INDEX FUND ENFORCEMENT

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ABSTRACT

Corporate America today is astonishingly beholden to three large financial institutions: BlackRock, Vanguard, and State Street Global Advisors. As investors have moved their money into low cost, highly-diversified investment vehicles known as index funds, the so-called "Big Three" institutional fund managers that dominate the index fund industry have grown rapidly and accumulated unprecedented economic power and influence. For instance, these three institutions now vote one out of every four shares of stock issued by large U.S. companies. Policymakers and scholars have begun to sound the alarm about this concentration of corporate ownership, and have proposed reforms to reduce or eliminate these institutions' influence over portfolio companies.

But concentrated power has its benefits, too. In this paper, I argue that the remarkable size, permanence, and cross-market scope of the Big Three's ownership stakes gives them the capacity and, in some cases, the incentive to punish and deter fraud and misconduct by portfolio companies. Corporate governance and securities regulation scholars have argued that these institutions have generally overriding incentives to refrain from meaningful corporate stewardship, but the facts on the ground tell a somewhat different story. Drawing on a comprehensive review of the Big Three's enforcement activities and interviews with key decision-makers for these institutions, I show how they have been using engagement, voting, and litigation to discipline culpable companies and managers. I also identify the "pro-enforcement" incentives that explain these actions.

Policymakers and scholars are now engaging in a heated debate over indexation and the future of the Big Three. To date, however, participants have overlooked the potentially beneficial role these institutions may play in the enforcement ecosystem. This paper corrects this oversight, bringing Index Fund Enforcement into focus. Policymakers should embrace regulatory reforms designed to enhance Index Fund Enforcement, not weaken it.

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INTRODUCTION

Three financial institutions now vote 25% of the stock in the largest U.S. public companies.[1] The figure may soon be closer to 40%.[2] Vanguard, BlackRock, and State Street Global Advisors – the so-called "Big Three" – dominate the market for the low cost, highly diversified investment vehicles known as "index funds." As more investors put their savings into these vehicles, these institutions have accumulated an unprecedented level of economic power. Policymakers and scholars have been working urgently to understand the social impact of this consolidation of ownership[3] and what to do about it – up to and including breaking up the industry.[4]

To date, however, this debate has overlooked an area where the Big Three's rise may have a particularly significant effect: the enforcement ecosystem. On the one hand, the problem of

[1] *See* Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 724 (2019).

[2] *Id.*

[3] Scholars have debated what these developments mean for competition, *e.g.*, Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016), inequality, John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, Harvard Public Law Working Paper No. 19-07 (Draft Sept. 20, 2018), *available at* https://ssrn.com/abstract=3247337, systemic risk, Itzhak Ben-David et al., *Do ETFs Increase Volatility?*, 73 J. FIN. 2471 (2018), corporate governance, Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018), climate change, Madison Condon, *Externalities and the Common Owner*, WASH. L. REV. (forthcoming 2019) NYU Law and Economics Research Paper No. 19-07 (Apr. 26, 2019), *available at* https://ssrn.com/abstract=3378783, and market efficiency, Steven D. Bleiberg, William W. Priest, David N. Pearl, *The Impact of Passive Investing on Market Efficiency*, Epoch Investment Partners White Paper (May 2017), *available at* https://www.wespath.com/assets/1/7/Epoch-The-Impact-of-Passive-Investing.pdf, among other topics. Policymakers have given serious consideration to some of these concerns. *E.g.*, *Oversight of the Enforcement of the Antitrust Laws: Hearing Before the S. Subcomm. On Antitrust, Competition Policy, and Consumer Rights of the S. Comm. On the Judiciary*, 114th Cong. (2016) (testimony of Assistant Attorney General for Antitrust Bill Baer) (describing Department of Justice investigations into possible anticompetitive conduct linked to common ownership); White House Council of Economic Advisers, Issue Brief: *Benefits of Competition and Indicators of Market Power* at 13-14 (Updated May 2016) (calling for further research into the anticompetitive effects of common ownership); U.S. Senator Amy Klobuchar, Statement on Antitrust Enforcement (Mar. 13, 2017) (stating that "It is easy to see" how "cross-ownership" of competing firms by "large institutional investors" "could hurt consumers").

[4] Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal To Limit The Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017) (proposing that investors be restricted to investing in either only one firm per concentrated industry or no more than 1% of the total industry).

corporate fraud might be *ameliorated* by a dramatic consolidation of shareholder power. The remarkable size, cross-market scope, and permanence of the Big Three's ownership stakes could give them a unique capacity to overcome collective action problems and impose meaningful accountability and deterrence. On the other hand, the Big Three may use their considerable power and influence to *insulate* managers and companies from accountability for misconduct. If so, their rise may dilute existing reputational enforcement mechanisms and undermine general deterrence.

According to some leading corporate governance scholars, the incentives of the Big Three seem to point towards the latter, darker possibility. Proponents of what I call the "Passivity Thesis" argue that index fund managers have generally overriding incentives to refrain from meaningful corporate "stewardship" – *i.e.* actions to influence and enhance the value of individual portfolio companies.[5] These scholars argue that because index managers are compensated with fees equal to a very low percentage of assets under management, they have little to gain from governance activities that enhance the value of individual portfolio companies.[6] And, they argue, spending money on governance might weaken a fund's competitive position because the benefits of the activity would be shared by all investors in the firm including rival index funds, whose investors would not be burdened with the additional incurred costs.[7]

This Passivity Thesis has been highly influential.[8] But it is not the whole story.

[5] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy,* 119 COLUM. L. REV. (forthcoming 2019), Harvard Law School John M. Olin Center Discussion Paper No. 986 (May 2019), *available at* https://ssrn.com/abstract=3282794; Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors,* 31 J. ECON. PERSPECTIVES 89 (2017); Lund, *supra* note _; *see also infra* Part III.

[6] Bebchuk & Hirst, *Index Funds*, *supra* note _ at 17-19; Bebchuk, Cohen & Hirst, *supra* note _ at 96-97.

[7] Bebchuk & Hirst, *Index Funds*, *supra* note _ at 19-20; Bebchuk, Cohen & Hirst, *supra* note _ at 97-98; Lund, *supra* note _ at 511-12.

[8] For instance, U.S. Antitrust regulators have relied on the Passivity Thesis in rejecting calls for investigations or enforcement actions related to the anticompetitive effects of "common ownership" by institutional investors. *See* Note By The United States, Hearing on Common Ownership By Institutional Investors And Its Impact On Competition, Directorate For Financial and Enterprise Affairs Competition Committee, OECD (Nov. 28, 2017) at ¶ 13 & n.30 (relying on Bebchuk, Hirst & Cohen, *supra* note _); FTC Commissioner Noah Joshua Phillips, *Taking Stock: Assessing Common Ownership* (June 1, 2018) (same). Scholars have similarly relied on the Passivity Thesis to

Consider some facts on the ground. In 2018, one of the Big Three pursued at least eight lawsuits against portfolio companies in foreign jurisdictions.[9] Vanguard has recovered well over a hundred million dollars for its investors in the last two years through non-class securities fraud litigation.[10] BlackRock has similarly pursued a slate of litigation on behalf of its investors, including a series of cases targeting misconduct related to residential mortgage backed securities and the financial crisis leading to the recovery of billions of dollars.[11] After the disclosure of Wells Fargo's fraudulent practice of creating fake accounts, the Big Three (each among the largest owners of the bank's stock) each voted against members of the bank's board of directors, causing several to step down from leadership roles.[12] Similarly, after reports that Exxon-Mobil suppressed critical information regarding the threat posed by climate change, each of the Big Three voted against several Exxon directors and supported a shareholder proposal that required the company to make enhanced climate risk disclosures going forward.[13] And after the disclosure of Volkswagen's emissions cheating practice, all three institutions similarly voted against multiple members of the company's supervisory board (including the Chair) and signed on to shareholder litigation against the company pending in Germany.[14]

The Passivity Thesis treats these enforcement-based stewardship activities by the Big Three as anomalies – unexplained departures from the generally overriding incentives to remain

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challenge the "common ownership" antitrust theory. Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221, 236 (2018) (same); Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L.J. 729, 764-65 (2017) (same); C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, at 48-50, YALE L.J. (forthcoming 2019) https://ssrn.com/abstract=3210373 (same). Some Passivity Thesis proponents have invited this reliance. Bebchuk, Cohen & Hirst, *supra* note _ at 109 ("our analysis suggests that it is implausible to expect that index fund managers would seek to facilitate significant anticompetitive behavior."); Lucian Bebchuk & Scott Hirst, *The Misguided Attack On Common Ownership*, Harvard Public Law Working Paper No. 19-10, Duke Law School Public Law & Legal Theory Series (Apr. 1, 2019), *available at* https://ssrn.com/abstract=3298983.

9 *Infra* Part IV.A.

10 *Id.*

11 *Id.*

12 *Infra* Part IV.B.

13 *Id.*

14 *Infra* Parts IV.A-B.

passive and defer to management. This article takes a different approach.

I argue that, in the wake of certain corporate scandals, the Big Three's general incentives to remain passive are overcome by countervailing "pro-enforcement" incentives.[15] Using hand-collected data from class action filings and SEC disclosures, I demonstrate that non-class litigation against portfolio companies gives index funds a way to achieve a competitive advantage over otherwise identical funds managed by rivals.[16] I also show that, for the Big Three, responding to corporate misconduct is both less costly and potentially more valuable than other forms of individualized corporate stewardship. Because of their size and salience, a small number of well-chosen enforcement-based stewardship activities by these institutions may have an outsize effect – on returns, on industry- or market-wide conduct, and on the public profile of the institution.[17]

To test these "pro-enforcement" incentives, I present a global review of the Big Three's enforcement activities in litigation, voting, engagement, and guidance – including several original hand-collected data sets, as well as insights from conversations with inside and outside counsel for the Big Three. This evidence confirms that in an important minority of cases the Big Three do take action to hold individual companies and their managers accountable for corporate fraud and misconduct and that these actions can have a significant impact.[18] For instance, the Big Three have pursued a moderate slate of non-class litigation against portfolio companies,[19] have used their substantial power to vote against culpable directors in the wake of high-profile corporate misconduct,[20] and have regularly engaged with portfolio companies in the aftermath of corporate scandals to gather information and demand action.[21]

These findings provide a reason to hesitate before embracing proposals from a wide range of commentators to restrict the Big

[15] *Infra* Part III.

[16] *Infra* Part III.B.

[17] *Infra* Part III.A, D & E.

[18] *Infra* Part IV.

[19] *Infra* Part IV.A.

[20] *Infra* Part IV.B.

[21] *Infra* Part IV.C.

Three's ability to influence portfolio companies.[22] As policymakers weigh these proposals, they should not overlook the important social benefit – punishing and deterring corporate fraud and misconduct – that the Big Three may provide through their influence over portfolio firms.

However, the evidence I present below regarding the Big Three's enforcement record also indicates that the Big Three are not yet living up to their full enforcement potential. While the Big Three have pursued a moderate slate of non-class litigation, they have done so predominantly against non-U.S. firms.[23] Similarly, while the Big Three have regularly voted against culpable directors in the wake of a major corporate scandals, they have often continued to support that same director at other companies where he or she serves, diluting the deterrent force of the "no" vote.[24] And the Big Three have failed to promulgate any guidance regarding how they exercise their enforcement powers – *i.e.*, when they will litigate against a portfolio firm, or when they will vote against a director for his or her complicity in corporate misconduct.[25]

At least some of this enforcement shortfall appears to be attributable to flaws in the regulatory regime governing the Big Three rather than to fundamental financial incentives associated with indexed investing. For instance, while mutual funds have extensive disclosure requirements with regard to proxy voting, they have no parallel obligations in the domain of litigation and therefore are free to make these decisions in a non-transparent and potentially conflicted manner.[26] As policymakers weigh new index fund regulation, they should consider reforms to *enhance* index fund enforcement, rather than weaken it.[27]

This paper makes several contributions.

First, it provides a new limitation on the Passivity Thesis – *i.e.*, the influential view among corporate governance that the Big Three have overriding incentives to *refrain* from value-enhancing corporate stewardship. I do not dispute that these incentives are

[22] *E.g.*, Lund, *supra* note _; Posner et al., *supra* note _; Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, TENN. L. REV. (forthcoming 2019); *see also infra* Part V.A.

[23] *Infra* Part IV.E.

[24] *Infra* Part IV.B.

[25] *Infra* Part IV.D.

[26] *Infra* Part V.C.

[27] *Infra* Parts V.C-D.

powerful or even that they predominate in the majority of cases. Rather, I suggest that there is an important minority of cases involving fraud or misconduct by portfolio companies in which the Big Three's incentives to passivity are overwhelmed by countervailing ones. And because of the size and salience of these institutions, even a small number of actions may have a significant impact.

This paper is the first to analyze these institutions' incentives and actions in the specific context of enforcement. However, I join a growing chorus of scholars who have recently been pushing back on the Passivity Thesis.[28] My analysis contributes new insights to this active debate, including the following:

(i) Prior efforts have not mapped the Big Three's incentives to use *ex post* methods like litigation and voting "no" in the aftermath of a corporate scandal to hold companies and managers accountable.[29] I show that such reactive enforcement-based stewardship pursued in the wake of a corporate crisis has some distinct advantages that have been overlooked.[30]

(ii) My analysis shows that the Big Three have some incentive to pursue governance at the *individual* firm level. Most of the challengers to the Passivity Thesis have conceded that the Big Three have no incentive to engage on a firm-specific level and instead have argued that they may have a powerful impact by engaging on industry-wide or market-wide governance activities.[31] I do not make the same concession here.[32]

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[28] Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding* (Apr. 13, 2019), *available at* https://ssrn.com/abstract=3370675 (manuscript at 39-57); Condon, *supra* note _; Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, NYU Law & Econ. Research Paper No. 18-39 (Apr. 4, 2019), *available at* https://ssrn.com/abstract=3295098; Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework For Passive Investors*, U. PA. L. REV. (forthcoming 2019); Assaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance,* 105 IOWA L. REV. (forthcoming 2019), *available at* Ehttps://ssrn.com/abstract=3194605; Coates, *supra* note _ at 2, 15-16; Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit,* BUS. & POLITICS (2019).

[29] *Cf.* Jahnke, *supra* note _ at 12-13 (discussing Big Three's incentives to invest in improving governance to *prevent* major corporate scandals); Fisch et al., *supra* note _ at 7 (similar).

[30] *E.g., infra* Part III.B.

[31] Elhauge, *Causal Mechanisms*, *supra* note _ at 42, 45 ("Bebchuk, Cohen, and Hirst are likely right that index funds have less incentive to engage in . . . company-specific efforts."); Kahan & Rock, *supra* note _ at 46 ("Advisors to

(iii) Many critics have challenged the Passivity Thesis' focus on *fund*-level incentives, given that the Big Three have highly centralized governance operations that make decisions on behalf of many family funds.[33] I embrace these points, but I also provide a *direct* response to the Passivity Thesis on its own terms, demonstrating that an *individual index fund* has a concrete financial incentive to pursue certain forms of enforcement-based stewardship.[34]

(iv) Unlike some critics of the Passivity Thesis, I do not dispute the fundamental validity of their analysis.[35] To the contrary, I assume here that the Passivity Thesis is correct that in the majority or even the overwhelming majority of cases the Big Three will have overriding incentives to remain passive and deferential to management. I argue, however, that in a small but important minority of cases following major corporate scandals, the Big Three have strong countervailing incentives to take action to hold portfolio companies accountable.

Second, this paper contributes to the literature on the future of private securities enforcement. In the shadow of various looming restrictions on the securities class action, commentators have turned to consider how various financial institutions may fill the resulting enforcement gap.[36] This paper suggests that, with some policy changes, the Big Three may be in a position to play an important role in this arena.

Third, I respond to the mounting research across various disciplines outlining various social *costs* associated with the rise of

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actively managed funds . . . are likely to be superior to index fund advisors in directly addressing company-specific performance problems."); Condon, *supra* note _ at 47 ("Diversified investors are unlikely to invest resources in many firm specific interventions . . . "); Eckstein, *supra* note _ at 8-9.

[32] *Infra* Parts III.A, B, D, E.

[33] Elhauge, *Causal Mechanisms*, *supra* note _ at 49-52 (noting that the Big Three "also have hundreds of billions of dollars in active funds, including hedge funds" and therefore at the family level there are strong incentives to take actions to increase portfolio value); Jahnke, *supra* note _ at 12-13, Kahan & Rock, *supra* note _ at 37, Fisch et al., *supra* note _ at 20.

[34] *Infra* Part III.B.

[35] *Cf.* Kahan & Rock, *supra* note _ at 7 (arguing that "the largest institutional investors have better financial incentives than just about anyone else").

[36] *E.g.*, David H. Webber, *Shareholder Litigation Without Class Actions*, 57 ARIZ. L. REV. 201 (2015).

indexation and the Big Three.[37] I take no position on these findings, but rather draw attention to an overlooked social *benefit* these institutions have the potential to provide – strengthened accountability and deterrence of corporate misconduct.[38] As policymakers confront problems associated with indexation and concentration of ownership, they should do so based on a complete picture of the relevant costs and benefits – including the potential benefits provided by Index Fund Enforcement.

Fourth, I provide some indirect support for those who have suggested that the Big Three (and other "common owners") are driving firms towards anticompetitive conduct.[39] Some regulators and scholars have challenged these antitrust critics by claiming that the Big Three's overriding incentives to remain passive would cause them to refrain from taking any actions to promote anticompetitive conduct by portfolio companies.[40] The theory and evidence presented here refutes that argument, showing that, in an important minority of cases, the Big Three can and do take actions to influence the behavior of portfolio companies – including actions at the individual firm level.[41]

This paper proceeds in five parts. Part I reviews the rise of index funds and the Big Three. Part II surveys four tools that the Big Three can use to punish and deter corporate fraud: litigation, voting, engagement, and guidance. Part III challenges the Passivity Thesis by offering an account of the "pro-enforcement" incentives these institutions face following misconduct by portfolio companies, and then uses these incentives to form a prediction about the kinds of enforcement activities that the Big Three will engage in. Part IV provides evidence regarding the enforcement activities of the Big Three. It presents and analyzes several hand-collected datasets and key anecdotes tracking the Big Three's litigation, voting, and engagement practices following corporate fraud and misconduct. Part V reviews the implications for debates about common ownership and index fund reform, and then

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[37] *E.g.*, sources cited *supra* notes _-_.

[38] *See* Miguel Anton et al., *Innovation: The Bright Side of Common Ownership?*, (June 21, 2018) *available at* https://ssrn.com/abstract=3099578 ("much less attention has been devoted to the potentially welfare-enhancing effects of common ownership.").

[39] *E.g.*, Elhauge, *Horizontal*, *supra* note _; Einer R. Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It*, (June 24, 2019), *available at* https://ssrn.com/abstract=3293822; Posner, et al., *supra* note _.

[40] *See supra* note _.

[41] *Infra* Part V.B.

proposes some disclosure and litigation reforms to enhance the Big Three's enforcement activities.

I. THE RISE OF THE BIG THREE

A. Indexing 101

"Indexing" is an investment strategy whereby an investor manages his or her portfolio of securities to track a particular benchmark *index, i.e.*, a list of companies typically created and maintained by a third-party financial services organization.[42] For instance, the "S&P 500" is a well-known index maintained by Standard & Poor's comprised of 500 large U.S. companies.[43]

Indexing is often referred to as a *passive* investment strategy because, once the investor has selected his reference index and tracking strategy, he no longer exercises any active discretion in the selection of securities.[44] But the term "passive" can be misleading: indexed investors must make an active choice regarding what reference index they decide to track, will still have to trade securities as the composition of the underlying index changes, and may choose to engage actively with the directors and management of the portfolio companies.[45]

An investor may choose to invest in a portfolio of securities that tracks the reference index by him or herself. But many investors choose to outsource the task of "tracking" the reference index to a professional fund manager by buying shares of a mutual fund that holds a portfolio of securities that tracks the index. Investors may also invest in Exchange Traded Funds ("ETFs") – a close cousin of index mutual funds.[46]

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[42] For a useful introduction, see ANANTH N. MADHAVAN, EXCHANGE-TRADED FUNDS AND THE NEW DYNAMICS OF INVESTING 4-7 (2016). For a critical evaluation of index construction see Adriana Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, YALE J. REG. (forthcoming 2019), https://ssrn.com/abstract=3244991.

[43] *E.g.*, S&P Dow Jones Indices, *S&P U.S. Indices Methodology* (Sept. 2018). For a critical analysis, see Adriana Robertson, *The (Mis)uses of the S&P 500* (2019) https://ssrn.com/abstract=3205235.

[44] MADHAVAN, *supra* note _ at 4.

[45] For a compelling critique of the "passive" label as applied to the investment decisionmaking, see Robertson, *Passive in Name Only, supra* note _.

[46] For a review of the distinct structure and mechanics of ETFs, see Martin Lettau & Ananth Madhavan, *Exchange-Traded Funds 101 for Economists*, 32 J. ECON. PERSPECTIVES 135 (2018).

B. The Financial Benefits of Indexed Investing

The growth of indexing is primarily linked to four financial benefits the strategy provides to investors.

Diversification – Portfolio diversification allows an investor to reduce firm-specific risk without sacrificing expected return. Index funds are an easy and cheap way for investors to diversify. By purchasing just a single share of an index fund tracking, for instance, the S&P 500, an investor acquires exposure to 500 different companies across all major sectors of the U.S. economy. The investor now stands to rise (or fall) with the market, and does not bear the idiosyncratic risks associated with any individual firm.[47]

Costs **–** Fund managers charge fees for the services they perform. Index fund managers perform fewer services than active managers because they do not have to conduct any of the research necessary to pick individual securities. As a result, they incur lower costs and pass those savings along to their investors.[48] This has significant implications for optimal investing strategy. It is impossible to know ex ante whether your strategy will outperform or underperform the market, but it is possible to know what fees your manager will charge. At the outset of a year an active fund investor and an index fund investor will not know which strategy will achieve better returns, but they will know that the index investor's fees will be lower.[49]

Taxes **–** Index Funds reduce taxable gains for investors because they buy and hold securities, minimizing trading and therefore taxable events.[50] However, whenever someone redeems their shares, this may produce a taxable event for the entire fund. ETFs have a further tax advantage over index funds because investors buy and sell ETF shares on the open market without redemption, thereby avoiding taxable realization events.[51]

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[47] *E.g.*, Richard A. Booth, *Index Funds and Securities Fraud Litigation*, 64 S. CAROLINA L. REV. 265, 281 (2012).

[48] Jan Fichtner et al., *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk*, 19 BUS. & POLITICS 298, 302 (2017); *see also* BURTON MALKIEL, A RANDOM WALK DOWN WALL STREET 382 (2015 ed.).

[49] *See* Booth, *Index Funds*, *supra* note _ at 282. Put differently, because they charge higher fees, active funds have to earn a higher gross return than an index fund in order to match the net returns.

[50] MALKIEL, *supra* note _ at 255-56, 382.

[51] MADHAVAN, *supra* note _ at 24-25; Todd Shriber, *Another Stellar Year For ETF Tax Efficiency*, BENZINGA (Nov. 27, 2018). At least some of ETFs' success in minimizing taxation depends on a controversial technique known as

Efficiency – The popularity of passive investing strategies reflects growing acceptance of the proposition that active managers cannot predictably outperform the market.[52] Once higher fees are factored in, investors would be wise to steer clear of actively managed funds and just invest in an index fund.

C. The Rise of the Big Three

Index funds have surged in popularity. The percentage of global fund assets in indexed funds has grown from almost zero in 1980 to about 30% 2017.[53] By 2024, passively managed funds are projected to account for more than half of U.S. assets under management.[54]

Three institutions have reaped enormous benefits from this trend. BlackRock, Vanguard, and State Street – often referred to as the "Big Three" – manage approximately 70% of all ETF assets[55] and 81% of index fund assets.[56] These institutions now

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"heartbeat trading" that has been sanctioned by the SEC but may violate tax law. Zachary R. Mider et al., *The ETF Tax Dodge Is Wall Street's "Dirty Little Secret,"* BLOOMBERG BUSINESSWEEK (Mar. 29, 2019).

[52] Bebchuk, Cohen & Hirst, *supra* note _ at 94; *see also* SEC Office of Investor Education and Advocacy, *Saving and Investing A Roadmap To Your Financial Security Through Saving and Investing* 18 ("Historical data shows that index funds have, primarily because of their lower fees, enjoyed higher returns than the average managed fund."); *see also* MALKIEL, *supra* note _ at 26 (active fund managers are no better at picking stocks than "a blindfolded monkey throwing darts at the stock listings."). *But see* MADHAVAN, *supra* note _ at 9-10 (collecting research, which is somewhat less conclusive than Malkiel suggests).

[53] James J. Rowley, Jr. et al., *Setting the record Straight: Truths About Indexing*, VANGUARD RESEARCH (Jan. 2018). For other statistics, see MADHAVAN , *supra* note _ at 6; Fichtner, *supra* note _ at 302; Bebchuk & Hirst, *Giant Three, supra* note _ at 727-28; Coates, *supra* note _ at 10-14. The most dramatic growth has been concentrated after 2000. Coates, *supra* note _ at 10.

[54] Moody's Investors Service, *Passive Investing To Overtake Active In Just Four To Seven Years In US* (Feb. 2, 2017); *see also* Coates, *supra* note _ at 13 (predicting that the majority of most companies will soon be owned by indexed funds); Bebchuk & Hirst, *Giant Three, supra* note _ at 727-28; Renaud de Planta, *The Hidden Dangers of Passive Investing*, FIN. TIMES (May 30, 2017) (noting that, at their current growth rate, passive funds would own all listed stocks by 2030).

[55] Trefis Team, *The Three Largest Players Have 70% Market Share In $4 Trillion Global ETF Industry*, FORBES (May 17, 2017); Trefis Team, *Five Largest ETF Providers Manage Almost 90% of the $3 Trillion U.S. ETF Industry*, FORBES (Aug. 24, 2017).

[56] John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018); *see also* Fichtner et al., *supra* note _ at 304.

manage about $14 trillion, including $5 trillion in U.S. Equities.[57] They own a much greater share of the US economy than any three single investors have ever previously done.[58] They each control one of the five largest stakes in at least 23 of the 25 largest U.S. Companies.[59] Together, they would be the largest single shareholder in almost 90 percent of all S&P 500 firms,[60] voting approximately 25% of the shares in those companies.[61] In two decades, the Big Three may vote as much as 40% of the shares of those companies.[62]

Vanguard – Vanguard was an early adopter of passive strategies, launching the first index fund in 1976.[63] Today, Vanguard manages about $5 trillion, including more than half of all index fund assets.[64] Vanguard has grown extremely rapidly.[65] It owns at least 5% of just under half (1,750) of all U.S. publicly listed companies, and at least 10% of 160.[66] Some credit Vanguard's unique ownership structure (whereby the funds own the manager[67]) with Vanguard's low fees, and its success.[68]

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[57] Bebchuk & Hirst, *Index Funds*, *supra* note _, at 1; *see also* Rachel Evans, et al., *BlackRock and Vanguard Are Less Than A Decade Away From Managing $20 Trillion*, BLOOMBERG (Dec. 4, 2017).

[58] Coates, *supra* note _ at 13.

[59] John Morley, *Too Big To Be Activist* S. CAL. L REV (forthcoming 2019), Yale Law & Econ. Research Paper No. 596 (manuscript at 3) (May 7, 2019) *available at* https://ssrn.com/abstract=3225555.

[60] Carmel Shenkar et al., *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, ANTITRUST CHRONICLE 51 (2017).

[61] Bebchuk & Hirst, *Index Funds*, *supra* note _, at 1. This figure accounts for the fact that some shares held by other investors are not voted.

[62] Bebchuk & Hirst, *Giant Three*, *supra* note _ at 724; *But see* Vanguard, *Vanguard Funds Plan To Grant Proxy Voting Responsibilities To External Managers* (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/proxy_ext_mgrs.pdf (announcing plan to cede proxy voting control over $471 billion worth of stocks in actively-managed funds to external managers).

[63] John C. Bogle, *The First Index Mutual Fund: A History of Vanguard Index Trust and the Vanguard Index Strategy*, https://www.vanguard.com/bogle_site/lib/sp19970401.html.

[64] Bogle, *Bogle Sounds A Warning*, *supra* note _.

[65] *See* Landon Thomas Jr., *Vanguard is Growing Faster Than Everybody Else Combined*, N.Y. TIMES (Apr. 14, 2017).

[66] Fichtner et al., *supra* note _ at 312.

[67] Vanguard, *Why Ownership Matters*, https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters.

[68] Fichtner et al., *supra* note _ at 305.

BlackRock – With $6 trillion in assets under management, BlackRock is the world's largest asset manager. Following the acquisition of the iShares ETF family from Barclay's in 2009,[69] BlackRock has become the second largest manager of passive funds.[70] As of 2017, BlackRock owned at least 5% of more than half of all U.S. public companies (about 2000), and at least 10% of 300.[71] BlackRock also maintains a large portfolio of actively managed funds – approximately one third of its equity assets.[72] BlackRock is a publicly traded company.

State Street Global Advisors – State Street launched the first ETF (the SPDR S&P 500 ETF) in 1993.[73] Today, State Street manages a little under $3 trillion. It has specialized in managing assets for public pension funds, and had more than 40% of the US public pension fund assets under management in 2015. [74] As of 2017, State Street owned at least 5% of 260 U.S. companies, and 10% of only 12.[75] State Street is a publicly traded company.

II. The Tools of Enforcement-Based Stewardship

Unlike other investors, index funds are contractually prohibited from selling off their positions in portfolio companies so long as they remain included in the reference index. Since they cannot "exit," their only opportunity to influence portfolio companies comes through mechanisms of "voice."[76] This Section reviews four tools of "voice" that the Big Three can use to punish and deter corporate misconduct: (A) Litigation; (B) Voting; (C) Engagement; and (D) Guidance.

A. Litigation

The Big Three may use litigation as a mechanism to discipline portfolio companies that have engaged in fraud and misconduct. This Section shows how these institutions may pursue both "fraud-

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[69] Michael J. De La Merced, *BlackRock's Big Deal With Barclay's*, N.Y. TIMES (Jun. 11, 2009).

[70] Bogle, *Bogle Sounds A Warning*, *supra* note _.

[71] Fichtner et al., *supra* note _ at 311.

[72] BlackRock, *Proxy Voting and Shareholder Engagement FAQ*, *https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-faq-global.pdf.*

[73] MADHAVAN, *supra* note _ at 16.

[74] State Street, *Pension Funds: Seeking Value*, http://www.statestreet.com/pensionfunds.html.

[75] Fichtner, *supra* note _ at 312.

[76] *E.g.*, Jahnke, *supra* note _ (discussing ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY 4 (1973)).

on-the-market" litigation under SEC Rule 10b-5 as well as other types of litigation to do so.

1. Fraud-on-the-Market (10b-5) Litigation

i. Doctrine

Index funds are eligible securities fraud plaintiffs under current law. Under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, a shareholder can sue a corporation for damages by establishing, inter alia, that they bought or sold securities in reliance on a material misstatement or omission.[77]

The requirement of a purchase or sale excludes claims by mere "holders."[78] The Big Three hold very large positions in companies, but they have also been growing rapidly,[79] which means they may have purchased many shares of companies whose managers engaged in fraud during the relevant period before the truth was revealed, and thus may have substantial claims in any given 10b-5 action.

In what sense do index funds "rely" on misstatements? By definition, index funds do not buy or sell stocks based on particular representations or statements made by individual companies. Indeed, the core of their appeal is the fact that they *do not* do this.

The Supreme Court has not resolved this question. In *Basic v. Levinson,* the Court held that any investor who buys or sells stock at a market price presumptively relies on any material misrepresentations unless the defendant "severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff or his decision to trade at a fair market price."[80] Twenty-six years later, in *Halliburton,* the Court clarified that the defendant can rebut the presumption of reliance by showing that the plaintiff "would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud."[81] However, the *Halliburton* Court declined the opportunity

[77] *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014).

[78] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

[79] *Supra* Part I.C.

[80] *Basic*, 485 U.S. at 248-49.

[81] *Halliburton,* 134 S. Ct. at 2408. For applications, see *Glickenhaus & Co. v. Household Int'l, Inc.,* 787 F.3d 408, 432 (7th Cir. 2015) and *Harnish v. Widener Univ. Sch. of Law*, 833 F.3d 298, 311 (3d Cir. 2016).

to clarify how this standard applies to purchases or sales by index funds.[82]

Some leading scholars have suggested (both before and after *Halliburton*) that index funds *ought* to be excluded from FOTM litigation.[83] But lower courts have shown no signs of following these views. Instead, they have held that all purchases by indexed investors are effectively entitled to an un-rebuttable presumption of reliance because indexing is the "ultimate acknowledgment that the market is efficient because it cannot be beat"[84]; because the reference indexes themselves rely "in turn" on the integrity of the market[85]; because indexed investors "rely exclusively upon the market" and have "close to perfect reliance on market price-setting"[86]; because indexing is "based on the market providing

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[82] Justices Thomas, Scalia, and Alito would have abandoned the *Basic* presumption because "a great many investors do *not* buy or sell stock based on a belief that the stock's price accurately reflects its value," including "indexed investors," who buy and sell securities "for reasons entirely unrelated to price" as well as "value" investors, who trade because they think the market has *not* correctly valued the stock. *Halliburton Co.*, 134 S. Ct. at 2422 (Thomas, J., dissenting). Responding to these points, the majority conspicuously failed to mention index funds and addressed only the point about "value" investors. *Id.* at 2411 (majority).

[83] Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WISC. L. REV. 333, 348-49 (suggesting that allowing index investors to recover in FOTM litigation leads to under-compensation of traders who perform the socially valuable function of translating company disclosures into market prices); Richard A. Booth, *The Two Faces of Materiality*, 38 DEL. J. CORP. L. 517, 559-60 (2013) (it is "arguable" that the FOTM presumption of reliance may be rebutted as to index investors because "it violates the idea of indexing strategy to seek out any company-specific information because to do so must of necessity add to the expenses associated with investing, the minimization of which is a primary goal of the strategy."); Donald C. Langevoort, *Judgment Day for Fraud-On-The-Market,* 57 ARIZ. L. REV. 37, 50-51 (2015) (suggested that there is "no self-evident answer" to whether index funds should be entitled to the FOTM presumption, because they "are entirely insensitive to information insofar as their entire methodology is just to mirror the index."); Adam C. Pritchard, *The Political Economy of Securities Class Action Reform*, 2008 CATO SUP. CT. R. 217, 223-24 (arguing that index fund investors "are not relying in the economically relevant sense" on any material misstatement); Ann M. Lipton, Halliburton *and the Dog That Didn't Bark*, 10 DUKE J. CONST'L L. & PUB. POL'Y 1, 16 (2015) (arguing that indexed investors have a weaker claim to recover damages by fraud because they "free-ride on the efforts of traders who analyze firm-specific information.").

[84] *In re Nortel Networks Corp.*¸ 2003 WL 22077464 (S.D.N.Y. Sep. 5, 2003). *But see id.* (holding that "a jury *may* conclude that pursuing an index strategy entails reliance").

[85] *In re Connetics Corp. Sec. Litig.*, 257 F.R.D. 572, 576 (N.D. Cal. 2009).

[86] *In re Countrywide Sec. Litig.*, 273 F.R.D. 586, 602 (C.D. Cal. 2009).

reliable information"[87]; because indexing is "a perfect example of reliance on the market"[88]; because "[t]racking an index for an efficient market is sufficient reliance . . . ."[89]; and because indexed investors "fundamentally rely on the assumption that the market provided reliable information in adjusting the price of the stock."[90]

This logic is flawed. First, the economic advantages of indexing are more fundamentally linked to diversification and cost-minimization than to market efficiency.[91] Second, index fund purchases are not all equal for purposes of reliance. Index funds buy some shares because a company was added to the underlying reference indices,[92] others in response to changes to the companies within the index (*i.e*., "rebalancing"),[93] and still others in response to net inflows to the funds. The reliance analysis applies differently in each circumstance.[94] For instance, a fraudulent misstatement leading to an increase in market capitalization could be *readily* connected to a purchase of the first and second kinds – where the company's fraudulently inflated value leads it to be added to a new index or require larger weight in the portfolio – but less strongly connected to a purchase of the third kind – where the purchase was driven by fund inflows, not market changes.

Nevertheless, under current doctrine, index purchasers and sellers are entitled to the fraud on the market presumption of reliance and may recover in 10b-5 litigation.

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[87] *Wilkof v. Caraco Pharm. Labs.,Ltd.*, 09-cv-12830 (E.D. Mich. Feb. 28, 2012).

[88] *In re Merck & Co., Inc. Vytorin/Zetia Sec. Litig.*, 2012 WL 4482041 (D.N.J. Sept. 25, 2012); *In re Schering-Plough Corp./ENHANCE Sec. Litig.*, 2012 WL 4482032, at *6 (D.N.J. Sept. 25, 2012).

[89] *In re Lehman Brothers Sec. & ERISA Litig.*, 2013 WL 440622, at *2 (S.D.N.Y. Jan. 23, 2013).

[90] *Plumbers & Pipefitters Nat'l Pension Fund v. Burns*, 292 F.R.D. 515, 526 (N.D. Ohio 2013).

[91] Booth, *Index Funds*, *supra* note _ at 282; JOHN C. BOGLE, DON'T COUNT ON IT 371 (2011); MALKIEL, *supra* note _ at 381.

[92] *E.g*., Corrie Driebusch & Asjylyn Loder, *Uber and Other IPOs Set for an Index Bounce* WALL ST. J. (Jun. 14, 2019).

[93] James D. Cox, *Understanding Causation in Private Securities Lawsuits*, 66 VANDERBILT L. REV. 1719, 1739 (2013); *Lawrence E. Jaffe Pension Plan v. Household Int'l Inc.*, 2012 WL 4343223 (N.D. Ill. Sept. 21, 2012). *But see* Andrew Lo, *What is an Index?* ("[A] portfolio weighted by market capitalization never needs rebalancing because the weights automatically adjusted the proportions as market valuations fluctuated.").

[94] *But see* Booth, *Index Funds*, *supra* note _ at 269 ("an index fund trades almost exclusively for purposes of portfolio balancing").

ii. Forms of Participation in 10b-5 Litigation

Index funds may participate in 10b-5 litigation in several ways.

Claims – When a securities class action settles, an index fund that bought (sold) shares during the relevant period may submit a claim seeking payment from the settlement fund.[95]

Lead Plaintiff – Under the Private Securities Litigation Reform Act of 1995,[96] courts are required to appoint a "lead plaintiff" to oversee a securities fraud class action.[97] There is a rebuttable presumption that the lead plaintiff will be the volunteering individual or institution with the largest financial stake in the outcome.[98] As large and growing institutions, index funds are likely to have acquired a large number of shares during a long class period and therefore might be eligible for these positions.

"Opt Outs" – An index fund may also choose to pursue individual litigation outside of the class action context. Pursuing non-class litigation gives institutions more control over the forum, the claims, and the timing and magnitude of the settlement.[99] "Opt-outs" are more common in the biggest cases, and are becoming more common overall.[100]

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[95] *Cf.* James D. Cox & Randall S. Thomas, *Leaving Money On The Table: Do Institutional Investors Fail to File Claims In Securities Class Actions?*, 80 WASH. U.L.Q. 855 (2002); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and The Legal Implications Of The Failure of Financial Institutions To Participate In Class Action Settlements*, 58 STAN. L. REV. 411 (2005).

[96] Pub. L. 104-67, 109 Stat. 737.

[97] 15 U.S.C. § 78u-4(a)(3)(B).

[98] *Id.* at § (a)(3)(B)(iii).

[99] John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better Than Voice*, 30 CARDOZO L. REV. 407, 417 (2008); *see also CalPERS v. ANZ Securities, Inc.*, 137 S. Ct. 2042 (2017) ("plaintiffs who opt out have considerable leverage and, as a result, may obtain outsized recoveries.") (citing Coffee, *Accountability*, *supra,* and Michael A. Perino, *Class Action Chaos? The Theory of the Core and an Analysis of Opt-Out Rights in Mass Tort Class Actions,* 46 EMORY L.J. 85 (1997)); Jordan A. Goldstein & Marina Olevsky, *Sitting at the Front of the Class: The Importance of Timely Opt Outs,* BUS. L. TODAY (Feb. 12, 2018).

[100] Amir Rozen et al., OPT-OUT CASES IN SECURITIES CLASS ACTION SETTLEMENTS, CORNERSTONE RESEARCH (2015) (reporting just 48 opt-outs in database of 1,458 class action settlements from 1996 to 2014). Recent Supreme Court decisions may temper the trend to opt-outs, by shortening the timeline in which an institution has to make a decision. *CalPERS.*, 137 S. Ct. 2042; *see also* John C. Coffee Jr. & Alexandra D. Lahav, *Class Actions in the Era of Trump: Trends and Developments in Class Certification and Related Issues* (2017) (noting that the rule will "almost certainly" apply to 10b-5).

Although the FOTM presumption of reliance was expressly adopted by the Supreme Court to facilitate class actions,[101] lower courts have extended it to plaintiffs pursuing individual "opt-out" actions under 10b-5. [102] The Supreme Court effectively ratified this view in a 2013 decision, noting in dicta that "fraud on the market is a substantive doctrine of federal securities-fraud law that can be invoked by any Rule 10b–5 plaintiff."[103]

2. <u>Foreign Litigation</u>

In cases involving securities issued by foreign companies purchased on foreign exchanges, the Big Three may be able to participate in securities litigation abroad. There is wide variation in the form shareholder litigation takes in foreign jurisdictions,[104] but because U.S.-style class actions are not common, institutional investors ordinarily must exert some sort of effort up front – *i.e.*, retaining counsel, filing a case, or agreeing to join one already underway. Information about institutional participation in foreign litigation is not easy to come by because many jurisdictions permit plaintiffs to keep their participation secret, including by banding together into a "foundation" to pursue the claims. [105]

3. <u>Litigation and Deterrence</u>

Litigation may combat fraud and misconduct by holding culpable individuals accountable and by spurring policy changes within the institution.[106]

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[101] *See Basic*, 485 U.S. at 242; *see also Halliburton*, 573 U.S. at 258 (recognizing that *Basic* adopted the FOTM presumption to avoid "effectively . . . prevent[ing] plaintiffs from proceeding with a class action in Rule 10b–5 suits.").

[102] *E.g.*, *GAMCO Inv'rs, Inc. v. Vivendi Univ., S.A.*, 838 F.3d 214, 218 (2d Cir. 2016); *Black v. Finantra Capital, Inc*., 418 F.3d 203, 209 (2d Cir. 2005).

[103] *Amgen Inc. v. Ct. Ret. Plans & Tr. Funds*, 568 U.S. 455, 462 (2013).

[104] For a useful review of the structure of securities litigation in a few key foreign jurisdictions, see Kessler Topaz Meltzer Check LLP, Global Securities Litigation, https://www.ktmc.com/focus-areas/global-securities-litigation.

[105] Because many foreign jurisdictions follow a "loser pays" rule for fees, and because contingency fees are banned in many countries, litigation finance plays a much bigger role than it does in the U.S. That is, before joining a case, a fund will ordinarily secure financing not only to pay for attorneys but also to cover the costs of the defendant's attorneys in the event of a loss. Cento Veljanovski, *Third-Party Litigation Funding in Europe,* 8 J.L. ECON & POL'Y 405 (2012).

[106] I do not address the longstanding debate as to whether these benefits are worth the costs. *Compare, e.g.,* William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market,* 160 U. PENN. L. REV. 69 (2011), *with, e.g.,* James C. Spindler, *We Have A Consensus on Fraud on the Market – And It's Wrong,* 7 HARV. BUS. L. REV. 67 (2017). Rather, I simply note that litigation is one form of enforcement-based stewardship that is available. For a

(i) Individual accountability - Individual accountability is key to deterrence of corporate fraud and misconduct.[107] Although private securities class actions frequently name one or more corporate director or officer in addition to the company itself,[108] these individuals are almost never forced to contribute to resulting settlements in these cases.[109] But recent research has shown that

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new proposal to bring private securities class actions in line with social goals, see Alexander I. Platt, *Gatekeeping in the Dark: SEC Control Over Private Securities Litigation Revisited* (working paper).

[107] *See* Donald C. Langevoort, *On Leaving Corporate Executives Naked, Homeless and Without Wheels*, 42 WAKE FOREST L. REV. 627, 629 (2007) ("scholars from across the ideological spectrum have now joined the doubters of enterprise liability, at least with respect to private securities litigation."); *see, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability For Fraud On Securities Markets: Theory And Evidence*, 1992 U. ILL. L. REV. 691; John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536, 1564 (2006); Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1498 (1996); Lisa M. Fairfax, *Spare The Rod, Spoil The Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 396 (2005); Pritchard, *Political Economy*, *supra* note _ at 239; Bratton & Wachter, *supra* note _ at 75. Political leaders of both parties have also embraced this view. *E.g.*, Hearing before the S. Comm. On Banking, Housing and Urban Affairs, *Nomination of Jay Clayton, of New York, To Be A Member of the Securities and Exchange Commission* (Mar. 23, 2017) (statement of Jay Clayton) ("individual accountability drives behavior more than corporate accountability"); SEC Division of Enforcement Annual Report: A Look Back At Fiscal Year 2017 at 2; Sally Quillian Yates, Memo to DOJ, Re: Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015) ("One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing."); SEC Chair Mary Jo White, *A New Model for SEC Enforcement: Producing Bold and Unrelenting Results* (Nov. 18, 2016) ("Holding individuals liable for wrongdoing is a core pillar of any strong enforcement program.").

[108] Claire E. Crutchley et al., *When Governance Fails: Naming Directors In Class Actions*, 35 J. CORP. FIN. 81 (2015); Francois Brochet & Suraj Srinivasan, *Accountability of Independent Directors: Evidence From Firms Subject to Securities Litigation*, 111 J. FIN. ECON. 430 (2014).

[109] Michael Klausner, *Personal Liability of Officers in US Securities Class Actions*, 9 J. CORPORATE L. STUDS. 349 (2009); Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057 (2006); Adam C. Pritchard, *Markets as Monitors*, 85 VA. L. REV. 925, 959 (1999); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 295 (2009); Amanda M. Rose, *Form vs. Function in Rule 10b-5 Class Actions*, 10 DUKE J. CONST'L L. & PUB. POL'Y 57, 61 (2015); Fisch, *Confronting Circularity*, *supra* note _ at 337; Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 BUS. LAW. 307, 314 (2014); Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 239 (2007); Hal S. Scott & Leslie N. Silverman, *The Alternative to Shareholder Class Actions*, WALL ST. J. (Apr. 1, 2012); Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1290 (2011).

officers and directors of firms targeted by class actions *do* suffer career penalties including removal,[110] reduced pay,[111] diminished opportunities at other firms,[112] negative ISS recommendations,[113] and fewer supportive votes from shareholders.[114] These impacts are especially pronounced when there is an institutional lead plaintiff,[115] when individual officers and directors are named in the complaint,[116] when the class action survives a motion to dismiss,[117] and when the settlement is large.[118]

(ii) Governance reforms – Litigation may generate governance reforms *directly* – as when plaintiffs negotiate for compliance reforms as part of the settlement of litigation – or *indirectly* – as when a firm targeted by a class action subsequently adopts a governance provision that it would not have adopted but for the litigation. The "direct" method – sometimes referred to as "Governance at Gunpoint"[119] – has been heavily promoted by the plaintiffs bar,[120] and reviewed favorably by some leading

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[110] Christopher F. Baum et al., *Securities Fraud and Corporate Board Turnover: New Evidence From Lawsuit Outcomes*, 48 INT'L REV. L & ECON. 14 (2016); Brochet & Srinivasan, *supra* note _; Mark L. Humphery-Jenner, *Internal and External Discipline Following Securities Class Actions*, 21 J. FIN. INTERMEDIATION 151 (2012); Greg Niehaus & Greg Roth, *Insider Trading, Equity Issues, and CEO Turnover in Firms Subject to Securities Class Actions*, FIN. MGMT. (1999); Phillip E. Strahan, *Securities Class Actions, Corporate Governance and Managerial Agency Problems* (1998). *But see* Eliezer M. Fich & Anil Shifdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth,* 86 J. FIN. ECON. 306 (2007).

[111] Humphery-Jenner, *supra* note _ at. *Cf.* Crutchley et al., *supra* note _.

[112] Brochet & Srinivasan, *supra* note _, at 444; Fich & Shifdasani, *supra* note _; Humphery-Jenner, *supra* note _ at; Crutchley et al, *surpa* note _. *But see* Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation,* 49 J. L.& ECON. 365 (2006).

[113] Brochet & Srinivasan, *supra* note _, at 438.

[114] Jie Cai et al., *Electing Directors*, 64 J. FIN. 2389, 2399 (2009).

[115]Crutchley et al., *supra* note _.

[116] Brochet & Srinivasan, *supra* note _; Crutchley et al., *supra* note _.

[117] Baum et al., *supra* note _.

[118] Helland, *supra* note _; Niehaus & Roth, *supra* note _; Baum et al., *supra* note _ at 23; Fich & Shifdasani, *supra* note _.

[119] Phyllis Plitch, *Governance at Gunpoint,* WALL ST. J. (Oct. 17, 2015).

[120] *E.g.*, William S. Lerach, *Achieving Corporate Governance Enhancements through Litigation,* 24 T. JEFFERSON L. REV. 1, 8 (2001). ISS has claimed that "Securities class action litigation has emerged as one of the investors ***most effective tools*** for improving corporate governance." Luke Green, *Governance Reforms Through Securities Class Actions*, 20 CORP. GOV. ADVISOR 9, 15 (2011).

scholars.[121] However, it appears to remains relatively rare in the context of class action litigation (as opposed to derivative litigation[122]) because, even if the lead plaintiff and the lead counsel in a class action are interested in compliance reforms, they are limited in their ability to negotiate for these because their fiduciary duty to the entire class requires them to maximize the dollars won through settlement.[123] As to the "indirect" method, recent research has shown that firms targeted by class actions experience the following changes – greater board independence,[124] reduced number of other boards sat on by directors,[125] increases in incentive pay,[126] and more disciplinary takeovers.[127] A recent paper also finds that the threat of a class action increases the quality of firm disclosure.[128] At least some of these changes are more likely when there is an institutional lead plaintiff,[129] and when individual directors and officers are named as defendants in the litigation.[130]

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[121] Stephen J. Choi et al., *Do Institutions Matter - The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L. Q. 869, 901 & n. 91 (2005); Jill E. Fisch, *Lawyers on the Auction Block*, 102 COLUM. L. REV. 714 n. 346 (2002); James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities* Law, at 203 (2009); James D. Cox, Randall S. Thomas & Lynn Bai, *There are Plaintiffs and . . .There are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 365 (2008). Scholars have been more skeptical of governance settlements in the context of derivative litigation. Jessica Erickson, *Corporate Governance In The Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1807-29 (2010); Stephen J. Choi et al., *Piling On? An Empirical Study of Parallel Derivative Suits*, 14 J. EMPIRICAL LEGAL STUDS. 653 (2017).

[122] Erickson, *supra* note _; Choi et al., *Piling on?*, *supra* note _.

[123] *E.g.*, Fisch, *Auction Block*, *supra note* _ at n. 346; Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1118, 1124-25 (2011); R. Chris Heck, Comment, *Conflict and Aggregation: Appointing Institutional Investors As Sole Lead Plaintiffs Under the PSLRA*, 66 U. CHI. L. REV. 1199, 1211 (1999).

[124] C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 377-80 (2010).

[125] Crutchley et al., *supra* note _.

[126] *Id.* (for CEOs not directors).

[127] Humphery-Jenner, *supra* note _.

[128] Justin Hopkins, *Do Securities Class Actions Deter Misreporting?*, 35 CONTEMP. ACCOUNTING RES. 2030 (2018).

[129] Crutchley, *supra* note _; Cheng, *supra* note _.

[130] Crutchley, *supra* note _.

Index funds can use litigation to push for individual accountability and governance reforms. As lead plaintiffs, an index fund can ensure that the complaint in the class action names any culpable directors and officers, to monitor the work of class counsel, and ensure that the case is settled for maximum value.[131] As an opt out plaintiff, an index fund can take parallel actions to put pressure on the culpable officers and directors – *i.e.*, naming individual officers and directors and attempting to increase the companies' total exposure in the case. Opting out also provides an external "check" on the lead counsel in the class actions, putting competitive pressure on the class counsel to achieve the best possible results for the class.[132]

The potential impact of foreign litigation on deterrence is less clear. As in the U.S., directors of public companies in countries like Australia, Canada, Britain, France, Germany, Japan and Korea rarely actually are forced to make any out-of-pocket contributions to settlements with private litigants.[133] But that still leaves room for the kind of indirect career impacts and governance changes that empirical scholars have discovered following U.S. litigation. As shareholder litigation becomes an increasingly global affair, this is an important subject for future research.

B. Just Vote "No"

Individual accountability for securities fraud is often left to market-based "reputational" mechanisms,[134] including corporate

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[131] Research suggests that institutional lead plaintiffs have produced larger settlements, Cheng, et al., *supra* note _; Choi et al, *Do Institutions Matter?*; Cox & Thomas with Kiku, *Does the Plaintiff Matter*; Cox & Thomas with Bai, *There are Plaintiffs and* . . ., and are more likely to survive a motion to dismiss. Cheng et al., *supra* note _ at 374.

[132] *See* Coffee, *Accountability, supra* note _; Perino, *supra* note _ at 105 nn.70 & 71 (collecting sources for the theory that opt outs provide a "market check" on the fairness and adequacy of class actions and limit the opportunities for class counsel to "Sell out" the class).

[133] Bernard Black et al., *Shareholder Suits and Outside Director Liability: The Case of Korea*, 10 J. KOREAN L. 325 (2011); Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385 (2006).

[134] The SEC and DOJ do better than class actions at holding individuals directly accountable for corporate misconduct. But they have also been criticized for repeatedly declining to hold culpable officers and directors directly accountable, instead opting for large payouts from corporate entities. Langevoort, *Without Wheels*, *supra* note _ at 654; Jed S. Rakoff, *The Financial Crisis: Why Have NO High-Level Executives Been Prosecuted?* N.Y. Rev. Books (Jan. 9, 2014); JESSE EISINGER, THE CHICKENSHIT CLUB (2017); David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1413 (2014); Renee M. Jones, *Unfit for Duty: The Officer and Director Bar as a Remedy for Fraud*, 82 U. CIN. L. REV. 439 (2013). *But see, e.g.*, Michael Klausner & Jason Hegland, *Corporate and*

elections. These elections offer shareholders an opportunity to weigh in on the individuals nominated to serve on the company's board of directors. In 1995, Joseph Grundfest outlined how shareholders could signal dissatisfaction with corporate performance cheaply and effectively by engaging in "just vote no" campaigns to vote against the *entire* board.[135] The concept has evolved and is now a mechanism for shareholders to hold *individual* directors accountable. While election rules vary by company,[136] the general idea is that after shareholders express substantial opposition to a particular director, that director should face consequences. A recent large-scale empirical study confirms that greater shareholder opposition makes directors more likely subject to removal, reassignment from high profile committees, and reduced directorships at other firms.[137]

Given the magnitude of their ownership positions, the Big Three's votes can have a substantial impact in these "just vote no" campaigns.[138] As "permanent capital," index fund managers have the capacity to commit to voting against the director in successive elections until he or she is removed. And as "horizontal" owners – *i.e*., significant owners of most companies in the market – index

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Individual Liability in SEC Enforcement Actions, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (May 12, 2016) (showing that the SEC imposes D&O bars in 70% of cases against executives). For the downstream career impacts of officers in directors of firms facing private class actions, see sources cited *supra* Part II.A.3. For the downstream career impacts of officers and directors of firms facing public regulatory enforcement, see, e.g., Jonathan M. Karpoff, et al., *The Consequences to Managers for Financial Misrepresentation,* 88 J. FIN. ECON. 193 (2008).

[135] Joseph Grundest, *Just Vote "No," 45* STAN. L. REV. 857 (1995).

[136] For instance, some firms have all directors on the ballot every year, while others have "staggered" boards. Yakov Amihud et al., *Settling the Staggered Board Debate*, 166 U. PENN. L. REV. 1475 (2018). Some firms require that directors receive a majority of votes in order to remain on the board while others require only a plurality. Stephen J. Choi, et al, *Does Majority Voting Improve Board Accountability?* 83 U. CHI. L. REV. 1119 (2016).

[137] Reena Aggarwal et al., *The power of Shareholder Votes: Evidence from Uncontested Director Elections,* 133 J. FIN. ECON. 134 (2019); *see also* Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?*, 90 J. FIN. ECON. 84 (2008) (finding that successful "just vote no" campaigns produced increased CEO turnover); Cai et al., *supra* note _ (similar). *But see id.* (finding no impact on director reputation); Yonca Ertimur et al., *Does the director election system matter? Evidence from majority voting*, 20 REV. ACCOUNT STUD. 1 (2015) (finding no impact on director turnover); Choi et al., *supra* note _ (finding only 8 out of over 24,000 director nominees failed to receive majority votes, and that only three of these actually left the board).

[138] *E.g*., Fichtner et al., *supra* note _ at 308; Fisch et al., *New Titans*, *supra* note _ at 23; Bebchuk & Hirst, *Index Funds, supra* note _ at 8.

managers can further enhance the penalty by voting against the same director at *all* companies where he or she seeks to be elected to the board. At the extreme, index managers can impose a permanent "collateral bar"[139] – voting against a director at all companies forever.[140]

The institutional structure of the Big Three further supports this function: each one has a centralized committee charged with making voting decisions on behalf of most of its funds.[141] Occasionally, these institutions split votes among various funds, but this is rare.[142]

C. Engagement

As prominent institutions with large and permanent ownership stakes, the Big Three enjoy direct access to corporate directors and management. In industry parlance, these institutions can "engage" directly with managers – and managers have a good reason to

[139] "A collateral bar is a tool by which the SEC can ban a market participant from associating with all classes based on misconduct regarding only one class." Bartko v. SEC, 845 F.3d 1217 (D.C. Cir. 2016).

[140] Some version of these voting functions is already being performed by "proxy advisors" ─ private firms that advise institutional investor clients on how to vote in corporate elections, including when to vote "no" on corporate directors. But these institutions are regarded with intense skepticism because they are not transparent in how they formulate their recommendations, have various conflicts of interest that skew their recommendations, and (most fundamentally) have no "skin in the game" – *i.e.*, that is, the proxy advisor depends on institutions paying for their services, not the companies increasing in value. In this very fundamental respect, the Big Three stand in a different (and superior) position to act as effective enforcers. *See* Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy advisors: Reality Meets Theory,* 7 HARV. BUS. L. REV. 221, 230-33 (2017); Matthew Fagan, Note, *Third-Party Institution Proxy Advisors: Conflicts of Interest and Roads to Reform,* 51 U MICH. J.L. REFORM 621 (2018). *But see* George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, *and* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?,* 59 EMORY L.J. 869 (2010).

[141] *See* Fichtner et al., *supra* note _ at 319; Coates, *supra* note _ at 14; Morley, *supra* note _ at 12; Lund, *supra* note _ at 515-18; Fisch et al., *New Titans*, *supra* note _ at 21; Bebchuk & Hirst, *Index Funds*, *supra* note _ at 13; Hemphill & Kahan, *supra* note _ at 38. Scholars and policymakers have been asking whether centralization is consistent with each fund's fiduciary duty to vote proxies in the best interests of its investors. Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation,* 19 TRANSACTIONS: TENN. J. BUS. L. 175 (2017); Roisman, *Keynote Remarks: ICI Mutual Funds and Investment Management Conference,* (Mar. 18, 2019).

[142] *E.g.*, Lund, *supra* note _ at 517.

listen.[143] The Big Three proudly emphasize such "engagement" in their promotional materials.[144]

Engagement can facilitate enforcement-based stewardship in several ways. It may serve an information-gathering function for the institution, generating valuable information regarding individual officers and directors or committees and their roles in preventing (or failing to prevent) the misconduct that has occurred, allowing institutions to participate with greater confidence in "just vote no" campaigns. It can also provide valuable insight into what institutional compliance mechanisms are lacking. Finally, engagement can also give institutions an opportunity to make enforcement-related demands and threats. An institution can use engagement to demand removal (or other penalization) of a culpable manager, or to recommend implementation of certain compliance reforms, under threat of voting or litigation.

D. Guidance

Finally, the Big Three can enhance the impact of the foregoing tools by adopting and publishing guidelines regarding how they will respond to corporate misconduct.[145] For instance, they might adopt "sentencing guidelines" indicating under what circumstances will they vote against directors, seek a change in management, or consider filing litigation, or seeking a role as lead plaintiff. If combined with a credible commitment to follow through, such guidance ought to be taken seriously by the large number of firms in the market who have significant ownership shares held by the Big Three.

III. DO THE BIG THREE HAVE A REASON TO CARE ABOUT CORPORATE MISCONDUCT?

Leading corporate governance scholars have explained that, because index managers are compensated with fees equal to a very low percentage of assets under management,[146] they have very

[143] *E.g.*, Coates, *supra* note _ at 16-17; Bebchuk & Hirst, *Index Funds, supra* note _ at 14; Lund, *supra* note _ at 109; Fisch et al., *New Titans*, *supra* note _ at 25; *see also* Black, *Agents Watching Agents, supra* note _ at 817.

[144] Vanguard, *Policies and Guidelines for Stewardship* (stating that engagement, "more so than voting, provide[s] an opportunity to . . . target feedback and messaging to companies."); BlackRock, *Investment Stewardship* (describing engagement as "core to our stewardship program"); STATE STREET, ANNUAL STEWARDSHIP REPORT at 19 (2017).

[145] *Cf.* Coates, *supra* note _ at 15 (explaining that index funds can exert influence by promulgating "'policies' regarding various kinds of decisions that the boards and managers of their portfolio companies must make").

[146] The average fee is 0.25%, 0.10%, and 0.16% for BlackRock, Vanguard and SSGA, respectively. Bebchuk & Hirst, *Index Funds, supra* note _ at 18

little to gain from governance activities that enhance the value of individual portfolio companies.[147] In fact, spending money on governance would tend to weaken a fund's competitive position, because the costs of the activity would be borne by the funds' investors in the form of increased fees (reducing net return), while the benefits would be shared by all investors in the firm, including rival index funds (increasing their net return).[148] In any case, because index funds contain many different securities, a fund's net asset value is unlikely to be meaningfully enhanced by an increase in the value of just one company.[149] Further, index funds lack the expertise (and institutional capacity to effectively generate this expertise) necessary for effective engagement.[150] Index funds also may be reluctant to engage in certain circumstances out of fear of triggering burdensome regulatory requirements.[151] Finally, because index fund managers are in the business of selling asset and retirement account management services to corporations, many portfolio companies are also current or potential *clients* – another good reason for the funds to adopt a deferential position.[152]

Securities regulation scholars have articulated additional reasons why index funds have little reason to actively participate in shareholder litigation when one of their portfolio companies engages in fraud. As diversified shareholders, index funds have already diversified away firm specific risk – including risk from

[147] Bebchuk & Hirst, *Index Funds, supra* note _ at 17-19; Bebchuk, Cohen & Hirst, *supra* note _ at 96-97; Hemphill & Kahan, *supra* note _ at 7, 49, 52, 65-66; Coates, *supra* note _ at 15.

[148] Bebchuk & Hirst, *Index Funds, supra* note _ at 19-20; Bebchuk, Cohen & Hirst, *supra* note _ at 97-98; Lund, *supra* note _ at 511-12; Fichtner et al., *supra* note _ at 307; Ronald J. Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 892 (2013); Morley, *supra* note _ at 10; Kahan & Rock, *Hedge Funds*, *supra* note _ at 1051; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 473-74 (1991); Elizabeth de Fontenay, *The Myth of the Ideal Investor*, 41 SEATTLE U. L. REV. 425, 435-36 (2018).

[149] Lund, *supra* note _ at 511; Gilson & Gordon, *supra* note _ at 891. The same, of course, is true of many actively managed mutual funds.

[150] Lund, *supra* note _ at 511-12; Griffith, *supra* note _.

[151] Morley, *supra* note _ at 14-22; Bebchuk & Hirst, *Index Funds, supra* note _ 25-27; Bebchuk, Cohen & Hirst, *supra* note _ at 103-04; de Fontenay, *supra* note _ at 436.

[152] Bebchuk & Hirst, *Index Funds, supra* note _ at 23-25; Bebchuk, Cohen & Hirst, *supra* note _ at 102; Morley, *supra* note _ at 25-26; Lund, *supra* note _ at 513; Fisch et al., *New Titans supra* note _ at 33; Coates, *supra* note _ at 18-19; Booth, *Index Funds*, *supra* note _ at 318; Kahan & Rock, *Hedge Funds In Corporate Governance, supra* note _ at 1055; de Fontenay, *supra* note _ at 436.

fraud – and therefore have no reason to engage in shareholder litigation.[153] And, because index funds are likely to hold vastly more shares in any company than what they acquired during the class period, they are likely to suffer more from any negative impact that the litigation itself has on the current stock price, than they would benefit from any settlement.[154]

These arguments – *i.e.*, the Passivity Thesis – have been very influential.[155] But, they do not capture the complete picture. In the wake of episodes of corporate fraud and misconduct by portfolio companies, the Big Three have countervailing incentives to take actions to discipline the companies and managers. This Part articulates these "pro-enforcement" incentives and then forms a prediction regarding the kinds of enforcement activities that the Big Three are likely to pursue.[156]

A. Enforcement As Cost-Effective Stewardship

The Passivity Thesis assumes that institutions can exert influence over portfolio companies through individuated company-by-company activities[157] or "unthinking" cross-market actions.[158] But this overlooks what Bernard Black called the "opportunity for deterrence" – *i.e.*, the prospect that a small number of high-profile votes, lawsuits, or other enforcement actions by these large and influential institutions will send a strong signal across the industry or marketplace.[159] Even assuming *arguendo* that index funds do

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[153] *See* Cooper, *supra* note _ at 1502 ("To the extent that investors are diversified against the risk of securities fraud, they have no need for additional compensation."); Pritchard, *Loser's History*, *supra* note _ at 36-37 ("The irony of the FOTM presumption . . . is that the ultimate passive investors – holders of index funds—***have already protected themselves against fraud*** in the secondary market, and at a very low cost."); Booth, *Class Conflict, supra* note _ at 766 ("Diversified investors are protected against securities fraud by virtue of being diversified and ***have no need*** for a remedy that effectively reduces their returns.").

[154] Booth, *Index Funds*, *supra* note _ at 287.

[155] *See supra* note _ (collecting governmental and scholarly reliance on the Passivity Thesis in the context of the "common ownership" debate).

[156] For a summary of how this analysis contributes to the mounting wave of scholarly pushback on the Passivity Thesis, see *supra* note _.

[157] *See* Elhauge, *Causal Mechanisms, supra* note _ at 42 (making this point).

[158] Lund, *supra* note _ at 513 (suggesting passive fund managers will "adhere to a low-cost, unthinking approach to governance"); *id.* at 511 (arguing that the Big Three are unlikely to engage in "thoughtful" governance).

[159] *See* Black, *Agents*, *supra* note _ at 835, 839 (acknowledging that the private incentives of large diversified institutional investors would generally limit their interest and capacity for engaging at the individual firm level, but suggesting

not benefit from single-firm enhancements, they may still have an incentive to pursue individuated corporate stewardship as a mechanism to produce portfolio-wide effects. The magnitude of the portfolio-wide impact of an individual "enforcement action" depends (inter alia) on the salience of the target, the nature of the misconduct (including how widespread it is in the industry), and the magnitude of the "penalty" imposed.

Enforcement-based stewardship does not require costly monitoring, unlike some other forms of individuated corporate stewardship.[160] Journalists, regulators, whistleblowers, and others do the "heavy lifting" of uncovering corporate misconduct; public pension funds and other governance entrepreneurs make public recommendations on voting in the wake of such disclosures; and plaintiffs' lawyers develop strategies and litigate cases – all for *no cost to the institution or its investors*. In the case of lawyers, they may work "on spec" to identify these cases and "pitch" them to the institutions (with whom they may have a pre-existing relationship), and if the institution elects to move forward with a case, the attorneys will perform all of the work of the case on a contingency basis or funded by an outside litigation funder – in either case, coming at no cost to the institution or its funds. The Passivity Thesis's reliance on the (low) number of individuals employed by the Big Three's stewardship teams or the (low) number of hours they devote to each individual portfolio company[161] fail to account for the enforcement-based stewardship performed by actors outside the institutions for little or no cost to the institution, its funds, or their investors.

The Big Three's position in the enforcement ecosystem is parallel to the role played by institutional investors in the market for corporate activism. Ronald Gilson and Jeffrey Gordon detailed the "happy complementarity" between institutional investors, who focus on providing cheap diversification for their investors, and

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that "the opportunity for deterrence . . . preserves some scale economies for actions formally taken only at a few companies" and that "by focusing on a few egregious cases, the institutions send a message to other managers to mend their ways, lest they too become a test case for institutional pressure.").

[160] *E.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 12 (1994) (describing "crisis monitoring," which "requires neither that the monitors manage day to day nor that they even understand the industry well" but only that they "be able to identify poor results and evaluate whether these results were due to poor management," and contrasting it with more extensive, in-depth forms of monitoring).

[161] *E.g.*, Lund, *supra* note _ at 515-16; Bebchuk & Hirst, *Index Funds, supra* note _ at 31-36.

activist hedge funds, who invest in monitoring and developing plans to enhance value of underperforming companies.[162] When the activist attempts to implement its plan, Gilson and Gordon showed, it can proceed by obtaining the support of a few large institutions who control the bulk of the votes necessary to move forward. The institution, meanwhile, obtains the benefits of value-enhancing improvements to portfolio companies merely by hearing out"pitches" from activists and deciding whether to support these plans, without spending resources on monitoring or developing plans themselves.[163] Something similar happens in the realm of enforcement – other actors do the legwork of monitoring, planning, and actually implementing the enforcement strategies, while the Big Three merely have to evaluate these plans and decide whether or not to lend their support.[164]

B. Competing With Other Index Funds

An essential premise of the Passivity Thesis is that index funds and their investors care about relatively small differences in net returns. The theory is that competition between index funds prevents funds from engaging in value-enhancing stewardship activities because the benefits of the stewardship activity would be shared by rivals, but the costs would be borne only by the fund itself, decreasing their net return relative to otherwise identical funds sponsored by rival institutions.[165] Although some have disputed this premise,[166] recent events seem to confirm it: after Fidelity recently announced the first ever *zero* fee index fund in 2018, Vanguard (already offering some of the lowest fees in the

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[162] Gilson & Gordon, *supra* note _.

[163] *But see* Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* Columbia Business School Research Paper No. 18-16; European Corporate Governance Institute (ECGI) - Finance Working Paper No. 601/2019 (Mar. 1, 2018) (finding that passively-oriented mutual fund advisers were less likely to support proxy challengers than actively-oriented ones), *available at* https://ssrn.com/abstract=3101473.

[164] *Cf*. Coates, *supra* note _ at 16 ("Indexation has also increased the power of what are sometimes derogatively called 'governistas' – the community of corporate governance activists ranging from academics to public pension fund staff to individual 'gadflies' to the staffs of proxy advisory firms such as ISS and Glass-Lewis.").

[165] Bebchuk & Hirst, *Index Funds*, *supra* note _ at 19; Lund, *supra* note _ at 511.

[166] *See* Kahan & Rock, *supra* note _ at 7 ("we are dubious that the indirect incentives from competing for fund flows plays a significant role" in shaping index fund manager behavior). Further, costs are only one source of potential differentiation: funds targeting the same index also may compete on well they track that index (*i.e.*, "tracking error"), the level of tax exposure, liquidity (for ETFs), size and other qualities of the fund sponsor, among others.

market) responded by *further* lowering these fees,[167] and BlackRock soon followed suit.[168]

Assuming *arguendo* that index funds do have a strong competitive incentive to avoid falling even slightly behind parallel index funds sponsored by rivals, these institutions should be very interested in litigation outside the class action context – whether in the form of "opt-out" litigation, or litigation in foreign jurisdictions that do not provide for class actions – which presents an opportunity for index funds to earn a "premium" over their rivals. In "opt outs," the fund may earn a higher per share recovery than its rivals who remain in the class. In foreign litigation, a fund may recover damages in a case that its non-litigating rivals may not pursue. By picking the right cases, a manager could earn a premium on the funds' annual return big enough to show up on its annual disclosures. Doing so regularly might be a way to favorably differentiate a fund from otherwise identical competitors.

As discussed above, litigation does not create significant costs that must be borne by the manager or passed along to investors in the form of higher fees. Plaintiffs' lawyers work on a contingency basis – taking a portion of the recovery, rather than fees out of the funds themselves – or are paid by an outside litigation funder. Overseeing outside counsel and litigation funders and selecting which cases to bring will incur some costs to the manager. But, while employing a team of highly-qualified in-house attorneys dedicated to this task would cost some millions of dollars, the potential recoveries from each case runs in the *tens* or *hundreds* of millions.

To test the viability of opt-out litigation as a strategy to boost index fund returns, I used information from class action filings and SEC disclosures to calculate what one prominent index fund – Vanguard's S&P 500 Index Fund (VFINX) – hypothetically might have earned if it had filed opt-out litigation in some of largest class actions settled in 2016. To calculate hypothetical opt-out recoveries, I used multiples – 5x, 10x, and 15x – that are well within the range of reported and estimated opt-out multiples.[169] Table 1 reports the results.

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[167] *E.g.*, Steve Garmhausen, *Vanguard Lowers Bar To Low-Fee Funds*, BARRON'S (Nov. 19, 2018) (noting that the change was made in "the wake of a high-profile pricing challenge from rival Fidelity").

[168] Crystal Kim, *BlackRock Steps Up Price War With Fee Cut on its S&P 500 Index Fund,* BARRON'S (Mar. 20, 2019).

[169] *E.g.*, Coffee, *Accountability, supra* note _ at 48 (estimating an opt-out premium multiple range of between 6 and 20); Josh Gerstein, *Time Warner Case Finds a Surprise*, N.Y. SUN (Dec. 7, 2006) (reporting opt-out multiple of 50x by

Table 1

Vanguard S&P 500 Index Fund (VFINX)
Hypothetical 2016 Opt-Out Recoveries[170]

	Hypothetical Opt Out (5x)	*Hypothetical Opt Out (10x)*	*Hypothetical Opt Out (15x)*
Bank of America	$4,556,539	$10,252,214	$15,947,888
Pfizer	$6,617,887	$14,890,247	$23,162,606
General Motors	$14,555,393	$32,749,634	$50,943,874
Hypothetical Total	$25,729,820	$57,892,094	$90,054,369
Hypothetical Return	0.01%	0.03%	0.04%

Alaska in AOL Time Warner Case); Gilbert Chan, *CalPERS' Time Strategy Pays Off: The State Pension Fund Gets $117.7 Million after Opting Out of Class Action against Media Giant*, SACRAMENTO BEE (Mar. 15, 2007) (reporting opt-out multiple of 17x by CalPers, and 16-24 x by University of California in in AOL Time Warner Case); Oakbridge, *Opt-Outs: A Worrisome Trend in Securities Class Action Litigation*, Vol. II (Apr. 2007) reporting opt-out multiple of 30x for CalSTRSS in Qwest litigation); Matthew P. Siben & David A. Thorpe, Recovering Investment Losses, at 6, available at http://www.dstlegal.com/downloads/Recovering-Investment-Losses.pdf (reporting opt-out multiple of 25X for NJ Pension Funds in TYCO litigation).

[170] I relied on ISS's list of the top Securities Class Action settlements to determine the largest settlements reached in 2016 against S&P 500 companies. For each of these, I estimated the VFINX recovery by (1) determining the class period for the litigation using filings on public dockets; (2) calculating the approximate number of shares VFINX acquired over the class period by reviewing the fund's quarterly SEC holdings disclosures; (3) multiplied this number by the estimated average gross recovery per share (disclosed in settlement notice published on public dockets); and (4) adjusting for fees and costs taken out by the class action attorney. To calculate hypothetical *net* opt-out recoveries, I multiplied the estimated class settlement recovery by multiples to reflect the difference between the class recovery and the hypothetical opt out.

These estimates are conservative because they likely significantly understate the class recovery. The estimated class recovery included in the Settlement Notice assumes that 100% of the class members will file claims, but it is well known that many members of the class do not file claims. Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421,1448-49 (1994) (reporting that up to 40% of eligible class members do not file claims); Cox & Thomas, *supra* note _.

For Vanguard's S&P 500 index fund, opting out in three cases could have increased its 2016 annual return by a few basis points. The Passivity Thesis assumes that index funds would be highly motivated by such differences. On that assumption, index funds appear to have a strong incentive to pursue individual litigation.

I also calculated similar hypothetical opt-out recoveries by looking at SSGA's press releases announcing receipt of proceeds from class action settlements in 2017. Table 2 reports the results.

Table 2

State Street SPDR Hypothetical Opt Out Recoveries (2017)

	Hypothetical Opt Out (5x)	***Hypothetical Opt Out (10x)***	***Hypothetical Opt Out (15x)***
Duke Energy	$29,062,564	$65,390,769	$101,718,974
AIG	$51,437,740	$115,734,915	$180,032,090
Hypothetical Total	$80,500,304	$181,125,684	$281,751,064
Hypothetical Return	0.01%	0.03%	0.05%

These results are similar to the ones for Vanguard's S&P 500 index fund. By filing strategic opt-outs in just a few cases, SPDR funds might have been able to increase their returns by a few basis points – again, enough to be visible to investors choosing among various competing index funds in the same class.

Finally, I also looked at disclosures filed by BlackRock for any indication of proceeds from litigation impacting the bottom line returns of certain funds. At least one index fund – the iShares U.S. Oil Equipment and Services ETF[171] – reported a 21 basis point bonus from litigation proceeds in 2018.[172]

[171] This fund seeks to track the investment results of the Dow Jones U.S. Select Oil Equipment & Services Index.

[172] Two other BlackRock funds also reported enhanced returns due to litigation. The Advantage International Fund, which invests 80% of its assets in securities listed on the MSCI EAFE index, reported a 6 basis point bonus due to litigation in 2018. BlackRock, Semi-Annual Report (Unaudited) for BlackRock Advantage International Fund at 46 (Mar. 31, 2018). And the US Index Sub-Fund of the Index Selection Fund "outperformed" its benchmark index due to

As discussed below, it is also possible that a manager could retain some portion of the recovery outside the fund – as a kind of "stewardship bonus" or in a separate account to be devoted to other governance activities.[173] This might further incentivize this form of enforcement-based stewardship.

For index funds, individual litigation is comparable to securities lending. The Big Three each have a program whereby they lend shares from their index fund portfolios to other institutions who are seeking to short a particular stock in exchange for a fee. Some of these institutions return 100% of the fee to the portfolios, while others "split" the fee retaining a portion of it.[174] The Big Three tout these programs as helping their investors increase net returns.[175] As this Part shows, litigation represents a parallel strategy to help investors earn a small premium over otherwise identical rival funds.

C. Competing With Non-Index Investment Vehicles

The Passivity Thesis assumes that index funds compete solely against other index funds. But index funds also compete against actively-managed funds for investment. Indeed, the explosive growth of the passively-oriented Big Three has been fueled in large part by flows out of actively-managed funds.[176] It is possible that this competition creates an incentive for index funds to reduce the incidence of fraud. Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon argue that index funds have greater exposure to some costs of securities fraud than savvy actively managed funds who can trade in and out of various companies, and therefore may also have an incentive to invest in mechanisms to reduce these costs. Unlike active portfolio managers who are free to exit (or not buy) shares in a firm suspected of fraud, an index fund has no such ability to exit (or not buy), and therefore index fund will have a reason to invest in mechanisms to reduce the risk of such events.[177]

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litigation proceeds in 2016. BlackRock, Annual Report and Audited Accounts, BlackRock Index Selection Fund at 10 (June 1, 2015 – May 31, 2016).

[173] *Infra* Part V.D.

[174] *See* Braham, *supra* note _.

[175] *E.g.*, State Street Global Advisors, *Understanding the Securities Lending Process*; Andrew S. Clark, CFA, Vanguard, Securities Lending: Key Considerations (Aug. 2016); *see also* Lewis Braham, *ETFs' Hidden Source of Return – Securities Lending,* BARRON'S (Apr. 9, 2018); SEC, Investment Company Disclosure Modernization, 81 Fed. Reg. at 81,887.

[176] *See* Fisch et al., *New Titans, supra* note _ at 12-16.

[177] Fisch et al., *New Titans*, *supra* note _ at 7 (noting that investors in S&P500 index funds "were forced to continue to hold Enron stock as it lost more than 99% of its value before being removed form the index" while some active funds

However, as Fisch herself pointed out in earlier work, diversified investors like index funds actually incur a disproportionately *small* portion of the costs of securities fraud as compared to "informed traders" (like actively managed funds) who pick and choose which companies to invest in based on disclosures and other information.[178] Indeed, Fisch argued that index funds *benefit* from fraud in many cases.[179] On this analysis, some frauds actually *help* index funds gain a competitive advantage over actively-managed funds. Thus, it is unclear to what extent competition against active funds gives index funds an incentive to reduce the incidence of fraud.

D. Reducing Systemic Risk

Index funds may also have an incentive to take actions to avoid *systemically significant* frauds. Patrick Jahnke argues that major governance failures – like the Facebook data scandal, the BP Deepwater Horizon oil spill, or the Volkswagen diesel emissions scandal – impair investor trust in the equity markets as a whole and thereby have a significant impact on the value of the index funds' entire portfolio far beyond the impact on the individual firm.[180] Accordingly, Jahnke argues that index fund would have an incentive to take ex ante steps to reduce the incidence of such events.[181]

The Big Three also have an incentive to try to *rebuild* public trust in the equity markets in the wake of these major events.

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were "able to avoid" these losses); *see also* Booth, *Index Funds*, *supra* note _ (arguing that index funds are big losers from securities fraud *litigation*, and thus have strong incentives to oppose this litigation).

[178] Fisch, *Confronting Circularity*, *supra* note _ at 347; *see also* sources cited *supra* notes _-_ (collecting scholars who have suggested that index funds be excluded from the fraud on the market presumption because they have already obtained "insurance" via diversification and do not rely on firm statements in the "economically relevant sense").

[179] Fisch illustrated the point with a scenario:

> [W]hen an issuer releases false information about the United States Food and Drug Administration testing of its new pharmaceutical product, informed traders are likely to buy. Uninformed traders, lacking that information, are more likely to be on the opposite side of those trades. Indeed, when the price increases as a result of the fraud, some uninformed traders, such as index funds, are particularly likely to sell because the price increase triggers the need to rebalance their portfolios.

Fisch, *Confronting Circularity, supra* note _ at 347.

[180] Jahnke, *supra* note _ at 13-14.

[181] *Id.*

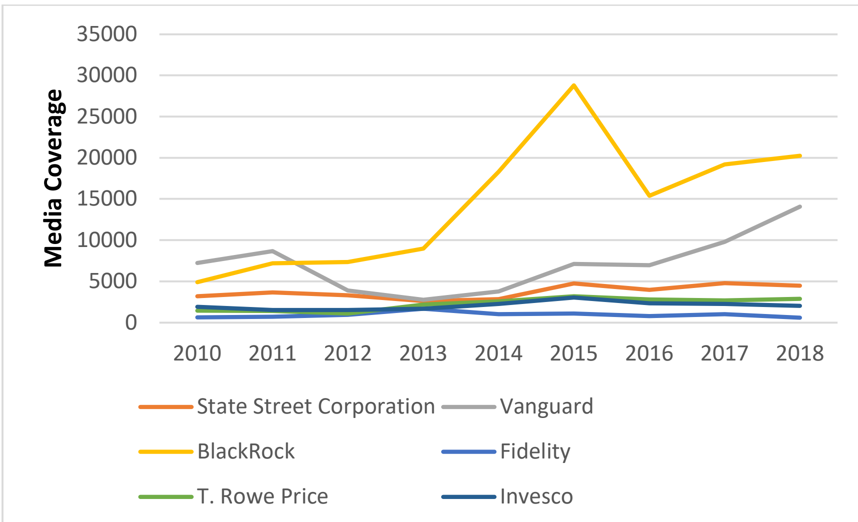
Taking highly salient public enforcement actions against firms and their managers may send a signal to the investing public that bad actors in the market are being held accountable by powerful actors, and so the market is safe for their investment.

E. Reputational Concerns

Taking a strong stand against corporate fraud may help the Big Three attract customers or provide other public relations benefits to these institution.[182] Compared to other mutual fund managers, Vanguard and BlackRock receive an enormous amount of media attention. Figure 1 reports the number of media stories about the Big Three as compared to a few other well-known mutual funds.

Figure 1

Relative Salience of the Big Three[183]



These institutions have a unique ability to reach a public audience of prospective clients and investors. Taking high-profile "enforcement" actions is one way to capitalize on this media attention.

The Big Three have another good reason to care about their public profile. They are facing a difficult regulatory climate. As research uncovers various social costs of indexation, various regulatory reforms have been proposed – up to and including stripping passive fund managers of the right to vote in corporate

[182] *See* Jahnke, *supra* note _ at 15 (discussing the "halo effect" emanating from engagement activities); Bebchuk & Hirst, *Index Funds*, *supra* note _ at 29 (noting that "index fund managers might care about how their stewardship is perceived, not just by the managers of their portfolio companies but also by their current and potential customers.").

[183] This information in this chart comes from Factiva.

elections[184] and effectively abolishing index funds as they are currently constituted.[185] The current Republican U.S. administration seems unlikely to support these proposals.[186] But a Democratic administration may look favorably on these proposals.[187] As attention focuses on the concentration of economic power as a problem in its own right,[188] it is possible that this could become a campaign issue for progressive Presidential candidates. Further, if there is another market crash, reform proposals that seem "off-the-wall" today may become "on-the-wall" for politicians looking to show voters they are "doing something" to respond.[189] As the Big Three face this mounting pressure, they have a powerful incentive to try to shore up public support. These institutions already use their power to push companies on politically salient issues like boardroom diversity,[190] climate change,[191] and gun control.[192] Taking a stand against highly salient episodes of corporate malfeasance fits into this portfolio.[193] Finally, unlike other forms of stewardship,

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[184] Lund, *supra* note _ at 528-30.

[185] Posner et al., *supra* note _.

[186] *See* U.S. OECD Note, *supra* note _; Phillips, *Taking Stock*, *supra* note _.

[187] *E.g.*, sources cited *supra* note _.

[188] Coates, *supra* note _ at 2 (warning that "control of most public companies . . . will soon be concentrated in the hands of a dozen or fewer people"); Bogle, *Bogle Sounds a Warning*, *supra* note _ (warning that the continued growth of the Big Three would not "serve the national interest."); Eric Posner, Fiona Scott Morton & Glen Weyl, Op-Ed, *A Monopoly Donald Trump Can Pop*, N.Y. TIMES (Dec. 7, 2016) (linking the rise of common ownership by large institutional investors, including the Big Three, to "the stagnation of working-class living standards in the face of record corporate profits").

[189] *See generally* Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 34 HOFSTRA L. REV. 25 (2014).

[190] *E.g.*, Jeff Green, *Fearless Girl Has Been A Publicity Coup For State Street*, BLOOMBERG (Mar. 7, 2018); Suzanne Vranica, *'Fearless Girl' Steals the Conversation*, WALL ST. J. (Jun. 19, 2017); Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018); Amy Whyte, *State Street to Turn Up the Heat on All-Male Boards*, INSTITUTIONAL INVESTOR (Sept. 27, 2018).

[191] *E.g.*, Emily Chasan, *BlackRock Wields Its $6 Trillion Club to Combat Climate Risks*, BLOOMBERG (Dec. 8, 2017).

[192] *E.g.*, Rob Cox, *Why BlackRock's Move to Disarm Some Funds Is Good Business*, N.Y. TIMES (Apr. 5, 2018).

[193] Some have suggested that the prospect of new regulation is a reason for index funds to *refrain* from stewardship, for fear of antagonizing corporate managers – a powerful force in policy debates. Bebchuk & Hirst, *Index Funds*, *supra* note _ at 27-28; Morley, *supra* note _ at 29-30.

enforcement-based stewardship carries low risk of triggering burdensome new tax, reporting, or other regulatory burdens.[194]

F. Beyond Index Funds

The rise of the Big Three is associated with the increasing popularity of equity index funds. But these institutions also manage trillions of dollars in other vehicles – including actively-managed equity funds, bond funds and more. The positions taken by these other funds in a particular company or sector, may drive the institution to pursue enforcement-based stewardship, for which the passive funds provide extra "ballast."[195]

G. Predicting The Big Three's Enforcement Activity

The Big Three are complicated institutions with complicated incentives. The Passivity Thesis provides very compelling reasons to expect that, in most cases, they will refrain from meaningful corporate stewardship. But I have just articulated a set of "pro-enforcement" incentives that suggest that, following certain episodes of fraud and misconduct, the Big Three will take steps to hold portfolio companies and their managers accountable.

Taking all of these into account, it is possible to form a rough prediction about what kinds of enforcement activities the Big Three will be most likely to pursue.

First, the Big Three have incentives to pursue ***high-profile*** actions that send a powerful deterrent signal, mitigate systemic risk, and enhance the institution's reputation among investors and regulators.

Second, the Big Three have incentives to pursue the set of ***non-class litigation*** opportunities that offer the prospect of a premium over otherwise parallel index funds managed by rivals.

The next section turns to test these predictions.

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[194] *Cf.* Morley, *supra* note _; de Fontenay, *supra* note _ at 436 n.56.

[195] *E.g.*, Elhauge, *Causal Mechanisms*, *supra* note _ at 49-52 (noting that the Big Three "also have hundreds of billions of dollars in active funds, including hedge funds" and therefore at the family level there are strong incentives to take actions to increase portfolio value); Jahnke, *supra* note _ at 12-13; Kahan & Rock, *supra* note _ at 37, Fisch et al., *supra* note _ at 20; *Cf.* Lund, *supra* note _ at 514 (noting that "passive funds may be able to free ride off of information from active funds housed within the same institution" and that these institutions centralize governance activities at the institutional level, but suggesting that the institutional decisions will nonetheless be dominated by the incentives of the passive funds). *But see* Morley, *supra* note _ (arguing that conflicts of interest between various funds impede activism by the manager).

IV. HOW DO THE BIG THREE RESPOND TO CORPORATE MISCONDUCT?

This Part provides a first look at the "enforcement" activities of the Big Three – *i.e.*, how these institutions engage, vote and litigate with companies in their portfolios following misconduct, fraud, or other scandals, and what guidance they provide regarding these activities. The evidence presented confirms that, in an important minority of cases, the Big Three have overcome their incentives to remain passive and deferential to management, to pursue various forms of enforcement-based stewardship. However, as discussed below, the evidence also reveals that the Big Three are not yet living up to their full enforcement potential.

The evidence presented includes several hand-collected data sets drawn from the institutions' regulatory disclosures, proxy voting records, legal filings, and promotional materials. It also includes anecdotal evidence drawn from particular "enforcement" episodes, as well as insights from conversations with inside and outside counsel for the Big Three.

Prior studies of Big Three stewardship activities have largely overlooked enforcement-based stewardship. For instance, many prior discussions of Big Three stewardship have overlooked litigation altogether. One study examines the Big Three's record as lead plaintiffs in securities class actions, but does not consider other forms of litigation such as foreign or opt-out litigation.[196] Similarly, prior studies of index fund voting have also not focused specifically on how these institutions leverage their power to vote to hold culpable directors accountable in the wake of significant fraud or misconduct.[197] Prior studies of engagement have looked at the total number of engagements,[198] or engagements directed at financial underperformance,[199] but not engagements in the wake of fraud and misconduct. Finally, prior studies of the guidance

[196] Bebchuk & Hirst, *Index Funds, supra* note _ at 53-55.

[197] *E.g.*, Bubb & Catan, *The Party Structure of Mutual Funds* (sorting mutual funds into "parties" based on revealed governance preferences but not isolating voting behavior in the specific context of corporate fraud or misconduct); Patrick Bolton et al. *Investor Ideology* (similar); Davidson Heath et al., *Passive Investors are Passive Monitors* (examining (inter alia) how index funds vote on director elections when ISS disagrees with management, but not isolating cases of corporate fraud or misconduct); Bebchuk & Hirst, *Index Funds*, *supra* note _ at 41 - 48 (concluding that index funds generally vote with management on say-on-pay, proxy contests, and shareholder proposals); Brav et al., *supra* note _ (institutional voting on proxy contests).

[198] Lund, *supra* note _ at 519-20; Bebchuk & Hirst, *Index Funds*, *supra* note _ at 36-38.

[199] Bebchuk & Hirst, *Index Funds*, *supra* note _ at 39.

promulgated by Big Three have focused on how the index fund guidelines weigh financial performance,[200] not fraud or misconduct specifically.

Claims regarding the Big Three's "passivity" should identify the baseline against which the institutions' stewardship activities can be compared. In some cases, where my goal is to determine whether the Big Three are responsive to corporate fraud and misconduct, I rely on comparisons to the Big Three's own baseline behavior. In other cases, where I am trying to assess how the rise of the Big Three will change the corporate governance ecosystem, I rely on comparisons to the set of institutions that the Big Three are displacing in the market – namely, actively-oriented mutual funds.[201] For instance, in some places, I compare the Big Three's activities with the "Shrinking Three" – the actively-oriented mutual fund families with the largest net outflows in 2018: Franklin Templeton (-$34 billion), T. Rowe Price (-$15 billion) and Invesco (-$12 billion).[202] In other places, I compare the Big Three's conduct with the recommendations of ISS – a leading proxy advisor whose recommendations are followed by many smaller, actively-oriented mutual fund families.[203]

A claim regarding the Big Three's passivity should address the ***impact*** of those activities, not merely their frequency.[204] Claims

[200] *Id*.

[201] *Compare* Lund, *supra* note _ at 512-13 ("as demand for passive funds continues to fuel an influx of assets from active funds, it is likely that . . . a growing share of corporate owners will have substantially weakened incentives to monitor and discipline management or invest in improving governance."), *with* Kahan & Rock, *supra* note _ at 17-29 (comparing the Big Three's incentives to invest in value-enhancing stewardship with those of actively-oriented fund families); Elhauge, *Causal Mechanisms, supra* note _ at 54 ("Large institutional investors have greater incentives to exert effort than small institutional investors").

[202] *See* Kevin McDevitt & Michael Schramm, *Morningstar Direct Asset Flows Commentary: United States* at 6.

[203] Comparisons to other actors may also be relevant. *See* Bebchuk & Hirst, *Index Funds, supra* note _ at 49, 51 (comparing the Big Three's participation in SEC rulemaking and Amicus Briefs to that of public pension funds CalPERS and CalSTRS); *id.* at 66 (comparing the incentive effects of index fund fees to the "so-called '2-and-20' compensation arrangements of hedge fund managers [which] enable them to capture a meaningful proportion of any governance gains they bring about").

[204] *Compare* Lund, *supra* note _ at 520 & n. 136 (noting that Vanguard engaged with just 800 out of 13,000 portfolio companies and arguing that, "In addition to being infrequent, engagement by passive funds is relatively ineffective because passive funds lack a credible exit threat"), *and* Bebchuk & Hirst, *Index Funds*, *supra* note _ at 37-38 (discussing the infrequency of Big Three engagement with portfolio companies and noting that "even in those cases in which private

that focus on frequency alone are of less value because, given their remarkable power and public salience of these institutions, even a comparably small number of actions may produce an outsize impact. However, because measuring impact is often impossible, in some cases below, I rely on frequency as a useful (but imperfect) stand-in.[205]

The data used here are limited in several important respects. The review of litigation activities by these institutions is limited to publicly disclosed litigation – it excludes any litigation that was threatened and settled confidentially, or pursued in foreign jurisdictions that do not require transparency. The voting data sets here are quite small – particularly in comparison to some other recent studies of mutual fund voting practices.[206] The data on engagements is limited by the fact that, of the Big Three, only SSGA discloses systematic information regarding these activities.

A. Litigation

Lead Plaintiff – Lucian Bebchuk and Scott Hirst found that the Big Three had never served as a lead plaintiff in a securities class action, and use this as evidence of the institutions' overriding incentives not to engage in individual company stewardship.[207] But all mutual funds (and other private institutions) have largely avoided the lead plaintiff role.[208] For instance, the "Shrinking 3" –

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engagement does occur, there are reasons for concern that the effectiveness of such private engagement is reduced by the Big Three's reluctance to use other stewardship tools."), *with* Coates, *supra*, note _ at 16 (discussing the powerful impact that index fund managers have through engagement, governance positions, and the threat of supporting control contests and activist campaigns); Kahan & Rock, *supra* note _ at 33 (noting that "most" of the 163,461 matters that BlackRock voted during 2017 had "no significant effect on firm value" and that the real question is whether the Big Three have the incentives to investigate and vote on the 10 to 100 of these that really matter); Bebchuk & Hirst, *Index Funds, supra* note _ at 35 (noting that "some stewardship activities of the Big Three have a large impact relative to the modest monetary resources invested"); Fisch et al., *supra* note _ at 18-19 (discussing impact of passive fund voting and engagement).

[205] *Cf.* Bebchuk & Hirst, *Index Funds, supra* note _ at 41-42, 49-50.

[206] *E.g.*, Bubb & Catan, supra note _ ; Bolton et al., supra note _.

[207] Bebchuk & Hirst, *Index Funds, supra* note _ at 53-55.

[208] Webber, *supra* note _ at 220-22 (noting that hedge funds, mutual funds, banks, insurance companies, and endowments "rarely" assume lead plaintiff positions); Choi & Pritchard, *Lead Plaintiffs and Their Lawyers*, (noting that hedge funds "have not become dominant players" in taking on lead plaintiff roles); Choi, Pritchard & Fisch, *Do Institutions Matter*, *supra* note _ at 879-80 (noting that "Mutual funds have failed to participate in securities fraud litigation at all, despite their substantial holdings").

large actively-oriented mutual fund families who are being displaced by the Big 3 – have similarly never served as lead plaintiffs. The fact that large private mutual fund families – both passively and actively-oriented – have both failed to serve as lead plaintiffs suggests that the reason has more to do with the structure of lead plaintiff provision than with any special incentives that apply to passively-oriented institutions. Indeed, scholars have long recognized that the PSLRA makes it economically irrational for private institutions to volunteer as lead plaintiffs because it saddles them with exceptional costs and risks without offering any special benefits.[209] Instead, lead plaintiff positions have been dominated by *public* institutions like pension funds – because they do not face the same competitive pressures, because they have a public mandate to stand up and "fix the system," or (in some cases) because they have received campaign contributions from the plaintiffs' attorneys firms.[210]

Direct Actions (Including Opt-Outs) – In 2017, Vanguard recovered as much as $73 million on behalf of their investors in settling an opt-out action against Brazilian oil company Petrobras.[211] In 2018, Vanguard recovered $90 million in a settlement of an opt-out suit against Vereit.[212] In both cases,

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There are exceptions. For instance, some funds (including index funds) managed by TIAA-CREF *have* served as lead plaintiffs. Third Amended Class Action Complaint, *In Re Am. Realty Capital Props., Inc. Litig.,* 15-mc-40 (S.D.N.Y. Sept. 30, 2016) Dkt. 312 (listing constituent funds of lead plaintiff TIAA-CREF including "TIAA-CREF Equity Index Fund," "TIAA-CREF Large Cap Value Index Fund," TIAA-CREF Small Cap Blend Index Fund," and "TIAA-CREF Life Equity Index Fund").

[209] Charles Silver & Sam Dinkin, *Incentivizing Institutional Investors To Serve As Lead Plaintiffs in Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471, 472 (2008); Cox & Thomas with Kiku, *supra* note _, at 1602-__. Conversations with outside counsel for the Big Three confirms that they agree with these relatively standard considerations that have dissuaded all types of private institutions from serving as lead plaintiffs in the majority of cases

[210] Choi, Fisch & Pritchard, *supra* note _ at 881; Cox & Thomas with Kiku, *supra* note _, at 1605; Cox & Thomas with Kiku, *supra* note _ at 1610-15; Bratton & Wachter, *supra* note _ at 143-44.

[211] Petrobras Press Release, (Jun. 19, 2017) https://brazilenergyinsight.com/2017/06/20/petrobras-approves-settlement-with-investors-to-end-individual-securities-action-in-the-united-states/ (announcing settlement with Vanguard and explaining that "As a result of the agreements reached and the stage of negotiations in progress with other individual action plaintiffs, the total value of the estimated provisions amounts to US$ 445 million for the second quarter of 2017, of which US$ 372 million had already been provisioned in the 2016 financial statements.").

[212] Press Release, VEREIT enters into settlement agreement and release with Vanguard (Jun. 11, 2018).

Vanguard stated claims on behalf of actively and passively managed funds, and both debt and equity funds.[213] And, in both cases, Vanguard expressly relied on the presumption of reliance established by *Basic v. Levinson*.[214] Earlier, Vanguard pursued litigation against Citibank based on its role in the Enron fraud,[215] settling the case for an undisclosed amount.[216]

BlackRock has also pursued opt-out litigation. In 2011, BlackRock joined with other institutions in settling an opt-out case against Tyco, recovering $57 million.[217] BlackRock also settled opt-outs against Countrywide (undisclosed amount),[218] and Vareit ($85 million),[219] and is currently pursuing one against Valeant Pharmaceuticals.[220]

State Street has apparently avoided any involvement in Opt-Out litigation.

The Big Three's opt-out record is roughly parallel to that of the "Shrinking 3." Franklin Templeton pursued an aggressive slate of

[213] Complaint ¶ 18, *Vanguard Int'l Equity Index Funds v. Petroleo Brasileiro S.A.,*, 15-cv-6283 (E.D. Pa. Nov. 23, 2015); Complaint ¶ 22, *Vanguard Specialized Funds, et al., v. Vereit, Inc.,* 15-cv-2157 (D. Az. Oct. 27, 2015).

[214] Petrobras Complaint ¶ 278 ("To the extent available, Plaintiffs will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine . . . "); Vereit Compl. ¶ 266 ("There is a presumption of reliance established by the fraud-on-the-market doctrine in this case. . . .").

[215] E.g., David B. Caruso, *Vanguard Group Says It Was Duped By Citibank on Enron,* AP (Apr. 11, 2003).

[216] Citigroup, Inc., Form 8-K at 121 (Oct. 13, 2009).

[217] The lawsuit was filed in 2008, before BlackRock acquired iShares. However, the suit was brought on behalf of a number of BlackRock funds, including a number of equity index funds. *E.g.,* Compl. ¶¶ 14, 18, 19, *BlackRock Global Allocation Fund, Inc. v. Tyco Int'l,* 08-cv-519 (D. N.J. Jan. 29, 2008).

[218] Marketwatch, *BlackRock, Calpers reach Countrywide settlement* (Nov. 22, 2011). The lawsuit was brought on behalf of a large number of BlackRock-managed funds, including a number of equity index funds. *See* Compl. ¶ 47, *Gov't of Guam Retirement Fund et al. v. Countrywide Fin. Corp.*, 11-cv-6239 (C.D. Cal. Jul. 28, 2011).

[219] Vereit, Press Release, VEREIT Enters Into Settlement Agreements and Releases with Eight Opt Out Plaintiffs (Oct 02, 2018). The suit was brought on behalf of a large number of BlackRock managed funds, including a number of equity index funds. E.g., Compl. ¶ 21, *BlackRock ACS US Equity Tracker Fund et al. v. Am. Realty Capital Props., Inc.,* 15-cv-8464 (S.D.N.Y. Oct. 27, 2015).

[220] *See* Am. Compl., *BlackRock Global Allocation Fund, INc. v. Valeant Pharm. Int'l, Inc.*, 18-cv-343 (D.N.J., Sep. 21, 2018). The suit is brought on behalf of a group of BlackRock funds – both indexed and actively managed – that invested equity and debt of Valeant. *Id.* The court denied a motion to dismiss in September 2018. *Blackrock Glob. Allocation Fund, Inc. v. Valeant Pharm. Int'l, Inc.*, 2018 WL 4401727 (D.N.J. Sept. 14, 2018).

opt-out litigation in the 2000s, but not much recently.[221] T. Rowe Price has pursued a few cases,[222] and Invesco has not pursued any. Table 3 presents the results.

Table 3

	Direct Securities Claims (2014-2018)	**Direct Securities Claims (2000-2013)**
Big Three	4	2
Shrinking Three	1	10

Other passively-oriented fund managers have also pursued opt outs aggressively.[223]

[221] Complaint and Jury Demand, *Franklin U.S. Rising Dividends Fund et al. vs. American Int'l Grp., Inc.*, 14-cv-7008 (D.N.J. Sept. 30, 2013) Dkt. 1; Compl. And Jury Demand, *Franklin Mutual Beacon Fund, et al. v. Beazer Homes (USA), INc.*, 09-cv-2578 (N.D. Ga. Set. 18, 2009); Compl., *Franklin Managed Trust et al. v. Fed. Nat'l Mtg. Assoc. et al.*, 06-cv-139 (D.D.C. Jan. 25, 2006) Dkt. 1; Compl., *FTWF Franklin Mutual Beacon Fund et al. v. Quest Comms. Int'l Inc. et al.*, 07-cv-945 (N.D. Cal. Feb. 14, 2007); Compl., *Franklin Mutual Advisers, LLC v. Tyco Int'l, Ltd.*, 07-cv-4575 (D.N.J. Sept. 24, 2007); Complaint, *Fla. State Bd. of Admin. Et al., v. Xerox Corp.*, 02-cv-8 (N.D. Fla. Jan. 4, 2002).

[222] T. Rowe v. Valeant, 16-cv-5034 (D.N.J. 2016); T.Rowe v. Countrywide, 11-cv-6239 (C.D. Cal. 2011); T. Rowe v. Trustees of Bradford College, 05-cv-11667 (D. Ma. 2004).

[223] *E.g.*, Compl., *Schwab S&P 500 Index Fund et al. v. Bank of America Corp.*, 11-cv-5016 (N.D. Cal., Oct. 11, 2011) (listing various funds as plaintiffs, including Schwab S&P 500 Index Fund, Schwab Fundamental US Large Company Index Fund, Schwab Total Stock Market Index Fund, and the Schwab S&P 500 Index Portfolio); Compl. *Schwab S&P 500 Index Fund v. Pfizer, Inc.*, 12-cv-8543 (S.D.N.Y. Nov. 21, 2012) (listing various funds as plaintiffs including the Schwab S&P 500 Index Fund, Schwab 1000 Index Fund, Schwab Total Stock Market Index Fund); Compl., *TIAA-CREF Large Cap Growth Fund v. Allergan et al.*, 17-cv-11089, (D.N.J. Nov. 3, 2017) (listing various funds as plaintiffs including TIAA-CREF Equity Index Fund, TIAA-CREF Large-Cap Value Index Fund, TIAA-CREF S&P 500 Index Fund, TIAA-CREF Large-Cap Growth Index Fund, TIAA-CREF Enhanced Large-Cap Value Index Fund, TIAA-CREF Enhanced Large-Cap Growth Index Fund, TIAA-CREF Life Stock Index Fund); Compl., *TIAA-CREF Investment Mgmt., LLC v. Perrigo Company PLC*, 18-cv-8175 (D.N.J. Apr. 20, 2018) (listing various funds as plaintiffs including CREF Equity Index Account, TIAA-CREF Enhanced Large-Cap Value Index Fund, TIAA-CREF Enhanced Large-Cap Growth Index, TIAA-CREF Equity Index Fund, TIAA-CREF Large-Cap Growth Index Fund, TIAA-CREF Large-Cap Value Index Fund, TIAA-CREF S&P 500 Index Fund, TIAA-CREF Life Stock Index Fund, TIAA Stock Index Account); Complaint, *Munder Asset Allocation Fund v. Joseph P. Nacchio*, 09-cv-172 (D. Col. Jan. 28, 2009)

Other U.S. Litigation **–** BlackRock has led a series of lawsuits (and threatened lawsuits) against various financial institutions for misconduct related to the financial crisis of 2008. First, BlackRock pursued litigation against financial institutions for faulty mortgage underwriting and servicing practices, ultimately recovering over $14 billion for investors.[224] Second, BlackRock also pursued litigation against financial institutions who served as trustees for these RMBS securities, seeking damages for losses of over $250 billion.[225] Third, as mentioned above, BlackRock opted out of a 10b-5 class action settlement against Countrywide based on misstatements regarding its mortgage servicing practices, settling for an undisclosed amount.[226] BlackRock appears to be unique among both the Big Three and the Shrinking Three for its focus on these RMBS cases.[227]

BlackRock has also pursued an antitrust case targeting major financial institutions for foreign exchange manipulation.[228] After

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(listing various funds as plaintiffs including Munder Index 500 Fund and Munder Instiitiutional S&P 500 Index Equity Fund).

[224] *See In re Bank of New York Mellon***,** 986 N.Y.S.2d 864 (N.Y. Sup. 2014), *aff'd* 127 A.D.3d 120 (N.Y. App. Div. 2015) (approving the settlement). Dan Fitzpatrick & Julie Steinberg, *Another J.P. Morgan Payout – Bank Settles With Investors for $4.5 Billion Over Mortgage Backed Securities*, WALL ST. J. (Nov. 16, 2013); Karen Freifeld, *JPMorgan Chase to pay $4.5 billion in Mortgage Security Deal*, REUTERS (Nov. 15, 2013); *see also* Nathan Vardi, *BlackRock Led Group Goes After JPMorgan With Mortgage-Backed Securities Claims*, FORBES (Dec. 16, 2011). BlackRock also took public steps towards bringing similar case against Ocwen, a mortgage servicing company, however, apparently never pushed for a settlement. Karen Freifeld, *Big Mortgage Investors Take First Step Toward Suing Ocwen,* Reuters (Jan. 23, 2015); Gibbs & Bruns LLP, Press Release, $1.13 Billion Settlement With Citigroup on Behalf of 18 Institutional Investors (Dec. 26, 2018).

[225] Al Yoon, *BlackRock Pimco Funds Sue Deutsche Bank, U.S. Bank Over Trustee Roles*, DOW JONES NEWSWIRES (Jun. 18, 2014); Jon Hill, *Deutsche Bank Settles BlackRock RMBS Suits,* LAW360 (Dec. 5, 2018); *Wells Fargo: Settles 2 RMBS Trust Class Actions for $43MM,* CLASS ACTION REPORTER (Nov. 28, 2018); *Royal Park Investments SA/NV v. HSBC Bank USA, N.A.*, 2018 WL 679495, at *1 (S.D.N.Y. Feb. 1, 2018) (denying certification); *Blackrock Allocation Target Shares: Series S Portfolio v. Bank of New York Mellon*, 180 F. Supp. 3d 246 (S.D.N.Y. 2016) (allowing some claims to proceed); *Blackrock Balanced Capital Portfolio (FI) v. U.S. Bank Nat'l Ass'n*, 165 A.D.3d 526 (N.Y. App. Div. 2018) (allowing some claims to proceed).

[226] David Benoit, *BlackRock, Calpers Reach New Settlement On Countrywide Claims*, WALL ST. J. (Nov. 22, 2011).

[227] *But see* Gibbs & Bruns LLP, Press Release, $1.13 Billion Settlement With Citigroup on Behalf of 18 Institutional Investors (Dec. 26, 2018) (including Invesco).

[228] Jonathan Stempel, *Big Investors Sue 16 Banks in U.S. Over Currency Market Rigging*, REUTERS (Nov. 7, 2018). The suit was brought on behalf of a

the LIBOR scandal, Vanguard and BlackRock both reportedly were "investigating" whether to file an antitrust suit – though neither one did.[229]

Foreign Litigation – A review of publicly available information confirms that the Big Three have pursued a modest slate of foreign shareholder litigation.[230] But, more importantly, based on conversations with well-placed individuals, these institutions have been pursuing foreign litigation very ***aggressively***. One of them joined as a plaintiff in <u>eight</u> foreign cases in 2018 alone. However, these cases are not on the public record.

B. Just Vote "No"

This part addresses four questions regarding how the Big Three utilize voting against directors in the wake of corporate fraud and misconduct as an enforcement tool: (1) Do the Big Three become more aggressive in voting against directors when the portfolio company is facing allegations of fraud or misconduct?; (2) Are the Big Three more likely to oppose directors in these cases than the actively-oriented funds they are displacing?; (3) When the Big Three do oppose a director in the wake of a corporate crisis, do they maintain that opposition against the same director at other companies where he or she serves?[231]; and (4) To what extent do the Big Three's "no" votes on directors in the wake of corporate misconduct have an impact on the enforcement ecosystem?

On the first question, I examine whether the Big Three are more likely vote against a corporate director at an individual firm following a major corporate scandal at that firm. I evaluated the Big Three's voting records at companies (a) targeted by securities class actions resulting in *very large* settlements (>$175 million);[232] (b) targeted by ordinary securities class actions[233]; and (c) involved

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largenumber of BlackRock-managed funds, including a number of equity index funds. *See Allianz Global Investors GMBH v. Bank of America Corp.*, Appendix C, 18-cv-10364 (S.D.N.Y. Nov. 7, 2018).

[229] Jean Eaglesham, *Suits Mount in Rate Scandal – Billions of Dollars At Stake in Claims,* WALL ST. J. (Aug. 27, 2012); Kristen Grind, *Global Finance: Libor Suits Weighed By Mutual Fund Firms,* WALL ST. J. (Jul. 27, 2012).

[230] *See* Appendix A.

[231] I plan to further explore "Horizontal Voting" by the Big Three and other institutional investors in a future project.

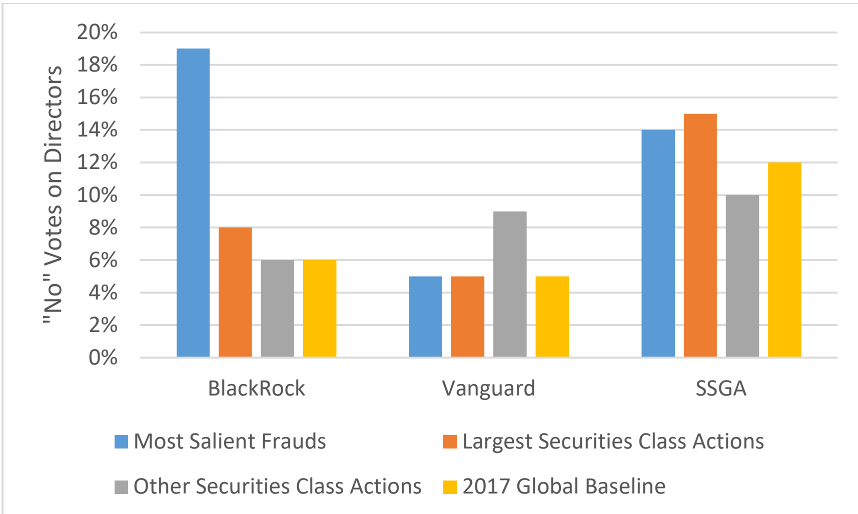
[232] I generated this list from the ISS list of top securities class action settlements of all time. The shareholder elections are the first ones held after the initial complaint.

[233] Using the *Stanford Securities Class Action* database, I constructed a list of class actions filed in the last and first quarter of each year, eliminated all cases that had not reached a settlement, and used Lexis Securities Mosaic to hand

in the some of most salient corporate scandals of the last decade, measured by media coverage.[234] Figure 2 presents these results, as compared against the Big Three's own baseline voting patterns – *i.e*., the general rate at which they vote "no" on directors.[235]

Figure 2

Voting against directors at companies facing allegations of fraud or misconduct



As reported in Figure 2, both BlackRock and SSGA appear to be more likely to vote against a director following the "most salient" frauds, and the largest securities class actions than they do in the baseline, while Vanguard is not. By contrast, for companies

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collect the voting records of the Big Three in corporate elections within one year of the initial filing. E.g., for companies facing class actions in 2012Q4 and 2013Q1, the relevant votes occurred during the 2013 proxy season.

[234] I used Factiva to generate a list of the top-covered companies in 2011, 2013, 2015 and 2017 for subjects "Financial Crime" "Fraud" or "Corporate Crime/Legal Action" in three publications: USA Today, NYT, and WSJ. I eliminated a small number of companies from the resulting lists that seemed to be covered due to general interest in interest in the company, not due to any particular misconduct or fraud. I chose 10 of the most covered companies from each year. For these companies, I identified the key fraud that was triggering the press coverage. For most, there was no difficulty – there was one obvious event or course of misconduct that triggered the press coverage. In some cases, however, there were multiple stories. For such companies, I assessed the general volume and salience of press coverage for each and determined which one appeared to be generating the most interest. Then I worked backwards to determine the date of the key corporate election – *i.e.*, the shareholder meeting at which shareholders would have had the first real opportunity to voice complaints about the misconduct in question. I used a combination of securities class action filings, media coverage, and proxy advisor recommendations to make this determination.

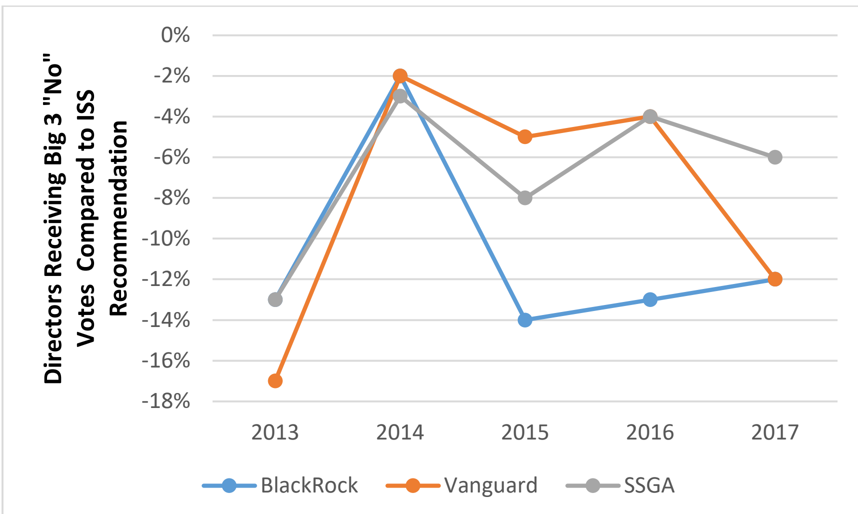
[235] As disclosed in their 2017 Stewardship Reports.

facing more run-of-the-mill class actions, Vanguard was more likely to vote "no," while BlackRock and SSGA were not.

To compare these voting patterns against the institutions they are displacing in the market – actively-oriented mutual funds – I compare the Big Three's voting records in the "other" class action cases against ISS voting recommendations (figure 3). The ISS recommendations are at the far end of the positions that a more aggressive, small, actively managed fund might take, and so form a good baseline to evaluate how the Big Three's rise may be changing the enforcement landscape.[236]

Figure 3

Voting against directors at companies facing securities class actions, compared to ISS recommendations



The results reported in Figure 3 suggest that for every ten directors up for election in companies facing a (subsequently settled) securities class action, the Big Three will vote against one less director than what ISS recommends. Thus, in these "ordinary" fraud cases, the Big Three do appear to be consistently more deferential to management, and less likely to vote against a director than the most aggressive actively managed mutual funds.

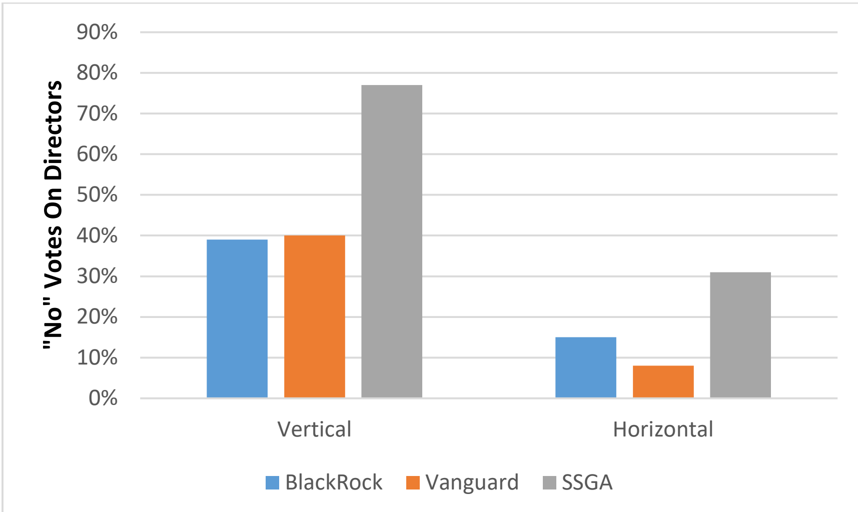
Third, I evaluated the extent to which the Big Three enhance the deterrent impact of their "no" votes by making them stick across time and at different companies where the director may serve. I call the former "vertical" and the latter "horizontal." Based on a review of a sample of "no" votes following the most

[236] *E.g.*, Patrick Bolton et al., *Investor Ideology*, *supra* note _ (finding that ISS is "to the left" of most mutual funds).

salient frauds (described above), the Big Three do take advantage of this capacity to enhance the deterrent power of their "no" votes, albeit only rarely. Figure 4 reports the results.

Figure 4

Big Three "Horizontal" and "Vertical" Director Voting (Most Salient Frauds)



As Figure 4 indicates, for all three, in the majority of cases where they vote against a director following a highly salient fraud, they continue to support that director at other companies where he or she serves. Where that director remains on the ballot at the same company in the following year, SSGA typically continues to oppose that director, but Vanguard and BlackRock are likely to revert to supporting that same director the following year.

Fourth, to examine the impact of the Big Three's voting decisions on the enforcement landscape, I draw on some case studies.

Wells Fargo – In 2016, the U.S. Consumer Financial Protection Bureau settled charges against Wells Fargo for defrauding millions of its customers by opening fake bank accounts and credit cards without authorization, generating millions of dollars in fees for the bank.[237] The settlement was the largest in the agency's history,[238] and launched a massive wave of

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[237] Consent Order, *In re Wells Fargo Bank, N.A.*, Admin. Proceeding 2016-CFPB-0015 (U.S. Consumer Financial Protection Bureau) (Sept. 8, 2016). The misconduct had been revealed earlier, by the Los Angeles times. E. Scott Reckard, *Wells Fargo's Pressure-Cooker Sales Culture Comes At A Cost*, L.A. TIMES (Dec. 21, 2013).

[238] *See* CFPB, Press Release, *Consumer Financial Protection Bureau Fines Wells Fargo $100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts* (Sep. 8, 2016).

government investigations,[239] Congressional hearings,[240] private litigation,[241] and public outrage.[242]

The Big Three were all among largest owners of Wells Fargo, After the scandal broke, Vanguard (Wells' second-largest owner[243]) engaged to "express[its] concerns about the board's responsibility in preventing and responding to the matter," and to question the risk committee's "ability to fulfill its obligations."[244] State Street also engaged multiple times on "governance" issues.[245] At the bank's 2017 shareholder meeting, the Big Three all voted "no" on one or more directors. Vanguard voted against the bank's Chairman Stephen Sanger, the Chair of the Risk Committee Enrique Hernandez, and a third director who sat on the Risk Committee, Federico Pena. Vanguard's votes were well-covered by the press,[246] and Vanguard publicized its actions (in thinly

[239] *E.g*., Paul Blake, *House Committee Launches Investigation Into Wells Fargo For Alleged Misconduct*, ABC NEWS (Sep. 16, 2016); Paul Blake & Josh Margolin, *FBI and Federal Prosecutors Probing Wells Fargo Amid Accounts Scandal, Official Says*, ABC NEWS (Sep. 14, 2016); Paul Blake, *Senators Call on Justice Department to Investigate Wells Fargo's Top Brass*, ABC NEWS (Oct. 5, 2016); Paul Blake & Margaret Chadbourn, *Wells Fargo Facing Criminal Investigation in California* (Oct. 19, 2016); Emily Glazer, *SEC Probing Wells Fargo Around Sales-Practice Disclosures*, WALL ST. J. (Nov. 2, 2016); James Rufus Koren, *Illinois, following California, sanctions Wells Fargo over accounts scandal*, L.A. TIMES (OCT. 3, 2016).

[240] Paul Blake, *Wells Fargo CEO John Stumpf Told to Resign By Sen. Warren,* ABC NEWS (Sep. 20, 2016); Paul Blake, *Round Two: Wells Fargo CEO Faces Blistering Rebuke From Congress Again*, ABC NEWS (Sep. 29, 2016); Jim Puzzanghera, *What Did Wells Fargo's New CEO Know About The Scandal? Senators Push for Answers*, L.A. TIMES (Oct. 20, 2016); James Rufus Koren & Jim Puzzanghera, *Lawmakers Spew Vitriol at Wells Fargo CEO and Ramp Up Demands for Wider Probe of the Banking Industry*, L.A. TIMES (Sep. 29, 2016).

[241] *See* James Rufus Koren, *Judge OKs $480-million settlement with Wells Fargo shareholders over unauthorized-accounts scandal,* L.A. TIMES (Sep. 5, 2018); Paul Blake, *Former Wells Fargo Employees File Lawsuit Amid Unauthorized Accounts Scandal*, ABC NEWS (Sep. 26, 2016); James Rufus Koren, *Wells Fargo's $142-million sham accounts settlement: What you need To know*, L.A. TIMES (Jul. 11, 2017).

[242] *E.g.*, Paul Blake, *Hillary Clinton Slams Wells Fargo for 'Egregious Corporate Behavior'*, ABC NEWS (Oct. 3, 2016).

[243] Kerber, *supra* note _.

[244] Vanguard 2017 Stewardship Report 23 (referring to "a U.S. financial company that was fined for fraud"); *see also* Kerber, *supra* note _.

[245] SSGA 2016 Stewardship report 53; SSGA 2017 Stewardship Report at 97.

[246] Sarah Krouse, *Vanguard Voted Against Wells Fargo Directors*, WALL ST. J. (Aug. 31, 2017); Ross Kerber, *Vanguard Withheld Support for Key Wells Fargo Directors: Filings*, REUTERS (Aug. 31, 2017); Erin Arvedlund, *Is Vanguard "Woke"? It Speaks Out On Wells Fargo, Climate-Risk Analysis, Gender Diversity*, PHILLY.COM (Sept. 5, 2017).

disguised terms) in its annual stewardship report.[247] BlackRock voted against seven directors, including the same three as Vanguard. SSGA voted against one director.

Chairman Sanger received just 56% approval from shareholders, and stepped down as Chair and off the Risk Committee. Mr. Hernandez, the Chair of Wells' Risk Committee, also received a low portion of the vote, and promptly stepped down from that role, and the third director on the Risk Committee also stepped down from that role.[248]

But the Big Three diluted the deterrent impact of their high-profile "no" votes in this case. Even as Vanguard and BlackRock voted against Chairman Sanger, they continued to support him as a director at Pfizer. Similarly, even as Vanguard and BlackRock voted against Wells' chair of the Risk Committee (Hernandez), they continued to support him at Chevron and McDonalds.[249] BlackRock did the same for two other Wells directors it opposed (*i.e.*, voting against their election to the Wells board, but continuing to support them at other companies).[250] One of the directors BlackRock opposed in 2017 at Wells (Quigley), BlackRock turned around and *supported* at Wells in 2018.

JPMorgan Chase – In 2012, J.P. Morgan disclosed that it had suffered massive losses (initially stated as $2 billion, later enlarged to $6.2 billion) as a result of a series of credit default swap trades made by a single employee – referred to as the "London Whale."[251] The firm's internal risk regulation protocols were widely blamed for the oversight (and for the highly inaccurate initial disclosure of the magnitude of the losses).[252] The scandal led to a wave of government investigations[253] and private litigation.[254]

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[247] VANGUARD, INVESTMENT STEWARDSHIP REPORT 2017 at 23.

[248] Kerber, *supra* note _.

[249] Ironically, the Wells Fargo scandal was precipitated in part by junior employees being told they "would end up working for McDonald's" unless they met their sales quotas. E. Scott Reckard, *Wells Fargo's Pressure Cooker Sales Culture Comes At A Cost*, L.A. TIMES (Dec. 21, 2013).

[250] Dean (2017 +18 McDonalds); Quigley (Hess 2017+2018).

[251] Patricia Hurtado, *The London Whale*, BLOOMBERG (Feb. 23, 2016); Heidi N. Moore, *JP Morgan's Loss: The Explainer*, MARKETPLACE.ORG (May 11, 2012).

[252] *E.g.*, Editorial, *Lessons from the London Whale*, N.Y. TIMES (Jan. 19, 2013).

[253] Securities and Exchange Commission, Press Release, *JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges* (Sep. 19, 2013); Aruna Viswanatha, *JPMorgan to pay $100 million in latest "London Whale" fine*, REUTERS (Oct. 16, 2013) (CFTC settlement); Ben Protess, *'London Whale' Case Leads to Fine for Former JPMorgan Executive*,

Ahead of the bank's annual shareholder meeting in 2013, financial journalists reported "an intensifying drumbeat or change" as a result of the scandal.[255] Leading proxy advisors uniformly called for the removal of three directors serving on the risk policy committee.[256]

The Big Three were each among the five biggest owners of JPMorgan.[257] State Street voted against the three risk committee directors. BlackRock also voted against the three – but did not actually make this decision itself, but rather (due to a conflict) had outsourced its vote to a third party.[258] And Vanguard supported all directors. The "no" votes had an impact. Two of the three targeted directors on the Risk Committee received barely enough votes for reelection, and then promptly resigned from the board.[259]

Volkswagen **-** From 2009 to 2016, Volkswagen installed software in hundreds of thousands of diesel vehicles that caused the vehicles to cheat on emissions tests, and then lied about it to regulators.[260] The scandal first broke in September 2015, following an investigation by the U.S. EPA.[261] State Street promptly engaged with Volkswagen to complain about the lack of independence on the company's board, as a contributing factor to the scandal.[262] At the annual shareholder meeting in 2016, the Big Three all voted against the firm's Chairman and multiple other

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N.Y. TIMES (Feb. 9, 2016); Chris Isidore & James O'Toole, *JPMorgan fined $920 million in 'London Whale' trading loss*, CNN MONEY (Sep. 19, 2013).

[254] Nate Raymond, *JPMorgan to pay $150 million in "London Whale" US Class Action*, REUTERS (Dec. 21, 2015).

[255] Brian Browdie, *JPM Battles More Calls to Overhaul Board, Name New Chairman*, AM. BANKER (May 6, 2013).

[256] Browdie, *supra* note _.

[257] John Carney, *Jamie Dimon Faces His Critics in Crucial Shareholder Vote,* CNBC (May 20, 2013).

[258] Susanne Craig & Jessica Silver-Greenberg, *Small Firm Could Turnt he Vote on Dimon,* N.Y. TIMES (May 7, 2013).

[259] Jessica Silver-Greenberg, *Two JPMorgan Directors Resign,* N.Y. TIMES (Jul. 19, 2013).

[260] *See, e.g.*, Department of Justice, Press Release, *Volkswagen AG Agrees to Plead Guilty and Pay $4.3 Billion in Criminal and Civil Penalties; Six Volkswagen Executives and Employees are Indicted in Connection with Conspiracy to Cheat U.S. Emissions Tests* (Jan. 11, 2017), *available at* https://www.justice.gov/opa/pr/volkswagen-ag-agrees-plead-guilty-and-pay-43-billion-criminal-and-civil-penalties-six.

[261] *E.g.*, Coral Davenport & Jack Ewing, *U.S. Orders Major VW Recall Over Emissions Test Trickery*, N.Y. TIMES (Sept. 19, 2015).

[262] SSGA 2016 Stewardship Report at 29.

board members. However, Vanguard and BlackRock continued to support one of these board members – Annika Falkengren – at another firm (Skandivaska Enskilda Banken). Volkswagen is a controlled company, so even large institutions like the Big Three[263] have limited ability to influence the company by voting. Thus, a few months after the "no" votes, all three firms joined a shareholder lawsuit against VW in Germany seeking billions of dollars from the company.[264] The lawsuit is ongoing.[265]

Wal-Mart **–** In early 2012, reports were published that Wal-Mart had engaged in widespread bribery in Mexico, and had illicitly shut-down its own internal investigation.[266] BlackRock voted against four director nominees, including the chairman, and two former CEOs of the company.[267] One journalist suggested that this was a "protest vote" to lay "some blame" on the board's most prominent members.[268] All of the targeted directors were re-elected, but one of them did not run for re-election in 2013, and two more were targeted by ISS the following year, in part because ISS said they deserved blame for the Mexico issues.[269]

Exxon Mobil **–** In 2015, reports were published that Exxon had suppressed research on the impacts of climate change – including the impacts on its business.[270] Several state Attorneys General launched high-profile investigations into whether Exxon had lied to shareholders,[271] the SEC launched an investigation[272] and shareholders filed a class action.[273]

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[263] BlackRock was the "eighth largest holder of VW's ordinary shares." Peter Campbell, *BlackRock Joins Investor Lawsuit Against Volkswagen*, FIN. TIMES (Sept. 15, 2016).

[264] *See* Peter Campbell, *BlackRock Joins (euro)2B Investor Lawsuit Against VW*, FIN. TIMES (Sept. 16, 2016); Christoph Rauwald, *VW Being Sued By BlackRock as More Investors, Governments Take Legal Action* (Sept. 16, 2016); Attracta Mooney, *Lessons To Learn From The VW Scandal*, FIN. TIMES (OCT. 10, 2016).

[265] ISS, U.S. Proxy Voting Guidelines: Benchmark Policy Recommendations at 16 (Jan. 4, 2018), *available at* https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf

[266] *E.g.*, David Barstow, *Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle*, N.Y. TIMES (Apr. 22, 2012).

[267] Carol J. Loomis, *BlackRock: The $4.3 trillion force,* FORTUNE (Jul. 7, 2014).

[268] *Id.*

[269] *Id.*

[270] Neela Banerjee, Lisa Song & David Hasemyer, *Exxon: The Road Not Taken*, INSIDE CLIMATE NEWS (Sep. 16, 2015).

[271] Justin Gillis, *Weighing Whether Exxon Lied On Climate; New York Official Looks At Statements To Public and Investors on Climate*, N.Y. TIMES; John

In a widely-covered vote in the company's 2017 shareholder election, the Big Three (all among Exxon's largest owners) all voted in favor of a shareholder proposal (and against management) to require the company to provide expanded climate risk disclosure.[274] The proposal passed.

***Mylan* –** In late 2016, the pharmaceutical company Mylan came under intensive public criticism for dramatically raising the price of its allergy-reaction injector EpiPen nearly six-fold, making it unaffordable to many consumers. The scandal provoked a wave of investigations and enforcement activities, including Congressional hearings,[275] a wave of class action litigation under antitrust and RICO theories, a related Justice Department False Claims Act lawsuit[276] an antitrust investigation New York Attorney General,[277] and pointed criticism from Presidential candidate Hillary Clinton.[278]

At Mylan's 2017 shareholder election, BlackRock (Mylan's third-largest shareholder) voted against four Mylan directors and also against approval of Mylan's executive compensation plan. As BlackRock explained in a public memorandum issued at the time of the votes, the votes expressed its view that Mylan "has been insufficiently responsive to shareholder concerns" including

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Schwartz, *Another Climate Investigation*, N.Y. TIMES (Jan. 22, 2016); John Schwartz, *States Stand By New York In Its Exxon Mobil Inquiry*, N.Y. TIMES (MAR. 30, 2016).

[272] Clifford Kraus, *S.E.C. Is Latest To Look Into Oil Valuations By Exxon Mobil*, N.Y. TIMES (Sep. 21, 2016).

[273] David Hasemyer, *Class-Action Lawsuit Adds to ExxonMobil's Climate Change Woes*, INSIDECLIMATE NEWS (Nov. 21, 2016).

[274] *E.g.*, Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST (May 31, 2017); Tom Buerkle, *Vanguard Speaks Softly But Carries A Big Stick*, N.Y. TIMES (Sep. 2, 2017); *BlackRock Urges Exxon to Disclose More About Climate Change-Related Risks*, REUTERS (Jun. 9, 2017); Dominic Rushe, *Shareholders Force ExxonMobil to Come Clean on Cost of Climate Change*, THE GUARDIAN (May 31, 2017); Bradley Olson, Sarah Krause & Sarah Kent, *BlackRock, Vanguard Mull Pressuring Exxon to Disclose Climate Risks*, WALL ST. J. (May 25, 2017).

[275] Katie Thomas, *Mylan Chief's Answers on EpiPen Frustrate House Panel*, N.Y. TIMES (Sep. 22, 2016); Josh Beckerman, *Senate Panel Urges FTC to Review Mylan*, WALL ST. J. (Nov. 7, 2016)

[276] Katie Thomas, *Mylan to Pay $465 Million in Epipen Overpricing Case*, N.Y. TIMES (Oct. 8, 2016)

[277] Austen Hufford, *New York Investigating Mylan Over EpiPen School Contracts*, WALL ST. J. (Sep. 6, 2016).

[278] Thomas M. Burton & Brent Kendall, *Hillary Clinton Calls for Mylan to Lower EpiPen Price Amid Outcry*, WALL ST. J. (Aug. 24, 2016)

regarding "the regulatory investigations and fines involving Mylan's EpiPen product."[279] The votes were reported in the press.[280] Vanguard and State Street supported the board, which was re-elected.[281]

Massey Energy – In 2010, an explosion at a coal mine in West Virginia operated by Massey Energy killed 29 miners.[282] Subsequent investigation revealed that the disaster was preventable and the company's management was negligent in failing to prevent it.[283] The scandal led to prosecutions of senior executives[284] and significant private litigation.[285]

Ahead of the company's 2010 shareholder meeting, leading proxy advisors recommended to vote no on three directors who served on the board's safety committee because of their failure to prevent the tragedy at the mine.[286] BlackRock and State Street both voted against all three of these directors, but Vanguard supported them. They were all elected by very narrow margins.[287]

C. Engagement

Only SSGA discloses systematic information regarding its engagements. Using the dataset above of meritorious class action filings, I calculated SSGA's rate of engagement with these companies in calendar year immediately following the filing of the class action as 9%, as compared with its rate of engagement with

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[279] BlackRock, https://www.blackrock.com/corporate/literature/press-release/blk-mylan-vote-bulletin-june2017.pdf

[280] *E.g.*, Toby Sterling, *Mylan Shareholders Vote Against Executive Pay, Re-Elect Board*, REUTERS (Jun. 22, 2017)

[281] Toby Sterling, *Mylan Shareholders Vote Against Executive Pay, RE-Elect Board*, REUTERS (Jun. 22, 2017).

[282] Jeff Young, *The story behind the Upper Big Branch mine disaster*, PRI (Apr. 13, 2010).

[283] Sabrina Tavernise, *Report Faults Mine Owner for Explosion That Killed 29*, N.Y. TIMES (May 19, 2011); Howard Berkes, *Report Blasts Massey For "Deviance" In Safety Culture*, NPR (May 19, 2011).

[284] *Former Coal CEO Sentenced to A Year In Prison After 2010 West Virginia Coal Mine Disaster*, WASH. POST (Apr. 6, 2016); Howard Berkes, *Former Massey Exec Gets 42 Months In Mine Disaster Case*, NPR (Sep. 10, 2013).

[285] *Massey Energy Parent To Pay $265M To Exit Shareholder Suit*, LAW360 (Dec. 9, 2013).

[286] Joann S. Lublin, *Glass Lewis Urges Vote Against 3 Massey Directors*, WALL ST. J. ONLINE (May 6, 2010); Eleanor Bloxham, *What Does Massey Do Now?* FORTUNE (May 18, 2010); CtW Investment Group, Letter to Massey Shareholders (Apr. 29, 2010).

[287] Steve James, *Narrow proxy victory for miner Massey's directors*, REUTERS (May 18, 2010).

all companies, 10%.[288] These findings do not support the proposition that SSGA engagement is driven by enforcement.

However, I do find some anecdotal evidence that the Big Three choose which portfolio companies to engage with, in part, based on corporate misconduct and fraud. Based on the narratives provided by these institutions in their promotional materials, these engagements are opportunities for the institutions to gain information about the crisis, to recommend compliance reforms, and to make demands for certain changes with the threat of a vote or litigation as a backup.

For instance, in recent years, ***BlackRock*** has engaged "a global energy company in Brazil" (*i.e.*, Petrobras) to discuss "a major bribery scandal at the company,"[289] several companies that "had experienced cyber-attacks"[290] including a "consumer credit reporting agency" (*i.e.*, Equifax),[291] several major Australian banks in the wake of "a series of banking and financial scandals,"[292] a "major Hong Kong based utility company" in the wake of a series of "contractor and employee fatalities in recent years,"[293] a "Taiwanese financial holding company" in the wake of "several scandals involving questionable related-party transactions,"[294] and a "Danish bank that was facing allegations of money laundering."[295]

Vanguard engaged (among others) a "U.S. consumer discretionary company" whose CEO had been forced out over sexual harassment allegations,[296] a "U.S. industrials company"

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[288] Bebchuk & Hirst, *Index Funds, supra* note _ (providing baseline engagement rate of 10%).

[289] BLACKROCK INVESTOR STEWARDSHIP REPORT: AMERICAS Q1 2017 (Mar. 31, 2017). BlackRock also states that it engages with companies when there has been "an event at the company that has impacted its performance or may impact long-term company value." BLACKROCK, THE INVESTMENT STEWARDSHIP ECOSYSTEM 7 (July 2018).

[290] BLACKROCK INVESTMENT STEWARDSHIP REPORT: AMERICAS Q4 2018 (Dec. 31, 2018)

[291] BLACKROCK, INVESTMENT STEWARDSHIP REPORT: AMERICAS Q2 2018 (Jun. 30, 2018)

[292] BLACKROCK INVESTMENT STEWARDSHIP REPORT: ASIA-PACIFIC Q4 2018 (Dec. 31, 2018)

[293] *Id.*

[294] *d.*

[295] BLACKROCK, INVESTMENT STEWARDSHIP REPORT: EUROPE, THE MIDDLE EAST, AND AFRICA (Q3 2018).

[296] VANGUARD, INVESTMENT STEWARDSHIP 2018 ANNUAL REPORT 13.

following news of a significant data breach,[297] an "Australian financial services company" following "numerous governance failings and a public investigation" (two board members resigned following the engagement),[298] an "Australian materials company" following a "fatal environmental disaster,"[299] and a U.S. financial company (*i.e.,* Wells Fargo) "fined for fraud."[300]

SSGA engaged (among others) General Motors following the disclosure of a massive ignition switch recall scandal in order "to understand their approach to vehicle safety, changes which have been made to their safety processes, and the extent to which the board has oversight of product safety,"[301] and Volkswagen in the wake of its emissions fraud scandal, to express concerns about the company's "board and ownership structures" and to encourage the company to adopt reforms to enhance the independence of the board.[302]

D. Guidance

The Big Three have promulgated some guidelines regarding the consequences for corporate misconduct, but only at a relatively high level of abstraction. There is no firm commitment to voting out directors or insisting upon the removal of managers following revelations of fraud. And there is also almost no mention of any litigation activities.

Vanguard's Stewardship literature articulates, in general terms, what the institution wants to see from a Board following a crisis: a "timely and transparent" response, "ongoing communications with shareholders as the situation unfolds" and an explanation of "what the board knew and when, how it is responding to the crisis, and what gaps have been identified in its internal board practices that it intends to address."[303] But, other than a veiled threat[304] there is no reference to individual consequences facing directors or managers following disclosure of fraud or misconduct. Vanguard says it will vote against director nominees where the actions of the

[297] *Id.* at 27.

[298] *Id.*

[299] VANGUARD, INVESTMENT STEWARDSHIP 2017 ANNUAL REPORT 23.

[300] *Id*.

[301] STATE STREET GLOBAL ADVISORS, ANNUAL STEWARDSHIP REPORT: 2014 YEAR END 26.

[302] SSGA STEWARDSHIP REPORT

[303] VANGUARD 2018 STEWARDSHIP GUIDE 26.

[304] *Id.* ("A company's response to a crisis often determines how shareholders vote in the wake of an incident.").

committee(s) on which nominee serves demonstrate "serious failures of governance,"[305] but defines "serious failures" in strictly procedural terms, not in terms of failing to prevent or redress a specific course of fraud or misconduct – "e.g., unilaterally acting to significantly reduce shareholder rights, failure to respond to previous vote results for directors and shareholder proposals."[306] Notably, Vanguard's stewardship literature fails to mention its two recent highly successful opt-out lawsuits.

BlackRock's stewardship literature states that its patience with the board "is not infinite" and, in appropriate circumstances, "we will not hesitate to exercise our right to vote against management recommendations."[307] But BlackRock does not spell out how and when corporate misconduct will result in discipline to managers, directors, to a lawsuit, or insisting on new governance measures to prevent future events. BlackRock has published commentaries on "climate risk,"[308] "strategy purpose and culture,"[309] "diversity,"[310] "human capital,"[311] and "executive compensation"[312] but not accountability for misconduct. BlackRock *does* mention that it may vote against directors based on their role as director in another company.[313] BlackRock's literature does not mention anything about its litigation on behalf of investors.

SSGA*'s* stewardship material states that it will vote against directors who "appear to have been remiss in their duties."[314] A 2018 Op-Ed by SSGA's CEO and President references "recent corporate scandals around poor internal controls" but he does so as support for the importance of *ex ante* engagement on governance

[305] VANGUARD PROXY GUIDELINES.

[306] Id.

[307] BR STEWARDSHIP PRIORITIES FOR 2018.

[308] BlackRock, *BlackRock Investment Stewardship's Approach To Engagement On Climate Risk* (Mar. 2018).

[309] BlackRock, *BlackRock Investment Stewardship's approach to engagement on long-term strategy, purpose, and culture* (Mar. 2018).

[310] BlackRock, *BlackRock Investment Stewardship's approach to engagement on board diversity* (Mar. 2018).

[311] BlackRock, *BlackRock Investment Stewardship's approach, to engagement on human capital management* (Mar. 2018).

[312] BlackRock, *BlackRock Investment Stewardship's approach to executive compensation* (Mar. 2018).

[313] BR GLOBAL CORPORATE GOVERNANCE AND ENGAGEMENT PRINCIPLES (Oct. 2017).

[314] STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES: NORTH AMERICA (UNITED STATES & CANADA) at 3 (Mar. 2018).

issues – and does not suggest SSGA has any role to play in punishing or responding this kind of conduct.[315] Like the other two institutions, SSGA does not mention litigation.

E. Assessing The Evidence

The evidence confirms that in an important minority of cases the Big Three overcome their general incentives to passivity to take action to discipline portfolio companies and their managers accused of misconduct or fraud. The Big Three's level of involvement in securities litigation – class and non-class – is not meaningfully less than actively-oriented funds, and their role in other types of litigation (foreign and RMBS) seems to be fairly aggressive. There is some evidence that *high-profile* episodes of corporate fraud and misconduct affects Big Three voting patterns at the individual firm level, and in some rare cases, the Big Three utilize their power to impose a heightened penalty – voting against a culpable director for multiple years, and across multiple companies. And in a number of high-profile cases, the Big Three's votes have had a significant impact – resulting in director turnover and significant media coverage. There is also anecdotal evidence that the Big Three engage with firms that are in the throes of a corporate scandal to gather information and make demands for reform.

Some of the evidence is consistent with the predictions articulated above. For instance, the Big Three do appear to have some preference for highly salient cases that can send a strong deterrent signal to the market – and (perhaps) an appealing pitch to potential customers. But in many of the high-profile votes, the Big Three undercut the real deterrent impact of their vote by continuing to support the same board member at other firms or even at the same firm, which indicates the institutions are mainly interested in generating a positive media impression, rather than deterring bad conduct.

Similarly, the Big Three have pursued a modest slate of non-class litigation. But they have done so predominantly against *foreign* firms. An innocent explanation is that the Big Three have lower ownership stakes in foreign firms, and thus have less to lose as "holders" in this litigation. A less innocent explanation is that the Big Three are foregoing potentially valuable litigation opportunities against U.S. firms because these firms with whom they are more likely to have profitable business relationships.

[315] Cyrus Taraporevala, *Index Funds Must Be Activists To Serve Investors*, FIN. TIMES (Jul. 24, 2018).

In sum, the evidence shows that the Big Three engage in more "enforcement" activities than the Passivity Thesis suggests, but somewhat less than what my "pro-enforcement" incentives might suggest. Certainly, this enforcement shortfall is in part a testament to the power of the incentives articulated by the Passivity Thesis. But at least some of the enforcement shortfall is traceable to flaws and asymmetries in the regulatory regime. Below, I discuss some reforms to the disclosure and litigation regimes that might remove some of the current obstacles to more aggressive index fund enforcement.

V. IMPLICATIONS AND REFORMS

A. Weighing The Social Costs And Benefits Of Index Funds

Critics of the Big Three from a wide variety of perspectives have converged on a common "solution" to the rising concentration of corporate ownership: take away the Big Three's ability to influence portfolio companies. For instance, proponents of the Passivity Thesis have proposed restricting passively managed funds' ability to vote in corporate elections.[316] A leading proponent of the antitrust theory that large institutional "common owners" of firms within concentrated industries (including, but not limited to the Big Three) are undermining competition has made a similar suggestion, with some important limitations.[317] Scholars

[316] Lund, *supra* note _; Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. (forthcoming 2020) (proposing that mutual funds should generally abstain from voting on governance issues because they do not possess good information); Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, forthcoming TENN. L. REV. (forthcoming 2019) (relying on Bebchuk & Hirst, *Index Funds*, *supra* note _, and proposing reforms to encourage mutual funds to follow board recommendations). Griffith carves out an exception for "protest votes" against underperforming directors – but suggests that these should be "relatively rare." Griffith, *supra* note _ at 53.

[317] As part of his original proposal for antitrust enforcement against common owners, Einer Elhauge suggested that "large investors" who "continue to buy stock across horizontal competitors" in concentrated industries might be able to lower (but not eliminate) their risk of antitrust liability by "buy[ing] only nonvoting stock" or "commit[ing] either to not vote their stock or to vote their stock in proportion to how nonhorizontal shareholders vote." Elhauge, *Horizontal*, *supra* note _ at 1315; *see also id.* at 1316 ("if index funds alone would create a problem of anticompetitive horizontal shareholding in a concentrated market, and those index funds feel the benefits of diversification across all firms in that market exceed the benefits of influencing corporate governance, ***they could commit not to vote their shares***."). Elhauge noted that this nonvoting method would be "less desirable than refraining from horizontal investments because having institutional investors refrain from voting increases the separation of ownership and control in a way that harms corporate governance and efficiency on a host of issues that do not raise anticompetitive

who worry about the Big Three leveraging their power for improper political purposes have similarly argued for restricting these institutions' voting authority and discretion.[318] Securities regulation scholars have called for index funds to be excluded from "fraud-on-the-market" litigation.[319] And some antitrust critics have called for categorically restricting the Big Three (and other large institutional investors) to *owning* just one firm in any concentrated industry (or no more than 1 percent of the total), which would also mean giving up the right to vote in these firms.[320]

The findings presented here suggest may be wise to proceed cautiously. The concentration of power in the hands of the Big Three has created the opportunity for a valuable new member of the private law enforcement community. In some cases, they are already performing this function. True, as the results above show, they are not fully embracing this role there yet. But policymakers and scholars should not lose sight of these potentially important

concerns." *Id.* More recently, Elhauge proposed another path towards avoiding antitrust liability: a fund family could sponsor several funds, each owning significant shares of different companies within the same concentrated industry, and avoid antitrust liability by decentralizing control over voting and giving each fund the power to vote in its own interest. Elhauge, *Causal Mechanisms, supra* note _ at 59. Notably, Vanguard has recently adopted something like this proposal, devolving voting control over half a trillion dollars to outside managers.

318 *E.g.*, Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 18-19 (2019) (proposing that SEC require mutual fund advisers to disclose "the policies and procedures they utilize to identify an actual link between support for a shareholder proposal and the enhancement of shareholder value"); Griffith, *supra* note _.

319 *Supra* notes _.

320 Posner et al, *supra* note _. Einer Elhauge also proposed that index funds "could avoid any risk of [antitrust] liability . . . by . . . index[ing] investments across industries without doing so across each firm in each industry." Elhauge, *Horizontal*, *supra* note _ at 1316; *see also* Elhauge, *Causal Mechanisms, supra* note _ at 58-59 ("Index funds . . . could avoid any risk of antitrust penalties by, for example, deciding to invest in only one firm in each concentrated market, so they would not have horizontal shareholdings."). Elhauge notes that "because only a fraction of institutional investors are indexed, index funds might not alone suffice to generate large enough horizontal shareholdings to produce [an anticompetitive effect.]" Elhauge, *Horizontal, supra* note _ at 1315. *But see id.* ("while index funds today may lack enough stock to alone create anticompetitive horizontal shareholdings in many concentrated markets, index funds have been growing rapidly in a way that increases the problem because they currently do index fully across horizontal competitors. . . ").

social benefits, and (as discussed below) should consider reforms that *enhance* index fund enforcement, not eliminate it.[321]

B. Common Ownership

In response to antitrust scholars who have argued that large institutional "common owners" of multiple firms within concentrated industries (including, but not limited to the Big Three) have caused these firms to take anticompetitive actions,[322] regulators and scholars have argued that the Big Three could not possibly have taken any actions to promote anticompetitive conduct at portfolio firms because of their overriding incentives to remain passive.[323]

My findings help to rebut that line of argument. It is clear from the theory and evidence presented here that the Big Three can and do take actions to influence the behavior of portfolio companies – including actions at the individual firm level.[324] The fact that these institutions have been punishing some portfolio firms for fraud and misconduct clearly does not mean that they are also violating the antitrust laws by pushing firms to raise prices or reduce output. But it does show that defenders of the Big Three have to do more than point to these institutions' purported lack of financial incentives to rebut the antitrust critics.

C. Disclosure Reforms

The SEC should consider expanding the enforcement-related disclosure obligations of the Big Three and other mutual funds. Under the current regime, mutual funds are required to disclose complete proxy voting records[325] and their internal procedures for proxy voting including how they deal with conflicts between the interests of fund shareholders and the fund sponsors.[326] But funds are not required to disclose information regarding participation in litigation – *i.e.,* when they submit a claim on a class action

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[321] *But see* Elhauge, *Causal Mechanisms*, *supra* note _ at 59 (arguing that, if institutions were required to concentrate their investments in one firm in each concentrated market, this would actually *increase* their influence over corporations since they "would have incentives to exercise their votes and influence to enhance the performance of their own funds to increase their fees and investment flow.").

[322] *E.g.*, Elhauge, *Horizontal*, *supra* note _; Posner et al., *supra* note _.

[323] *See supra* note _ (collecting governmental and scholarly reliance on the Passivity Thesis in the context of the common ownership debate).

[324] For more on this issue, see Elhauge, *Causal Mechanisms*, *supra* note _ at 35-57.

[325] 17 C.F.R. §270.30b1-4.

[326] *E.g*., SEC N-1A item 17(f); 17 C.F.R. § 275.206(4)-6.

settlement, when they join in litigation as a plaintiff (domestic or otherwise), when they receive proceeds from litigation, and what amounts of such recoveries were retained as fees by attorneys or other agents. Much of this information is not publicly available.

The SEC should consider requiring broader disclosure of litigation activities. As with proxy voting, such disclosure may provide important reputational incentives that encourage funds to pursue litigation more aggressively,[327] and reduce the impact of conflicts of interest in restraining funds from doing so. This disclosure will also provide valuable information for investors, who may be interested in a fund that will take a more (or less) aggressive stance on corporate fraud and misconduct. Whether or not fund managers have a fiduciary duty to take litigation action,[328] they surely have a duty to *adopt reasonable procedures for considering* litigation opportunities, particularly where they may face a conflict of interest. Funds should be required to adopt and disclose procedures to fairly consider and evaluate opportunities to litigate – as lead plaintiff, as opt-out, in foreign litigation, filing claims, negotiating attorneys' fees, and reaching settlements.

The SEC may also consider requiring broader disclosure regarding engagements with portfolio companies. As discussed above, engagements play a major role in the Big Three's stewardship activities, including enforcement-based stewardship following a corporate scandal.[329] Of the Big Three, only SSGA systematically discloses information regarding its corporate engagements.[330] The SEC should consider mandating annual disclosure of basic information regarding fund engagements, including the companies engaged and the general subject of the engagement (*e.g.*, executive pay, proxy contest/M&A, governance, compliance, environmental/social issues). Further, the SEC could

[327] *See* Bubb & Catan, *supra* note _ (documenting this reputational effect in driving Big Three voting behavior).

[328] *Cf.* Cox & Thomas, *Letting Billions*, *supra* note _ (suggesting that asset managers potentially breached their duty by failing to file claims on class action settlements); Brian J. Shea, *Better Go It Alone: An Extension of Fiduciary Duties For Investment Fund Managers In Securities Class Action Opt-Outs*, 6 WM. & MARY BUS. L. REV. 255 (2015) (asset managers do *not* have a fiduciary duty to *pursue* profitable opt out litigation).

[329] Parts II.C & IV.C.

[330] SSGA publishes quarterly "Stewardship Activity Reports" that list all Companies engaged, and annual reports that list all companies engaged, whether there were multiple engagements, and whether the engagement related to governance, proxy contest/M&A, pay, or environmental/social issues. Vanguard and BlackRock periodically disclose anecdotes about particular engagements (which SSGA does as well).

require disclosure of whether there were multiple engagements, whether the engagements were conducted in person, whether the fund voted against management on any issues in subsequent corporate elections, whether the engagement was initiated by the firm or the institution. Much like the disclosure of proxy votes, disclosure of engagements would help investors make educated decisions, could illuminate potential conflicts of interest, and might encourage funds to become more engaged, including in the wake of corporate crises.[331] Vanguard and BlackRock have maintained that such disclosure would harm its ability to engage effectively.[332] This argument seems to be belied by SSGA's practice of systematically disclosing engagements – although it is possible SSGA has lost its engagement efficacy after making disclosures. However, it is notable that the same argument BlackRock and Vanguard raise now was also raised in opposition to the SEC's 2003 proposal to mandate disclosure of proxy voting. Ultimately, the SEC determined that the "shareholder's interests in knowing how their funds have voted their portfolio securities" outweighed such concerns. [333] The same is arguably true with respect to engagements.

The SEC may also revisit the proposal to require systematic disclosure of business ties with portfolio companies, and any fees received by them.[334] Such transparency might put pressure on institutions not to "go soft" on companies with whom they have a business relationship, and thereby spur on some more aggressive enforcement activities by the institutions involving companies with whom they are connected. The SEC considered and rejected this proposal in 2003, finding that "disclosure of the fund's complete voting record" would give investors enough information to adequately monitor fund voting.[335] It may be time to revisit it now.

D. Litigation Reforms

The SEC could also encourage institutional participation in shareholder litigation by explicitly authorizing institutions to retain a portion of the recoveries from these cases outside of the funds.

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[331] *Cf.* 68 Fed. Reg. 6566.

[332] *E.g.*, Vanguard, Glenn Booraem, *Top ten questions about Investment Stewardship* (Aug. 16, 2018).

[333] 68 Fed. Reg. 6568.

[334] *See* Bebchuk, Cohen & Hirst, *supra* note _ at 108.

[335] SEC, Final Rule, Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies 68 Fed. Reg. 6570 (Feb. 7, 2003).

The SEC already permits fund managers to retain some earnings from securities lending,[336] so long as the terms are properly disclosed.[337] For instance, BlackRock retains 30% or more of securities lending revenues.[338] The SEC could authorize funds to do the same with respect to litigation proceeds. Giving fund managers a "piece" of the action would incentivize them to pursue profitable litigation opportunities. These funds could also be specially earmarked and dedicated to offsetting the cost of future enforcement or governance activities, which would counterbalance the incentives to remain passive. It may be objected that it is unfair to deprive beneficial investors of any part of the proceeds from litigation. However, by the time litigation is resolved, many of the investors who were actually damaged by the fraud are no longer invested in the fund. The investors who buy into the fund after the disclosure of the fraud and before the litigation is resolved receive, in effect, a (small) windfall.[339] Authorizing fund managers to siphon off a piece of these returns to fund future governance activities may not be so objectionable.

Congress may also consider revising the "lead plaintiff" provision of the PSLRA to incentivize the Big Three to participate in this role. As discussed above, there is currently no economic incentive for them to do so – serving as lead plaintiff exposes them to additional costs, without any prospect of an additional benefit.[340] To remove this obstacle, and incentivize index fund managers to participate as lead plaintiffs, Congress should consider revising the PLSRA to permit the award of "bonuses" to lead plaintiffs. Specifically, as Charles Silver and Sam Dinkin

[336] *See* SEC, Investment Company Reporting Modernization, 81 Fed. Reg. 81870, 81939 n. 962 (Nov. 18, 2016); In Re Maxim Series Fund, Inc., Release No. 25878 (Dec. 27, 2002); *see also* SEC Securities Lending Page ("To the extent that a fund seeks . . . to compensate an affiliated lending agent with a share of the lending program's revenues, exemptive relief from the Commission may be required.").

[337] N-CEN, Item C.6; Form N-1A Item 19(i); Form N–CSR Item 12.

[338] *See* Adam McCullough, *Securities-Lending Risk is Overblown*, MORNINGSTAR BLOG (Jan. 17, 2019); *see also Laborers' Local 265 Pension Fund v. iShares Tr.*, 769 F.3d 399 (6th Cir. 2014).

[339] *Cf.* John D. Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L. J. 84, 109-10, 126-29 (2010).

[340] *Supra* Part IV.A.

proposed a decade ago, the bonuses could be tied to the size of the lead plaintiff's current *holdings* in the company.[341]

E. Private Reforms

The Big Three could also take voluntary steps to enhance their enforcement footprints. For instance, they could hire a former senior public enforcement official (*e.g.*, from SEC or DOJ) to serve as a "Director of Enforcement," leading the institution's efforts to identify profitable and impactful enforcement-based stewardship opportunities. The Big Three may also consider augmenting their proxy voting guidelines and other stewardship materials by publishing "sentencing guideline" regarding what punishments they will impose on culpable individuals and corporations following major frauds. For instance, they could commit to presumptively voting against members of certain committees (*e.g.*, risk, audit, technology, etc.) following certain types misconduct. They could also explain when they will vote against certain culpable directors not only at one firm for one year, but for multiple years and at all firms where they may be on the ballot. These guidelines might have a general rubric of "factors" that the institution will weigh, and the range of penalties that might be imposed. Finally, the Big Three may also adopt public guidelines regarding its litigation decision-making – *i.e.*, procedures and factors to explain the institutions approach to when it will solicit analysis from plaintiff firms regarding opt-outs, when the institution will consider foreign litigation, lead plaintiff roles, and when it will seek governance reforms through litigation.[342]

CONCLUSION

For much of the twentieth century, corporate shareholders were weak and diffuse, and corporate governance was understood as a struggle against the "agency costs" imposed by this ownership structure.[343] Things changed towards the end of the century as institutional investors grew and leading corporate governance scholars to begin to theorize the prospective benefits of

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[341] *See* Charles Silver & Sam Dinkin, *Incentivizing Institutional Investors to Serve As Lead Plaintiffs In Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471 (2008).

[342] *Cf.* Webber, *supra* note _ at 235 (noting CALstrs' policy of seeking lead plaintiff appointments in cases in which its stake is greater than $5 million).

[343] Foundational corporate governance theory is based on this ownership structure. *See* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976).

concentrated ownership for corporate governance.[344] Around the same time, securities regulation scholars proposed – and Congress adopted – a major reform of securities litigation designed to reduce the agency costs involved in class actions by giving these institutions the role of "lead plaintiffs."[345]

This optimism about the institutional role in corporate governance proved to be short-lived. Skeptics quickly pointed out that these institutions imposed another layer of "agency costs" – that their own private incentives that would steer them away from optimal monitoring of corporations.[346] And evidence mounted showing that private institutional investors were slow to take up any meaningful role in corporate governance. Large private institutions failed to step forward to serve as lead plaintiffs[347] – indeed, in many cases, they failed even to even file claims on class action settlements.[348] By the dawn of this century, the conventional wisdom was that large private institutional investors were not viable as meaningful corporate monitors.

The pendulum is now swinging back. The dramatic consolidation of ownership in the hands of a few institutions[349] has led scholars to reconsider their role in corporate governance – for better or for worse. These institutions' power to influence corporate conduct has also been recognized by civil society organizations, who have increasingly turned towards the Big Three

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[344] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Ronald J. Gilson & Reineer Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

[345] *See* Elliott J. Weiss & John S. Beckerman, *Let the Money Do The Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

[346] Rock, *The Logic*, *supra* note _; Roberta Romano, *Public Pension Fund Activism In Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

[347] *Supra* notes _-_

[348] Cox & Thomas, *Leaving Money*, *supra* note _; Cox & Thomas, *Letting Billions*, *supra* note _.

[349] Consolidation appears to be happening in the asset management industry outside the Big Three. *See* Alicia McElhaney, *Asset Managers Cashing In On Merger Madness*, INSTITUTIONAL INVESTOR (Jul. 5, 2018); Bloomberg Intelligence, *Global Asset Manager 2019 Outlook* (Dec. 20, 2018); Robin Wigglesworth, *One in Three Asset Management Firms Could Disappear, Says Invesco Chief*, FIN. TIMES (Mar. 13, 2019); Simon Jessop, *Asset Managers Brace For More Job Cuts Amid Market Turbulence*, REUTERS (Jan. 21, 2019).

to further progressive policy agendas,[350] and by those opposed to these organizations, who seek to rein them in.[351]

As this important debate moves forward, scholars and policymakers should not overlook the potential, but as yet unrealized role these institutions might play in policing corporate fraud and misconduct.

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350 *E.g.*, BlackRock's Big Problem, https://www.blackrocksbigproblem.com/ (large coalition of leading environmental groups calling on BlackRock to adopt more aggressive climate change policies); Adam Gabbatt, *NoRAL Activists and Stars Launch Gun Control Campaign to Battle NRA*, THE GUARDIAN (Apr. 21, 2018) (noting that David Hogg, survivor of Parkland shooting, called on followers to "boycott" vanguard and BlackRock because of their support for gun manufacturers); Brady Campaign, Report, The Private Sector's Role in Reducing the Gun Violence Epidemic in America (May 2018) (praising steps by BlackRock and State Street to put pressure on Gun Manufacturers and calling for more aggressive actions by these institutions); Corporate Reform Coalition, *59,000 Petitions Urge Vanguard to Support Political Spending Disclosure*, (Jan. 19, 2016); Eleanor Bloxham, *Corporate Political Donations and Lobbying are still trapped in a Murky, Dark Cloud*, FORTUNE (Mar. 7, 2016) (describing efforts by leading "good governance" groups advocacy groups including Public Citizen, Common Cause, and U.S. PIRG, to pressure Vanguard to require portfolio companies to disclose political spending).

351 Main Street Investors Coalition; Phil Gramm & Michael Solon, *Enemies of the Economic Enlightenment*, WALL ST. J. (Apr. 16, 2019); Executive Order on Promoting Energy Infrastructure and Economic Growth § 5 (Apr. 10, 2019).

Appendix A

Big Three Publicly-Disclosed Foreign Shareholder Litigation (2014-2018)

	Defendant	*Country*
Vanguard	VW[352]	Germany
BlackRock	VW[353]	Germany
	Novo Banco[354]	Portugal
	Valeant[355]	Canada
	RBS[356]	UK
State Street	VW[357]	Germany
	Olympus[358]	Japan
	RBS[359]	UK

352 Christoph Rauwald, *VW Being Sued By BlackRock as More Investors, Governments Take Legal Actions,* AUTOMOTIVE NEWS (Sept. 16, 2016).

353 Peter Campbell, *BlackRock Joins Investor Lawsuit Against Volkswagen*, FIN. TIMES (Sept. 15, 2016); Rauwald, *supra* note _; Ed Adamczyk, *German Court Opens $10B Trial In Volkswagen Emissions Scandal*, UPI (Sept. 10, 2018).

354 Thomas Hale, *The Novo Banco Debacle And The Rule Of Law*, FIN. TIMES (Jan. 19, 2018); Robert Smith & Peter Wise, *PIMCO Files For Damages Over Sale Of Novo Banco*, FIN. TIMES (Mar. 1, 2018); Christopher Whittal, *Investors File Suit Against Bank of Portugal Over Novo Banco,* WALL ST. J. (Apr. 6, 2016); Paul J. Davies, *Why A Legal Wrangle In Portugal Raises Big Questions For European Banks*, DOW JONES INST'L NEWS (Apr. 5, 2016); Thomas Hale & Martin Arnold, *Fourteen Asset Managers Sue Portuguese Central Bank,* FIN. TIMES (Apr. 4, 2016).

355 *BlackRock Asset Management Canada Limited et al. v. Valeant, et al.* [CANADA] (Court File No. 500-11-054155-185); *Bausch Health: Continues to Defend Canadian Securities Lawsuits*, CLASS ACTION REPORTER (Aug. 28, 2018).

356 Ben Martin, *RBS Faces Lengthy Legal Battle After Some Investors Reject L800m Rights Issue Settlement*, TELEGRAPH (Dec. 5, 2016).

357 Campbell, *supra* note _.

358 Sophie Knight, *Olympus Says Being Sued By Six Banks For $273 Million Over 2011 Scandal*, REUTERS (Apr. 9, 2014); Ben McLannahan, *Banks Sue Olympus For $273m Y28bn Over Accounting Fraud,* FIN. TIMES (Apr. 9, 2014).

359 Investors Look To Sue RBS for GBP3 Bin Over Rights Issue: Sources Report, DOW JONES GLOBAL EQUITIES NEWS (Sep. 2, 2012); Rabiya Maqbool, *Report: RBS Shareholders Plan L3.3B lawsuit over Bank's Rights Issue,* SNL Bank Weekly, (Sept. 10, 2012).