We Three Kings: Disintermediating Voting at the Index Fund Giants

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ABSTRACT

The meteoric rise of passive investing has placed three large index funds in a new and pivotal role as the arbiters of corporate law controversies and the framers of market-wide governance standards. Collectively, the "Big Three" — Vanguard, BlackRock, and State Street — control a supermajority of index funds assets. The single largest investor in almost 9 out of 10 publicly-traded companies is one of the Big Three. As their growth is projected to continue unabated, it is difficult to overstate the centrality and importance of these institutions for the future of corporate governance.

Society is only just beginning to grapple with the implications of this concentrated economic power. On the one hand, there is potential for this power to be used for good. Index fund investors are uniquely concerned with long-term, sustainable economic growth and stability, and they are likely to be more representative of the average American investor than many other financial industry players, such as hedge funds. Concentrating the power of many dispersed "ultimate investors" through index fund voting has the potential to better align corporate behaviors with the interests of a broad swath of American society. On the other hand, to the extent that this power is divorced from the actual interests and perspectives of individual investors, index funds' considerable power may instead be used to advance the interests of index fund agents or other special interests in a way that is harmful to society at large.

As it currently stands, individual index fund investors are utterly unable to express their preferences in how voting decisions are made. They cannot rely upon index fund providers to take their unique interests and values into consideration when deciding how to vote (or even to know what these interests and values might be). Further, index fund investors cannot even indirectly express their preferences by selecting a particular fund or a particular index fund provider that is more likely to vote in line with their interest and values, since the shares controlled by different individual funds are nearly always voted in the exact same manner and since the different index fund providers share very similar voting philosophies and priorities. As a result, a small number of individuals at a handful of index fund providers wield increasingly dominant power with only very limited accountability.

To address this problem, a number of corporate law scholars have recently proposed solutions that would limit index fund providers' power in some way, whether by requiring increased transparency, placing caps on index funds' ownership of a given company or industry, or even going so far as to disenfranchise index funds entirely. Instead of these solutions, which generally rely upon regulators, auditors, or index fund advisers themselves to promote better outcomes, this Article proposes a novel solution that would harness the voice of individual index fund investors in the decision-making process. This approach builds off of the technological innovations that have permitted index funds to streamline the process of deciding how to vote their funds' shares. It proposes using this infrastructure to overcome individual shareholders' rational apathy instead of using that infrastructure merely to simplify the work of index fund employees. The involvement of individual investors could take one of three forms. First, an "indirect

democracy" approach would allow individual investors to elect to have the votes corresponding to their indirect share ownership cast according to the recommendations of a particular agent (such as the index fund provider, portfolio company management, a particular proxy adviser, or another institutional investor). Second, a policy of "informed discretion" would entail solicitation by index fund providers of more information about the characteristics and values of their investors, which they would use to better inform their voting decisions. Third, "pass-through voting instructions" would give individual investors the opportunity to participate in shareholder voting by completing a general, issue-based survey about how they desired to vote on a number of key corporate governance issues. The answers to this survey would effectively create basic proxy voting guidelines for a given investor's shares, which would guide fund advisors in voting the proxies corresponding to the investor's fund ownership. The uniting feature of all three approaches is that they would involve individual investors in the voting process to a greater degree, thereby diminishing the power of index fund agents, mitigating concerns about the concentrated power of index funds, and reducing agency costs. The proposals set forth in this Article set out to re-democratize shareholder democracy and to give voice to individuals typically shut out of the corporate decision-making process. With passively-indexed investments set to overtake active investments in the very near future, now is a crucial time to map the future exercise of funds' corporate governance power.

I. Introduction

There is a fairy tale that goes something like this: *Once upon a time, in the faraway land of Sharetopia, there lived three powerful kings. They acted as stewards of their citizens' money (for a small fee of course), and their control over this money gave them influence over large swaths of the land's productive activities. As the power of these kings grew until it dominated the whole of Sharetopia, the citizens began to wonder whether the kings were ever tempted to use their power in their own self-interest rather than in the interests of their citizens. When the citizens presented these concerns at an audience with the kings, the kings declared that it would take far too many resources to figure out the actual interests of their citizens, even in very general terms. Instead, the three kings promised that they would use their power in the citizens' "best interests," although they reserved the right to define exactly what that might mean. When the citizens asked whether they might provide some thoughts about what their own "best interests" were, the kings politely declined. In any event, the kings noted, the very high barriers to entry for the position of king meant that, now and for the foreseeable future, the citizens had few realistic alternatives. The citizens went home pleased to have such a well-functioning democracy.*

As it currently stands, the index fund voting landscape — dominated by three massive index funds — shares some striking similarities with the satirical Sharetopia. Index fund investors entrust their savings to index fund providers, who retain the power to vote the fund's proxies. In lieu of a true democracy where index fund investors would be involved in voting decisions, index fund agents can vote shares representing their investors' economic stake in a given firm with only very limited constraints: first, index funds must disclose certain information about their voting policies and the votes they cast.[1] Second, index funds are required to vote "in a manner consistent with the best interests" of index fund investors.[2]

There are some important problems with the "best interests" standard. The first question begging to be answered is, *whose* best interests? One hundred percent of investors? Fifty one percent? Should values and preferences held by only a minority of investors be accorded any importance at all? A key problem is that fund investors are human beings, and, as human beings, they have diverse preferences and values. Currently, funds ignore the diversity of their investors while voting their shares, preferring to identically vote virtually all the shares they own.[3] Second, even if funds were clear on exactly whose interests the fund should be representing, and whether such representation should be winner-take-all or proportional, how do index funds discover or discern those interests? Currently, they make no serious effort to do so. Interestingly, this obviates the need for them to answer the first question — simply ignoring that diverse preferences exist makes short work of them. Third, the vagueness of the "best interests" standard, and the lack of any mandate to discover any actual interests of their shareholders, makes it difficult to hold fund management accountable for violating this standard, potentially increasing agency costs. Beyond a clear conflict of interest, it seems likely that the "best interests" standard would be satisfied by virtually any colorable claim to that effect. This means that, for votes where a plausible argument can be made for supporting either side, fund managers have near total discretion in their voting decisions, regardless of whether substantial amounts of their investors disagree and without even attempting to discern whether they disagree. Thus, while the "best interests" standard is likely to prevent serious conflicts of interests, it is little more than a fiduciary fig leaf when it comes to promoting accountability and cabining the voting discretion of fund management.

This Article analyzes the implications of index funds' rise to power and their increasing dominance over corporate decision-making. Part II begins with a brief description of the index fund's rise to power, moving in Part III to an analysis of their current capacity to influence corporate governance. Part IV contains a detailed analysis of how index funds' shares are currently voted. Part V examines the changes wrought by index funds' growing influence and discusses a number of key concerns engendered by their current scale and voting practices. In Part VI, this Article analyzes the strengths and weaknesses of several proposed solutions and the reasons why they fall short. Part VII proposes an alternate approach, which disintermediates index fund voting by involving individual index fund investors in the process of setting voting priorities. Ultimately, this Article argues that this approach could re-democratize shareholder democracy and effectively reduce the power of the Big Three while obviating the need for more drastic solutions.

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[1] *See generally*, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922 (Jan. 31, 2003) [hereinafter Exchange Act Release No. 47,304], https://www.sec.gov/rules/final/33-8188.htm.

[2] *Id.* ("An investment adviser voting proxies on behalf of a fund . . . must do so in a manner consistent with the best interests of the fund and its shareholders.").

[3] *See* Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 316-317 (2017).

II. The Rise of the Index Fund

A. Theoretical Origins of the Index Fund

A group of influential economists laid the foundation for the creation of the first index fund in a series of academic papers. In 1965, Paul Samuelson published a seminal article in which he demonstrated mathematically that future stock prices fluctuate unpredictably.[4] That same year, Eugene Fama coined his Efficient Markets Hypothesis, which holds that it is difficult if not impossible to outperform the stock market given that market prices incorporate information quickly and efficiently.[5] In 1967, Michael Jensen provided empirical proof to support Fama's theory, showing that, over the period from 1945 to 1964, market indexes outperformed actively-managed funds.[6] In 1973, Burton G. Malkiel explicitly called for the creation of the index fund: "Fund spokesmen are quick to point out you can't buy the market averages. It's time the public could."[7] Specifically, he called for "a no-load, minimum-management-fee mutual fund that simply buys the hundreds of stocks making up the market averages and does no trading (of securities)."[8] In other words, he called for an index fund.

B. Emergence of the Index Fund

Eventually, the call of these economists came to fruition: a man named John Bogle filed the Declaration of Trust for the first index fund, First Index Investment Trust, on December 31, 1975.[9] Bogle, founder of the Vanguard Group, had successfully convinced his board to launch a fund that would attempt to simply mirror the performance of the S&P 500 rather than attempting to outperform the market by picking individual stocks.[10] The emergence of this fund was met with great enthusiasm by Paul Samuelson and other economists, who lauded the fund for attempting to match a broad-based index of the overall market, charging very low fees, having low portfolio turnover, offering high levels of diversification, and being available to investors of modest means — features that would serve as hallmarks of index funds going forward.[11]

Despite the support of such economists, the initial performance of the fund was characterized by Bogle himself as "a complete flop."[12] The fund fell a whopping 95% short of its original goal for its initial public offering, achieving a paltry $11.4 million in assets rather than the $250 million initially envisioned.[13] Given its limited size, the fund

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[4] Paul A. Samuelson, *Proof That Properly Anticipated Prices Fluctuate Randomly*, 6 INDUS. MGMT. REV. 41 (1965).
[5] Eugene F. Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSTS J. 55 (1965).
[6] Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389 (1967).
[7] Burton Malkiel, A RANDOM WALK DOWN WALL STREET (1973).
[8] *Id.*
[9] John C. Bogle, *The First Index Mutual Fund: A History of Vanguard Index Trust and the Vanguard Index Strategy,* Bogle Financial Markets Research Center (1997) [hereinafter Bogle, The First Index Mutual Fund].
[10] *Id.*
[11] *Id.*
[12] *The Index Fund Turns 40 - And Gets Its Revenge,* NASDAQ (Sep. 1, 2016) available at: https://www.nasdaq.com/article/the-index-fund-turns-40-and-gets-its-revenge-cm673349
[13] Bogle, The First Index Mutual Fund, *supra* note 9.

was not even able to own all of the stocks in the S&P 500 index, and it instead invested in only 280 stocks.[14]

For its part, Wall Street as a whole seemed to reject the strategy of indexed investment.[15] Edward C. Johnson III, Fidelity's chairman at the time, put it this way: "I can't believe that the great mass of investors are [sic] going to be satisfied with just receiving average returns. The name of the game is to be the best."[16] Such a statement, however, ignored emerging data on the general superiority of returns from index investing.[17] Due to a combination of hubris and self-interest, the major players in the industry were loath to believe that funds that passively mirrored the market could be superior to funds that were directed and managed by some of America's brightest minds.

C. The Growth of Index Funds

As its poor initial reception foretold, the index fund remained relatively obscure well into the 1980's.[18] The First Index Investment Trust attracted an average of only $16 million per year in cash flow in its first decade,[19] and it remained the sole index fund until 1984, when Wells Fargo opened a fund that was also designed to match the performance of the S&P 500.[20]

However, as time wore on, the index fund began to demonstrate the financial benefits of passive investing. From the period 1981-1986, Vanguard's First Index Investment Trust outperformed actively managed funds by 3 percentage points.[21] It again outperformed other funds by 2.1 percentage points from 1987-1992 and again by 2.6 percentage points from 1992-1997.[22]

This success was noticed in the marketplace, and more and more competitor index funds emerged.[23] Even Fidelity came around, finally offering its own index fund in

[14] *The Index Fund Turns 40 - And Gets Its Revenge, supra* note 12.
[15] Bogle, The First Index Mutual Fund, *supra* note 9.
[16] *Id.*
[17] Jensen, *supra* note 6.
[18] Bogle, The First Index Mutual Fund, *supra* note 9.
[19] John C. Bogle, *Bogle Sounds a Warning on Index Funds,* WALL ST. J. (Nov. 29, 2018) [hereinafter Bogle, Bogle Sounds a Warning].
[20] *Id.*
[21] Bogle, The First Index Mutual Fund, *supra* note 9.
[22] *Id.*
[23] *Id.*

1990.[24] By 2000, index funds, and their cousin the index-based exchange-traded fund (ETF),[25] had acquired two percent of the overall equity market in the United States.[26]

That figure, however, was only the beginning of index funds' explosive growth. By 2002, index funds had more than doubled their holdings to reach 4.5% of the entire U.S. stock market.[27] By 2009, the funds had doubled again to 9%.[28] By 2018, the funds had nearly doubled yet again, reaching 17%.[29]

Even this figure likely understates the scale of index fund ownership, as it fails to include index fund assets held by pension funds, insurance companies, non-profits and foreign funds, as well as assets invested in "closet index funds" (funds that totally or nearly track an index while claiming to be actively managed).[30] Altogether, index funds likely control greater than 20% and potentially 30% or more of nearly all publicly-traded companies in the United States.[31] This figure is expected to grow further, with some predicting that index funds will control the majority of shares at most American corporations in the near future.[32]

III. Index Funds' Increasing Influence on Corporate Governance

A. From Rational Apathy to Significant Influence

As the index fund has grown, so too has the power of index funds to influence corporate governance. In the early days of the index fund, these vehicles owned such a small share of the overall market that their ability to influence corporate behavior was virtually non-existent.[33] Accordingly, it made sense for managers of index funds to be rationally apathetic to the management of portfolio companies and to defer to other market actors on corporate governance decisions.[34] For their first few decades, index

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[24] *Id.*
[25] ETFs are typically funds that issue shares in large blocks, creation units, to their participants. These units are then traded as shares on an exchange. Because these funds are often linked to an index fund, they have much in common with index funds themselves. For most corporate governance purposes and this paper as a whole, index funds and ETFs will be considered functionally equivalent and will be referred to generally as index funds. *See* John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 682 (2009) (explaining the basic characteristics of ETFs); John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, Working Paper 1, 10 (2018) [hereinafter Coates, The Future of Corporate Governance Part I](explaining the functional similarity between ETFs and index funds).
[26] John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve,* Working Paper 1, 10 (2018).
[27] Bogle, Bogle Sounds a Warning, *supra* note 19.
[28] *Id.*
[29] *Id.*
[30] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10.
[31] *Id.* at 13
[32] *See Id.* at 13 ("[E]ven if the trend flattens, the majority of most companies will soon be owned by indexed funds"); Trevor Hunnicutt, *Index funds to surpass active fund assets in U.S. by 2024*: Moody's, REUTERS (Feb. 2, 2017) https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by2024-moodys-idUSKBN15H1PN (predicting that index funds will hold over half of the market by 2024).
[33] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10.
[34] *Id.*

funds had no material impact on overall corporate governance or on the behavior of individual firms.

The situation has changed enormously in recent decades: these funds have gone from controlling virtually 0% of shares to controlling 20-30% of shares at nearly all publicly traded companies in the United States.[35] Even the sheer size of the holdings controlled by index funds understates their power, as control of the index funds themselves is highlighly concentrated. Just three index fund providers control the bulk of index fund assets.[36] Known together as the "Big Three," Vanguard, BlackRock, and State Street collectively own 81% of index funds assets.[37] Vanguard itself owns 51% while BlackRock owns 21% and State Street owns 9%.[38] In 2017, these three players controlled roughly 15% of the S&P 500, representing a radical departure from the traditional dispersed ownership of the stock market.[39] At 88% of public companies, the largest investor is either Vanguard, BlackRock, or State Street Global Advisors, a figure demonstrating their remarkable influence over Wall Street as a whole.[40]

The nature of the index fund industry suggests that no competitors will successfully wrest that control away from the Big Three. Low fees are a cornerstone of the index fund business model, and it would be extraordinarily difficult for a new competitor to outperform on fees given the massive economies of scale enjoyed by the Big Three.[41] Indeed, with some index funds now charging no fees at all,[42] it seems likely that new funds would have little financial incentive to enter the market and little to gain if they were to do so, further decreasing the likelihood of a new competitor emerging.[43] Thus, it appears that the concentrated power of the Big Three is likely to endure.

The power of the Big Three is even greater than their substantial share ownership suggests due to the fact that a significant fraction of shareholders do not vote their shares.[44] For example, only 28% of shares held by individual investors were voted at annual meetings in 2018.[45] Because of this absenteeism, index funds control a greater percentage of *voted* shares than they do shares as a whole.[46] This amplifies their power over voting decisions. In even reasonably close contests, such power has the potential to determine the overall outcome.[47] Additionally, certain regulatory developments that have decreased the number of votes cast, such as the elimination of discretionary broker

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[35] *Id.*
[36] Bogle, Bogle Sounds a Warning, *supra* note 19.
[37] *Id.*
[38] *Id.*
[39] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10.
[40] Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 676 (2017).
[41] Bogle, Bogle Sounds a Warning, *supra* note 19.
[42] Fidelity offers Fidelity ZERO Large Cap Index Fund (FNILX), Fidelity ZERO Extended Market Index Fund (FZIPX), Fidelity ZERO Total Market Index Fund (FZROX) and Fidelity ZERO International Index Fund (FZILX), which all feature a 0% expense ratio and no minimums to invest. *Mutual Fund Investing Ideas,* FIDELITY https://www.fidelity.com/mutual-funds/investing-ideas/index-funds
[43] Bogle, Bogle Sounds a Warning, *supra* note 19.
[44] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13.
[45] Broadridge & PWC ProxyPulse*, 2018 Proxy Season Review* (2d ed. 2018), https://proxypulse.broadridge.com/.
[46] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13.
[47] Fisch et al., *supra* note 47, at 18 (referring to passive investors' "power to determine the outcome" in many shareholder votes).

voting in uncontested director elections,[48] as well as the implementation of the e-proxy "notice and access" system,[49] have had the (likely unintended) consequence of shifting additional power to the Big Three.

Overall, index funds have gone from having virtually no ability to influence corporate decision-making to having substantial influence in a remarkably short amount of time. As a result, the situation has transformed from one where it was rational for index funds to be apathetic about corporate decision-making to one where they have their hands on the reigns of shareholder power.

B. How Index Funds Exert Their Influence

Index funds exert their considerable influence in three primary channels: (1) standard setting, (2) engagements, and (3) voting their shares.[50] Standard setting involves establishing general principles that encapsulate voting priorities and beliefs about what constitutes good corporate governance.[51] The index providers make these guidelines publicly available,[52] an act which itself indirectly manifests the voting power of the index fund providers.[53] In signaling how these funds will vote, index fund providers pressure companies towards certain ends even before a vote has been called.[54] Additionally, by publishing principles of "good corporate governance," the Big Three index providers (and other smaller players) have the opportunity to coordinate without colluding, thereby further enhancing their potential power over corporate decision makers.[55]

Second, index funds also participate in engagements. Engagements involve communication with management of a given company, whether in person, by phone, by

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[48] Stephen J. Choi et al., *Who Calls the Shots?: How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, at 37, FN 1 (2013).
[49] Luis A. Aguilar, *Ensuring the Proxy Process Works for Shareholders*, Statement by SEC Commissioner, U.S. SEC. & EXCH. COMM'N (Feb. 19, 2015), https://www.sec.gov/news/statement/021915-psclaa.html ("I noted in February 2009 that retail investor voting, already at low numbers, had plummeted at those companies using the notice and access model permitted by this rule. Indeed, the reports that compiled statistics on the level of participation by investors before and after the notice and access model was put in place at their companies found decreases of over 30% for large investors, and over 60% for smaller investors. Other reports find that retail response rates have declined each year since the introduction of the notice and access model, falling to less than a 13% response rate for the period from July 1, 2013 to June 30, 2014").
[50] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 15-18.
[51] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 15.
[52] *See, e.g., Investment Stewardship Annual Report*, VANGUARD INVESTMENT GROUP (2018) [hereinafter Vanguard 2018 Investment Stewardship Report], https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf; *BlackRock Investment Stewardship: 2018 Annual Report,* BLACKROCK (2018) [hereinafter BlackRock 2018 Investment Stewardship Report], https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf; *Stewardship 2017,* STATE STREET GLOBAL ADVISORS (2017) [hereinafter State Street 2017 Investment Stewardship Report], https://www.ssga.com/investment-topics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf.
[53] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 15.
[54] *Id.*
[55] *Id.*

mail, or over email.[56] Through these communications, index fund providers are able to express their priorities, concerns, and desires directly to company management and, in so doing, exert influence over these decision makers.[57] These dialogues frequently result in portfolio companies altering their practices or procedures voluntarily.[58] Data suggests that these engagements are occurring at a substantial number of companies. In 2018, Vanguard conducted engagements with 721 different firms, representing 47% of the firm's total assets under management.[59] In 2018, BlackRock was involved in 2,049 company engagements with 1,453 companies, representing 51.9% of BlackRock's assets under management.[60] In 2017, State Street participated in a total of 2,297 engagements, of which 676 involved direct communication, either in-person or via telephone.[61]

Third, index funds wield power by voting the shares controlled by their firm.[62] In 2003, the U.S. Securities and Exchange Commission (SEC) issued a rule that required index fund providers to disclose how they voted their shares in proxy vote contests.[63] Though not explicitly required by the rule, index fund providers have since voted nearly all of their shares.[64] Given their highly diversified holdings, the number of votes cast by these funds each year is enormous. Vanguard voted on 168,786 proposals in 2018[65] while BlackRock voted on 158,942 proposals in 2018[66] and State Street voted on 154,458 proposals in 2017.[67] These shares are typically voted in accordance with the guidelines set out by the firms' corporate governance teams and in accordance with the priorities expressed in engagements.[68] In this way, each of these channels of influence can be used to support the other.

IV. How Index Funds' Shares are Voted

A. Index Fund's Approach to Voting

Given the power of index funds over corporate decision-making, a crucial question emerges: how do index funds identify voting priorities and ultimately vote their shares? Stewardship and voting decisions for the enormous number of shares controlled by the Big Three are typically made by a centralized investment stewardship team, which is tasked with the responsibility for creating voting guidelines and

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[56] Fisch et al., *supra* note 47, at 25.
[57] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 16.
[58] Fisch et al., *supra* note 47, at 18.
[59] *See* Vanguard 2018 Investment Stewardship Report, *supra* note 52, at 9.
[60] BlackRock 2018 Investment Stewardship Report, *supra* note 52, at 27.
[61] State Street 2017 Investment Stewardship Report, *supra* note 52, at 60.
[62] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 17.
[63] Exchange Act Release No. 47,304 ("We believe, however, that the time has now arrived for the Commission to require mutual funds to disclose their proxy voting policies and procedures, and their actual voting records. Investors in mutual funds have a fundamental right to know how the fund casts proxy votes on shareholders' behalf.").
[64] Fisch et al., *supra* note 47, at 21.
[65] Vanguard 2018 Investment Stewardship Report, *supra* note 52, at 34.
[66] BlackRock 2018 Investment Stewardship Report, *supra* note 52, at 20.
[67] State Street 2017 Investment Stewardship Report, *supra* note 52, at 4.
[68] *See, e.g.,* Vanguard 2018 Investment Stewardship Report, supra note 52; BlackRock 2018 Investment Stewardship Report, *supra* note 52, at; State Street 2017 Investment Stewardship Report, *supra* note 52.

principles of good corporate governance, conducting engagements, and casting votes.[69] Because these teams generally make voting decisions for *all* the shares controlled by the firm as a whole, the impact of the votes controlled by a given index fund provider is consolidated and their firm's impact on corporate decision-making is correspondingly amplified.[70] Data on the matter reveal the scale of the coordination: in 2015, Vanguard's many different investment funds voted in concert in all but 6 votes out of 100,000.[71] Similarly, BlackRock voted its shares asynchronously on only 18 out of 100,000 proposals.[72] Likewise, while State Street deviated on just 195 out of 100,000 proposals.[73] Such figures reveal that it is very rare indeed for index fund providers to vote subsets of shares in different ways.[74]

The investment stewardship teams making voting decisions are generally quite small in size: Vanguard has about 20 employees[75] who share responsibility for researching and voting on 168,786 ballot items,[76] or roughly 8,400 per employee. Similarly, BlackRock employs 36 people to analyze and vote on 158,942 proposals, or nearly 4,500 issues per employee.[77] Finally, State Street has 12 people on staff[78] to investigate and vote on over 154,458 proposals,[79] an average of about 12,900 issues per employee. These small teams must research, analyze, and draw conclusions on a huge number of proposals at a large number of companies, a task impossible to do with any great specificity.[80]

To reduce this enormous burden, the corporate governance teams at each of these firms greatly simplify voting decisions by crafting a set of generic voting

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[69] *See, e.g.,* State Street 2017 Investment Stewardship Report, *supra* note 52, at 12 ("All voting and engagement activities are centralized within the stewardship team, irrespective of investment strategy or geographic region."); *see also* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors,* 31 J. ECON. PERS. 89, 95 ("the voting and stewardship decisions of mutual fund families are commonly concentrated in a single corporate governance department or proxy voting department of the investment manager"); Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 Yale L.J. 1870, 1915 (2017) ("[T]he fund family will, at best, establish a centralized voting unit comprised of comparatively less expensive employees, who will develop voting policies and make sure government mandates for voting are satisfied").

[70] *See* Strine, *supra* note 69, at 1913–14 (explaining that index fund owners get "no independent thinking at all or any separate voice" and that the index fund will vote the same way as the actively traded funds in the fund complex"); Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10 (noting that there is no "legal prohibition against an advisory firm from voting, monitoring, or engaging with a given portfolio company on behalf of all of its funds in an identical and coordinated manner" and that this means such a company's senior management controls how all of its shares are exercised).

[71] Fichtner et al., *supra* note 3, at 316-317.

[72] *Id.*

[73] *Id.*

[74] *But see* Dawn Lim and Cara Lombardo, *Vanguard Is Handing Over Some of Its Voting Power*, WALL ST. J. (April 25, 2019) https://www.wsj.com/articles/vanguard-is-handing-over-some-of-its-voting-power-11556190120 (noting that firms which manage Vanguard's active equity funds will receive the power to vote on certain issues, a change affecting approximately 9% of Vanguard's assets).

[75] State Street 2017 Investment Stewardship Report, *supra* note 52, at 3.

[76] Vanguard 2018 Investment Stewardship Report, *supra* note 52, at 7.

[77] BlackRock 2018 Investment Stewardship Report, *supra* note 52, at 4, 20.

[78] E-mail to Author (Feb. 12, 2019, 12:57 PM) (on file with author).

[79] State Street 2017 Investment Stewardship Report, *supra* note 52.

[80] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. Corp. L. 493, 516 (2018).

guidelines, which they follow closely in individual contests.[81] The policies crafted by these governance teams are remarkably consistent across the Big Three, a consistency that has emerged despite the lack of consensus on best practices for corporate governance.[82] All three firms support director independence, seek to tie executive compensation to long-term performance, oppose antitakeover provisions, and generally oppose major changes to corporate structure.[83] Additionally, representatives from one index fund provider regularly meet with representatives from other index fund providers.[84] In these discussions, the index fund representatives develop and discuss approaches to corporate governance, a process that yields "significant coordination over many if not all topics on which shareholders routinely vote."[85] As with the concentration of vote decision-making at the firm level rather than the fund level, the unity between investment advisory firms has the effect of strengthening the voice of the Big Three, for better or worse.

An advantage of reliance upon generalized voting guidelines is that such an approach reduces the costs of engagement and research, a valuable feature for funds that prize themselves on their low fees.[86] These guidelines also provide index fund providers with influence over corporate actors, as these guidelines send signals to portfolio companies, which may preemptively comply with the guidelines before a vote is even called.[87] Further, such an approach complies with federal regulations, which require investment advisers exercising voting authority over an index funds' proxies to "[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [the investment advisers] vote client securities in the best interest of clients."[88]

However, critics argue that this type of generalized, "unthinking" corporate governance will "make many companies worse off."[89] Common critiques of this approach to corporate governance include that it concentrates too much power in the hands of too few individuals,[90] that it favors certain behaviors and activities that are not necessarily superior,[91] and that it empowers individuals with insufficient incentives to promote optimal corporate governance.[92]

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[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 15.
[85] *Id.*
[86] Lund, *supra* note 80, at 512.
[87] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 15.
[88] 17 C.F.R. § 275.206(4)-6 (2016).
[89] Lund, *supra* note 80, at 495.
[90] *See, e.g.,* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10 (warning that indexation is concentrating power in the hands of a small number of individuals); Fisch et al., *supra* note 47, at 37-41 (arguing that indexation is causing a worrisome concentration of stock ownership).
[91] Lund, *supra* note 80, at 518 (arguing that good corporate governance is "endogenous to the particular firm" and that the failure of index funds to vote with specificity is therefore inconsistent with good corporate governance).
[92] *See, e.g., Id.* at 512 ("[U]nlike active funds, passive funds have no financial incentive to monitor management or invest in governance interventions."); Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10 (stating "index provider managers have very weak incentives to use their control, at least as conventionally understood); Bebchuk et al., *supra* note 69, at 90 (arguing "that index funds have especially poor incentives to engage in stewardship activities that could improve governance and increase value").

Corporate governance teams also simplify their task by availing themselves of the services of outside proxy advisory firms. These firms provide research support and voting recommendations to their clients. Like the index fund industry itself, the proxy advisory market is highly concentrated. Only two firms, Institutional Shareholder Services (ISS) and Glass Lewis, control a staggering 97% of the market for proxy advisory services.[93] Unsurprisingly, then, all of the Big Three rely upon the recommendations and research of Institutional Shareholder Services (ISS), and BlackRock also utilizes Glass Lewis for research support.[94] Outsourcing some of the burden for researching and casting proxy votes has the potential to reduce costs, simplify voting, and provide an outside and potentially objective perspective on important decisions for low-cost index funds.[95] However, proxy advisors have also been critiqued for a number of faults, including a lack of transparency,[96] simplistic research methods,[97] the lack of competition in the market for proxy advisory services,[98] and insufficient incentives.[99] The fact that many of these critiques mimic critiques of the corporate governance teams themselves suggest that proxy advisory firms may not be a sufficient tool to overcome the limitations facing index funds in casting their votes.

Overall, then, the nature of index fund voting can be summarized as unified (as votes are typically cast in unison within an individual firm), synchronous (as votes are typically cast similarly across the Big Three), concentrated (as decision-making power is in the hands of a small group), and non-specific (as voting decisions generally adhere to a set of generalized principles). The advantages of these features in reducing costs, simplifying the voting process, and strengthening the voice of index funds also entail corresponding costs in the form of reducing the thoroughness of analysis, decreasing specificity of recommendations, and potentially over-empowering individuals with insufficient incentives to promote optimal corporate governance. Moreover, the unified, synchronous, concentrated, and non-specific voting decisions of the Big Three risk creating and enforcing a corporate governance monoculture. Such voting may advance a set of corporate governance principles that do not necessarily constitute best practices

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[93] Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725, 743 (2016).
[94] Lund, *supra* note 80, at 516.
[95] *See The Investment Stewardship Ecosystem,* BLACKROCK VIEWPOINT (July 2018) (extolling the benefits of proxy advisors) https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf; *see also* Bebchuk et al., *supra* note 69, at 109 (raising the concern that "a reduction in the activities of proxy advisors would not be offset by increased spending on analysis by institutional investors sufficient to maintain even their current levels of monitoring").
[96] *See, e.g.,* Rachel McTague, *Chamber Approaches RiskMetrics with Proposed Changes to Policy-Setting*, 40 SEC. REG. & L. REP. 569, 589 (2008) (noting that the proxy firm's "lack of transparency has led the U.S. Chamber of Commerce to describe ISS's process for making proxy recommendations as a 'black box.'").
[97] *See, e.g.,* Charles M. Nathan et al., *Proxy Advisory Business: Apotheosis or Apogee?,* LATHAM & WATKINS CORPORATE GOVERNANCE COMMENTARY 1, 4 (Mar. 2011), https://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf ("In essence, proxy advisory firms cope with their problem of large numbers and seasonality through automation of as large a portion of the vote recommendation process as feasible.").
[98] *See, e.g.,* Asaf Eckstein & Sharon Hannes, *A Long/short Incentive Scheme for Proxy Advisory Firms*, 53 WAKE FOREST L. REV. 787, 798 (2018) (noting the "extreme lack of competition in the proxy advisory industry" and the importance of competition for "improving the quality of proxy advisory services").
[99] *See, e.g., Id.* at 817 (proposing ways to strengthen proxy advisory firms' incentives to produce high-quality research).

and that may not reflect the true interests and values of the index fund investors themselves.

C. What Index Fund Voting Is Not

As the foregoing has decidedly emphasized, index fund voting can be characterized by its remarkable **uniformity**, a uniformity which can be observed in the concentration of voting power in the hands of a single team at each index fund provider, in the coordinated way in which the individual funds of a given index fund provider tend to vote, and in the coordinated preferences and priorities of the Big Three index fund providers. In stark contrast, however, the millions of individual index fund investors on behalf of whom the Big Three cast their votes exhibit remarkable **diversity**.[100] Indeed, index funds hold the funds of a sizable subset of the American investing public, and index fund investors reflect the diverse characteristics of society at large. Index fund investors include the young, the middle aged, and the elderly. Some are mere days away from retirement, while others are decades away.[101] Index fund investors include politically liberal, politically conservative, and apolitical individuals, and these political affiliations likely would correlate to differing opinions on corporate political speech, political donations, and other more general matters.[102] Given the option, some index funds investors would assuredly sacrifice financial gains for environmental or social benefits while others would not choose to do so.[103] Even Vanguard's investment stewardship team recognizes that "[its] shareholders have a wide range of ideological perspectives."[104] Index fund investors also vary substantially in their financial situation — some are rich while some are of modest means.[105] Based upon the heterogeneity of

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[100] *See, e.g.,* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163, 174 (2008) (noting that shareholders have differing interests); Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1591 (1993) (arguing that directors should consider divergent shareholder interests in their decision-making); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577 (2006) (pointing out that shareholders come "in different flavors"); Stephen M. Bainbridge, Director Primacy: THE MEANS AND ENDS OF CORPORATE GOVERNANCE, 97 NW. U. L. REV. 547, 557 (2003) (referencing "shareholders' widely divergent interests" as a problem for directors in making consensus decisions).

[101] Anabtawi, *supra* note 100, at 579 (pointing out that shareholders have divergent time horizons for their investments).

[102] *See, e.g.,* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 111–17 (2010) (discussing potential solutions to situations where shareholders disagree on political issues such as corporate political speech).

[103] Indeed, many index fund investors are already opting to invest in funds specifically designated as socially responsible. For instance, investors have already chosen to invest $4.4 billion in Vanguard's "Vanguard FTSE Social Index Fund," "a low-cost fund [that] seeks to track a benchmark of large- and mid-capitalization stocks that have been screened for certain social, human rights, and environmental criteria" intended to serve investors who "choose investments based on social and personal beliefs"). *Vanguard FTSE Social Index Fund Investor Shares: Overview*, VANGAURD, (Dec. 31, 2018), https://investor.vanguard.com/mutual-funds/profile/VFTSX. Despite this supposed social orientation, however, it is likely that socially responsible index funds vote in concert with all of Vanguards other index funds, even on questions that relate to social, human rights, and environmental matters. *See* Strine, *supra* note 69, at 1936.

[104] Vanguard 2018 Investment Stewardship Report, *supra* note 52.

[105] The mean income of families with some amount of holdings sheds light on the diversity in income that can be exhibited by investors. Those in the bottom 20% had a mean income of $15,100 while those in the top 10% had a mean income $260,200, based upon data from 2016. *2016 SCF Chartbook*, FED. RES.

investors themselves, it is undeniable that the individual interests and preferences of individual index fund investors can differ significantly from the uniform approaches taken on their behalf by index funds and their corporate governance teams.[106]

With that in mind, index fund voting can also be usefully described by what it is *not*. Index fund voting is *not* varied. Although there is no consensus on corporate governance, the Big Three have taken a consensus approach to corporate governance.[107] Consequently, index fund investors lack the ability to express voting preferences by selecting a particular index fund provider.

Index fund voting is *not* differentiated. The various individual funds owned by a given investment company typically vote in unison, despite considerable variation in their clientele and holdings.[108] Indeed, even when investors have opted to invest in a fund with an expressed commitment to a social value, such as environmental sustainability, the fund often fails to vote in line with that commitment.[109] This lack of variation means that individual investors are also unable to express voting preferences by through their selection of individual funds.

Further, index fund voting is *not* individualized. It does not reflect the individual preferences of the actual index fund investors, including their unique financial circumstances, their political and social values, their priorities, their investment time horizon, or their employment situation. Rather, the votes controlled by index funds are almost exclusively cast in unison.[110] An individual human investor cannot rely upon an index fund provider to even be aware of his or her individual interests when making voting decisions, let alone to act upon those interests.

As it stands, the human investors who collectively make up index funds have virtually no way to ensure that the votes cast on their behalf are cast in line with their preferences or priorities. Heterogeneity does not exist in the way an individual's proportional shares are voted, nor does it meaningfully exist at the fund level or even the index fund provider level. Thus, human investors are well characterized as "not so much citizens of the corporate governance republic as they are the voiceless and choiceless many."[111] They lack both a direct voice on corporate governance matters as well as the opportunity to make even an indirect or constrained choice.

V. Impact of Index Fund Voting on Corporate Governance

A. Index Funds & "Minority Control"

(2016) at 8. Though this data includes individuals with a great variety of holdings and not solely index funds, it is likely that index fund investors would similarly include individuals with diverse financial circumstances.

[106] Anabtawi, *supra* note 100, at 577–92 (2006) (detailing key differences between shareholders and how those differences would result in different priorities for firm management); William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1092 (1999) ("[I]nstitutional investors' and individual shareholders' interests may diverge.").

[107] Lund, *supra* note 80, at 516.

[108] Strine, *supra* note 69, at 1913–14.

[109] *Id.* at 1913 (noting that "[i]f you invest in a fund that is supposed to be "socially responsible," it is likely to vote on issues in exactly the same way as the other funds in the fund family, however inconsistent that is with the fund's stated purpose").

[110] Strine, *supra* note 69, at 1913-14.

[111] *Id.* at 1872.

The concentration of voting power in the hands of index funds' corporate governance teams represents a significant departure from the traditional management and ownership structure of corporations. Since Berle and Means first explicated the concept in their seminal 1932 text, modern corporations have been thought to feature as a primary characteristic the separation of ownership and control, where the shareholder owners have substantial ownership and minimal control and the managers have substantial control and minimal ownership.[112] This separation of ownership and control has been taken as a given in virtually all corporate law scholarship, with scholars focusing on mitigating the agency costs stemming from this separation.[113]

However, Berle and Means also identified an important exception to the separation of ownership and control assumed in a modern corporation.[114] They demonstrated that the separation of ownership and control hinged upon the dispersed ownership of stocks — even a relatively small, non-majority, block of stocks could give its owner effective control over the enterprise as a whole.[115] Berle and Means described corporations with substantial control in the hands of a single individual as minority-controlled corporations, which they distinguished from management-controlled corporations.[116]

How much control in the hands of a single owner transforms a corporation from a manger-controlled to a minority controlled corporation? Berle and Means noted that the "dividing line between control by a minority interest and control by management is not clear."[117] However, they classified corporations according to the following guidelines: corporations with below 5% minority ownership constituted management control, corporations with 5-20% minority ownership constituted joint minority and management control, corporations with 20-50% minority ownership constituted minority control.[118] For his part, John Bogle deemed 30% ownership to be the threshold for "effective control" over a corporation.[119]

As index funds have gained control over an increasingly large percentage of the shares of individual corporations, they have almost decidedly entered into the territory labeled by Berle and Means as constituting "joint minority and management control" for most large corporations and may be nearing Bogle's threshold for "effective control."[120] If, as is predicted,[121] index funds continue to draw additional investment, it is possible

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[112] Adolf A. Berle & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932), 2-5.
[113] Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 672 (1995).
[114] Berle & Means, *supra* note 112, at 80-84.
[115] *Id.* at 80-84.
[116] *Id.* at 84-88.
[117] *Id.* at 85.
[118] *Id.* at 109.
[119] Bogle, Bogle Sounds a Warning, *supra* note 19 (stating that in the near future, "the 'Big Three' might own 30% or more of the U.S. stock market—effective control").
[120] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13 (stating "indexed funds now own more than 20% and perhaps 30% or more of nearly all U.S. public companies").
[121] Bogle, Bogle Sounds a Warning, *supra* note 19.

that they will increasingly wield pure "minority control" or perhaps even majority control over a substantial swath of corporate America.[122]

B. Empirical Studies of the Impact of Index Fund's "Minority Control"

The real world impact of index funds' control can already be observed in some empirical analyses of corporate behaviors. At a general level, several scholars have provided empirical confirmation that index funds do actively wield their considerable power over corporate decisionmakers. For example, Joseph A. McCahery and his co-authors used a survey methodology to confirm that institutional investors actively deploy their influence to shape corporate governance decisions and that they conduct direct engagements with management to shape behaviors.[123] They also found that long-term investors (such as index fund investors) intervene more intensely than their short-term counterparts.[124]

Whether these engagement efforts yield positive or negative benefits is less clear in the literature. On the one hand, some scholars have found positive benefits from index fund providers' engagement in corporate governance activities. For instance, Ian Appel and his co-authors demonstrated that increased index fund ownership in a given corporation is associated with (1) an increased share of independent directors, (2) an increased likelihood that takeover defenses, particularly poison pills and restrictions on the ability to call special meetings, will be removed, and (3) a decreased likelihood that firms will have unequal voting rights (such as a dual class share structure).[125] The authors found that these interventions were associated with improved long-term performance.[126] Likewise, Jarrard Harford and his co-authors have demonstrated that index fund investment is correlated with strong corporate governance, reduced managerial misbehaviors, decreased external financing, increased payouts to shareholders, and overall higher returns for shareholders.[127]

On the other hand, scholars have also identified quantifiable harms associated with index funds' growing power over corporate governance efforts. Economist Jonathan Brogaard and his co-authors have suggested, based on the effect of introducing indexing in the commodities markets, that index fund control over a given industry may be associated with worse production decisions, lower profits, and higher costs.[128] Additionally, Economist José Azar and his colleagues have suggested that index funds' considerable influence on natural competitor firms has demonstrably reduced competition and therefore resulted in higher prices for consumers.[129] Though they focus on the airline industry as a test case, they suggest that these outcomes may be observed

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[122] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13 ("[E]ven if the trend flattens, the majority of most companies will soon be owned by indexed funds."); Hunnicutt, *supra* note 32 (predicting that index funds will hold over half of the market by 2024).
[123] Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016).
[124] *Id.* at 2929.
[125] Ian R. Apfel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016).
[126] *Id.*
[127] Jarrard Harford, *Do Long-Term Investors Improve Corporate Decision Making?*, 50 J. CORP. FIN. 424 (2018).
[128] Jonathan Brogaard et al., *The Economic Impact of Index Investing,* REV. FIN. STUDIES (2018).
[129] José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1563 (2018).

across the economy as a whole.[130] Cornelius Schmidt and Rüdiger Fahlenbrach also find negative consequences from increased index fund ownership.[131] They demonstrate such ownership to be associated with increased CEO power, fewer independent director appointments, decreased returns after appointments of new independent directors, and qualitatively worse merger and acquisition activity.[132]

Thus, the literature seems to provide convincing evidence that index funds are influencing the ways in which corporations are managed. Whether that influence is for better or worse is unclear, and it is certainly possible that index funds yield mixed effects. At any rate, the data does not provide clear indication that index funds are either exclusively beneficial or exclusively harmful.

C. Concern over "Minority Control"

At the descriptive level, a whole chorus of voices have emerged expressing concern that the increased concentration of power over corporate governance in the hands of index funds will produce negative outcomes for investors at large and for the economy as a whole. These concerns have been expressed in the popular press. John Bogle himself issued a warning in the *Wall Street Journal* about the growing power of index funds:

> *If historical trends continue, a handful of giant institutional investors will one day hold voting control of virtually every large U.S. corporation. Public policy cannot ignore this growing dominance.*[133]

These concerns have been echoed by academics, including Professor John Coates, who recently issued a similar prediction:

> *[I]ndex providers are increasingly a, if not the, dominant force in governance of public companies. As they accumulate more and more assets, they accumulate more and more votes. Those votes, even if coupled to tiny staffs and modest expenditures on monitoring, create real power. That power creates a legitimacy and accountability challenge. The power is held by agents, and because of how important large public companies are, those agents have increasing influence over the economy, society, and both the inputs and outputs of the political system. For a dozen individuals to hold such power. . . is not a sustainable political or legal equilibrium.*[134]

As these statements indicate, there is growing concern over the rising power of index funds and increased interest in taking steps to manage or control that power.

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[130] *Id.*
[131] Cornelius Schmidt & Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?*, 124 J. FIN. ECON. 285 (2017).
[132] *Id.*
[133] Bogle, Bogle Sounds a Warning, *supra* note 19.
[134] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 19.

D. Key Concerns

Concerns about the rising power of index funds vary, and they sometimes contradict one another other. However, it is possible to compile a discrete list of key concerns regarding the increased power of index funds, which include (a) the inherent problems with concentration of power, (b) homogeneity in the voting & standard setting promoted by index fund providers, (c) insufficient incentives and resources to ensure that power is well-used, (d) the problematic separation of ownership from ownership that is a fundamental feature of the structure of index funds, (e) agency costs accompanying this separation of ownership from ownership, and (f) potential passivity of the index funds in addressing corporate governance challenges. These concerns will be discussed in turn in the subsections that follow.

a. Concentration of Power

A fundamental concern centers on the inherent problems associated with concentration of power.[135] Vesting substantial control over corporate American in the hands of a few individuals increases the incentive and opportunity for those individuals to use that power to promote self-interested aims.[136] Additionally, even where these individuals mean well, they may make incorrect judgments about the optimal course of action, and the negative consequences of their misjudgments will be magnified by the scale of their power in the marketplace.[137]

At the same time, some commentators see concentration of power as a potential benefit, given that it has the potential to overcome the rational apathy of individual investors.[138] Additionally, the fact that this power is concentrated in the hands of individuals (ideally) concerned with the welfare of ordinary investors means that this power may be used as a counterweight to the power of hedge funds, short term investors, self-interested investors, and self-dealing directors.[139] Thus, the challenge is to address concerns about concentration of power "without losing the corporate governance benefits of increased monitoring that flow from less dispersed ownership."[140]

b. Homogeneity in Voting & Standard Setting

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[135] Bogle, Bogle Sounds a Warning, *supra* note 19.
[136] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 18-19 (describing how index fund managers may be able to use their positions of power to obtain private benefits, such as political office or business relationships with the corporations in which they vote, in a way that has the potential to harm index fund investors).
[137] *See* Lund, *supra* note 80, at 516.
[138] Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); Ronald Gilson & Renier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575-91 (1990)
[139] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13.
[140] *Id.*

A related concern involves the tendency for the shares controlled by index funds to vote in similar ways both at the fund level and at the index fund provider level. As mentioned above, the Big Three tend to vote all shares controlled by their many individual funds, and they adhere to similar principles of "good corporate governance."[141] Problematically, however, there is no consensus on best practices of corporate governance.[142] It may be that all or some of their policies do not promote optimal outcomes for index fund investors or the economy as a whole, as is potentially suggested by some of the negative economic analyses of index funds and their effects on corporate behaviors.[143]

Because there is no way for an individual investor to express a preference for a certain behavior or approach to corporate governance (such an option does not exist at the individual vote level, the fund level, or even the index fund provider level), there is no way for individual shareholders to alter the behavior of index funds or to express a preference towards different approaches and priorities.[144] This means that while portfolio companies will attempt to win the approval of index fund providers by adhering to their principles of corporate governance, the index fund providers themselves are under little competitive pressure to pursue optimal principles of corporate governance. This has the effect of entrenching the priorities of the Big Three — even though they may not be optimal — rather than permitting a competitive marketplace wherein firms can distinguish themselves by their superior performance. Some scholars have identified the corporate governance standards of the Big 3 and their proxy advisors as "close to binding" on company management.[145]

c. *Insufficient Incentives & Resources*

Third, a related concern is that index fund agents have insufficient incentivizes and resources to yield their power over firms in a manner conducive to optimal corporate governance. The lack of incentives stems from a variety of causes. One cause is that index fund corporate governance employees do not experience a significant direct benefit when a portfolio company does well (or the reverse if a company does poorly).[146] A second cause is that index funds are committed to owning all companies in the index regardless of how any individual company performs.[147] A third cause is that index funds

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[141] *See supra* notes 81-85 and accompanying text.
[142] *See In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd,* 906 A.2d 27 (Del. 2006) (referring to "the protean nature of ideal corporate governance practices, particularly over an era that has included the Enron and WorldCom debacles"); Lund, *supra* note 80, at 516 (referring to the lack of consensus on principles of corporate governance).
[143] *See supra* note 128-132 and accompanying text.
[144] *See supra* Part IV.C.
[145] *See* Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* (unpublished draft) 1, 4-5, *https://www-cdn.law.stanford.edu/wp-content/uploads/2019/01/1-Edward-Rock-Cover-Sheet-2019-01-15-at-10.51.07-AM.pdf*.
[146] *See* Bebchuk et al., *supra* note 69, at 93 (noting that index fund providers "invest other people's money," which reduces their incentives to promote optimal governance); Coates, The Future of Corporate Governance Part I, *supra* note 25, at 13 (noting index fund providers have "weak incentives to do anything" given their fee structure).
[147] Lund, *supra* note 80, at 511 ("Because a passive fund seeks only to match the performance of a market index-- not outperform it--the fund lacks a financial incentive to ensure that the companies in their portfolio are well run.").

compete on fees and therefore have an incentive to minimize the expenses associated with their corporate governance efforts.[148] Altogether, the lack of incentives and resources raises concerns that index fund providers are ill-poised and insufficiently motivated to promote optimal corporate governance, which creates a particularly problematic situation given the scale of their influence.

d. *Separation of Ownership from Ownership*

A fourth concern relates to what is known as the "separation of ownership from ownership."[149] This concept refers to the fact that money managers, including index fund providers, wield the power to vote on behalf of their clients, but that these agents do not necessarily have interests aligned with their investors.[150] Indeed, these managers may not even know of their clients interests and priorities, and they do not currently undertake any efforts to ascertain the true perspectives of individual clients.[151] Though they are charged with acting on behalf of clients, they do so by considering the interests of an abstract, generalized investor rather than dealing with the particular nuances of their actual client base.[152]

e. *Agency Costs*

A related concern is that the interests of index fund management are divorced from those of the actual human investors controlling the shares. This means that these managers might use their considerable power to pursue self-interested ends or private benefits, rather than the best interests of index fund investors.[153] Such benefits might include establishing relationships and connections that would advance their career, furthering their clout in academic or social circles, positioning themselves to run for political office, pursuing personal values in their corporate governance efforts, or other such actions. Because index funds have substantial power and vest that power in small corporate governance teams, those concerns are magnified.

f. *Competitive Effects*

A sixth concern is that the rising power of index funds is producing anticompetitive effects.[154] It is feared that by reducing pressure on natural competitors through their large ownership shares in each of the competing firms, index funds are

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[148] *See* Bebchuk et al., *supra* note 69, at 93 (arguing that index fund providers have incentives to underspend on stewardship); Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 Minn. L. Rev. 11, 52 (2017) ("Some institutions, such as index funds, compete by minimizing their operating expenses, and devoting substantial resources to governance research may be in tension with that business model.").
[149] Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 Colum. L. Rev. 449 (2014).
[150] *Id.*
[151] *See* Strine, *supra* note 69, at 1913-14.
[152] *See Id.*
[153] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 18.
[154] *See*, *e.g.*, Posner et al., *supra* note 40, at 670; Einer Elhauge, *Horizontal Shareholding*, 109 Harv. L. Rev. 1267 (2016).

providing these entities with the opportunity to raise prices.[155] These price increases are detrimental for consumers and the economy overall, and they may even be a net negative for index fund investors themselves.[156] Economic research suggests that these abstract concerns may be born out in the real world, with scholars associating index fund ownership with price increases in both the airline[157] and commodities industries.[158]

g. Passivity

A seventh concern is passivity on the part of index fund managers. Some commentators fear that, because index fund managers and corporate governance teams do not have strong incentives to engage in good corporate governance, they will be passive with regards to corporate governance.[159] This passivity, in turn, may decrease monitoring of firms by shareholders, reduce incentives for good corporate governance, and increase opportunities for mismanagement and self-dealing on the part of corporate directors and managers.[160] This concern, of course, runs counter to concerns about the index funds' increasing power over corporate governance standards but reflects the same underlying fear: that the growth of index fund investing will result in worse corporate governance and worse monitoring of portfolio companies.

VI. Proposed Solutions to Corporate Governance Challenges

Given the increasing attention to this issue, a number of corporate law scholars have proposed policy solutions that attempt to mitigate concerns over the growing concentration of power in the hands of index funds or to preserve the status quo. This Article responds to these proposals in the subsections that follow.

A. No Action

One potential course of action would be to do nothing.[161] Such an approach does not necessitate pretending that there are no problems with the status quo, but rather

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155 Posner et al., *supra* note 40, at 670.

156 For a discussion of how price increases may disserve ordinary investors even if they produce share price gains, *see* Caleb N. Griffin, *Mergers Aren't So Black & White*, 43 Del J. Corp. L. 213 (2019).

157 Azar et al., *supra* note 129, at 1563.

158 Jonathan Brogaard et al., *supra* note 128.

159 *See, e.g.,* Ashley Alder, *Keynote Speech at Companies Registry Corporate Governance Roundtable*, HONG KONG SEC. & FUTURES COMM'N (March 13, 2017) at 5, available at http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/AIA_20170313.pdf. ("If a large slice of institutional investor money is passive, this could mean that few of them have any interest in holding boards to account. The concern is that if boards do not feel accountable to shareholders, incentives for good governance could wither away."); Michael Blanding, *Vanguard, Trian And The Problem With 'Passive' Index Funds,* HARV. BUS. SCH. WORKING KNOWLEDGE (30 Jan. 2017) https://hbswk.hbs.edu/item/passive-index-fund-leaders-push-for-shareholder-reforms (identifying concerns that "[i]ndex funds are the major shareholders in many large- and medium-sized public companies, but their passive investment nature offers few checks on those companies' executives.")

160 Alder, *supra* note 159, at 5.

161 Kahan & Rock, *supra* note 145, at 54 (analyzing the status quo, noting advantages and disadvantages of index funds' power, considering alternatives and concluding "[u]ntil and unless there is a proposal that would significantly improve matters, we should just let shareholders be shareholders.").

deciding that the status quo is superior to any proposed solution. Professors Marcel Kahan and Edward Rock endorse such a course of action because they believe that "no proposed fix can do better" than the status quo.[162]

There are many advantages to this approach. First, there would be no need to implement this proposal (or any others), no changes to the current structure of index fund providers, and no potential increase in fees for index fund services. There also would be no limits on the abilities of index fund providers to accurately mimic the performance of indexes and no need to fundamentally change the structure of index fund providers. Additionally, to the extent that index fund fiduciaries advocate for their clients somewhat effectively, this approach would ensure that some degree of consideration is given to the interests of actual index fund investors.

However, it is unclear that index fund investors are doing a sufficient job of advancing index fund investors' actual interests and values. The simplified voting guidelines crafted and utilized by index fund stewardship teams are not tailored to individual clients' situation or values, and there is no way for those investors to express a preference because of the homogeneity in the corporate governance approaches at the fun and index provider level. Additionally, one of Kahan and Rocks' rationales for their proposal to preserve the status quo is that managers at the Big Three index funds have "direct financial incentives to vote intelligently that are typically larger than any other shareholder,"[163] signaling out individual investors as one group with far smaller financial incentives.[164] However, relying upon dollar value of the financial stake is an imperfect way to measure incentives. For example, it seems unlikely that a billionaire would be ten times more motivated by a raise of $50 per hour than a person of modest means would be motivated by a raise of $5 per hour. Though the dollar value of financial incentives at stake matters, so does the relative impact of that financial stake on a given portfolio, whether those financial incentives are internalized by any individual actor, and whether financial gains are accompanied by any negative externalities.[165]

B. Stewardship Codes

A second approach to the corporate governance challenges implicated by the growing power of index funds would be to implement voluntary stewardship codes.[166] These stewardship codes would commit adherents to providing periodic reporting on stewardship activities and to increasing transparency.[167] However, as voluntary commitments, these codes would likely be modest in their effects.[168] Additionally, the corporate governance teams for all of the Big Three index fund providers already provide annual reporting on their investment stewardship activities (including

[162] Kahan & Rock, *supra* note 145, at 54.
[163] *Id.* at 1.
[164] *Id.* at 16.
[165] *See* Fisch, *supra* note 148, at 45 (stating that "[e]ven if a retail investor's stake in a voting outcome is relatively small, the underlying investment is likely to be economically meaningful to that shareholder." The same rationale applies to the investments of index fund investors.).
[166] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 20.
[167] *Id.*
[168] *Id.* at 20-21.

engagements),[169] and they are relatively transparent about their corporate governance priorities[170] and their actual voting behaviors.[171] In fact, registered management investment companies are already required to disclose both the policies and procedures guiding their voting decisions and their actual voting record.[172] As such, efforts to increase transparency and disclosures would likely not present a significant departure from the status quo. Overall, stewardship codes seem unlikely to address the fundamental concerns with index fund voting described above, though they would be a step to further highlight the importance of transparency and disclosure.

C. Public Enforcement or Auditing of Good Stewardship

A third, related proposal to address the concentration of power in the hands of index funds involves enforcement of good stewardship practices, such as transparency and disclosure, through legal obligations and/or auditing.[173] Like the prior approach, however, these legal obligations would be unlikely to significantly change the status quo, as the existing index fund providers are relatively transparent and are under some degree of legal obligation to continue that transparency.[174] The costs accompanying auditing or other enforcement mechanisms might also raise the prices of index fund services, which would negatively affect index fund investors.[175] Overall, enforcement of good stewardship practices would not provide a substantial change from the status quo, and it is unclear whether such an uncertain benefit would be worth the associated costs.

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[169] Vanguard has its 2018 investment stewardship report available as of the time of this writing. It is a 44 page document summarizing Vanguard's four pillars of good governance, its structure and approach to investment stewardship, and case studies highlighting its efforts to engage directly with corporations. *See* Vanguard 2018 Investment Stewardship Report, *supra* note 52. Likewise, BlackRock also has its 2018 investment stewardship report publicly available at the time of this writing. The report summarizes BlackRock's investment stewardship efforts over the past year and details the company's principles, priorities and engagement commentaries. BlackRock 2018 Investment Stewardship Report, *supra* note 52. State Street also provides data and analysis on its investment stewardship activities in its annual report. This document also summarizes State Street's stewardship philosophy and objectives. State Street 2017 Investment Stewardship Report, *supra* note 52.
[170] Vanguard provides a statement of its voting guidelines on its website. *See Vanguard's Proxy Voting Guidelines*, Vanguard *https://about.vanguard.com/investment-stewardship/policies-and-guidelines/*. Likewise, BlackRock similarly publishes its proxy voting guidelines. *See Proxy Voting Guidelines for U.S. Securities*, BlackRock (Jan. 2019) https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf. Likewise, State Street also provides digital access to its engagement and voting guidelines for its holdings in various world regions online. *See Asset Stewardship*, State Street https://www.ssga.com/global/en/about-us/asset-stewardship.html.
[171] Vanguard makes the details of all proxy votes cast freely available online. *See How Our Funds Voted*, Vanguard *https://about.vanguard.com/investment-stewardship/how-our-funds-voted/*. Likewise, BlackRock makes its complete vote records available online. *See Investment Stewardship,* BlackRock https://www.blackrock.com/corporate/about-us/investment-stewardship#our-responsibility. State Street also provides digital access to its engagement and voting guidelines for its holdings in various world regions online. *See Asset Stewardship*, State Street https://www.ssga.com/global/en/about-us/asset-stewardship.html
[172] *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies,* 68 Fed. Reg. 6564, 6566 (Feb. 7, 2003) (codified at 17 C.F.R pts. 239, 240, 270, 274).
[173] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 21
[174] *See supra* note 170 and accompanying text.
[175] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 21.

D. Loss of Voting Power

Another, far more drastic, policy proposal calls for restricting passive funds from voting their shares entirely.[176] Such action would have two primary effects: eliminating the voice of passive investors and thereby increasing the voice of remaining shareholders.[177] Though such a proposition would of course successfully reduce the voting power of index funds (to zero), it would produce a number of deleterious consequences. First, such action would disenfranchise a huge swath of investors, undermining the shareholder franchise itself — the "ideological underpinning" of corporate law.[178] If, as predicted, passive investing overtakes active investing in the next few years, this would result in the disenfranchisement of the majority of all equity investors.[179]

Second, such action would empower activist investors, hedge funds, and other potentially short-term-oriented investors by increasing the impact of their vote.[180] To the extent the remaining investors have interests adverse to index fund investors,[181] such action would harm index fund investors by definition.[182]Additionally, in comparison to index fund investors who tend to be more interested in long-term performance and overall economic stability,[183] activist investors, short-term investors, and investors interested in extracting private benefits are more likely to have interests adverse to long-term, sustainable economic growth.[184] In this way, eliminating the vote for index fund investors could also have negative consequences for both long-term shareholders and society as a whole.

Third, as Marcel Kahn and Edward Rock note, no shareholder has pure incentives or zero conflicts of interest.[185] To the extent that these conflicts vary, diversity

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[176] *See* Lund, *supra* note 80, at 528–30.
[177] *See Id.* at 530.
[178] *Blasius Industries, Inc. v. Atlas Corp.*, 564 A2d at 659 (Del. Ch. 1988).
[179] Hunnicutt, *supra* note 32 (predicting that index funds will hold over half of the market by 2024).
[180] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 21.
[181] *See, e.g.,* Anabtawi, *supra* note 100, at 564 (describing the potential for hedge fund activists to promote short-term ends at the expense of long-term benefits); Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1258 (2008) (contrasting the short-term focus of hedge funds with the interests of index funds and individual investors); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083 (2007) (labeling hedge funds the "archetypal short-term investor"); Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACC. REV. 315, 330 (1998) (providing evidence that investors can influence the degree to which corporations invest in the long-term in harmful ways); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 269 (2011) (discussing harms of short-termist thinking).
[182] *See* Strine, *supra* note 69, at 1923 (discussing how it is already true that "the most vocal and powerful of the electorate will be those with investment horizons the least aligned with human investors" and that hedge funds and actively managed funds are currently determining outcomes that do not match the interests of human investors").
[183] Strine, *supra* note 69, at 1923 (describing index fund investors as "uniquely long-term and committed to sustainable wealth creation").
[184] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 21 (noting that were such a policy to be implement, some remaining shareholders "would have distinct personal interests in control" and that such a policy could "creat[e] the temptation to extract private benefits and in any event providing a windfall without apparent gains to shareholders or society as a whole").
[185] Kahan & Rock, *supra* note 145, at 5.

of shareholders involved in the voting process can help to balance and thereby limit the effects of impure motives on actual outcomes. Reducing this balance and increasing the power of the remaining shareholders would increase the vulnerability of corporations to these weaknesses of the remaining shareholders, perhaps strengthening conflicts of interest or increasing the ability of shareholders with imperfect incentives to act on those incentives.[186]

Fourth, such a move would distort the relationship between voting control and share ownership, increasing the voting power of non-indexed stocks without increasing their share ownership. Such a change could have unforeseen consequences on the behavior of investors, corporations, and the market in general by significantly recalibrating the relationship between investors, proxy voting, and firm behavior.[187] These unforeseen consequences may produce market shocks or other undesirable disruptions.

E. Dilution of Voting Power

A more constrained version of the prior proposal might entail reducing the weight of votes wielded by index funds, perhaps to half or a quarter of a standard vote. Though this approach would be more muted than eliminating index fund franchise altogether, it would have similar negative costs in terms of empowering other shareholders and reducing the voice of a substantial subset of investors. Indeed, dilution would merely shift power between index fund managers and other players rather than addressing the disconnect between the preferences of individual investors and the ways in which index funds vote.

Professor Dorothy Lund suggests such dilution might also be achieved by instituting pass-through voting, either uniformly or as a default rule.[188] This pass-through voting would mean that the votes on non-routine matters would be decided by the individual investors themselves, unless such investors opt out under a default regime.[189] On its face, such a proposal appears to give the opportunity for individual investors to promote their own interests in voting decisions. However, Professor Lund cites as a key advantage of such an approach the fact that individual investors would be unlikely to actually vote their shares, as they would be rationally apathetic to vote outcomes due to the large burdens of voting their shares and the minimal benefits that would accrue to them given their relatively small levels of investment.[190] Because pass-through voting does not provide individual investors with a way to consolidate their voting decisions, it is unlikely to overcome rational apathy and would instead result in a similar outcome to eliminating voting for index funds entirely.[191] As such, instead of increasing the power of individual human investors to shape corporate decision-making, such an approach would actually diminish their power, since the benefits of expressing

[186] *See* Kahan & Rock, *supra* note 145, at 54 (stating “conflicts of interests are endogenous to the legal system and a change in voting rules is likely to cause shareholders at gain more voting power to develop stronger conflicts”).
[187] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 21.
[188] Lund, *supra* note 80, at 530-31.
[189] *Id.*
[190] *Id.*
[191] *Id.*

their preferences in such a granular fashion would likely be too small to warrant the effort.

F. Ownership Caps

Another proposal to mitigate problems associated with the rise of index funds is to implement firm-level or industry-level ownership caps that would specify investment levels that a given index fund could not exceed.[192] Like voting limits, such ownership caps would dilute the power of a given index fund provider, preventing it from exerting too much power over a given company. By reducing each index fund's power, these limits might also reduce opportunities for self-dealing by index fund agents.

However, this policy suggestion also has a number of key limitations. First, it would be difficult for regulators to determine the ownership threshold that accords index funds with sufficient but not excessive power. Second, ownership in proportion to the broader index is the very strategy index funds use in their investment approach. Forcing artificial limits on investment could have the perverse outcome of eliminating true indexing and replacing it with a distorted cousin, potentially compromising the financial wellbeing of index fund investors.[193] Third, to the extent that index fund providers continue to share similar priorities and voting preferences,[194] industry-level ownership caps would not significantly change the way in which shares are voted. If not paired with percentage-based caps, industry-level caps might actually result in each of the Big Three exerting greater control over the artificially limited number of companies in which they were allowed to invest. Fourth, such a move would do little to address other problems, agency costs, the way in which shares are voted, and the disconnect between the preferences of an individual investor and a given index fund provider. Fifth, if the policy distorted the market for index fund services, such a move could raise fees at index funds and thereby harm the financial situation of index fund investors. Though these price increases might be small in scale, the philosophy of index fund investing is predicated in part on the harmful effect of high fees, an effect which is compounded over time.[195] Given these costs, it is unclear whether such an approach would ultimately be beneficial.

G. Structural Limits

Another policy suggestion is to limit the power in the hands of index fund agents by placing structural limits on index fund providers.[196] One approach would involve limiting index fund providers' power by constraining the activities such entities were permitted to do, such as requiring index fund providers to only market and manage index funds and not other investment vehicles like actively-managed mutual funds.[197]

[192] John C. Coates, Coates, The Future of Corporate Governance Part I, *supra* note 25, at 20-21; *see also* Bogle, Bogle Sounds a Warning, *supra* note 19.
[193] Bogle, Bogle Sounds a Warning, *supra* note 19 (stating in relation to industry ownership caps that "such a drastic change would lead to the destruction of today's S&P 500 index fund, by common agreement, the most beneficial innovation for investors of the modern age").
[194] *See supra* notes 81-85 and accompanying text.
[195] *See* Bogle, The First Index Mutual Fund, *supra* note 9.
[196] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 22
[197] *Id.* at 22-23.

This approach would reduce the power wielded by index funds and thereby decrease the concentration of power in the hands of index fund providers, as many index fund providers vote the shares from actively- and passively-managed funds as a block.[198] It would have the additional benefit of focusing index fund providers on serving the needs index fund investors only, which might better align their incentives with those of their principals and would thereby reduce potential conflicts of interest.

However, voting decisions would still reflect the priorities of the set of agents involved in the decision-making and not necessarily the actual preferences and interests of the investors themselves. Second, these structural limits might make it more difficult for index fund investors to shift their investments from index funds to actively managed funds, potentially diminishing competitive pressures on index funds by making the exit options more logistically difficult.[199]

Another approach would be to promote structural division of authority, perhaps dividing voting power for different issue areas to different team members, giving certain employees control over just a single channel of influence, or giving individuals voting control for just a subset of votes.[200] This approach would reduce the overall power wielded by individual index fund employees, which would reduce opportunities or incentives for self-dealing behaviors. Additionally, to the extent that this approach subdivided the votes for individual index funds or sets of index funds, this approach might also diversify the courses of action taken by index fund agents. Indeed, such differentiation in voting behavior can be seen at Fidelity, where individual fund managers make voting decisions rather than a centralized team.[201] Fidelity funds exhibit internal disagreement in 3,144 per 100,000 votes, 542 times more often than funds at Vanguard, 175 times more often than funds at BlackRock, and 16 times more often that funds at State Street.[202]

However, there are some limitations to this approach as well. Like the former version of structural limits, this approach also does not promote awareness of or attention to the actual interests and perspectives of index fund investors. Second, to the extent that this approach increases costs by complicating investment stewardship, index fund investors would have to pay higher fees for investment services. Third, the division of power might blunt the ability of index fund providers to wield their power effectively, potentially to the disservice of index fund investors. Finally, to the extent that the employees of Vanguard, BlackRock, State Street, and other such funds are committed to similar principles of corporate governance (and to hiring individuals with similar

[198] Strine, *supra* note 69, at 1913-14 ("If you are a rational index fund investor and your fund will not exit until the portfolio stock leaves the index, you will find you get no independent thinking at all or any separate voice. Rather, your index fund will vote the same way as the actively traded funds in the fund complex, regardless of the fact that the active funds do not hold long term, and regardless of key factors such as whether the issue on the table is a stock-for-stock merger in which the index fund holds both the acquirer and the target.").

[199] *See* Kahan & Rock, *supra* note 145, at 12 (noting that "investors find it substantially easier to move funds within a mutual fund family than between mutual fund families"); Fisch et al., *supra* note 47, at 1 (arguing that "investors in index funds can exit at any time by selling their shares and receiving the net asset value of their ownership interest. This exit option causes mutual funds – active and passive – to compete for investors both on price and performance.").

[200] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 22-23.

[201] Fichtner et al., *supra* note 3, at 316-317.

[202] *Id.*

values), such a policy may not lead to as high a level of differentiation as has been seen at Fidelity.

H. Antitrust

An additional way to limit the power of index funds is via antitrust responses. One such proposal would limit the ability of index funds to control multiple companies in a given industry, particularly in industries that are of "competitive concern" due to market concentration.[203] Such an approach, particularly if limited to areas of true concern and if well-applied, could have the benefit of redressing anticompetitive effects some believe are associated with the rise of indexing.[204]

However, there would be negative implications to this proposal as well. Like ownership caps, industry caps would limit the ability of index funds to accurately mimic indices of the broader market in a way that could harm index fund investors and their portfolios. Second, index funds might be forced to select one competitor in a given industry despite its proportional size in the actual index. Such competitors would be induced to compete for index fund providers' investment in their particular firm. As a result, this approach might inadvertently strengthen the power and influence of index funds over firms' behaviors in concentrated industries. Third, it is not clear if there is enough heterogeneity among fund providers' incentives and corporate governance philosophies in order to produce real change in this area. Under the status quo, the Big Three tend to share similar priorities and have similar corporate governance philosophies, suggesting that the anticipated benefits from limiting ownership of any one index fund provider to one competitor in a given industry might be limited. The goal of this approach could be undermined if the multiple index fund providers each controlling a competitor merely imposed the same corporate governance practices in vogue before. Fourth, it might be exceedingly difficult for regulators or commentators to meaningfully define an "industry" and to define the threshold levels of concentration in a given market — the impact of such a change would vary substantially based on the breadth of this definition.[205] As such, this proposal might be difficult to implement well. Altogether, this proposal might have the benefit of addressing concerns about anticompetitive effects due to the increasing power of index funds; however, the side effects, including logistical difficulties, uncertain benefits, and negative impacts on index funds investors themselves, might render this approach undesirable.

I. Policing Conflicts of Interest

An additional proposal involves efforts to limit conflicts of interest. For example, compliance officers could regularly report on potential or actual conflicts of interest and the measures taken to address these conflicts.[206] Efforts to curb conflicts of interest would have the potential to increase the independence of index fund corporate governance teams. To the extent that compliance with these requirements increases

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[203] Posner et al., *supra* note 40, at 670.
[204] *See supra* notes 154 through 158 and accompanying text.
[205] Bogle, Bogle Sounds a Warning, *supra* note 19 (referring to the "the dubious ability of either academia or federal bureaucrats to define precisely what constitutes a given industry").
[206] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 22-23.

burdens on index fund providers, such efforts would be likely to slightly raise the fees for index funds to defray the accompanying costs.

Though these efforts might be a useful way to reduce conflicts of interest, some efforts to manage conflicts of interest are already underway at the Big Three index fund providers, calling into question whether additional efforts would significantly change the status quo. For example, Vanguard intentionally separates power between individuals charged with voting decisions and those whose duties include external client relationship management or sales.[207] In addition, Vanguard provides training on conflicts of interest, requires employees to recuse themselves when conflicts of interest do exist, has a Conflicts of Interest Policy, and maintains a Conflicts Register.[208] BlackRock, for its part, also has policies and procedures set in place to counter potential conflicts of interest, including relying upon an independent fiduciary to vote on behalf of clients when necessary.[209] Likewise, State Street takes considerable efforts to reduce potential conflicts of interest. These efforts include vesting sole voting discretion to members of the Asset Stewardship team, requiring mandatory disclosure of potential conflicts of interest, utilizing a Proxy Review Committee to oversee the stewardship team and to manage potential and actual conflicts of interest, and outsourcing voting decisions when necessary.[210] Given these considerable efforts at the largest index fund providers, it may be redundant to pursue additional efforts to mitigate potential conflicts of interest. At the most, these efforts would represent only a moderate change to the status quo, and they would be unlikely to address concerns about concentration of power, lack of homogeneity in recommendations, and lack of attention to individual investors' actual preferences.

J. Regulation of Engagements

An additional proposal would take steps to regulate or eliminate engagements between index fund providers and portfolio companies.[211] Regulating engagements could involve placing limits on which index fund employees could participate in engagements, on the content or nature of these discussions, or on how these interactions are reported to the public, while eliminating engagements would involve an outright ban on these activities with accompanying monitoring to ensure compliance.[212]

Efforts to constrain and control engagements might reduce the potential for abuse of power by index fund employees, since these channels of communication are not currently directly monitored. Additionally, to the extent that these measures involve disclosure, they would give investors more information about how index fund providers are acting on their behalf, which could give them more power to encourage best practices and limit misconduct.

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[207] *Stewardship Policy*, VANGUARD INVESTMENT GROUP (Oct. 2016), https://global.vanguard.com/documents/stewardship-policy.pdf.

[208] *Id.*

[209] *BlackRock Investment Stewardship*, BLACKROCK, https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.

[210] *2018 SSGA Conflict Mitigation Guidelines*, State Street Global Advisors (2018) https://www.ssga.com/our-insights/viewpoints/2018-ssga-conflict-mitigation-guidelines.html.

[211] *See* Coates, The Future of Corporate Governance Part I, *supra* note 25, at 22-23

[212] *Id.*

However, index fund providers do already provide some information on engagements to their clients and the public at large, including overall statistics and case study examples.[213] Additionally, it is possible that these efforts to minimize engagements could simply result in a shift from engagements to less direct forms of communication, such as publishing more detailed voting guidelines or engaging with popular media to express concerns about a particular company or practice. In this way, these efforts may not produce a significantly different outcome than the status quo.

K. Insufficiency of Current Proposals

These solutions individually and in combination have the potential to remedy some concrete problems associated with the rise in index fund ownership, including concentration of power, anticompetitive effects, potential for abuse of power by index fund agents, conflicts of interest, and insufficient transparency. However, none of the above proposals successfully mitigates one key problem: the disconnect between how index funds vote their shares and the actual preferences and interests of their individual investors. Some proposals, including those involving dilution or elimination of voting for index funds, would only deepen the disconnect between the interests of index fund investors and corporate decision-making. To the extent that we view shareholder franchise as a valuable exercise, insulating or totally excluding actual investors from the decision-making process subverts the fundamental goals of shareholder democracy.[214] The following section sets out a proposal that would both mitigate some concerns about the rising power of index funds and would give individual investors themselves the opportunity to influence how that power is wielded.

VII. An Alternate Approach

"Human investors," the individuals investing in the stock market for retirement or other long-term goals, have long been characterized as "rationally apathetic" about corporate governance decisions.[215] Even though their investments may represent a large portion of their life savings, their holdings in a given company tend to be so small that their vote has minimal impact on the outcome of a shareholder vote.[216] As a consequence, the value of conducting research on ballot items or engaging with boards of directors is far offset by the costs of such activities, meaning that the typical human

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[213] *See, e.g.*, Vanguard 2018 Investment Stewardship Report, *supra* note 52, at 11-30 (providing 20 pages of information and case study data on engagement activities); BlackRock 2018 Investment Stewardship Report, *supra* note 52, at 7-21; State Street 2017 Investment Stewardship Report, *supra* note 52, at 48-99 (providing data, statistics, and case study information on engagement efforts).
[214] See, *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").
[215] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 558 (2003) ("[M]ost shareholders are rationally apathetic. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs. Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the outcome of shareholder votes.").
[216] *Id. See also* Kobi Kastiel & Yaron Nili, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 41 Del. J. Corp. L. 55, 60 (2016).

investor is better off choosing not to exercise his or her voting rights.[217] This rational apathy manifests itself in actual voting behavior: only 28% of shares held by individual investors were voted at annual meetings in 2018.[218]

Index funds, however, represent an opportunity for this rational apathy to be transformed into rational involvement. This is because index funds already employ a team of corporate governance experts and proxy advisory firms to engage in research and to perform the actual voting in the many shareholder meetings on behalf of the ordinary humans that invest in index funds. These funds are in turn supported by considerable infrastructure and proxy advisory services that permit index fund providers to automate voting decisions according to a set of voting guidelines. Though it is irrational for these individual index fund investors to replicate such efforts, it is not irrational for these investors to express their general preferences to existing corporate governance teams, particularly if doing so can be done efficiently.

This priority setting can take various forms, which will be discussed below. However, the common element to all of these approaches is that they involve an infrequent expression of generalized priorities or preferences which would be used to guide index fund representatives in casting votes on behalf of the index fund.

A. Options for Involving Index Fund Investors

a. Indirect Democracy

One approach to involving human investors in the voting process would be to permit investors to select a representative that they desire to determine voting decisions.[219] For example, human investors could express a preference to have the votes corresponding to their ownership cast according to the index fund provider's recommendations, according to a given proxy advisory company's recommendations, according to the board's recommendations, in accordance with another institutional investor, proportionally in line with other investors in the fund, or to abstain from voting altogether.[220] Alternately, they might have the option to choose between a menu

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[217] Kastiel & Nili, *supra* note 216, at 60.

[218] *Broadridge & PWC ProxyPulse*, *supra* note 45.

[219] This model was pioneered by private third-party service providers such as Moxy Vote. However, Moxy Vote and others are now defunct, in part due to the cost and complexity of complying with burdensome proxy solicitation requirements. *See* Ross Kerber, *Shareholder website closing, cites complex voting rules*, Reuters, (July 10, 2012), https://www.reuters.com/article/moxyvote-shutdown/shareholder-website-closing-cites-complex-voting-rules-idUSL2E8IA8XU20120710. This Article posits that, because funds are legally voting their own proxies rather than those of "ultimate investors," a similar approach in the context of index fund / ETF voting would have reduced complexity and a greater likelihood of success.

[220] Steve Norman, former Corporate Secretary of American Express, proposed a similar approach to harnessing retail investors' votes as a part of the New York Stock Exchange's 2005 Proxy Working Group. He suggested that retail shareholders be given four options, including that their votes (1) be cast in favor the board's recommendation; (2) be case against the board's recommendation; (3) not be voted; or (4) be voted proportionally with the votes of other retail investors. *See See* Fisch, *supra* note 148, at 30. Similarly, Professors Kobi Kastiel and Yaron Nili proposed permitting retail investors to select from a menu of options for casting their votes, including: (1) the option to vote with management, (2) the option to vote according to the recommendations of proxy advisors, (3) the option to vote with the majority of shareholders (which might be calculated with or without managements' shares), and (4) the option to abstain from voting). Kastiel & Nili, *supra* note 216, at 88. Because institutional investors already have

of different proxy advisory services — indeed, additional demand for more tailored proxy advisory services could spur new entry into this space, providing much-needed competition in a sector dominated by only two firms.[221] The selection of a representative would be expressed at an infrequent interval, perhaps annually or biennially.

When making this decision, investors could be offered information and resources about how these various groups tend to vote, the voting guidelines crafted by these groups, and/or data on the impact that these groups have had on corporate decision-making or share price. Individual investors could also decide to seek advice on their decision from corporate governance experts or financial advisors, whether paid or unpaid. Since the decision would be infrequent and impactful, seeking paid guidance on the choice of representation would be more financially feasible than doing so for individual companies or individual ballot items. Additionally, individual investors might also opt to pursue independent research on these entities, perhaps availing themselves of resources provided by the entities themselves, the index fund provider, corporate law scholars, economists, or others with relevant expertise.

To be sure, such a policy would not offer human investors infinite choices and may force them into small boxes that imperfectly represent their actual needs and interests. However, even this level of involvement in decision-making would harness their perspectives on corporate governance to a greater degree than the status quo. Moreover, with such a policy in place, it seems likely that the various entities involved would seek to distinguish themselves on matters of corporate governance and call attention to their differences, thereby further increasing the true choices available to human investors. Such an approach might also encourage competition between index fund providers, proxy advisors, and related entities, providing the opportunity for superior approaches to corporate governance to be identified and rewarded.

b. *Informed Discretion*

A second way that individual human investors could be involved in shaping the voting decisions made by index funds is through expressing their individual circumstances and values in an annual or even quinquennial survey. In these surveys, individual human investors would be asked to provide relevant information about their financial circumstances and investment priorities, such as their time horizon for investment, their wealth class, their risk tolerance level, their spending habits, and their age. Investors could also be given the opportunity to express their values regarding political, environmental, social, and labor issues. This data would then be shared with

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systems in place to centralize voting decisions and because there are fewer legal hurdles to involving individual investors in the voting process at the index fund level, it may be substantially easier to implement these types of policies in the context of index fund investors. *See infra* Part VII.C. Additionally, given the decline of retail investing and corresponding the growth of index funds, providing these options at the index fund level may be a more effective way to involve human investors in the voting process. *See* Brian G. Cartwright, Gen. Counsel, SEC, *Address at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation* (Oct. 24, 2007) (transcript available at http://sec.gov/news/speech/2007/spch102407bgc.htm) ("[O]ver the last half century direct stock ownership by U.S. retail investors has been in an ongoing decline relative to ownership by institutions. Institutional ownership used to be almost irrelevant. Now, retail ownership seems to be headed in that direction.").

[221] Tingle, *supra* note 93, at 743.

corporate governance teams at a given index fund provider (or their chosen proxy advisory firms), who would be tasked with utilizing this information in shaping voting decisions.[222] Because of the vast scale of index funds and the concentration of voting power in centralized corporate governance teams, this information could be aggregated and grouped, simplifying the burden on index fund management while still ensuring that due consideration is given to the unique situations of actual human investors.

There are a number of voting decisions that might be better made by agents with some sense of the unique situation of their individual investors. For example, investors with a long time horizon for investment would be more likely to favor significant investment in research & development.[223] Some investors might be passionately committed to promoting environmental sustainability, human rights, fair labor practices, religious values or other social goals (either alone or in combination) and desire for index fund providers to advocate for these outcomes on their behalf.[224] Investors of modest means who spend a significant portion of their income on household goods might be wary of mergers that might induce price increases, while wealthier investors with substantial portfolios would be more likely to benefit from such mergers even in the face of price increases.[225] When considering questions such as these, data on investor composition and values would aid index funds in promoting the actual interests and desires of their shareholders.

A potential shortcoming of this approach is that it necessitates giving considerable discretion to index fund representatives in interpreting how the characteristics and priorities of individual investors should translate to actual votes. Nonetheless, this approach offers many advantages in comparison to the status quo. First, as numerous scholars have argued,[226] shareholders have diverse characteristics and priorities that ought to be reflected in how companies are managed, and attention to these diverse characteristics is a vital first step in ensuring that they are translated into how corporations are managed. Second, by virtue of increasing accountability of index funds to the actual perspectives of their shareholders, such a policy reduces the power of index fund managers. Third, this approach would likely entail greater deviation in how index funds vote the shares under their control, reducing the overall power of index funds to determine voting outcomes and better aligning the votes with the actual

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[222] If these changes are not taken up at the fund level, other market actors may generate their own "feedback mechanisms" to facilitate the expression of their values. *See* Letter from John Wilcox to Brent Fields, Secretary, U.S. Securities and Exchange Commission (December 28, 2018) https://www.sec.gov/comments/4-725/4725-4840503-177168.pdf (stating that concerns such as "(i) concentration and common ownership of stocks by index funds; and (ii) the exercise of voting power by ETFs without reference to the views of ultimate owners in managed accounts . . . combined with the growing popularity of collective investment vehicles will sooner or later give rise to private sector mechanisms for informal pass-through referendums on ETF's and indexers' voting policies.").

[223] *See* Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 61 (2007) ("Longer-term investors are interested in the redeployment of capital for research and development to generate profits tomorrow.").

[224] *See, e.g.,* Hung-Gay Fung et al., SOCIALLY RESPONSIBLE INVESTMENT IN A GLOBAL ENVIRONMENT 5 (2010) (describing shareholder engagers and activists who endeavour to utilize their influence to promote social ends).

[225] *See* Griffin, *supra* note 55.

[226] *See, e.g.,* Stout, *supra* note 100, at 174 (noting that shareholders have diverse interests); Orts, *supra* note 100, at 1591 (1993) (arguing for recognition and consideration of shareholders' diverse and potentially conflicting interests).

traits and preferences of investors. Fourth, this approach has the potential to diversify the approaches taken by index funds and to allow them to compete on how they exercise their control, giving more options to investors and creating competitive pressure towards optimal corporate governance.

c. *Pass-Through Voting Instructions*

A third way in which index funds could involve human investors in the decision-making process is to enable them to express a preference for how to tackle the key issues in corporate governance in the form of pass-through voting instructions.[227] These voting instructions could be selected once when an account with the fund provider was opened, with an annual option to update preferences or to leave them as before. Investors could also be given the option to defer to other agents, such as an index fund provider, proxy advisor, portfolio company management, or another institutional investor, on most questions, but to select a few individual questions about which they desire to express their preferences more directly. These preferences could vary in specificity, but the basic goal would be to give investors greater voice regarding the way index funds to vote their shares. For example, a relatively simple survey might ask whether the individual investor would prefer to have the funds' votes cast in support or in opposition to a merger where the fund only owned shares of the acquirer, unless the fund provider had a convincing reason to vote otherwise.[228] A more detailed survey might ask the following question:

> *In a merger where you own shares only of the acquirer, you would desire the funds' shares:*

[227] Other scholars have proposed a similar approach in the context of retail investors. *See, e.g*. *See* Fisch, *supra* note 148, at 45 (proposing the implementation of standard voting instructions that would "allow [retail] investors to designate issue-specific voting policies or guidelines, such as voting against classified boards, in favor of separating the chair and CEO, or against overboarded directors . . . An even more complex menu might enable investors to set up screens which would operate to direct the investors' vote in accordance with specified criteria—such as voting in accordance with management recommendations unless the screen flags a problem like underperformance or poor corporate governance."); Kastiel & Nili, *supra* note 216, at 90 (proposing that retail shareholders could have the option to select "a different short-cut for each type of questions that are brought for a shareholder vote."). There are several factors which suggest that this proposal might be more effectively implemented in the index fund context, including existing infrastructure at index fund provider companies to support such a policy and fewer legal hurdles to soliciting this information from investors since index fund investors do not legally have proxies to solicit. *See infra* Part VII.C. Additionally, as more and more human investors transition to index fund investing, the index fund context may be a more efficient route for involving large numbers of individual investors in the voting process. *See* Cartwright *supra* note 219. There has recently been growing interest in providing "pass-through voting" functionality for mutual fund and ETF investors. *See generally*, Letter from John Wilcox to Brent Fields, *supra* note 222 ("A case can be made that investors who delegate stock picking and proxy voting decisions to third-party professionals, while having no standing to vote at shareholder meetings, should have some means to voluntarily inform their fiduciaries about their views on issues affecting their investments.").

[228] If past investors had chosen to vote "no" on all mergers in which they held shares only in the acquirer, there is evidence to suggest that they would have obtained superior returns. *See, e.g.*, Anup Agrawal et al., *The Post-Merger Performance of Acquiring Firms: A Reexamination of an Anomaly*, 47 J. FIN. 1605 (finding "acquiring firms suffer a statistically significant loss of about 10% over the five-year post-merger period"). It is plausible to think that such information could change investor voting preferences.

(a) to always be voted to approve the merger,
(b) to always be voted to oppose the merger,
(c) to be voted to oppose the merger unless there was compelling evidence of unique circumstances making increased returns more likely than average,
(d) to be voted according to management's recommendations,
(e) to be voted according to [a given proxy advisor]'s recommendations
(f) to be voted according to the stewardship team's recommendations
(g) to be voted in proportion to the survey results from all other index fund shareholders, or
(h) not be voted.

In either survey form, shareholders could be provided with links to articles that summarize the debates over these issues, including the positions of both sides and various pros and cons. These summaries might be written by independent advisors, proxy advisors, academics, or other experts. These brief articles could also include links to longer papers and studies for investors interested in more information. Additionally, individual investors would also have the option of doing their own research into these topics and of discussing these matters with financial advisors or other experts before making any decisions.

Overall, this process would allow individual investors to express their actual views on key corporate governance issues, giving them greater voice on matters that are likely relevant to their financial interests and to their personal values and beliefs. Deferring to investors on these issues would have the benefit of diversifying the pool of decisionmakers charged with tackling these important questions. It would also significantly blunt the power of index fund agents, since they would be constrained by the preferences of their investors. To the extent that voters express conflicting preferences, such a policy might also reduce the power of index fund providers as a whole, since they might have to divide their influence in support of opposite ends.

On the negative side, however, this option is the most likely to impact the prices of index fund services, since it might be more burdensome to implement the views expressed by individual investors. However, given the existing infrastructure to support automated voting according to voting guidelines and the economies of scale enjoyed by index fund providers and other institutional investors, such price effects might not be significant at a per investor level.[229] Additionally, such a policy could reduce the efforts index fund providers must expend to research and set priorities on their own, since investors would be involved in the priority setting (and thereby would provide the fund with valuable data as to overall investor preferences). This might help offset any accompanying costs. Finally, some investors may be happy to pay slightly higher fees (perhaps a few basis points) to have a say in voting at the companies in which they are ultimately invested. As competing with the Big Three based on fees is difficult due to their scale, competition on something other than fees (i.e., pass-through voting functionality) could spur welcome new entrants into the index fund space.

[229] *See, infra* Part VII.C.

B. Potential Benefits of Deference to Index Fund Investors

a. Reduced Concentration of Power

At a general level, a policy involving some degree of deference to the actual preferences of human investors would entail numerous benefits. First, by giving index fund investors some influence over voting decisions, such a policy would spread decision-making power to a larger group of individuals. This would reduce the concentration of power in the hands of index fund providers, in-house corporate governance divisions, individual index fund provider employees, and proxy advisors. This would take proposals to spread index funds' power across more index fund employees several steps further, spreading that power to potentially millions of index fund investors rather than a few dozen index fund employees.

b. Increased Heterogeneity in Decision-making

Deference to individual investors would diversify the pool of decisionmakers, including the voices of segments of society who currently have little voice in corporate decision-making. Additionally, to the extent that these individual investors have diverse interests, such a policy also has the potential to increase the heterogeneity of voting priorities and voting guidelines at the fund level, index fund provider level, or both. This could result in increased differentiation between funds, proxy advisors, and index fund providers on matters of corporate governance, potentially providing the opportunity for optimal corporate governance practices to competitively emerge. While currently index funds are "essentially commodities,"[230] such differentiation would reduce the interchangeability of index funds and spur competition on factors other than fees.[231] Like competition in any market, competition in the market for voting control would have the benefit of increasing incentives for good corporate governance and would create greater opportunities for good corporate governance practices to be attempted, identified, recognized, and rewarded.

c. Increased Alignment with Index Fund Investors' Interests

Third, such a policy would better align the preferences and priorities of actual human investors with the voting behaviors of index fund providers. Such an outcome would give voice to the interests of the actual owners of index funds, i.e., the principals in this agency relationship, whose interests should be paramount. Fund managers have a fiduciary duty to ensure that the funds' shares are voted in their investors' best interests,[232] and allowing investors to express their own interests is almost certainly

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[230] Kahan & Rock, *supra* note 145, at 12, 51.
[231] *Id.* at 51 (stating that ESG issues "could also be justified as effective marketing. . . a form of non-price competition designed to attract investments into what has become a commodity").
[232] Exchange Act Release No. 47,304 (referring to an investment funds' board and its investment advisers' "fiduciary duties to vote proxies of portfolio securities in the best interest of fund shareholders.").

more accurate than allowing a small, centralized corporate governance committee to attempt to discern those interests independently.[233] Additionally, because index fund investors are uniquely interested in long-term, sustainable economic growth and stability, advancement of their interests has the potential to benefit society as whole.[234]

d. Decreased Rational Apathy

Fourth, such a policy would help overcome the rational apathy of individual investors, since an infrequent expression of voting preferences would be a far briefer and less onerous activity than deciding how to vote on individual ballot items. This would reduce the potential for index funds to be passive players in the corporate governance arena. Additionally, by countering rational apathy, this policy would efficiently harness index fund investors' incentives. After all, rational apathy does not mean that these investors have *no* interest in good corporate governance but rather that expressing their preferences is too burdensome. By reducing obstacles to involvement and allowing investors to provide broad answers to *types of questions* rather than the granular questions themselves, this policy would harness index fund investors incentives to promote good corporate governance and put them to more efficient use.

Further, as a normative matter, including the heterogenous views of such investors legitimizes shareholder democracy. Even if a significant portion of investors fail to exercise this power, at least they will do so by choice. Simply because many, or even most, investors would be rationally apathetic should not be cause for denying direct participating in the franchise for all others.[235]

e. Improved Incentives for Good Corporate Governance

Fifth, deference to human investors has the potential to better align the incentives of those wielding power over corporate governance standards with the outcomes they promote. Prompting index fund investors to go through the process of answering these questions might make them realize that "they" have been voting for things they do not support and are entirely antithetical to their interests. The act of selecting their preferences may provide valuable information to principals about the way that their fiduciary is voting, perhaps making an environmentalist investor realize that their shares have been used to oppose green initiatives at companies for years. In this way, involving individual investors in the voting process might make them more aware of the actions of their agents, more interested in monitoring the behaviors of those agents, and more vocal in promoting their own interests, which would provide a beneficial check on index funds' power. Moreover, if investors are involved in deciding what constitutes their best interests in some way, then index fund investors will have a metric that they can use to assess whether or not index fund providers are adequately pursuing that interest. By giving investors some check on index fund providers' power,

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[233] *See generally,* Friedrich Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).
[234] Strine, *supra* note 69, at 1967.
[235] *See* Fisch, *supra* note 148, at 45 (stating as a normative matter that "voting results should convey the views of all shareholders"). Although mutual fund investors are owners of shares in the mutual fund and not the company itself, the fund itself is a fiduciary agent for its investors that is bound to vote in their, rather than its own, interests.

this approach could decrease agency costs, encourage transparency, and improve the incentives of index fund investors.

f. Overall

In the ways discussed in the subsections above, it may be possible to use deference to index fund investors to address some of the key concerns about the rising power of index funds without resorting to disenfranchising index funds and their investors and without relying on regulations which might raise prices for index fund services or promote outcomes not necessarily consistent with index fund investors' will.[236] By involving the index fund investors themselves in the decision-making process, it could be possible to simultaneously increase alignment of outcomes with index fund investors' actual interests, to increase competition and diversity in index fund corporate governance, and to provide a check on the growing power of index funds and their managers.

C. Potential Concerns about Deference to Index Fund Investors

a. Reliance upon "Uninformed" Judgments

However, there are some potential limitations to deferring to index fund investors. First, such an approach might inspire fears that involving unsophisticated or uninformed investors in decision-making would lead to worse outcomes.[237] To some extent, these fears might be the byproduct of paternalistic thinking on the part of academics, commentators, or index fund representatives, and, therefore, these fears might be difficult to overcome.

However, a number of features specific to this proposal might mitigate such concerns. Deference to individual investors could involve providing these investors with the option to defer to the recommendations of more sophisticated players, such as index fund representatives, proxy advisors, or firm management, and individual investors could always be given the option to opt out of expressing their preferences (or instead be required to initially opt in). Additionally, deference to individual investors would be designed in such a way that these investors have greater incentive to become informed, since their involvement would be less burdensome and more efficient, making them more informed on the questions asked of them than they might be about the particulars of a single ballot item or a single company. Finally, given that there is no consensus on which corporate governance practices, if any, are uniformly superior, it is impossible to say that individual investors would be wrong in their expressed preferences. They may, in fact, pursue economically superior outcomes to existing corporate governance teams, and, at any rate, they would be more likely produce the voting outcomes that they prefer.

Additionally, a number of characteristics about individual index fund investors suggest that the risk of these individuals making unthinking or uninformed judgments might be low. First, index fund investors often place a significant portion of their life

[236] *See* Kastiel & Nili, *supra* note 216, at 96.
[237] *See, e.g.,* Lund, *supra* note 80, at 531 (implying that individual index fund investors might engage in "uniformed thinking").

saving in their investments, funds which they use for major life expenses such as saving for retirement, funding their children's' education, or setting aside an emergency fund.[238] Though their investment might seem "small" compared to the size of Vanguard's holdings or the net worth of a director, it is likely to be a "large" investment in terms of its importance to individual investors and their financial future. Because of the personal importance of these funds, it is likely that individual investors will either make informed choices, defer to another player, or abstain from expressing an opinion.[239] Second, these individuals are likely to be considerably more diverse than the corporate managers and index fund agents who represent them. Because they are more representative of America as whole, index fund investors are likely to be far more impacted by economic and social externalities of corporate behaviors, meaning these individuals are likely to be more invested in mitigating externalities and promoting sustainable economic growth.[240] In this way, they are potentially more likely to be affected by and more informed about negative externalities than other players in corporate decision-making.

b. Infrastructure

An additional concern is how to develop the infrastructure to support such an undertaking. Fortunately, however, there already exists substantial infrastructure at index fund providers to support voting.[241] Existing corporate governance teams could be redeployed in efforts to better represent the actual preferences of index fund investors, and existing relationships with proxy advisory companies could be altered to provide extra support on research or voting implementation. Additionally, there are already digital tools in place that allow index fund providers to cast, manage, and execute ballots via a digital platform, and these tools could permit index fund investors to automatically vote shares according to their voting guidelines without the need to engage with each individual contest or ballot item.[242] For example, ISS offers ProxyExchange, a tool which "simplifies the proxy voting process" by allowing clients to "automate their routine tasks" and vote according to standardized voting guidelines.[243] Similarly, Broadridge offers ProxyEdge, a digital proxy management solution that allows its users to have their votes cast according to "automated voting rules and integrated vote recommendations."[244] Tools like these could be applied to the task of voting the index funds' shares according to the preferences set out by individual shareholders themselves

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[238] Strine, *supra* note 70, at 1874.
[239] *See* Fisch, *supra* note 148, at 44-46.
[240] *See* Strine, *supra* note 70, at 191 (describing how "most workers have a substantial interest in the durable appreciation of their portfolio, and do not benefit in any way from stock bubbles arising from gimmicks or unsustainable strategies because these gains will go away and if those bubbles result in economic recessions and diminutions in economic growth, the worker will suffer both at the time of retirement, and perhaps more importantly, during their working careers, as economic slowdowns that result in job losses and wage stagnation threaten their most important source of wealth.").
[241] *See* Fisch, *supra* note 148, at 39.
[242] *Id.* at 22-23.
[243] *Proxy Exchange,* INSTITUTIONAL SHAREHOLDER SERVICES, https://www.issgovernance.com/solutions/proxy-voting-services/proxy-exchange/
[244] *ProxyEdge*, BROADRIDGE https://www.broadridge.com/_assets/pdf/broadridge-proxyedge-complete-proxy-management-from-voting-through-reporting.pdf.

instead of the preferences determined by index fund teams. Because this substantial infrastructure exists and is already utilized by index fund providers, the task of incorporating index fund investors' perspectives would be considerably less burdensome than it might initially appear.

c. *Increased Index Fund Fees*

Third, depending on the characteristics of the approach taken, deference to index fund investors might increase the costs associated with index fund services. It may be more burdensome and therefore more costly to ascertain investors' actual preferences and then implement those preferences, requiring additional employees or additional support from outside firms such as proxy advisors.

However, given the existing infrastructure are index funds that permits funds to divide proxy questions into categories and vote their proxies according to predetermined guidelines as well as the existing corporate governance teams and proxy advisor services that provide research support, these cost increases are unlikely to be especially significant at a per-investor level.[245] There may be some minimal costs associated with modifying these existing tools to support increased investor involvement, and there would be costs involved in developing the survey and conducting the survey. Considering the existing infrastructure and the enormous scale of index fund providers, it seems likely that any incremental cost increases would be relatively modest.[246]

d. *Potential Legal Impediments*

An additional concern centers on whether there are any legal impediments to seeking index fund investors' input on proxy voting and other related matters. First, there are the potentially burdensome requirements for proxy solicitations to consider. For example, under Section 14(a) the Securities Exchange Act of 1934, the SEC requires that all proxy solicitations must be duly filed unless an applicable exception exists.[247] Likewise, proxy statements frequently trigger the obligation to furnish shareholders with a proxy statement.[248] Proxy solicitations are defined as "[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[249] Unlike

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[245] *See* Fisch, *supra* note 148, at 39 (noting that "institutional investors have access to a variety of services that simplify the mechanics of proxy voting, including: (1) a centralized Internet platform on which they can access information relating to voting matters for their entire portfolio; (2) the ability to cast votes through this platform; and (3) the ability to designate voting policies or preferences, rather than casting votes on an individual, firm-by-firm basis").

[246] Coates, The Future of Corporate Governance Part I, *supra* note 25, at 10 (noting that index funds benefit from economies of scale when implementing investment stewardship *See* Fisch, *supra* note 148, at 43 ("[S]ome institutional investors, such as Blackrock and Vanguard, devote substantial resources to voting research.").

[247] 17 C.F.R. § 240.14a-2 (providing that "Sections 240.14a–3 to 240.14a–15, except as specified, apply to every solicitation of a proxy with respect to securities registered pursuant to section 12 of the Act (15 U.S.C. 78), whether or not trading in such securities has been suspended.").

[248] *See* 17 C.F.R. § 240.14a-3 (outlining information that must be furnished to shareholders).

[249] 17 C.F.R. § 240.14a-1.

in the context of retail investors,[250] an attempt by index fund providers to learn more about the interests and voting priorities of their clients very likely would not constitute a proxy solicitation. This is because the index fund itself is the beneficial owner of all shares controlled by that index fund and therefore retains the right and obligation to vote shares.[251] The board of an index fund generally delegates voting authority to an investment advisor, and the board and these investment advisers have a fiduciary duty "to vote proxies of portfolio securities in the best interest of fund shareholders," in this case, the index fund investors.[252] Because of the way that this relationship is structured, seeking input of individual index fund investors about voting priorities and interests would be a way for index fund providers to better fulfill their fiduciary duties to index fund investors and not a proxy solicitation. This means that the burdensome requirements accompanying proxy solicitations would not apply to this context, making it considerably easier in this respect to involve index fund investors in the decision-making process as compared to retail investors.[253]

An additional potential legal hurdle is Rule 14(a)-4(d). This rule restricts the time in which a proxy can confer voting authority, prohibiting conference of authority "with respect to more than one meeting" or for "any annual meeting other than the next annual meeting."[254] Again, these time limitations do not apply in the index fund context due to the structure of mutual funds and the fact that the mutual fund itself retains the right to vote the funds' proxies.

Still, these provisions likely reflect a more general concern by regulators that allowing investors to preemptively express preferences on how they would like to vote would encourage uninformed, generic voting.[255] Despite these fears, the proposals suggested here would not be a change from the status quo in terms of promoting preemptive voting. Index fund providers already cast their votes largely according to generic voting guidelines that are formulated without reference to individual contexts and may be shaped in advance of proxy solicitations. Additionally, steps could be taken to mitigate concerns about reliance upon generic or pre-formulated voting guidelines, including opting to have index fund investors select representation by other agents who would have the ability to investigate firm-specific issues more thoroughly, permitting index fund investors to update their preferences or survey data at any point, requesting surveys be updated once annually, and allowing investors to designate authority for index fund managers to override preferences recorded in a survey when firm-specific considerations support doing so. In these ways, it is possible that seeking index fund investors' input on voting decisions could be structured in such a way as to involve regular input from these investors or to permit some consideration of firm-specific issues.

A third potential legal impediment would be any laws or regulations imposing duties on shareholders to cast their votes in an informed manner. Once again, such

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[250] *See* Fisch, *supra* note 148, at 40.
[251] Exchange Act Release No. 47,304 ("Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities.").
[252] *Id.*
[253] Anabtawi & Stout, *supra* note 181, at 1276 (noting that "participation in a proxy solicitation triggers burdensome federal disclosure obligations").
[254] § 240.14a-4(d)(2)-(3).
[255] *See* Fisch, *supra* note 148, at 43.

regulations would not apply to index fund investors, since they are not shareholders in portfolio companies but rather shareholders of the index fund itself. If anything, action by index fund providers to better understand the interests, perspectives, and priorities of their shareholders would likely result in more informed voting that enabled index fund providers to better fulfill their fiduciary duties to vote shares in the best interests of index fund investors.[256] Moreover, neither state law[257] nor federal law predicate voting rights on being duly informed.[258] Thus, even if investor involvement in shaping voting decisions would be based upon uninformed thinking, there are no clear legal requirements for informed voting and no prohibitions on non-voting indirect investors engaging in an informed expression of their interests and values.

e. A Choice Between Fractured Power and a Unified Voice

Fifth, deferring to shareholders raises an important question for how those votes would be carried out. To the extent that shareholders express different and opposite preferences (whether directly or indirectly), index fund fiduciaries would be charged with voting on behalf of conflicting parties. These fiduciaries would then need to either vote a proportional number of shares in favor of each opposite position or to vote all shares according to the most popular position.

The former (proportional) approach would diminish the power of index funds, since their power would be fractured in support of two different and opposite ends. However, to the extent that the concentration of power in the hands of index funds is a problem, limiting this power is advantageous. Additionally, dividing votes between priorities would ensure that these votes were cast in proportion to a given proposals' actual support, making it more likely that the outcome with the greatest support actually comes to fruition once all votes are tabulated. The proportional approach may also complicate engagements, since it would likely be more difficult to exert indirect pressure towards opposing ends. Again, this may be a positive consequence, particularly if these engagements give undue influence to index funds or reduce transparency and accountability.

The latter (winner-take-all) approach would maintain index funds' power and maximize their ability to leverage their influence via engagements. However, it would also mean that index fund agents would be demonstrably pursuing ends antithetical to the express interests and wishes of many of their principals, an outcome in tension with the principles of agency law and fiduciary relationships generally. Of course, it is extremely likely that index funds *already* utilize their votes in a way that is inconsistent with the preferences and interests of some of their clients; these preferences are just unknown and therefore much easier to ignore or dismiss. In this way, aligning the voting behaviors with the preferences of even a majority of investors would be an improvement on the status quo.

Ultimately, it would be preferable for index funds to wield their votes proportionally to the preferences expressed by actual index fund investors to the extent possible, as the advantages of maximum faithfulness to the interests of their investors appear to outweigh the costs in the form of diminished influenced (which, depending on

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[256] Exchange Act Release No. 47,304.
[257] *See* Fisch, *supra* note 148, at 47.
[258] *Id. ("Federal law does not actually require, however, that shareholders be informed.").*

one's perspective, may actually be an added benefit). Such an outcome is also more consistent with our notions of shareholder democracy, which generally feature voting in proportion to share ownership.

f. A Question of Method

Finally, there is the question of which of the above approaches to deferring to index fund investors ought to be the one utilized and who ought to decide that matter. The best way to capture the true interests and values of individual investors as they relate to corporate governance would be to take a direct approach. By surveying their investors directly on key corporate governance issues, rather than relying on indirect measures such as representation and inferences based on their general characteristics, index funds can best understand and utilize the actual views of their investors. Such a course of action would provide individual investors with the most direct avenue for influencing corporate governance as well as the greatest check on index funds' power.

Alternatively, however, it would be possible to let individual index fund investors decide for themselves through the market. If index fund providers were to offer their investors a choice between different forms of involvement (or if different index fund providers varied in the types of involvement they offered), investors would be able to select whichever option they preferred, whether that be selection of representation, provision of general data to be used in guiding decisions, or direct input on key questions in corporate governance. In making their selection, these investors would be able balance the degree of control offered against the costs in the form of increased fees, to the extent that there are any. In this way, it may not be necessary or even desirable to select a single option; if the index fund industry pursues multiple ways for individual investors to interact with index fund agents and their investment stewardship teams, this will provide maximum choice for investors and allow investors to select the option that best fits their needs.

VIII. Conclusion

The proposals set forth in this Article start from the basic premise that shareholder democracy should be democratic — that is, it should be controlled by the individual human investors who make up its constituents. As it currently stands, the shareholder franchise does not extend to individual human investors if they invested indirectly through certain intermediaries, including as index funds. When index fund investing was relatively rare, the fact that these individuals did not retain voting power was essentially irrelevant, since their degree of influence was so small that it was unlikely to impact voting outcomes. Now that index fund providers have the power to shape the behaviors of nearly all publicly traded companies in the United States, however, the contrast between notions of a true democracy and the status quo where a handful of index fund agents wield virtually all of index funds' power is exceedingly stark.

This Article seeks to promote a version of index fund voting that better approximates a true democracy by involving individual human investors in the voting process. It argues that such a course of action would ensure that corporate decision-making was better aligned with individual human investors' interests and values.

Further, the proposed changes would also mitigate several problems with index funds' increasing dominance by decreasing concentration of power, increasing the heterogeneity in voting by index fund providers, improving incentives for good stewardship, reuniting ownership with ownership, reducing agency costs, and ensuring that index funds are not passive in their approach to corporate governance. Moreover, the proposals herein accomplish the same goals as other competing proposals while avoiding their potentially drastic consequences, such as destroying the fundamental business model of index funds via heavy-handed antitrust solutions or totally disenfranchising the holders of what will soon be the majority of all equity assets.

These proposals also serve as an important step to transcend rational apathy for individual investors. Individual investors have long been uninvolved in corporate decision-making because of their relatively small stake in a given company and the large and burdensome task of engaging with individual ballot items at individual portfolio companies. By greatly simplifying and concentrating these tasks, this proposal utilizes the existing infrastructure at index fund providers to transform individual investors' rational apathy into rational involvement. Given the current state of such infrastructure and other digital technology, there is no reason that institutional investors should be able to rely upon services and tools that allow them to aggregate and automate voting decisions while individual investors themselves are deprived of such tools. Such changes would add much-needed legitimacy to the shareholder franchise, the foundation of all other corporate governance, and they would provide a voice to the actual human investors for whom the whole system is supposed to be working.