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'Public' Mutual Funds

Jeff Schwartz

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The concentration of public equity in the hands of just a few mutual-fund complexes has raised concerns about whether these institutions take seriously the stewardship obligations that come with the significant voting power that they have amassed. One leading theory, the agency-cost theory, is that the major fund complexes, all of which specialize in passively managed funds, lack the incentive to adequately police corporate managers on behalf of fund shareholders. Others counter that competition for mutual-fund investors provides sufficient incentive for satisfactory oversight.

I argue that neither agency costs nor competitive incentives are the primary driver of stewardship behavior. Rather, the large mutual-fund complexes act out of fear of public retribution. They recognize that failure to look like good stewards could lead to potentially costly regulations. This 'publicness' view stems from work that explains important aspects of securities regulation as a response to the public's desire to impose accountability and transparency mechanisms usually associated with public bodies on powerful private institutions. This lens suggests that large mutual-fund complexes act as stewards to avoid the consequences of publicness, but does not suggest a need for reform.

Keywords: mutual funds, stewardship, publicness, agency costs, index funds, Vanguard, BlackRock, State Street

"We are not a public company, but we must continuously earn and maintain the public trust."

—Vanguard[1]

The rise of mutual funds has been a defining trend in finance. Unlike many financial innovations, they have greatly improved the financial well-being of retail investors, many of whom invest in mutual funds to save for retirement.[2] Over the last 40 years, the bulk of retail

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[1] Glenn Booraem, *What We Do. How We Do It. Why It Matters*, 14 (2019), https:// about.vanguard.com/investment-stewardship/perspectives-and-commentary/ what_how_why.pdf (*quoted in* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2072 n.112 (2019)).

[2] INV. CO. INST., 20201 INVESTMENT COMPANY FACT BOOK (60th ed.), fig 7.10, 151 (2020) (showing that mutual funds hold about $10 trillion in tax-favored retirement accounts).

investors have shifted from owning stocks directly in companies to holding them through these financial intermediaries.[3] This is a foremost example of economic theory impacting behavior and bettering peoples' lives. Finance theory teaches the value of a diversified portfolio. Mutual funds offer diversification otherwise unobtainable to typical investors. Finance theory also teaches that investors, on average, cannot earn returns in excess of the market.[4] Through passively managed funds (i.e., index funds), investors can own a portfolio that simply tracks an index of securities. This frees them from fruitless stock-picking and unnecessary fees finance professionals charge for it.[5]

Though a boon to investors, the tidal success of mutual funds has also brought challenges. Professional stock pickers add value to markets because their buying and selling activities bring stocks closer to fundamental value.[6] Some worry that the widespread shift to index funds means that there are too few monitoring what stocks are actually worth, meaning that today's prices may be far off.[7]

The popularity of mutual funds has also brought concentrated ownership. When investors hold shares in companies through mutual funds, the funds are technically the

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[3] Kristian Rydqvist et al., *The Evolution of Aggregate Stock Ownership: A Unified Explanation*, CEPR Discussion Paper No. DP7356 (2009), *available at* https://www.ifk-cfs.de/fileadmin/downloads/events/conferences/2011-07-01-Rydqvist_et_al.pdf (discussing the trend of declining individual ownership of investment assets). Today, institutions own about 80% of the stock market. *See* Charles McGrath, Pension & Investments, *80% of Equity Market Cap Held by Institutions* (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

[4] William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J., Jan.-Feb. 1991, at 7 (*quoted in* Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 550 (2009)).

[5] The conventional wisdom, and much empirical work, suggests that—on average and after fees—actively managed mutual funds underperform passively managed ones; but there is recent evidence to the contrary. *See generally* Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. 1 (2015) (discussing conflicting evidence and finding that active management adds value).

[6] Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 183 (2010).

[7] *See generally* STEVEN D. BLEIBERG ET AL., EPOCH INV. PARTNERS, THE IMPACT OF PASSIVE INVESTING ON MARKET EFFICIENCY (2017). In this volume, Professor Krug also argues that passive management compromises investor protection. *See generally* Anita Krug, *The Overlooked Effects of Passive Management*, *in* THE CAMBRIDGE HANDBOOK OF INVESTOR PROTECTION, (Arthur Laby ed., *forthcoming* 2020).

shareholders of the company. Voting rights formerly dispersed among countless individual investors have become concentrated in mutual funds. Beyond that, a few mutual-fund complexes dominate the industry. Considered together, the so-called "Big 3"—Vanguard, State Street, and Blackrock—are the largest shareholder in nearly ninety percent of S&P 500 firms.[8]

The implications of this fundamental shift in corporate control are something that scholars are just beginning to grapple with.[9] One key concern involves how it impacts competition among portfolio firms.[10] Controversial empirical work suggests that concentrated equity ownership has anticompetitive effects.[11]

A related concern—and the focus here—is corporate stewardship. The shift in voting power from individual owners to the Big 3, among other major fund complexes, begs the question whether these institutions take their corporate governance rights seriously. Two competing models of mutual-fund voting have recently emerged that seek to answer this question; I introduce a third.

Professors Lucien Bebchuk and Scott Hirst argue that mutual funds, the Big 3 in particular, serve as poor stewards because they lack the incentive to expend the necessary resources.[12] In what they refer to as an "agency cost" model, the authors contend that these mutual-fund complexes do not fully internalize the benefits of good corporate governance at the

[8] *See* Jan Fichtner et al., *These Three Firms Own Corporate America*, The CONVERSATION (May 10, 2017), http://theconversation.com/these-three-firms-own-corporate-america-77072.
[9] *See, e.g.,* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1261 (2014); 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, 867 (2013); *see generally* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Harvard Pub. Law Working Paper No. 19-07 2018), https://corpgov.law.harvard.edu/wp- content/uploads/2019/11/John-Coates.pdf.
[10] *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).
[11] *See* Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—and Why Antitrust Law Can Fix It*, 10 HARV. BUS. L. REV. 207, 218-54 (2020) (reviewing empirical literature).
[12] Bebchuk & Hirst, *supra* note 1, at 2052.

firms that they own and therefore underinvest.[13] This results in lack of adequate oversight of portfolio firms.[14] The authors argue for a number of reforms to address this.[15] Professors Jill Fisch, Asaf Hammadi, and Steven Davidoff Solomon ("FHDS") see the opposite.[16] They argue that the major mutual-fund complexes have ample competitive incentive to invest in corporate governance, and that no regulatory changes are necessary.[17] I refer to this as the "competitive incentive" model.

I argue that both views, while important and illuminating, fail to capture the fundamental driver of voting behavior at large mutual-fund complexes. The value proposition of stewardship for mutual funds and their shareholders is uncertain.[18] But mutual funds, especially the Big 3 fund complexes, are keenly aware that the public is watching them. This drives them to participate in corporate governance just enough to ward off public opprobrium and potential regulation. This explanation for their voting behavior can be characterized as a "publicness" model. It builds on the publicness view of securities regulation, which starts from the insight that even though public companies are nongovernmental entities, they have comparable power.[19] The public thus demands transparency and accountability from these entities akin to truly public institutions.[20] Companies seek to ward off regulation by quelling such fears.[21] I extend this

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[13] *Id.*
[14] *Id.* at 2084 ("the total benefit produced by [Big 3] stewardship is less than would be desirable for their beneficial investors.")
[15] *Id.* at 2116-17.
[16] *See generally* Jill Fisch et al., *The New Titans of Wall Street*, *A Theoretical Framework for Passive Investors*, 168 PENN. L. REV. 17 (2019).
[17] *Id.* at 26-27.
[18] *See infra* Part II.D.
[19] *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1066 (2009); *see generally* Donald C. Langevoort & Robert B. Thompson, *'Publicness' in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013); Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 138 (2011); Hillary A. Sale, *Public Governance*, 81 GEO. W. L. REV. 1012 (2013).
[20] *See* Langevoort, *supra* note 19, at 1066.
[21] This implication of publicness has not yet been fully explored, though Professor Sale lays the groundwork: "Corporate actors who want to maintain a zone of self-regulation must act with an understanding of the nature of

concept to large mutual-fund complexes. Their reluctance to engage in stewardship until pushed by regulators and public pressure, combined with their approach to stewardship, in which they expend few resources and favor the same things regulators do, suggests they are driven more by publicness concerns than agency costs or competition.

The publicness lens is descriptive, rather than normative. It is too abstract to provide a roadmap for reform. Nevertheless, analyzing the Big 3's actions in terms of publicness suggests that immediate regulatory changes are unnecessary. Although the Big 3 may not be engaging in stewardship for the ideal reasons, their actions seem to largely align with the best interests of the mutual-fund shareholders whom they are supposed to represent.

In Part I, I describe the unique and counterintuitive structure of the mutual-fund industry and how this structure fits in with public-company governance. Part II describes and critiques both the agency-cost and the competitive-incentive models. Finally, Part III introduces the publicness model and explores its implications.

I. Mutual Funds and Public-Company Governance

A. The Mutual Fund Industry

Mutual funds are pooled investment vehicles.[22] Investors purchase shares in a fund, which is frequently organized as a corporation. The fund then invests shareholder money in securities, typically stocks or bonds. The fund owns the securities. The fund investors own shares in the fund, which entitles them to an indirect pro-rata claim to the underlying fund

corporate publicness. The failure to do so will result in further pressure for more public governance…" Sale, *Public Governance*, *supra* note 19, at 1033.

[22] For an overview of mutual-fund structure, see Jeff Schwartz, *Mutual Fund Conflicts of Interest in the Wake of the Short-term Trading Scandals: Structural Change Through Shareholder Choice*, 2 N.Y.U. J. L. & BUS. 91, 93-98 (2005).

holdings. Mutual funds themselves do not have officers or employees or any assets aside from the portfolio. Rather, the fund is managed by its sponsor, which is typically an independently owned entity.[23] Some, including Blackrock and State Street, are even public companies. A fund sponsor may manage hundreds of individual mutual funds.

The U.S. mutual-fund industry is huge. At the end of 2019, there were about 21,000 mutual funds[24] managed by 826 sponsors.[25] The industry as a whole owns 32% of public equity.[26] It has about $25.7 trillion in assets under management.[27]

A key distinction in the industry, which is particularly relevant to mutual-fund voting, is whether a fund is actively or passively managed. In an actively managed equity fund, the sponsor attempts to beat the market by picking good stocks, buying low, and selling high. A passively managed fund invests in an index of securities, like the S&P 500, without any attempt at stock picking or market timing. Passively managed funds have grown tremendously in recent years. In 2009, they held about $1.5 trillion in assets; 10 years later they held about $8.4 trillion.[28] Over that time period, they went from 18% of total U.S. fund holdings to 38%.[29]

The Big 3 sponsors advise primarily passive funds, although each has significant active holdings. About two-thirds of BlackRock's holdings are passive; 75% of Vanguard's; and 80% of State Street's.[30]

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[23] Vanguard is an important exception. Its firms are generally "internally managed," meaning that the mutual fund employs its managers. There is no Vanguard sponsor with its own shareholders; instead each mutual-fund investor owns a Vanguard mutual fund. *See* Schwartz, *supra* note 22, at 133-35.
[24] INV. CO. INST., *supra* note 2, at 31 fig. 2.2.
[25] *Id.* at 44.
[26] *Id.* at i.
[27] *Id.*
[28] *See id.* at 39 fig. 2.8.
[29] *Id.*
[30] HORTENSE BIOY ET AL., PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP 4 (2017), https://www-prd.morningstar.com/content/dam/ marketing/shared/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf

Because index funds have low overhead, they charge lower fees than actively managed funds, sometimes even zero.[31] This makes them an attractive proposition, especially given long-standing doubts about whether active management justifies the costs.[32]

The Big 3's formidable holdings have given them enormous voting power. As noted earlier, they are collectively the largest shareholder in about 90% of the largest companies. And this understates their influence. Individual investors vote less than 1/3rd of their shares while institutions vote almost all of them.[33] As a result, mutual funds, the Big 3 in particular, are the dominant players in corporate governance.

B. Public Company Corporate Governance

The rise of mutual funds has upended the traditional view of corporate governance and its shortcomings. Corporate governance consists of three layers. Officers run the day-to-day affairs of corporations. Boards of directors select the officers, decide their compensation, and oversee them. Shareholders elect the members of the board. They also have the right to vote on fundamental matters, like change-of-control transactions,[34] and the right to make and vote on nonbinding shareholder proposals. The recently enacted "say-on-pay" rules provide that public company shareholders have the additional right to vote on executive compensation, although the vote is nonbinding and occurs after the compensation award has already been determined.[35]

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[31] *See* Jeff Sommer, *A Price War Has Driven Fund Fees to Zero. They May Be Set to Drop Further.*, N.Y. TIMES (Apr. 5, 2019), https://www.nytimes.com/2019/04/05/business/price-war-fund-fees-zero-negative.html.
[32] *See* discussion *supra* note 5.
[33] *See* PROXY PULSE, 2019 PROXY SEASON REVIEW 5 (2019), https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2019-review.pdf; *See, e.g.,* Bioy et al., *supra* note 30, at 11.
[34] Del. Gen. Corp. L. 242, 251 (2020).
[35] 17 CFR § 240.14a-21 (2020).

The conventional law-and-economics conception of corporate governance views this setup as a mechanism to police managerial agency costs.[36] Shareholders are conceptualized as the owners of the corporation and executive officers as their agents, duty-bound to maximize profits on the shareholders' behalf. Like all agents, however, officers have an incentive to shirk their responsibilities and engage in self-dealing. The board's role is to police the executives for such behaviors on behalf of the shareholders.

Scholars viewed this arrangement as unsatisfactory for almost 100 years, but changes to regulations and corporate practices, as well as the rise of mutual funds have made the critique far less powerful. The Berle-Means thesis, as this longstanding critique is known, maintains that dispersed public ownership renders corporate management unaccountable.[37] In its modern form, the theory is that the board of directors insufficiently police shareholder interests. Uninformed public-company shareholders with small holdings lack both the expertise and incentive to ensure that the board is actually monitoring management. Without shareholder oversight, boards relinquish their supervisory role and executives runs amuck. Management compensation and perquisites skyrocket while shareholder returns languish.

Under this lasting view of corporate governance, the principal challenge was to align management incentives with shareholders and bolster board oversight. Over the last thirty years, reformers have made major inroads with respect to both goals. Concern about management agency costs fueled a migration to stock-based executive compensation. The trend began in the 1980s and now equity awards make up the bulk of executive pay.[38] Fear of ineffectual boards

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[36] D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1059 (1996).
[37] For *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[38] *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1917-18 (2013).

also led to independence requirements. The NYSE and Nasdaq now require that listed firm boards are majority independent.[39] With management compensation now tied to stock performance and their work subject to review by independent directors, concerns about management effort and devotion are less salient.

And now the key factual underpinning of Berle-Means is dubious. The thesis assumes that retail investors are widely dispersed and unsophisticated. This is why they cannot properly oversee corporate boards and managers. The rise of mutual funds means that this is no longer true. A handful of sophisticated institutions now hold what amount to controlling voting blocks.[40] They are much better positioned to oversee boards. If mutual funds are reliable corporate-governance stewards, then the era of Berle-Means has come to an end.

It is often said that it takes a theory to beat a theory. A theory of mutual-fund voting is a key underpinning for a new theory of corporate governance. This is where the agency-cost model and the competitive-incentive model fit in—as competing theories about the nature of mutual-fund stewardship.

II. Competing Theories of Mutual-Fund Stewardship

A. The Agency-Cost Model

Bebchuk and Hirst argue that agency costs are the "first-order driver of stewardship decisions" at the Big 3.[41] Agency costs at these fund complexes create an incentive for them to underinvest in stewardship and excessively defer to corporate management.

[39] *See* NASDAQ, THE NASDAQ STOCK MARKET LLC RULES 5605 (2020), http://nasdaq.cchwallstreet.com/NASDAQ/Main/; NYSE, NYSE LISTED COMPANY MANUAL § 303A.01, https://nyseguide.srorules.com/listed-company-manual.
[40] *See* Coates, *supra* note 9, at 13-14 ("'The Big 3' … controlled approximately 15% of the S&P 500 in 2017 -- a much greater share of US public companies than any three single investors have ever previously done.").
[41] Bebchuk & Hirst, *supra* note 1, at 2042.

According to Bebchuk and Hirst, the agency costs primarily stem from positive externalities. A fundamental economic principle is that activities that generate benefits for third parties will be underprovided. Agitating for performance-improving change at public companies has always been seen as one such activity. It is expensive and risky to challenge incumbent management and gains are shared with all shareholders. The so-called "Wall Street Rule" says it makes more sense to sell than to steer a poorly performing firm toward a more promising future.[42]

Bebchuk and Hirst extend this line of thought to the fund context. Individual funds bear the full costs of stewardship investments, but gains are shared with other funds. The incentive is, therefore, to underinvest.[43] Their focus is passively managed funds. Take an S&P 500 index fund. Because these funds hold the same companies in the same proportion, gains in performance brought about through stewardship investments by one S&P 500 index fund are shared identically with all other such funds. That being the case, there is no competitive advantage gained through stewardship.[44] The authors argue in other work that the problem is similar for actively managed funds.[45] Any gains from stewardship are shared with all other active managers that hold the same investment.[46]

The Bebchuk-Hirst critique also highlights positive externalities within the fund. They argue that fund sponsors fail to internalize all of the gains from stewardship that accrue to its own funds. Fund shareholders gain pro rata from the increase in the value of portfolio companies that stem from performance-enhancing interventions. But the sponsors charge a fee

[42] *Id.* at 2052.
[43] *Id.* at 2052.
[44] *Id.* at 2056-57.
[45] *Id.* at 2118; *See also* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 95-104 (2017).
[46] Bebchuk & Hirst, *supra* note 1, at 2059.

based on the percentage of assets under management. Thus, they only get a small compensation uptick based on any increased fund value from stewardship.[47] Since they do not internalize all of the gains from active oversight, they have an incentive to underinvest in it.

Bebchuk and Hirst also argue that the incentive to be passive is combined with an incentive to be deferential to management. Sponsors compete to administer the 401(k) plans of the very same public companies in which their funds invest. 401(k) plans give employees the opportunity to set aside a portion of their salaries in mutual funds on a tax-favored basis.[48] If a sponsor wins a company's 401(k) business, then company employees will be channeled toward the sponsor's funds. This means fees for the sponsor from both administration and fund management.[49] It, therefore, cannot be good for business for sponsors to challenge the managers of portfolio companies. These same managers choose, or have power over those who choose, what sponsor oversees their company's 401(k) plan. According to Bebchuk at Hirst, while fund shareholders want sponsors to actively oversee companies in their funds, the sponsors themselves have the incentive to treat them with kid gloves.[50] Because all public companies are potential clients, the incentive to defer even exists for companies where the fund has no investments.[51]

A further disincentive, according to Bebchuk and Hirst, is that active involvement might lead to a political backlash. If sponsors challenge powerful executives at public companies, they might lobby politicians to enact costly mutual-fund regulations.[52]

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[47] *Id.* at 2054-55.
[48] For a critique of 401(k) plans, *see generally* Jeff Schwartz, *Rethinking 401(k)s,* 49 HARV. J. LEG. 53 (2012). For a critique in this volume, *see generally* Natalya Shnitser, *Retirement Plan Reforms in the Absence of a Retirement Policy*, *in* THE CAMBRIDGE HANDBOOK OF INVESTOR PROTECTION, (Arthur Laby ed., *forthcoming* 2020).
[49] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES, GAO-O7-21, 3 (2006).
[50] *Id.* at 2062-2063.
[51] *Id.* at 2064.
[52] *Id.* at 2069.

Finally, there is a regulatory hurdle if sponsors want to actively push for change at public companies where they hold greater than 5% of its shares. They must file a Schedule 13D. This would generate significant paperwork.[53]

Bebchuk and Hirst argue that empirical evidence, much of it their own, supports their critique. They show that the Big 3 have small stewardship teams[54] and engage in few private engagements with portfolio companies,[55] particularly in comparison to their vast holdings. They also show that the Big 3 vote based on certain governance principles rather than on performance,[56] and that they rarely oppose management compensation in say-on-pay votes (and oppose far less than actively managed funds).[57] Bebchuk and Hirst additionally fault index funds for not being proactive. Such funds do not generally (i) intervene to address firm underperformance,[58] (ii) nominate directors,[59] (iii) submit shareholder proposals,[60] (iv) comment on SEC proposals,[61] (v) submit amicus briefs on relevant cases,[62] or (vi) serve as lead plaintiffs in class actions.[63]

Their claim that the Big 3 make for poor stewards leads them to a number of reform proposals. Most aggressively, they recommend imposing mandatory stewardship expenditures[64]

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[53] *Id.* at 2065-66.
[54] Bebchuk & Hirst, *supra* note 1, at 2039, 2077.
[55] *Id.* at 2086-88.
[56] *Id.* at 2089-90.
[57] *Id.* at 2092-94.
[58] *Id.* at 2095.
[59] *Id.* at 2098.
[60] Bebchuk & Hirst, *supra* note 1, at 2102.
[61] *Id.* at 2107
[62] *Id.* at 2110
[63] *Id.* at 2112.
[64] *Id.* at 2121.

and size caps on fund complexes,[65] and prohibiting 401(k) advising by mutual funds (or at least more disclosure related thereto).[66]

B. Critique of the Agency-Cost Model

The thrust of Bebchuk's and Hirst's argument is that index funds, and the sponsors that oversee them, should be more activist—that they should intervene in portfolio-company affairs with demands that would improve firm performance—and that agency costs are what hold them back. While they are right that index funds are not activists, it is unlikely that agency costs are the key driver.

Intervention is Costly and Uncertain. In most cases, insiders know best how to maximize the value of the firm's they run. They are intimately aware of the details of its operations. Shareholders are outsiders with a significant informational and expertise disadvantage. Shareholders are not dissimilar to regulators, who are often criticized for imposing rules without detailed knowledge of company operations.

Just like regulators, however, there are times when shareholders should intervene. Executives are not immune from negligence or opportunism. But acquiring the information, developing a competing business plan, and lobbying for change requires significant investment. There is also a great deal of uncertainty. Outsiders can, and frequently are, wrong.[67] Further still, even if the interlopers are right, the gains they engineer are shared with the other equity-

[65] Bebchuk & Hirst, *supra* note 1, at 2129. Bebchuk and Hirst also recommend a regulatory safe harbor to allow proportional allocation of the costs of stewardship within fund families, *id.* at 2120, facilitating pooling of research on company underperformance, *id.* at 2120, mandating more detailed reports on private engagements, *id.* at 2123-24, and reconsideration of Section 13(d) as applied to index funds, *id.* at 2128.
[66] *Id.* at 2122-23.
[67] *See, e.g.,* Svea Herbst-Bayliss, Katya Wachtel, *Hedge Fund Manager Ackman Says Mistakes Made in JC Penney Turnaround*, REUTERS, Apr. 5, 2013, https://www.reuters.com/article/us-hedgefunds-ackman-jcpenney-idUSBRE9340MS20130405.

holders. The only way such intervention makes sense is if the activist has a large enough stake to justify the cost based on their pro-rata share of the gains.

Bebchuk and Hirst argue that index funds and their sponsors should engage in this sort of activism.[68] But they are ill-positioned to do so. Anyone with sufficient industry-specific expertise will demand extraordinary and performance-based compensation, both of which are incompatible with the steady and low base fee charged by index funds. Someone with the financial wizardry to chart a different, and superior, course for Microsoft is not going to work for the stewardship department of State Street.

The Big 3 also lack sufficiently large investments. While they do have significant stakes in portfolio companies, even large stakes are part of a diversified portfolio. Thus, even a sizeable gain at a single firm will have a limited impact on the fund's overall return. Expensive, bespoke, activism is simply an ill fit.

The formula for financially viable interventions is highly compensated managers who oversee an undiversified portfolio—in other words, activist hedge funds. These funds comb the public market in search of opportunities to boost share price.[69] It is no surprise that this is where the market has settled. In line with fundamental principles of economic specialization, those market actors with the most efficient structure are the ones who exploit and capitalize on opportunities that fit their structure.[70]

The controversy surrounding activist hedge funds shows how hard it is to boost corporate performance. They tend to eschew customized interventions in favor of a handful of generic

[68] Bebchuk & Hirst, *supra* note 1, at 2095.
[69] *See* Jeff Schwartz, *De Facto Shareholder Primacy*, 79 U. MD. L. REV. 652, 679-80 (describing hedge-fund activism).
[70] Professors Gilson and Gordon make a similar argument. *See* Gilson & Gordon, *supra* note 9, at 896-97.

tactics that quickly affect share prices.[71] They seldom try to shift operations to better orient target firms toward long-term value.[72] Rather than undertake the expense and uncertainty that comes with activism, it makes perfect sense for index funds and their sponsors to wait on the sidelines and support hedge-fund activists when it is in their interests.[73]

Bebchuk and Hirst suggest that activist hedge funds are not sufficiently activist because they are too slow: "The empirical evidence…indicates that companies often underperform for several years before an activist emerges to push for change. The interests of index fund investors are therefore not served by ignoring underperformance for long periods in the hope that an activist hedge fund may choose to address it sometime in the future."[74]

This logic is unconvincing. It suggests that index funds can more adeptly and quickly act on underperformance than hedge funds. Why would this be the case when hedge funds have the expertise and incentive to intervene as quickly as possible. It also implies that hedge funds are not short-term oriented enough, and that one or two quarters of underperformance are reason to pressure management. If anything, there is already too much pressure on managers to deliver short-term performance, pressure that may hurt long-term index-fund investors.[75] Finally, anecdotal evidence indicates that sponsors suggest potential points of intervention lest anything fall through the cracks.[76]

Contrary to Bebchuk's and Hirst's argument, the Big 3 do not avoid active intervention because they share gains with other index-fund sponsors. Nor is it because management fails to

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[71] Schwartz, *supra* note 69, at 680.
[72] *Id.* at 683.
[73] *See* Gilson & Gordon, *supra* note 9, at 897.
[74] *Id.* at 2097.
[75] *See* Lynne Dallas, *Short-termism, The Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 310-315 (2011) (discussing incentives for managers to focus on short-term results).
[76] *See* Che Odom, *Long-Term Investors Increasingly Hiding Behind Activists*, BLOOMBERG BNA (March 16, 2016); Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1898 & n.97 (2017).

internalize gains from stewardship that accrue to its own funds. Managers do not invest fund resources in active intervention because the principals themselves—the shareholders in their funds—would be ill-served. It would not increase the value of index funds for their managers to pretend they run hedge funds.

Index Fund Shareholders Benefit From Free-Riding. As noted above, Bebchuk and Hirst argue that index-fund managers have no incentive to invest in stewardship because doing so gives them no competitive advantage vis-à-vis other index funds. They frame this as a reason why competition for additional investors does not cure the agency cost between managers and index-fund shareholders that they identify.[77] But it is much more straightforward to view the lack of a competitive incentive as an outgrowth of the incentives of the index-fund shareholders themselves.

The concern of index-fund managers is that investment in stewardship necessitates an increase in fees to pay for it. This puts them at a competitive disadvantage vis-à-vis other index funds because investors would switch to lower-cost funds, where they could get the benefit from stewardship without the cost. In other words, if an index fund invests in stewardship, its shareholders could get a better deal elsewhere. If they could get a better deal elsewhere, it means that active stewardship is not in the index-fund investors' best interests. They would prefer that another index fund (or a hedge-fund activist) incur the costs.[78] Bebchuk and Hirst look at the competitive landscape from the fund manager's perspective, and thereby frame it as yet another problem with manager incentives, but the core issue is the free-rider problem at the index-fund

[77] Bebchuk & Hirst, *supra* note 1, at 2057.
[78] Since, as noted above, hedge-fund activists have the right structure and incentives to intervene, it makes sense for an index fund to wait for them to bear the costs of intervention and free ride off of their efforts. This is true even if intervention by the index fund would increase the value of the fund. Waiting for an activist to intervene would lead to the same increase in value without the associated costs. Thus, *not* intervening dutifully reflects index-fund shareholders' best interests.

shareholder level. There is no competitive advantage to stewardship, because shareholders are better off if another fund bears the stewardship expense.

The Incentives of Index-Fund Managers are Unimportant. Bebchuk's and Hirst's arguments are based on the assumption that the incentives of index-fund managers are the primary driver of stewardship decisions at the Big-3. This overstates their say. First, and this is mostly semantics, it is not like there are really index-fund managers in the way the term manager is usually thought of. The index fund is managed by an algorithm. While there are people who run the fund, their main job is administrative.[79] Second, and more importantly, the stewardship decisions at the Big 3 are centralized.[80] The index fund "managers" do not decide how the index fund's shares are voted. Rather, the sponsor generally votes all of its funds' shares the same way.[81] For example, BlackRock's shares are usually voted the same way regardless of whether they are held in active or passively managed funds.[82] Voting is at the sponsor level rather than the fund level.

Finally, the index funds do not dictate how the sponsor votes its shares on behalf of the fund family. They have a very limited role. According to a recent survey by Morningstar, "Index portfolio managers [at the Big 3, among others,] have no say in the voting of their portfolio holdings. Index portfolio management is a highly automated process whereby

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[79] As FHDS point out, there are index funds that have components of active management. *See* Fisch et al., *supra* note 16, at 19 n.2.

[80] Bebchuk and Hirst even note this. Bebchuk & Hirst, *supra* note 1, at 2050.

[81] Fisch et al., *supra* note 16, at 44-45; Bioy et al., *supra* note 30, at 10, 11; *See also* Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 15, Eur. Corp. Gov. Inst., Finance Working Paper N° 601/2019, March 2019, *available at* http://ssrn.com/abstract_id=3101473 (finding that a fund diverges from its family in 5.5% of proxy contests).

[82] Bioy et al., *supra* note 30, at 26. Active managers at BlackRock, but not passive managers, have discretion to vote differently but rarely do. *Id.* Active managers at Vanguard have discretion to vote their shares on certain matters. *See* Erin Arvedlund, *Vanguard to let fund managers vote independently*, Apr. 29 2019, https://www.inquirer.com/business/vanguard-fund-manager-voting-right-independent-shareholder-proxy-20190429.html.

delivering the index performance is the overriding mandate."[83] Thus, even if Bebchuk and Hirst were right that there were significant agency costs at the index-fund level, that would not translate to actual voting behavior at the Big 3. The sponsor's incentive is to vote the shares based on what is best for the mutual-fund complex as a whole. And just because the Big 3 have primarily passive holdings, that does not prescribe how they vote. It makes good sense for them to vote their funds' shares in a way that favors the managers of funds that make the biggest profits for the sponsor, and this is their active managers. If anyone is going to have an outsized role, it will be the managers of successful large active funds.[84]

The "Backlash" is Against Big-3 Deference. Bebchuk and Hirst argue that the Big 3 are worried that if they are too hard on corporate executives, those executives will lobby for changes that would target the Big 3's "power and activities."[85] This argument is unpersuasive. Fear of corporate political payback does not seem to have deterred activist hedge funds. And they have faced no new regulations.[86]

Further, although the authors leave vague exactly what changes corporations would push for, the nature of the argument implies that public companies would seek to curtail mutual fund voting rights to curb their influence. It is quite plausible that mutual funds would not care. As

[83] Bioy et al., *supra* note 30, at 15.
[84] BlackRock earns a large portion of its fees from its active funds. Chris Flood, *BlackRock's Rivers of Gold From Active Management*, FIN. TIMES, Oct. 15, 2017, https://www.ft.com/content/f62ed0c2-ada1-11e7-beba-5521c713abf4. Vanguard is the second largest active-fund manager. *See* Erin Arvedlund, *Vanguard Crushing the Competition with Largest Fund Inflows So Far in 2019*, PHIL. INQ., May 27, 2019, https://www.inquirer.com/business/vanguard-jack-bogle-passive-active-mutual-fund-etf-20190527.html.
[85] Bebchuk & Hirst, *supra* note 1, at 2069.
[86] The SEC even floated, and later scrapped, a proposal that would have helped activist hedge funds. Ortenca Aliaj, *SEC Disclosure Change Would Allow Activists to 'Go Dark', Lawyers Warn*, FIN. TIMES, July 23, 2020, https://www.ft.com/content/1968c32d-5ac0-4502-8af8-7d45ec39791a; Alicia McElhaney, *Why the SEC May Have Scrapped Its Controversial 13F Proposal*, INSTITUTIONAL INV., Oct 30, 2020, https://www.institutionalinvestor.com/article/b1p176msszqf3p/Why-the-SEC-May-Have-Scrapped-Its-Controversial-13F-Proposal. But they suffered a minor setback with the recent proxy advisor rules. *See* Benjamin Bain, *Companies Get Win Over Activists in SEC Proxy Adviser Crackdown*, BLOOMBERG, July 22, 2020, https://www.bloomberg.com/news/articles/2020-07-22/companies-to-notch-big-win-over-activists-in-sec-proxy-overhaul.

discussed further below, mutual funds did not pay attention to proxy voting until regulators forced their hand. Mutual-fund managers would very likely rather focus on managing portfolios than governance.

Finally, the bigger concern about backlash is the one that comes from being overly passive. Indeed, Bebchuk's and Hirst's article itself is evidence that a passiveness backlash is occurring. The authors' argue that mutual-fund managers need not fear repercussions from inactivity or deference, because "most investors are unlikely to have sufficient expertise or resources to evaluate the many stewardship decisions made by index fund managers."[87] But investors are not their only audience. The backlash to fear from inactivity is not from investors (who, as I argue above, are fine with it), but from academics, the press, and most importantly, regulators. If mutual funds want to avert regulation, the last thing they want to do is appear soft on executive compensation.

The Empirical Evidence is Ambiguous. Bebchuk and Hirst cite much evidence that the Big 3 do not actively intervene in firm affairs. While passiveness is consistent with an agency-cost theory, it is also consistent with the null hypothesis—that there are no agency costs. The passive behaviors that Bebchuk and Hirst lean on may be exactly what is in the best interests of mutual-fund shareholders. They may also stem from some other cause.

Moreover, some of the evidence that Bebchuk and Hirst cite do not support their claims. To back their assertion that the Big 3 are too deferential to management, they point to evidence that actively managed funds vote against management compensation more frequently than the Big 3.[88] But the authors' arguments about deference should extend to active managers as well.

[87] Bebchuk & Hirst, *supra* note 1, at 2073.
[88] *Id.* at 2094-95.

Both actively and passively managed funds should fear political backlash, and sponsors of both seek 401(k) advising opportunities. Thus, deference cannot explain the discrepancy.

The authors also point to evidence that stronger business ties between funds and portfolio companies correlates with deference.[89] But later they emphasize that the deference from business ties extends to all companies: "We refer to [the deference] problem as 'general management favoritism,' by contrast to client favoritism, because it involves the manager's interest in business ties to induce the manager to be excessively deferential not only toward managers of companies with which the manager has business ties but toward corporate managers of public companies in general."[90] The evidence of increased passivity toward business ties directly contradicts the claim that funds are deferential to all firms.

In addition, the authors point to evidence that, even though many companies have not adopted governance frameworks in line with the Big 3's principles, the Big 3 take no action.[91] Based on this, the authors argue that the Big 3 cannot simply rely on others to agitate for change.[92] But it may make perfect sense for the funds to wait. The companies that have not incorporated Big 3 governance principles are smaller firms, which likely represent a tiny fraction of the sponsors' funds' portfolios. Actively agitating for governance changes that would have a miniscule impact on returns is a waste of investor money. The authors never mention that the vast majority of S&P 500 firms have adopted governance practices in line with the Big 3's principles.[93]

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89 *Id* at 2063.
90 *Id.* at 2064.
91 *Id.* at 2104.
92 *Id.* at 2104-05.
93 MARK S. GERBER, US CORPORATE GOVERNANCE: FROM THE FRYING PAN INTO THE FIRE? (2020), https://www.skadden.com/insights/publications/2020/01/2020-insights/us-corporate-governance

Finally, the authors show that the Big 3 do not file Schedule 13Ds, the form required if they were undertaking active intervention. They imply that the cost associated with the filing explains this finding.[94] But the Big 3 may not be filing these forms because it is not in their shareholders' interests to be taking the actions that trigger the filings, not because they wish to avoid the filings themselves.

Conclusion. Bebchuk's and Hirst's argument that agency costs explain stewardship conduct at the Big 3 is unconvincing. While the interests of fund sponsors and fund investors are not perfectly aligned, the conflict is not the key driver of fund stewardship. The core problem with their argument is that they set up an unrealistic level of stewardship as the standard by which fund sponsors should be measured and then critique them for failure to meet that standard.

C. Competitive-Incentive Model

The FHDS article is not directly opposed to Bebchuk and Hirst. Bebchuk and Hirst take the position that active intervention in the affairs of portfolio companies is the standard of stewardship by which mutual funds should be measured and that mutual funds fall below that standard because of agency costs. FHDS argue that the Big 3 have ample incentive to invest in stewardship: "Our fundamental insight is that because of the competition faced by mutual fund sponsors, the sponsors that offer passive funds need to exercise their governance rights in an informed manner to promote firm value."[95] The sponsors promote firm value primarily by encouraging and supporting good governance practices at portfolio firms.[96]

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[94] *Id.* at 2127.
[95] Fisch et al., *supra* note 16, at 71.
[96] *Id* at 37.

The key to their argument is the competitive landscape for index funds. They argue that index funds have the incentive to invest in good governance because they are competing against actively managed funds. Because index funds cannot exit, the only way for them to distinguish themselves against actively managed funds is through voice. They must improve the companies that they own because they cannot leave.[97]

They also point out that the Big 3's scale mitigates the collective action problem that typically deters shareholder involvement in firm affairs. The usual shareholder owns a tiny percentage of a firm's stock, so any incremental improvement in value is likely far outweighed by the cost of investment. But the Big 3 have significant holdings, meaning they capture a large share of the gains they create.[98] Ordinary investors also face an incentive to shirk because their small holdings give them little power. But the Big 3 own such a large portion of company shares that they have a pivotal say on the outcome of intervention efforts.[99] Finally, the Big 3 also enjoy economies of scale. When borne by a single investor, cost may make engaged stewardship infeasible. But the Big 3 can spread the expense across its fund family.[100]

FHDS do not argue that fund stewardship is perfect. They acknowledge conflicts of interest and other concerns.[101] Ultimately, however, they conclude that the Big 3 have sufficient incentive to engage with their portfolio companies and have effectively done so.[102] That being the case, they argue that regulatory intervention designed to inspire more participation is unfounded.[103]

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[97] *Id.* at 32, 35.
[98] *Id.* at 38.
[99] *Id*.
[100] *Id* at 39.
[101] *Id*. at 55-71.
[102] *Id.* at 55-56.
[103] *Id.* at 72.

D. Critique of the Competitive-Incentive Model

A premise of the FHDS argument is that the level of intervention mutual funds exhibit is driven and cost-justified by the increase in value that stewardship generates for portfolio companies. This increase in value improves returns for fund shareholders and, therefore, gives the sponsor an advantage over competitors. This is a reasonable and appealing narrative that adds much to our understanding of mutual-fund voting. Building on its insights, below I point out some difficulties with the theory stemming from the diversity and complexity of the mutual-fund marketplace.

Switching Sponsors is Difficult for Many Investors. The authors argue that investments in good governance at portfolio firms provide a way for index funds to distinguish themselves from actively managed funds. This competitive advantage is only useful, however, if investors can readily switch to a competing sponsor's actively managed fund. Switching to a competitor is not always easy, though. As noted above, many mutual-fund investors participate through their employer's 401(k) plan.[104] These plans emphasize funds offered by the sponsor that serves as the plan administrator.[105] While many sponsors do offer funds from competitors in the 401(k) plans they oversee, these tend to be specialized funds that the sponsor does not offer.[106] Thus, 401(k) investors are unlikely to find a direct competitor in their slate of options.

The Competitive Environment for Sponsors is Complex. Sponsors face a range of competing competitive concerns when deciding how to vote. First consider the competitive landscape at the index-fund level. Good stewardship does not provide index funds with an

[104] *See infra* note 49 and accompanying text.
[105] *See* Veronika K. Pool, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, 71 J. FIN. 1779, 1788 (2016).
[106] *Id.*("[A]ffiliated funds are more likely to be more basic investment options (such as standard domestic equity funds or passively managed index funds), whereas unaffiliated funds are more likely to be specialized funds (such as international or sector funds)").

advantage over all actively managed funds. Rather, it only provides them with an advantage over those funds that own a smaller proportional share of the targeted portfolio companies. In fact, if a competing actively managed fund owns more shares, on a proportional basis, than the sponsor's index fund, stewardship activities by the index fund might actually lead to a competitive disadvantage. If the stewardship intervention is successful, the competing fund's value will rise by more than the sponsor's index fund. Thus, increasing the value of their portfolio holdings does not equate to a general competitive boost for index funds and their sponsors vis-à-vis the actively managed funds of their competitors.

The competitive landscape becomes even more complex when viewed at the sponsor level. Perhaps a competing sponsor's actively managed fund has an investment in a company that is larger than the sponsor's index fund, but smaller than the sponsor's large and profitable actively managed fund. Because intervention helps the more lucrative actively managed fund, it may be justified on the sponsor level even though it hurts the index fund's competitive position with respect to this particular competitor's actively managed fund.[107]

The Big 3 run corporate bond funds as well. Because bondholders prefer corporations take on less risk, the interests of bondholders often conflict with the interests of shareholders.[108] Thus, voting in the interests of its equity mutual-fund shareholders may actually harm the interests of the investors in the sponsor's bond funds, decreasing their returns, and making them less competitive.[109] This further complicates the voting calculus for sponsors. Gains to equity funds are countered, at least to some degree, by losses to bond funds. Whether an increase in value at its index fund actually confers a net benefit for a sponsor quickly becomes an

[107] FHDS acknowledge the possibility that sponsors will favor their actively managed funds, but view this as a positive because the competitive benefit inures to all investors in the fund family. Fisch et al., *supra* note 16, 66-67.
[108] Rock, *supra* note 38, at 1927.
[109] *See* John D. Morley, *Too Big To Be Activist,* 92 U.S.C. L. REV. 1407, 1439-40 (2019).

exceedingly complex problem, which depends on the nature of its funds and their holdings and the makeup of competitor funds.

Moreover, sponsors may not have a full picture of their competitors' investments. While mutual funds must report their holdings on a quarterly basis, these are delayed snapshots as of a certain date, not real-time information.[110] This means sponsors may lack the data necessary to assess the competitive advantage conferred through stewardship. Moreover, assuming dated fund holdings information is even useful, analyzing it for where to expend stewardship resources would be costly and time intensive.[111]

Finally, the complexity of the competitive landscape suggests that if interventions were truly driven by competitive concerns, fund stewardship activities would be heterogeneous. Sponsors would focus their efforts only on those portfolio companies where improving governance would provide a competitive advantage. Instead, the Big 3 apply blanket policies. This suggests that the search for competitive advantage is not driving their decisions. Along the same lines, if fund managers really thought there were gains to be made from stewardship, then they would keep voting for themselves rather that delegate responsibility to a small team of bureaucrats. The centralization and uniformity of sponsor voting decisions suggests that the competitive landscape is too ambiguous and complex, both at the fund and sponsor level, to motivate stewardship.[112]

Good Governance May Not Increase Firm Value. The idea that investments in governance at portfolio firms increases the value of those firms may also be faulty. "Good

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[110] *See* U.S. SEC. & EXCH. COMM'N, OMB. NO. 3235-0578, FORM N-Q.
[111] Professors Kahan and Rock make a similar point. *See* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1796-97 (2020).
[112] The above analysis focuses on the incentives of passively managed funds, but it also applies to actively managed funds. They would not face a blanket incentive to intervene in all of their portfolio companies, only those where they have greater relative holdings.

governance" is generally synonymous with shifting power from management to shareholders. It increases firm value to the extent that it reduces the opportunity for management to exploit their positions or to continue to serve despite poor performance. But it is not cost free. Independent directors and shareholders are not as well informed as management. Apple's board famously fired Steve Jobs.[113] Good governance only increases firm value when the benefit of the increased oversight outweighs the cost of the expertise gap. Good governance is likely good for some firms and not for others. It depends on the ability and commitment of current management. Probably because of the ambiguity of the good governance equation, empirical evidence on its effects are mixed.[114]

And the low-hanging fruit of good governance was plucked in Sarbanes-Oxley and related rule changes by the stock exchanges. Public companies are required to have majority independent boards,[115] and completely independent audit,[116] compensation,[117] and nominating committees.[118] Thus, even if good governance is value enhancing, the biggest features have already been incorporated. The governance-related proposals that mutual funds are asked to consider now, even if they improve performance, would only do so on the margin. For example,

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[113] Joel Siegel, *When Steve Jobs Got Fired By Apple*, ABC NEWS, Oct. 6, 2011, https://abcnews.go.com/Technology/steve-jobs-fire-company/story?id=14683754.

[114] *See generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (critiquing governance-related reforms in Sarbanes-Oxley); *see* Nattawut Jenwittayaroje & Pornsit Jiraporn, *Do Independent Directors Improve Firm Value? Evidence from the Great Recession*, 19 INT'L REV. FIN. 207, 207 (2017) ("In spite of such a large volume of research on this topic, the empirical evidence is ambiguous on the effect of board composition on firm value. The more recent literature recognizes that board composition is endogenously determined and represents efficient responses to firms' contracting and operating environments." (internal citations omitted)); *see, e.g.,* Yakov Amihud et al., *Do Staggered Boards Matter for Firm Value?* 30 J. APPLIED CORP. FIN. 61 (2018) (finding no relationship between staggered boards and firm value); Jill Fisch, *The Uncertain Stewardship Potential of Mutual Funds*, *in* GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 114-15 (Dionysia Katelouzou & Dan W. Puchniak eds, Cambridge Univ. Press, forthcoming).

[115] *See* NASDAQ, THE NASDAQ STOCK MARKET LLC RULES 5605 (2020), http://nasdaq.cchwallstreet.com/NASDAQ/Main/; NYSE, NYSE LISTED COMPANY MANUAL § 303A.01 (2020), https://nyseguide.srorules.com/listed-company-manual.

[116] *See* 15 U.S.C. § 78j-1 (2020).

[117] *See* NASDAQ, *supra* note 115, at 5605; NYSE, *supra* note 115, at § 303A.05.

[118] *See* NASDAQ, *supra* note 115, at 5605; NYSE, *supra* note 115, at § 303A.04.

proxy access, one of the most heralded changes, has become a staple in public companies through the shareholder proposal process. But it has been used only once.[119]

The Benefits of Stewardship May Not Outweigh the Costs. Even if shareholder-empowering governance changes at portfolio firms do create value, which confers a competitive advantage for the sponsor that initiates such changes, any value increase may not be worth the investment. The Big 3 have increased their stewardship staffs in recent years (though they remain quite small).[120] Their salaries and related costs are only justified if the value they create is greater.

There are also more abstract costs. Given the competing incentives of fund managers with respect to different portfolio firms, voting in pursuit of sponsor-level competitive advantage could cause infighting among managers. This could weigh on morale at the sponsor and even lead to exit of talent. Finally, there is a relational cost. As noted above, supporting measures that shift power away from management likely strains relations with the management that oversees the selection of 401(k) administrators. This cost must be weighed against any value gained from increased fees from improved performance of portfolio companies and additional fund investors.

Conclusion. FHDS's central claim is that competitive incentives drive the Big 3 to support good governance at firms in their index funds' portfolios. The difficulty with this claim is that the Big 3's market-wide approach to voting, where they support certain governance structures regardless of the firm involved, does not consistently offer a competitive advantage given the complex institutional and competitive environment in which they operate. Their

[119] Holly J. Gregory et al., Proxy Access: A 5 Year Review, https://corpgov.law.harvard.edu/2020/02/04/proxy-access-a-five-year-review/ (last visited Feb. 23, 2021).
[120] *See* Bioy et al., *supra* note 30, at 19 ("BlackRock expanded its team from 20 members in 2014 to 33 today; Vanguard's team went from 10 in 2015 to 21.").

simplified voting strategy suggests they may be using stewardship to signal to the public and regulators rather than to best their competitors.

III. 'Public' Mutual Funds

A. Publicness Theory and the Big 3

Publicness theory is the idea that private institutions acquire a public nature when they amass sufficient power and visibility.[121] This leads to calls for public-like transparency and accountability from these institutions and to rules responsive to these calls.[122] This theory has been used to explain the breadth and depth of the regulation of public companies today.[123]

The textbook policy rationale for the securities laws is to protect investors, but it seems clear that the laws have transcended that objective. For example, the board independence rules noted earlier are difficult to defend on investor-protection grounds. So too are rules that require comprehensive executive compensation disclosures and provide shareholders with a say-on-pay vote over executive compensation. These rules provide public-like checks and balances on firm governance, as well as pay transparency akin to what exists for public employees.

Publicness is often used to explain regulations, but an important implication of publicness theory is that private institutions in the public eye will foresee regulatory efforts and take steps to ward them off. This implication provides a compelling explanation for mutual-fund stewardship behavior: the current level of stewardship is an attempt to engage with portfolio companies just enough to ward off regulation of their voting behavior.

[121] In a testament to the prescience of Professors Berle and Means, they also anticipated publicness theory: "The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. The organizations which they control have passed far beyond the realm of private enterprise—they have become more nearly social institutions." *See* BERLE & MEANS, *supra* note 37, at 46.
[122] Sale, *Public Governance*, *supra* note 19, at 1013-14.
[123] *See* Langevoort, *supra* note 19, at 1066.

The Big 3 are clearly "public" in terms of their power. Their vast holdings give each an enormous say in, and collectively control over, many of the biggest companies in the world.[124] This is an unprecedented concentration of power in the hands of a few companies and the individuals in charge of them.[125]

Given this power, publicness theory predicts that these institutions will face a backlash. It has arrived. Many countries have enacted rules governing mutual-fund stewardship behavior and pushing for more active engagement.[126] And mutual-fund voting is clearly on the minds of U.S. regulators. The SEC regulated adjacent institutions, proxy advisors, in 2020.[127] These companies' principal business is to advise mutual funds how to vote their shares. Around the same time, the SEC issued revised guidance to mutual funds about lawful voting behavior.[128] In a keynote address to the Investment Company Institute, the mutual fund trade organization, SEC Commissioner Roisman expressed concern about conflicts of interest between funds in the same family and how the centralized voting of fund proxies addresses those conflicts.[129] This record of regulation and commentary shows that the SEC is concerned about corporate governance and keeping tabs on mutual-fund voting.

Academics, trade groups, and journalists are also increasingly voicing concern. In comments on the proxy-advisory rulemaking, the American Securities Association the ("ASA"), a trade association representing regional wealth managers, called on the SEC to regulate mutual-

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[124] *See* Coates, *supra* note 9, at 13-14.
[125] *See generally id*.
[126] Bioy et al., *supra* note 30, at 3, 8 (noting the adoption of stewardship codes in the United Kingdom, Switzerland, and Japan); Bebchuk & Hirst, *supra* note 1, at 2045; Fisch, *supra* note 114, at 105-06.
[127] *See generally* Sec. & Exch. Comm., Exemptions From the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55082 (2020).
[128] *See generally* Sec. & Exch. Comm., Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 84 Fed. Reg. 47,420 (2019).
[129] *See* Elad L. Roisman, Commissioner Sec. & Exch. Comm., Keynote Remarks: ICI Mutual Funds and Investment Management Conference (Mar. 18, 2019).

fund voting.[130] It singled out Blackrock for a surprisingly passionate assault. According to the ASA, "BlackRock's market power has eroded investor returns and harmed the least advantaged within our society."[131] It goes on to argue that Blackrock "wields its vast market power to harm American investors for its own benefit, in complete violation of its legal fiduciary duty to those very same investors."[132] The comment was the subject of a laudatory editorial in the Wall Street Journal.[133]

Finally, there are provocative studies that suggest the Big 3's concentrated holdings have anti-competitive effects.[134] As a result, antitrust regulators in the U.S. and Europe are investigating.[135]

Publicness theory predicts that such heightened public scrutiny will cause the large mutual-fund complexes to act in a manner designed to mollify their critics. The way that they currently engage in stewardship fits this theory well.

Until recently, the mutual-fund industry has shown little interest in stewardship. Their disregard for voting led first to Department of Labor ("DOL") regulation and then to SEC rules.[136] In the 1980s, the DOL specified that the fiduciary duties of pension-plan advisors extended to proxy voting.[137] In 2003, the SEC went further. It began requiring that sponsors

[130] Christopher A. Iacovella, CEO, American Securities Association, Letter to the SEC re: Re: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (Feb. 3, 2020), https://www.sec.gov/comments/s7-22-19/s72219-6738826-207680.pdf.
[131] *Id.*
[132] *Id.*
[133] Ed., *The BlackRock Backlash,* WALL ST. J. (Feb. 27, 2020), https://www.wsj.com/articles/the-BlackRock-backlash-11582849130.
[134] *See* Elhauge, *supra* note 11, at , 218-54.
[135] Ed., *supra* note 133.
[136] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 & n.14 (Feb. 7, 2003) ("Traditionally, mutual funds have been viewed as largely passive investors, reluctant to challenge corporate management on issues such as corporate governance.")
[137] The statement first came in an interpretive letter. See Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, U.S. Dept. of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), 1988 WL 897696. The obligation is now codified as 29 C.F.R. § 2509.08-2 (2020).

"adopt and implement policies and procedures for voting proxies in the best interest of clients, to describe the procedures to clients, and to tell clients how they may obtain information about how the adviser has actually voted their proxies."[138] In addition, the SEC began mandating that mutual funds publicly report how they vote on each matter on Form N-PX.[139]

The early response from industry was to outsource research and analysis of voting decisions to proxy advisory firms.[140] The outsourcing never thrilled the SEC, which worried, in part, that it was a partial abrogation of the fund's fiduciary responsibilities.[141] The scrutiny around the role of proxy advisors likely explains why the Big 3 are now building larger in-house compliance teams. More broadly, the reluctance to engage in stewardship until prodded by regulators suggests that large mutual-fund complexes do not see clear benefits for themselves or their shareholders in it, and engage in it now to appease regulators, and ward off calls for further oversight.

Another indication that publicness may be driving voting behavior is that sponsors have been particularly vocal about their commitment to stewardship. They would have you believe it is the central thing they do.[142] This is likely a show for regulators (and, perhaps, tangentially, investors who may be concerned about it). If funds were engaging in stewardship in order to gain a competitive advantage, then they likely would not be so vocal about their efforts. They do not talk about their stock picks.

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[138] *See* Sec. & Exch. Comm'n., Proxy Voting by Investment Advisors, 68 FED. REG. 6586, 6586 (Feb. 7, 2003).
[139] *See* 17 C.F.R. § 274.129 (2020).
[140] Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 U.S.C. L. REV. 1359, 1397 (2014).
[141] Sec. & Exch. Comm., Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,989, 43,011 (2010); *see generally*, Sec. & Exch. Comm, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (IM/CF), June 30, 2014.
[142] *See* Bebchuk & Hirst, *supra* note 1, at 2034.

Similarly, the market-wide approach and the tendency to vote for governance structures now considered "best practices" suggests that funds are using their voting power to signal their good intentions.[143] Voting in this way is low cost and sends the message that there is nothing worrisome about their activities.

Publicness may also explain the disconnect between what the Big 3 say about social and environmental issues and their actions. Their words evidence broad support for progressive stances, but votes for such initiatives are spotty.[144] The rhetoric may be designed to generate a positive public image; their actions designed to keep regulators at bay.

As noted above, mutual funds owe a fiduciary duty to vote shares in the "best interests" of fund shareholders. Neither the DOL nor the SEC appears particularly receptive to the idea that progressive environmental and social votes necessarily serve shareholder interests. The DOL just finalized two sets of rules clarifying its stance. The first forbids consideration of such issues when selecting investment alternatives for 401(k) participants;[145] the second forbids consideration of such issues when voting.[146]

The SEC is less strident, but is traditionally lukewarm on these topics. The disclosures it requires are almost entirely limited to economic issues. Through interpretive guidance, the agency has encouraged companies to make disclosures related to climate change.[147] But the

[143] *See* Ryan Bubb & Emiliano Katan, *The Party Structure of Mutual Funds*, European Corporate Governance Institute - Law Working Paper 560/2020 (fig. 13, 66-68) (showing mutual fund voting behavior)*, available at https://papers.ssrn.com/*sol3/papers.cfm?abstract_id=3124039. The Big 3 tend to vote for measures that increase shareholder power at annual meetings. *Id.* at 24.
[144] Caleb N. Griffin, Environmental and Social Voting at the Big 3, June 16, 2020, https://clsbluesky.law.columbia.edu/2020/06/16/environmental-and-social-voting-at-the-big-three/.
[145] *See generally* Dept. of Labor, Employee Benefits Security Administration, Financial Factors in Selecting Plan Investments, 88 Fed. Red. 72846, 72864 (2020).
[146] *See generally* Dept. of Labor, Employee Benefits Security Administration, Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81,658 (2020).
[147] Sec. & Exch. Comm., Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6,290 (2010).

guidance has been largely ignored and the SEC has not taken steps to push companies harder.[148] The SEC also recently adopted rules that make it more difficult to make shareholder proposals,[149] something seen as a blow to social activists.[150]

More generally, the SEC sees its mission primarily in economic terms, and responds coolly when pushed into the social arena. Former SEC Chairman Piwowar has been vocal. In comments about the scope of securities-law disclosures, he said "[t]he first and most important step to improve disclosure effectiveness is to stop the Commission from being used as a pawn of the union and social justice power brokers. The focus on non-material, special interest disclosure provisions is a deplorable corruption of our mission."[151] While mutual funds that take environmental and social issues into account will probably not run into trouble with the SEC, the safest, most orthodox, route is to focus on matters clearly related to shareholder value.[152]

Publicness suggests that mutual-fund sponsors engage in stewardship, not because they think it adds value, but because it appeases regulators. This explains why they engage in it even though it does not offer clear benefits, why they are so vocal about their engagements, and why they support policies and proposals that aligns with what regulators would likely support.

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[148] *See generally* Alan Palmiter, Climate Change Disclosure: A Failed SEC Mandate (Aug. 3, 2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2639181; Allison Herren Lee, Commissioner, Sec. & Exch. Comm., "Modernizing" Regulation S-K: Ignoring the Elephant in the Room (Jan. 30, 2020), *transcript available at* https://www.sec.gov/news/public-statement/lee-mda-2020-01-30.

[149] Sec. & Exch. Comm., Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, 85 Fed. Reg. 70,240 (Nov. 4, 2020).

[150] Douglas MacMillan, *Small Investors Have Pushed Big Companies Toward Social Change. A New Rule Will Limit Their Influence*, WASH. POST (Sept. 25, 2020), https://www.washingtonpost.com/business/2020/09/25/sec-shareholder-rule/.

[151] Joe Mont, *Piwowar: SEC Must Focus on Materiality, Not Social Issues*, COMPLIANCE WEEK (Nov. 8, 2015), https://www.complianceweek.com/piwowar-sec-must-focus-on-materiality-not-social-issues/11479.article.

[152] A shift at the SEC, however, is underway. Acting Chair Allison Herren Lee is committed to ESG issues, as is the new director of the corporate-finance division, Professor John Coates. *See* Andrew Ramonas, *ESG Reporting Top Priority for SEC Director on Leave From Harvard*, BLOOMBERG TAX (Feb. 24, 2021), https://news.bloombergtax.com/financial-accounting/esg-reporting-top-priority-for-sec-director-on-leave-from-harvard.

B. Regulatory Implications

Publicness theory is descriptive. It purports to explain the world, not provide an outline for reform. There is good reason for this. Welfare considerations, such as whether actors are engaging in misconduct and whether regulatory gaps exist, rather than boundaryless concepts like transparency and accountability, should guide regulatory analysis.

This is not the place to engage in such work. Nevertheless, the descriptive analysis thus far counsels against immediate reform. It is difficult to see egregious misconduct. I argued above that index funds and their sponsors do not engage in more active stewardship because doing so runs counter to the interests of index-fund shareholders. This implies that shareholders are mostly satisfied with the status quo.

Moreover, engaging in stewardship to avert publicness-driven regulations makes reform less necessary. Although the Big 3 might not be acting precisely as regulators prefer (or for the reasons they prefer), they are meeting them halfway. Without readily identifiable wrongdoing, the specter of regulation may be sufficient. Finally, it is possible that what begins as regulatory appeasement morphs into something more substantive. Those newly hired stewardship employees at Vanguard probably believe in what they do. In this way, values imposed by regulators steep into firm culture. It seems there is time to wait and see whether a culture of stewardship emerges without further intervention.

IV. Conclusion

An emergent literature grapples with the enormous voting power of the Big 3. Two competing theories seek to explain their stewardship behavior. In their agency-cost model, Bebchuk and Hirst argue that the Big 3 are poor stewards because they lack sufficient incentive to police portfolio companies on behalf of their mutual-fund shareholders. FHDS on the other hand, accept that the Big 3 may not match a Platonic stewardship ideal, but argue that such funds have sufficient competitive incentive to invest in a largely appropriate amount of oversight.

I argue that neither agency costs nor competitive incentives explain fund stewardship. Rather, the Big 3 invest the amount they do in stewardship, and vote the way they do, in an attempt to mollify the public and regulators. This publicness theory of mutual-fund stewardship is agnostic about reform. If anything, just as the Big 3 intended, their conduct in response to public pressure blunts potential policy concerns.