ASSET MANAGEMENT, INDEX FUNDS, AND THEORIES OF CORPORATE CONTROL

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ABSTRACT

Recently, several academic theories have expressed concern over the growth of index funds. Some have argued that the growth of index funds will afford the asset managers who provide them too much influence over the public companies they invest in, through increased voting power and engagement activities. This, they assert, may lead to the effective control of public companies by a few individuals. Conversely, others claim that index fund managers do not, and will not, sufficiently exercise their voting power and potential influence through engagement leading to increased deference to company managements and inadequate monitoring of companies.

This paper seeks to ground the debate around asset managers, index funds and corporate control firmly in the practical context of the operation and regulation of asset managers. Acting on behalf of clients, asset managers are incentivized to monitor companies for long-term performance. As minority shareholders, they lack sufficient voting power to exercise control. Voting records exhibit variation in asset manager voting behavior, challenging the perception of coordinated voting blocs. Thousands of actors are involved in corporate decision making, many better positioned to influence public companies than asset managers. The investment stewardship activities of asset managers raise the bar on corporate governance and increase the focus on long term sustainability. Some policy measures suggested by academic commentators seeking to limit or silence the voice of asset managers would stifle this effort and harm ordinary savers and investors.

JEL Classification: G23; G34; K22

Keywords: Index funds, index investing, institutional investors, corporate governance, stewardship, engagement, agency problems, shareholder activism, hedge fund activism

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Asset Management, Index Funds and Theories of Corporate Control

Matthew J. Mallow*

I. Introduction

In the asset management industry, client objectives shape the activities of asset managers. Most investors who use asset managers, whether institutions or private individuals, are saving and investing for long-term financial goals. For institutional investors such as pension funds and insurers, this may include funding future liabilities. For individuals, saving for retirement or for college expenses for children or grandchildren are two of the principal goals.

At year-end 2018, approximately $29.1 trillion---one third of the total U.S. financial assets of $85 trillion---were invested for retirement.[1] A further $311.1 billion was invested in Section 529 plans—qualified tuition programs designed to help save for higher education expenses.[2] The growth of retirement and education assets have, at least in part, contributed to the expansion of asset management and drives the long-term investment horizons of asset managers. At the same time, index funds,[3] have grown in popularity, as a simple, low-cost, diversified method of managing this capital. The apparent concentration of index fund growth among a small number of asset managers, has attracted critical attention from various points of view, in particular addressing possible impacts on corporate control.

In Section I, we provide an introduction both to the current debate around asset managers and corporate control, and the popularity of index investment products. In Section II, we provide background on the asset management industry – the business, its size, and how it is regulated. In Section III, we debate the principal arguments of three papers addressing asset management, index funds and corporate control: "The Future of Corporate Governance Part I: The Problem of Twelve" by John C. Coates, IV; and "The Specter of the Giant Three" and "Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy," both by Lucian A. Bebchuk and

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[1] Investment Company Institute, "US Total Retirement Market Assets," (2019), https://www.ici.org/research/stats/retirement/ret_19_q1, US Total Retirement Market Assets June 19, 2019). The remaining two thirds are composed of: deposits (checking deposits and currency; time and savings deposits; and money market funds), debt securities (bonds and open-market paper) equity in non-corporate businesses, and the cash value of life insurance. (Exhibit I).

[2] Investment Company Institute. "529 Plan Data," December 2018. https://www.ici.org/research/stats/529s/529s_18_q4 (Exhibit II). In addition to 529 Plans, many individuals utilize asset managers to save for retirement or higher education outside of structured tax vehicles.

[3] In this paper, for simplicity, we will refer to both index mutual funds and Exchange Traded Funds as "index funds."

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Scott Hirst.[4] In Section IV, we consider the principal policy measures suggested by academic commentators, and describe the possible impact they may have on the ability of index funds to continue serving diverse investors. Finally, in Section V, we conclude with suggestions for future research and for policy makers.

Fundamentally, this paper is grounded in the practical context in which the asset management business operates. Acting on behalf of clients, asset managers are incentivized to monitor companies for long-term performance and lack sufficient voting power to exercise control. Voting records indicate that individual asset managers exhibit variation in voting patterns, and do not operate as a group, challenging the perception of aggregated voting blocs. Thousands of actors are involved in corporate decision making, many better positioned to influence corporations than asset managers. The investment stewardship activities of asset managers help raise the bar on corporate governance and increase the focus on long term sustainability. Policy measures proposed by some, which seek to limit or silence the voice of asset managers would stifle this effort and harm ordinary investors.

A. Current debate: Asset managers and theories of corporate governance

Paradoxically, asset managers have been criticized by media and political commentators both for having too great an influence on how the companies they invest in are governed,[5] and for doing too little to hold companies to account.[6]

Some academic papers contributing to this debate overstate the level of control that asset managers have over companies they invest in through voting and engagement. At the same time, they understate the role of a diverse range of shareholders and various stakeholders and market participants. This has resulted in several academic papers offering conflicting theories about the willingness and ability of asset managers to influence the governance and strategy of public companies.

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[4] Coates, John C., IV, "The Future of Corporate Governance Part I: The Problem of Twelve," Harvard Public Law Working Paper No 19-07, (2019), https://ssrn.com/abstract=3247337 (Coates); Bebchuk, Lucian A. and Hirst, Scott, "The Spector of the Giant Three," (forthcoming) Boston University Law Review, Vol. 99 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3385501 (Bebchuk & Hirst I). See also, Bebchuk & Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy," (2019), (forthcoming) Columbia Law review, Vol 119 (2019), https://dx.doi.org/10.2139/ssrn.3282794 (Bebchuk & Hirst II).

[5] Investor's Business Daily, "Is Investing Giant BlackRock Trying to Push Companies to Be More Liberal?" (2018), https://www.investors.com/politics/editorials/blackrock-letter-ceo-corporate-social-responsibility/. CNBC, "Billionaire Sam Zell: BlackRock's Larry Fink is 'Extraordinarily Hypocritical' to Push Social Responsibility," (2018), https://www.cnbc.com/2018/01/16/sam-zell-blackrock-ceo-fink-is-hypocritical-to-push-social-responsibility.html (Billionaire Sam Zell).

[6] Sierra Club, "New Campaign Is Calling Out BlackRock's Big Climate Problem," (2018), https://www.sierraclub.org/compass/2018/10/new-campaign-calling-out-blackrock-s-big-climate-problem (New Campaign Is Calling Out BlackRock's Big Climate Problem); See also: The Hill, "Proxy Advisory Firms Are a Silent Threat to Main Street Investors," (2018), https://thehill.com/opinion/finance/420869-proxy-advisory-firms-are-a-silent-threat-to-main-street-investors.

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In "The Problem of Twelve," John Coates asserts that the "rise of indexing presents a sharp, general, political challenge to corporate law."[7] He hypothesizes that index funds, and the asset managers that provide them, will potentially have "economic control" derived from their large ownership stakes,[8] and speculates that the social consequences may be "the likelihood that in the near future roughly twelve individuals will have practical power over the majority of U.S. public companies."[9] Without establishing a causal connection, Coates suggests that the power of index fund managers---as well as private equity fund advisors---is further evidence of wealth inequality based on the influence of big business in all realms of political life.[10]

Coates both oversimplifies how public companies are run and overstates the role of asset managers in this process. He expresses his concern about the rise of index investing without putting it in the context of overall investing.[11] The popularity of index funds has grown in recent years in response to an increasing awareness of their value proposition and to various regulatory initiatives. Focusing largely on index funds, Coates acknowledges, but essentially disregards, the roles of active investment strategies, in-house managers, activist hedge funds, sovereign wealth funds, and more. As a result, his paper significantly overstates the voting, and the supposed resulting economic power in the hands of a few asset managers who run index funds.

Coates sees the continued growth of index funds and their voting power as inevitable. However, increases in assets managed do not always result in increased voting power.[12] In February 2019, Vanguard announced a decision to outsource the vote on equity investments held by Vanguard funds to the sub-advisory asset managers who actually manage the investments. The transfer of voting from Vanguard to the sub-advisors will reduce the votes that Vanguard casts directly by approximately 14%.[13]

Bebchuk & Hirst in their recent paper "The Specter of the Giant Three"[14] make diametrically opposite predictions about the impact of the growth of index funds. Looking at essentially the same facts as Coates, Bebchuk & Hirst seek to demonstrate that Vanguard, BlackRock and State Street, three providers of index funds, do not sufficiently utilize their influence on the companies they invest in on behalf of clients. Bebchuk & Hirst's analysis reviews the growth of equity assets managed by, and the resulting share control of, Vanguard, BlackRock, and State Street.

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[7] Coates, p. 2.

[8] Coates, p. 2.

[9] Coates, p. 1.

[10] Coates, p. 3.

[11] See, infra, pp. 13-14, for a discussion of the size of index investing.

[12] See, infra, pp. 12-13, 25-27, for other reasons voting power may not follow increases in assets, including the withholding of voting authority from asset managers by clients and the use of dual class structures by founders to retain control.

[13] In its announcement, Vanguard Investment Stewardship said that "25 external managers collectively managed more than $471 billion in equity assets across portions of 27 Vanguard funds." Vanguard funds' equity assets as of December 31, 2018 were $3.3 trillion (calculated from data published in Pensions & Investments Money Manager Rankings) of which $471 billion is approximately 14%. This calculation is only an approximation of the voting power to be transferred by Vanguard as the equity assets are as of December 31, 2018 and Vanguard funds' total assets probably increased during the first two months of 2019.

[14] Bebchuk & Hirst I.

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From this, they then extrapolate, based solely on arithmetic, that in about twenty years' time these three firms will collectively cast about 40% of the votes of U.S. listed companies.

In making their prediction, Bebchuk & Hirst presume that no current or future rival firms will challenge today's front-runners by bringing investment innovations or new product ideas to asset management. In light of the significant shifts in investment strategies, products and investment managers over the past few decades, this prediction is not a robust foundation for policy proposals. A similar prediction twenty years ago could not have foreseen the growth of index investing as we know it today.

Bebchuk & Hirst are concerned that Vanguard, BlackRock and State Street have incentives to "be excessively deferential to corporate managers," and that this will "depress shareholder intervention overall."[15] They suggest, consistent with their earlier academic work, that managers of index funds are disincentivized to invest meaningfully in engagement because of potential conflicts and cost.[16] Bebchuk & Hirst would prefer that the three firms utilize their control of large index funds to act more as activist investors.

In sum, John Coates posits that asset managers will take control of companies even though they have minority voting positions both individually and collectively. Bebchuk & Hirst find that asset managers are not sufficiently active in opposing company management and taking more corporate control. The three papers overstate the size and influence of index funds and do not reflect the practical realities of asset management.

B. Index funds make diversified investment portfolios accessible to more people

Index funds seek to provide investors with returns that track the return of securities contained in a specific index, such as the S&P 500 or the Dow Jones Industrial Index. Before these funds were readily available, investors wishing to invest in, for example, the S&P 500 index had no convenient and affordable way to buy, hold and periodically rebalance the components of the index. At best, investors could choose a small number of securities as a rough proxy or buy an actively managed fund benchmarked to this index with high costs and mixed performance results. Since the launch of the first index funds in the 1970's,[17] investors can replicate an index in one trade, and at low cost.

Today, both institutional and individual investors can choose from thousands of different index funds through which to invest their capital. In general, the index fund holds the securities of the

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[15] Bebchuk & Hirst I, p. 3.

[16] Bebchuk & Hirst I, p. 3; Bebchuk & Hirst II, pp. 5-6.

[17] In response to research underscoring the potential benefits of "passive investing," Wells Fargo and American National Bank both launched index mutual funds in 1973 for institutional customers. Vanguard's John Bogle followed suit a few years after when he established the first publicly traded index mutual fund in late 1975. Beginning with just $11 million-USD in assets, Bogle's fund tracked the S&P 500. For more information, see: Cullonton, Dan, Morningstar, "A Brief History of Indexing," (Aug. 2011), https://www.morningstar.com/articles/390749/a-brief-history-of-indexing.

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benchmark index, and the fund manager monitors the composition of the index and adjusts the holdings from time to time to follow changes determined by the index provider. Although three managers—Vanguard, BlackRock and State Street— are the largest providers of index funds, numerous other asset managers offer these products globally.[18] Characteristic of index investing are the low fees charged to index funds as compared to the fees charged by actively managed funds that seek to beat their benchmark index.[19] A combination of forces have driven the growth of index funds, including increasing awareness of their value proposition, the increased regulatory focus on fees and changes in the brokerage model that put more emphasis on asset allocation using low fee building blocks.

Low cost and ease of purchase and sale has helped index funds make diversified investment portfolios accessible to more people than ever before.[20] In the U.S., the median household wage income of all working households with exposure to the stock market – whether through a workplace-sponsored defined benefit or defined contribution pension plan; an IRA; a brokerage account; individual holdings of stocks, bonds, or mutual funds– is $70,884, corresponding to 69% of the U.S. working population.[21] The important role of index funds in lowering the barriers to diversified investment opportunities has been largely undervalued or ignored by its critics.

Coates' and Bebchuk & Hirst's concerns about the degree of influence—whether too great or too little---that managers of index funds may have on companies they invest in must be addressed based on a clear understanding of how asset managers operate their businesses.

II. Asset Management and Index Investing

In general, asset managers act as agents of asset owners, large and small. Asset owners are the clients, with capital to invest, and may be institutions or individuals. They take the risk and obtain the benefit of investment of their assets. Asset owners pay a fee to the asset manager for advice and asset managers rely on this generally stable income stream for their revenue. Asset owners decide which strategies, asset classes and regions they wish to have their managers invest in on their behalf: active or index; debt or equity (or many subcategories), alternatives; domestic, international or emerging markets. Often asset owners seek diversification through allocating assets to a number of different strategies and may use multiple investment advisory providers.

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[18] Other large asset managers who manage index products include, but are not limited to, Fidelity, Citi Group Asset Management, Credit Suisse Asset Management, Goldman Sachs Asset Management and J.P. Morgan Asset Management.

[19] CFA Institute, "Passive Equity Investing,"(2019), https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/2019/passive-equity-investing.

[20] The race to "zero fees" is likely over, as several brokerage firms cut commissions on all U.S. equities, options and ETFs in the last few weeks. Charles Schwab, E-Trade Financial, TD Ameritrade, and Fidelity have all eliminated fees from their exchange traded funds, for example. Since the middle of 2018, firms including Vanguard Group and JPMorgan Chase & Co. have eliminated fees and commissions on a range of offerings, as well. For more see: Gittelsohn, John and Massa, Annie, Bloomberg, "Schwab Triggers Online-Broker Bloodbath as Price War Deepens," (Oct. 2019), https://www.bloomberg.com/news/articles/2019-10-01/charles-schwab-to-end-online-stock-etf-and-options-commissions.

[21] Morningstar FTC Comment Letter. Some commentators argue that the top 10% of the wealth distribution owns a significant fraction of mutual funds. See e.g. Fiona M. Scott Morton, Herbert J. Hovenkamp, "Horizontal Shareholding and Antitrust Policy" (2018), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2934&context=faculty_scholarship. While this is no doubt true, it does not deny or rebut the democratization of investing that has occurred.

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Nobel Prize winner Harry Markowitz's 1952 article titled "Portfolio Selection," laid the foundation for what we know as Modern Portfolio Theory. He posited that "Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim."[22] Modern Portfolio Theory "…means that putting all your money in investments that may all go broke at the same time, i.e., whose returns are highly correlated, is not a very prudent investment strategy—no matter how small the chance is that any one single investment will go broke."[23] Diversification, and obtaining it at a low cost, is the fundamental benefit and a primary reason for the popularity of index investing.

Unlike other financial institutions, such as banks, asset managers do not invest their own balance sheets in principal trades with their clients or have access to central bank liquidity or deposit insurance. Nor do asset managers rely on balance sheet leverage to enhance revenue generation. The risk and return of investment rests with the clients and not with the asset manager. These characteristics of asset management make it a fundamentally different business than commercial and investment banking, insurance or government-sponsored entities, where balance sheet size and principal activity often are hallmarks of success.

Asset managers are fiduciaries and must put clients' interests above their own. In the words of the Securities and Exchange Commission, "As a fiduciary, an investment adviser owes its client undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent."[24] Clients come first and potential conflicts must be, and are, identified and mitigated.

Portfolio managers and a broad assortment of other asset management professionals support the implementation of investments in accordance with clients' instructions. Institutions enter into investment management agreements with an asset manager setting forth the parameters of their desired investments, which may be as broad or narrow as the client determines. Retail investors gain access to professional asset management through choosing one or more funds with investment objectives that are suitable for them and their objectives. Both institutional and retail investors can purchase index mutual funds that give them the geographical or industry-wide exposure they seek.

Equity funds, whether active or index strategies, may vote the shares of portfolio companies they hold at annual or special meetings of shareholders. These votes are cast on behalf of the fund by

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[22] Markowitz, Harry, "Portfolio Selection," (1952), https://www.jstor.org/stable/pdf/2975974.pdf?refreqid=excelsior%3A2b8b9686aa6cc1989990321b3d983876 (Portfolio Selection).

[23] Fabozzi, Frank J., Gupta, Francis., & Markowitz, Harry M, "The Legacy of Modern Portfolio Theory," (2019), https://joi.iijournals.com/content/iijinvest/11/3/7.full.pdf (The Legacy of Modern Portfolio Theory).

[24] Securities and Exchange Commission, "General Information on the Regulation of Investment Advisers," (2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (General Information on the Regulation of Investment Advisers).

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the asset manager that provides the fund with investment advice. Institutional clients with segregated accounts can delegate voting to the asset manager or they can retain the right to vote themselves, as many institutions do.[25]

If voting is delegated to the asset manager, the manager must make the substantive decision on how to vote the ballot item, as well as the mechanical implementation of casting the vote. Since asset managers are fiduciaries, they must cast their vote with the best economic interests of the client in mind.[26] To meet this standard, they must inform themselves on the issues being voted on. In performing this function, small institutions (and some retail customers owning individual securities) often rely on the recommendation of one or more of the proxy advisory firms. The most prominent of these are Institutional Shareholder Services, better known as ISS, and Glass Lewis.[27] Both ISS and Glass Lewis provide company-specific research on issues put to shareholder votes, including routine issues such as auditor selection and uncontested director election, and more contentious issues, such as shareholders proposals and proxy contests for corporate control.[28]

The larger asset managers, notably Vanguard, BlackRock and State Street, maintain dedicated investment stewardship teams, which independently develop their own guidelines for engagement and voting.[29] These teams engage with companies and other stakeholders to become informed voters on ballot items. Stewardship groups at each of these asset managers cast votes at

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[25] See, e.g., Washington State Investment Board, Re: FTC Hearing #8: Competition and Consumer Protection: Holdings of Non-Controlling Ownership Interests in Competing Companies (2018), https://www.ftc.gov/system/files/documents/public_comments/2018/12/ftc-2018-0107-d-0002-163005.pdf.

[26] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Advisers Act Release No. IA-5325 and Investment Company Act Release No. IC-33605 (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf. The guidance clarifies Rule 206(4)-6 under the Advisers Act, which requires every investment adviser who exercises voting authority with respect to client securities to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients; *see also*: Department of Labor (DoL) Fiduciary Rule, 29 CFR 2510.3-21 (Apr. 2017), https://www.federalregister.gov/documents/2017/04/07/2017-06914/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best. In letters issued in 1988 and 1990, the DoL first expressed its longstanding position that the fiduciary act of managing plan assets that are shares of corporate stock includes making decisions on proxy voting. In what are known as the Avon and Monks Letters, the DoL underscored the fiduciary importance under ERISA of plan fiduciaries voting shares in the best interests of plan participants. As such, to satisfy its duty of prudence, a plan fiduciary should engage in, and document, a robust decision-making process for proxy voting and maintain accurate records of proxy voting, in much the same way it would for other investment decisions. In sum: generally, the DoL believes that investment managers are expected to vote proxies, although there are exceptions. For more see: Interpretive Bulletin 2016-01 (IB 2016-01), including a preamble, was published in the Federal Register at 81 FR 95879 (Dec. 29, 2016), and is codified at 29 CFR § 2509.2016-01. In 1994, the Department of Labor issued its first Interpretive Bulletin 94–2 (IB 94–2) on this subject which collected and summarized views the Department previously expressed in several interpretive letters. In 2008, the Department replaced IB 94–2 with Interpretive Bulletin 2008–2 (IB 2008-2). The Department's intent was to clarify and update the guidance in IB 94–2, and to reflect interpretive positions issued after 1994 on shareholder activism and socially-directed proxy voting initiatives. In 2016, the Department replaced IB 2008-2 with IB 2016-01.

[27] See, ISS, "Current Voting Policies," (2019), https://www.issgovernance.com/policy-gateway/voting-policies/ (ISS Current Voting Policies); Glass Lewis, "Policy Guidelines," http://www.glasslewis.com/guidelines/ (Glass Lewis Policy Guidelines).

[28] See, e.g., https://www.glasslewis.com/proxy-paper-samples/; see also: https://www.issgovernance.com/solutions/governance-advisory-services/.

[29] These guidelines are generally available on the firms' websites and are developed independently from the proxy advisory firms. See, e.g., Vanguard, "Principles and Policies," https://about.vanguard.com/investment-stewardship/principles-policies/

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thousands of meetings around the world and meet with a large number of companies to inform their voting.[30] These stewardship groups do not coordinate or discuss their voting and often vote differently on controversial matters.[31]

A. Index funds help raise the bar for corporate governance

As fiduciaries, asset managers have a duty to determine whether a vote is in the best economic interests of their clients. SEC rules require mutual funds, including index funds, to have a policy on voting and report if and how they vote.[32] The Department of Labor views the vote as an attribute owned by an asset management client that is subject to ERISA. Asset managers are fiduciaries to their ERISA clients as well so must vote in their best economic interest, except in situations where the client has retained the vote to exercise themselves.

As a general matter, index fund managers have an additional incentive to engage with companies they invest in. Since managers of index investment strategies must track their benchmark index, and therefore cannot simply sell shares of companies whose governance practices are not conducive to strong performance, they are incentivized to work with companies to improve them.[33] For the same reason, funds are long-term investors and take a patient and persistent approach to

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(Vanguard Principles and Policies); BlackRock, "Principles and Guidelines," https://www.blackrock.com/corporate/about-us/investment-stewardship#guidelines (BlackRock Principles and Guidelines); State Street Global Advisors, "2019 Proxy Voting and Engagement Guidelines: North America (U.S. & Canada)," (2019), https://www.ssga.com/na/us/institutional-investor/en/our-insights/viewpoints/2018-proxy-voting-and-engagement-guidelines-north-america.html (State Street Global Advisors Proxy Voting and Engagement Guidelines).

[30] See, e.g., Vanguard, "2018 Investment Stewardship Annual Report," (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf (Vanguard 2018 Investment Stewardship Annual Report); BlackRock, "BlackRock Investment Stewardship 2018 Annual Report," (2018), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf (BlackRock Investment Stewardship 2018 Annual Report); State Street Global Advisors, "Stewardship 2017," (2018), https://www.ssga.com/investment-topics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf (State Street Global Advisors Stewardship 2017 Annual Report).

[31] Most votes are cast without opposition by all shareholders (or are totally non-controversial). In order to determine how frequently these firms support management, it's best to focus on the contested or controversial votes. Looking at all votes provides a skewed view of stewardship since overwhelmingly proxy ballot items are routine or uncontested.

[32] 15 U.S.C. § 80a-1.

[33] See, e.g. Hortense, Bloy, et. al., Morningstar, "Passive Fund Providers Take an Active Approach to Investment Stewardship," (2017) (Passive fund Providers Take an Active Approach to Investment Stewardship): "Managers have a fiduciary duty to their investors to push for changes that will increase shareholder value…the shift to index investing hasn't led to an abdication of stewardship responsibilities."; *see also*: Fisch, Jill, Hamdani, Assaf, Solomon Steven, "The New Titans of Wall Street: A Theoretical Framework for Passive Investors." (2019) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069 (The New Titans of Wall Street: A Theoretical Framework for Passive Investors). For a contrary view, see Lund Shapiro, Dorothy, "The Case Against Passive Shareholder Voting," (2017), https://chicagounbound.uchicago.edu/lawand_economics/846/ (The Case Against Passive Shareholder Voting).

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stewardship. Nevertheless, when an activist investor presents a proposal to corporate management that is likely to benefit the long-term value of the company, index fund managers do support such proposals, as evidenced by their voting record and public statements.[34]

Academic research has found that the increase in index investing has led to improvements in board governance at many public companies.[35] In fact, asset managers often engage with companies on topics relating to long-term sustainability and governance. Research has found that "Passive investors are particularly well-placed to evaluate provisions such as proxy access, forum-selection bylaws, or staggered boards and to determine whether these provisions are likely, as a general matter, to increase or decrease firm value at the majority of portfolio companies. They are more likely to internalize any spillover effects that may arise from governance provisions."[36] Several academics have acknowledged that multiple types of shareholders are likely beneficial,[37] in contrast to those who are more inclined to promote the benefits of activist investing.[38]

In addition to benchmark returns and diversification at a low cost, the growth of index investing has coincided with improvements in board quality and other governance quality indicators, at least in part through institutional investors' stewardship activities. However, it is important to note that without additional shareholder support from active funds, in-house managers and others, these improvements might not have occurred.

The rise of index investors is also associated with more independent directors, and greater support for shareholder-initiated governance proposals.[39] Appel, Gormley and Keim find that index

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[34] See e.g. Barron's, "'Corporate America Had Better Take Note.' Fund Managers Are the New Activist Investors," (2019), https://www.barrons.com/articles/mutual-fund-managers-activist-investors-51554498763; see also: Reuters, "Passive fund manager Vanguard turns activist in some board votes, (2013), https://www.reuters.com/article/vanguard-proxyvotes/passive-fund-manager-vanguard-turns-activist-in-some-board-votes-idUSL2N0H00YV20130913; see also "BlackRock Investment Stewardship: Protecting our clients' assets for the long-term" (2018), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf (BlackRock Investment Stewardship)

[35] Appel, Ian and Gormley, Todd A. and Keim, Donald B., Passive Investors, Not Passive Owners (February 6, 2016). Journal of Financial Economics (JFE), Forthcoming. https://ssrn.com/abstract=2475150 or http://dx.doi.org/10.2139/ssrn.2475150 (Passive Investors, Not Passive Owners).

[36] The New Titans of Wall Street: A Theoretical Framework for Passive Investors.

[37] See e.g. Rock, Edward, Kahan, Marcel, "NYU Law and Economics Research Paper No. Index Funds and Corporate Governance: Let Shareholders be Shareholders," (2018) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098 (Let Shareholders be Shareholders); Michel, Allen, Shaked, Israel, "Does Business Diversification Affect Performance?" https://www.jstor.org/stable/3665297?casa_token=CbAdpE04-fAAAAAA:2cUyGAAS6KcwBN_HqtIueGj1TaODgn6X6A5gEzi4VriL6V9gm-Rc1_BVJCFBSMACxHxYIn2eob27tkrIZoHkIPRC-v20W5ZWyfB8OpKfJ3lbDe-qUtE&seq=1#metadata_info_tab_contents.

[38] Bebchuk, Lucian, et al., "The Long-Term Effects of Hedge Fund Activism," (2015), https://www.nber.org/papers/w21227.pdf (The Long-Term Effects of Hedge Fund Activism): "We find no evidence that interventions, including the investment-limiting and adversarial interventions that are especially resisted by opponents, are followed in the long-term by declines in operating performance. Indeed, we find evidence that such interventions are followed by long-term improvements, rather than declines, in performance;" Schmalz, Martin, "Common Ownership and Competition: Facts, Misconceptions, and What to Do About It," (2017), http://www.law.northwestern.edu/research-faculty/colloquium/law-economics/documents/Spring18Schmalzprimer.pdf (Common Ownership and Competition: Facts, Misconceptions, and What to Do About It): "Competition requires that firms' most influential share-holders don't also own the firms' competitors…Incentives to compete are present for example when an entrepreneur and/or sufficiently large block holders concentrate wealth in one firm – but not the firm's competitors."

[39] Passive Investors, Not Passive Owners, p. 29.

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investment is associated with improvements in firms' longer-term performance.[40] Managers of index funds are found to have a positive interaction effect with activist investors, making the efforts of activists more effective.[41] Institutional investing has also been found to be associated with more corporate innovation.[42] Voting policies reflect these associations through common themes such as withholding support or voting against boards that are not sufficiently independent, or broad opposition to takeover defenses.[43]

B. Putting asset manager size and index investing in context

According to Pensions & Investments, global equity assets under management (AUM) of the world's top 300 asset managers totaled $26 trillion in 2018, down from $28 trillion the previous year.[44] The compounded annual growth rate ("CAGR") of global equity AUM of Vanguard, BlackRock, and State Street was 12%, 5%, and 2% respectively, from 2013 to 2018. They were not, however, the fastest growing among well-known top 30 asset managers. For example, the CAGR of global equity AUM of Charles Schwab Investment Management Inc. (20%), Dimensional Fund Advisors LP (9%), Goldman Sachs Group Inc. (8%), Morgan Stanley (7%), T. Rowe Price Associates Inc. (6%), and Capital Group (3%), grew at faster or similar rates during the same period.[45]

During the same period the global equity AUM CAGR varied considerably among the top 300 asset managers, but overall, averaged just 1.5% from the years 2013 to 2018.[46] These trends suggest that growth in asset management is not attributable to only the largest firms and that the future is neither certain nor predictable, especially with regards to individual firms over time.

In the U.S., index mutual fund and ETF assets have grown steadily in the past few years. Much of the money flowing into these vehicles comes from investors who have moved capital out of actively managed mutual funds.[47] Still, index mutual funds and ETF's represented only 17% of

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[40] "Passive investors appear to exert influence through their large voting blocs, and consistent with the observed governance differences increasing firm value, passive ownership is associated with improvements in firms' longer-term performance." Passive Investors, Not Passive Owners.

[41] "Our findings suggest that the recent growth of passive institutional investors mitigates free-rider problems and facilitates activists' ability to engage in costly, value-enhancing forms of monitoring." Appel, Ian and Gormley, Todd A. and Keim, Donald B., Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism (June 30, 2018) https://ssrn.com/abstract=2693145 or http://dx.doi.org/10.2139/ssrn.2693145)

[42] Aghion, P., Van Reenen, J., Zingales, L., 2013. Innovation and institutional ownership. American Economic Review 103, 277–304.

[43] Passive Investors, Not Passive Owners, p. 31.

[44] Pensions & Investments, "Largest Money Managers: 2019," (2019), https://researchcenter.pionline.com/v3/rankings/money-manager/datatable (P&I). All figures are self-reported to P&I as of year-end 2018.

[45] P&I. Among the top 30 global asset managers only five, Fidelity Investments (-1%), Prudential Financial (-1%), J.P. Morgan Asset Management (-3%), BNY Mellon Investment Management (-6%), and Franklin Templeton (-6%) had a decline in equity AUM.

[46] P&I.

[47] Bebchuk I, Table 1, p.8.

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U.S. stock market capitalization as of year-end 2018.[48] Contrary to some of the concerns expressed, the growth of index mutual funds and ETF's relative to the U.S. stock market capitalization has not been exponential.[49] Index mutual funds and ETF's still represent a small portion of a much broader investment universe. In the U.S., there are additional equity assets managed in index strategies either by asset owners themselves or through institutional separate accounts at asset management firms.

While asset managers have increased in size and prominence, a large portion of equity assets are managed directly by their owners rather than outsourced for investment by asset managers.[50] In addition, many other stakeholders play a role in corporate governance, including most prominently, proxy advisors and compensation consultants. Many asset owners, particularly institutions, turn to investment consultants for help and advice in choosing one or more asset managers and, as a result, investment consultants are particularly significant in the asset management world.[51]

C. Index funds help investors manage risk through diversification

In recent years there has been a shift in the U.S. from Defined Benefit retirement plans to Defined Contribution retirement plans. This shift has moved the investment risk from the plan sponsors to individual plan participants. As shown in Exhibit III, U.S. Corporate Defined Contribution plan assets have almost doubled from $3.6 trillion in 2010 to $5.7 trillion in 2018.[52] In addition, brokers have increasingly evolved from providing individual security suggestions and execution to providing total portfolio solutions for their clients.

In this new environment, the use of index funds as a core investment vehicle has significantly increased, in part because they provide diversification and benchmark returns at a low cost. Index funds charge fees -- expense ratios -- that are substantially lower than active funds. In the U.S., new regulations around best interest advice have led financial advisors to deliver greater value by

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[48] BlackRock obtained index mutual fund data from Simfund and Broadridge and EFT data from iShares Global Business intelligence (GBI). All data is as of December 2018.

[49] Bebchuk I, Figure 1, "Percentage of Corporate Equity Held by Big Three Index Funds", p.14, shows, for example, Vanguard going from 3.6% to 8.8%, BlackRock going from 6% to 7.1% and State Street Global Advisors going from 4.3% to 4.6%, respectively, of S&P 500 companies from 2008 to 2017. It appears that in Bebchuk I, Figure 1, the percentages are the raw average of the individual percentage holdings in the companies included in the S&P 500 without adjustment for market capitalization. As a result, a large percentage holding in a smaller cap company has more weight than a smaller percentage but more valuable holding in a large cap company. Using cap weighted averages, Vanguard went from 3.3% to 7.7%, BlackRock from 4.4% to 5.0% and State Street Global Advisors from 4.6% to 4.7%, of the S&P 500 companies from 2008 to 2017, substantially less growth than the impression created by Bebchuk I, Figure 1.

[50] BlackRock estimates that more than half of all global equity assets and more than a third of U.S. equity assets are not managed by an external asset manager. To reach these estimates, BlackRock used data obtained from World Federation of Exchange Database (WFED) (data as of December 2018), Bank for International Settlements (BIS) (data as of Q2 2018), Hedge Fund Research (HFR), Cerulli, Simfund (data as of Dec 2018), iShares Global Business Intelligence (GBI) (data as of December 2018), Global Heat Map, McKinsey Cube (data as of December 2017).

[51] CompArchive, "2017 Consultant Market Share Tables," (2017), https://comparchive.com/2017-consultant-market-share-tables/ (CompArchive 2017 Consultant Market Share Tables).

[52] Investment Company Institute, "2019 Investment Company Fact Book," (2019), https://www.ici.org/pdf/2019_factbook.pdf. Calculation excludes 457 plans, Federal Thrift Savings Plans (TSP), and 403(B) plans.

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charging fees for their services instead of profiting from commissions.[53] This has led many financial advisors to combine low cost products into an appropriate portfolio for each client.[54]

Today, financial advisors often provide active strategies through their advice about asset allocation. Asset allocation often consists of weighting various index funds that compose a portfolio. Globally, thousands of securities indexes span diverse regions, industries, companies of different sizes, and a host of other factors. Investment advisors play a significant role in guiding investors in how to allocate their capital across indexes, combining active asset allocation with index funds. As a result, the distinction between active and index investment often has diminished relevance.[55]

D. Regulation of asset managers and products

Asset managers are highly regulated throughout the world at both the manager level and at the portfolio and product level. In the U.S., the principal regulator of asset managers is the Securities and Exchange Commission (SEC), which administers the two main statutes under which asset managers conduct their business – the Investment Company Act of 1940[56] and the Investment Advisers Act of 1940.[57] The SEC also administers the provisions of the Securities Exchange Act of 1934 that requires disclosure of holdings of 5% or more of publicly traded companies either by a single asset manager or by several asset managers that form a group.[58]

These statutes provide the framework that determines the activities of asset managers, establishes the boundaries around the asset management business, and provide civil, criminal and regulatory penalties for violations of those boundaries. Both the Investment Company Act and the Investment Advisers Act require advisors to act in their clients' best interest, to employ reasonable care

[53] Sethi, Jasmin, Szapiro, Aron, & Spiegel, Jake, Morningstar, "Conflicts of Interest in Mutual Fund Sales," (2018), https://www.morningstar.com/lp/conflicts-of-interest (Conflicts of Interest in Mutual Fund Sales); Lacurci, Greg, "DOL Fiduciary Rule Pushing Broker-Dealer Assets To Fee-Based Accounts, Away From Commissions," (2019), https://www.investmentnews.com/article/20170524/FREE/170529958/dol-fiduciary-rule-pushing-broker-dealer-assets-to-fee-based (DOL Fiduciary Rule Pushing Broker-Dealer to Fee-Based Accounts); Kitces, Michael, "The Transformation of the 1% AUM Fee-From Levelized Commission to Fee for Advice," (2016), https://www.kitces.com/blog/great-convergence-1-aum-fee-schedule-for-investment-advisers-and-12b-1-and-wrap-fees-for-brokers/37. (Conflicts of Interest in Mutual Fund Sales 2018)

[54] Conflicts of Interest in Mutual Fund Sales 2018.

[55] "…the shift from active to passive is really just a mirage; what's really occurring is a process where financial advisors are remaining active, but disintermediating mutual fund managers and going hands-on to actively build the portfolio themselves…"

Kitces, Michael, "The Passive Investing Mirage and the Disintermediation of Active Mutual Fund Managers," (2017).

https://www.kitces.com/blog/passive-investing-mirage-financial-advisor-etfs-disintermediate-mutual-fund-managers/ (The Passive Investing Mirage and the Disintermediation of Active Mutual Fund Managers).

[56] Investment Company Act of 1940, (2018), https://legcounsel.house.gov/Comps/Investment%20Company%20Act%20Of%201940.pdf (15 U.S. Code § 80a–3).

[57] Investment Advisers Act of 1940, (2019), http://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf (15 U.S. Code § 80b–2).

[58] For a fuller discussion of the effect of the disclosure rules under the Securities Exchange Act of 1934, see below, "III. Coates and Bebchuk & Hirst: Debating Theories of Corporate Control, D. Asset managers do not coordinate voting."

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to avoid misleading clients, and to fully and frankly disclose all material facts.[59] Additionally, the advisor must obtain client consent, prior to engaging in any transaction with the client where the advisor acts as a principal, or where the advisor acts as a broker for someone other than the client.[60]

Mutual funds are subject to the Investment Company Act[61] as well as to reporting requirements that disclose a fund's proxy voting via Form N-PX.[62] In addition, many U.S. investment managers, depending on their activities, are also regulated by the Commodity Futures Trading Commission (CFTC), Department of Labor (DOL), or if offering collective investment trust funds, either the Comptroller of the Currency for national banks or state banking commissions for state banks. Outside of the U.S., the Financial Conduct Authority in the United Kingdom, the Hong Kong Securities & Futures Commission of (SFC), the Japanese Financial Services Agency (FSA) and numerous other regulatory bodies[63] throughout the world supervise and regulate the conduct and activities of asset managers and the products they offer to investors.

Many asset managers are bound by global and regional stewardship codes. While many of these codes are voluntary, asset managers who sign onto them are bound to perform their fiduciary duty by voting in the best interest of their clients, disclosing their voting behavior, and engaging with portfolio companies to enhance the long-term return of their portfolios.

In the U.S., the Investor Stewardship Group (ISG) lists a series of principles that managers should follow if they choose to be a member of the group. ISG requires members to provide extensive disclosure concerning the extent to which a fund delegates its proxy voting decisions to the recommendations of a third party, policies and procedures relating to matters that may affect substantially the rights or privileges of the holders of securities to be voted, and policies regarding the extent to which the fund will support or give weight to the views of management of a portfolio company.[64] As far as engagement disclosures go, ISG members must disclose how they manage potential conflicts of interest that may arise in their engagement activities.[65]

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[59] Investment Company Act of 1940, (2018), https://legcounsel.house.gov/Comps/Investment%20Company%20Act%20Of%201940.pdf (15 U.S. Code § 80a–3); 15 U.S.C. § 80b-6.

[60] 15 U.S.C. § 80b-6(3).

[61] 15 U.S.C. § 80a35(b).

[62] 15 U.S.C. § 80a-1.

[63] Other notable global regulators include, but are not limited to: Australian Securities and Investments Commission, Australian Prudential Regulatory Commission, China Securities Regulatory Commission, Federal Financial Supervisory Authority, Mandatory Provident Fund Schemes Authority, Hong Kong Monetary Authority, Central Bank of Ireland, The Surveillance Commission of the Financial Sector, Monetary Authority of Singapore, Financial Services Commission, Mutual Commission for Securities Markets, Comisión Nacional Bancaria y de Valores, Federal Banking Commission, Financial Supervisory Commission, Securities & Exchange Commission, Financial Industry Regulatory Authority, National Futures Association, and Federal Reserve Board.

[64] Investor Stewardship Group, "Stewardship Principles," (2018), https://isgframework.org/stewardship-principles/ (ISG Stewardship Principles 2018).

[65] ISG Stewardship Principles 2018.

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In the European Union (E.U.), the Revised Shareholders Rights Directive (SRD II) is a binding set of principles that requires institutional investors, including asset managers, in the EU to annually disclose details of how they prepare research, advice and voting recommendations. They must also disclose how engagement is integrated into the investment strategy and annually make public how various policies were implemented.[66]

The Principles for Governance Monitoring, Voting and Shareholder Engagement in Canada has similar requirements. Published by the Canadian Coalition for Good Governance (CCGG), the Principles for Governance Monitoring, Voting and Shareholder Engagement requires its members to disclose proxy voting policies or guidelines, voting record within a reasonable period of time following a shareholder meeting or as required by law, and policies on how they intend to engage with investee companies, individually or collaboratively.[67]

On top of national and regional stewardship guidelines, asset managers around the world can become members of the United Nations' Principles of Responsible Investing and follow its six core principles, which encourage asset managers to incorporate environmental, social, and governance (ESG) considerations into their practices.[68] Aside from these binding and voluntarily adopted stewardship codes, there are several other jurisdictions that utilize their own version of a set of stewardship guidelines.[69] Thus, the investment stewardship duty of asset managers is recognized around the world.

III. Coates and Bebchuk & Hirst: Debating Theories of Corporate Control

Having briefly explained asset management and index investing, we next examine theories of corporate control put forward by John Coates and Bebchuk & Hirst. As a result of the rise of index investing –and private equity investing -- Coates argues that roughly "twelve individuals" will imminently control corporate America, a theory he refers to as the "Problem of Twelve." In this section, we first address the arguments in this theory and related literature. We then turn to Bebchuk & Hirst, who, in contrast to Coates, suggest that asset managers, through a combination of incentives and conflicts, do not, and will not, sufficiently assert their influence on portfolio companies.

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[66] Willis Towers Watson, "The EU Shareholders' Rights Directive – disclosures are coming, are you ready?" (2018), https://www.willistowerswatson.com/en/insights/2018/07/the-eu-shareholders-rights-directive-disclosures-are-coming (The EU Shareholders' Rights Directive – Disclosures Are Coming, Are You Ready?).

[67] Canadian Coalition for Good Governance (CCGG), "Principles for Governance Monitoring, Voting and Shareholder Engagement, Canadian Coalition for Good Governance," (2005) https://ecgi.global/code/principles-governance-monitoring-voting-and-shareholder-engagement-canadian-coalition-good (Principles for Governance Monitoring, Voting and Shareholder Engagement 2005).

[68] UN Principles of Responsible Investing (UN PRI), "About the PRI," (2019), https://www.unpri.org/about-the-pri (About the PRI).

[69] See e.g. Financial Reporting Council, "The UK Stewardship Code 2020," (2019), https://www.wlrk.com/docs/TheUKStewardshipCode2020.pdf (The UK Stewardship Code 2020); "Financial Services Council. FSC Standard 23: Principles of Internal Governance and Asset Stewardship," (2017), https://webcache.googleusercontent.com/search?q=cache:1QCTAmXpkYQJ:https://ecgi.global/download/file/fid/14084+&cd=1&hl=en&ct=clnk&gl=us (FSC Standard 23: Principles of Internal Governance and Asset Stewardship July 2017).

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A. The principal-agent problem undermines the "Problem of Twelve" theory

The principal-agent problem is a well-documented conflicts of interest phenomenon that arises out of relationships between parties where one party (the agent) is expected to act in the interest of another party (the principal). When the interests of the two are not aligned, the theory posits that agents act in their own interest instead of the interest of the principal. The relationship between shareholders and corporate managers is often cited as a textbook example of the principal-agent problem.[70] In this scenario, management (the agent) is tasked with the duty of maximizing value for the shareholder (the principal) despite their inherent interest in maximizing their own wealth.

Coates' assessment of the ability of institutional index investors to influence corporate managers does not consider the principal-agent problem. It is not clear that Coates' theory is consistent with the long-observed principal-agent phenomenon in the shareholder-management relationship. Asset managers, although acting as agents of their clients, are akin to principals when they invest client assets in portfolio companies. The portfolio company managers (agents) have no reason to prioritize asset managers over other principals.[71]

Coates does not address the mechanisms of control he posits, nor does it appear in his comparison of index fund control to that of a sole owner. It is therefore unclear how a handful of shareholders whose aggregate ownership is well below the level of control (and who act independently) would be able to dominate the corporate landscape without facing serious principal-agent resistance from corporate managers.

The doubt that the principal-agent problem casts on the "Problem of Twelve" was echoed by Commissioner Noah Phillips of the U.S. Federal Trade Commission (FTC) in remarks he delivered in December 2018 on the subject of common ownership. In a variation of the "Problem of Twelve," common ownership theories claim that institutional index investors may have sufficient influence to produce anticompetitive effects on consumer prices when holding shares in more than one company in concentrated industries.[72] Commissioner Phillips expresses skepticism of

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[70] Gilson, Ronald J. and Gordon, Jeffrey N., "The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights," Columbia Law Review, Vol. 113 (2011), https://columbialawreview.org/content/the-agency-costs-of-agency-capitalism-activist-investors-and-the-revaluation-of-governance-rights/.

[71] There is a separate principal agent relationship between the asset managers and their clients and that is not the subject of this article. Coates does not address this as well.

[72] See "Azar et al. Airline Paper"; see also: Elhauge, Einer, "Horizontal Shareholding." For a discussion of why theories about the potential harms of common ownership are implausible arguments, see Lambert, Thomas, "Calm Down About Common Ownership," (2018), https://object.cato.org/sites/cato.org/files/serials/files/regulation/2018/9/regulation-v41n3-4.pdf (Calm Down About Common Ownership); "BlackRock Policy Spotlight: Common Ownership Data Is Incorrect," (2019), https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-common-ownership-data-is-incorrect-january-2019.pdf (BlackRock Policy Spotlight: Common Ownership Data Is Incorrect); Szapiro, Aron, "Would Policymakers Target Index Funds? Concentrated Ownership Debate Has Found a Receptive Audience Among Politicians," (2018), http://www.nxt-book.com/nxtbooks/morningstar/magazine_20181201/index.php?startid=18#/20 (Would Policy Makers Target Index Funds?);

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the control that minority shareholders, such as asset managers, might have in light of the principal-agent problem. Referring to the incentives of company managers, he states that common ownership:

> "…presumes that managers are very particularly attuned to the desires of a minority of their shareholders and act to maximize value to them, whereas corporate law assumes that managers, unless forced to behave otherwise, will act to maximize their own interests over that of shareholders generally and of minority shareholders specifically."[73]

Although Commissioner Philips recognizes the implausibility of the argument that corporate managers prioritize small minority common owners over other shareholders, his statement applies equally to the "Problem of Twelve" theory. There is no evidence to explain why corporate managers of companies whose securities are held by index funds would be incentivized to permit the control by institutional index investors that Coates describes.[74]

B. Asset managers are minority shareholders with limited voting power and corporate control

Coates argues that asset managers exercise undue control over the boards and management of their portfolio companies.[75] He notes, "Indexation, private equity, and globalization threaten to permanently entangle business with the state and create organizations – advisors to index funds and private equity funds – controlled by a small number of individuals with unsurpassed power."[76] At best, this argument conflates many societal trends and makes no evidence-based causal statement.

The power of any index fund manager to influence board composition, CEO pay, or other company outcomes is limited to the influence of their vote and to their voice. Asset managers can and do make their views known, including on environmental, social, and governance (ESG) issues. In reality, however, asset managers may not be able to bring about changes in the ESG arena that they might seek because they do not have sufficient voting power to do so without the support of other shareholders. There is no threat of index fund managers 'voting with their feet' by selling shares of a company because as long as a company's securities remain in an index, the index

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Bryan, Alex, "Much Ado About Nothing: Impact of Diversified Funds on Competition," (2018), https://www.morningstar.com/articles/843172/much-ado-about-nothing-the-impact-of-diversified-f.html (Much Ado About Nothing). We note that the papers criticizing common owners obtained institutional ownership data from Form 13 filings to the SEC. These filings are not at the asset owner level and, therefore, do not individually or collectively present an accurate picture of common ownership.

[73] Phillips, Noah, "Remarks at FTC Hearing #8: Competition and Consumer Protection in the 21st Century," (2018), https://www.ftc.gov/system/files/documents/public_events/1422929/ftc_hearings_session_8_transcript_12-6-18.pdf (Remarks at FTC Hearing #8); see also: Phillips, Noah, "Taking Stock: Assessing Common Ownership," (2018), https://www.ftc.gov/system/files/documents/public_statements/1382461/phillips_-_taking_stock_6-1-18_0.pdf (Taking Stock: Assessing Common Ownership).

[74] See, supra, pp. 19-20.

[75] Coates, p. 3.

[76] Coates, p. 3.

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fund will own it. Corporate ownership is either highly dispersed, or one or more large shareholders are present. In neither case can an index fund manager swing the outcome of proxy votes to control, for example, the composition of company boards of directors.

As highlighted in Exhibit IV, we break down the support for Russell 3000 Director Elections proposals by Director Elected and Director NOT-Elected voting percentages. It highlights that 88% of director elections in the Russell 3000 this past year have received 90%+ support from all shareholders. In addition, 95% of Russell 3000 director elections are won by a margin greater than 30%. This means even the combined vote within the control of the three leading asset managers would not swing the outcome in at least 95% of director elections.[77]

In fact, less than 1% of all Russell 3000 director elections were won or lost by a margin less than 10%. Only in some of these elections could any of the three leading asset managers have individually, even theoretically, operated as a swing vote. These numbers highlight that in more than 99% of director elections even the largest diversified institutional investor in most companies could not have cast a swing vote. The bottom line is that large asset managers are not the 'deciding' factor in the composition of public company boards.

Coates attempts to support his central theory that the majority of U.S. public companies will be controlled by a dozen or fewer individuals by highlighting the ownership profile of Apple Inc. (Apple). He notes that Vanguard, BlackRock, and State Street collectively control about 17% of outstanding shares in Apple.[78] However, the top 10 institutional shareholders of Apple together only control 30.98% of shares outstanding.[79] In fact, it would take around 20 additional shareholders each with 1% (the percentage of outstanding shares held by the tenth largest shareholder of Apple)[80] to reach 50% of shares. It would take a substantial number of institutional shareholders voting as a bloc to control Apple, a prospect not in sight, not even over the horizon. There is no evidence to conclude that 12 or so firms would reach a controlling level of share ownership imminently. It seems even less likely that they would all vote similarly either by design or coincidence and there is no basis to assume that this would occur simultaneously in every large U.S. public company.

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[77] FactSet data for the N-PX disclosure period ending June 30, 2018. The Russell 3000 index is a broad-based index comprised of the 3,000 largest US public companies by market capitalization and thus provides a broad sample of US companies from which to analyze proxy voting activity. Assuming that a single asset manager can vote 10% of a company's shares, Exhibit IV shows that during the 2017-2018 proxy season, less than 1% of Russell 3000 director elections could have been decided by a 10% shareholder changing their vote. In addition, Exhibit

IV shows that in the 2017-2018 proxy season, 95% of Russell 3000 director elections were won by a margin greater than 30%. This means that even three 10% shareholders changing their votes in the same direction would not have changed the outcome.

[78] Coates, p. 14.

[79] Yahoo Finance Apple Inc. (AAPL) NasdaqGS Real Time Price, Top Institutional Holders, (June 20th, 2019), https://finance.yahoo.com/quote/AAPL/holders/.

[80] Yahoo Finance Apple Inc. (AAPL) NasdaqGS Real Time Price, Top Institutional Holders, (June 20th, 2019), https://finance.yahoo.com/quote/AAPL/holders/.

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Coates use of Apple as an example warrants a deeper look at Apple's actual shareholders. While the two largest holders of Apple shareholders are asset managers, the third largest holder of Apple is not an asset manager or fund at all but instead is Berkshire Hathaway at 5.42%,[81] the holding company based in Omaha, Nebraska, founded by investor Warren Buffett.[82] Buffett, with more than 40 years of experience as a Chairman and CEO of publicly and privately held companies, provides the board of directors of companies in which he invests with investment leadership and management experience. He or a designee often serves as a Director on the board of Directors for companies held by Berkshire Hathaway.[83]

Further, among the top ten holders of Apple is Norges Bank Investment Management (Norges Bank), the investment advisor to the Norwegian sovereign wealth fund.[84] Norges Bank manages the fund on behalf of the Norwegian Ministry of Finance, which owns the fund on behalf of the nation. The fund's aim is to "ensure responsible and long-term management of revenue from Norway's oil and gas resources in the North Sea so that this wealth benefits both current and future generations."[85] Norges Bank holds shares in about 9000 companies and voted on 113,216 resolutions at 11,084 shareholder meetings in 2017.[86] The fund voted in line with the board's recommendation on 94 percent of these resolutions.[87] Of the resolutions where Norges Bank voted against the board's recommendation, 52 percent were related to the election of directors.[88] Their goals for engagement and voting are to encourage long-term investment, strengthen governance, improve performance, and promote sustainable practices.[89] Thus, while index funds are among the larger holders of Apple, none of them hold a large enough percentage to exercise control, and there are other large holders with different investment purposes, methods of investment, and time horizons, resulting in a diversity of views when casting votes.

The "Problem of Twelve" theory is mistaken that institutional index investors have a degree of effective control comparable to that of a sole owner of a company. Coates writes: "If an index fund were to spend its limited resources on governance in getting the incentives, CEO selection, and basic strategy right, it would be in much the same position as a sole owner of a complex,

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[81] Yahoo Finance Apple Inc. (AAPL) NasdaqGS Real Time Price, Top Institutional Holders, (June 20th, 2019), https://finance.yahoo.com/quote/AAPL/holders/.

[82] Hargrave, Marshall, "What is Berkshire Hathaway," (2019), https://www.investopedia.com/terms/b/berkshire-hathaway.asp (Berkshire Hathaway).

[83] Bloomberg, "Warren Buffet Executive Summary," (2019), https://www.bloomberg.com/research/stocks/private/person.asp?personId=255253&privcapId=255251 (Warren Buffet Executive Summary).

[84] Yahoo Finance Apple Inc. (AAPL) NasdaqGS Real Time Price, Top Institutional Holders, (June 20th, 2019), https://finance.yahoo.com/quote/AAPL/holders/.

[85] Norges Bank Investment Management, "About the fund, (2019), https://www.nbim.no/en/the-fund/about-the-fund/ (About the Fund).

[86] Norges Bank Investment Management, "Responsible Investment: Government Pension Fund Global," (2017) https://www.nbim.no/contentassets/67c692a171fa450ca6e3e1e3a7793311/responsible-investment-2017---government-pension-fund-global.pdf (Responsible Investment: Government Pension Fund Global).

[87] Responsible Investment: Government Pension Fund Global.

[88] Responsible Investment: Government Pension Fund Global.

[89] Responsible Investment: Government Pension Fund Global.

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multi-layered business."[90] Beyond lacking an empirical basis, this theory demonstrates a lack of understanding about the actual holdings of asset managers, how they operate, and the diversity of other shareholders with whom they share ownership of public companies. Influencing complex companies as if the asset manager were the sole owner is not their business model.

Proposals presented for shareholder votes range from ordinary to controversial. In many cases, management proposals relate to routine matters, such as the reappointment of auditors. The vast majority of asset owners and asset managers support management on such routine proposals.[91] Shareholder proposals tend to be more contentious than management proposals. These proposals receive greater public and media coverage, amplifying their non-routine nature.[92] As a result of the media attention that surfaces from a small number of engagements and votes per year, asset managers experience intense scrutiny on select situations that strike a chord with the public. Most of the time, however, engagement and voting by asset managers is unnoticed as the vast majority of situations involve no controversy. Often this scrutiny on a small number of instances of non-routine matters brought to a shareholder vote is generalized to give the impression of much larger impact on companies. In 2018, for example, only two proposals per company were submitted to the stockholders' meetings of companies in the S&P 100. Among all of the S&P 500, only 0.7 proposals were submitted per company, and in the Russell 3000 just 0.1 proposals per company. [93]

Executive compensation is cited by Coates as evidence of the influence of index fund asset managers on corporate behavior. This disregards the role of boards of directors, compensation committees and compensation consultants who are the critical decision makers in determining executive compensation.[94]

C. Voting records show variation in asset manager voting behavior

Coates' argument rests on the assumption that asset managers are homogenous and act in a uniform way --- that they all have similar incentives and voting behaviors --- making it reasonable to consider them as a unit. While voting on management proposals is generally non-controversial and these ballot items represent the vast majority of all votes, an analysis of data on shareholder proposals can provide insight into the variation in voting records and approaches to investment

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[90] Coates, p. 17.

[91] Data from FactSet and ProxyInsight for the N-PX period ending June 30th 2018.

[92] See e.g. The New York Times, "Exxon Mobil Shareholders Demand Accounting of Climate Change Policy Risks," (2017), https://www.nytimes.com/2017/05/31/business/energy-environment/exxon-shareholders-climate-change.html; See also: The New York Times, "Procter & Gamble Bets on Electoral Math to Keep Nelson Peltz Away" (2017), https://www.nytimes.com/2017/10/06/business/dealbook/procter-gamble-nelson-peltz.html.

[93] Data from FactSet for N-PX period ending June 30, 2018. The S&P 100 companies tend to garner the most media and shareholder scrutiny and attract the largest number of shareholder proposals. For example, as of May 13, 2019, Alphabet had received 13 proposals, Amazon 12, Facebook 8 and Exxon Mobil 7.

[94] See below, "III. Coates and Bebchuk & Hirst: Debating Theories of Corporate Control: F. Asset managers do not determine corporate executive pay packages."

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stewardship among different types of investors. The analysis shows that there is significant variation in voting across asset managers of all types and sizes.

We looked at the voting record on shareholder proposals, and observed that among large asset managers, the votes in favor of these proposals ranged from 8% to 37% during the period from July 2015 through June 2018.[95] In addition, none of the commentators, Coates included, have adequately measured the significant (and generally acknowledged) influence of the proxy advisory firms—principally ISS and Glass Lewis—who are the main sources of voting advice for many smaller institutions, including mutual funds, and, to some extent, retail investors.[96]

One estimate is that the proxy advisory firms' recommendations determine between 20-30% of the vote among institutional investors who lack their own investment stewardship teams.[97] According to this estimate, the proxy advisory firms' influence is greater than that of Vanguard, BlackRock and State Street combined. Even commentators who are critical of the concentration of assets among these three firms estimate that the mean aggregate percentage ownership by these three institutions in public companies is just 17.6%.[98]

Vanguard, BlackRock, and State Street have each developed their own in-house teams and voting principles, independently of each other or ISS and Glass Lewis.[99] Each of these asset managers dedicates a large team, more than 30 employees at Vanguard and over 40 at BlackRock, to engage with portfolio companies.

Various commentators suggest that, increasingly, large asset managers can decide the outcome of proxy votes.[100] These commentators often highlight Vanguard, BlackRock and State Street and their aggregated holdings on behalf of clients while ignoring equity holdings by other large in-house and external asset managers. The theory is based on a handful of closely contested elections in which the outcome was determined by fewer votes than Vanguard, BlackRock and State Street individually controlled. Exhibit IV illustrates that in less than 1% of Russell 3000 director

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[95] See Exhibit V. Data from ProxyInsight during the period from July 1st, 2015 to June 30th, 2018.

[96] For instance, although BlackRock uses research from both ISS and Glass Lewis, BlackRock does not follow any single proxy advisor's voting recommendations, and in most markets BlackRock subscribes to two research providers and uses several other inputs in their own analysis in advance of making its voting decision. BlackRock performs annual in-person due diligence of the firms whose research they use.

[97] Nadya Malenko & Yao Shen, "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design," (2016), https://academic.oup.com/rfs/article/29/12/3394/2418027 (The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design). For a view on the role of index funds in voting see Boone, Audra, Gillan, Stuart L. and Towner, Mitch, "The Role of Proxy Advisors and Large Passive Funds in Shareholder Voting: Lions or Lambs," https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2831550.

[98] Hidden Power of the Big Three.

[99] See BlackRock Investment Stewardship, January 2017, https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-engprinciples-global.pdf; See also: Vanguard Principles and Policies, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/; See also: State Street Global Advisors Asset Stewardship, https://www.ssga.com/about-us/asset-stewardship.html.

[100] Let Shareholders be Shareholders, p. 1.

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elections could the vote of the largest shareholder have been the determining factor.[101] In fact, even if the three largest shareholders voted similarly, the outcomes of the director elections would have changed in only 4.73% of the elections.[102]

Of course, in those rare instances, it could be said that almost any small minority shareholder or combination of shareholders provided the margin of victory. However, this overlooks the influence of ISS or Glass Lewis as well as the growing influence of NGOs, or other factors including management efforts, the views of consultants, and the media reporting on the voting contest.

As highlighted in Exhibit V, based on a review of shareholder proposals that were voted on in the 2017 SEC Form N-PX filing by asset managers who held shares in companies in the Russell 3000 Index, the voting patterns differ considerably across various asset managers and the managers' records differ strongly when compared to ISS recommendations.[103] Assuming coordination, therefore, is unfounded and implausible.

D. Asset managers do not coordinate voting

While Coates acknowledges that large institutional holders do not explicitly collaborate, he finds de facto collusion via industry gatherings or, indirectly through the engagement meetings stewardship teams have with company management on corporate governance issues.[104] His assertion is factually and fundamentally incorrect and requires a leap of faith as to the nature and extent of discussions at stewardship meetings. Asset managers do not coordinate their voting. We have already shown empirical evidence of variation, in Section III, and we will now turn to the regulatory hindrances to coordination.

If two or more holders coordinate their approach to voting specific company shares, they 'form a group' for securities law purposes and need to jointly file disclosures with the Securities and Exchange Commission if they together hold more than 5% of a company, even if they individually hold less than 5%.[105] In addition to the attribution of the ownership position of each group member to the group on an aggregated basis, the investment intent of each group member is relevant to the status of the group as well.

The SEC has adopted several different forms on which shareholders report their holdings. The SEC requires disclosure of 5% positions on short-form Schedule 13G when a shareholder has no control intent,[106] but requires a shareholder with control intent to disclose their position on the

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[101] See Exhibit V. FactSet data for the N-PX disclosure period ending June 30, 2018.

[102] See Exhibit V. FactSet data for the N-PX disclosure period ending June 30, 2018.

[103] BlackRock, "The Investment Stewardship Ecosystem" (2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf, (The Investment Stewardship Ecosystem).

[104] Coates, p. 15

[105] 15 U.S.C. § 78m (d),(g); 17 CFR §240.13d-5(b) 2019.

[106] 15 U.S.C. § 78m (d); 17 CFR § 240.13d-102 2019.

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long-form Schedule 13D.[107] Schedule 13D is intended as an advance warning to the issuer, the market and regulators of a possible change of control, and requires both in-depth disclosure and frequent updating.[108] If one member of a group has taken an action that is deemed by the SEC to be indicative of an intent to exert control,[109] all members of the group are 'tainted' by the one shareholder's control intent.[110] A group Schedule 13D filing must be maintained jointly by the members of the group. This requires ongoing coordination, which would reduce the autonomy of each individual asset manager and erode each manager's ability to satisfy its fiduciary duty in a fully independent manner. Asset managers have a strong incentive not to coordinate with each other on voting specific company shares.[111]

As Bebchuk & Hirst found, there are no "group" 13-D filings by asset managers providing independent confirmation that in practice asset managers do not coordinate their voting.[112]

E. Role of boards of directors and shareholders in corporate governance

Much of Coates' and Bebchuk & Hirst's critiques minimize the importance of the role of directors in corporate governance. Regardless of the potential influence of any one set of shareholders, whether they pursue active or index strategies, public company boards of directors provide the first line of oversight over company executives and act as fiduciaries representing the best interests of all of the company's shareholders. While company executives can sit on their own

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[107] 15 U.S.C. § 78m (d); 17 CFR §240.13d-5(b)(i) 2019.

[108] 15 U.S.C. § 78m (d)(2)(a); 17 CFR §240.13d-5(b) 2019.

[109] 15 U.S.C. § 78m (d); 17 CFR §240.13d-1(b)(1)"Generally, engagement with an issuer's management on executive compensation and social or public interest issues (such as environmental policies), without more, would not preclude a shareholder from filing on Schedule 13G so long as such engagement is not undertaken with the purpose or effect of changing or influencing control of the issuer and the shareholder is otherwise eligible to file on Schedule 13G." See Release No. 34-39538 (Jan. 12, 1998)(stating that a shareholder's proposal or soliciting activity relating to such topics generally would not cause a loss of Schedule 13G eligibility).

Engagement on corporate governance topics, such as removal of staggered boards, majority voting standards in director elections, and elimination of poison pill plans, without more, generally would not disqualify an otherwise eligible shareholder from filing on Schedule 13G if the discussion is being undertaken by the shareholder as part of a broad effort to promote its view of good corporate governance practices for all of its portfolio companies, rather than to facilitate a specific change in control in a particular company.

By contrast, Schedule 13G would be unavailable if a shareholder engages with the issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors" *See* SEC, "Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting," (2016), https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm (SEC Regulation 13D-G FAQs).

For a discussion some other aspects Schedule 13D and Schedule 13G see footnote 136.

[110] Bebchuk & Hirst II, pp. 102-103.

[111] Institutional investment managers holding more than $100 million in assets are also required to file quarterly on Schedule 13F an itemized list of their equity holdings that trade on an exchange without regard to size of the holding or intent as to control.

[112] Bebchuk & Hirst I, pp. 7-8; 73-74; 102-103.

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board of directors, the New York Stock Exchange (NYSE)[113] and NASDAQ rules[114] require a majority of directors for companies listed on these exchanges to be independent. Boards of directors act as fiduciaries in hiring and firing senior management and in holding company management accountable. They are particularly important in instances where the interests of company management may conflict with those of shareholders – for example in executive compensation decisions.

Shareholders act as a second layer of oversight. First and foremost, shareholders vote to elect board directors at annual shareholder meetings. Shareholders can vote, among other issues, to approve or disapprove: the company's auditor, executive compensation packages through "say-on-pay" votes, shareholder proposals, and mergers and acquisitions. Shareholders are diverse, and can include pension plans, sovereign wealth funds, mutual funds, activist hedge funds, endowments, foundations, and individual investors. Many institutional shareholders, including most asset managers, publish their proxy voting guidelines online so that companies can ascertain in advance of annual meetings how those shareholders are likely to vote on routine matters.[115]

Recently, a number of companies, many in the media, entertainment and technology industries, have gone public with dual class share structures.[116] These companies issue various classes of common stock, often including a high vote class held by the founders who may only own a small percentage of the equity of the company, and a low vote or even a no vote class sold to the public. The consequence is that the founders retain either perpetual or long-term control of the company to the exclusion of the public, including index funds and their managers.[117] Among the

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[113] New York Stock Exchange, "NYSE: Corporate Governance Guide," (2014), https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf (Corporate Governance Guide)

[114] Nasdaq Stock Market. Rule 5605(b)(1). "A majority of the board of directors must be comprised of Independent Directors as defined in Rule 5605(a)(2). The Company, other than a Foreign Private Issuer, must comply with the disclosure requirements set forth in Item 407(a) of Regulation S-K. A Foreign Private Issuer must disclose in its next annual report (e.g., Form 20-F or 40-F) those directors that the board of directors has determined to be independent under Rule 5605(a)(2)." (2019) http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selected-node=chp%5F1%5F1%5F4%5F4%5F8%5F3&CiRestriction=independent&manual=%2Fnasdaq%2FMain%2Fnasdaq%2Dequityrules%2F

[115] See e.g. State Street Global Adviser, "Proxy Voting and Engagement Guidelines North America (United States & Canada)," (2019) https://www.ssga.com/na/us/institutional-investor/en/our-insights/viewpoints/2019-proxy-voting-and-engagement-guidelines-north-america.html; BlackRock Regional Proxy Voting Guidelines, https://www.blackrock.com/corporate/about-us/investment-stewardship#principles-and-guidelines; Vanguard's proxy voting guidelines, https://pcg.law.harvard.edu/wp-content/uploads/2016/09/5-Vanguards-proxy-voting-guidelines-_-Vanguard.pdf.

[116] Papadopoulos, Kosmas, Harvard Law School Forum on Corporate Governance and Financial Regulation, "Dual-Class Shares: Governance Risks and Company Performance," (Jun. 2019), https://corpgov.law.harvard.edu/2019/06/28/dual-class-shares-governance-risks-and-company-performance/.

[117] Kerber, Ross, Reuters, "FTSE Russell to exclude Snap from stock indexes over voting rights," (2017), https://www.reuters.com/article/us-snap-russell/ftse-russell-to-exclude-snap-from-stock-indexes-over-voting-rights-idUSKBN1AB2TW (FTSE Russell to exclude Snap from stock indexes over voting rights).

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companies in the Russell 3000 index, 310 (approximately 10%)[118] have dual class stock and/or various anti-takeover provisions, making pursuing change a formidable challenge.[119]

A common strategy of activist investors, such as hedge funds, is to seek board seats to effectuate changes at companies.[120] Each year, a number of high-profile activist shareholders use their equity stake in companies to pressure management. Proponents of the process argue that it provides enhanced focus on corporate governance practices, independent research and analysis, and financial discipline, collectively leading to improved company performance. Opponents contend that activists impose a short-term view, impairing in the long-term the company, its employees and perhaps also its community. Although they do not traditionally participate as activists themselves, managers of index investment strategies analyze each situation as the boards and strategies of the public companies in which they invest on behalf of clients are impacted by the process. Often, index fund managers will engage both with the target company's board and the activists, in order to understand the complexities of the situation and make an assessment should the situation eventually come to a shareholder vote. More often than not, however, these "proxy contests" result in a settlement between the two sides.[121]

Although proxy contests make the news, it is rare for firms to be targeted by activists seeking board seats. So rare in fact that on average only 1% of firms are targeted per year.[122] In addition, of that 1%, less than half proceed to the voting stage.[123]

F. Asset managers do not determine corporate executive compensation

Executive pay is often suggested as a channel for influencing company executives. Indeed, Coates argues "stock options caused executive compensation to soar and provided strong incentives for managers to willingly sell their firms."[124] Properly designed, executive compensation is intended to provide incentives to maximize shareholder return generally through the ongoing,

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[118] Council of Institutional Investors, "Dual Class Companies," (2017), https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf (Dual Class Companies).

[119] Council of Institutional Investors, "Dual Class Companies," (2017), https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf (Dual Class Companies).

[120] In the activist profiles compiled by Lazard, the median holding period for all activist investors has been under 5 years. Lazard Shareholder Advisory Groups, "Profiles of Selected Shareholder Activities," (2018), https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf (Profiles of Selected Shareholder Activities). See also, Bebchuk & Hirst I, p. 3; Bebchuk & Hirst II, pp. 109-114.

[121] Jay Frankl and Steve Balet, The Rise of Settled Proxy Fights https://corpgov.law.harvard.edu/2017/03/22/the-rise-of-settled-proxy-fights/.

[122] Alon Brav, Wei Jian, Tao Li, James Pinnington, "Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests," (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473

[123] Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests

[124] Coates, p. 15. "No explicit collusion is required to send highly aligned signals about what they want to each other and to management of portfolio companies."

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normal operations of the company and less by sale and it has been empirically found to be effective.[125]

Executive compensation is usually determined by a recommendation of a compensation committee of the board of directors and, in public companies, is thereafter put to a non-binding, advisory "say-on-pay"[126] vote by the shareholders. The primary goals of say-on-pay are to improve transparency, create executive accountability for firm performance, enlarge shareholder participation in corporate governance and control executive compensation levels from increasing excessively.[127] While say-on-pay was initially considered a laudable initiative, it has been a challenge to determine its effectiveness.[128]

The number of say-on-pay votes held in the U.S. in 2017 was 2,154, a decrease of about 23.5% from the number of votes held in 2011.[129] The highest rejection rate of pay packages since 2015, which occurred in 2018, was only 2.6%.[130] This result implies that shareholders almost always accept pay packages as determined by the board. Indeed, this outcome is supported by the empirical evidence and is the natural result of the compensation-setting process.

The compensation committee is a board committee independent from management. In addition, most boards hire special compensation consulting firms to provide independent guidance on executive pay. The role and identity of compensation consultants is disclosed in annual proxy statements. Based on a review of company filings, there are at least 10 compensation consulting firms that advise U.S. public companies, adding to the list of other non-shareholder influences on company management.[131]

According to one study, approximately 90% of large public firms in the U.S. routinely retain compensation consultants to provide guidance in setting executive pay packages.[132] These consultants provide services such as supplying proprietary data on the compensation of other firms, selecting a list of peers to benchmark pay, and guiding the compensation committee through

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[125] Sigler, Kevin J., Joseph, Haley P., "CEO Pay and Company Performance," (2013), https://www.emeraldinsight.com/doi/abs/10.1108/eb018501?journalCode=mf (CEO Pay and Company Performance).

[126] Center On Executive Compensation, "Say on Pay," (2019), http://www.execcomp.org/Issues/Issue/say-on-pay

[127] Mason, A., Stephani, Medinets, F., Ann, Palmon, Dan., "Say-on-Pay: Is Anybody Listening?" (2017), http://www.execcomp.org/Issues/Issue/say-on-pay. (Say-on-Pay: Is Anybody Listening?)

[128] Say-on-Pay: Is Anybody Listening?, p. 304.

[129] Semler Brossy, "2018 Say on Pay and Proxy Results Russell 3000," (2018), https://www.semlerbrossy.com/wp-content/uploads/SBCG-2018-Year-End-SOP-Report.pdf (2018 Say on Pay and Proxy Results).

[130] 2018 Say on Pay and Proxy Results.

[131] CompArchive: 2017 Consultant Market Share Tables https://comparchive.com/2017-consultant-market-share-tables/. The largest consultants by market share in the Russell 3000 include Fred Cook (12.3%), Pearl Meyer (8.3%), Meridian (7.1%), Aon Hewitt Companies (7%), and Willis Towers Watson (6.1%).

[132] Chacon, R., Gordon, R., Yore, A., "Compensation Consultants: Who Do They Serve? Evidence from Consultant Switching" (2019), http://fmaconferences.org/SanDiego/Papers/Compensation_Consultants_Conference_Submission_FMA_2018.pdf (Compensation Consultants: Who Do They Serve? Evidence from Consultant Switching).

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compliance with regulatory and tax related issues. Perhaps most importantly, they offer recommendations about appropriate compensation for top management. Under current practice, the board of directors is ultimately responsible for approving CEO pay. The study finds that while management occasionally retains their own compensation consultants or influences who is chosen, at nearly 90% of firms[133] it is the board contracting with the compensation advisor that determines CEO pay.

G. Who does have corporate control?

If the "Problem of Twelve" is as imminent as Coates suggests, how many people control the corporate landscape today? We counted. As many as 28,000 individuals are responsible for overseeing public companies in the U.S., including approximately 3,900 CEOs[134] (some of whom hold positions in multiple public companies) and 24,100 board directors (excluding CEOs who sit on their own boards).[135] In addition, there are thousands of public company shareholders; at least 10 compensation consultants[136] that make recommendations about executive pay packages; countless law firms that advise company boards and management; and in the U.S. two major proxy advisory firms (ISS, Glass Lewis) and several minor proxy advisory firms.

Focusing solely on the growth of index investing and commensurate shareholdings in public companies by index fund managers, commentators invoking the "Problem of Twelve" theory omit the pronounced role of company executives in running our nation's public companies and boards of directors in holding company management accountable.

H. Why asset managers are not activist investors

Bebchuk & Hirst's vision of how an asset manager should operate differs fundamentally from that of Coates. Unlike Coates who is concerned that large index and other institutional managers will overexert their influence, Bebchuk & Hirst suggest that index fund managers do not, and will not, sufficiently exert their potential influence. They suggest institutional investors should function like activist investors and forcefully tell companies how they should run, manufacture, and distribute products, and they are disappointed with actual behavior.

Expounding on their belief that institutional investors should behave like activists, Bebchuk & Hirst suggest that large institutional investors should submit their own shareholder proposals and potentially even initiate proxy fights.[137] However, Vanguard, BlackRock, and State Street each

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[133] "Compensation Consultants: Who Do They Serve? Evidence from Consultant Switching"

[134] FactSet as of 3/31/19. Note that in a few cases, there are CEOs that are the CEO of more than one public company.

[135] FactSet as of 3/31/19.

[136] See, supra, footnote 131.

[137] Taking the types of actions suggested by Bebchuk & Hirst would trigger the obligation to report 5% positions on Schedule 13D instead of Schedule 13G. Any person/investor that acquires beneficial ownership of more than 5% of a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934, and who may change or influence company management and policies is required to file a Schedule 13D. A shorter form, Schedule 13G, is available to 5% shareholders who hold

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act as long-term investors that have expertise on ESG issues, express their views on these issues to companies, and allow boards and managements the time to implement them properly. Unlike many activist investors, they are interested in long-term horizons, not temporary bumps in a company's stock price. Vanguard, BlackRock, and State Street have all publicly underscored the critical role of board diversity, board expertise, board oversight, and review or participation in the development of a company's strategic plan.[138] They promote these goals through engagement rather than hostile proxy contests.

Bebchuk & Hirst assert that Vanguard, BlackRock and State Street don't exert their potential influence because of conflicts and disincentives to rocking the boat. Asset managers recognize the potential for conflicts and manage them. They strictly maintain the independence of their engagement groups. As noted previously, asset managers are fiduciaries and must put clients' interests above their own. As fiduciaries, asset managers owe clients a duty of loyalty and care in implementing investment activity on their behalf. Clients come first and potential conflicts must be, and are, identified and mitigated.[139]

Bebchuk & Hirst present evidence on a firm wide basis from which they conclude that the large institutional investors do not devote enough resources to engagement activities to be effective. The authors fail to take-into-account that annual engagement heavily skews to companies which represent approximately half of each firm's respective client's AUM.[140] Due to their size and influence, those firms are likely to receive the most scrutiny, the largest number of shareholder proposals, and therefore garner the most attention in the engagement process. The analysis by Bebchuk & Hirst is merely an arithmetic calculation of how many companies each member of a stewardship group theoretically covers and the amount of time that could be devoted to each company.

Bebchuk & Hirst's analysis also does not consider that the vast majority of issues on which shareholders vote are non-contested and non-controversial. If the universe of company votes is

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securities without the purpose or effect of changing or influencing control of an issuer and not in connection with, or as a participant in, any transaction having such purpose or effect. Filing Schedule 13D forms would be extremely difficult for asset managers. Schedule 13D requires filing amendments every time a material change occurs in the facts set forth in a filer's Schedule 13D, including a 1% change in ownership. Schedule 13D filers make more extensive disclosures including the purpose of the transaction and all transactions in the prior 60 days. Schedule 13D filers that hold 10% or greater positions are also required to file insider reports under Section 16 of the Exchange Act and monitor transactions for "short swing" profits during any six-month period.

[138] Vanguard 2018 Investment Stewardship Annual Report, (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf; see also BlackRock Investment Stewardship 2018 Annual Report (2018), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf.; see also SSGA Stewardship 2017, (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf.

[139] BlackRock, "How BlackRock Investment Stewardship manages conflicts of interest," (2019), https://www.blackrock.com/corporate/literature/publication/blk-statement-conflicts-of-interest.pdf; see also State Street Global Advisors, "2019 State Street Global Advisors Conflict Mitigation Guidelines," (2019), https://www.ssga.com/na/us/financial-advisors/en/our-insights/viewpoints/2019-ssga-conflict-mitigation-guidelines.html.

[140] Vanguard, BlackRock and State Street Global Advisors report that their stewardship activities cover 47%, 51.9% and 45% of their equity AUM, respectively, See, Vanguard 2018 Investment Stewardship Annual Report, BlackRock Investment Stewardship 2018 Annual Report and State Street Global Advisors Stewardship 2017 Annual Report.

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narrowed to just those votes that are more heavily contested, it becomes evident that Vanguard, BlackRock and State Street engage with managements and vote against management with reasonable frequency.[141] In practice, investment stewardship is more nuanced than they suggest.

IV. Coates' and Bebchuk & Hirst's Policy Suggestions

Addressing the importance of institutional investors such as asset managers exercising their voice and vote on behalf of their clients, a recent Vanguard report presents the following insight:

"In 2018, institutional investors (including mutual funds) collectively held 70% of public company shares in the United States and voted 91% of the shares they held. Individual investors who directly held stocks accounted for the remaining 30% of share ownership, yet they voted only 28% of the shares they held. Some interest groups have suggested that mutual funds muffle the voice of individual investors. The truth is, mutual funds are the voice of individual investors."[142]

It is clear then, that if institutional investors such as Vanguard, BlackRock, State Street, Fidelity, Capital Group and others did not speak out and vote on behalf of their millions of clients, the already powerful voices of management, activists, and proxy advisors would be augmented. The various policy proposals suggested by Coates and Bebchuk & Hirst as possible responses to address the issues they identify need to be considered in light of the above insight from Vanguard.

Coates and Bebchuk & Hirst make several policy suggestions for discussion rather than as proposals to be adopted.

One suggestion raised by Coates is permitting ownership concentration "to continue to grow while restraining the activities of advisors or affiliates of index sponsors."[143] It is not clear what types of restraints Coates is referring to nor how they would affect ordinary investors, so it is impossible to evaluate them. If restraints were related to voting they would almost certainly infringe on shareholder rights. Such regulation, if applied to index funds, would fundamentally deprive shareholders in these funds of rights inherent in share ownership and increase the influence of other shareholders, most particularly activists and company insiders, which may adversely affect index fund shareholders.

Another possible policy Coates discusses might prohibit index funds, or index fund sponsor's senior managers, from participating in engagements (i.e., meeting with portfolio company management and/or directors), "which would not eliminate their power but cut off one important channel of influence."[144] Adoption of this policy might require changes in state law and, in any event, would simply diminish index funds', or active funds run by index managers', ability to

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[141] Exhibit V.

[142] Glenn Booream, "Vanguard: What we do. How we do it. Why it matters," (April 2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf.

[143] Coates, p .22.

[144] Coates, p. 23. At, Vanguard, BlackRock, and State Street, by design of the stewardship process, senior managers do not participate in either engagement or voting decisions in order to avoid the very conflict Coates seeks to address.

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impact sustainability and governance. This is particularly notable because other commentators argue that asset managers should actively promote ESG considerations in engagements with the public companies in which they are invested on behalf of clients.[145]

Coates also considers the option that "index sponsors could be tasked with evaluating whether their positions on 'issues' that arise routinely in corporate governance are not only good for shareholders, but for society."[146] Contrary to Coates' assertions, many shareholders already consider these outcomes, consistent with their fiduciary duty, as they affect long-term investment performance.[147]

Coates asserts that conflicts of interest "could be more extensively regulated or more intensively policed with public or private enforcement. Index fund agents could be banned from taking political or corporate office after retiring from the index funds."[148] He appears to support the policy option that "disclosure of potential conflicts could be coupled with active management of conflicts by independent agents accountable to the investors in the index funds."[149] Conflicts of interest are already heavily regulated, and it is unclear what added benefit Coates' recommendation would have to what already exists.[150]

Bebchuk & Hirst consider some policy proposals that are consistent with the issues they raise about the inadequacy of stewardship by the index fund advisors. They reject the suggestions of some that index funds should be prohibited from voting or should be limited in the amount any one index manager could vote or be required to pass through voting to the ultimate beneficial owners.[151]

Among the suggestions they offer that they offer for consideration are: having index funds bear the cost of stewardship rather than asset managers as is currently the practice; sharing among index managers of outside research providers; mandating a minimum level of stewardship expenses; limiting additional business relationships between index fund managers and portfolio companies or, less severely, requiring disclosure of these relationships; increasing transparency of engagements between asset managers and portfolio companies; rethinking Section 13 (d) rules

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[145] The New Model of Asset Manager Stewardship Activities.

[146] Coates, p. 23.

[147] Taraporevala, Cyrus, "State Street Global Advisors: 2019 Proxy Letter," (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/01/2019%20Proxy%20Letter-Aligning%20Corporate%20Culture%20with%20Long-Term%20Strategy.pdf (State Street Global Advisors: 2019 Proxy Letter); Fink, Larry, "Larry Fink's 2019 Letter to CEO's: Power and Profit," (2019), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (Larry Fink's 2019 Letter to CEO's: Power and Profit).

[148] Coates, p. 22.

[149] Coates, p. 22.

[150] Sethi, Jasmin, Cook, Jackie, "The New Model of Asset Manager Stewardship Activities: Active Ownership in Proxy Voting," (2019), https://www.morningstar.com/blog/2019/03/29/manager-stewardship.html (The New Model of Asset Manager Stewardship Activities).

[151] Bebchuk & Hirst II, p. 92-95.

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to reduce their current deterrence to index managers being activist investors; and, most restrictively, limiting the amount of holdings any single asset manager could have in a portfolio company to no more than 5%.[152]

Vanguard, BlackRock and State Street are already quite transparent about their engagement activities.[153] However, most of the other policy proposals would represent a fundamental shift in current practice. In addition to carefully analyzing the merits of Bebchuk & Hirst's proposals, policy makers would need to consider the extent of the costs to determine whether these costs are ultimately worthwhile to investors. Before imposing stewardship costs on index funds and their investors, for example, it would be necessary to decide what level (and even how to measure the level) of investment stewardship activity would be appropriate, and how to measure it. Stewardship activity based on mandated expenditures may well not improve either the quantity or quality of stewardship depending on how effectively it is spent. Bebchuk & Hirst suggest a minimum stewardship investment of a small percentage of AUM but they do not explain how to measure the quality of stewardship.

A number of questions on the investment stewardship proposal remain outstanding. Would all managers – large or small – be expected to spend their own or fund assets on stewardship? Would it change from year to year as AUM rises or falls? Would it be based only on marketable equity AUM or also include fixed income securities, alternatives, private equity, etc.? Who would determine that? Once agreed on the minimum stewardship commitment, what level of expenses would be passed along to funds and their shareholders? Who would determine how such expenses should be allocated among a number of funds which are managed by a single asset manager? The questions presented here are illustrative of the numerous questions which arise from these and the other proposals put forward by Bebchuk & Hirst. The implications of each, which are beyond the scope of this paper, would need to be carefully considered.

Bebchuk & Hirst are concerned that their predicted concentration of control will come without an adequate commitment to exercising influence on portfolio companies. Their analysis of the merits of current investment stewardship activities reflects their model, their vision, of the appropriate level of influence. This vision is not currently shared by U.S. regulators or by asset managers.

V. Conclusion

In this article, we have sought to ground the academic debate about asset management, index funds, and theories of corporate control, by providing context on the industry's operation, regulation and utility to investors. Asset managers are minority shareholders representing a diverse,

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[152] Bebchuk & Hirst II, pp. 95-107

[153] Vanguard, BlackRock, and State Street each produce a wide variety of publications detailing their engagement activities, voting outcomes, and views on macroeconomic and geopolitical trends that impact their stewardship activities. For their respective voting guidelines, see footnote 29 in this paper. For their respective, and most recent annual reports, see footnote 30.

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long-term client base and generally utilize what influence they have to promote long-term sustainability and governance.[154]

Much of the academic research to date, including that of Coates and Bebchuk & Hirst, gives little account to the realities of the asset management business and speculates as to future events. We have provided data and context for the activities and incentives of asset managers which we hope will contribute a more robust foundation for future research on asset managers, index funds and corporate control. Without this, the present research risks promoting the premature adoption of public policies that may harm the interests of ordinary investors.

[154] Passive Investors, Not Passive Owners.

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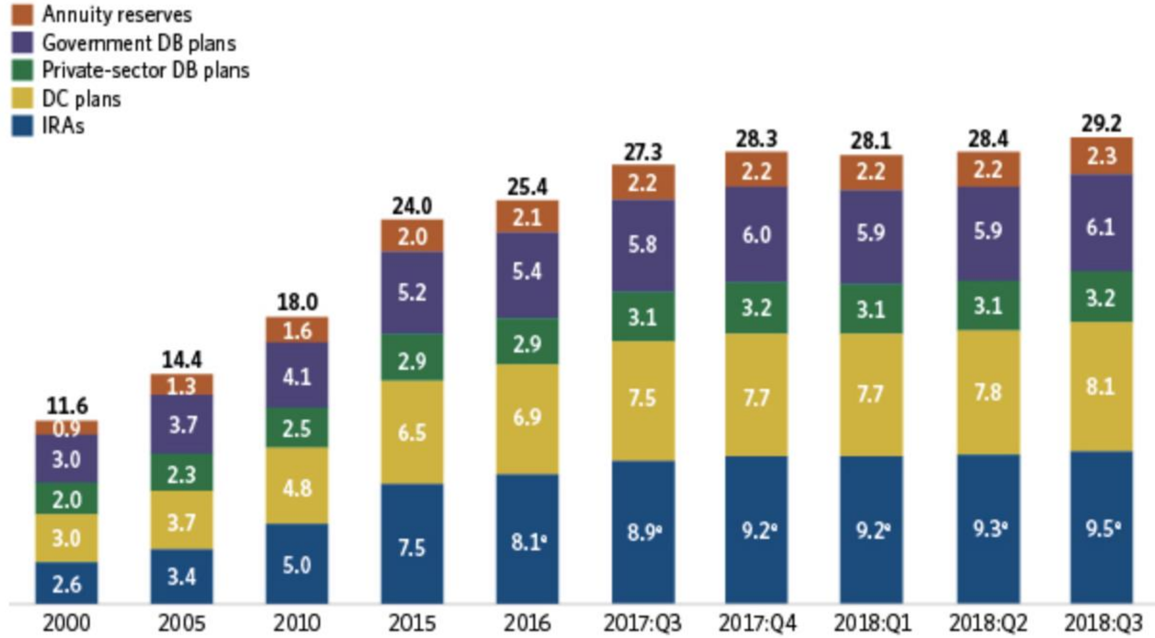
EXHIBITS

EXHIBIT I: U.S. Total Retirement Assets



Source: Investment Company Institute

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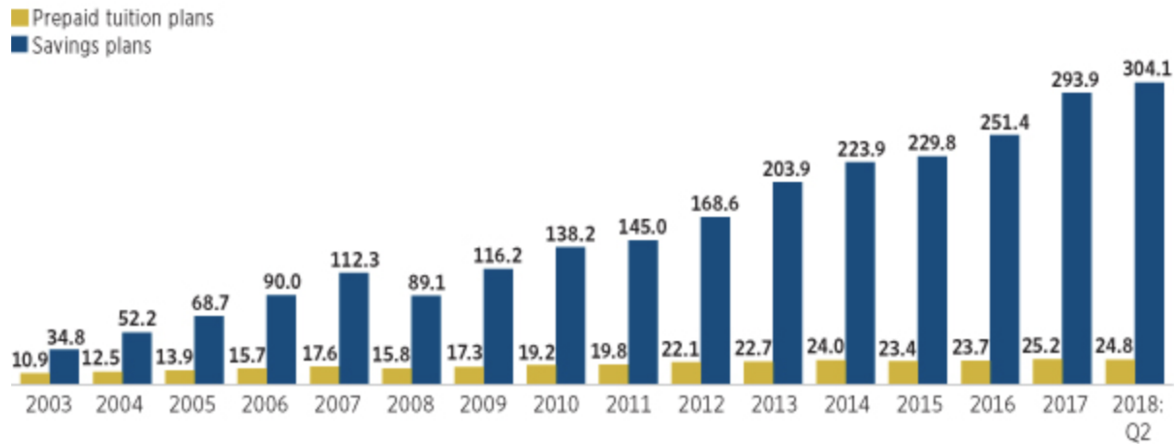
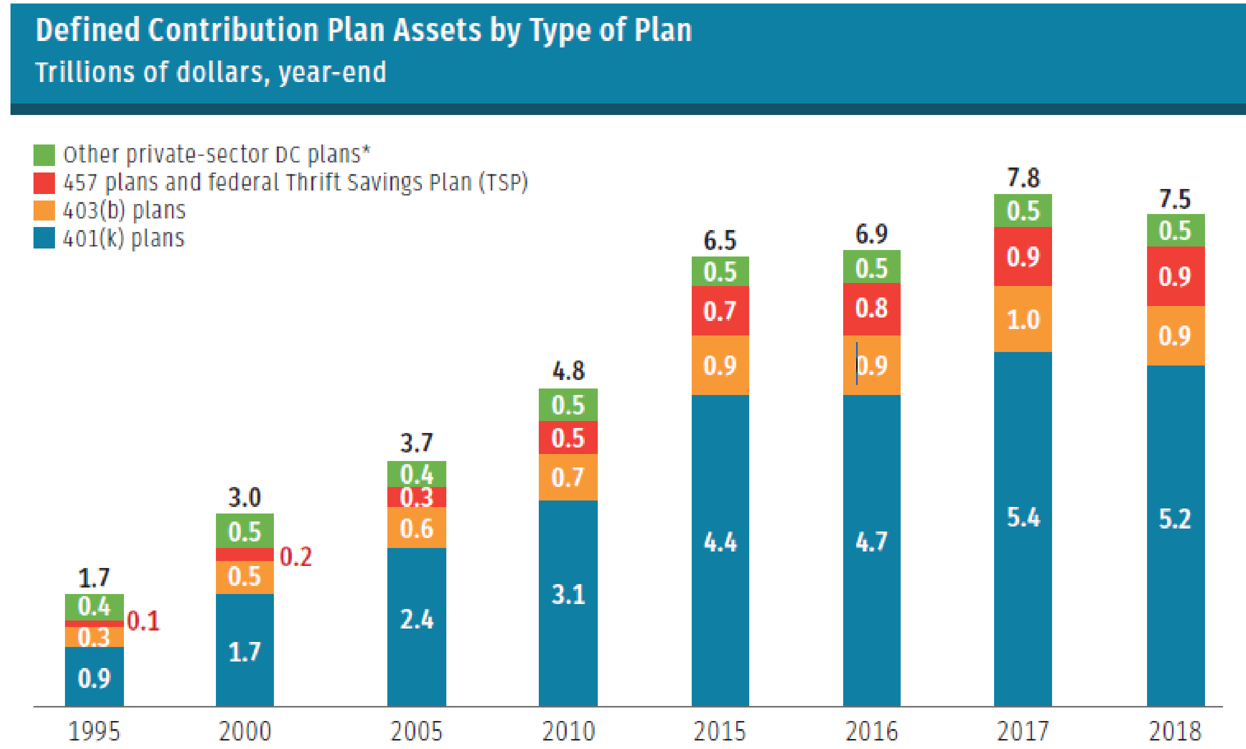
EXHIBIT II: 529 Assets



Source: Investment Company Institute

Electronic copy available at: https://ssrn.com/abstract=3483573

EXHIBIT III: Historical Retirement Market Assets by Segment, 1995–2018 ($billions)



* *Other private-sector DC plans* includes Keoghs and other private-sector DC plans (profit-sharing, stock bonus, and money purchase) without 401(k) features.

Sources: Investment Company Institute, Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, and American Council of Life Insurers. See Investment Company Institute, "The US Retirement Market, Fourth Quarter 2018."

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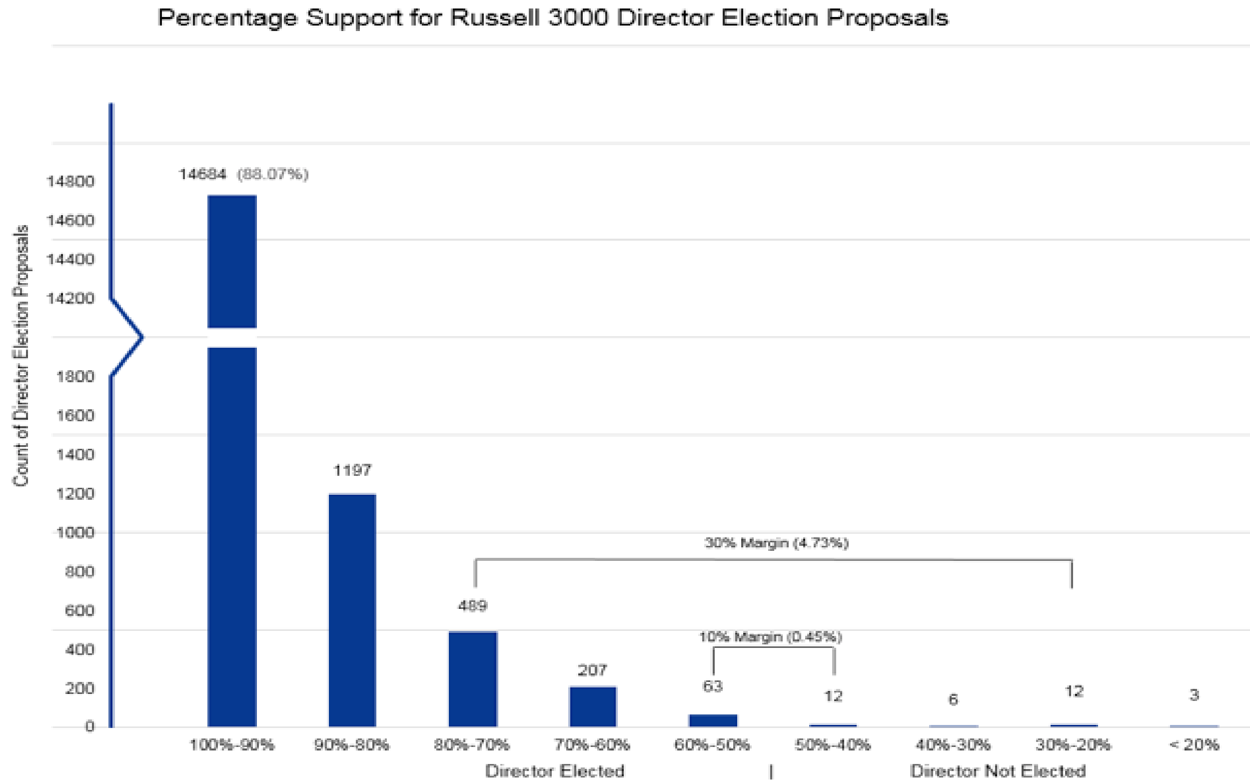
EXHIBIT IV: Percentage Support for Russell 3000 Election Proposals



Source: FactSet

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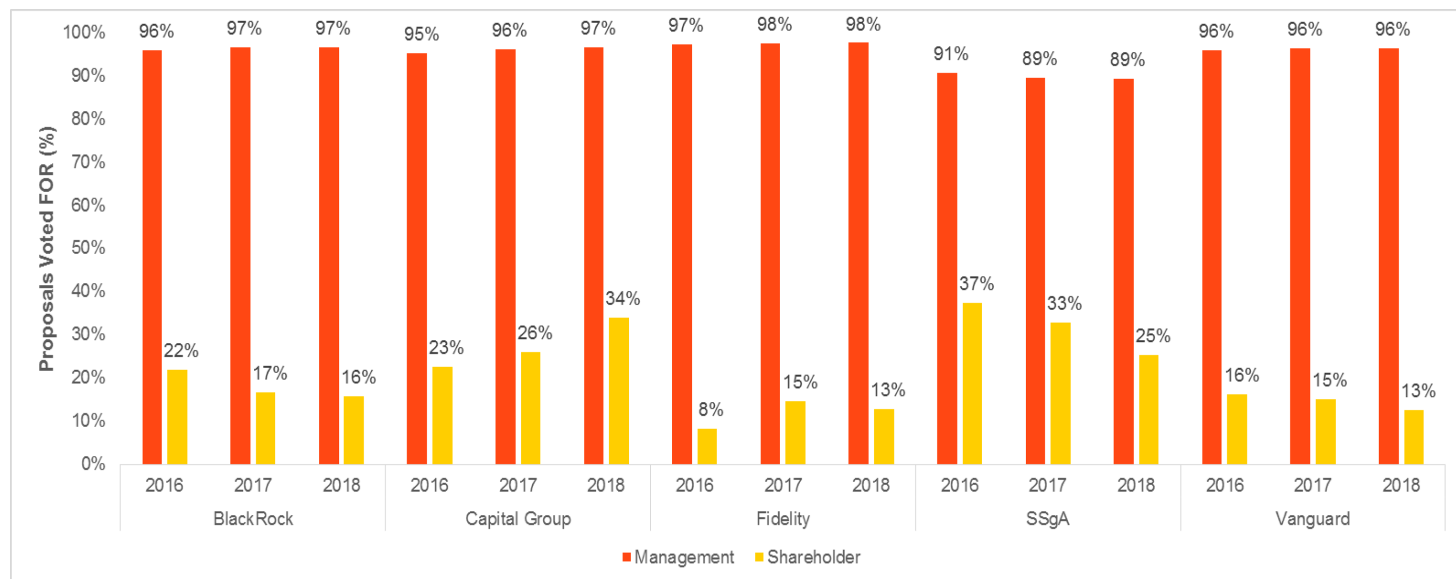
EXHIBIT V: Inclusion of Routine Proposals Increases Misperception of Similarities in Voting Records



Source: ProxyInsight

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