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The Case Against Passive Shareholder Voting

Dorothy Shapiro Lund

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Abstract

American investors have begun to embrace the reality that academics have been championing for decades—that a broad-based passive indexing strategy is superior to picking individual stocks or investing in actively managed funds. But there are several reasons to believe that the rise of passive investing will have harmful consequences for firm governance, shareholders, and the economy. First, because passive funds seek only to match the performance of an index—not outperform it—they lack a financial incentive to ensure that each of the companies in their very large portfolios are well-run. Second, passive funds face an acute collective action problem: any investment in improving the performance of a company will benefit all funds that track the index equally, while only the activist fund incurs the costs. Third, passive funds do not generate firm-specific information as a byproduct of investing and thus must expend additional resources to identify underperforming firms and evaluate interventions proposed by other investors. Such expenditures would undo the cost savings that attracted investors to the passive fund in the first place.

For these reasons, many passive funds are likely to leave company performance to the invisible hand of the marketplace. And even if a fund does choose to intervene, it will rationally adhere to a low-cost, one-size-fits-all approach to governance that is unlikely to be in the company's best interest. The scope of this problem is potentially immense: as investors continue to flock toward passive investment vehicles, the institutional investors that dominate the passive fund market will increasingly influence and even control the outcome of shareholder interventions—from shareholder votes to those proposed by hedge fund activists—creating widespread economic harm. For that reason, this paper proposes that lawmakers consider restricting passive funds from voting at shareholder meetings. Doing so would reduce the influence of passive funds in governance and also preserve the role of informed investors as a force for managerial discipline.

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† Harry A. Bigelow Teaching Fellow and Lecturer in Law, University of Chicago. The author is grateful for comments from Will Baude, Douglas Baird, Omri Ben-Shahar, William Birdthistle, Tony Casey, Adam Chilton, Stephen Choi, Scott Davis, Gillian Hadfield, Todd Henderson, Aziz Huq, Ronald Gilson, Daniel Hemel, Genevieve Lakier, Alex Lee, Saul Levmore, John Morley, Eric Posner, Ed Rock, Mark Roe, Leo Strine, Jr., Guhan Subramanian, and the University of Chicago Bigelow Fellows, as well as enlightening conversations with executives, hedge fund analysts, and mutual fund advisors who wish to remain anonymous. Email: dorothyshapiro@uchicago.edu.

I. INTRODUCTION

The one-share, one-vote system is at the core of American shareholder democracy. It has been the default under state law for over a century, supported by economic theory indicating that linking voting rights and residual ownership is the most efficient way to run a corporation. The recent rise of passive investing, however, casts doubt on the continued validity of this received wisdom.

In the past few years, millions of investors have abandoned actively managed mutual funds, or "active funds," in favor of passively managed funds, or "passive funds." This past year alone, investors withdrew $340 billion from active funds (approximately 4 percent of the total) while investing $533 billion into passive funds (growing the total by 9 percent).[1] And this historically unprecedented shift in investor behavior has generated a flurry of news coverage, with articles proclaiming that index funds "are eating the world."[2]

The rise of passive investing is good news for investors, who benefit from greater diversification and lower costs. But the implications for corporate governance are less positive. Unlike active funds, which pick stocks based on their performance, passive funds—a term that includes index funds and exchange traded funds ("ETFs")—are designed to automatically track a market index. For this reason, this paper contends that the growth of passive funds has the potential to distort and dampen the market for corporate influence.[3]

Participants in the market for corporate influence—generally institutional investors and activist hedge funds[4]—use the influence that accompanies their large ownership positions to discipline management. And although these investors lack perfect incentives to engage in corporate stewardship,[5] their presence provides a

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[1] *See* MORNINGSTAR DIRECT ASSET FLOWS COMMENTARY: UNITED STATES (Jan. 11, 2016), https://corporate.morningstar.com/us/documents/assetflows/assetflowsjan2017.pdf.

[2] *See, e.g.*, Sarah Krouse, David Benoit, and Tom McGinty, *The New Corporate Power Brokers*, WALL ST. J. (Oct. 24, 2016); Tom McGinty, Sarah Krouse, and Elliot Bentley, *Index Funds are Taking Over the S&P 500*, WALL ST. J. (Oct. 17, 2016); Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J. (Aug. 26, 2016); John Authers and Chris Newlands, *Exchange Traded Funds: Taking Over the Markets*, FIN. TIMES (Dec. 6. 2016); Nicole Bullock and Dan McCrum*, Rapid Rise of ETFs Sparks Growing Pains*, FIN. TIMES (Dec. 6, 2016).

[3] The origin of the phrase "the market for corporate influence" is Brian R. Cheffins and John Armour, *The Past Present and Future of Shareholder Activism by Hedge Funds*, 37 J. OF CORP. L. 51(2011).

[4] Although hedge funds are institutional investors, this paper separates activist hedge funds into their own category because of their *ex ante* investing strategy. *See* note 14, *infra.*

[5] Much has been written about the hedge fund activist's short-term perspective, as well as the collective action problems facing mutual funds. *See, e.g.*, Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458–59 (2014) (contending that empowering investors with short-term investment horizons will compromise long-term value); Iman Anabtawi and Lynn Stout*, Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1290–92 (2008) (arguing that activist investors' push for short-term benefits may harm long-term shareholders); Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 887 (2013) (discussing the collective action problem facing institutional investors); Edward B. Rock, *Institutional Investors in Corporate Governance* (University of Pennsylvania Working Paper, July 21, 2015) (manuscript

check against managerial slack, primarily because they identify underperforming firms as part of their investing strategy and are incentivized to discipline wayward management.

Passive funds are different. Because they seek only to match the performance of a market index, passive funds lack a financial incentive to ensure that each of the companies in their portfolios are well-run. For one, passive funds tend to have very large portfolios, and therefore, an investment in improving governance at a single firm is especially unlikely to enhance the fund's overall performance. Second, passive funds face an acute collective action problem because investments in governance interventions equally benefit all funds tracking the index, while only the activist fund bears the costs. Third, governance interventions are especially costly for a passive fund—unlike active funds, passive funds do not generate information about firm performance as a byproduct of trading. Therefore, thoughtful governance interventions require the passive fund to expend additional resources gathering firm-specific information as well as develop governance expertise. Such expenditures would undo the cost savings that attracted investors to the passive fund in the first place.

Accordingly, as assets continue to flow into passive funds, agency costs will increase because managers of passive funds will be less likely to engage thoughtfully with portfolio companies and discipline management. Passive fund managers will also be likely to adhere to low-cost voting strategies, such as following a proxy advisor's recommendation or voting "yes" to any shareholder proposal that meets pre-defined qualifications. And without a consensus about what constitutes good governance, there is reason to believe that the proliferation of an unthinking, one-size-fits-all approach to governance will make many companies worse off.

In addition, the rise of passive investing has the potential to distort hedge fund activism. Hedge fund activists are increasingly moderated by large institutional investors with the power to block campaigns that are not in the interest of their long-term shareholders and catalyze interventions that are deemed beneficial. But passive funds are less likely to serve as a "keel" to activism, which means not only that certain beneficial interventions will not occur, but also that certain detrimental interventions may nonetheless garner substantial support.

For now, the majority of mutual fund assets are invested in active funds, which lessens concerns about governance distortions.[6] But the rapid growth of passive investing is predicted to continue, and already some S&P 500 companies have passive fund ownership in excess of 20 percent. Moreover, the institutional investors that dominate the passive fund market—Vanguard, BlackRock, and State Street Global Advisers—already have a substantial voice in corporate governance. Together, the "Big Three" are the largest shareholder of 88 percent of major U.S.

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at 13) (explaining that institutional investors suffer from a misalignment of incentives that causes them to be relatively passive when it comes to corporate governance).

[6] McGinty et al., *Index Funds are Taking Over the S&P 500*, *supra* note 2.

companies.[7] In other words, the institutional investors that favor a passive investing strategy are beginning to crowd out the active investors.

So long as institutional investors house passive funds and active funds under the same roof, the passive funds may be able to free ride off of information generated by active funds when there is investment overlap. But active funds invest in a smaller number of companies than passive funds and so overlap is not guaranteed. And as assets continue to flow out of active funds, there will be even fewer common investments, as well as less information generated by active fund managers.

There is another reason to suspect that passive fund ownership will soon approach a problematic level: the optimal amount of active participation in governance is likely to be greater than the amount that is necessary to keep stock market pricing efficient. If a few active funds police the market for underperforming stocks and use that information to inform trading decisions, stock prices will rise and fall with company value.[8] But a small percentage of informed investors cannot control governance outcomes. If passive funds own only 51 percent of a company's stock, they will be able to unilaterally determine the success of shareholder proposals, proxy contests, and hedge fund activism, even in the face of total opposition from informed investors. And even with less than absolute voting control, passive funds could still substantially affect corporate behavior.[9] This means that governance distortions will appear long before stock price inefficiencies do.

The legal literature has thus far focused on a different problem associated with the rise of passive investing, and institutional investing more broadly—the potential for anticompetitive behavior that arises when institutional investors own large stakes in rival firms in oligopolistic industries.[10] The theory is that managers of highly diversified institutional investors may pressure portfolio company management to refrain from aggressive price competition that would harm their other investments.[11]

This paper provides an alternative explanation: rather than inducing companies to collude, passive fund managers are not doing enough to push management to maximize shareholder welfare. Moreover, when passive funds do intervene in governance, there is little reason to believe that their influence will benefit companies and investors. And the scope of the problem is potentially much larger than the

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7 *See* Eric A. Posner, Fiona M. Scott Morton, and E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, ANTITRUST L. J. (forthcoming 2017) (manuscript at 7).

8 *See generally* Eugene Fama, *Efficient Capital Markets: a Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

9 *See* Anabtawi & Stout, *supra* note 5, at 1270-71 (discussing how minority shareholders can influence corporate decisionmaking even when they have small stakes in the company).

10 *See* Posner et al., *supra* note 7; Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291-1292 (2016); Eric Posner & E. Glen Weyl, *Mutual Funds' Dark Side*, SLATE (Apr. 16, 2015), http://www.slate.com/articles/news_and_politics/view_from_chicago/2015/04/mutual_funds_make_air_travel_ more_expensive_institutional_investors_reduce.html. *But see* Edward B. Rock and Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (March 1, 2017), NYU Law and Economics Research Paper No. 17-07.

11 *See* Posner et al., *supra* note 7.

threat of anticompetitive conduct because it extends beyond companies in oligopolistic industries, and concerns all companies with a high concentration of passive ownership, which is a large and growing segment of the U.S. market.

In linking passive investing and governance distortion, this paper makes four novel contributions. First, it redeems the oft-criticized institutional investor as an important participant in the market for corporate influence. It shows that there is a difference between institutional investors that favor an active management strategy and those who take a passive approach to investing and supports this observation with a description of mutual fund activism. Second, it solves a puzzle that has perplexed some corporate law scholars—why passive funds have failed to act as seriously engaged owners in spite of the fact that their buy-and-hold investment strategy gives them an interest in the long-term health of portfolio companies. In so doing, the paper develops a theory describing the acute incentive problems that prevent passive funds from participating thoughtfully in governance. Third, the paper shows how the rise of passive investing may exacerbate agency cost problems at corporations, with the potential to create billions of dollars in social welfare losses.

Finally, the paper offers a novel policy proposal for lawmakers: that the law could restrict truly passive funds from voting at shareholder meetings. By diminishing the role of passive investors in governance, this rule would not only reduce the risk of distortion, but also preserve the voice of informed investors as a force for discipline. And there is a compelling legal rationale for such a restriction. Passive funds lack governance expertise and firm-specific knowledge, and so a thoughtful voting strategy would increase costs without meaningfully improving portfolio returns. Thoughtless voting is also likely to harm investors, as well as other shareholders, especially as passive funds grow in size and influence. In other words, pursuit of either approach would put the passive fund at risk of breaching its fiduciary duty to act in its investors' best interests. A law restricting passive funds from voting, therefore, would make both investors and fund managers better off.

This paper proceeds as follows: Part II maps the rise of institutional investor ownership and the role that it has played in controlling agency cost problems created by the separation of ownership and control. Part III details the dramatic and historically unprecedented rise of passive investing. It then describes the incentive problems facing passive funds and shows how the structure of institutional investors that favor a passive investment strategy reflect those incentives. It contends that the rise of passive investing will increase agency costs and distort corporate governance, both by decreasing the frequency and efficacy of governance interventions by informed investors and increasing the likelihood that ineffective or detrimental interventions will succeed. It discusses evidence showing that passive investing is already beginning to affect firm governance at companies with a large concentration of passive fund ownership and contends that these distortions will grow more severe in the future. Part IV proposes several policy reforms that would restrict or limit the voting power of passive funds. It also explains why reforms aimed at incentivizing actively managed funds to take an active role in governance would be less effective than restricting passive funds from voting. Part V concludes.

II. AGENCY COSTS, INSTITUTIONAL INVESTORS, AND THE MARKET FOR CORPORATE INFLUENCE

Controlling agency costs has been a focus in corporate legal scholarship since at least the 1930s, when Adolph Berle and Gardiner Means first highlighted the agency problem created by the separation of ownership and control.[12] Berle and Means posited that collective action problems would prevent dispersed shareholders from optimally monitoring management. Knowing this, entrenched management would do just enough to satisfy shareholders and retain the residual benefits of management for themselves.[13]

However, we no longer live in a Berle and Means world of dispersed shareholdings—the investor base is now consolidated in the hands of large institutional investors.[14] From 1980 to 1996, large institutional investors nearly doubled their share of ownership of U.S. corporations from under 30% to over 50%.[15] By 2010, institutional investors held approximately 80% of the U.S. stock

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[12] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[13] *Id*. at 82-83.

[14] The term "institutional investor" encompasses institutions with very different structures and incentives. First, there are for-profit asset managers, some of which are publically held, such as BlackRock. Rock, *supra* note 5, at 6. Second, there are "mutual" and nonprofit management companies, including Vanguard, whose management company is owned by Vanguard funds and is thus indirectly owned by Vanguard investors. *Id.* at 7. Third, there are public-employee pension funds, such as CalPERS, whose boards are appointed by politicians or directly elected by voters. Unsurprisingly, these funds are generally responsive to political pressure. Fourth, there are union-related funds, including the AFL-CIO, which typically pursue a labor agenda. *Id.* This paper focuses on the first and second types of investors, which have been the primary drivers of the growth in institutional investing.

Hedge funds are also institutional investors. Hedge funds are privately organized investment vehicles that are not widely available to the public and thus mostly operate outside of securities regulation. The typical hedge fund manager has strong incentives to generate positive returns because his or her pay depends primarily on performance. *See* Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. OF FIN. 1729, 1735 (2008). Hedge funds can be "activists," identifying problematic companies *ex ante* and then making strategic interventions, or they can take an *ex post* approach to governance like mutual funds and pension funds. Because of their *ex ante* investment strategy, this paper excludes activist hedge funds from the institutional investor category.

[15] Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 QUARTERLY J. ECON. 229 (2001).

market.[16] Mutual funds have been the largest drivers of this growth: in 1980, they owned $70 billion in assets, and in 2009, that number was up to $7.2 trillion.[17]

Initially, the increasing concentration of the shareholder base was lauded as the solution to the agency cost problems created by the separation of ownership and control.[18] In theory, an investor with a large ownership stake in a company should have strong incentives to monitor and discipline management because less of the benefit of monitoring will be shared. In addition, because of their large ownership positions, institutional investors should be less likely to use "exit" as a disciplinary tool because selling shares en masse would depress the stock price and cause the firm to incur greater losses. For that reason, the scholarly consensus was that large institutional investors would increasingly use "voice" to discipline management.[19]

But institutional investors failed to live up to these high expectations.[20] In the first place, proxy voting data seems to confirm that institutional investors take a passive approach to governance. During the 2007 to 2009 proxy seasons, for example, mutual funds proposed only 4.5% of all shareholder proposals, and only 0.9% addressed corporate governance or performance issues. [21] In addition, a recent study indicates that institutional investors rarely support other shareholder proposals

[16] Posner et al., *supra* note 7, at 7; *see also* Marshall E. Blume and Donald B. Keim, Working Paper, *Institutional Investors and Stock Market Liquidity: Trends and Relationships*, The Wharton School, University of Pennsylvania (Aug. 21, 2012). Although there has been a sharp increase in retail ownership of equities in the past forty years—approximately 50% of United States households own stock, which is up 30% from 1977—equity mutual funds have been the source of this growth, and not the ownership of individual stocks. *Id.* at 884.

[17] Rock, *supra* note 5 at 5. Changes in federal retirement policy were responsible for the growth of institutional investing. *See generally* Gilson and Gordon, *supra* note 5, at 879; Rock, *supra* note 5, at 5. In 1974, after it came to light that a large number of pension plans were underfunded, Congress enacted the Employee Retirement Income Security Act (ERISA), which requires retirement plans to support any promised pension with segregated pools of assets. *See* I.R.C. § 411(a)(2)(A), (b)(1) (2006) (setting forth minimum vesting requirements for defined benefit plans); Employee Retirement Income and Security Act of 1974 § 203, 29 U.S.C. § 1053 (2006) (same); *id.* §§ 301–308 (providing for minimum funding standards). To comply, companies diverted assets into pensions and retirement accounts that were then invested into the capital markets. Gilson and Gordon, *supra* note 5 at 879-80.

Modern portfolio theory also played a role in the growth of institutional investing by increasing investor demand for highly diversified investment vehicles. According to Markowitz's theory of the efficiency of mean-variance investing (the precursor to modern portfolio theory), diversification improves risk-adjusted returns, and the larger the portfolio, the greater the diversification. Moreover, because secondary markets in mature equities are highly efficient, research that adds value is expensive and its fixed cost is best spread across large portfolios. These insights were a boon to the mutual funds and index funds offered by institutional investors. *See id.*

[18] *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795-85 (1993); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); Ronald Gilson and Renier Kraakman, *Reinventing the Outside Director: an Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575-91 (1990).

[19] *See id.*; John Coffee, Jr., *Liquidity versus Control: the Institutional Investor as Corporate Monitor*, 91 COLUMBIA L. REV. 91, 1277-13 (1977) (discussing the tradeoff between liquidity and voice).

[20] *See* Rock, *supra* note 5; William W. Bratton and J.A. McCahery, *Introduction to Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation* (2015); Gilson and Gordon, *supra* note 5; Strine, *Can We Do Better?*, *supra* note 5, at 481.

[21] Gilson and Gordon, *supra* note 5, at 887.

and are very likely to support management proposals, voting against management only about ten percent of the time.[22] The fact that hedge fund activism has skyrocketed in the past ten years also indicates that institutional investor stewardship has been less than perfect. If institutional investors were optimally monitoring management, successful activist interventions that generate sustained increases in firm value would not be so common.[23]

Two explanations for institutional investors' passive approach to governance have been offered. First and most importantly, the structure of the mutual fund industry creates a new collective action problem: a fund that invests in governance will bear the costs, but share the benefits with competitor funds.[24] And because mutual funds compete against each other on the basis of relative performance—*i.e.*, how the fund performed relative to its industry peers—those funds that invest in governance and stewardship will find themselves less desirable than their rival funds. Second, certain interventions require the fund to navigate a complex regulatory web, further increasing costs of governance interventions.[25]

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[22] *See* Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk* (CORPNET, University of Amsterdam Working Paper, October 28, 2016) (manuscript at 21), *available at*: https://ssrn.com/abstract=2798653. Much has been written about the problems with institutional investor voting, including the degree to which it merely serves to amplify the voice of third party proxy advisors. *See, e.g.*, Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1 (2007); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?,* 66 BUS. LAW. 1 (2010); David F. Larcker, Alan McCall, Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, __J. OF FIN.__ (forthcoming), *available at:* https://www.gsb.stanford.edu/faculty-research/working-papers/outsourcing-shareholder-voting-proxy-advisory-firms.

[23] *See* C.N. V. Krishnan, Frank Partnoy, Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. OF CORP. FIN 296 (2016); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2013); Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence From a Sequential Decision Model*, 107 J. FIN. ECON. 610, 625 tbl.8, tbl.4A (2013) (reporting average (median) "raw" shareholder returns of approximately 39% (33%) over the average nineteen-month campaign period and average (median) annualized market-adjusted returns of approximately 4% (4%)); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1750 tbl.III (2008) (reporting average (median) raw target shareholder returns of 42% (18%) over the campaign period and annualized average (median) market adjusted returns of 21% (4%)); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188, 226 (2009) (reporting average target shareholder market-adjusted returns of approximately 22% over a one-year post-initiation period).

[24] *See* Lucian Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, Working Paper, *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2982617; Gilson and Gordon, *supra* note 5, at 887; Rock, *supra* note 5, at 13; Jill Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO ST. L. J. 1009 (1994).

[25] MARK ROE, STRONG MANAGERS, WEAK OWNERS (1996); Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Black, *Shareholder Passivity Reexamined*; Black, *Agents Watching Agents*. Since these articles were written, certain regulatory constraints have been loosened. Most notably, the SEC reformed the proxy rules in 1992 to allow institutions to communicate with other institutions without fear of liability for improper solicitation of proxies. *See* United States, SEC, Regulation of Communication Among Shareholders, Securities Exchange Act of 1934 Release No.

But in spite of these incentive problems and transaction costs, this paper argues that institutional investors play a vital role in reducing agency costs, a role that has been underappreciated. In the first place, the collective action problem facing active funds has been overstated. Actively managed funds rarely have equivalent investments in the same companies as rival funds, and so an active fund can improve its relative performance by overweighting a stock and then investing in governance. Although some of the benefits will be shared, the active fund still has a financial incentive to use voice as a disciplinary mechanism for investments that make up a large part of its portfolio (or rather, a larger part of its portfolio than that of its competitors).

By focusing on voting, the literature also has understated the mechanisms of institutional investor voice, as well as the expense. Active funds generate information about portfolio company underperformance as a byproduct of investing, and they can put that information to work in a variety of ways. In addition to voting, fund managers can utilize three other inexpensive and effective disciplinary tools: they can (1) voice displeasure in conversations with management, (2) threaten to sell some of their stock, or (3) tip off or otherwise support activist hedge funds. And there is evidence that institutional investors use these tools regularly and effectively.

As for the first tool, institutional investors have increasingly forgone activism at the ballot box in favor of communications with management, or "engagement," which is more effective than proxy voting, though much harder for outsiders to observe and measure.[26] A recent study documents widespread behind-the-scenes intervention by institutional investors.[27] In this study, most institutional investors indicated that they use the proxy machinery only after informal communications fail, which would explain some of the dismal proxy voting records.[28] Another study reveals that fund analysts regularly meet and converse with management during one-

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31,326, 57 Fed. Reg. 48,276 (Oct. 16, 1992). But substantial regulatory hurdles remain. *See generally* Marcel Kahan and Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021 (2007) (describing regulatory barriers to institutional investor activism).

[26] *See* Joseph McCahery, Zacharias Sautner, & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preference of Institutional Investors*, J. FIN. (forthcoming 2016), *available at*: http://onlinelibrary.wiley.com/doi/10.1111/jofi.12393/ful; Matthew J. Mallow and Jasmine Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debates*, 12 N.Y.U. J. L. & BUS. 386 (2016); Susanne Craig, *The Giant of Shareholders Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html. By contrast, shareholder proposals have very low passage rates, *see* Stuart Gillan and Laura Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000); Stuart Gillan and Laura Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55 (2007), and proxy fights are very expensive, *see* Gantchev, *supra* note 23, at 9.

[27] *See* McCahery et al., *supra* note 20 ("The 143 respondents to our survey, mostly very large institutional investors with a long- term focus, indicate that voice, especially when conducted behind the scenes, is highly important. For example, 63% of the respondents state that, in the past five years, they have engaged in direct discussions with management, and 45% have had private discussions with a company's board outside of management's presence.")

[28] *Id.*

on-one meetings at road shows, conferences, investors' offices, and firm headquarters.[29]

There is also evidence that informal communications with management are quite effective. In a study conducted in 1998, researchers evaluated correspondence between the Teachers Insurance Annuity Association-College Retirement Equities Fund ("TIAA-CREF") and the 45 firms that it contacted about governance issues between 1992 and 1996.[30] The correspondence indicated that TIAA-CREF was generally able to secure its desired governance change without resorting to a proxy contest: the fund reached agreements with 98% of the firms that it contacted, despite obtaining majority support in only one case. Other studies that have evaluated the success rate of fund interventions report similar results.[31] In addition, this past year, almost half of the S&P 500 companies that disclosed engagement with investors also disclosed making changes to their governance and practices as a result of such engagement.[32]

Second, there is evidence that institutional investors can and do use the threat of exit as a disciplinary tool.[33] One study of institutional investor engagement reports that funds commonly use the threat of exit in conversations with management and that such threats are successful in securing desired changes 40% of the time.[34]

Third, and finally, institutional investors increasingly collaborate with other investors to influence management.[35] The most important form of collaboration is with activist hedge funds. Hedge fund activists buy large stakes in underperforming companies with the goal of agitating for changes that would improve shareholder returns.[36] These interventions range from minor policy changes, such as instituting

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[29] *See* David Soloman and Eugene Soltes, *What Are We Meeting For? The Consequences of Private Meetings with Investors* 58 J. LAW. & ECON. 325 (2016) (finding that 97% of CEOs of publicly traded firms meet privately with investors, and a 2010 survey showed that on average CEOs and CFOs had meetings with investors on 17 and 26 days out of the year respectively).

[30] Willard T. Carleton, James M. Nelson, and Michael S. Weisbach, *The Influence of Institutions on Corporate Governance though Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998).

[31] *See* Elroy Dimson, Oguzhan Karakas, and Xi Li, *Active Ownership*, Working Paper, London Business School (2014); Marco Becht, Julian Franks, Colin Mayer, and Stefano Rossi, *Returns to Shareholder Activism: Evidence From a Clinical Study of the Hermes UK Focus Fund*, 22 REV. FIN. STUDIES 3093 (2009); Michael Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996).

[32] *Four Takeaways from Proxy Season 2015*, Ernst & Young (June 2015), http://www.ey.com/Publication/vwLUAssets/EY-four-takeaways-from-proxy-season-2015/$File/EY-four-takeaways-from-proxy-season-2015.pdf.

[33] Although exit becomes more costly as an investor's stake increases, it is not impossible—market analytics show that institutional investors routinely decrease their stake in underperforming companies. *See* Strine, *Can We Do Better?, supra* note 5 at 479 n.87.

[34] *See* McCahery et al., *supra* note 20.

[35] Such communication became possible in 1999, when the SEC adopted Rule 14a-12, which allows investors to communicate with an unlimited number of shareholders. *See* 17 C.F.R. 240.14a-12; Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 687-88 (2007).

[36] *See* Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1045 (2007).

stock buybacks or dividend payments, to large-scale efforts, such as pressuring the company to sell itself or replace members of the board of directors. Because of their concentrated stakes in companies and compensation structure that allows managers to recoup a substantial fraction of the profits from an intervention, activist hedge funds have strong incentives to improve the value of their investment.[37]

As such, whether the activist hedge fund should be welcomed as a beneficial force for discipline or spurned as a corporate raider has been debated extensively. Critics, including the Chief Justice of the Delaware Supreme Court, contend that activist hedge funds push for policies skewed to their own short-term interests, without sufficiently weighing whether those policies create too little long-term investment or too much leverage and externality risk.[38] This advocacy has led to increased regulatory scrutiny of activist hedge funds.[39]

In spite of skepticism from academics and regulators, the empirical evidence generally shows a sustained increase in firm value following an activist intervention, as well as more innovation and improved firm performance.[40] This may be because

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[37] *See* Bebchuk, Cohen, and Hirst, *supra* note 24, at 21.

[38] *See* Strine, *Can We Do Better?, supra* note 5, at 458–59 (contending that empowering investors with short-term investment horizons will compromise long-term value); Strine, *One Fundamental Corporate Governance Question*, *supra* note 22 (explaining the difficulty of ensuring that corporations are managed to promote long-term growth when most shareholders hold shares for only a short time); Anabtawi and Stout*, supra* note 5, at 1290–92 (2008) (arguing that activist investors' push for short-term benefits may harm long-term shareholders); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006) (explaining that active funds alter their investment positions with high frequency and seek to profit from short-term fluctuations in price without regard to a company's long-term profits); Stephen M. Bainbridge, *Response, Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1751 (2006) (noting that activist investors are the stockholders most likely to take advantage of increased stockholder power and most likely to misuse that power for their own purposes); William W. Bratton and Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 654, 726–27 (contending that "managing to the market is the problem that needs to be addressed" and linking the 2008 financial crisis to shareholder pressures to focus on short-term price increases); Martin J. Lipton*, Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAWYER 1369, 1377 (2005) (contending that activist shareholders do not consider long-term interests of corporation or shareholders as a whole).

[39] The SEC has focused recent insider trading suits on hedge funds. *See* Todd Henderson and Kevin Haeberle, *Information-Dissemination Law: The Regulation of How Market-Moving Information Is Revealed*, 101 CORNELL L. REV. 1373 (2016). In addition, the SEC's somewhat recent adoption of Regulation FD is widely viewed by corporate officers and directors as an obstacle to more robust communication between management and shareholders. *See* Regulation FD, 17 C.F.R. § 243.100(b)(2)(ii); Stephen M. Bainbridge, *Constraints on Shareholder Activism in the United States and Slovenia* (May 15, 2000), *available at:* https://ssrn.com/abstract=228780 (contending that Regulation FD will chill communications between management and large shareholders). Recently, the SEC has received requests to shorten the Schedule 13D disclosure window and broaden the definition of beneficial share ownership to cover purely economic positions generated by derivative trades. These proposals, if enacted, would substantially reduce the returns to activist shareholders by reducing the economic stake that an activist shareholder can accumulate before news of its presence drives up the price of the target company's stock. *See* Gilson and Gordon, *supra* note 5, at 904; Lucian A. Bebchuk and Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39 (2012).

[40] *See* C.N. V. Krishnan et al., *supra* note 23; Bebchuk, et al., *Long-Term Effects*, *supra* note 23; Nickolay Gantchev, Oleg Gredil and Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism*, Working Paper (Jan. 2015); Gantchev, *supra* note 23, at 625 tbl.8, tbl.4A; Alon Brav,

the activists who are willing to bear the high costs associated with an activist campaign are those that will reap substantial gains from activism, perhaps because a company is very badly managed. And it may also be because of the involvement of institutional investors, which have become a "keel" for hedge fund activism.[41]

At the outset, an activist investor knows that it will be critical to secure the support of institutional investors if the campaign is to succeed. When an activist launches a campaign, it rarely purchases enough stock to control voting outcomes—for campaigns launched in 2015, the median percentage ownership of the activist investor or group of investors was less than 7%, and less than 3% at companies with a market capitalization of over $20 billion.[42] Therefore, to succeed in proxy contests (or better yet, to secure a favorable settlement with management and avoid the expense of a proxy contest, which may cost upwards of $10 million),[43] the activist hedge fund must secure the support of large institutional investors.[44]

Accordingly, activist hedge funds engage in rigorous investor analysis before deciding to target a firm. If the fund decides that there are too many unfriendly institutional shareholders, it will be unlikely to intervene.[45] And if the fund chooses to carry out the campaign, it will go to great lengths to make its case to large institutional investors, generally after it has alerted the market to its presence with a Schedule 13D filing.[46] The activist fund may also recruit other small hedge funds before or after the announcement in a phenomenon known as "wolf-packing."[47]

Wei Jiang & Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Industry Concentration*, REV. FIN. STUDIES (forthcoming 2017) (manuscript at 5–7); Alon Brav et al., *Hedge Fund Activism, supra* note 23, at 1750; Klein et al., *supra* note 23, at 226.

[41] *See* Gordon and Gilson, *supra* note 5 (describing a "happy complementarity" between hedge fund activists and institutional investors in which the activist frames and seeks to force governance changes and will succeed only if the proposal can attract broad support from sophisticated institutional investors).

[42] *2016 U.S. Shareholder Activism Review and Analysis: Activists Face Headwinds in 2016*, Sullivan & Cromwell Memos (Nov. 28, 2016), https://www.sullcrom.com/2016-us-shareholder-activism-review-and-analysis-activists-face-headwinds-in-2016.

[43] Gantchev, *supra* note 23, at 9.

[44] *See* Gordon and Gilson, *supra* note 5, at 897-900.

[45] Empirical evidence shows that activist hedge funds typically target companies with a high level of institutional ownership, consistent with theory that activists are more likely to intervene when they can easily accumulate voting support. *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* 28-39 (Columbia Law & Econ., Working Paper No. 521, 2015). A recent study likewise reveals that the presence of "activism-friendly" institutional investors increases the likelihood that a firm will be targeted for hedge fund activism; accordingly, the presence of activism-unfriendly institutional investors decreases the likelihood of becoming a target. *See* Simi Kedia, Laura Starks, & Xianjue Wang, *Institutional Owners and Hedge Fund Activism*, Working Paper, (forthcoming 2017).

[46] *See* 17 C.F.R. § 240.13d-1(a) (2012) (requiring any person acquiring beneficial ownership of any equity security of more than 5% to file with SEC statement on Schedule 13D within ten days after acquisition). As just one recent example, the activist hedge fund Jana Partners gauged potential support from large institutional investors before making demands of management at Agrium. *See* David Gelles & Michael K. De la Merced, *New Alliances in the Battle for Corporate Control*, N.Y. TIMES (March 18, 2014), http://dealbook.nytimes.com/2014/03/18/new-alliances-in-battle-for-corporate-control/?_r=0; *see also* Coffee and Palia, *supra* note 45; Mario Becht et al., *supra* note 31 (suggesting

Ultimately, the fund knows that it is critical to secure the support of one or more institutional investors.[48] Doing so will not only help the activist accumulate voting power, but will also signal credibility to other investors, making it more likely that they will join in supporting the activist campaign.[49]

As soon as the activist's Schedule 13D becomes public, however, management will begin a campaign of its own in an attempt to convince institutional investors that the activist's plan is short-sighted or problematic for other reasons. In fact, such lobbying may occur even before an activist intervenes—there is evidence that management views enhanced communications with large shareholders as an important defense to hedge fund activism.[50]

Therefore, even though institutional investors are unlikely to take an activist position themselves, they play an important role in catalyzing hedge fund activist campaigns. And institutional investors will occasionally initiate an activist campaign by contacting hedge funds and informing them about underperforming portfolio companies in the hope that a fund will intervene.[51] For these reasons, management knows that when institutional investors are unhappy, there is a real risk of displacement. And the very threat of this partnership can be sufficient to induce management to focus on maximizing shareholder wealth.[52]

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shareholder activism is predominantly executed through private interventions both with target management and with other institutions).

47 *See* Susan Pulliam et al., *Activist Investors Often Leak Their Plans to a Favored Few: Strategically Placed Tips Help Build Alliances for Campaigns at Target Companies*, WALL ST. J. (Mar. 26, 2014), http://www.wsj.com/articles/SB10001424052702304888404579381250791474792; Coffee & Palia, *supra* note 45; Briggs, *supra* note 35, at 686-94.

48 As an example, the activist hedge fund ValueAct was successful in obtaining a seat on Microsoft's board with less than 1% of stock because Microsoft recognized that other large institutional investors supported the fund's demand. *See* Gelles & De la Merced, *supra* note 46.

49 Ian Appel, Todd A. Gormley, & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper No. 22707 (manuscript at 2), *available at:* http://www.nber.org/papers/w22707.

50 *See* PwC's 2016 Annual Corporate Directors Survey, *The Swinging Pendulum: Board Governance in the Age of Shareholder Empowerment* (Oct. 2016), *available at:* http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/top-10-findings.html (noting that "nearly four of five directors say their board took proactive steps to prepare for actual or potential activism. About half say their board regularly communicated with the companies' largest investors and used a stock-monitoring service to provide regular updates about changes to company ownership…. A number of directors also say their board took action by revising executive compensation plans or changing board composition (21% and 16%, respectively).").

51 According to Bill Ackman, founder of activist fund Pershing Square Capital, "Periodically, we are approached by large institutions who are disappointed with the performance of companies they are invested in to see if we would be interested in playing an active role in effectuating change." He reports that institutional investors even use an informal term for this phenomenon: "R.F.A." or request for activist. *See* Gelles & De la Merced, *supra* note 46.

52 *See* Gantchev, et al., *Governance under the Gun*, *supra* note 40 (finding that managers of peer firms view activism in their industry as a threat and undertake real policy changes to mitigate it); PwC's 2016 Annual Corporate Directors Survey, *supra* note 50, at 15 (noting that four out of five directors say that the board took proactive steps, including altering compensation plans, identifying strategic vulnerabilities, and changing the board compensation to reduce the risk of becoming a target of activism).

Institutional investors also discipline hedge fund activists: because of their voting power, they are able to block interventions that they deem to be detrimental to the long term health of the company. Accordingly, activists have begun to adjust their tactics to match the priorities of institutional investors. For years, hedge fund activists had focused on pushing for changes in business strategy, balance sheet changes, divestitures, or selling the company.[53] The more recent trend in proxy contests is to focus on board-related governance issues—issues that mutual funds favor—and balance sheet campaigns have fallen by the wayside.[54] More study is required to determine whether the presence of institutional investors is responsible for this shift and whether these changes have benefitted shareholders. But perhaps some of the evidence indicating that hedge fund activist interventions generally increase firm value can be explained by institutional investors, who are unlikely to support changes that do not benefit their long-term investors.

In sum, although institutional investors' incentives are imperfect, there is evidence that the presence of large, sophisticated investors with a financial interest in the long-term health of portfolio companies has become an important corporate governance safeguard.

III. THE THREAT OF PASSIVE INVESTING

We are entering a new investment era brought on by the rise of passive investing that has changed the corporate landscape once again. And the concentration of assets in passive funds will create a far greater agency problem than has been previously encountered—shareholders will be ceding control to investors with *no* financial incentive to invest in monitoring management or securing good governance.

This section begins by documenting the steep increase in assets invested in passive funds. It then describes the acute incentive problems facing passive funds and presents evidence supporting the theory that passive investing has the potential to distort corporate governance and worsen agency costs at public companies.

A. The Rise of Passive Investing

Passive funds are funds whose investment securities are not chosen because of their performance, but are instead automatically selected and weighted to match an index or other subset of the market. Passive funds include index funds and ETFs, both of which seek to replicate stock indices while minimizing expense ratios. Although passive fund managers may initially exercise some judgment in creating the fund by setting the philosophy of their portfolio and then determining how to track

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[53] S&C 2016 U.S. Shareholder Activism Review and Analysis (Nov. 28, 2016), *available at*: https://www.sullcrom.com/2016-us-shareholder-activism-review-and-analysis-activists-face-headwinds-in-2016.

[54] Fichtner et al., *supra* note 22, at 2.

the index, the fund's trading decisions are largely automated. For this reason, passive funds generally charge much lower fees than active funds.[55]

Passive funds have been around for a while—the modern index fund was launched in the mid-1970s by John Bogle,[56] the founder of the Vanguard Group—and for over forty years, academics have touted their benefits for investors.[57] Studies comparing active and passive funds likewise indicate that the majority of active funds have not been able to consistently generate higher returns than benchmark indices such as the S&P 500.[58] When they do, any increase in returns is often eaten away by higher management fees.[59]

But only very recently have investors embraced passive investing, and they have done so wholeheartedly. Between 2008 and 2015, investors sold holdings of actively managed equity mutual funds worth roughly $800 billion, while at the same time buying approximately $1 trillion in passively managed funds.[60] This past year alone, investors withdrew $340 billion from actively managed funds and invested $533 billion into passive funds, increasing the total amount of assets invested in passive

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[55] As of the end of 2015, the asset-weighted average net expense ratio was only 0.12 percent for U.S. equity index funds, compared to 0.79 percent for U.S. actively managed equity funds. Oatricia Oey, *Average Fund Costs Continued to Decline in 2015, But Investors Are Not Necessarily Paying Less*, Morningstar Research Library (2016), *available at*: http://corporate1.morningstar.com/ResearchArticle.aspx?documentId=750768.

[56] *See* Zweig, *supra* note 2. In the 1930s, there existed something very similar to the modern index mutual funds: fixed trusts, which had redeemable shares and fixed portfolios. But for unknown reasons, they declined in popularity by the 1940s. *See* John Morley, *Collective Branding and the Origins of Investment Fund Regulation, 1936-1942*, 6 VA. L. & BUS. REV. 341 (2012).

[57] In 1976, John Langbein and Richard Posner first advocated for an indexing approach, concluding that "the trustee's rational strategy . . . is to buy shares in a mutual fund or other investment vehicle that holds the market portfolio—a market fund…. The advantages [of market funds] seem decisive: at any given risk/return level, diversification is maximized and investment costs minimized." *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 30 (1976).

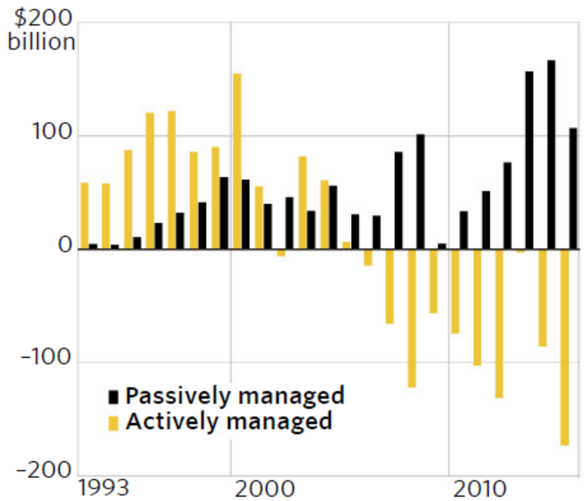
[58] *See* William F. Sharpe, *Mutual Fund Performance*, 39 J. BUS. 119, 137 (1966) (finding that a sample of stock mutual funds underperformed the Dow Jones Industrial Average on a risk-adjusted basis); Michael C. Jensen, *Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios*, 42 J. BUS. 167, 239 (1969) (finding that mutual funds, on a risk-adjusted basis, had lower net returns than the market as a whole); Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Funds*, 52 J. FIN. 783, 787 (1996) (finding that actively managed funds had annual returns that were 65 basis points below the applicable market indices); Russ Wermers, *Mutual Fund Decomposition: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses*, 55 J. FIN. 1655 (2000) (finding that actively managed funds hold stocks that outperform the market, but on a net basis underperform indices by 1%); Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153 (2009) (finding underperformance of 21 to 71 basis points, depending on the set of controls).

[59] *Id.*; Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 550-51 (2009) ("[W]hen [active managed funds'] higher costs are taken into account, the average actively managed dollar under-performs a passively managed index of securities…This account leaves open the possibility that some actively managed funds will beat the market…Much, however, conspires against the average investor picking out consistently above-average performers…. Investing in an actively managed mutual fund is betting on one horse in a very crowded field…According to one study, over a fifteen year period, 84% of actively managed mutual funds failed to yield returns in excess of the stock market as a whole.").

[60] Fichtner et al., *supra* note 22, at 2.

funds by 9 percent.[61] Assets under management in passive funds now represent $4 trillion, or 34% of the U.S. mutual fund market, up from just 4% in 1995.[62] And in the past ten years, the share of total U.S. market capitalization held by passively managed funds has quadrupled to more than 8%, or 12% of the S&P 500.[63]

Fig. 1. Net Flows of U.S. Stock Market and Exchange Traded Funds



Source: Wall Street Journal

This rapid growth is predicted to continue.[64] Actively managed funds, on average, have continued to underperform compared to market indices, making passive funds look especially appealing.[65] And because global economic growth rates are expected to remain low, low fee passive funds will continue to have a competitive advantage.[66] Accordingly, Ernst & Young has forecasted annual growth rates for the ETF industry of between 15 and 30 percent in the next few years.[67] PricewaterhouseCoopers predicts even more dramatic growth, estimating that assets invested in ETFs will double annually until 2020.[68]

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[61] Anne Tergesen and Jason Zweig, *The Dying Business of Picking Stocks*, WALL ST. J. (Oct. 17, 2016), *available at*: https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749.
[62] *Id.* at 6.
[63] Ian Appel, Todd A. Gormley, and Donald B. Keim, *Passive Investors, Not Passive Owners*, __J. FIN. ECON. __ (manuscript at 49) (forthcoming).
[64] *See* Madison Marriage, *Large Investors Pull $350bn From Active Equity Funds*, FIN. T. (Dec. 10, 2016), https://www.ft.com/content/4418502e-be2e-11e6-8b45-b8b81dd5d080 (describing the actively managed fund industry's bleak future).
[65] Fichtner et al., *supra* note 22 at 6.
[66] Sarah Krouse, *Investors Leave Active Funds Despite Fee Cuts*, WALL ST. J. (Jan. 6, 2017), http://www.wsj.com/articles/active-funds-fee-cutting-doesnt-stem-investor-exodus-1483376271.
[67] EY Global ETF Survey: 2015 and Beyond (Oct. 7, 2014), http://www.ey.com/Publication/vwLUAssets/ey-global-etf-survey-2015-and-beyond/$FILE/ey-etf-survey-2015-and-beyond.pdf.
[68] Judith Evans and Jonathan Eley, *Democratising Finance: How Passive Funds Changed Investing*, FIN. T. (2015), http://www.ft.com/intl/cms/s/0/b3c0c960-a56c-11e4-bf11-00144feab7de.html.

Regulatory scrutiny of mutual fund fees has also fueled the growth of passive funds. In April 2016, the Department of Labor ("DOL") issued a final rule expanding the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 ("ERISA").[69] That rule, which went into effect on June 9, 2017, requires investment advisers to act as fiduciaries when making recommendations or giving advice on 401(k) plans or individual retirement accounts ("IRAs").[70] Similarly, in June 2016, the SEC's Office of Compliance Inspections and Examinations announced that SEC examiners will scrutinize whether advisors have conflicts of interest when making recommendations about share classes to their clients.[71] The announcement makes clear that an investment advisor fails to uphold its fiduciary duty when it causes a client to purchase a more expensive share class when a less expensive share class is available.[72] And this enhanced scrutiny from the DOL and SEC, combined with an uptick in litigation challenging mutual fund fees,[73] has encouraged investment advisors begin moving IRA assets—which represent $7 trillion—out of actively managed funds and into passive funds.[74]

The surge in demand for passive funds has benefitted some institutional investors more than others. That is because the passive fund industry is remarkably concentrated—BlackRock, Vanguard, and State Street (the "Big Three") together

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69 *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946, 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509–2510, and 2550).

70 *See* Tara Siegel Bernard, *Obama's Fiduciary Rule, After a Delay, Will Go Into Effect,* N.Y. TIMES (May 23, 2017), *available at*: https://www.nytimes.com/2017/05/23/business/obamas-fiduciary-rule-after-a-delay-will-go-into-effect.html?_r=0. The rule was originally scheduled to be phased in beginning on April 10, 2017 but the start date was delayed until June 9, 2017, with full implementation required by July 1, 2019. Many observers wonder whether the delay may be extended indefinitely. *See, e.g.*, Ashlea Abeling, *Will DOL Gut Fiduciary Rule By Latest July 1, 2019 Extension?*, FORBES (Aug. 9, 2017), *available at:* https://www.forbes.com/sites/ashleaebeling/2017/08/09/will-dol-gut-fiduciary-rule-by-latest-july-1-2019-extension/#2779d4365840.

71 Office of Compliance Inspections and Examinations Risk Alert, *OCIE's 2016 Share Class Initiative* (July 13, 2016), https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

72 *Id.*

73 For the past ten years, the ERISA plaintiffs' bar has been aggressively challenging fund fees, with a growing emphasis on arguing the imprudence of active management in the administration of an employee retirement plan. *See Rosen v. Prudential Retirement Ins & Annuity Co et al.*, No. 3:2015cv01839 (D. Conn. 2016) (rejecting plaintiff's argument that the employer's selection of higher-cost actively managed mutual funds rather than passively managed funds violated ERISA); *Taylor v. United Techs. Corp.*, No. 3:06-CV-1494, 2009 WL 535779, at *10 (D. Conn. Mar. 3, 2009), *aff'd*, 354 F. App'x 525 (2d Cir. 2009) (rejecting plaintiff's argument that the presence of a high concentration of mutual funds with revenue-sharing arrangements violated ERISA despite expert evidence in support of the notion that actively-managed mutual funds generally underperform passive index funds). This liability risk has pushed some companies to switch their retirement accounts from actively managed funds to index funds. *See, e.g.*, Tergeson and Zweig, *supra* note 61 (describing how the Illinois State Board of Investment voted to convert its $4 billion 401(k) plan for state workers to an all-index plan in the face of increased liability risk).

74 John Waggoner, *DOL Rule Silver Lining? It May Trigger a Shift of $1 Trillion to ETFs*, INVESTMENTNEWS (Apr. 3, 2016), http://www.investmentnews.com/article/20160403/FREE/304039997/dol-rule-silver-lining-it-may-trigger-a-shift-of-1-trillion-to-etfs.

hold 70% of the ETF market.[75] Index fund market share data are not publically available, but recent estimates put Vanguard as holding 75% of the market.[76]

And as a result of the growth of passive investing, the Big Three have become significant players in governance. In 2015, the Big Three together constituted the largest owner of nearly 90% of public companies in the S&P 500, which is up from 25% in 2000.[77] When considering all listed companies in the U.S., together the Big Three were the single largest shareholder at least 40% of the time.[78] In 2016, passive funds from just one manager—Vanguard—controlled 5% or more of shares in 468 companies in the S&P 500. Ten years ago, the number of companies was only three.[79]

Although the cause of increased demand for passive funds is benign, some financial commentators have predicted that the growing concentration of assets in the hands of passive investors may have harmful market effects. One worry is that passive investing will increase investor herding behavior and lead to more correlated market movements, exacerbating the pro-cyclicality of financial markets.[80] A related concern is that widespread passive investment will reduce stock market pricing efficiency because certain companies, such as those listed on the S&P 500, will always have a ready market for their shares. Moreover, stock in companies that are not listed on an index may have fewer possible buyers, causing those companies to become undervalued.[81] Even Bogle admitted that if everyone were to index, there would be "chaos without limit. You [couldn't] buy or sell, there [would be] no liquidity, there [would be] no market."[82] But he explained that perverse market effects would not manifest until investment in passive funds rose to about 90% of the equity market.[83]

The legal literature has generally focused on a different problem created by the rise of institutional investing—the prospect for anticompetitive behavior by

[75] Fichtner et al., *supra* note 22, at 6.
[76] *Id.*
[77] Posner et al., *supra* note 7, at 7.
[78] Fichtner et al., *supra* note 22, at 17.
[79] Dennis K. Berman and Jamie Heller, *Wall Street's Do-Nothing Revolution,* WALL ST. J. (Oct 17, 2016), http://graphics.wsj.com/passivists/.
[80] *See* Andrew Haldane, *The Age of Asset Management?*, Speech at the London Business School (April 2, 2014), *available at:* http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.
[81] Russ Wermers and Tong Yao, *Active vs. Passive Investing and the Efficiency of Individual Stock Prices*, Working Paper, University of Iowa and University of Maryland (May 2010), *available at*: https://finance.uni-mannheim.de/fileadmin/files/areafinance/files/Paper_Finance_Seminar/Wermers.pdf; Inigo Fraser-Jenkins et al., *The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism*, Sanford C. Bernstein & Co., LLC (Aug. 23, 2016); *but see* Miles Johnson, *Why Active Fund Managers Should Cheer the Rise of ETFs*, FIN. T. (Dec. 7, 2016) (contending that actively managed funds should view the rise of passive funds as opportunities to exploit undervalued stocks that are not suitable for inclusion on indices).
[82] Zweig, *supra* note 2.
[83] *Id.*

institutional investors with large ownership stakes across competitor firms. Sparked by empirical research showing that common institutional ownership is correlated with higher prices in at least two concentrated U.S. industries,[84] Eric Posner, Fiona Morton, and E. Glen Weyl, as well as Einer Elhauge, have asserted that institutional investors may pressure managers to refrain from aggressive price competition because of their substantial interests in rival companies.[85]

The next section provides an alternative explanation—the problem is not that powerful institutional investors are pressuring management to compete less aggressively, but that a growing share of the market is not doing as much to monitor and discipline management. When those passive investors do intervene, they will pursue an unthinking and automated approach to governance that is unlikely to be in the company's best interest. And if this trend continues, the scope of the problem is potentially much larger than the threat of anticompetitive conduct because it extends beyond companies in oligopolistic industries, and concerns all companies with a high concentration of passive ownership, which is a large and growing segment of the U.S. market.

B. Passive Investing and Corporate Governance

A passive fund's goal is to replicate the performance of a market index, and so the fund's exit opportunities are limited. For this reason, one might suppose that a passive fund's incentives are closely aligned with those of its long-term investors.[86] But passive funds face acute collective action and agency problems that render their thoughtful participation in governance unlikely.

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[84] José Azar, Martin C. Schmalz, & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, Ross School of Business Paper No. 1235 (2016), *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2427345 (examining within-route airline ticket price variation over time and showing that common ownership correlates with increases in ticket prices); José Azar, Sahil Raina, and Martin Schmalz, *Ultimate Ownership and Bank Competition*, Ross School of Business Working Paper (2016), *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252. The evidence of higher prices in certain industries is not inconsistent with my theory; indeed, Azar et al. theorized that a lack of investor demand for competition could result in an equilibrium with reduced competition and sustained high profit margins. *See Anti-Competitive Effects*, *supra* note 84, at 4-5. But I argue that the potential for anticompetitive behavior is only one facet of this problem, and that a lack of investor discipline would likely also lead to heightened agency costs. And the agency cost problem extends beyond companies in concentrated industries, with the potential to generate welfare losses across the entire market.

[85] Posner et al., *supra* note 7; Elhauge, *supra* note 7.

[86] *See e.g.*, Strine, *Can We Do Better?, supra* note 5, at 478 ("Precisely because index funds do not sell stocks in their target index, those funds have a unique interest in corporations pursuing fundamentally sound strategies that will generate the most durable wealth for stockholders. Index fund investors do not benefit by bubbles that burst. Index fund investors also have a more durable interest in the prospects of the corporations in the index than investors in actively traded funds. Actively traded funds turn over at a rate which makes it difficult to believe that their managers are basing their decisions on a genuine assessment of the corporations' long-term cash flow prospects as opposed to their speculation about where the market is heading.").

Because a passive fund seeks only to match the performance of a market index—not outperform it—it lacks a financial incentive to ensure that the companies in their portfolio are well run.[87] In the first place, a passive fund portfolio is highly diversified and therefore includes many more companies than the typical actively managed mutual fund. For example, an S&P 500 tracker fund (one of the more popular passive fund options) generally consists of 500 portfolio companies, more than five times the amount in the average actively managed mutual fund.[88] This means that any investment in improving governance at a single portfolio company will be even less likely to impact the fund's overall performance.[89]

In addition, passive funds face an acute collective action problem because a beneficial governance intervention will improve the performance of all funds tracking the index. Unlike actively managed funds, which can modify the weight of a portfolio company based on its expected performance and out-compete rival funds with strategic investments in governance, passive funds hold stock in proportion to the company's weight on a market index. A passive fund that invests in governance, therefore, would improve the performance of all rival passive funds in equal measure. And investing in governance would also benefit active funds—in fact, active funds are able to reap even greater benefits from the passive fund's investment because they can overweight the target company upon learning about the intervention. In other words, any investment in governance would benefit competitor funds while simultaneously driving up the passive fund's costs. Therefore, unless the intervention were costless, it would be certain to harm the passive fund's relative performance.

But thoughtful interventions are especially costly for passive funds, which generally lack local knowledge—"knowledge of people, of local conditions, and of special circumstances"—of the firms that they invest in.[90] Because of its automated

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[87] To understand the power of their commitment to the indexing strategy, consider that passive funds may refuse to tender into an offer to purchase their shares at a premium, even if they view the deal as beneficial, so long as the stock is still included in the index that the fund is tracking. That is because the gap between the offer price and the market price, as well as the gap in time between the tender and the squeeze-out, interferes with the fund's ability to track the index. *See Some Tender Offer Quirks*, Kirkland & Ellis M&A Update (Oct. 9, 2009), *available at*: https://www.kirkland.com/files/MA_Update/100909.pdf.

[88] David M. Smith and Hany Shawky, *Optimal Number of Stock Holdings in Mutual Fund Portfolios Based on Market Performance*, 40 FIN. REV. 481, tbl.2 (showing that in 2000, the mean number of companies in a mutual fund portfolio was 92).

[89] The literature has previously deemed "neutral" shareholders as those who have entered into a derivative transaction that negates all the economic risk associated with the underlying position in its shares. *See* Frank Partnoy, *U.S. Hedge Fund Activism*, RESEARCH HANDBOOK ON SHAREHOLDER POWER 13-14 (forthcoming 2015); Henry T.C. Hu and Bernard Black, *Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011 (2006). This paper expands the concept of a neutral shareholder to include highly diversified passive fund managers who lack any incentive to invest in improving the performance of the firms within the fund's portfolio.

[90] Freidrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945). This is somewhat less true for index funds that sample firms in order to replicate the performance of an index—those funds may need to readjust their portfolio if one company begins to underperform relative to the

trading strategy, a passive fund does not monitor the fundamentals of companies in its broad portfolio.[91] The consequence of this passive approach to trading is that a proactive and informed approach to governance requires the passive fund to incur additional expenses associated with identifying underperforming companies, pinpointing the reason for their underperformance, and then determining the most effective way to intervene.[92] This also means that it will be expensive for the fund to thoughtfully evaluate shareholder proposals and governance interventions proposed by other investors. A passive fund that incurred these expenses would need to charge a higher fee, which would likely drive fee-sensitive investors to competitor funds.[93]

In sum, passive investing exacerbates agency and collective action problems associated with intermediated finance—although investors desire good governance, they are not willing to pay the fees necessary to secure it and would instead prefer to free ride on the investments of others. The same is true for passive fund managers, who will not invest in improving firm governance because any such investment will harm the fund's competitiveness. Therefore, unlike active funds, passive managed funds have *no* financial incentive to monitor management or invest in governance interventions. Or, as Bogle has explained, historically, index funds managers traditionally (and rationally) believed that they should leave the performance of the companies in their portfolios to "the invisible hand of the marketplace."[94]

Therefore, as demand for passive funds continues to fuel an influx of assets from active funds, it is likely that the market for corporate influence will experience two dramatic changes. First, a growing share of corporate owners will have substantially weakened incentives to monitor and discipline management or invest in improving governance. Second, there is the risk that passive fund voting will do more harm than good. This is because passive fund managers will be especially likely to adhere to a low-cost, unthinking approach to governance, such as automatically voting "yes" to any shareholder proposal that meets pre-determined qualifications. Passive funds

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industry. But even in that case, those funds would have no incentive to determine why the fund is underperforming and then expend resources to try to improve firm performance.

[91] Vanguard has emphasized that the funds are able to charge low fees because they do not expend resources investigating individual companies or meeting with managers. *See* Frank Partnoy, *Are Index Funds Evil?*, THE ATLANTIC (Sept. 2017).

[92] Moreover, the Big Three, by virtue of their very large stakes in many public companies, risk triggering Section 13(d) of the Exchange Act of 1934 when they intervene in company performance. Section 13(d) subjects investment managers with a 5% or greater investment in a company to extensive disclosure requirements. But so long as the investment manager does not exercise "control," which includes nominating directors and waging a proxy contest, they will be subject to much more limited disclosure requirements under Schedule 13G. *See* John Morley, *Too Big to Be Active: Large Investment Managers, Conflicts of Interest, and the High Costs of Corporate Control* (Working Paper). This rule may cause investment managers with large investments to avoid taking any actions that could be viewed as seeking to gain influence.

[93] *See generally* Yang Sun, *The Effect of Index Fund Competition on Money Management Fees*, Working Paper (forthcoming 2017); Lisa Beilfuss, *Readers React: Low Fees Are Driving Us Into Passive Funds*, WALL ST. J. (Oct. 24, 2016), http://www.wsj.com/articles/readers-react-low-fees-are-driving-us-into-passive-funds-1477318719. Note that the fee-sensitivity of investors is somewhat disputed. *See* Erik Sirri and Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998).

[94] Krouse et al., *supra* note 2.

will also be especially likely to succumb to their serious conflicts of interest. Most prominently, they will have an incentive to vote with management—an important source of defined contribution plan assets, which are a large and growing pool of capital invested in index funds.[95]

Moreover, governance distortions associated with passive fund ownership will likely materialize well before stock price inefficiencies manifest. That is because that the market for corporate influence requires more active participation to remain efficient than is necessary to keep the stock market's pricing efficient. If only a small number of investors actively trade based on information about the company, the stock price will incorporate that information. But a small number of active investors cannot so easily influence governance outcomes, meaning that governance inefficiencies arising from passive investing would arise much sooner.[96]

Consider the following example: Company Y is 51% owned by passive funds and those funds have internal guidelines that state that the funds will vote yes to any proposal that results in greater board independence. A shareholder files a proposal that purports to make the board of directors more independent by separating the CEO from the chairman. The passive funds lack firm-specific knowledge and thus do not know whether this controversial proposal would actually improve shareholder value. And yet, because passive funds adhere to their voting guidelines closely, the proposal will pass, even if all other active shareholders oppose it.[97]

As another example, consider Company X, which is also 51% owned by passive funds. Informed investors have decided that Company X is underperforming and that an intervention would improve firm efficiency, but management will successfully oppose the intervention unless a majority of shareholders support it. Let us further assume that the intervention is not blessed by the passive funds' voting guidelines. Rather than expend resources to determine whether the intervention is beneficial, the

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[95] In 2015, 401(k) assets under management totaled $4.7 trillion, with 60% held in mutual funds. Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, ICI Research Perspective (2016), *available at*: http://www.ici.org/pdf/per22-04.pdf; *see also* Simon C. Y. Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, BUTTERWORTHS J. INT'L BANKING & FIN. L. 481 (Sept. 2011), *available at*: http://ssrn.com/abstract=1925485. And there are examples that indicate that management is willing to use its power as a client to send a strong message. As just one example, in 1990, Armstrong World Industries, a strong supporter of a Pennsylvania antitakeover law, switched its $180 million employee savings plan to Fidelity from Vanguard after Fidelity withdrew its opposition to the new law. *See* Black, *Shareholder Passivity Reexamined, supra* note 18, at 602.

[96] Zweig, *supra* note 2.

[97] Whether to separate the CEO and chairman positions is a hotly contested issue in corporate governance. In recent years, the trend has consistently moved toward separation in spite of the fact that the empirical evidence does not find it to be unambiguously positive. David F. Larcker and Brian Tayan, *Chairman and CEO: The Controversy Over Board Leadership Structure,* Stanford Closer Look Series (June 24, 2016), *available at*: https://ssrn.com/abstract=2800244. In fact, there is little evidence that separating the two positions really improves firm performance or governance quality, and a recent study has found that forced separation due to shareholder pressure is associated with a decrease in market valuation and lower future operating performance. *See* Aiyesha Dey, Ellen Engel, and Xiaohui Liu, *CEO And Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595 (2011).

passive fund manager would likely do nothing or vote with management, meaning that the intervention would fail, even if all informed shareholders support it.

Two features of the passive fund industry dissipate some of these concerns. First, passive funds may be able to free ride off of information from active funds housed within the same institution. As of June 2016, Vanguard and BlackRock each had 19% of their equity assets under management invested in actively managed funds, while State Street had 3%.[98] And when an institution has investment overlap between active and passive funds, there is the possibility of beneficial information sharing that increases the likelihood of informed voting.[99]

As an example, last year, BlackRock's passive funds changed their vote on a high profile merger based on advice from active fund managers. The issue was a proposed $18 billion merger between professional-service providers Towers Watson and Willis Group. Towers Watson investors disliked the proposed terms: a package of cash and shares in the combined company worth less than Towers' stock price on the date the deal was announced. Yet the deal was expected to increase revenue and decrease costs for Towers Watson, meaning that shareholders would capture the upside from the deal later.[100] Both ISS and Glass Lewis recommended a "no" vote (in a position that was called "short-termist" by other proxy advisors)[101] and BlackRock's passive team initially agreed, but the institution's active fund portfolio managers supported the deal and eventually convinced their colleagues to do the same.[102] And because of BlackRock's change of heart, the deal was approved by shareholders.

Information sharing can therefore reduce the risk of bad outcomes, but investment overlap between active and passive funds is not always guaranteed. This is because active funds invest in far fewer companies than passively managed funds. Moreover, as assets continue to flow out of actively managed funds, causing them to close or lay off investment analysts,[103] there will be less generation of information

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98 *See* Fichtner et al., *supra* note 22, at 7 tbl.1.

99 For some evidence that beneficial information sharing occurs across large institutional investors, *see* Michelle Lowry and Peter Iliev, *Are Mutual Funds Active Voters?*, 28 REV. FIN. STUDIES 446 (2015) (demonstrating that, although 25% of mutual funds blindly follow ISS recommendations, larger mutual funds and funds that belong to larger fund families engage in active voting more often and theorizing that this is because those large funds can spread their research costs and benefits across various funds).

100 Paul J. Davies, *Towers Watson-Willis Merger: Battle to Save a Dubious Deal*, WALL ST. J. (Nov. 19, 2015), http://www.wsj.com/articles/towers-watson-willis-merger-battle-to-save-a-dubious-deal-1447950545.

101 Leanna Orr, *Critics React to Contentious Towers Watson Merger*, CHIEF INVESTMENT OFFICER HEADLINES (Dec. 15, 2015): http://www.ai-cio.com/channel/newsmakers/critics-react-to-contentious-towers-watson-merger/

102 Krouse et al., *supra* note 2.

103 This has already begun to happen at the Big Three: recently, State Street and BlackRock reported record high layoffs even as passive funds—their primary investment vehicles—experience a record influx of assets. *See* Sarah Krouse, *BlackRock to Cut About 400 Jobs*, WALL ST. J. (March 30, 2016), http://www.wsj.com/articles/blackrock-to-cut-about-400-jobs-1459370775 (reporting that BlackRock plans to cut about 400 jobs, or three percent of its workforce, in the largest round of layoffs to date); Ross Kerber, *State Street Net Income Flat, Plans Job Cuts*, REUTERS (Oct. 23, 2015), http://www.reuters.com/article/statestreet-results-idUSL1N12N17320151023 (reporting that State

and thus less beneficial spillover. The rise of passive investing, therefore, makes it increasingly likely that institutional investors will have a substantial passive presence in a company without guidance from active fund managers.

The second complicating feature of the passive fund industry is the fact that largely passive institutions, like many other large institutional investors, locate voting and engagement efforts for passive funds in a centralized corporate governance team.[104] In theory, a well-staffed group of engaged employees who are capable of thoughtfully directing fund votes and engaging with management would lessen many of the concerns identified in this paper. The following subsections describe what we know about the structure and governance efforts of the Big Three's governance groups, which indicate that they are not yet up to the task. The next subsections also discuss evidence indicating that the rise of passive investing may already be distorting the outcome of shareholder votes, as well as the substance of hedge fund activist campaigns.

i. Passivity, Voting, and Engagement

The Big Three advertise that their governance groups are active participants in firm governance, but a closer look induces some skepticism about these claims.[105] Those governance groups do not have their pay tied to the funds' performance.[106] They are also understaffed: Vanguard employs 15 people devoted to engagement and voting at about 13,000 companies based around the world, BlackRock employs about 20 people who work on governance issues at some 14,000 companies, and State Street employs fewer than 10 people devoted to governance issues at around

Street plans to cut 600 jobs worldwide); Deirdre Fernandes, *State Street Corp. Eyes 7,000 Layoffs by 2020*, BOSTON GLOBE (March 29, 2016), https://www.bostonglobe.com/business/2016/03/29/state-street-official-pegs-staff-reduction-workers/89HmTzw98F6AvUCVyA9A4I/story.html (reporting that State Street announced at an investor conference plans to lay off up to 7000 workers in the next three years "to become a more tech-driven company … less reliant on manual trades").

104 *See* Charles M. Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Apr. 6, 2010), *available at*: http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-ofinstitutional-investing-and-institutional-voting/#10b (noting that many larger investment managers have staff dedicated to voting all portfolio companies' shares and that this staff "typically is entirely separate from the portfolio managers and reports either to the general counsel or senior compliance officer of the investment manager, not to the investing function").

105 BlackRock, for example, explains that its engagement program "is focused on protecting and enhancing the economic value of the companies in which it invests on behalf of clients" through engagement with boards and management of investee companies. BlackRock, *Global Corporate Governance and Engagement Principles* (2014), https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment-1engprinciples-global-122011.pdf. Vanguard likewise emphasizes that it takes an active approach to engagement to "ensure that [its portfolio] companies' policies and practices in relation to corporate governance matters support the creation of long-term value for investors." Vanguard, *Vanguard's Approach to Corporate Governance*, https://americas.vanguard.com/institutional/about-vanguard/our-approach-to-corporate-governance.htm; *see also* State Street, *Global Proxy Voting and Governance Principles* (March 2016), https://www.ssga.com/investment-topics/environmental-social-governance/2016/Global-Proxy-Voting-and-Engagement-Principles-20160301.pdf.

106 Rock, *supra* note 5, at 10.

9,000 companies.[107] Put differently, each member of Vanguard's governance team is tasked with making governance decisions for nearly one thousand companies, even though Vanguard is likely to be one of the company's largest shareholders.

Given the number of companies the engagement teams are charged with overseeing, simply voting the shares, without even considering how to vote them, is an enormous task.[108] It would not be possible for teams of that size to prepare corporate governance reports, issue and evaluate governance guidelines, research and thoughtfully vote proxies, and also meet with management and the board. Accordingly, the engagement teams do not use an active voting strategy and instead promulgate voting guidelines and follow them closely. They also outsource voting decisions to proxy advisor services: BlackRock reports that its governance team relies on ISS and Glass Lewis to help summarize proxy statements and devotes close analysis only when those services have identified an issue.[109] State Street and Vanguard similarly utilize ISS as a voting agent and a provider of research for certain proxy issues.[110]

In spite of the fact that there are no generally accepted best practices for governance, the Big Three have adopted nearly identical voting guidelines: each institution articulates a preference for director independence, some relationship between long-term company performance and executive compensation, and skepticism about anti-takeover provisions and major changes to the corporation, such as mergers, reorganizations, or changes to capital structure.[111]

SEC regulations shed some light on the topics chosen for inclusion. In 2003, when announcing that investment managers have a fiduciary obligation to vote proxies responsibly and in the interests of their investors, the SEC provided guidance on appropriate topics for mutual fund voting guidelines:

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[107] Krouse et al., *supra* note 2. On the opposite end of the spectrum is activist hedge fund Pershing Square Capital Management that has an investment team of eight, as well as several additional employees, that together oversee a portfolio of twelve companies. *Id.*

[108] *See* Strine, *Can We Do Better?*, *supra* note 5, at 475 (explaining that institutional investors holding broad portfolios are required to cast thousands of votes every year).

[109] Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html.

[110] State Street Global Advisors, *Global Proxy Voting and Engagement Principles* (March 2016), *supra* note 105; Eleanor Bloxham, *Shareholder Research Firms Are Not the Enemy*, FORTUNE (Mar. 19, 2014), http://fortune.com/2014/03/19/shareholder-research-firms-are-not-the-enemy/.

One might conclude that this delegation is beneficial, but proxy advisors themselves adhere to one-size-fits-all voting policies, lack a financial interest in the portfolio company, and suffer from conflicts of interest that undermine the value of their proxy voting guidance. *See* Charles M. Nathan, *Proxy Advisory Business: Apotheosis or Apogee?*, Harvard Law School Forum on Corporate Governance and Financial Regulation (March 23, 2011), *available at*: https://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee/; Robert M. Krasne, *Proxy-Voting Concern: ISS Wields Extraordinary Clout in Recommendations to Investors, Yet Also Provides Services to Corporations*, PENSIONS & INVES., May 31, 2004, at 12, http://www.pionline.com/article/20040531/PRINTSUB/405310706/1026/TOC.

[111] *Id.*; BlackRock, *Global Corporate Governance and Engagement Principles*, *supra* note 105; Vanguard, *Vanguard's Approach to Corporate Governance*, *supra* note 105.

> The following are examples of specific types of issues [for] which disclosure would be appropriate [in the voting guidelines]: Corporate governance matters, including changes in the state of incorporation, mergers and other corporate restructurings, and anti-takeover provisions such as staggered boards, poison pills, and supermajority provisions; Changes to capital structure, including increases and decreases of capital and preferred stock issuance; Stock option plans and other management compensation issues; and Social and corporate responsibility issues.[112]

On the substance of each of these issues, the Big Three's voting guidelines generally follow recommendations from proxy advisors like ISS and Glass Lewis, which likewise embrace one-size-fits-all voting policies.[113]

The Big Three closely adhere to their voting guidelines and are thus able to achieve lock-step consistency in voting across funds. At BlackRock in 2015, in only 18 per 100,000 of shareholder proposals, one of their funds did not vote along with the other funds. Likewise, at Vanguard, only 6 out of 100,000 proposals featured a fund voting differently than its other funds.[114] State Street also showed a low level of internal disagreement, voting inconsistently in 195 per 100,000 proposals.[115] By contrast, Fidelity (which has only 16% of its equity invested in passive funds) had internal disagreement in 3,144 of 100,000 votes.[116] This difference is likely due to the fact that institutions tend to give active fund managers freedom to cast the fund's votes, and different fund managers will reasonably reach different conclusions for controversial proposals, or have varying perspectives based on the differing needs of their investors. This lock-step consistency, therefore, suggests that a centralized voting strategy may not be in the best interests of all investors.

In light of the their growing market share and uniform preferences, it is not surprising that the Big Three may already be influencing election outcomes. The first and only study to consider this issue has shown that an increase in passive fund ownership is correlated with a higher likelihood of implementation of the shareholder governance proposals that are favored by the Big Three, including

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112 *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Release Nos. 33-8188, 34-47304, IC-25922, 2003 SEC Lexis 3143 at *23-24. (2003).

113 *See* Nathan, *Proxy Advisory Business, supra* note 111 ("[A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits-all voting policies and simplistic analytic models designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.").

114 Fitchner, *supra* note 22, at 20-21.

115 *Id.*

116 *Id.*

proposals that increase board independence, remove poison pills and other takeover defenses,[117] and eliminate dual class structures.[118]

We should be wary of this trend. Decades of scholarship have failed to generate consensus about what good governance is, concluding that it is endogenous to the particular firm. And there is reason to believe that one-size-fits-all governance solutions imposed across vastly different firms will make all firms worse off. For example, a recent study finds a statistically negative impact on stock price as the result of certain compensation changes made in response to comments from proxy advisory firms.[119] Another study reports similar results after the implementation of stock option exchange programs recommended by ISS.[120]

But voting is only part of the story. As discussed, engagement is perceived by institutional investors to be the most important and effective way to influence and discipline management. How do engagement efforts by the Big Three fare?

[117] One could argue that passive funds strategically remove takeover defenses in the hope that the external threat of a takeover will discipline management and obviate the need for shareholder monitoring. But there are problems with this argument. First, a hostile takeover is a very expensive option—"only a badly mismanaged target can justify the typical 50% takeover premium." Black, *Shareholder Passivity Reexamined*, *supra* note 18, at 522. Hostile takeovers also face strong legal obstacles, most notably, state antitakeover statutes. *See* Guhan Subramanian, *Is Delaware's Antitakeover Statute Unconstitutional?*, 65 BUS. LAW. 685, 734, 721-722 (2010). Large public companies are especially unlikely to be the targets of hostile takeovers in light of the expense and regulatory hurdles of purchasing control. Finally, purchasing control is often more than is necessary to correct a problem: for companies with competent managers who could benefit from closer oversight, a takeover is a disproportionate remedy and one that creates large disruption and transaction costs. *See* Black, *Shareholder Passivity Reexamined*, *supra* note 18, at 522.

[118] Appel et al., *Passive Investors*, *supra* note 63, at 4-5. This same study revealed that although institutions with a higher share of passive fund assets vote with management almost 90% of the time, the number is slightly lower than it is for funds with a high percentage of assets in active funds. *Id.* But this result does not necessarily prove that passive funds are active voters—to the contrary, it is also consistent with the theory that passively managed funds follow their voting guidelines or defer to proxy advisors even when the better choice is to vote with management.

The study also found that an increase in passive ownership was correlated with a small increase in a company's return on assets. *Id.* The authors suggest that this evidence indicates that passive fund ownership was the reason for these beneficial changes, but there are other explanations: for example, companies with higher concentration of passive fund ownership often have a high concentration of active fund ownership, too. *See* Martijn Cremers & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay For? The Legal Consequences of Closet Index Funds*, __VA. L. BUS. REV__ (forthcoming 2017) (showing that a number of high fee active funds in fact hold portfolios that substantially overlap with market indices). Although Cremers and Curtis characterize "closet indexing," which occurs when active funds largely track an index with the exception of a few big bets, as an abusive practice, this paper shows that it may provide a benefit. If closet index fund managers are motivated to act as stewards of portfolio companies in order to determine which companies should be overweighted relative to the index, all investors will benefit from this investment.

In sum, the fact that active funds may also favor companies that are listed on indices may drive some of performance results found in the Appel study. But as investors continue to shift assets from active to passive funds, this protection will recede.

[119] *See generally* Larcker et al., *supra* note 22. Other studies have found similar results. *See Do Proxy Advisors Say on Pay Voting Policies Improve TSR*?, Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 20, 2015).

[120] *See* David Larcker, Alan McCall, & Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Exchanges: The Case of ISS*, Rock Center for Corporate Governance Working Paper (2011).

Engagement is difficult to evaluate, but Vanguard and BlackRock both report the number of meetings with management annually: in 2015, BlackRock reported 1,421 engagements worldwide.[121] About a third of these constituted engagements with U.S. companies, and only 13% were categorized as "extensive" (as opposed to "moderate" or "basic").[122] Likewise, Vanguard reported 800 worldwide engagements, or "conversations," with management and directors (State Street does not report engagement data).[123]

These numbers appear high, but they indicate that the vast majority of portfolio companies—at least 12,200 in the case of Vanguard—were neglected. These engagement efforts are also dwarfed by those of institutional investors that favor an active investing strategy. For example, in 2015, Fidelity International, a small institutional investor with an active investment approach (not to be confused with Fidelity Investments, which does not report its annual engagements),[124] reported 1,001 engagements conducted by its governance and engagement team.[125] But that number does not include over 16,000 company meetings and visits by analysts and other employees as part of "the normal conduct of [their] business."[126] T. Rowe Price, a large institutional investor that invests only 8.9% of its assets under management in passive funds, similarly reports that the majority of meetings are "driven by portfolio managers and supported by the expertise of … industry-focused analysts," and that corporate engagements merely supplement due diligence meetings conducted by analysts in the ordinary course of investing.[127]

In other words, active fund analysts, not members of corporate governance teams, are the primary drivers of informal meetings and interactions with management. The rise of passive investing is therefore likely to affect not only proxy voting outcomes, but also the occurrence and efficacy of investor meetings with management—perhaps the most important form of institutional investor

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121 BlackRock, *Investment Stewardship Report, Voting and Engagement Quarterly Statistics* (Oct. 1, 2015–Sept. 30, 2016), *available at*: https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-voting-engagement-annual-figures-q2-2015-q1-2016.pdf.

122 *Id.*

123 Vanguard, *Our Engagement Efforts and Proxy Voting: An Update* (June 30, 2016), *available at*: https://about.vanguard.com/vanguard-proxy-voting/update-on-voting/index.html. Vanguard explains that its index funds are able to charge low fees because fund managers need not incur the costs of meeting with companies. Indeed, according to a Vanguard representative, index fund managers never engage with companies about their businesses because doing so would require the fund to make new regulatory filings and change their investment guidelines. *See* Partnoy, *Are Index Funds Evil?*, *supra*, note 91.

124 Fidelity International has $290 billion in assets under management. *See* Fidelity International: About Us, *available at*: https://www.fidelityinternational.com/global/about/default.page?.

125 Fidelity International, *Governance and Engagement Report* (2015), *available at*: http://www.fidelityilf.com/assets/pdf/governance-engagement-report.pdf. By contrast, Vanguard has $4 trillion assets under management and BlackRock, $5 trillion. Sarah Krouse, *Vanguard Reaches $4 Trillion for First Time*, WALL ST. J. (Feb. 10, 2017), https://www.wsj.com/articles/vanguardreaches-4-trillion-for-first-time-1486745349.

126 *Id.*

127 T. Rowe Price, *Building on Our Values*, at *5 (2014), https://www3.troweprice.com/usis/content/dam/trowecorp/Pdfs/CSRReport2014.pdf.

influence.[128] When that happens, fewer agreements will be reached in back room conversations; instead, investor influence, when it occurs at all, will come in the form of costly proxy contests.

ii. Passivity and Hedge Fund Activism

As the composition of institutional investors moves toward passivity, in theory, those investors will also be less likely to serve as a keel to hedge fund activism.[129] Recall that active funds generally have the incentive and ability to evaluate activist interventions and then catalyze those that are deemed beneficial, while refusing to support those that are not in the interests of their long-term investors.

Passive funds, again, are different. Even the most beneficial intervention will not improve the passive fund's relative performance, nor will it materially improve portfolio returns. Thus, a passive fund manager is unlikely to support an activist unless doing so is costless. But there are a few reasons to think that partnering with an activist would be expensive for passive funds. First, because passive funds lack information about the company and its performance, they would need to invest time and resources to evaluate the activist's proposal. Second, supporting an activist would cause the fund to incur the costs of interfacing with management and potentially participating in litigation.[130]

Third, a passive fund manager will likely worry that supporting an activist could jeopardize her relationship with the target company and put the fund at risk of losing corporate pension fund assets.[131] Not only that, the company might be a client for the institution's investment services.[132] And because securities law requires funds to

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[128] In addition to being infrequent, engagement by passive funds is relatively ineffective because passive funds lack a credible exit threat: their indexing strategy often requires them to hold stock regardless of the company's performance. Indeed, the prospect of tracking error might even force passive fund managers to buy in situations where they would prefer to sell. *See* McCahery et al., *supra* note 20, at 16.

[129] In addition, the decline of actively managed mutual funds could make hedge fund activism more costly, as there will be fewer analysts identifying problematic companies and tipping off hedge fund activists.

[130] Robert C. Pozen, *The Role of Institutional Investors in Curbing Corporate Short-Termism*, 71 FIN. ANALYSTS J. 81 (Oct. 2015).

[131] As activist hedge fund manager William A. Ackman explained in a letter to investors, "corporate pension fund assets are one of the largest pools of capital invested in index funds. It does not help index fund managers win business from corporate America if they have a reputation for being an activist or if they support activists. In fact, the opposite is likely true. If their reputation is more for protecting incumbent management than for supporting activists, they are much more likely to garner assets from corporate pension plans than index fund managers who are known to vote against management." Pershing Square Annual Letter (Jan. 26, 2016), https://assets.pershingsquareholdings.com/2014/09/Pershing-Square-2015-Annual-Letter-PSH-January-26-2016.pdf; *see also* Wong, supra note 95; Black, *Shareholder Passivity Reexamined, supra* note 18, at 602.

[132] Bebchuk, Cohen & Hirst*, supra* note 24, at 19.

disclose all votes,[133] votes cast in favor of activist investors are impossible to hide from actual and potential clients.[134]

It is increasingly evident that management views close relationships with institutional investors as a primary defense against investor activism.[135] Indeed, creating goodwill among institutional investors has become an increasingly important part of management's job.[136] And passive funds make especially good targets for these efforts because the benefits of supporting an activist are almost non-existent.

Finally, passive funds might decline to support an activist for fear that doing so would harm other investments. As Elhauge and others have argued, institutional investors with large ownership positions in competitor firms could push management to compete less vigorously so as to maintain high profits.[137] One might suppose that doing so would encourage activist hedge funds to target the colluding companies and agitate for a more aggressive business strategy or for a change in management. But passive institutional investors, which are most likely to have horizontal investments across competing firms, would have no interest in seeing the activist investor succeed because the increased competition would harm their other investments. In such a case, the passive funds could simply refuse to support the intervention under the theory that it was short-sighted.

For these reasons, if approached by an activist, a passive fund would likely choose to do nothing.[138] If the fund does support a hedge fund activist, it will likely do so for idiosyncratic, and perhaps even political reasons.

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133 17 C.F.R. Parts 239, 249, 270, and 274, Release Nos. 33-8188, 34-47304, IC-25922.

134 Several empirical studies have found evidence that business relationships influence the voting decisions of investment managers. *See* Dragana Cvijanović et al., *Ties that Bind: How Business Connections Affect Mutual Fund Activism. The Journal of Finance* (2014) (finding that mutual fund families with business ties to a corporation are more likely to cast pro-management votes in closely contested situations at the corporation); Rasha Ashraf et al., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANT. ANALYSIS 567 (2009) (finding that mutual fund families with greater business ties to corporations tend to vote more favorably to corporate managers on executive compensation matters at all corporations).

135 Wall Street firms are developing teams that focus solely on advising management on how to strengthen corporate relationships with large institutional investors as a defense to activism. *See* Sonali Basak & Beth Jinks, *It's Getting Harder to Keep the Barbarians at the Gate—and It's This Guy's Job*, BLOOMBERG MARKETS (Feb. 1, 2017); *see also* PwC's 2016 Annual Corporate Directors Survey, *The Swinging Pendulum: Board Governance in the Age of Shareholder Empowerment* (Oct. 2016), http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/top-10-findings.html; *The Effect of Shareholder Activism on Corporate Strategy*, NYSE Report (2016), *available at*: https://www.nyse.com/publicdocs/Shareholder_Engagement_Survey_Report_2016.pdf.

136 *Id.*

137 *See* Elhauge*, supra* note 85; Posner et al., *supra* note 7.

138 On average, the Big Three are less likely to support dissident board nominees than institutions with a greater share of assets in active funds. In 2015, Vanguard supported dissident nominees 16% of the time; BlackRock, 36%; and State Street, 28%. By contrast, Fidelity supported dissident nominees half of the time; T. Rowe Price, 63%. *See* Steve Wolosky & Aneliya Crawford, *Shareholder Activism: Investing in a Stronger Corporate America* (July 29, 2015), *available at:* http://www.olshanlaw.com/assets/htmldocuments/Shareholder%20Activism%20-%20Investing%20in%20a%20fStronger%20Corporate%20America.PDF.

The problem, of course, is that passive funds are increasingly likely to determine the outcome of activist campaigns. And a world in which the success of activist interventions hinges on passive funds should be unwelcome to observers on both sides of the investor activism debate. Those who believe that activist interventions are harmful for companies and their long-term shareholders should be concerned that passive funds will support activist campaigns for reasons unrelated to their merits. By contrast, those who believe that hedge fund activists play an important role in disciplining management should fear that passive funds will often choose to vote with management or do nothing rather than take a chance on an intervention proposed by an activist.

The problem is not only that passive funds are more likely to be unwilling to serve as a keel to hedge fund activism. It is also concerning that hedge fund activists may tailor their interventions to satisfy the least informed investors.

There is some evidence that the rise of passive investing is already affecting the types of campaigns waged by hedge fund activists. A research team from Wharton has conducted the only empirical research on this topic. In two studies, they were able to isolate the effects of passive fund ownership by comparing companies near the cutoff point for being included in the Russell 1000 and the Russell 2000 indices.[139] The first study found that greater ownership by passive mutual funds is associated with less hedge fund activism and a greater incidence of votes against activist shareholder proposals.[140] This was so despite the fact that a higher percentage of passive fund ownership is correlated with the removal of takeover defenses.[141]

In a second study, which examined this question using a more recent dataset, the authors again found that companies with greater passive fund ownership were slightly less likely to be targets of activist campaigns than firms with less passive ownership (although the result was not statistically significant).[142] But they discovered a bigger change in the types of campaigns utilized by activists at companies with a higher concentration of passive funds: the study reported an increase in campaigns seeking board representation and a corresponding decrease in campaigns seeking policy changes such as increased dividends.[143] The study also

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[139] Appel et al., *Standing on the Shoulders of Giants, supra* note 49; Appel et al., *Passive Investors, Not Passive Owners*, *supra* note 49. Index funds are generally market-cap weighted, so the larger the market capitalization of the company, the larger its representation in the index. As a result, companies at the bottom of the Russell 1000 have little passive-fund ownership, while those at the top of the Russell 2000 have much more. And because those two groups of firms are of similar size and represent a cross section of industries, the methodology isolates the changes that arise from an increase in passive ownership.

[140] Appel et al., *Passive Investors, Not Passive Owners*, *supra* note 49.

[141] *Id.*

[142] Appel et al., *Standing on the Shoulders of Giants*, *supra* note 49.

[143] *Id.*

found that a higher level of passive fund ownership correlated with a higher number of proxy fights, as well as settlements culminating in a board seat for the activist.[144]

Of course, this is only the first study to consider this question, and it is still too early to say how exactly the rise of passive investing will affect hedge fund activism. But these results support the theory that passive investing will alter activist campaigns, and not necessarily for the better. The researchers interpreted the results as indicating that activist investors are more likely to utilize aggressive tactics and be successful in appointing new directors to the board when passive ownership increases. If true, it is concerning in light of the incentive problems facing passive funds, as well as anecdotal evidence indicating that passive institutions do not spend much time evaluating activist campaigns. It is also somewhat surprising because passive funds are less likely to support dissident directors in proxy fights.[145]

One theory that could explain these results is that activist hedge funds are aware that balance-sheet campaigns are likely to be viewed skeptically by passive funds. And so, the better strategy for hedge funds is to pick targets that would benefit from a board shakeup, a more intrusive and expensive endeavor, but one that may be consistent with the institution's voting guidelines and therefore more likely to gain the support of the passive funds. Another theory is that the threat of an expensive proxy contest will more likely to induce management to settle with an activist when management has trouble engaging with and taking the temperature of the company's largest shareholders.

In sum, there is reason to believe that the rise of passive investing will undermine the beneficial complementarity between institutional investors and activist hedge funds, although more study is necessary to determine how exactly these shareholder dynamics will play out.

IV. POLICY PROPOSALS

The flow of assets out of the hands of informed investors and into passive funds is likely to have adverse consequences for the market for corporate influence, shareholders, and the economy. Although precise quantification of this harm is beyond the scope of this paper, there is evidence to suggest that it would be

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[144] *Id.* 2016 saw a pronounced reduction in activist interventions at large public companies—the same companies that have the largest concentration of passive fund ownership. Andrew Birstingi, *FactSet's 2016 Shareholder Activism Review* (Feb. 1, 2017), *available at*: https://insight.factset.com/hubfs/Resources/Research%20Desk/Market%20Insight/FactSet%27s%202016%20Year-End%20Activism%20Review_2.1.17.pdf (noting that 2015 saw 32 campaigns against U.S. companies with market values greater than $10 billion, compared with 17 of such campaigns in 2016). By contrast, smaller companies with market capitalization less than $1 billion actually saw a dramatic *rise* in activist interventions. *Id.* This data may indicate that hedge funds are returning to their traditional approach of focusing on smaller companies in light of the high cost of assembling a stake in larger companies. *See* Coffee and Palia, *supra* note 45, at 554. It may also indicate that hedge funds are learning that their campaigns are more uncertain when companies have a high concentration of passive investors.

[145] *See* Wolosky & Crawford, *supra* note 138.

substantial. A recent study finds that ownership by "distracted" institutional investors is correlated with a material reduction in stock price.[146] Specifically, companies with institutional investors who experience exogenous shocks to unrelated parts of their portfolio (and were therefore distracted) were more likely to announce diversifying, value-destroying acquisitions with stock prices 33% lower than the average announcement return, and 9.5% lower 36 months after deal completion.[147] Those companies were also more likely to grant opportunistically-timed CEO stock options, cut dividends, and less likely to fire the CEO for poor performance. The companies that did not experience a takeover underperformed their industry peers by an average of 15 basis points per month.[148]

Research quantifying benefits from takeover activity also suggests that reduced constraints on management lead to large social welfare losses. Michael Jensen estimates that four-and-a-half years of takeover activity in the 1980s generated $40 billion in shareholder returns, excluding gains generated by actions undertaken proactively in an attempt to ward off takeover attempts.[149] Since then, the market for corporate influence has eclipsed the market for corporate control as the primary mechanism for constraining management, suggesting that the weakening of an important force for managerial discipline will result in shareholder losses of a similar magnitude.[150]

Of course, passive funds are unlikely to give management complete freedom—some may choose to voice displeasure at the ballot box. But as mentioned, this could result in the implementation of uniform governance structures across widely divergent firms, which is also likely to harm shareholders. As just one example, a recent study found that the average risk-adjusted return for companies that followed proxy advisor recommendations when adjusting compensation was 0.44% lower than firms whose changes to compensation were unrelated to proxy advisor recommendations.[151]

Therefore, there is reason to fear that the rise of passive investing will result in substantial economic harm.[152] And thus, lawmakers face a daunting question: what to

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146 Elisabeth Kempf, Alberto Manconi, & Oliver G. Spalt, *Distracted Shareholders and Corporate Actions*, __REV. FIN. STUDIES__ (forthcoming 2017).
147 *Id.* at 3, 22.
148 *Id.* at 31.
149 Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 MIDLAND CORP. FIN. J. 1, 4 (1986).
150 *See, e.g.,* Robert Thompson, *The Limits of Hedge Fund Activism*, Working Paper (Oct. 6, 2006) (describing how takeover activity receded in the face of the growing availability of defensive tactics in the late '80s and attention shifted to institutional investors to confront the problems created by the separation of ownership and control).
151 Larcker et al., *supra* note 120.
152 Recent scholarship has observed a link between short-termism and ownership by "quasi-indexers," or funds that adhere to a passive, buy-and-hold strategy of investing in a diversified set of firms. Specifically, firms in concentrated industries with a high degree of quasi-indexer ownership invest far less than their peers, in spite of high profitability and valuation. *See* German Gutierrez & Thomas Philippon, *Investment-less Growth: An Empirical Investigation*, NBER Working Paper (Dec. 2016),

do when the market for corporate influence loses a critical mass of active participants, and when the loudest voices are the least informed?

Government intervention is necessary because the market distortion is the result of an acute collective action problem, a classic market failure justifying regulation. In addition, investors who care about governance have incomplete information: although investors are entitled to know about a fund's voting history, this information does not reveal much about the quality of the voting or the fund's other governance efforts. Moreover, passive funds have an incentive to exacerbate this information asymmetry between funds and investors because advertising that the fund plays an active role in governance will help the fund attract investor assets.

There is of course the possibility that the market would self-correct in time. When harms from passive investing materialize, they will be felt most severely by passive fund investors. At that point, actively managed funds, which will have moved into different segments of the market, will begin to attract investors because of their higher relative performance.

But it would take time for investors to sufficiently correct market distortions; investors do not change behavior immediately, and instead wait until years of poor performance materialize into a visible long-term trend. If this sounds implausible, recall that academics have recommended passive investment vehicles for forty years and only in the past ten years have investors begun to favor them.[153] Without regulatory action, therefore, it is possible that millions of investors would experience social welfare losses for many years.

For these reasons, lawmakers would be wise to consider taking action to reduce the influence of passive funds in governance. Such action would be preferable to prohibiting or discouraging investors from investing in low-fee and diversified investment vehicles. From an investor's perspective, passive funds are generally superior to active funds, and recent regulatory reforms have adopted this point of

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http://papers.nber.org/tmp/85446-w22897.pdf. A team from the McKinsey Global Institute has attempted to quantify the costs of a short-term mindset, observing that companies with a long-term focus (measured by the level of investment, as well as earnings quality and growth) have consistently outperformed their industry peers since 2001: average revenue and earnings growth were 47% and 36% higher for the firms with a long-term mindset. In addition, this study observed that firms with a long-term focus generated substantial social welfare gains: they added approximately 12,000 more jobs on average than their peers from 2001 to 2015. The authors calculate that U.S. GDP would have grown by an additional $1 trillion (and the economy would have generated more than 5 million additional jobs) if all companies had performed as well as those with a long-term perspective. The study also posits that the U.S. economy will give up another $3 trillion in GDP and job growth by 2025 if companies continue to focus on short-term performance. *See* Dominic Barton, James Manyika, Timothy Koller, Robert Palter, Jonathan Godsall, & Joshua Zoffer, *Measuring the Economic Impact of Short-Termism*, McKinsey Global Institute Discussion Paper (Feb. 2017), http://www.fcltglobal.org/docs/default-source/default-document-library/20170206_mgi-shorttermism_vfinal_public.pdf?sfvrsn=0.

153 *See, e.g.*, Langbein & Posner, *supra* note 57.

view.[154] But future reforms should not ignore the benefits that active investors provide for shareholders and the economy more broadly.

Instead, regulators could consider restricting truly passive funds from participating in governance, and specifically, voting in shareholder elections. The next section proposes several policy recommendations that would diminish the influence of passive funds in corporate governance. It then demonstrates why these restrictions are superior to proposals that would encourage institutional investors to be thoughtful participants in governance.

A. Rethinking Passive Fund Voting

The primary governance problem created by the rise of passive investing is that passive funds wield sizeable influence in governance, and yet they have little incentive to use their influence to maximize firm value. In light of the fact that any investment in voting will likely generate higher costs than benefits for the fund, it is surprising that passive funds vote at all.

The answer is that most investment fund managers believe, wrongly, that they are required to cast proxy votes under SEC regulations. The origin of this misperception is relatively recent. Mutual and pension funds have been highly regulated since the enactment of the Investment Company Act of 1940, but for years, federal and state regulation was largely indifferent to their voting and governance activities.[155] By the 1970s, however, as the growth of institutional ownership portended a new governance dynamic, the SEC began to take the position informally that investment funds had a fiduciary duty to vote their shares in accordance with the best interests of their beneficiaries.[156]

On January 23, 2003, the SEC solidified this position by adopting a rule mandating that investment fund advisors disclose their votes, as well as their policies and procedures for voting, in corporate elections. In the adopting release to the rule, the SEC explained, "the investment adviser to a mutual fund is a fiduciary that owes the fund a duty of … good faith …. This fiduciary duty extends to … the voting of

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[154] *See, e.g.*, Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946, 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509–2510, and 2550).

[155] *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1461-62 (2002).

[156] *Id.* (quoting an SEC Staff Report of Corporate Accountability which explained, "The fiduciary principle applies to all aspects of investment management, including voting. In exercising the stock franchise, the fiduciary has a duty to vote in such a way as to promote the interests of the beneficiaries."); Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Dep't of Labor, to Helmuth Fandl, Chairman of Ret. Bd., Avon Prods., Inc., Dep't of Labor Interpretive Letter on Avon Products, Inc. Employees' Retirement Plan, 1988 WL 897696, at *2 (Feb. 23, 1988) ("In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock.").

proxies relating to the fund's portfolio securities."[157] This rule was widely interpreted as mandating that mutual funds vote all of the shares of their portfolio companies. As a result, large asset managers, including the Big Three, generally do so.

But the law has never required investment advisers to vote all portfolio shares on all matters. Recently, the DOL categorically rejected that position in an interpretation of the application of ERISA fiduciary standards to the exercise of the shareholder franchise:

> The fiduciary duties described at ERISA Sec. 404(a)(1)(A) and (B), require that, in voting proxies … the responsible fiduciary shall consider only those factors that relate to the economic value of a plan's investment and shall not subordinate the participants and beneficiaries to unrelated objectives…. *If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of … other restrictions, the fiduciary has an obligation to refrain from voting.*[158]

The SEC has taken a similar view, explaining: "We do not suggest than an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. *There may even be times when refraining from voting a proxy is in the client's best interest*, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client."[159]

In sum, rather than being required to vote all shares on all matters, an institutional investor is required to balance the cost of casting a vote on a particular matter—which includes the cost of analysis and casting the vote, as well as the risk the vote would reduce shareholder value—against the potential economic benefit to be gained by voting. If the investor concludes that the costs of voting exceeds the benefits, the duty is to *not vote*.[160] Under this framework (and in light of the lack of consensus about governance best practices that would justify a one-size-fits-all

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[157] 17 C.F.R. Parts 239, 249, 270, and 274, Release Nos. 33-8188, 34-47304, IC-25922; *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Jan. 31. 2003), *available at*: https://www.sec.gov/rules/final/33-8188.htm.

[158] *See* Department of Labor interpretation of the legal standards imposed by Sections 402, 403 and 404 of Title I of ERISA, codified in 29 C.F.R. Part 2509.08-2, Section 1 (emphasis added). The release went on to explain: "The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan's investments. However, fiduciaries also need to take into account costs when deciding whether and how to exercise their shareholder rights, including the voting of shares. Such costs include, but are not limited to, expenditures related to developing proxy resolutions, proxy voting services and the analysis of the net effect of a particular issue on the economic value of the plan's investment. Fiduciaries must take all of these factors into account in determining whether…the voting of a proxy…is expected to have an effect on the economic value of the plan's investment that will outweigh the cost of exercising such rights." *Id.*

[159] Investment Advisers Act Release No. 2106, "Proxy Voting by Investment Advisers," (Jan. 31, 2003) (emphasis added).

[160] *See* Nathan, *The Parallel Universes*, supra note 104.

voting approach), it is likely that a passive fund manager who votes under all circumstances would breach its fiduciary duty to investors, unless that fund manager is relying on information from an active fund manager housed within the same institution.

Perhaps all that is needed is for the SEC to emphasize once again that passive fund managers breach their fiduciary duties to investors when their voting creates costs in excess of the benefits. If passive funds knew that they could be subject to liability for uninformed voting, perhaps some would abstain more often.

But it is likely that something more is needed to deter passive funds from voting. This is because the institution may benefit from casting votes in shareholder elections, even when voting is not in investors' best interests. There are two motivations that may compel institutions to vote regularly. First, if the institution is perceived as being an involved and engaged steward, that will help funds attract assets and clients, especially from pension funds (a large and growing passive fund client) or other groups that view governance as a priority.[161] The fact that the Big Three increasingly tout their governance expertise in their marketing materials, in speeches,[162] and in op-eds[163] indicates that they believe that creating an appearance of governance expertise will help them win clients.

Moreover, there is a first-mover disadvantage to abstaining from voting—the market could view the decision to not vote as a signal of poor quality, especially when all other funds continue to highlight their governance abilities. In other words, unless all passive funds collectively gave up their voting rights, it is unlikely that any one institution would voluntarily choose to do so.

Second, and more cynically, an institution may view the role of key decisionmaker as a powerful tool that can help it win points with another set of actual or potential clients: the companies that they invest in. If management is a key

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[161] CalPERS, the largest U.S. pension fund (with $300 billion in assets under management) states clearly in its Investment Policy that "CalPERS expects all … external managers of CalPERS capital to integrate the CalPERS Principles into investment decision making, including proxy voting…." CalPERS Total Fund Investment Policy, https://www.calpers.ca.gov/docs/total-fund-investment-policy.pdf.

[162] *See, e.g.*, F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, Harvard Forum for Corporate Governance and Financial Regulation (June 24, 2015), *available at*: https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/ ("[W]e are permanent shareholders. To borrow a phrase from Warren Buffet: Our favorite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits….That is precisely why we care so much about good governance.").

[163] F. William McNabb III, *Proxy Votes Certainly Matter to Index Funds*, WALL ST. J. (July 5, 2017), *available at*: https://www.wsj.com/articles/proxy-votes-certainly-matter-to-index-funds-1499289400?tesla=y; Vanguard, *The Ultimate Long Term Investors*, Seeking Alpha (Aug. 2, 2017), *available at*: https://seekingalpha.com/article/4089524-ultimate-long-term-investors.

client of the institution, either for 401(k) assets or other services, that institution will have a strong motivation to cast management-friendly votes.

The Big Three are therefore unlikely to voluntarily abstain from voting without legal intervention. The sections that follow propose several rules that would restrict passive funds from voting in shareholder elections.[164]

i. *Eliminate Passive Fund Voting*

The simplest proposal would restrict passive funds from voting their shares.[165] In other words, the law would treat a passive fund manager like a derivative holder when it comes to voting.

There is a compelling legal rationale for such a law: a passive fund attracts investors on the basis of its ability to track an index. As such, active and informed voting will increase costs for investors without corresponding benefits and therefore would arguably breach the fund's fiduciary duty under ERISA. Likewise, a thoughtless, automated approach to voting would also be likely to harm investors. As such, the law would make all parties better off by restricting passive funds from casting uninformed votes.

The rule could employ a presumption that any fund that uses indexing as an investment strategy is a passive fund. That presumption could be rebutted, allowing the passive fund to be "certified" for voting, if the fund showed that its strategy incorporated meaningful portfolio company research—including ongoing monitoring and fundamental analysis—and that its investment in governance is above a certain threshold (based on the fund's size). A passive fund could also be certified to vote shares of certain companies if it demonstrated that it had access to information generated by actively managed funds housed in the same institution.[166] To qualify, the passive fund would need to show that the actively managed fund had a meaningful investment in the shared portfolio company and that the active fund otherwise met the requirements for voting certification (*i.e.*, that it met the monitoring, analysis, and investment threshold). Finally, a passive fund could retain its votes if it committed itself to "mirror voting" under all circumstances, which

[164] Ronald Gilson and Curtis Milhaupt have made a similar proposal to limit the voting ability of sovereign wealth funds who acquire significant stakes in domestic companies. *See Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism*, Stanford Law and Economics Olin Working Paper No. 355 (February 18, 2008).

[165] To ease the burden of implementation, the rule would specify that restricted shares would not be counted in the denominator for quorum or director election purposes. In addition, the rule would not encumber the stock and thus devalue it—voting stock would continue to provide the holder with the right to vote, but the passive institution would be restricted from exercising that right. Finally, the rule could incorporate narrow exceptions to reduce the risk of abuse, such as allowing voting rights for corporate actions that would harm passive investors' economic interests.

[166] Many passive funds would likely meet this exception in light of the fact that they are often housed within the same institution as actively managed funds. But if the level of overlap declines with the rise of passive investing, the rule would greatly reduce the uninformed voting power of passively managed funds. Moreover, the exception might have the beneficial effect of encouraging institutions to maintain actively managed funds whose investments overlap with passive funds.

would require the passive fund to vote its shares in the same way as the other shareholders.

This rule would be relatively costless to implement because it would simply relieve passive funds of obligations rather than impose new ones. In addition, passive fund managers would be unlikely to oppose a rule that freed them from onerous governance obligations that have few benefits for their investors.[167]

Moreover, a passive fund that wished to retain its voting power could do so by increasing its investment in governance. For this reason, the rule would encourage beneficial fund differentiation and make the market for funds more transparent: investors who cared about governance could choose a certified fund and pay a higher fee to support its governance efforts. Other investors who wanted nothing more than stable returns could invest in truly passive funds, without fear of paying for costly and potentially harmful voting efforts.

Of course, the primary benefit of this rule would be to diminish the voice of uninformed investors in governance, reducing the risk of market distortion. But by diminishing the voice of passive funds, the rule would also preserve the influence of informed investors by giving each active investor a proportional increase in voting power.[168] Although voting is only a part of the institutional investor's toolkit, the added voting power would improve active fund's efficacy in backroom conversations. It would also enable investors that are motivated to secure the long-term health of the company to determine the success of hedge fund activist campaigns.

ii. Institute Pass-Through Voting for Passive Funds

The second proposal would not eliminate passive voting entirely, but would instead specify that voting power for "non-routine" matters would flow through to the passive fund's investors in a phenomenon known as "pass-through voting."[169]

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[167] The fact that the Big Three have vocally opposed the rising incidence of dual class structures casts some doubt on this claim. They have also participated in lobbying efforts to ban dual class companies from stock exchanges and stock indices, arguing that they are forced to buy nonvoting and low-voting shares because of their indexing strategy, even when they oppose it. *See* Alexandra Scaggs, *Investor Group to Exchanges: Stop Dual Class Listings*, WALL ST. J. (Oct. 11, 2012), *available at*: https://www.wsj.com/articles/SB10000872396390443749204578050431073959840.
But this opposition has come from the leaders of the Big Three, and is consistent with the theory that it is motivated by the institution's desire to retain influence, rather than an optimal strategy for the institution's passive funds.

[168] Corporate insiders would also benefit from an increase in voting power, potentially worsening agency cost problems. But except for the few shareholder proposals that passive funds embrace, the Big Three generally cast votes in favor of management. Therefore, omitting the passive fund vote would more likely decrease management's influence over governance in most cases.

[169] *See, e.g.*, Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 47–52 (1991) (proposing pass-through voting to allow pension fund beneficiaries to determine fund voting policies); Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 IOWA J. CORP. L. 843, 888–89 (2009) (mentioning optional pass-through voting as a potential option to allow mutual fund shareholders to overcome the passivity of their intermediaries).

This would mean that two groups of investors would control the funds' votes: institutions, such as pension funds like CalPERs,[170] as well as retail shareholders. The former group of investors are likely to be relatively sophisticated, engaged, and capable of exercising their vote in an informed manner, especially if they also own shares in the company through other active investments. The latter group of investors would be unlikely to vote because of collective action problems, providing a benefit similar to that of the first proposal—reducing the incidence of uninformed voting.[171]

There is some precedent in the law for pass-through voting: other investment vehicles, such as Employee Stock Ownership Plans, are required to pass through votes to plan participants.[172] In addition, mutual funds already have a voting mechanism in place for their own governance, and so the rule could simply require mutual funds to circulate proxy materials for portfolio companies using the same process.

However, because passively managed funds involve pooled investments, the burden of passing voting authority for hundreds of companies to investors would not only be overwhelming for the fund, but also for investors. Restricting the rule to "non-routine" matters would help reduce this burden. The New York Stock Exchange ("NYSE") provides a blueprint for such a distinction: under NYSE rules, brokers cannot cast discretionary votes for shareholders on non-routine matters, which are defined to include director elections, proposals to declassify the board of directors, proposals to eliminate supermajority voting requirements, and proposals enacting certain types of anti-takeover provision overrides.[173] Similarly, a pass-through voting rule could mandate that votes for non-routine matters would pass through to investors.

This version of the rule would have another benefit. Because the passive fund would also be likely to pass implementation costs on to investors, this rule would make passively managed funds slightly more expensive, and thus, slightly less appealing relative to actively managed funds. In this way, the rule could somewhat ameliorate the free rider problem and staunch the flow of assets from active to passive funds.

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[170] *See* Ananth N. Madhavan, EXCHANGE-TRADED FUNDS AND THE NEW DYNAMICS OF INVESTING 16 (Oxford U. P. 2016) (noting that 65% of ETF ownership is institutional).

[171] Luis A. Aguilar, *Ensuring the Proxy Process Works for Shareholders*, SEC Public Statement (Feb. 19, 2015), *available at*: https://www.sec.gov/news/statement/021915-psclaa.html (noting that retail shareholder participation in the proxy process has been falling steadily since 2009, with less than a 13% response rate for the period from July 1, 2013 to June 30, 2014).

[172] *See* 26 U.S.C.S. § 409(e)(2).

[173] *See* NYSE Rule 452; NYSE Information Memo 12-4, Application of Rule 452 to Certain Types of Corporate Governance Proxy Proposals, *available at*: http://www.nyse.com/nysenotices/nyse/information-memos/detail;jsessionid=0610BF54CEE27EE065651385975C6C1B?memo_id=12-4.

iii. Institute Pass-Through Voting as a Default

Finally, a rule could provide for pass-through voting on non-routine matters as a default, allowing investors the option of reassigning the proxy back to the fund.[174] The primary benefit of this version of the rule is that it would foster competition and differentiation in governance activity across passive funds. Certain passive funds might invest in monitoring and analysis so as to market themselves as governance experts and attract not just investors, but their votes. Moreover, institutions that house both passive and active funds will be more likely to recognize the value of active fund stewardship if it helps the institution secure greater voting power.

A passive fund could also attract investors and votes by developing governance expertise in a certain area. And although passive funds that invest in governance would likely charge higher fees than truly passive funds, investors who care about good governance would be more likely to tolerate them. If this seems implausible, consider the modest success of social responsibility funds, which attract investors by selecting portfolio companies based on certain criteria, such as a commitment to environmentally friendly practices.[175]

For investors who want nothing more than low-cost diversification, there would be the option to invest in passive funds that also take a passive approach to governance. The investor who chooses such a fund would likely hold on to her vote—default rules tend to be sticky[176]—and abstain from voting. In other words, this rule would ensure the votes that are the least likely to be the product of informed thinking are also the least likely to be cast.

* * *

Any of these simple and low-cost rules would diminish the uninformed voting power of passive funds in governance and thus preserve the voice and influence of active and informed investors. But there are other benefits. By restricting the governance activities of passive funds, these proposed rules would increase the visibility of benefits provided by active funds. In this way, these rules would improve market transparency, enabling investors to distinguish between funds with governance expertise and those that offer nothing more than the opportunity to make low-cost and stable market returns. They would also make it easier for active

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174 The rule would be drafted in such a way as to avoid the possibility that funds would evade it by adding a standard clause to every share purchase agreement that reassigned voting authority back to the fund managers. As an example, the rule could require the active assignment of voting rights by investors.

175 *Does Socially Responsible Investing Make Financial Sense?*, WALL ST. J. (Feb. 28, 2016), http://www.wsj.com/articles/does-socially-responsible-investing-make-financial-sense-1456715888 (discussing the rising popularity of socially responsible investing).

176 *See* Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 4-5 (2006) (describing the "iron law of default inertia").

funds to attract investors who care about governance and make it harder for passive funds to free ride on their investments in stewardship.[177]

At first glance, these rules appear to be an extreme departure from our system of shareholder democracy. Traditionally, shares of common stock include economic rights, as well as a right to vote that is proportional to share ownership. But shareholder democracy is not a political democracy where every person has a constitutional right to vote. Instead, voting rights are generally allocated on a per share basis—in other words, voting power grows with an individual's stake in the company. And for over a century, permissive corporate codes have allowed companies to depart from the one-share-one-vote default and even deprive classes of stock of voting rights.[178]

Nor does the right to vote in a shareholder election further participatory or civic interests. It originated as a protection for the residual claimants and has been justified as efficient because it allocates voting control to those who have the best incentives to use their vote to maximize the firm's value.[179] In other words, voting is instrumental to corporate welfare only, and there is therefore a principled basis for

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177 Restricting the voting power of uninformed and unmotivated shareholders has another important benefit. Delaware courts have increasingly awarded special deference to corporate decisions that are ratified by a majority of disinterested shareholders. For example, in *Corwin v. KKR Financial Holdings,* the Delaware Supreme Court held that transactions subject to enhanced scrutiny under *Revlon* will be reviewed under the business judgment rule if such shareholder approval is granted. 125 A.3d 304 (Del. 2015). This decision was justified, in part, by the fact that public companies are held by sophisticated institutional investors with "an actual economic stake in the outcome." *Id.* But, for the reasons discussed, passive funds lack the incentives to vote intelligently, undermining the rationale that courts should defer to decisions blessed by their votes.

178 State law today generally provides corporations with considerable flexibility with respect to allocations of voting rights: virtually all state corporate codes adopt one vote per common share as the default rule but allow corporations to depart from the norm. *See* Stephen Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights*, UCLA School of Law Research Paper No. 07-16, *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=985707; Del. Code Ann. Tit. 8 § 151 (authorizing a corporation to have different classes of stock with such rights, powers, and preferences as may be set forth in the certificate of incorporation or the board, if the certificate gives the board that power). Many corporations depart from the one-share-one-vote rule by adopting dual class capital structures that are routinely upheld by courts.

In fact, limitations on shareholder voting rights are as old as the corporate form itself. In the mid-1800s, before the adoption of general incorporation statutes, corporate charters granted by legislatures employed varying voting structures. Some embraced a one-share-one-vote rule, while others limited the voting rights of large shareholders, such as by capping the number of votes any one shareholder could cast. *Id.* at 4. By the 1900s, the vast majority of U.S. corporations had established one vote per share as a default rule, leaving corporations free to deviate from the statutory standard. *Id.* at 5. During this time, the current norm of limiting the voting rights of preferred stock became common. *Id.* In addition, companies began to issue non-voting common stock—in the years between 1927 and 1932, at least 288 corporations issued non-voting or limited voting rights shares (which was almost half of the total number of such issuances). *Id.* at 7.

179 *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63, 67 (1991).

depriving uninformed shareholders of the right to vote if doing so would improve firm efficiency.[180]

But how could one of these proposals be enacted into law? The SEC is an obvious candidate because regulation of the proxy process is a core function of the agency. However, the SEC's only effort to regulate substantive voting rights was struck down by the D.C. Circuit in 1988.[181] During the 1980s, as companies began to recognize the power of dual class stock schemes to defend against hostile takeover bids, the SEC responded by adopting Rule 19c-4, which effectively prohibited public companies from issuing securities or taking other corporate action nullifying, restricting, or disparately reducing the voting rights of existing shareholders.[182] It did this by adding a new rule to the listing standard of each national securities exchange and securities association.[183]

The SEC had argued that it had the authority to adopt the rule based on Securities Exchange Act § 19(c), which permits it to amend exchange rules provided that the action furthers the Act's purposes. The agency contended that § 14(a) of the Act embodied the purpose of protecting shareholder democracy. The D.C. Circuit disagreed, ruling that § 14(a) did not give the SEC power to regulate substantive aspects of shareholder voting, but only to regulate the procedures by which proxy solicitations are conducted, as well as proxy voting disclosure.[184]

The Supreme Court did not review that decision, but the Court had previously made clear that it views the substance of corporate voting rights as solely being a matter of state concern. In *CTS Corp. v. Dynamics Corp.*, the Court explained, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[185] Accordingly, without a clear expression of congressional intent, it is unlikely that the Supreme Court would uphold a federal agency's enactment of a law governing the substance of shareholder voting rights.

But the Securities Exchange Act's preference for shareholder democracy is intended to protect against the "control of great corporations by a very few persons."[186] When the equal allocation of corporate voting rights has the potential to

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180 Others have made similar arguments in the context of judicial elections, where the large majority of voters are uninformed and incentivizing them to master technical issues of governance arguably results in an inefficient division of labor. *See* Richard A. Posner, *Judicial Autonomy in a Political Environment*, 38 ARIZ. ST. L.J. 1, 5 (2006); Dmitry Bam, *Voter Ignorance and Judicial Elections*, 102 Kentucky L. J. 553 (2013); Charles Gardner Geyh, *Why Judicial Elections Stink*, 64 OHIO ST. L.J. 43, 52 (2003).
181 *See Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).
182 Bainbridge, *SEC Authority*, *supra* note 178, at 8.
183 *Id.* at 9 n.25.
184 *Bus. Roundtable v. SEC*, 905 at 408.
185 481 U.S. 69, 89 (1987); *see also Green v. Santa Fe Indus.*, 430 U.S. 462, 477-80 (1977) (clarifying that internal corporate affairs are for the states to govern).
186 *SEC v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948) (discussing the reasons behind the enactment of Section 14(a) of the Securities Exchange Act).

empower a small number of institutions and risk market distortions and wide-scale economic harm, it may be appropriate for the federal government to step in. And federal intervention is likely the only option: corporations would be unlikely to voluntarily amend their certificates of incorporation to restrict the majority of their shareholders from voting, and states could not be counted on to require such a restriction that might cause large institutional investors to flee to other states.

B. The Difficulty of Incentivizing Beneficial Investment in Governance

Thus far, in considering how to address the agency cost problem, regulators and scholars have proposed reforms aimed at incentivizing large institutional investors to be responsible stewards of their investments. For example, the SEC justified rules imposing proxy voting disclosure obligations on mutual funds on the ground that such rules would "encourage funds to become more engaged in corporate governance of issuers held in their portfolios."[187] These rules have not had this intended effect—instead, it appears that disclosure obligations have merely increased pressure on mutual funds to vote all shares, an enormous task that makes it difficult, if not impossible, to cast an informed vote in all cases.[188] The rules also failed to address the collective action problem that discourages mutual funds from investing in governance. Thus, any future reform aimed at encouraging institutional investor engagement would need to tackle this incentive problem head on.

One possible reform could be modeled after the derivative suit, the traditional corporate tool used to combat agency problems within a corporation. The derivative suit was intended to reduce conflicts between managers and shareholders by allowing shareholders to pursue claims on the behalf of the corporation.[189] The classic case is an action for a breach of fiduciary duty against corporate directors: the directors cannot be expected to cause the corporation to sue themselves, and so the derivative action allows the shareholders to take over the litigation and prosecute on behalf of the corporation. If the suit confers benefits to the corporation and its shareholders, the shareholder plaintiff can recover attorneys' fees and expenses from the corporation,[190] which reduces the problem of other shareholders free riding off of the efforts of the shareholder plaintiff.[191]

Like the shareholder who brings a beneficial derivative suit, a fund that invests in governance at a portfolio company secures a benefit that all shareholders desire but

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[187] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Release Nos. 33-8188, 34-47304, IC-25922, 2003 SEC Lexis 3143 (2003).

[188] *See* Strine, *Can We Do Better*?, *supra* note 5, at 483-90 (noting that "the present system involves too many votes for the institutional investor community to address thoughtfully and creates a rational basis to suspect that even proxy advisory firms cannot afford to employ enough qualified analysts to provide a genuinely studied recommendation on every vote").

[189] *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 10 (1991).

[190] Ralph C. Ferrara, Kevin T. Abikoff, & Laura Leedy Gansler, SHAREHOLDER DERIVATIVE LITIGATION: BESEIGING THE BOARD SECTION 14.06, *Attorneys' Fees and Incentive Awards* (2005).

[191] FRANK EASTERBROOK AND DANIEL FISCHEL, HANDBOOK OF LAW AND ECONOMICS 897 n.192 (2007).

are not willing to pay for. Therefore, a rule providing expense reimbursement for shareholders who intervene in governance and secure a benefit would make stewardship more appealing for institutional investors.

Currently, our regulatory system does the opposite—regulators penalize actively managed funds that invest in monitoring and governance by scrutinizing management fees. These policies are well-intentioned, as there is ample evidence of funds levying inappropriately high fees to take advantage of uninformed investors.[192] But scrutinizing fees is a blunt tool for policing abuse, and a rule that would allow a governance intervenor to recoup expenses associated with a beneficial intervention would reduce the risk of unintended consequences caused by regulatory scrutiny. It would also improve the competitiveness of funds with governance expertise and thus staunch the flow of assets out of those funds.

Such a rule could define a reimbursable governance intervention to be an action that results in a policy change that substantially benefits the company. The benefit could be demonstrated by a sustained (at least a year) boost in stock price following the intervention. The intervenor would receive costs associated with that intervention, limited to research costs incurred no more than one month prior to the intervention, as well as the costs of meeting with management, voting, or waging a proxy contest. Those costs could not exceed the benefit to the corporation.

Although this rule would incentivize governance interventions, it would do so at a lower than optimal level. This is because a fund would only be able to recoup a fraction of the costs, because interventions generally require sustained, firm-specific monitoring and the development of governance expertise over many years. Relatedly, it would be difficult to quantify the costs and the long-term benefit of the intervention, and therefore the rule would likely generate expensive litigation.

One might suppose that awarding a portion of the benefit from the intervention, rather than the cost, would address some of these concerns. As an example, the SEC's whistleblower program provides a monetary reward for "high-quality original information that leads to [an] enforcement action in which over $1,000,000 in sanctions is ordered."[193] The range for the award is 10% and 30% of the money collected.[194] If a shareholder (or group of shareholders) were able to recoup even 10% of the benefit of any governance intervention, this would greatly improve incentives to invest in stewardship.

But there are reasons why the law generally avoids benefit-based liability: it is very difficult to quantify the benefit, as well as determine causation. The latter determination would be particularly challenging in this context, where an activist investor may influence management by targeting a firm in the same industry, or

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192 *See* WILLIAM BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW (OUP 2016).
193 SEC Office of the Whistleblower, *available at*: https://www.sec.gov/whistleblower/.
194 *Id.*

making a threat to intervene.[195] In addition, the statutory definition of "benefit" would likely influence the type of intervention that is chosen, again risking governance distortions. Therefore, a rule incentivizing investors to be engaged owners would likely result in more costs than benefits.[196]

V. CONCLUSION

In the past twenty years, the market for corporate influence has become an important force for managerial discipline. Yet, the rise of passive investing has the potential to dampen and distort this market, increasing agency costs and harming shareholder welfare. Although the amount of assets invested in actively managed funds is currently ameliorating the risk of distortion, the rapid influx of assets into passive funds may soon overwhelm this temporary balance. Lawmakers, therefore, should consider whether legal intervention is warranted.

At this time, it appears that a rule restricting passive funds from voting would offer the most benefits and generate the fewest costs. Although voting is just one tool used by institutional investors to influence management, the rise of passive investing will make it even more important. Active fund analysts are the primary drivers of meetings with management and the board; as their number decreases, institutional investor engagement will become less frequent and less effective. Accordingly, fewer battles will be settled in a back room conversations, as many are now, and a greater number will be resolved in expensive proxy battles.

By restricting passive funds from voting, the law would reduce the risk of governance distortion created by the rise of passive investing. It would also preserve

[195] An example from civil rights law exemplifies some of the difficulties associated with determining causation. For years, courts have struggled to interpret fee-shifting provisions in the Fair Housing Amendments Act and the Americans with Disabilities Act, which permit a court to award reasonable attorney's fees to the "prevailing party." In 2001, the Supreme Court held that the predominating approach—examining whether the plaintiff was the "catalyst" for the result—was improper. *See Buckhannon Bd. And Care Home, Inc. v. West Virginia Dept. of Health and Human Resources*, 532 U.S. 598 (2001). Instead, a court could only shift fees if the plaintiff secured a judgment on the merits or in a court-ordered consent decree. *Id.* In so holding, the Court emphasized the difficulty of determining the defendant's subjective motivation in changing its conduct—the catalyst approach was "clearly not a formula for 'ready administrability.'" *Id.* at 609. A law allowing a plaintiff to recover a portion of the benefit from a governance intervention would create similar administrative difficulties.

[196] Another possible solution would be to regulate the proxy advisors that offer advice to passive funds. In fact, Congress is considering whether to mandate greater regulatory oversight of proxy advisors, proposing to require them to: register with the SEC; employ an ombudsman to receive complaints about voting information accuracy; disclose potential conflicts of interest; disclose procedures and methodologies for formulating proxy recommendations and analyses; and essentially provide companies with an opportunity to review and comment on a proposed recommendation by a proxy advisory firm before the recommendation is provided to investors. *See* Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016). But this regulation would significantly increase the costs of third party proxy advisory services without addressing the real problem: that third party proxy advisors lack any financial incentive in the outcome of their recommendations. And it would be difficult for Congress to craft a rule that would lessen that problem.

the voice of informed investors as a force for discipline and a safeguard against agency problems created by the separation of ownership and control.