Pension Funds Divided on Dell Deal*, PENSIONS & INV. (July 22, 2013, 1:00 AM), http://www.pionline.com/article/20130722/PRINT/307229983/pension-funds-divided-on-dell-deal (reporting opposition to Dell LBO by several institutional investors); Alex Sherman, *Dell's VMware Deal May Hinge on How the Companies Split Up Value from Dell's Tracking Stock*, CNBC (Mar. 23, 2018, 3:47 PM), https://www.cnbc.com/2018/03/23/dell-vmware-deal-may-hinge-on-how-they-split-dells-tracking-stock.html [https://perma.cc/8S2A-5A6S] (reporting that T. Rowe Price publicly announced its opposition to the Dell-VMware merger).

[130] Such spillover knowledge is conceptually distinct from the economies of scope discussed in the prior Section. Economies of scope arise when an adviser invests more in acquiring this information because it knows that certain information is relevant to multiple

encountered an activist challenger in one of its prior election contests and may base its vote in the current contest in part on its assessment from the prior contest. Advisers with more concentrated portfolios would be less likely to have such information.

C. *Voting Distortions from Short-Term Trading Horizons*

Whether stock prices reflect fundamental values, what accounts for any deviations, and how easy it is to detect deviations are subjects of major controversy.[131] 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 nonpublic information.[132] Others disagree, some fervently.[133]

To be sure, even if the market is not fully efficient, changes in a company's long-term value will ultimately be reflected in its stock price or its payouts to shareholders. However, 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 instead those who became shareholders at a later point, when their effects on value became evident. In inefficient markets, therefore, a shareholder's trading horizon—the length of time a shareholder expects to hold on to stock 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 portfolio changes (mergers and similar events), voluntary portfolio changes, and net redemptions by mutual fund shareholders.

These factors affect active funds and index funds differently. While both types of funds are affected by involuntary portfolio changes and net redemptions, they differ with respect to voluntary portfolio changes. Index funds make quasi-voluntary portfolio changes only if the composition of the underlying index

votes. Spillover knowledge arises because an investment adviser (or a stock picker) happens to have acquired information for a different vote or purpose than is now relevant to the vote at hand.

[131] *See, e.g.*, Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 851-53 (1992); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 59-61 (2003) (discussing predicability of stock price movements).

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

[133] *See, e.g.*, Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 140-43 (2002) (discussing evidence against market efficiency). *See generally* JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET (2009).

changes (for example, when a firm enters or leaves the S&P 500 index).[134] Active funds, by contrast, make voluntary portfolio changes in response to changed assessments of their stock pickers. Historically and intrinsically, therefore, index funds have had a much lower portfolio turnover rate than active funds.[135] The average turnover rate—defined as the lesser of stock purchases and sales divided by average stock portfolio value[136]—for managed domestic stock funds was 63%.[137] In contrast, the average turnover rate for the Vanguard 500 Index Fund was 3.9%.[138] For funds with no net flows, these turnover rates imply an average holding period of 28.5 years for index funds and 2.9 years for active funds.[139]

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

Active funds are different. The very rationale for the existence of an active fund is that detectable deviations between fundamental value and stock price are common and significant enough to warrant running a fund designed to exploit them.[140] Deviations can, in principle, be due either to the failure of the stock price to reflect some element of fundamental value or to the incorporation by the stock price of some element that does not bear on fundamental value. The foundation of most active investing is to buy stock at a time when some positive elements of fundamental value are not incorporated or some irrelevant elements depress the stock price—*and* when the mispricing will be corrected soon enough to make it worthwhile to acquire the stock *now*.[141]

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[134] *See Index Funds*, *supra* note 119.

[135] *See* INV. CO. INST., *supra* note 2, at 124.

[136] James Chen, *Portfolio Turnover*, INVESTOPEDIA (Aug. 7, 2019), https://www.investopedia.com/terms/p/portfolioturnover.asp [https://perma.cc/NS35-HXN5].

[137] Stephan A. Abraham, *Turnover Ratios and Fund Quality*, INVESTOPEDIA (July 11, 2020), https://www.investopedia.com/articles/mutualfund/09/mutual-fund-turnover-rate.asp [https://perma.cc/9Y4M-C4XL].

[138] *Vanguard 500 Index Fund Admiral Shares (VFIAX)*, VANGUARD, https://investor.vanguard.com/mutual-funds/profile/portfolio/vfiax [https://perma.cc/6Y22-UT6Z?type=image] (last updated Aug. 31, 2020).

[139] Holding periods are calculated by dividing one by the turnover rate.

[140] Pam Krueger, *Active vs. Passive Investing: What's the Difference?*, INVESTOPEDIA (Sept. 5, 2020), https://www.investopedia.com/news/active-vs-passive-investing/ [https://perma.cc/9BQE-M3U8].

[141] Our argument that short-term trading horizons can cause voting distortions applies to most actively managed mutual funds. By contrast, activist hedge funds, unlike most actively managed mutual funds, do not try to exploit market inefficiencies; they try to generate value through their activist interventions. Rejection of the efficient market hypothesis, in other

Stock pickers may or may not be right in their assessment that a stock is undervalued and that the undervaluation will be corrected within a certain time frame. But whether they are is, for our purposes, irrelevant. Rather, what is relevant is what stock pickers believe. Stock pickers, in giving their views on a vote, will thus tend to give no weight to its effect on fundamental value if they *believe* that it will not be reflected in stock price by the time they sell the stock and will give weight to its effect on irrelevant elements if they *believe* it will be reflected in the stock price by the time they sell the stock. To the extent that stock pickers affect the vote, the shorter-term trading horizons of active funds in conjunction with their efforts to exploit market inefficiencies may therefore result in voting distortions. In particular, active funds designed to exploit transient inefficiencies in market prices, which would have very short-term trading horizons, would have only minimal incentives to invest in voting because they may sell their shares between the time they vote and the time the outcome of the vote becomes public.

Voting distortions generated by stock pickers are then the flip side of spillover knowledge generated by stock pickers. Just like stock pickers obtain spillover knowledge from their investment activities that can be beneficial in inducing votes that increase the stock price, stock pickers can induce deviations from value-maximizing votes to the extent that they believe—as they must—that stock prices do not always fully reflect fundamental values.

D. *How Incentives and Spillover Knowledge Stack Up*

For the Big Three, we now consider how incentives, economies of scope, spillover knowledge, and voting distortions stack up for the three categories of engagements that characterize contemporary corporate governance: Type A issues in which votes are likely to have a material impact on the value of an individual company, Type B issues involving market-wide governance standards, and Type C issues that relate to company-specific performance and governance.

1. Type A Issues: Market-Moving Votes

In the small number of high-profile election or merger contests, management and activists produce detailed presentations and meet in person with each of the large shareholders. The large stakes that the Big Three generally hold in the companies at issue give them a material stake in the outcome and mean that their votes have a high chance of being pivotal.[142] As a result, the Big Three have

words, is not part of the DNA of activist hedge funds. While activist hedge fund managers have limited trading horizons, and while they may not subscribe to the efficient market hypothesis, there is no *a priori* reason to assume that they believe that deviations between fundamental value and stock price are common and significant or that they orient their investment towards exploiting these inefficiencies.

[142] *See supra* Section I.B.1.

material incentives to acquire and analyze 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 than advisers to active funds, their incentives to acquire such information will often be superior to those of such advisers.[143]

To be sure, advisers to active funds will often benefit from spillover knowledge from the analyst side.[144] Such spillover knowledge decreases their need to acquire information just for voting purposes. The centralized voting groups at the Big Three may have less access to spillover knowledge from the analyst side than some advisers to active funds do.[145] On the other hand, the voting groups at the Big Three may benefit more from spillover knowledge from past contested votes that involved the same activists and will be less subject to voting distortions due to short-term trading horizons than advisers to active funds.

As advisers to index funds and advisers to active funds base their votes to some extent on differing sets of information, they may approach market-moving votes from somewhat different perspectives. Advisers to active funds, such as T. Rowe Price Advisers, may rely more on portfolio managers with deep knowledge of portfolio companies and may be more familiar with—and thus focus more on—management's shortcomings before the activist became involved. The Big Three may rely more on the prior record of the specific activist and may have a longer-term orientation.

But while their initial perspectives may differ, each set of advisers will also have some access to the perspective of the other set. The Big Three run their own, or are affiliated with other advisers that run, active funds; the financial press, proxy advisory firms, and, the contestants themselves will provide information and analysis, including information about the past record of the activist; and through personal or institutional connections, the voting group at one adviser will at least be somewhat aware of the views of the voting group at other advisers.

On the whole, there is no *a priori* reason to believe that one set of advisers will make systematically better decisions than the other set. Rather, the initially different perspectives of different advisers complement each other and together are likely to produce a superior voting outcome.

2. Type B Issues: Market-Wide Governance Standards

With respect to the setting of market-wide governance standards,[146] the Big Three are likely to have incentives and information that are superior to those of

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[143] *See supra* Section I.B.1.

[144] *See supra* Section II.B.

[145] *See supra* note 46 and accompanying text.

[146] Some refer to these issues as "corporate hygiene." *See, e.g.*, Joseph A. Grundfest & Michael Callahan, *Stanford Law's Joe Grundfest and Mike Callahan Correct Common*

advisers of active funds. Their larger stakes in individual companies and their wider economies of scope give the Big Three an inherent advantage.

In comparison, access to company-specific spillover knowledge from stock pickers will matter little for these types of votes. This is not because "one size fits all" on these governance issues. Rather, because the stakes in any individual vote are low and issue-specific information will often dominate company-specific information, even advisers to active funds may often not bother to integrate company-specific information in deciding how to vote.[147]

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

Advisers to actively managed funds, as well as activist hedge funds, are likely to be superior to advisers to index funds in identifying and addressing company-specific performance problems, whether through engagement on these issues or through voting.[148] Advisers to active funds and activist hedge funds have access to their stock pickers' assessments of the cause of poor performance that were generated for investment purposes. Especially for a poorly performing company in which such an adviser is substantially overweight, such advisers and funds may have sufficient incentives to engage with company management or outside directors to address the performance problems or to cast votes that reflect their performance concerns.

By contrast, while advisers to index funds can easily identify underperforming companies, the scarcity of in-house analysts makes it difficult for them to pinpoint the cause for low performance and recommend specific changes. In the ordinary course, therefore, they are unlikely to take the lead in addressing performance concerns through engagements or voting.[149]

Here, a division of labor that reflects the differing incentives of the different players seems to be emerging. Company-specific performance problems are raised in the first instance by the investors with the best incentives and capacity to do so: actively managed mutual funds and activist hedge funds. If a firm rejects their proposed suggestions for improvement, activists, if sufficiently determined, can force the issue by means of a proxy contest. This converts a Type C issue into a Type A issue and gets the Big Three involved.

Misconceptions About Corporate Governance in the Venture Capital Arena, STAN. L. SCH.: LEGAL AGGREGATE BLOG (Feb. 13, 2019), https://law.stanford.edu/2019/02/13/stanford-laws-joe-grundfest-and-mike-callahan-correct-common-misconceptions-about-corporate-governance-in-the-venture-capital-arena/ [https://perma.cc/3666-UVCZ].

[147] T. Rowe Price, for example, has developed proxy voting guidelines that address many recurrent governance issues on a one-size-fits-all basis. T. ROWE PRICE, PROXY VOTING GUIDELINES 4-5 (2020), https://www.troweprice.com/content/dam/trowecorp/Pdfs/51326_TRP_Proxy_Voting_Guide_EN_PE_0220_HI_NC.pdf [https://perma.cc/482U-5DCC].

[148] Sell-side securities analysts, whose recommendations affect the pricing of stocks in the secondary market, also provide information that assists in the identification of performance problems. *See* Anne Heinrichs, Jihwon Park & Eugene F. Soltes, *Who Consumes Firm Disclosures? Evidence from Earnings Conference Calls*, 94 ACCT. REV. 205, 207-17 (2019).

[149] *See* Bebchuk & Hirst, *The Specter of the Giant Three*, *supra* note 11, at 731-37.

Company-specific *governance* issues, by contrast, are often handled by the Big Three stewardship groups in their periodic engagement meetings. Here, as discussed above, the Big Three are likely to have good information and incentives, and, unless the governance problem has already started to effect performance, actively managed mutual funds and hedge funds tend to be uninterested.

III. CONFLICTS

Investment advisers to mutual funds face a myriad of potential conflicts of interest. Conflicts can arise between an investment adviser and mutual fund shareholders, between a mutual fund (as shareholder of a company) and other shareholders of the same company, and among funds managed by the same adviser. Most of these conflicts are not specific to advisers to index funds; indeed, some affect mostly advisers to active funds. However, some conflicts may be more prevalent in the Big Three than in smaller advisers.

Since prior literature has discussed the first two sets of conflicts at length, we address them only briefly.[150] We discuss the third set in more detail.

A. *Adviser-Investor Conflicts*

Adviser-investor conflicts are mostly generated by other business operations of an investment adviser. Many investment advisers for mutual funds are affiliated with financial institutions such as investment banks or insurance companies.[151] Others manage corporate defined-benefit and defined-contribution pension plans. Such advisers may be reluctant to antagonize potential banking or insurance clients or companies that may engage them to run their pension funds.[152]

The reputational and marketing interests of investment advisers that we discussed earlier[153] may also give rise to conflicts. Consider, for example, ESG issues such as climate change or sustainability. The well-known letter by Larry Fink stressing BlackRock's commitment to ESG issues[154] may reflect his sincere belief that a greater focus on ESG will promote the long-term value of portfolio companies. But it may also reflect an attempt to shore up BlackRock's public image, market its funds, or fend off regulation. To the extent that advisers—for reputational or marketing reasons—take positions or cast votes that reduce firm value, their interests conflict with those of at least some of their fund investors.

[150] *See, e.g.*, Rock, *supra* note 14, at 468-76 (discussing conflicts that may arise in managing a fund).

[151] Kahan & Rock, *Hedge Funds in Corporate Governance*, *supra* note 14, at 1054 (reporting that nine of twenty largest mutual fund families had affiliations with financial institutions).

[152] *Id.* at 1055.

[153] *See supra* Section I.B.3.

[154] *See supra* text accompanying note 107.

To the extent that such conflicts arise, both competitive pressures and politics limit the degree to which advisers can deviate from pursuing goals that conflict with investor interests. On the competitive front, State Street responded to Larry Fink's letter by emphasizing that it pursues "value not values."[155] State Street, in other words, tried to appeal to investors that do not share Fink's "values" or who were not willing to sacrifice "value" to promote them. On the political front, former Senator Phil Gramm has castigated large institutional investors for using investors' money to pursue liberal goals that they have failed to achieve legislatively.[156]

B. *Intrashareholder Conflicts*

A second long-recognized source of conflicts derives from the desire of stock pickers to maintain cordial relationships with managers of their portfolio companies.[157] Stock pickers benefit from such relationships to get their questions answered in public venues and to obtain information privately that may not be legally material on its own but helps them fill gaps in their understanding of the firm's operations.[158] They use this access to make better predictions of stock price movements and hence for the benefit of fund shareholders. But to the extent that they maintain such access by not casting votes against management when doing so would enhance firm value, they do so at the expense of shareholders at large. Advisers to index funds, which rely less on stock pickers, would be less affected by these conflicts than advisers to active funds.

[155] Cyrus Taraporevala, *Index Funds Must Be Activists to Serve Investors*, FIN. TIMES, July 25, 2018, at 9 ("We are creating longterm value; not imposing values."). *But see* DOUGLAS BEAL ET AL., BOS. CONSULTING GRP., TOTAL SOCIETAL IMPACT: A NEW LENS FOR STRATEGY 3-9, 38 (2017) (advocating for intergating ESG issues into corporate strategy).

[156] Phil Gramm & Mike Solon, Opinion, *Keep Politics Out of the Boardroom*, WALL STREET J., July 19, 2018, at A17 ("Arguments for imposing political and social objectives on business often are little more than rationalizations for forcing businesses to abide by values that have been rejected in Congress . . . .").

[157] *See* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1054-56 (2003) (noting conflicts from securities analysts attempting to maintain their standing with or curry favor from sources of information).

[158] There is evidence suggesting that companies sometimes retaliate against analysts by avoiding their questions in conference calls. Susan Pulliam, *Analysts to Tell Congress That Skepticism Gets Them Abuse*, WALL STREET J., Mar. 19, 2002, at C1.

C. *Fund Family Conflicts*

Conflicts among funds managed by the same adviser constitute a third set of conflicts.[159] Consider, for example, a proposed merger between companies A and B. Suppose that an investment adviser believes that the price that A is offering for B is too low.[160] This creates potential conflicts of interest between funds that are equally weighted in A and B (for which the price is irrelevant), funds that may be overweight in B (for which the price is a reason to oppose the merger), and funds that are overweight in A (for which the price is a reason to support the merger).

More fundamentally, because advisers charge higher fees to active funds than to index funds, advisers that manage both types of funds have incentives to benefit active funds at the expense of index funds. Consider, for example, Amazon's recent acquisition of PillPack, an online pharmacy.[161] The acquisition sent the shares of pharmacy stocks like CVS, Walgreens, and Rite Aid plummeting.[162] Suppose that an active fund in a family with a large index fund is overweight in Amazon and underweight in pharmacy stocks. Its portfolio manager would like the adviser to vote the shares held by the index fund to support the acquisition of PillPack. That the acquisition will cause other stocks to decline is a matter of indifference (or even joy) to its portfolio manager. But

[159] *See* Fisch, Hamdani & Davidoff Solomon, *supra* note 98, at 33-36; Aneel Keswani, Anh Tran & Paolo Volpin, *Institutional Debt Holder Governance* 28-29 (European Corp. Governance Inst., Finance Working Paper No. 613/2019, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282394 [https://perma.cc/D3XD-RSCQ] (presenting empirical evidence that holdings by fund family of corporate bonds of a firm is associated with higher propensity of voting shares in that firm in line with the interests of firm debt holders); Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS 175, 178-83 (2017); Morley, *supra* note 15, at 1261-63 (discussing conflicts among funds managed by the same adviser).

[160] This was arguably the case with the 2002 Hewlett Packard–Compaq merger, see ROBERT F. BRUNER & ANNA D. BUCHANAN, THE MERGER OF HEWLETT-PACKARD AND COMPAQ (A): STRATEGY AND VALUATION 9-10 (2004) (noting that critics "contended that HP was paying too much for Compaq and that shareholder value would be destroyed by the merger"), and the 2007 CVS-Caremark merger, see *Caremark Says Shareholders Approve CVS Merger*, N.Y. TIMES: DEALBOOK (Mar. 16, 2007, 10:19 AM), https://dealbook.nytimes.com/2007/03/16/caremark-says-shareholders-approved-cvs-deal/ [https://perma.cc/US3Y-H2KY] ("CVS took fire for offering bids that analysts said were too low.").

[161] *See* Matt Levine, *Profiting from Disruption Trades*, BLOOMBERG (June 29, 2018, 11:02 AM), https://www.bloomberg.com/view/articles/2018-06-29/profiting-from-disruption-trades.

[162] *Id.*; *see also* Sharon Terlep & Laura Stevens, *Amazon Shakes Up Pharmacy Business—A $1 Billion Deal for Website PillPack Poses Direct Threat to the Industry*, WALL STREET J., June 29, 2018, at B1 (discussing potential negative effects of deal).

the index fund will, of course, hold shares in all those companies, and investors in that fund will suffer from the price drop.

Note the subtlety of the problem: while Amazon's acquisition of PillPack might hurt investors in the index fund, it will have no effect on the *relative* performance of the index fund vis-à-vis competing index funds—and thus will not hurt the management company in its index fund competition—but it will improve the relative performance of the active fund vis-à-vis other active funds. From that perspective, running an index fund can produce a win-win for an adviser to active funds. It adds to the heft of an adviser, which may be used to increase returns to active funds and overall fee income, and, even if index fund returns decline, the index funds would not be disadvantaged in its competition with other index funds.[163]

There are two basic ways to handle these conflicts: case by case or structurally. One can, for example, delegate the voting decisions to the managers of individual funds whenever such conflicts arise. This is how Vanguard handles the potential conflicts of interest among its funds. For example, in the CVS-Caremark merger, some Vanguard funds voted in favor of the merger while

[163] 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? Would not the assets in Fidelity's 500 Index Fund, a $150 billion index fund, be valuable support when a portfolio company board considers the views of a Fidelity Contrafund portfolio manager? The history is interesting. Geode was originally part of Fidelity and was used to experiment with higher-risk computer trading strategies. *See* John Hechinger, *Fidelity Spins Off Geode Investors—Move Could Allay Concerns About Conflicts of Interest*, WALL STREET J., Aug. 5, 2003, at D7 (detailing Fidelity's spin-off of in-house investment firm Geode). These "experiments" raised concerns that Fidelity might be betting against its own investors in its funds. *Id.* To assuage these concerns, Geode was spun off in 2003. *Id.* Post spinoff, Geode's CEO was a Fidelity veteran, Jacques Perold, who had run Geode at Fidelity and had overseen Fidelity's $28 billion in index funds as part of those responsibilities. *Id.* In what the *Wall Street Journal* described as a "coup" for Geode's CEO, Geode took the index funds with it. *Id.* ("Fidelity, which prefers to stress stock-picking, said it doesn't consider indexing a 'core business.'"). Interestingly, Perold left Geode in 2009 to return to Fidelity Asset Management, Inc. as president. *See* Erin Kello, *Fido Finally Finds Its Top Asset Management Exec*, THEMUTUALFUNDWIRE.COM (May 21, 2009), http://www.mfwire.com/article.asp?storyID=21616&template=article&bhcp=1 [https://perma.cc/6DKW-MGNJ].

others voted against it.[164] Alternatively, one can delegate the voting of index fund shares to an independent company, as in the case of Fidelity and Geode.[165]

For advisers 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 if advisers have significant direct incentives to vote intelligently. But delegating voting authority to another entity reduces direct incentives. By contrast, material conflicts, while real, do not arise frequently and can thus be handled on a case-by-case basis.

D. *Conflicts and Voting Rights*

Mutual fund investment advisers, of course, are not the only shareholders to face potential conflicts. Public pension funds face political constraints and conflicts of interests that may bias their voting, including pressure from groups that pursue aims other than increasing firm value.[166] Union-affiliated pension funds may pursue a labor agenda.[167] Managers and other employees of the firm who are shareholders may vote their shares to maintain their job security and improve the terms of their employment. Controlling shareholders may vote to preserve their private benefits of control by opposing measures that dilute such control (such as issuance of additional voting stock) or hamper their effective exercise of control (such as the election of independent-minded directors). Hedge fund managers, though well incentivized to maximize the value of their funds,[168] may pursue complex investment strategies that can drive a wedge between what is best for the hedge fund and what is best for other company shareholders.[169]

The pervasive potential for conflicts of interests is yet another reason why one should be reluctant to deprive some shareholders of voting rights because their incentives to cast an informed vote are lower than those of other shareholders.

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164 In the CVS-Caremark deal, the 500 Index Fund voted all shares of both companies *against* the CVS-Caremark merger, while Vanguard's Specialized Health Care Fund voted *in favor*. Vanguard Index Funds, Annual Report of Proxy Voting Record (Form N-PX) (Aug. 22, 2007); Vanguard Specialized Funds, Annual Report of Proxy Voting Record (Form N-PX) (Aug. 22, 2007); *see also* Patrick Dennis, Kristopher Gerardi & Carola Schenone, *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* 21 n.35, (Fed. Reserve Bank of Atlanta Working Paper Series, Working Paper No. 2019-15, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3423505 [https://perma.cc/TJ8A-32MN] (describing instances of dissenting votes by funds within fund families).

165 *See* Hechinger, *supra* note 163.

166 Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1416-18 (2011).

167 Kahan & Rock, *Hedge Funds in Corporate Governance*, *supra* note 14, at 1060-62 (discussing affiliation with labor unions by funds).

168 *Id.* at 1066-68 (analyzing conflict differences between mutual funds and hedge funds).

169 *Id.* at 1072-77 (detailing differing hedge fund view when buying as compared to selling).

The shareholders with superior incentives to cast an *informed* vote may have conflicts of interest that distort their incentives to vote for the outcome that *maximizes company value*. Thus, for example, advisers to index funds may lack access to spillover knowledge that comes from stock picking, while advisers to active funds with access to such spillover knowledge may be conflicted due to their desire to maintain good relationships between analysts and managers.

In a world in which incentives to become informed and conflicts of interest are a matter of degree and where virtually the only group of shareholders without conflicts—retail investors—is also the group that has the least overall incentives to become informed, it is hard to achieve superior outcomes by fine-tuning the voting system. While we see room for some modest measures designed to reduce conflicts of interest, such as enhanced disclosure requirements of business relationships between advisers and portfolio companies,[170] we are skeptical about the merits of broader schemes.[171]

CONCLUSION

With the growth of institutional investors, power in the governance of U.S. corporations has shifted significantly from managers to shareholders. In the highest profile contests between hedge funds and managers, the largest institutional investors are often the presumptive deciders. And in the determination of governance best practices, the largest institutional investors, along with the proxy advisory firms, act as standard setters.

With this newfound power has come a vast increase in scrutiny as well as a significant dose of paranoia. The Big Three—BlackRock, Vanguard, and State Street—have been buffeted with suggestions as to what they should do, what they should not do, how they should do it, and how many people they should hire. Some have even suggested that they be broken up or forced to choose between abandoning their business model and committing to complete governance passivity.[172]

But someone has to decide key corporate governance issues. Corporate voting is highly imperfect; it entails severe collective action problems and low-to-moderate conflicts of interest are widespread. Most publicly traded corporations

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[170] *See* Bebchuk & Hirst, *The Specter of the Giant Three*, *supra* note 11, at 737-41 (proposing such requirements).

[171] For example, Bebchuk and Hirst also propose prohibiting investment managers from administering 401(k) plans for employers. *Id.* at 726. But the assets of 401(k) plans are inherently invested in mutual funds and investment advisers will thus continue to have an interest in attracting investments from 401(k) plan participants.

[172] Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669, 708 (2017) (proposing that index funds should be limited to maximum of 1% total holding in oligopolistic industry or opt for pure passivity—not casting any votes and abstaining from any meetings with executives).

have few individual shareholders that have a stake sufficient to lead them to become informed but do not also suffer from severe conflicts of interest.

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

We do not believe that such a case has been made. Advisers to index funds—including, in particular, the Big Three, which manage the bulk of index fund assets—compare favorably to advisers of active funds in some respects and unfavorably in others. Small individual shareholders, who are least likely to have conflicts of interests, have among the worst incentives to become informed. Public pension funds generally have worse incentives than large mutual fund advisers and are subject to different types of conflicts.

While no class of corporate voters can be relied upon invariably to cast informed votes to maximize the value of companies, different institutions have different advantages that complement each other. Advisers to index funds, in particular, tend to hold high stakes in companies and have correspondingly high direct incentives to become informed, benefit from economies of scope, and have a long-term trading horizon. Large advisers to active funds have greater access to spillover knowledge, and smaller advisers as well as hedge funds may in addition have significant flow-based incentives. They can all play a valuable role in corporate governance. Rather than trying to fine-tune this complex system by depriving some shareholders of their voting rights or by imposing special rules on index funds, we therefore favor letting shareholders be shareholders.