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Passive Investors

Jill Fisch

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June 4, 2018

“If index funds underperform active funds, then assets will flow out from passives to actives.”
== Bill Ackman, CEO, Pershing Square International¹

Abstract

The increasing percentage of the modern capital markets owned by passive investors – index funds and ETFs – has received extensive media and academic attention. This growing ownership concentration as well as the potential power of passive investors to affect both corporate governance and operational decision-making at their portfolio firms has led some commentators to call for passive investors to be subject to increased regulation and even disenfranchisement. These reactions fail to account for the institutional structure of passive investors and the market context in which they operate. Specifically, this literature assumes that passive investors compete primarily on cost and that, as a result, they lack incentives to engage meaningfully with their portfolio companies.

We respond to this failure by providing the first theoretical framework for passive investment and its implications for corporate governance. Our key insight is that although index funds are locked into their investments, their investors are not. Like all mutual fund shareholders, investors in index funds can exit at any time by selling their shares and receiving the net asset value of their ownership interest. This exit option causes mutual funds – active and passive – to compete for investors both on price and performance. While the conventional view focuses on the competition between passive funds tracking the same index, our analysis suggests that passive funds also compete against active funds. Passive fund sponsors therefore have an incentive to take measures to neutralize the comparative advantage enjoyed by active funds, that is, their ability to use their investment discretion to generate alpha. Because they cannot compete

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¹ Email from Steve Fraidin, General Counsel Pershing Square Capital to Steven Davidoff Solomon dated May 30, 2018.

by exiting underperforming companies, passive investors must compete by using “voice” to prevent asset outflow.

We show that passive investors behave in accordance with this theory – their engagement with portfolio firms continues to grow, and they are devoting increasing resources to that engagement. Passive investors also exploit their comparative advantages – their size, breadth of portfolio and resulting economies of scale -- to focus on improving corporate governance, efforts that reduce the underperformance and mispricing of portfolio companies. Passive investors thus seek to reduce the relative advantage that active funds gain through their ability to trade.

We conclude by exploring the overall implications of the rise of passive investment. Significantly, although existing critiques of passive investors are unfounded, the rise of passive investing has the potential to raise concerns about ownership concentration, conflicts of interest and corporate law’s traditional deference to shareholders.

Introduction

Passive investors are the new power brokers of modern capital markets.² An increasing number of retail investors are investing through exchange traded funds (ETFs) and indexed mutual funds (collectively, index funds or passive funds), driven by the lower costs of these products as well as the literature reporting that even savvy money managers cannot consistently beat the market.³ This shift has concentrated a growing portion of the public capital markets in the hands of the sponsors that operate these index funds, particularly the so-called big three of Blackrock, Vanguard and State Street.⁴ Although the extent to which index funds will continue to grow remains unclear, some estimates predict that by 2024 they will hold over 50% of the market.⁵

² Although a variety of rules-based investment strategies might be termed “passive”, such as algorithmic trading, we focus in this article on traditional passive investors - index funds and ETFs. *See, e.g.,* Andrew W. Lo, *What is an Index*, (Oct. 12, 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2672755 (describing the breadth of investment strategies that could be termed index investing and arguing that the critical characteristics of an index are that it be transparent, investible and systematic).

³ The popular press makes a broad claim that actively-managed funds systematically underperform index funds and their market benchmarks. *See, e.g.,* Mark Hulbert, *This is how many fund managers actually beat index funds*, MARKETWATCH, (reporting that “Over the last 15 years, 92.2% of large-cap funds lagged a simple S&P 500 index fund.”), available at <https://www.marketwatch.com/story/why-way-fewer-actively-managed-funds-beat-the-sp-than-we-thought-2017-04-24>. The story in the finance literature is more complex. *See infra* notes __ through __ and accompanying text. *See also* Diane Del Guercio & Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, 69 J. FIN. 1673 (2014) (finding “strong support . . . that actively managed funds earn the same after-fee alphas as index funds” within the “direct sold segment” of the mutual fund market).

⁴ *See, e.g.,* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUQ. & POL. 238, 304 (2017) (explaining that BlackRock, Vanguard and State Street dominate the passive fund industry and terming them the “big three”).

⁵ *See* Trevor Hunnicutt, *Index funds to surpass active fund assets in U.S. by 2024: Moody's*, REUTER, Feb. 2, 2017, available at <https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN>.

A number of commentators have expressed concern, even alarm, over the growth of passive investors and its implications for capital market efficiency and corporate governance.⁶ The literature to date, however, ignores the institutional structure of passive funds and the market context in which they operate. As a result, it fails accurately to reflect the incentives of passive investors. Moreover, the literature has failed to assess the overall implications of the rise of passive investment for corporate law and governance.

We respond to that deficit. In this Article, we provide the first theoretical framework for passive investment and use this framework to explore the role of passive funds in corporate governance. We then explore the role that index funds play within the structure of the mutual fund market. Against this background, we consider the overall implications of the rise of passive investment.

Prior criticism has focused on two key attributes of passive funds. First, passive funds, by virtue of their investment strategy, are locked into the portfolio companies they hold. They cannot increase their investment in underpriced companies or follow the Wall Street rule and exit from underperforming companies the way traditional shareholders, particularly active funds, can.⁷ Second, passive funds compete against other passive funds primarily on cost.⁸ As a result, critics argue that passive investors will be unwilling to incur the costs of firm-specific research and monitoring of their portfolio companies.⁹

We challenge this portrayal of the passive investor business model as incomplete and offer a more nuanced approach. Our key insight is that although index funds are locked into their investments, the shareholders who invest in these funds are not. Like all mutual fund shareholders, investors in index funds can exit at any time by selling their shares and, when they do so, they receive the net asset value of their ownership interest.¹⁰ As a result of this exit option,

⁶ See, e.g., Dorothy Lund Shapiro, *The Case Against Passive Shareholder Voting*, __ J. CORP. L. __ (forthcoming 2018) (arguing that passive investors lack adequate incentives to become informed and should therefore not be able to vote their shares); Shawn Langlois, *Robert Shiller: Passive investing is a 'pseudoscience' and it's bad for markets*, MARKETWATCH, NOV. 15, 2017, available at <https://www.marketwatch.com/story/robert-shiller-passive-investing-is-a-pseudoscience-and-its-bad-for-markets-2017-11-14> (citing interview in which Nobel prize-winning economist Robert Shiller describes indexing as a “chaotic system” that’s taking a toll on the business landscape across the United States.”). See also Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, ANTITRUST L. J. (forthcoming 2017) (arguing that ownership concentration by the largest passive investors will undermine product market competition); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, __ YALE L.J. __ (forthcoming 2018), <https://ssrn.com/abstract=3046203> (same).

⁷ See Anat R. Admati & Paul Pfleiderer, *The “Wall Street Walk” and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2445 (2009) (explaining how shareholders can respond to poor performance through exit).

⁸ The literature notes that passive funds also compete on tracking quality. See, e.g., Ari Weinberg, *Watch an Index Fund's 'Tracking Error'*, WALL ST. J., Jul. 9, 2012 (explaining tracking error and how it can vary among index funds).

⁹ See, e.g., Lund, *supra* note 6; Lucian A. Bebchuk, Alma Cohen and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERS. 89, 90 (2017) (arguing that “index funds have especially poor incentives to engage in stewardship activities that could improve governance and increase value.”).

¹⁰ See, e.g., John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 89 (2010) (explaining the mutual fund shareholders can exit at net asset value, which is not affected by expected returns).

mutual funds compete for investors. Moreover, there is no reason to believe that index funds compete for investors only against other index funds tracking the same index. Rather, index funds compete, on an ongoing basis, both with other passive (i.e. index) funds and with actively-managed funds.¹¹ This competition is not based solely on cost. The market for mutual funds demonstrates that mutual fund inflows are based on fund performance meaning that passive investors risk losing assets if the performance of passive funds lags that of actively-managed funds on a cost-adjusted basis.¹²

In addition, the existing literature analyzes the behavior and incentives of passive investors at the level of the individual mutual fund. This approach is misguided. A mutual fund is simply a pool of assets.¹³ The decisions of the mutual fund are made by third parties that contract with the fund – the fund’s sponsor and investment adviser.¹⁴ The incentives of those third parties drive fund behavior. We use the term passive investors to describe the third parties who make these decisions on behalf of index funds, rather than the index funds themselves. Most significantly, the business model of the fund sponsor involves maximizing the revenue from the menu of funds it offers, and that revenue, in turn, is a product of both assets under management and fund fees.

Understanding the business model of passive investors leads to a comprehensive theory of their incentives and behavior, a theory that we set forth in Part I. We first show that the competition between active and passive funds gives passive funds an incentive to engage in stewardship. Active funds compete based on their ability to generate alpha through the use of their investment discretion – choosing particular securities to under- and over-weight relative to their benchmark on the basis of firm-specific information. This enables active managers to generate inflows of investor funds based on their ability to generate alpha.¹⁵ If active managers can generate substantial alpha on a cost-adjusted basis, fund investors will exit index funds in favor of actively-managed alternatives. Passive investors can reduce the comparative advantage of active funds by monitoring their portfolio companies and exercising their governance rights to promote firm value. Passive investors must do this by relying on voice, rather than exit.¹⁶ Importantly, because passive investors hold the market, their monitoring need not be firm-

¹¹ For evidence that active funds compete with passive ones, *see generally* Martijn Cremers et al., *Indexing and Active Fund Management: International Evidence*, 120 J. FIN. ECON. 539 (2016).

¹² *See, e.g.*, Susan E.K. Christoffersen, David K. Musto & Russ Wermers, *Investor Flows to Asset Managers: Causes and Consequences*, 6 ANN. REV. FIN. ECON. 289 (2014) (reviewing empirical literature on the factors that influence the flow of funds into and out of mutual funds).

¹³ *See* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1968 (2010).

¹⁴ *Id.*

¹⁵ *See, e.g.*, Del Guercio & Reuter, *supra* note 3 (demonstrating that active funds expend resources to generate alpha in circumstances in which investor inflows are responsive to alpha).

¹⁶ Institutional investors are well aware of this limitation and note it frequently in communications with investors and firms. *See, e.g.*, Lawrence D. Fink, Larry Fink’s Annual Letter to CEO’s A Sense of Purpose, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> (“In managing our index funds, however, BlackRock cannot express its disapproval by selling the company’s securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever.”)

specific. Instead, passive investors can exploit economies of scale to improve governance across their portfolios.

This theory is borne out in reality. In Part II, we document the emerging engagement by passive funds and their increasing influence with respect to individual and general firm governance. We show that passive investors have responded to the incentives to identify governance weaknesses that contribute to underperformance and to seek to reduce governance risk. We also document how passive investors coordinating with and mediating the efforts of shareholder activists. We cite the evidence, albeit preliminary, from a number of empirical studies that the effect of this behavior has been to improve both firm governance and performance.¹⁷

In Part III, we consider the implications of our theory for firm governance. Specifically, we show that, although proposals to disenfranchise passive investors due to governance concerns appear to be misguided, the rise of passive investors raises other potential concerns. We delineate those concerns and the potential regulatory issues they raise. We also discuss the issue of potential conflicts within fund families and highlight this area as one that warrants continued monitoring.

Before we begin, two caveats. First, our analysis is a comparative one. We do not argue that passive investors have perfect incentives to engage in stewardship. Passive funds, like all institutional investors face inevitable collective action problems that limit their incentives to engage in stewardship.¹⁸ The rise of passive investment has focused attention on the specific question of whether the stewardship incentives of active fund managers are superior to those of passive fund managers.¹⁹ Thus, we address this comparative question rather than traversing the well-trod general topic of the participation of institutional investors in corporate governance. In particular, we do not address the generic concern that mutual funds, as a whole, will prefer to free-ride off the actions of other investors, such as activists.²⁰

¹⁷ See, e.g., Ian Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism* (Feb. 2, 2018), available at SSRN: <https://ssrn.com/abstract=2693145> (finding that higher passive ownership is associated with more vigorous hedge fund activism in seeking director positions, proxy fights, settlements and the sale of the firm); Ian Appel, Todd A. Gormley & Donald B. Keim, *Passive investors, not passive owners*, 121 J. FIN. ECON. 111 (2016) (finding that the presence of increased ownership by passive investors results in more independent directors, removal of takeover defenses, and more equal voting rights as well as better long-term performance); Andrew Bird & Stephen Karolyi, *Do institutional investors demand public disclosure?*, 29 REV. O. FIN. STUD. 3245 (2016) (finding that increased ownership by passive investors “significantly increases the information content of 8-K filings”); Audra Boone and Joshua T. White, *The effect of institutional ownership on firm transparency and information production*, 117 J. FIN. ECON. 508 (2015) (finding that increased passive ownership is associated with “greater management disclosure, analyst following, and liquidity, resulting in lower information asymmetry”).

¹⁸ We also do not address the comparative question of institutional versus retail investors. Cf. Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 15 (2017) (observing that retail investors may have different governance preferences than institutional investors and, as a result, vote their shares differently).

¹⁹ See Lund, *supra* note **Error! Bookmark not defined.** (arguing that active funds have better incentives to monitor and that, as a result, passive funds should not be allowed to vote the shares of their portfolio companies).

²⁰ See, e.g., Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021 (2007) (observing that gains from a fund’s effort to improve a company’s performance will be

Second, we are not making a normative claim about the quality of specific institutional investors' governance preferences or their effect on firm value.²¹ Our claim is simply that passive investors have stewardship incentives that are as strong or arguably superior to those of active funds.²² The evidence to date suggests that passive investors provide economic value on the whole, and our framework provides institutional and theoretical support for these conclusions. Our results are therefore best viewed as foundational, paving the way for further research in this area as well as guiding early policy makers.

I. A Theory of Passive Investor Incentives

In this Part, we offer a comprehensive theory of the incentives of passive investors, informed by the institutional context in which they operate. In Section A, we provide critical background on the institutional context, a context that has been largely ignored by existing academic research. In Section B, we explain that passive funds compete for investors both against other passive funds and against active funds and that this competition is not based exclusively on an effort to minimize fees. In Section C, we show that competition among funds incentivizes passive investors to take measures to improve the performance of under-performing companies in their portfolio. In Section D, we analyze how these incentives lead passive investors to invest in governance and stewardship.

A. *The Institutional Context of Passive Funds*

A mutual fund or ETF²³ is simply a pool of liquid assets – assets that may include, stocks, bonds, cash and other types of investments.²⁴ The value of the mutual fund, commonly described as net asset value or NAV, is the value of the assets owned by the fund.²⁵ Mutual

shared by all the company's shareholders). Nor do we consider the relative incentives of mutual funds versus activists to influence corporate decision-making in ways that maximize firm value.

²¹ A range of empirical literature continues to debate the effect of particular governance practices to which institutional investors have objected, such as dual class stock and staggered boards, on firm value. *See, e.g.*, Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling The Staggered Board Debate*, U. PENN. L. REV. (Forthcoming 2018) (reviewing the empirical literature on the relationship between staggered boards and firm value); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 603 n. 60 (2017) (summarizing empirical literature on dual class stock).

²² We further note that the line between active and passive funds is not clear in that many funds that claim to be actively-managed closely resemble less expensive index funds. *See, e.g.*, Owen Walker, *Closet tracker funds face tougher regulatory scrutiny*, FIN. TIMES, Apr. 8, 2018 (reporting “a global crackdown on so-called closet trackers”). For a methodology of evaluating the extent to which a mutual fund is actively managed, *see* K. J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009) (developing “Active Share”, a measure of active fund management).

²³ Technically, both mutual funds and ETFs are investment companies. *See* Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1, 12 (2016) (explaining that “[t]he term 'mutual fund' is a market term" as is the term 'ETF.'”).

²⁴ *See* Fisch, *supra* note 13, at 1968.

²⁵ *See* Jill Fisch & Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?*, 2012 U. ILL. L. REV. 1003, 1008 (explaining the calculation of NAV).

funds themselves have no independent operations or employees, and the operational decisions of the fund are made by external service providers.²⁶ Funds themselves do not make money – the fees that they collect go, in part, to pay for services such as investment advice and administrative support, with the remainder going to the fund sponsor.²⁷ The mutual fund sponsor is the company, typically a financial services company,²⁸ that establishes and sells mutual fund shares. It is important to distinguish the interests from the fund itself from those of the fund sponsor.²⁹ Sponsors, with the exception of Vanguard,³⁰ are typically public companies such as BlackRock³¹ or private companies, such as Fidelity.³² In either case, the net fees generated by funds generate a profit for the sponsor’s shareholders. The goal of the sponsor is to maximize this profit.

Funds charge their investors an annual fee or expense ratio which is calculated as a percentage of the assets that a particular fund manages – assets under management.³³ Expense ratios vary substantially within the industry and even within a single mutual fund sponsor. As a result, a small fund that charges a higher fee may be more profitable to a sponsor than a fund with a very low fee and more assets under management. The offerings of fund sponsors differ substantially but typically include a mixture of passive and active funds.³⁴ Some sponsors such

²⁶ See Fisch, *supra* note 13, at 1968.

²⁷ Shares in the mutual fund are offered by fund sponsors, which offer investors a menu of different types of funds. See generally SEC, *Mutual Funds*, Dec. 14, 2010, available at <https://www.sec.gov/fast-answers/answersmutfundhtm.html> (explaining that shares in a mutual fund are offered by fund sponsors, which offer investors a menu of different types of funds). See also John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 OKLA. L. REV. 83, 84-85 (2008) (explaining that “[w]hile fund advisers or their affiliates typically derive revenue from distributing the fund’s shares or performing other administrative services (such as serving as the fund’s transfer agent), advisory income from portfolio management is the fund adviser’s profit center.”).

²⁸ Most fund sponsors are independent fund advisers, but mutual funds are also sold by banks, insurance companies and brokerage firms. See INVESTMENT COMPANY INSTITUTE, 2016 ICI FACTBOOK, at 15.

²⁹ See, e.g., John Morley, *Too Big to be Activist*, working paper (2018) (noting that it is “easy to conflate Fidelity with its various clients, but we must nevertheless keep them conceptually distinct”).

³⁰ Vanguard is a special case. The Vanguard Group, the fund sponsor, is owned by its mutual funds, and the sponsor therefore provides services to the funds at cost. See Vanguard, *Why Ownership Matters*, available at <https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters/> (describing Vanguard’s ownership structure).

³¹ See BlackRock, *Our History*, available at <https://www.blackrock.com/corporate/about-us/blackrock-history> (explaining that BlackRock became a public company in 1999 and that its shares are listed on the New York Stock Exchange).

³² See Tim McLaughlin, *How the owners of Fidelity get richer at everyday investors’ expense*, REUTERS, Oct. 5, 2016, <https://www.reuters.com/investigates/special-report/usa-fidelity-family/> (explaining that “Fidelity Investments is owned by privately held FMR LLC, which is controlled by the Johnson family.”).

³³ Some funds also charge other types of fees such as loads and 12b-1 fees. See Fisch, *supra* note 13 at 1961 (discussing loads and 12b-1 fees). This article focuses on the expense ratio which reflects the ongoing cost to investors and the ongoing revenue to fund sponsors.

³⁴ Sponsors vary tremendously. Some sponsors limit their business to mutual funds, some engage in a broader range of asset management activities, and others engage in other activities that may include banking, investment banking and more. For example, both Goldman Sachs and Deutsche Bank offer ETFs. See Asjlynn Loder, *Goldman’s \$3 Billion Drop in the ETF Bucket*, WALL ST. J., Mar. 2, 2017, <https://www.wsj.com/articles/goldmans-3-billion-drop-in-the-etf-bucket-1488483434>; Asjlynn Loder, *ETFs Provide Some Good News at Deutsche Bank*, WALL ST. J., Feb. 27, 2017, <https://www.wsj.com/articles/etfs-provide-some-good-news-at-deutsche-bank-1488191402>. See also

as Vanguard specialize in passively-managed funds;³⁵ others, such as Fidelity³⁶ and T. Rowe Price, focus more on active management.³⁷

Consequently, the role of passive funds and their economic significance within a sponsor's overall business model vary. To understand a fund sponsor's incentives, it is critical to understand the relative role of passive funds and active funds in generating revenues for any particular fund sponsor. Some sponsors focus on passive funds and compete largely on cost. Vanguard's business model, for example, is driven by an effort to be the low-cost leader overall, and Vanguard advertises the fact that its average fund expense ratio is well below the industry average.³⁸ In contrast, fund sponsors that charge higher fees can generate substantial revenues even if they attract a far smaller volume of assets. BlackRock, which is currently the largest global asset manager with almost \$6 trillion in assets under management, for example, manages three quarters of that money in passive funds.³⁹ Yet the fees generated by BlackRock's actively-managed products are roughly equivalent to those generated by its much larger passive funds.⁴⁰ In addition, a sponsor may adjust the mixture of funds that it offers in response to business conditions or market developments. For example, State Street, which is known for its indexing, recently announced that current market conditions may favor shifting assets to actively-managed

Morley, *supra* note 29 (observing that some fund sponsors generate substantial revenue from offering hedge funds, providing running separately managed accounts, and administering 401(k) plans).

³⁵ Even Vanguard, which is typically considered a pure passive investor, offers a mix of active and passive funds. For example, as of March 2018, Vanguard offered 129 mutual funds, of which, according to its website, 67 were actively-managed funds. See *Vanguard Mutual Funds*, <https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns>. Active assets account for approximately 30% of Vanguard's total assets under management, with a dollar value of more than \$1 trillion. See Vanguard, *Vanguard believes in active management*, <https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvComActiveMgmtInfoGraphic>

³⁶ Fidelity offers investors over 200 mutual funds of which 22 are index funds. Fidelity, *Why Fidelity Funds?*, available at <https://www.fidelity.com/mutual-funds/why-fidelity-funds>. Fidelity's index funds include domestic and international equity funds, bond funds, and a real estate fund. *Id.* Fidelity customers are shifting an increasing percentage of their assets to the index funds. Tirthankar Chakraborty, *Vanguard vs Fidelity: Fee War Heats Up*, NASDAQ, Aug. 25, 2017, <https://www.nasdaq.com/article/vanguard-vs-fidelity-fee-war-heats-up-cm837199>

³⁷ See T. Rowe Price, *Time-tested and disciplined. The T. Rowe Price approach to active management*, available at <https://corporate.troweprice.com/ccw/jsp/pages/active-management/investment-approach.jsp> (describing T. Rowe Price's "commitment to active management"). Even T. Rowe Price, however, offers several index funds. See, e.g., T. Rowe Price, *Mutual Fund Research Tool*, available at <https://www3.troweprice.com/fb2/mfpathways/pathways.etc?facets=domesticStock,intStock> (describing T. Rowe Price Equity Index 500 Fund).

³⁸ See Vanguard, *Why Ownership Matters*, available at <https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters/> (noting that Vanguard's average asset-weighted expense ratio in 2016 was .12% and that the industry average was .62%). See also Owen Walker, *Vanguard's Campaign to Drive Down Fees Runs Out of Road*, FIN. TIMES, March 17, 2018 (noting that Vanguard "has led the way in cutting fees over the past decade").

³⁹ Chris Flood, *BlackRock's rivers of gold from active management*, FIN. TIMES, Oct. 14, 2017, <https://www.ft.com/content/f62ed0c2-ada1-11e7-beba-5521c713abf4>.

⁴⁰ See *id.* (reporting that BlackRock's active funds generated \$1.32 billion in the third quarter of 2017 and that its passive funds generated \$1.33 billion).

funds.⁴¹ For a given family then, the business model involves both navigating the potential loss of assets to other fund families and maximizing the potential revenue from existing customers.⁴²

These business decisions are made in the context of a highly competitive market.⁴³ As of the end of 2016, there were approximately 850 fund sponsors.⁴⁴ These sponsors compete to offer over 9,500 different mutual funds to investors.⁴⁵ The asset class of passive funds itself demonstrates substantial variation.⁴⁶ Although the term passive fund typically evokes an S&P 500 index fund, the universe of market indexes has exploded to the point where there are now more indexes than publicly-traded U.S. stocks.⁴⁷ The new indexes often provide a way of converting what has traditionally been active investment strategy into a rule-based approach, using custom criteria such as high dividends or low volatility.⁴⁸ These strategies have been termed “smart beta” strategies.⁴⁹ Although the costs of smart beta and other more sophisticated passive funds are lower than those of traditional active funds, they are substantially higher than S&P 500 index funds.⁵⁰ There are also funds which contain passive components but allow for a

⁴¹ See Bailey McCann, *Surprising Cry from an Index Firm: 'Go Active,'* WALL ST. J., Apr. 8, 2018.

⁴² For some fund complexes, a cheap index fund can be a loss leader designed to get investors to bring their entire portfolio to the fund family with the goal of attracting investment in the complex's other more-costly fund options. See, e.g., Ben Johnson, *Penny-Pinching Index Fund Investors May Pay a Price*, Morningstar, Apr. 14, 2017, <http://www.morningstar.com/articles/802512/pennypinching-index-fund-investors-may-pay-a-price.html> (“In many settings, these low-cost building blocks are simply loss leaders, a cheap gallon of milk meant to entice consumers into the store in hopes that they’ll grab some Cheetos and a pack of gum before they get to the counter.”). Moreover, a sponsor reputation in one segment of the mutual fund business, like passive investing, can attract investors to other segment, See, e.g., Clemens Sialm & T. Mandy Tham, *Spillover Effects in Mutual Fund Companies*, 62 MANAGEMENT SCIENCE, 1472 (2016) (finding that mutual fund flows increase with the stock price performance of the (publicly-traded) fund sponsor); David P. Brown & Youchang Wu, *Mutual Fund Flows and Cross-Fund Learning within Families*, 71 J. Fin. 383, 385 (2016) (finding that flows to a member fund respond positively on average to family performance),

⁴³ See generally John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151, 153 (2007) (“review[ing] the structure, performance and dynamics of the mutual fund industry, and show[ing that] they are consistent with competition”)

⁴⁴ *Id.* at 16.

⁴⁵ At the end of 2016, there were 9,511 mutual funds in the U.S. See *Number of mutual funds in the United States from 1997 to 2016*, Statista, <https://www.statista.com/statistics/255590/number-of-mutual-fund-companies-in-the-united-states/>

⁴⁶ Recently, for example, the NYSE listed for trading the NYSE Pickens Oil Response ETF, an ETF that “reflects the investment philosophy of legendary oilman and energy investor T. Boone Pickens,” but is nonetheless classified as an index fund. See, e.g., Tom DiChristopher, *Legendary oilman T. Boone Pickens inspires new ETF with the 'BOON' fund*, CNBC, Feb. 28, 2018, available at <https://www.cnbc.com/2018/02/28/legendary-oilman-t-boone-pickens-inspires-new-etf-with-the-boon-fund.html>.

⁴⁷ See, e.g., *There Are Now More Indexes Than Stocks*, BLOOMBERG NEWS, May 12, 2017 <https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks> (documenting that, as of May 2017, there were almost 5000 stock indexes).

⁴⁸ See, e.g. Jason Stoneberg & Bradley Smith, *Getting smart about beta*, Invesco white paper, <https://www.invesco.com/static/us/financial-professional/contentdetail?contentId=634ff6163339f410VgnVCM100000c2f1bf0aRCRD> (describing smart beta strategies and evidence suggesting they outperform traditional indexing).

⁴⁹ See *There are Now More Indexes*, *supra* note 47.

⁵⁰ *Id.*

measure of active investing.⁵¹ The proliferation of indexes and index-based investment strategies has led some commentators to argue that there is, in fact, “no such thing as passive investing.”⁵²

B. Passive Fund Competition

The conventional view focuses on the competition between passive funds tracking the same index. This view assumes that an investor’s preference to invest in a passive fund that tracks a specific index is exogenously determined. It then assumes that passive funds that track this index compete to attract investors based on cost⁵³ and tracking error.⁵⁴ This view, however, is incomplete. Passive funds, and more accurately the sponsors that offer these funds, compete for investor assets not only with each other but also with active funds. Furthermore, funds compete for investor assets based not only on fees, but also on performance. This form of competition, we argue, provides passive investors with the incentive to use their governance rights to target underperforming companies in their portfolio.

Mutual fund investors have a broad range of investment options even within employer-sponsored retirement plans that typically include passive funds, actively-managed funds, stable value funds and other products.⁵⁵ The finance literature has consistently shown that mutual fund assets flows respond to past performance.⁵⁶ Moreover, mutual fund investors, whether they invest directly or through a retirement account are not locked into a particular mutual fund.⁵⁷

⁵¹ See, e.g., Fidelity U.S. Sustainability Index Fund (“Each fund will attempt to replicate the performance of its respective index, before expenses, by normally investing at least 80% of its assets in securities included in the index.”)

⁵² Dani Burger, *Investing in Index Funds Is No Longer Passive*, BLOOMBERG, Feb. 27, 2018, <https://www.bloomberg.com/news/articles/2018-02-27/passive-becomes-the-new-active-as-indexing-rules-everything>.

⁵³ See, e.g., Tirthankar Chakraborty, *Vanguard vs Fidelity: Fee War Heats Up*, Nasdaq, Aug. 25, 2017, available at <https://www.nasdaq.com/article/vanguard-vs-fidelity-fee-war-heats-up-cm837199> (describing competitive cost-cutting between Fidelity and Vanguard’s S&P 500 index funds).

⁵⁴ See, e.g., Weinberg, *supra* note 8 (observing that returns of two otherwise identical index funds can differ due to tracking error).

⁵⁵ See, e.g. *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans*, 2014, at 32 (Dec. 2016), available at https://www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf (reporting that, in 2014 the average 401(k) plan offered investors 21 investment options (counting target date funds as a single investment option)).

⁵⁶ See, e.g., Jonathan Berk & Jules H. van Binsbergen, *Mutual Funds in Equilibrium* (Feb. 9, 2017), <https://ssrn.com/abstract=2914669> (“fund flows into mutual funds are known to be highly predictable based on past performance”); C. Wei Liy, Ashish Tiwariz & Lin Tong, *Investment Decisions under Ambiguity: Evidence from Mutual Fund Investor Behavior*, 63 MGMT. SCI. 2509 (2016) (describing the “the well-documented phenomenon of performance-chasing by fund investors”).

⁵⁷ Concededly, there is a documented stickiness to investment through fund families and defined benefit plans. See generally Anne M. Tucker, *Locked In: The Competitive Disadvantage of Citizen Shareholders*, 25 YALE L.J. FORUM 163 (2015); Morley & Curtis, *supra* note 10.

Instead, they have an ongoing option to exit the fund at fair value or NAV, and a fund's NAV is unaffected by investors' expectations about the fund's future fees or performance.⁵⁸

Although the finance literature has documented the competition between active and passive funds,⁵⁹ it has not examined the effect of this competition on passive fund incentives. Actively-managed mutual funds and hedge funds seek to generate alpha, a return that exceeds that available by investing in a passively managed-benchmark.⁶⁰ They do this by investing in firm-specific research and using that research to overweight some stocks and underweight others relative to their benchmark portfolio. For example, a portfolio manager who researched Enron and determined that it was a massive fraud would underweight or sell Enron stock, hoping to benefit when the market identified the fraud.⁶¹ Active funds incur higher costs due to this research and charge their investors higher fees based on the premise that these funds' stock picking activities will produce higher returns, net of fees, than the benchmark portfolio.⁶²

If investors believe that passive funds cannot offer a better rate of return than active funds, they will flee to active funds, and vice versa. The finance literature documents that investor assets move into funds with superior performance and provides reasons to believe that performance-chasing by mutual fund investors is reasonable.⁶³ The fact that this competition between active and passive funds persists, even with the dramatic recent inflows into passive funds is evidenced by the fact that some actively-managed funds with strong performance both continue to attract substantial new assets and charge fees that are considerably higher than those charged by index funds.⁶⁴

⁵⁸ See, e.g., *id.* at 89 (explaining that a mutual fund's "NAV is unaffected by expectations about future fees or portfolio changes").

⁵⁹ See generally Cremers et al., *supra* note 10 (finding that increased presence of index funds reduces fees and increases alpha for active funds).

⁶⁰ See Paolo Guasoni, Gur Huberman & Zhenyu Wang, *Performance Maximization of Actively Managed Funds*, Fed. Res. Bank of NY Staff Report, 2010, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr427.pdf (explaining alpha).

⁶¹ See, e.g., Jen Wieczner, *Hedge Fund Manager Who Spotted Fraud at Enron Calls Tesla 'The Anti-Amazon'*, FORTUNE, Sept. 13, 2016 (describing Jim Chanos, the hedge fund manager who famously identified the Enron fraud before the market and profited by selling Enron stock short).

⁶² See, e.g., Cremers & Petajisto, *supra* note _ (demonstrating that mutual funds whose holdings differ most from their benchmark tend to outperform that benchmark net of fees).

⁶³ See, e.g., Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POLIT. ECON. 1269 (2004) (providing rational explanation for investors to chase past performance by mutual funds). Indeed, scholars have documented that assets flow into a successful fund but that, because the fund adviser's ideas are finite, eventually investors will no longer receive an excess return. See Berk & van Binsbergen, *supra* note 56 (explaining that, for mutual funds, "this equilibrium is reached by increasing the size of the fund."). The growth in the size of a successful fund enables the fund managers to receive a return on the skill that they invest, even as the returns of the fund revert to the mean. See Hyunglae Jeon, Jangkoo Kang & Changjun Lee, *Precision about manager skill, mutual fund flows, and performance persistence*, 40 N. AM. J. ECON. & FIN. 222 (2017).

⁶⁴ See, e.g., Lee Conrad & Andrew Shilling, *Fund flows: Who's the big winner YTD?*, FINANCIAL PLANNING, Dec. 13, 2017, available at <https://www.financial-planning.com/slideshow/mutual-funds-and-etfs-with-the-biggest-net-flows-ytd#slide-1> (documenting funds with substantial inflows in 2017). For example, Oakmark International Investor, an actively-managed fund with an expense ratio of almost 1%, attracted \$9.7 billion in new investments in 2017 and, in early 2018, closed to new investors). See Greg Carlson, *Oakmark International Announces Soft Close*, MORNINGSTAR, Jan. 30, 2018, <http://www.morningstar.com/articles/845771/oakmark-international-announces-soft-close.html> (reporting fund's announcement that it was closing to new investors).

This institutional reality sharply contrasts with the view of some scholars that passive investors are largely indifferent to the performance of companies in their portfolio.⁶⁵ Our analysis, in contrast, suggests that passive funds are in competition not only with other passive funds and but also with active funds and that they compete along the dimensions of both cost and performance.⁶⁶ Passive fund sponsors therefore have an incentive to take measures to neutralize the comparative advantage enjoyed by active funds, that is, their ability to use their investment discretion to generate alpha. As we explain in the next Section, this competition provides reasons for passive funds to engage in stewardship and, in particular, to seek to improve the underperforming companies in their portfolios.

Before we explore the implications of passive funds' competition with active funds for their governance activities, we should make several clarifications about the nature of these incentives. First, passive funds' competition with active funds is characterized by an asymmetric collective action problem. A specific active fund can make itself attractive to potential investors by deploying its stock picking skills to attempt to beat the benchmark. In contrast, a passive fund's market-wide efforts are likely to benefit all passive funds tracking the same index. This asymmetry, however, underlies the inevitable collective action problem that characterizes all institutional investor engagement in corporate governance.⁶⁷ Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies.

This collective action problem may well limit the extent to which passive funds are willing to participate in costly engagement efforts. There are several countervailing considerations, however. First, as we explain in more detail below, the engagement activities of passive funds are facilitated by the informational advantages of active funds in the same family and inure to the benefit of those funds as well as the passive funds. Second, because of their size, the Big Three enjoy substantial economies of scale with respect to corporate governance and market-wide initiatives. The size of the Big Three and the stickiness of deposits in retirement accounts with them creates a path dependency whereby they can continue to invest in these measures because they are able to capture outside benefits from those investments. Indeed, through these governance mechanisms the big three can create further barriers to entry to other participants. Third, fund sponsors may see governance engagement as a branding or marketing

⁶⁵ See, e.g., Lund, *supra* note 6, at 18 (stating that a passive fund “lacks a financial incentive to ensure that the companies in their [sic] portfolio are well run”). An increase in company value of course has a direct effect on fund fees, as it increases assets under management. This direct effect, however, does not provide mutual funds with powerful stewardship incentives given collective action problems and the fact that sponsor fees are not based on investment returns. See Kahan & Rock, *supra* note 20.

⁶⁶ And to a degree, with other passive funds.

⁶⁷ See, e.g., Jill E Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1024 (1994) (arguing that, because its competitors are able to free-ride on an institutional investor's monitoring, that monitoring “diminishes the institutional investor's returns relative to the market as a whole.”)

tool that provides them with another dimension on which to compete for assets.⁶⁸ Finally, and perhaps most important, the theory set forth in this article focuses on economic incentives, but we recognize that those incentives are not exclusive. Mutual funds manage a substantial quantity of assets on behalf of their beneficiaries, and they act as fiduciaries for those beneficiaries.⁶⁹ Their fiduciary duties include taking reasonable measures to maximize the value of the assets that they invest and create an additional reason for funds to behave as responsible owners.⁷⁰

Second, the effect of the competition between active and passive funds may vary across fund sponsors. Those with greater interest in offering passive funds are more likely to take costly steps to limit the comparative advantage of active funds. For a similar reason, these incentives are likely to become more meaningful as the industry becomes more concentrated. Given their large share of the passive investment market, the Big Three have stronger incentives to take active measures to make passive investment more attractive. As we show in the next section, these incentives appear to have influenced the Big Three's growing level of engagement.

Third, the competition takes place primarily between fund complexes. Sponsors with substantial passive operations are more likely to have a stake in undermining active managers. Yet, we also believe this competition occurs within the fund complex itself. In today's environment, much investment happens through defined contribution plans, otherwise known as 401(k) plans. A number of asset managers, including primarily passive sponsors such as Vanguard and active sponsors such as Fidelity compete both to administer these plans and to provide the funds that will serve as investment options in the plans. In this model, index funds compete within the fund complex for investment fund flows but also enable the sponsor to compete for the administrator position by lowering the average fee level of the overall plan. At the same time, once an asset manager wins a company's 401(k) plan business, they typically provide a plan that includes both lower cost index options and higher cost actively-managed funds, and those funds compete for investment dollars within the plan.⁷¹

C. Passive Funds and Governance

1. Governance Incentives

⁶⁸ Cf. Arno Riedl & Paul Smeets, *Why Do Investors Hold Socially Responsible Mutual Funds?*, 72 J. FIN. 2505 (2017) (reporting that investors are willing to pay higher fees and earn lower returns for investing in social responsible mutual funds).

⁶⁹ We explore the role of fiduciary duties in Part II.E., *infra*.

⁷⁰ We note that the UK has attempted to formalize the stewardship obligations of institutional investors through the adoption of the Stewardship Code. See, e.g., Iris H-Y Chiu, *Institutional Investors as Stewards: Toward a New Conception of Corporate Governance*, 6 BROOK. J. CORP. FIN. & COM. L. 387 (2012) (describing the UK Stewardship Code).

⁷¹ See, e.g., Clemens Sialm et al., *Defined Contribution Pension Plans: Sticky or Discerning Money?*, 70 J. FIN. 805 (2015) (finding that that flows into funds from DC assets are more volatile and exhibit more performance sensitivity than non-DC flows, primarily due to adjustments to the investment options by the plan sponsors).

The comparative advantage of active funds is that they exercise discretion in making investment decisions. They conduct research in the form of investigating and picking stocks. Because they have discretion, active funds can take advantage of market mispricing by overweighting companies that they expect to outperform the market and underweighting companies that they expect to underperform. For example, even in a semi-efficient capital market, an active fund can rely on its private information to exit poorly-run companies before the market fully prices the company's underperformance.⁷² In contrast, an index fund does not have a choice over the companies it holds or their relative weight in its portfolio. Put differently, it must invest in the bad companies along with the good ones.

Active funds can generate alpha by engaging in research that enables them to identify mis-priced company shares and use that mis-pricing to identify profitable trading opportunities. Passive funds, therefore, would like to reduce active funds' ability to exploit mispricing. They can do this in two ways. The first is by reducing the incidence of mispricing. The second is by reducing governance risks that may increase price volatility, thereby increasing the returns that may be available by exploiting mispricing. In both cases, the mechanism that passive investors can use is improved corporate governance. Moreover, since they cannot exit poor investments, passive funds must use their votes to improve the performance of companies in their portfolio.

Good corporate governance can increase transparency directly, such as by improving the quality of financial reporting accuracy. In addition, empirical research shows that corporate governance enables good managers to signal their quality to the market, enabling investors to price their companies more accurately.⁷³ Both these results reduce the incidence of mispricing in the market.

Good governance can also reduce price volatility. A firm with greater governance risk may experience more frequent price movements due to the materialization of those risks and its price movements in response to firm or market-wide developments may be more extreme as the developments generate greater investor uncertainty about the impact of those developments on the firm.⁷⁴ High quality corporate governance is also likely to reduce the frequency of various value-decreasing events such as insider self-dealing, fraud, overconfidence bias, director groupthink, and so forth.⁷⁵ Generic governance improvements such as corporate boards with independent and expert directors thus offer the potential for reducing underperformance by the "bad" companies in a market portfolio.

⁷² See, e.g., Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481 (2010) (showing that informed blockholders can benefit from selling shares of overvalued companies); Admati & Pfleiderer, *supra* note 7 (same).

⁷³ See, e.g., Merritt B. Fox, Ronald J. Gilson & Darius Palia, *Corporate Governance Changes as a Signal: Contextualizing the Performance Link*, 2016, <https://ssrn.com/abstract=2807926> (showing that improved corporate governance enhances share price accuracy and reduces information asymmetries).

⁷⁴ Fox et al. observe that the signaling value of good governance matters more "in times when managerial quality is more difficult to observe directly"). See *id.* at 3.

⁷⁵ See generally Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VANDERBILT L. REV. 859 (2003).

Governance improvements are also an efficient mechanism for passive investor engagement. Because of the large size of their portfolios and their limited firm-specific knowledge, passive investors are poorly-positioned to identify the firm-specific operational qualities that would enable them to prompt individual companies to outperform.⁷⁶ Nor can they benefit from such outperformance, because they cannot overweight their portfolio with those companies and gain an advantage relative to their competitors.

On the other hand, identifying governance “best practices” that are likely to reduce the risk of underperformance requires little firm-specific information, and the investment in identifying a governance improvement can be deployed across a broad range of portfolio companies.⁷⁷ For example, the NYC Comptroller incurred a minimal marginal cost in submitting its proxy access shareholder proposal to 75 portfolio companies.⁷⁸ In addition to improving the return of the passive funds, this strategy reduces the advantage that active funds enjoy through exit.

Because governance is the passive funds’ only outlet to improve underperforming firms, it becomes their comparative advantage.⁷⁹ In turn this incentivizes passive investors to dedicate greater resources to governance, including the evaluation of corporate governance measures, the informed exercise of their voting rights, and meeting directly with corporate insiders. The growth in passive funds is transforming the governance landscape. Since passive funds cannot exit their investment in underperforming companies, they have an incentive to ensure that companies in their portfolio are more responsive to shareholder demands, and their growing size gives them the voting power to demand that responsiveness.

2. Governance Costs

Several features of passive investors and the modern governance landscape enable passive investors to engage in governance effectively. First, the business model of passive investors, with its emphasis on larger size and lower costs supports economies of scale.⁸⁰ Due to economies of scale, large funds can charge lower fees,⁸¹ thereby becoming more attractive for investors. The three largest asset managers today are the big three – BlackRock, Vanguard and

⁷⁶ We note that mutual funds and pension funds generally lack the expertise and access to information to identify operational improvements that should be implemented to improve the performance of companies in their portfolio.

⁷⁷ A passive investor can also target a generic governance reform to those companies that it identifies as underperformers. CalPERS, one of the first governance activists, employed this strategy in the early years of its engagement. See, e.g., Stephen L. Nesbitt, *Long-term Rewards from Shareholder Activism: A Study of the "CalPERS Effect"*, 6 J. APP. CORP. FIN. 78 (1994) (describing CALPERS’ strategy of targeting underperforming companies for governance reform).

⁷⁸ See Nikita Stewart, *City Comptroller Reaches Deals With 5 Companies on Giving Shareholders Say on Directors*, THE N.Y. TIMES, Mar. 10, 2015.

⁷⁹ To the extent that passive investors are motivated by their fiduciary duties, their incentive to improve governance is increased.

⁸⁰ See, e.g., Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329, 351 (2016) (“Economies of scale exist and are substantial in the portfolio management process.”).

⁸¹ See ICI 2017 Factbook, at 94.

State Street -- and the majority of the assets that they manage are invested in passive funds.⁸² Because of their substantial size, these large fund sponsors own substantial stakes in their portfolio companies and are less likely than active ones to suffer from collective action problems of smaller shareholders.⁸³ Even though the overall expense ratios at the passive funds are low, because of their large size, they nonetheless generate substantial fees for their sponsors, enabling them to devote substantial resources to governance.⁸⁴

Passive investors own the entire market and therefore also enjoy economies of scale in evaluating governance provisions, because the same governance provisions are likely to be in play at multiple companies within the passive fund's portfolio. Thus, passive investors are particularly well-placed to evaluate provisions such as proxy access, forum-selection bylaws, or staggered boards and to determine whether these provisions are likely, as a general matter, to increase or decrease firm value at the majority of portfolio companies.⁸⁵ Moreover, they are more likely to internalize any spillover effects that may arise from governance provisions.⁸⁶

The increasing importance of shareholder voting rights facilitates the ability of passive investors to exercise influence through voting.⁸⁷ Dodd-Frank, for example, implemented a requirement that issuers allow shareholders the opportunity to vote on executive compensation.⁸⁸ Shareholder proposals have broadened in scope, putting a wide range of topics before the shareholders.⁸⁹ Modifications to the process of electing directors, such as proxy access and

⁸² See Mutual Fund Directory.Org, <http://mutualfunddirectory.org/> (reporting that, as of 3/12/18, the largest three mutual fund companies were BlackRock, Vanguard and State Street.). Notably, the next three, in terms of size, Fidelity, JP Morgan and BNY Mellon, rely more heavily on active management.

⁸³ Cf. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2111-12 (1995) (explaining, analogously, that institutional investors' large stakes make it rational for them to participate actively in shareholder litigation).

⁸⁴ We detail passive investors investments in engagement and governance in Part II below. See notes ___ through ___ *infra* and accompanying text.

⁸⁵ We explicitly recognize that governance provisions may have differential effects at different companies, and that passive investors may be poorly-positioned to identify firm-specific factors that might cause a governance provision to have a distinctive effect. See Matthew D. Cain, Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *How Corporate Governance is Made: The Case of the Golden Leash*, 164 U. PENN. L. REV. 649, 697-98 (2016) (presenting evidence that "governance provisions have heterogeneous effects depending upon firm-specific characteristics and investor perception of those characteristics); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 107 Col. L. Rev. 7676 (2017) (arguing that there is no one governance structure that is value enhancing for all public companies). This limitation has led to the criticism that passive investors take a "one-size-fits-all" approach to corporate governance.

⁸⁶ See, e.g., Andrea Pawliczek & A. Nicole Skinner, *Common Ownership and Voluntary Disclosure* (Jan. 22, 2018) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3002075; Jie He, Jiekun, & Shan Zhao, *Internalizing Governance Externalities: The Role of Institutional Cross-Ownership* (May 12, 2017) available at SSRN: <https://ssrn.com/abstract=2940227> or <http://dx.doi.org/10.2139/ssrn.2940227>

⁸⁷ See, e.g., Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 14 (2017) (observing that "Recent regulatory changes and the rise of shareholder activism have made shareholder voting power increasingly important.").

⁸⁸ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78n-1).

⁸⁹ See, e.g., *Trinity Wall St. v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015) (evaluating obligation of issuer to include shareholder proposal seeking to have issuer develop standards regarding the sale of firearms); *Deere & Company*, 2015 SEC No-Act. LEXIS 481 (Dec. 3, 2015) (considering shareholder proposal requesting an annual

majority voting, have made shareholder votes on director elections more significant.⁹⁰ And changes to state corporate law have increased the legal significance of shareholder voting with respect to a range of issues, including approval of mergers and the structure of director compensation plans.⁹¹ Voting on all these issues gives passive investors a powerful tool to pressure issuers for change and enables institutional investors to signal their dissatisfaction with specific issuer policies and, more generally, with the issuer's economic performance.⁹²

The rising importance of voting further empowers passive investors, as they are increasingly likely to be pivotal voters. Their substantial holdings give them, in many cases, the power to determine the outcome.⁹³ A fund's status as a pivotal investor not only increases its voting leverage but also reduces the cost of monitoring because corporate managers appreciate the importance of cultivating the votes of passive investors and are more likely to be responsive to their requests for information. Similarly, because the support of passive investors is necessary for activist campaigns to be successful, activists are likely to approach them voluntarily in order to share their ideas and enlist their support. A well-documented highway of information runs between activist shareholders and the Big Three, as each trades information about underperforming firms.⁹⁴

Indeed, because of their voting power, passive investors are able to serve as gatekeepers for hedge fund activism. As Ron Gilson and Jeff Gordon have observed, hedge funds typically purchase less than 10% of an issuer's shares and, as a result, cannot wage a successful campaign unless they have the support of passive funds.⁹⁵ Hedge funds, unlike passive funds, expend substantial resources identifying opportunities to improve the return of portfolio companies.

report to the shareholders on the corporation's political activity); Exxon shareholders approve measure on climate-change report, CNBC, May 31, 2017, <http://www.cnbc.com/2017/05/31/exxon-steps-up-efforts-to-sway-shareholders-on-climate-report-vote.html> (reporting on shareholder proposal requesting that the company report on "the impact on its business of compliance with global climate change guidelines.").

⁹⁰ See, e.g., Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119 (2016) (describing shift from plurality to majority voting).

⁹¹ See, e.g., *Corwin v. KKR Financial Holdings*, 125 A.3d 304, 306 (Del. 2015) (limiting litigation exposure for merger approved by fully-informed shareholder vote); *Cambridge Ret. Sys. v. Bosnjak*, 2014 Del. Ch. LEXIS 107 (Del. Ch. 2014) (applying waste standard of review to dismiss challenges to outside directors' equity awards where awards had been approved by shareholder vote).

⁹² See, e.g., Jill Fisch, Darius Palia and Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, HARV. BUS. L. REV. (forthcoming 2018) (documenting responsiveness of say on pay voting to both characteristics of compensation plans and issuers' overall economic performance).

⁹³ See Alon Bray, Wei Jiang and Tao Li, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* (December 8, 2017), Columbia Business School Research Paper No. 18-16, available at SSRN: <https://ssrn.com/abstract=3101473> or <http://dx.doi.org/10.2139/ssrn.3101473>.

⁹⁴ See David R. Beatty, How activist investors are transforming the role of public-company boards, McKinsey Client Alert (Sept. 2017) ("Collaboration between activists and traditional asset managers is changing the boardroom") available at <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-activist-investors-are-transforming-the-role-of-public-company-boards>. See also Simi Kedia, Laura Starks & Xianjue Wang, *Institutional Investors and Hedge Fund Activism* (Sept. 2017), available at file:///C:/Users/steven/Downloads/InstitutionalInvestorsAndHedgeFundA_preview.pdf (finding that shareholder activism is more pervasive at firms with higher ownership by institutional investors).

⁹⁵ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013).

Notably, studies have demonstrated that “hedge funds have aggressively intervened in corporate governance at firms seen as undervalued,” precisely those firms for which it is rational for passive funds to support their efforts.⁹⁶ Index funds can mediate activist efforts by supporting them if and only if they believe the activist’s strategy is likely to be successful. Notably, the response of index funds to activism is likely to contrast with the response of active managers who, because they can overweight an activist target and then quickly exit may support activist campaigns without regard for their potential to extract short term gains at the expense of long term firm value. Passive funds may also support structural changes that facilitate firm-specific interventions by activist shareholders. For example, passive funds might support governance changes like majority voting or proxy access that make it easier to change corporate leadership following poor performance. That leadership change might be a replacement of existing directors or the CEO. Commonly the identification and production of these leaders comes not from the passive funds but through activist shareholders who work with these funds and whose concentrated ownership stake in the company gives them an above-market return from successful activism.

Finally, passive funds do not engage in governance efforts in a vacuum. As noted above, most fund complexes include a mixture of active and passive funds. This mixture creates the potential for efficient cross-subsidization due to the differing expertise of active and passive funds. Active funds benefit from the governance expertise of passive funds, while passive funds benefit from the firm-specific information generated by active investors in connection with stock-picking. Indeed, as we detail below, it is common for fund sponsors to coordinate the engagement and voting activities of their active and passive funds through a centralized governance or stewardship committee, a measure that increases information flow between active and passive funds.

Moreover, these features also make passive investors more likely to engage in *market-wide* initiatives to improve governance. The existing literature has failed to recognize that action at the firm level is not the only option for passive investors. Index funds can push for governance policies that are reflected in ISS voting recommendations or private standard-setters’ principles of good governance.⁹⁷ In turn, these governance policies enable passive funds, together with their activist partners to respond more easily to under-performance. As our theory suggests,

⁹⁶ Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1361 (2014). See also Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (explaining that “Hedge fund activists tend to target companies that are typically ‘value’ firms”).

⁹⁷ Passive funds can also exert market pressure through the composition of their indexes. For example, Fidelity offers two sustainability index funds, and a shift by investors of substantial assets into these funds would create an incentive for issuers to adopt more sustainable business practices. See Fidelity, *Fidelity Launches First Two Sustainability-Focused Index Funds*, May 15, 2017, <https://www.fidelity.com/about-fidelity/institutional-investment-management/first-two-sustainability-focused-index-funds> (announcing the launch of the two ESG funds). Similarly, in response to the recent controversy about the sale and manufacture of firearms following the Parkland shooting, BlackRock has suggested the development of “index-based portfolios that specifically exclude firearms manufacturers and retailers.” Peter Smith, BlackRock offers Clients ways to Opt out of US gun stocks, Reuters, Mar. 2, 2018.

passive investors are more likely than active ones to expend resources on such governance initiatives.⁹⁸

These institutional features significantly reduce the cost of passive investors' effective engagement and make passive investors more likely to invest in stewardship, especially governance. The focus by passive investors on governance reduces the alpha available to active funds because, by bringing up underperforming companies, passive fund engagement limits the ability of active funds to earn returns based on stock-picking. Instead, active funds are pushed more towards beta, as passive funds remove their ability to recognize and produce alpha.⁹⁹ The net result in either case is to push funds towards the median return.

To be sure, our analysis suggests that, in the vast majority of cases, passive investor engagement will neither seek to obtain higher returns from the better performing stocks in an index nor to identify and address firm-specific operational deficiencies. Either strategy would require the fund to engage in active monitoring and expend substantial sums first to understand the business and operations of a single firm and then to identify changes that the existing managers failed to identify. This feature, however, is not unique to passive investors. Although activist hedge funds may be able to perform this task, both active and passive mutual funds lack the economic incentives and the mechanisms to do so effectively.¹⁰⁰ In contrast, governance engagement does not require a fund to generate an improved business strategy for a specific company in its portfolio. This observation highlights the limitations of passive investor engagement because, although funds can use low-cost corporate governance initiatives to address chronic underperformance or strengthen market discipline, good governance, by itself, does not produce visionary leaders who outperform the market.¹⁰¹ But the passive funds' goal is not outperformance; instead, the goal is for the fund to earn a sufficient return to prevent capital flight to active funds or alternatively composed competing indexes.

II. The Passive Investor in Practice

The preceding Part set out our theory of passive investors. In this Part we document the institutional context and demonstrate how the behavior of passive investors is consistent with our

⁹⁸ In addition, passive funds can bring their governance focus to bear on listing rules or the composition of the indexes themselves. See *infra* Part III D (describing efforts by some institutional investors to limit the use of dual class stock). See also Joann S. Lublin, *Big Investor Group to Push for End to Dual-Class Shares*, WALL ST. J., Jan. 31, 2017 (reporting effort by a group including BlackRock, State Street and Vanguard to obtain a ban on dual class shares).

⁹⁹ The fact that active mutual funds cluster around the median supports this notion, though there are many factors which drive this result. See Eugene F. Fama & Kenneth R. French, *Luck versus Skill in the Cross Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010). We thank Curtis Quinn for making this point.

¹⁰⁰ See, e.g., Fisch, *supra* note 87 at 1024; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523 (1990) (arguing that "institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes").

¹⁰¹ See also Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016) (arguing that entrepreneurs value corporate control because it allows them to produce above-market returns by pursuing their visions).

theory. Section A examines how governance works in the mutual fund complex. Section B examines how passive funds affect governance through voice. Section C looks at how passive funds affect governance through policy and other system-wide work. Section D documents prior studies which have looked at the effect of passive investors on firm value and governance. Finally, Section E looks at how the role of fiduciary duties influences the incentives of passive funds to express voice.

A. *How Governance Works at a Mutual Fund Complex*

Contemporaneous with the growth of passive investors has been their increasing involvement in corporate governance. Institutional investor participation in corporate governance began with the engagement of several large public pension funds – most visibly CalPERS.¹⁰² Mutual funds, both passive and active, did not join in the initial efforts, and commentators offered a variety of reasons why mutual funds lacked the incentives to participate in efforts to improve the corporate governance of their portfolio companies.¹⁰³

The SEC's 2003 adoption of a rule requiring mutual funds to disclose how they vote their portfolio company shares changed the situation.¹⁰⁴ Although the rule technically does not require mutual funds to vote on every issue that is submitted to the shareholders, as a practical matter, mutual funds now vote virtually all of their shares.¹⁰⁵ BlackRock for example states that it aims to vote 100% of its shares in 17,000 firms across 90 markets.¹⁰⁶ These votes and any policies underlying the voting are filed publicly with the SEC and tracked by others in the market, allowing mutual funds not only to express their voice at the firm level but to the entire market.¹⁰⁷

¹⁰² See Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008) (describing CalPERS' leadership role and empirical research studying its effectiveness).

¹⁰³ See, e.g., James Cotter, Alan Palmiter, & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 8-10 (2010) (describing and offering reasons for traditional mutual fund passivity).

¹⁰⁴ *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922 (Jan. 31, 2003).

¹⁰⁵ See Proxy Pulse 2017 Proxy Season Review (reporting that institutional investors voted 91% of their shares in the 2017 proxy season).

¹⁰⁶ See Blackrock, *Proxy Voting and Shareholder Engagement Q&A*, available at <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-faq-global.pdf> (“We aim to vote at 100% of meetings where our clients have given us authority to vote their shares – thus we vote at approximately 17,000 shareholder meetings across more than 90 markets each year.”).

¹⁰⁷ See Final Rule: *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 17 CFR Parts 239, 249, 270, and 274 Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02 (2003). See generally Martijn Cremers & Romano, Roberta, *Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation* (August 23, 2007). Yale ICF Working Paper No. 07-10; Yale Law & Economics Research Paper No. 349; ECGI - Law Working Paper No. 83/2007. Available at SSRN: <https://ssrn.com/abstract=982493>

Mutual fund sponsors can exercise their voting authority in different ways.¹⁰⁸ Many large fund complexes centralize voting decisions through the use of a voting or governance staff that makes voting decisions on behalf of the entire fund complex.¹⁰⁹ For example, each Vanguard mutual fund delegates voting authority to its Investment Stewardship Oversight Committee.¹¹⁰ Blackrock also centralizes its voting decisions, although individual fund managers retain ultimate voting authority.¹¹¹ An alternative is for funds to allocate voting authority to individual portfolio managers or to have some central recommendation method. T. Rowe Price for example has a proxy committee that recommends how funds vote.¹¹² The ultimate discretion is with the fund manager but because the fund manager must document their reasons from deviation there is little divergence from the central recommendation.¹¹³ Invesco uses an innovative voting platform to allow its individual fund managers to debate upcoming votes at their portfolio companies and to reach consensus.¹¹⁴ Even funds that centralize voting decisions in general may give voting authority to fund managers with respect to particular issues such as mergers or election contests where firm-specific information is important. Finally, a fund may outsource its voting decisions.¹¹⁵ A number of small fund complexes appear to delegate voting decisions to a proxy advisor such as Institutional Shareholder Services (ISS).¹¹⁶

Both active and passive funds at a mutual fund complex vote simultaneously, even when the complex gives portfolio managers the discretion to make voting decisions for their funds. As a result, sponsors are able to leverage their resources across all funds to make voting decisions.

¹⁰⁸ See generally Bonnie Saynay & Henning Stein, *Proxy Voting: The Hallmark of Active Ownership*, Invesco Whitepaper at 6, https://apinstitutional.invesco.com/ap-public/dam/jcr:c15b0254-7307-4602-acb4-b8543bd21470/Macro_20170718_ESG%20Proxy%20Voting-the%20hallmark%20of%20active%20ownership-July2017.pdf (describing voting strategies as “absolve, resolve or devolve”).

¹⁰⁹ 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, 478 n. 85 (2014) (citing sources documenting centralization of voting authority at BlackRock, Fidelity and Vanguard); but see Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 47-48 (2013) (reporting varying degrees of centralization among mutual fund families).

¹¹⁰ Vanguard, *Vanguard’s proxy voting guidelines*, <https://about.vanguard.com/investment-stewardship/policies-and-guidelines/>; Hortense Bioy, Jose Garcia-Zarate & Alex Bryan, *Passive Fund Providers and Investment Stewardship*, Harv. Law Sch. Forum on Corp. Gov. & Fin. Reg., Dec. 21, 2017, <https://corpgov.law.harvard.edu/2017/12/21/passive-fund-providers-and-investment-stewardship/> (observing that at “Vanguard, SSgA, and LGIM, . . . the corporate-governance teams have ultimate authority on the final votes”).

¹¹¹ See BlackRock, *Proxy Voting and Shareholder Engagement*, *supra* note 40 (outlining how Blackrock votes shares through its Investor Stewardship Committee); Bioy et al., *supra* note 110 (explaining that at “BlackRock, Amundi, and UBS, the policy is for active fund managers to vote consistently across all funds, but they retain the authority to vote differently from the house view.”).

¹¹² See T. Rowe Price, *Proxy Voting Guidelines*, available at https://www3.troweprice.com/usis/content/trowecorp/en/utility/policies/_jcr_content/maincontent/polices_row_1/pa-ra-mid/thiscontent/pdf_link/pdffile (stating that proxy vote recommendations are made by the Proxy Committee and that fund managers ultimately have the discretion to vote).

¹¹³ *Id.*

¹¹⁴ Saynay & Stein, *supra* note 108, at 8.

¹¹⁵ For example, Fidelity outsources the voting by its index funds to subadvisor Geode. Bioy, et al., *supra* note 110.

¹¹⁶ See Choi et al., *supra* note 109, at 53, 55 (reporting that mutual fund voting that is most closely aligned with ISS recommendations accounts for a relatively small proportion of mutual fund assets).

Active funds benefit from the governance expertise of passive funds, and passive funds, in turn, rely on the company-specific knowledge of active managers.¹¹⁷ Notably, fund voting involves ongoing interaction between the governance groups and between passive and active fund managers.¹¹⁸ Significantly, although many mutual fund complexes coordinate voting among their funds, fund complexes do not appear to coordinate their voting.¹¹⁹ There are significant differences among fund complexes in their voting policies and in the frequency with which they vote against management.¹²⁰

In addition, because of the size of their stakes, passive funds have the power to swing the vote. Empirical evidence indicates that funds that have a greater percentage of an issuer's equity are more likely to engage in active voting,¹²¹ more likely to devote resources to making voting decisions¹²² and less likely to follow the recommendations of ISS. Critically this suggests that, for the votes in which passive investors are most influential, they are most likely to be informed.¹²³

The impact of mutual fund voting is substantial. A variety of studies, both empirical and anecdotal, have documented the effect of mutual fund voting on corporate governance and operational decisions.¹²⁴ The exercise of passive funds' voting power has been pivotal on issues ranging from individual proxy contests to shareholder proposals regarding sustainability disclosures.¹²⁵ For example, according to media reports, a vote by any of the big three voted in favor of activist Nelson Peltz would have changed the result of the proxy contest at DuPont and

¹¹⁷ Some mutual fund companies explicitly rely on their active managers to determine the voting policies of their passive funds. See, e.g., Saynay & Stein, *supra* note 108, at 6 (explaining that Invesco's passive funds engage in echo-voting to "leverage active equity expertise").

¹¹⁸ See, e.g., *id.* at 7 (explaining how Invesco's proxy voting platform "encourages an internal debate on any vote, enabling managers who might have deeper insights and more up-to-date information to share their knowledge among colleagues.").

¹¹⁹ The failure of fund complexes even to coordinate their voting behavior offers reasons to question academic papers suggesting that common ownership among large passive investors raises antitrust concerns. See, e.g., Posner et al., *supra* note 6.

¹²⁰ See Bioy, et al., *supra* note 110, exhibit 3 (detailing differences across fund complexes).

¹²¹ See Michelle Lowry & Peter Illiev, *Are Mutual Funds Active Voters?*, 28 REV. FIN. STUD. 446, 458 (2015) (finding that fund families and funds that hold a larger fraction of the company's equity are more likely to engage in "active" voting). Notably, although the bulk of the Lowry and Illiev analysis focuses on actively-managed funds, the authors analyze the voting behavior of index funds separately and report that the "results are consistent with index funds investing considerable attention in the governance of firms in which they have substantial holdings, and which, by definition, they are not able to sell because they represent a large portion of the underlying index." *Id.* at ___.

¹²² See *id.* at 455 (finding that larger fund families are less likely to follow ISS voting recommendations); see also Choi, et al., *supra* note 109, at 53-54, 61-62 (2013) (reporting that large fund families are less likely to follow ISS recommendations and identifying divergence between Vanguard's votes and ISS recommendations).

¹²³ This contrasts with Professor Lund's claim that passive funds adhere to a "a low-cost, unthinking approach to governance." See Lund, *supra* note 6, at 20.

¹²⁴ See, e.g., Cain, et al., *supra* note 85.

¹²⁵ Steven Mufson, *Financial firms lead shareholder rebellion against ExxonMobil climate change policies*, WASH. POST, May 31, 2017, https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?utm_term=.9579fd3049f6 (reporting that BlackRock and Vanguard owned 13% of ExxonMobil and that their votes were pivotal in the passage of a shareholder proposal seeking improved disclosure about the effects of climate change).

given Peltz a victory.¹²⁶ In post-mortems on the vote, Du Pont’s advisors cited engagement with passive investors as a factor in Du Pont’s win.¹²⁷

B. Passive Investors and Activists

Passive investors both benefit from activists and mediate their influence. Passive investors may benefit in two ways from activists. First, activists’ targeting of underperforming companies—and the mere threat of intervention—improve corporate performance.¹²⁸ Indeed, activist hedge funds offer passive funds a more powerful mechanism to cope with underperforming companies than either governance changes or the ability of an active fund to exit the investment. Second, activists devote substantial resources to investing in firm-specific information for the purpose of proposing potential operational or other improvements. Passive investors benefit from the firm-specific information that they acquire through their contacts with both activists and issuers that are responding to the actual or perceived threat of activism. Because of their potential influence, activists and issuers pay increasing attention to passive investors and their concerns both when developing strategic interactions and when considering governance changes.

Their role as pivotal voters creates a unique opportunity for passive investors to engage in stewardship – mediating the role of activists. Passive funds have a potentially critical role in screening activism because their incentives may differ from those of the activists. Passive investors share in company-wide gains from valuable activism, but they lose if the activist can implement changes that produce short term gains but destroy the company for the long term,¹²⁹ because passive investors, unlike active investors, cannot exit before that happens. These incentives are likely to make passive investors take a more cautious approach and be less willing than actively-managed funds to support some activists.¹³⁰ Recently some passive funds have

¹²⁶ Stephen Gandel, *DuPont nearly lost its war with activist Nelson Peltz*, FORTUNE, Jun. 4, 2015, <http://fortune.com/2015/06/04/dupont-nelson-peltz-vote/>

¹²⁷ Andrew R. Brownstein, *Winning a Proxy Fight—Lessons from the DuPont-Trian Vote*, Harvard Corp. Gov. Blog., dated May 18, 2015, available at <https://corpgov.law.harvard.edu/2015/05/18/winning-a-proxy-fight-lessons-from-the-dupont-trian-vote/>.

¹²⁸ See, e.g., Alon Brav, et. al., *How Does Hedge Fund Activism Reshape Corporate Innovation?*, J. FIN. ECON. (forthcoming) (documenting activists’ influence in reshaping companies towards more innovation).

¹²⁹ See, e.g., *In re PLX Tech. Inc. Stockholders’ Litig.*, No. 9880-VCL, Del. Ch., Sept. 3, 2015, transcript ruling at 27 (citing the concern that “particular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those strategies.”); Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 772 (2015) (arguing that activist shareholder “pressure may logically lead to strategies that sacrifice long-term performance for short-term shareholder wealth.”); Kai Haakon Liekefett & Lawrence Elbaum, *Think Twice Before Settling with an Activist*, LAW360, Dec. 9, 2016 (stating that activists “focus on short-term event-driven strategies.”).

¹³⁰ Factset Sharkrepellent reports that in 2016 and 2017, activists hedge funds had a 55% and 53% success rate, respectively in dissident proxy contests. For a specific example in the recent case of Marcato’s proxy contest with Deckers Outdoor Corp., BlackRock and Vanguard which were two of the five biggest shareholders in the company voted with management. Glass Lewis sided with management while ISS sided with the activist. See Svea Herbst-Bayliss, *Deckers wins proxy contest against hedge fund Marcato*, REUTERS, Dec. 14, 2017.

also expressed the concern that issuers not settle with activists before seeking the input of longer-term institutional investors.¹³¹ These conclusions also suggest that passive investors will be able to develop reputational sanctions to constrain destructive hedge fund activism.¹³²

C. *Affecting Governance through Voice*

In addition to exercising their voting rights, passive investors use multiple mechanisms to make their voting power more effective. One such mechanism is influencing the voting policies of proxy advisory firms such as ISS and Glass Lewis. These advisory firms reduce information costs with respect to governance - which is critical for cost-conscious passive investors with large portfolios. Advisory firms also have a major influence on firm governance by developing governance policies that serve as the basis of their voting recommendations. The advisor voting policies are, however, heavily influenced by the viewpoints of the fund complexes.¹³³ ISS explicitly uses the viewpoints of its institutional customers to develop its voting guidelines.¹³⁴ This allows investors to aggregate preferences and overcome collective action problems and to leverage their views by influencing smaller fund complexes with more limited governance expertise. Importantly and evidential of the independent and active voice of many mutual funds, while ISS and Glass Lewis inform mutual fund voting they do not dictate it. Instead, studies have found that mutual funds increasingly engage in independent analysis of voting decisions.¹³⁵

A second mechanism is engagement. Because of the size of passive investors' holdings, corporate insiders are responsive to their requests for engagement. By bringing investors' concerns to issuers, engagement often has the effect of persuading issuers to change their policies voluntarily.¹³⁶ At the same time, passive investors wield a powerful tool if, as a result of

¹³¹ Liekefett & Elbaum, *supra* note 129.

¹³² See Reshma Kapadia, *Passive Investors are the New Shareholder Activists*, BARRON'S, Jul. 8, 2017.

¹³³ See, e.g., David F. Larcker, Allan L. McCall & Brian Tayan, *And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?*, Stanford Closer Look Series, Feb. 25, 2013, <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf> (summarizing and criticizing policy formulation procedures of ISS and Glass Lewis).

¹³⁴ See Institutional Shareholder Services, Policy Formulation Process, available at <https://www.issgovernance.com/policy-gateway/policy-formulation-application/> (describing process by which ISS formulates its voting policies). Glass Lewis also appears to rely in part on the views of its investor clients in formulating its voting policies. See Glass Lewis, *Best Practice Principles for Providers of Shareholder Voting Research & Analysis*, Glass Lewis Statement of Compliance for the Period of 1 January 2017 through 31 December 2017, at 11, <http://www.glasslewis.com/wp-content/uploads/2018/02/GL-Compliance-Statement-2018.pdf> ("Glass Lewis policies are formulated via a bottom-up approach that involves extensive discussions with a wide range of market participants, including investor clients, corporate issuers, issuer organizations, academics and subject matter experts, among others.").

¹³⁵ See Lowry & Iliev, *supra* note 121 (finding that "[e]ngaged mutual funds frequently disagree with ISS recommendations on contentious votes: a one standard deviation increase in a fund's predicted net benefits of voting is associated with a 12 to 17% increase in the tendency to disagree with ISS").

¹³⁶ See, e.g., Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 N.Y.U. J. L. & BUS. 385, 395 (2016) (observing that "Among the S&P 500 companies that disclosed engagement, almost half (forty-six percent) disclosed changes in practices or disclosure as a result of such engagement in 2015").

their engagement, they are not satisfied with management's response - the exercise of their voting rights. Studies show that issuers are responsive to the interests of large investors and will frequently modify their policies rather than putting issues to a vote that they expect to lose.¹³⁷

In recent years, mutual funds have increasingly made direct contact, by letter, phone, electronic communication and, increasingly direct meetings, with the officers and directors of their portfolio companies.¹³⁸ This so-called "shareholder engagement," takes a variety of forms.¹³⁹ One recent survey reports that 63 percent of large institutional investors engaged in direct discussions with management over the past five years, and 45 percent had private discussions with a company's board outside of management presence.¹⁴⁰ Similarly, the percentage of S&P 500 companies reporting investor engagement rose from six percent in 2010 to 72 percent as of June 2017.¹⁴¹

The engagement of the large passive investors has particularly increased. During 2017, BlackRock had over 1600 engagements with its portfolio companies, Vanguard participated in more than 800 engagements and State Street participated in more than 600.¹⁴² In addition to in-person engagements, State Street reported sending hundreds of letters to its portfolio companies.¹⁴³ BlackRock, Vanguard and State Street all have dedicated corporate governance teams that are responsible for engagement with their portfolio companies.¹⁴⁴ BlackRock explains, for example, that its governance specialists engage "in thousands of conversations with companies each year," conversations that build on the new amount and access to information that

¹³⁷ See, e.g., Rob Bauer, Frank Moers & Michael Viehs, *Who Withdraws Shareholder Proposals and Does it Matter? An Analysis of Sponsor Identity and Pay Practices*, 23 CORP. GOV. AN INT'L REV. 472 (2015) (documenting that managers proactively settle with large shareholders by changing corporate practices rather than putting proposals to a vote and losing).

¹³⁸ Engagement is, of course, not limited to passive investors, but also utilized by actively-managed mutual funds and hedge funds. See, e.g., Mallow & Sethi, *supra* note 136, at 395 (reporting that T. Rowe Price "holds hundreds of short, direct conversations with companies owned in portfolios it manages throughout the year on issues that fall beyond the normal due diligence meetings with the companies").

¹³⁹ See, e.g., Sarah Krouse, *At BlackRock, Vanguard and State Street, 'Engagement' Has Different Meanings*, WALL ST. J., Jan. 20, 2018, <https://www.wsj.com/articles/at-blackrock-vanguard-and-state-street-engagement-has-different-meanings-1516449600> (noting that engagement takes different forms for different passive investors); State Street Global Advisors, *Proxy Voting and Engagement Guidelines United States March 2017*, <https://www.ssga.com/investment-topics/environmental-social-governance/2017/Proxy-Voting-and-Engagement-Guidelines-US-20170320.pdf> (reporting that "SSGA engages with companies to provide insight on the principles and practices that drive our voting decisions. We also conduct proactive engagements to address significant shareholder concerns and environmental, social and governance ("ESG") issues in a manner consistent with maximizing shareholder value. ").

¹⁴⁰ Joseph McCahery, Zacharias Sautner & Laura Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016).

¹⁴¹ Ernst & Young, *2017 Proxy Season Review*, available at [http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/\\$File/ey-2017-proxy-season-review.pdf](http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf) (last visited Oct. 9, 2017).

¹⁴² Krouse, *supra* note 139.

¹⁴³ *Id.*

¹⁴⁴ See, e.g., Madison Marriage, *BlackRock, Vanguard and State Street bulk up governance staff*, FIN. TIMES, Jan. 28, 2017, <https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a> (observing that, as of Jan. 2017, BlackRock had increased the size of its governance staff to 31 persons, Vanguard had 20 governance employees, and State Street had 11); Krouse, *supra* note 139 (reporting that BlackRock expects to expand its governance team to 60 people in the next three years).

investors have gained in recent years “to glean investment insights.”¹⁴⁵ Vanguard explained that, in 2016, its engagements represented nearly \$1 trillion in fund assets and reflected an increase in engagement volume of 67% over the prior three years.¹⁴⁶

Despite these activities, some commentators have criticized passive investors for the limited size of their governance staffs.¹⁴⁷ We have three responses. First, as their level of engagement increases, passive investors are increasing the size of the governance staffs.¹⁴⁸ Second, given the fact that passive funds do not focus on individual firm-specific characteristics, the size of their governance staffs offers substantial manpower to analyze governance issues. By way of comparison, the total number of employees at many hedge funds, which engage in significantly greater firm-specific research, is not dramatically higher than full-time governance staff at the major passive investors.¹⁴⁹ Finally, these critiques ignore the shareholder ecosystem today where individual fund complexes interact and rely upon not only proxy advisory firms but shareholder activist hedge funds to supplement their voice, monitoring and information gathering processes. These mechanisms substantially lower informational gathering and assessment costs for both passive and active funds.

Issuers and shareholders are also developing private initiatives to promote board-shareholder engagement. Again, passive investors have been at the forefront of these efforts. For example, in 2014, major U.S. issuers collaborated with several big institutional investors, including BlackRock and Vanguard, to create the “Shareholder-Director Exchange Program.”¹⁵⁰ Similarly, in 2016, representatives of major U.S. corporations and major investors, including again BlackRock, State Street and Vanguard, signed an accord supporting a set of commonsense principles of corporate governance and calling for an ongoing constructive dialogue among issuers and shareholders.¹⁵¹ The “Investor Stewardship Group,” (ISG), a collective of 16 large asset managers including Vanguard and BlackRock, was formed “to establish a framework of

¹⁴⁵ Blackrock - Viewpoint, *Exploring ESG: A Practitioner’s Perspective 2* (Jun. 2016), <https://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-exploring-esg-a-practitionersperspective-june-2016.pdf> (last visited Oct. 12, 2017)

¹⁴⁶ Vanguard, *Our engagement efforts and proxy voting: An update For the 12 months ended June 30, 2016*, <https://about.vanguard.com/investment-stewardship/update-on-voting/>

¹⁴⁷ See, e.g., Lund, *supra* note 6 at 23 (“Vanguard employs fifteen people devoted to engagement and voting at about 13,000 companies based around the world, BlackRock employs about twenty people who work on governance issues at some 14,000 companies, and State Street employs fewer than ten people devoted to governance issues at around 9,000 companies”); Bebchuk et al., *supra* note 6, at 100 (noting that “each of these major investment managers devotes less than one person-workday per year, on average” to undertaking stewardship activities with respect to each of their portfolio companies).

¹⁴⁸ See *supra* note 144 (reporting increased size of governance staffs).

¹⁴⁹ See, e.g., Svea Herbst-Bayliss, *Ackman cuts staff, shuns limelight as he seeks to turn around fund*, REUTERS, Jan. 22, 2018, <https://www.reuters.com/article/us-hedgefunds-ackman-exclusive-ackman-cuts-staff-shuns-limelight-as-he-seeks-to-turn-around-fund-idUSKBN1FB32Y> (reporting Pershing Square’s decision to reduce its total number of employees to 46).

¹⁵⁰ James Woolery, *Introduction to the SDX Protocol*, Harv. L. Sch. F. On Corp. Governance & Fin. Reg. (Feb. 5, 2014), <https://corpgov.law.harvard.edu/2014/02/05/introduction-to-the-sdx-protocol/>; see also SDX Protocol, About SDX, <http://www.sdxprotocol.com/about-sdx/> (last visited Oct. 14, 2017).

¹⁵¹ Tim Armour et al., *Commonsense Corporate Governance Principles*, available at <http://www.governanceprinciples.org>.

basic standards of investment stewardship and corporate governance for U.S. institutional investor and boardroom conduct.”¹⁵²

D. *The Role of Policy*

Passive investors increasingly have a role in politics and regulation.¹⁵³ They actively engage in policy discussions and generally push for greater voice for investors. They also engage with policymakers with respect to a variety of issues beyond corporate governance. As such, they can bring their knowledge of policy considerations to issuers and can bring the interests of their portfolio companies to policymakers.

Passive investors have worked in a variety of ways to ensure that the power of their voice can be expressed. Passive investors regularly comment upon and call for change to the rules adopted by SEC under the federal securities laws. This practice has a long history and has been accomplished largely through system-wide efforts by both active and passive funds. In April 1991 for example Institutional Investor published a report calling for a number of proxy reforms to allow for increased cooperation among mutual funds.¹⁵⁴ The SEC enacted these changes in 1992.¹⁵⁵ Institutional investors have been active in a variety of other SEC reforms to enhance voting. Most recently institutional investors have been active in shaping and attempting to forestall regulation of proxy advisor services currently pending before Congress.¹⁵⁶

The scope of passive investor activity in the policy sphere has been expanding. As Asaf Eckstein documents, passive investors spend substantial sums on lobbying, provide comments on agency rule-making and participate in roundtables and other policy discussions as well as private meetings with lawmakers.¹⁵⁷ Eckstein notes that some executives at some passive investors have testified before Congress.¹⁵⁸ Passive investors participate in trade groups like the Council for Institutional Investors to develop and support corporate governance best practices as well as other policy positions.¹⁵⁹ Institutional investors now regularly file amicus briefs and take policy

¹⁵² David A. Katz & Laura A. MacIntosh, *Common-Sense Capitalism*, Harv. L. Sch. Forum on Corp. Gov. & Fin. Reg., July 28, 2017, <https://corpgov.law.harvard.edu/2017/07/28/common-sense-capitalism/>.

¹⁵³ See Asaf Eckstein, *The Upside of Common Ownership in Corporate Law*, working paper (2018).

¹⁵⁴ See Alicia McElhaney, *Fight for Your Right to Proxy*, INSTIT. INV., Nov. 10, 2017, available at <https://www.institutionalinvestor.com/article/b15kfxz7qzdrpy/fight-for-your-right-to-proxy>.

¹⁵⁵ Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 1992 SEC LEXIS 2470, *7 (Oct. 16, 1992).

¹⁵⁶ See Letter sent by the Council of Institutional Investors to the United States Senate Committee on Banking, Housing, and Urban Affairs, regarding the legislation of H.R. 5311, the Corporate Governance Reform and Transparency Act of 2016, available at <https://corpgov.law.harvard.edu/2016/09/26/the-regulation-of-proxy-advisory-firms/>. On the perils of regulating proxy advisors, see Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77 (2015).

¹⁵⁷ See Eckstein, *supra* note 153, at 44-45.

¹⁵⁸ *Id.*

¹⁵⁹ See Council of Institutional Investors, Associate Members, https://www.cii.org/associate_members (listing BlackRock, Vanguard and State Street as among the CII's associate members).

positions on legislation.¹⁶⁰ Institutional investors were active in the negotiation and passage of the Dodd-Frank Act and subsequent legislative efforts.¹⁶¹ Recently institutional investors, including fund complexes with primarily passive funds, have been active in the fight against climate change.¹⁶²

This policy work includes both broad-based policy initiatives and firm-specific efforts. The big mutual fund complexes regularly issue out policy letters and missives, and several have begun using an annual letter to issuers to highlight their policy concerns. For example, BlackRock's chairman Larry Fink recently issued a letter to the CEOs of all of the public companies in which the fund complex invests in calling for more sustainable business practices.¹⁶³ Similarly, a number of institutional investors have issued announcements calling for more gender diversity on corporate boards.¹⁶⁴

E. Empirical Research on Passive Investor Influence

Although an extensive body of empirical research has examined the role of institutional investors in corporate governance and the effects of their engagement on firm performance, by and large, the literature does not distinguish between passive and active investors. Several recent papers focus specifically on passive investors, however. Appel, Gormley and Kim study the effect of passive ownership through a discontinuity analysis using stock assignments in the Russell 1000 and 2000 indexes.¹⁶⁵ They examine three types of governance measures and conclude that passive ownership influences the governance of the firm. Increased passive ownership is associated with an increased number of independent directors, decreased takeover defenses and an increase in one-share, one-vote ownership rights. In addition, the paper finds that passive ownership is associated with not just observed governance differences, but improved performance as measured by return on assets and Tobin's Q. Using a slightly different

¹⁶⁰ See, e.g., Zach Wener-Fligner, *Every US company arguing for the Supreme Court to legalize same-sex marriage*, QUARTZ, Mar. 10, 2015, <https://qz.com/359424/every-us-company-arguing-for-the-supreme-court-to-legalize-same-sex-marriage/> (reporting that BlackRock signed an amicus brief to the U.S. Supreme Court arguing for marriage equality for same sex couples).

¹⁶¹ See, e.g., Council of Institutional Investors, *Dodd-Frank Act*, available at https://www.cii.org/dodd_frank_act (explaining that the Council of Institutional Investors "as a leading voice for long-term, patient capital, advocated vigorously for many elements of the Dodd-Frank Act,").

¹⁶² See, e.g., Ken Silverstein, *More Institutional Investors Throw Weight Into Fight Against Climate Change*, FORBES, Dec. 12, 2017, <https://www.forbes.com/sites/kensilverstein/2017/12/12/is-the-financial-and-political-heft-behind-the-climate-fight-enough-to-make-a-difference/#41639a621551>

¹⁶³ Fink, *supra* note 16.

¹⁶⁴ See, e.g., Brianna Castro, *Raising the Stakes on Board Gender Diversity*, Harv. L. Sch. Forum on Corp. Gov. & Fin. Reg., Jan. 8, 2018, <https://corpgov.law.harvard.edu/2018/01/08/raising-the-stakes-on-board-gender-diversity/> (reporting announcements by State Street, BlackRock and Vanguard).

¹⁶⁵ See Appel, et al., *supra* note 17.

methodology, however, Schmidt and Fahlenberg find that an increase in passive ownership is associated with greater CEO power and longer terms for independent directors.¹⁶⁶

There is also evidence that greater passive ownership is associated with a greater likelihood of the firm being targeted by activist shareholders.¹⁶⁷ A second study authored by Appel, Gormley and Kim finds that higher passive investor ownership is associated with greater activism and increased proxy fights.¹⁶⁸ This study also finds that activists are more successful in these circumstances and activists are more likely to obtain board representation or effect a sale of the company.¹⁶⁹ These findings run contrary to anecdotal evidence suggesting that passive investors are unwilling to support activists.¹⁷⁰

These studies are the first of what are likely to be many and rely heavily on discontinuity analysis of the Russell 2000/1000 to tease out the role of passive investors from the effects of institutional investors more generally.¹⁷¹ They offer preliminary support for our views both that passive investors have an impact on governance and with the theory that one component of this impact is the reliance by activists on institutional investors and the votes they convey.¹⁷²

Other research lends further support to our analysis. One of the first institutional investors to engage extensively in corporate governance was the California Public Employees Retirement System (CalPERS).¹⁷³ CalPERS' was heavily indexed, its strategy focused on targeting underperforming companies, and several studies reported that firms targeted by CalPERS' interventions experienced improved performance.¹⁷⁴ Along the same lines, a recent paper by Fisch, Palia and Solomon empirically examines the factors that drive low shareholder support for executive compensation in say on pay votes.¹⁷⁵ The paper reports that firm economic performance is a key driver of a low say on pay vote. Critically, the paper explains that even problematic pay packages do not generate substantial shareholder dissent in the absence of poor economic performance. The findings are thus consistent with our theory that the efforts of passive investors are targeted to improving underperformers.

¹⁶⁶ See Cornelius Schmidt & Rudiger Fahlenberg, *Do exogenous changes in passive institutional ownership affect corporate governance and firm value?*, 124 J. FIN. ECON. 285 (2017). They also find that firms make inferior mergers and acquisition decisions after an increase in passive ownership.

¹⁶⁷ See Appel, et al., *supra* note 17.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ See Lund, *supra* note 6.

¹⁷¹ The use of the Russell 2000/1000 as an IV method has been ubiquitous and has now been used in at least six different studies. See Ian Appel, Todd Gormley & Donald B. Keim, *Identification using Russell 1000/2000 index assignments: A discussion of methodologies* (March 29, 2016), available at <https://ssrn.com/abstract=2641548>. It is unclear to us whether this IV is a correct one or is merely picking up changes in companies that are destined to either enter or exit the index as index recalibration is predictable from year to year and is reflected in firm performance. Nonetheless, they do give some preliminary evidence of passive investor influence, evidence which is buttressed by extensive anecdotal evidence.

¹⁷² Brav, et al., *supra* note **Error! Bookmark not defined.**; Michael Bradley, Alon Brav, Itay Goldstein & Wei Jiang, *Activist arbitrage: A study of open-ending attempts of closed-end funds*, 95 J FIN. ECON. 1 (2010).

¹⁷³ See, e.g., Choi & Fisch, *supra* note 102, at 315-16 (describing CalPERS' leadership in institutional activism).

¹⁷⁴ *Id.*

¹⁷⁵ Fisch, et al., *supra* note 85.

F. The Role of Fiduciary Duties

The fund advisors to mutual funds are also subject to fiduciary duties.¹⁷⁶ These fiduciary duties partially explain why mutual funds, including passive investors exercise voice. Fiduciary duties also direct funds to exercise that voice in a manner that is intended to increase the value of the fund and its portfolio companies. The SEC justified its adoption of rules governing the voting and disclosure of voting by mutual funds by reference to mutual fund fiduciary duties.¹⁷⁷

Although the application of fiduciary duties to fund managers and the SEC rule explain in part why mutual funds vote, they do not explain the bulk of recent passive fund engagement. Instead, passive funds would rely more heavily on ISS recommendations. They would not be expanding the size of the governance staffs, developing customized voting policies or engaging directly with the representatives of hundreds of portfolio companies. In sum, they would seek to minimize their governance engagement because that engagement would be seen primarily as a compliance cost. As a result, we believe that although fiduciary duties contribute to passive funds' incentives for engagement and may, to some degree, influence the form and direction of that engagement,¹⁷⁸ we do not believe that fiduciary duties are the driving force behind current levels of passive fund involvement in corporate governance. Put differently, if fiduciary duties were the sole explanation for passive fund voice, one would observe much less significant activity instead of the increasing activity observed in the market today.¹⁷⁹

III. The Implications of the Theory

In this Part we consider the implications of our theory for corporate law and governance. We emphasize that the substantial and growing level of passive ownership is a new development. Accordingly, while our theory draws on institutional realities and existing empirical research, our

¹⁷⁶ See Investment Company Amendments Act of 1970, Pub. L. No. 91-547, sec. 20, § 36(b), 84 Stat. 1413, 1429 (codified as amended at 15 U.S.C. § 80a-35(b) (2006)) (imposing fiduciary obligation on fund advisors); James Cox & Randall Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L. Q. 855 (2002) (describing the fiduciary obligations of mutual fund advisors).

¹⁷⁷ See Disclosure of Proxy Voting Policies Voting Records By Registered Management Investment Companies, Investment Company Act Release No. 25922, 17 C.F.R. 239, 2003 WL 215451 (Jan. 31, 2003) (explaining that “investment adviser to a mutual fund is a fiduciary that owes the fund a duty [which] extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities.”).

¹⁷⁸ For example, under our theory, passive funds, because they cannot overweight strong performers, might have an incentive to push for poor corporate governance at well-performing companies or to block attractive activist campaigns from which actively-managed funds could benefit more, on a relative basis, than passive funds. Such actions would, however, be inconsistent with passive funds' fiduciary duties.

¹⁷⁹ If one believes that all mutual funds (even active funds) vote only because their fiduciary duties require them to do so (and not because they have an economic incentive), then arguably there should be no difference between active and passive, so our paper, which is comparative, is consistent with such view. Yet, even under such a view (which is consistent with history), passive investors may be more engaged than active for two reasons. First, since they cannot exit, they must use voice. Second, since to tend to hold significant stakes, their vote could be pivotal. This means they must take their role more seriously.

analysis is necessarily preliminary.¹⁸⁰ As the foregoing Parts detail, we challenge the claim that passive investors are unengaged and uninformed.¹⁸¹ Instead, we provide evidence of increasing passive investor engagement, a theoretical explanation for why passive investors have incentives to monitor their portfolio companies actively, and empirical evidence that this monitoring is effective.¹⁸² Our critiques of the literature addressing passive investors' stewardship do not mean there is no reason to be concerned about the rise of passive investors.¹⁸³ In this Part, we sketch out several possible issues that warrant further research. While further research and monitoring by regulators of the significant advent of passive investor investing is warranted, we do not believe that, at this time, specific regulatory measures are warranted.

A. *Conflicts of Interest*

a. *Voting Conflicts*

The first concern created by the growth of passive funds is the increased potential for conflicts of interest between fund investors and fund sponsors. Like other institutional investors, passive funds are managed by entities and individuals that have their own incentives and interests. The mutual fund sponsors and investment advisors, who make decisions on behalf of passive investors, do not own the assets that they manage, and instead “[i]nvestment managers invest other people’s money.”¹⁸⁴ As a result, the interests of mutual fund managers are not always aligned with those of their investors.

Although scholars have analyzed the agency costs and moral hazard problems associated with institutional investors generally, passive investors raise several distinctive issues. On the one hand, this misalignment is less troublesome for passive funds, as these funds have no discretion to make investment decisions.¹⁸⁵ On the other hand, the concern is that agency costs could arguably have a substantial effect on passive funds’ voting.

¹⁸⁰ In particular, we intend to write a follow-up article further exploring the legal implications of the rise of passive ownership.

¹⁸¹ Cf. Lund, *supra* note **Error! Bookmark not defined.** (arguing that active funds have better incentives to monitor and that, as a result, passive funds should not be allowed to vote the shares of their portfolio companies).

¹⁸² We also provide a description of the channels for passive investor engagement that is inconsistent with academic claims that passive investor common ownership raises antitrust concerns. *See, e.g.,* Posner, et al., *supra* note 6.

¹⁸³ We do not make the claim that passive investors engage in stewardship that is socially optimal. In addition, passive investors may influence the incentives of actively-managed funds. *See, e.g.,* David C. Brown & Shaun Williams Davies, *Moral Hazard in Active Asset Management*, 125 J. FIN. ECON. 311 (2017) (arguing that competition from passive funds creates a moral hazard problem and reduces the effort expended by active fund managers).

¹⁸⁴ Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 93 (2017).

¹⁸⁵ Fund sponsors and advisors face the potential of conflicts whenever they allocate investment opportunities because of their ability to favor one client or fund over another. *See, e.g.,* Tim McLaughlin, *How the owners of Fidelity get richer at everyday investors’ expense*, REUTERS, Oct. 5, 2016, <https://www.reuters.com/investigates/special-report/usa-fidelity-family/> (describing as a conflict Fidelity’s decision to invest in a variety of pre-IPO companies through its private venture funds, which are owned by the Johnson family, rather than through its mutual funds).

Because of their large size, passive funds give their sponsors substantial power to influence their portfolio companies. At the same time, passive funds generate much smaller fees than sponsors' other funds or business activities. As a result, there is a greater risk that fund sponsors will exploit the influence of passive funds, not for the benefit of those funds, but for their own benefit or that of other clients.¹⁸⁶ Commentators have identified some of the potential conflicts arising from business ties between public companies and fund sponsors.¹⁸⁷ For example, Vanguard and Fidelity provide extensive services to employer-sponsored 401(k) plans.¹⁸⁸ These services create the risk that Vanguard and Fidelity will vote the shares of their funds in favor of management rather than in the best interests of the fund shareholders, in order to curry favor from management and win or retain 401(k) plan business. The literature has noted that sponsors might favor some funds over others,¹⁸⁹ but it has not fully explored these conflicts. Because of the size of their holdings, passive funds offer active funds at the same fund family the opportunity to leverage their votes.

A similar concern arises in the context of takeovers in which the interests of a funds' beneficiaries are based on the funds' relative holdings of the acquirer and the target. As some commentators have observed, when both bidder and target are public companies that belong to an index, it is common for mutual funds to hold shares of both.¹⁹⁰ Mutual funds' fiduciary duties require them to vote in a manner that benefits their investors, not each company that they hold in their portfolio.¹⁹¹

Unpacking the appropriate exercise of voting power in this situation is not easy. On the one hand, a fund with a larger fraction of the *bidder's* shares might vote its *target* shares in favor of a merger in which the bidder underpays target shareholders. Alternatively, a fund might vote its bidder's shares in favor of a value-decreasing acquisition if it owns shares in the target.¹⁹²

¹⁸⁶ Note that this concern is mitigated to the extent that passive and active funds within the same fund family rely on a centralized voting function.

¹⁸⁷ See, e.g., Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007).

¹⁸⁸ See, e.g., Greg Iacurci, *Fidelity pushes Vanguard to compete on brand in 401(k) plans*, INV. NEWS, Jan. 24, 2018, <http://www.investmentnews.com/article/20180124/FREE/180129959/fidelity-pushes-vanguard-to-compete-on-brand-in-401-k-plans> (describing competition between Fidelity and Vanguard both for revenue from administering 401(k) plans and for investment funds in such plans).

¹⁸⁹ See, e.g., Jose-Miguel Gaspar et al., *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006).

¹⁹⁰ This situation is common to all mutual funds and is not unique to index funds. It is also an issue that comes up whether the takeover is structured as a merger or a tender offer.

¹⁹¹ We focus on cross holdings by the same fund. Potential conflicts also can arise when different funds within the same fund family hold different stock. See generally Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017).

¹⁹² This example is not hypothetical. In the recent Tesla-Solar City merger, Tesla's top 25 institutional shareholders, which collectively held 45.7% of Tesla's stock, also owned shares in Solar City. In re Tesla Motors, Inc., Stockholder Litig., C.A. No. 12711-VCS, memorandum op. at 32, n.183 (Del. Ch. Mar. 28, 2018). In litigation challenging the merger, the plaintiffs argue that these shareholders were not "disinterested" and that their shares should be excluded from the vote tally for the purposes of considering whether the merger had been approved by a majority of disinterested shareholders. *Id.*

The risk is that, in making a voting decision for a specific fund, a fund sponsor might not consider only the interests of that fund's beneficiaries, but instead may consider the interests of other funds within the fund family, the overall value or surplus created by the merger, or the interests of the funds' shareholders across the entire portfolio. These possibilities are of particular concern at a fund family that centralizes or coordinates its voting decisions because of the risk that active managers will cause passive funds to vote in ways that favor the interests of the active funds.¹⁹³

Evidence on the effect of horizontal shareholding on mergers is mixed. At least one study found that institutional investors' ownership of both bidders and targets affects their voting on acquisitions.¹⁹⁴ In contrast, a study focusing on the years 1984-2006 found no effect of such cross holdings on vote outcomes or deal characteristics.¹⁹⁵ If the rise in passive investment continues, however, a significantly larger fraction of shareholders might hold both bidder and target shares in the future.¹⁹⁶ Although it is unclear how mutual funds should vote in the context of horizontal shareholders, the dilemma is exacerbated by the growth in the size of passive funds and the fact that, as a result, the policies that they adopt with respect to these votes are likely to be pivotal in the outcome of merger votes. While this is an area of concern, however, there is no evidence that this is a problematic practice or indeed any specific instance where this type of behavior has been shown to have an adverse effect.¹⁹⁷

b. Access to Information

The ability of sponsors, by virtue of their passive funds, to access firm-specific information creates another potential conflict of interest. As noted above, passive fund sponsors, because of these funds' substantial holdings, enjoy access to management and to corporate information. Sponsors could, in theory, use that information for the benefit of investors in their other products, such as actively-managed funds or hedge funds. For example, sponsors could

¹⁹³ Fidelity's unique policy of delegating the voting of its index funds to a third-party advisor is one way to address this concern. See *supra* note __ (describing Fidelity's approach to voting by its index funds).

¹⁹⁴ See Gregor Matvos & Michael Ostrovsky, *Cross-ownership, Returns, and Voting in Mergers*, 89 J. FIN. ECON. 391, 400 (2008) (finding that cross ownership of bidder and target might affect mutual funds' merger votes); Brooks et. al., *Institutional Cross-ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, 48 J. CORP. FIN. 187, 189 (2018) (acquirers with higher institutional cross-ownership pay lower premiums for targets and tend to use more stock as the method of payment). See also Andriy Bodnaruk & Marco Rossi, *Dual Ownership, Returns, and Voting in Mergers*, 120 J. FIN. ECON. 58 (2016) (focusing on investors holding shares and bonds).

¹⁹⁵ See Jarrad Harford et al., *Institutional Cross-holdings and Their Effect on Acquisition Decisions*, 99 J. FIN. ECON. 27 (2011) (finding that investors with cross-holdings were not influential enough to impact most bids).

¹⁹⁶ See Brooks et. al., *Institutional Cross-ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, 48 J. CORP. FIN. 187, 189 (2018) (finding that, in a sample of 2604 mergers between U.S. public firms from 1984 to 2014, on average, 18% of acquirer stocks are held by target institutional owners and 21% of target stocks are held by acquirer institutional owners).

¹⁹⁷ To the extent that such fund voting policies were shown to have an adverse effect, corporate law, which closely scrutinizes merger voting, could respond.

use negative information to short or underweight their holdings in particular companies, enabling their active funds to outperform the benchmark.¹⁹⁸

This conflict between passive and other funds within the same family, however, may reduce sponsors' incentive to use passive funds' voice to improve the governance or operations of underperforming companies. Because active funds generate higher fees, the reward to the sponsor from this outperformance may outweigh the harm resulting from the poor performance of the market index in which the passive funds are invested.

Similarly, passive fund sponsors may value the access to management afforded by the substantial stakes held by their passive funds, access that provides value to their actively-managed funds. To the extent that sponsors can leverage this access into better-informed stock-picking by active managers, it will enable them to charge higher fees for their actively-managed funds. There is some evidence that fund sponsors tend to favor funds that charge higher fees and are therefore more profitable for them.¹⁹⁹ This favoritism could, in theory, lead a mutual fund family to refrain voting its substantial passive fund holdings against or criticizing management, even when such opposition would be warranted. Similarly, contrary to the interests of its beneficiaries, a passive fund might support an activist campaign that is likely to produce only short-term value if that actively-managed funds in its fund family hold substantial positions in shares of the target company.

c. Time Horizons

A final potential conflict concerns the time horizon of passive funds. The conventional wisdom is that passive investors invest for the very long term, since they hold stock for an eternal time horizon and because of the high percentage of their assets that represent retirement

¹⁹⁸ The extent to which this occurs is unclear. We note, however, that BlackRock received attention in connection with the January 2018 collapse of Carillion in the U.K. See Emma Rumney, Ben Martin, & Alasdair Pal, *Carillion collapse hits banks and investors, boosts short sellers*, REUTERS, Jan. 15, 2018, <https://uk.reuters.com/article/uk-carillion-restructuring-funds/carillion-collapse-hits-banks-and-investors-boosts-short-sellers-idUKKBN1F424D> (describing BlackRock's ownership of Carillion). BlackRock's mutual funds owned a substantial long position in Carillion. According to disclosures made to U.K. regulators, however, BlackRock also held a 1.95% short position, a position that its mutual funds, including its passive funds, could not take. *Id.* It appears that BlackRock's short position was held by its hedge funds. See, e.g., Blackrock, *Custom Hedge Fund Solutions*, <https://www.blackrock.com/ca/institutional/en/strategies/alternative-strategies/hedge-fund-solutions?nc=true&siteEntryPassthrough=true> (describing BlackRock's hedge fund advisory services). See also Bloomberg News, *BlackRock's cheap hedge fund doubles its assets in six months*, Aug. 2, 2017, <http://www.investmentnews.com/article/20170802/FREE/170809983/blackrocks-cheap-hedge-fund-doubles-its-assets-in-six-months> (explaining how BlackRock broke the 1% fee barrier with its "cheap" hedge fund and that the fund has experienced substantial inflows in assets).

¹⁹⁹ See Jose-Miguel Gaspar et al., *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006); Diane Del Guercio et. al. *Playing Favorites: Conflicts of Interest in Mutual Fund Management*, 128 J. FIN. ECON. 535 (2018) (funds whose managers also manage hedge funds underperform peer mutual funds).

savings.²⁰⁰ Indeed, passive fund sponsors have consistently highlighted their nearly perpetual time horizon.²⁰¹

Our theory, however, leads to a more nuanced account of the time horizon of passive investors. Passive funds cannot take advantage of trading opportunities and, as a result, they do not raise the same concerns about short termism. Yet, although the money invested in passive funds is largely invested for the long term, if the returns on those funds lag significantly, investors can move their money from a passive fund to another passive fund or to an actively-managed fund. If our theory is correct, passive funds sponsors may worry about flight from their index products, and that worry may lead them to focus not only on long term returns but also on short term relative performance. Although further empirical study is required to determine the effect of these incentives, we note that they have the potential to make passive funds' time frames more indeterminate.²⁰² This has the potential to create conflicts between the fund itself and its portfolio companies.

B. Concentration of Economic Power

The continuing inflows into passive funds, combined with the economies of scale that characterize passive investors, have had the effect of increasing the quantity of assets under management at the largest mutual fund families-- BlackRock, Vanguard, and State Street. The so-called Big Three are getting pretty big, and the rise of passive investment will undoubtedly contribute to their future growth. This growth raises a second concern – the concentration of economic power in the hands of a small number of institutional intermediaries.²⁰³

This increased ownership concentration will clearly change the nature of corporate governance. Its ultimate effects, however, are difficult to predict at this stage. On the one hand, the rise of institutions with a significant ownership stake may reduce the collective action

²⁰⁰ See, e.g., Strine, *supra* note 109, at 477 (arguing that “the bulk of the stockholder vote is wielded by mainstream mutual funds, most of whose investors are retirement savers”).

²⁰¹ See, e.g., letter sent by F. William McNabb III, *Vanguard’s Chairman and CEO, to the independent leaders of the boards of directors of the Vanguard funds’ largest portfolio holdings*, dated Feb. 27, 2015, available at https://about.vanguard.com/investment-stewardship/CEO_Letter_03_02_ext.pdf (“More than half of the money that we manage is in index equity funds and represents essentially permanent investments in our portfolio companies.”); Fink, *supra* note 16 (“index investors are the ultimate long-term investors – providing patient capital for companies to grow and prosper.”)

²⁰² This discussion assumes that there is indeed short-termism, a matter of much debate. Theoretically, if markets are efficient no investor will take short term actions which are harmful to shareholders in the long term. However, we recognize that the question of market efficiency in terms of time horizons is heatedly debated and currently the subject of disagreement. See generally Lawrence H. Summers, *Is Corporate Short-Termism Really a Problem? The Jury’s Still Out*, HARV. BUQ. REV., Feb. 16, 2017; J.B. Heaton, *The “Long Term” in Corporate Law*, 72 BUS. LAW. 353, 355 (2017) (“there is virtually no evidence¹⁰ that shareholders ever prefer short-term gains that are smaller than larger (discounted) long-term gains.”).

²⁰³ See, e.g., Fichtner et al., *supra* note 4 (identifying concern that “the concentration of ownership in the hands of the Big Three may also lead to a position of structural power”).

problems that modern corporations have faced since the 1930s.²⁰⁴ Berle-Means identified the managerial agency costs that arise in corporations with dispersed public ownership.²⁰⁵ The reconcentration of ownership in the hands of the major mutual fund families offers the potential to reduce these agency costs.²⁰⁶ Moreover, although the investment horizon of passive investors is indeterminate, as noted above, it is likely to be longer than those of active funds and activists.²⁰⁷ Thus, for those concerned with the short-termism that may accompany greater monitoring by active mutual funds and hedge funds, passive investors with a significant ownership stake serve as a valuable antidote. Ironically, this reconcentration and empowerment of mutual funds may partially overcome some of the management entrenchment motivation that led to the regulation of the mutual fund industry and the variety of requirements that have the effect of fragmenting mutual fund ownership of portfolio companies.²⁰⁸

On the other hand, concentrating ownership of virtually all public companies in the hands of a few complex intermediaries with a range of interests and imperfect incentives raises concerns. For example, the substantial size of passive fund families creates the potential for self-dealing and other forms of agency costs. Those in control of these new power brokers could use their immense influence over to pursue pecuniary or nonpecuniary private benefits of control.²⁰⁹

Ultimately, the main concern with this concentration may be the concentration itself. The prospect of large portions of U.S. public companies under the ownership of a small group of fund complexes is a prospect that regulators and market participants have never encountered. We believe that the receptiveness of the public to proposals to disenfranchise passive investors on either antitrust or governance grounds feeds off this unease which itself has historical and cultural foundations. More specifically, since the progressive era, American society has itself eschewed concentration of corporate power and ownership, at least as a principle, if not a practice. In reality though, what this all means is that regulators and the government itself need to keep a watchful eye on the growth of passive funds. While we believe there is no convincing

²⁰⁴ Berle and Means most notably identified the problem of dispersed small ownership and the resulting empowerment of management. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

²⁰⁵ *Id.*

²⁰⁶ See, e.g., Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. FIN. ECON. 23 (2014) (reviewing the literature on the various ways in which large shareholders engage in corporate governance, including voice and exit, and identifying the potential of such shareholders both to improve corporate governance and to obtain private benefits).

²⁰⁷ See, e.g., Jeffrey Busse, Lin Tong & Qing Tong, *Trading Regularity and fund performance*, __ Rev. Fin. Stud. __ (2018) (explaining that active funds trade more frequently in response to information and finding that such trading correlates with performance); Bidisha Chakrabarty, Pamela C. Moulton & Charles Trzcinka, *The Performance of Short-term Institutional Trades*, 52 J. FIN. & QUANT. ANAL. 1403 (2017) (identifying the concern that mutual fund managers engage in short term trading to “look active”).

²⁰⁸ For development of the argument that regulation of the mutual fund industry was a result of political pressure designed to prevent institutions that potentially could influence industry from becoming too big and powerful, see Mark Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991).

²⁰⁹ Cf. Ronald Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006) (discussing controlling shareholders' pursuit of different types of private benefit of control).

evidence to act now to limit this power, it may create unintended effects on governance and the economy. It should be closely monitored.

The increasing concentration of ownership may also increase the level of systemic risk in the capital markets.²¹⁰ Policymakers have expressed concern about the potential that herding by investment managers may increase systemic risk²¹¹ – indeed this was one of the factors that led the Financial Stability Oversight Board to consider designating the large asset managers as systemically significant financial institutions.²¹² To the extent that asset managers invest in similar portfolios and the concentration of managers in those portfolio companies increases, a shock to the financial condition of a large portfolio company or asset manager could have a spillover effect on other firms. Herding may increase price volatility during times of market instability both because it reduces liquidity and because of increased redemptions that affect the price of commonly-held securities.²¹³ The Office of Financial Research, in its 2013 report, noted in particular the risk that ETFs “may transmit or amplify financial shocks originating elsewhere.”²¹⁴

Although further study is warranted, we do not believe that the increase in passive investing is likely to have a substantial effect on systemic risk. First, although the dollar amount invested in the largest indexes such as the S&P 500 index is enormous, the portfolio companies in that index are among the largest in the world, and their stocks are highly liquid. Second, although the money invested in passive funds continues to increase, as noted earlier, there are a tremendous number of indexes, meaning that the total amount of money invested in passive funds is not invested in a lockstep manner but only partially correlated. Indeed, this increase has resulted in a decline in the percentage of money that is invested in the S&P 500 index fund.²¹⁵

Another concern is that passive investing will reduce “efficient price finding on equity markets.”²¹⁶ The premise that stock prices reflect firm value drives the market for corporate

²¹⁰ See, e.g., Rodney N. Sullivan & James X. Xiong, *How Index Trading Increases Market Vulnerability*, 68 FIN. ANALYSTS J. 70, 83 (2012) (“suggest[ing] that the observed rise in systematic risk emanates, in part, from growth in passive index trading, especially ETFs, owing to increased trading commonality over time and across stocks”).

²¹¹ See, e.g., Office of Financial Research, Asset Management and Financial Stability, Sept. 2013, https://www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf. For an explanation of the concept of systemic risk, see Douglas J. Elliott, *Systemic Risk and the Asset Management Industry*, May 2014, https://www.brookings.edu/wp-content/uploads/2016/06/systemic_risk_asset_management_elliott.pdf.

²¹² See, e.g., Noam Noked, *Nonbank SIFIs: No Solace for US Asset Managers*, HARV. L. SCH. FOR. ON CORP. GOV. & FIN. REG., Mar. 27, 2014, <https://corpgov.law.harvard.edu/2014/03/27/nonbank-sifis-no-solace-for-us-asset-managers/> (explaining that the publication of a joint consultative document by the Financial Stability Board and the International Organization of Securities Commissioners “further the likelihood that a few, large US asset managers will ultimately be designated by the US’s Financial Stability Oversight Council (“Council”) as systemically important financial institutions (“SIFIs”).”).

²¹³ Office of Financial Research, *supra* note 211 at 10.

²¹⁴ *Id.* at 11.

²¹⁵ See Andy Martin, *The Rise of Passive and Indexed Investing, and its Effect on Market and Liquidity Risk*, Advisor Perspectives, Feb. 27, 2017 at 3 (reporting that “the percentage of mutual funds that are indexed to the S&P 500 has fallen from 71% to 31% in the 15-year period ending 2015.”).

²¹⁶ Fichtner, et al., *supra* note 4 at ___.

control and guides courts and independent directors.²¹⁷ An important mechanism underlying market efficiency is trading. Informed investors sell overpriced stock, thereby pushing its price down to reflect its fundamental value (and vice versa).²¹⁸ Passive investors, however, have no investment discretion: even if they believe some shares in their portfolio to be overpriced, passive investors cannot sell them. With passive investors comprising an increasingly large fraction of the market, the concern is that there will not remain enough investors to engage in information and price discovery and that market prices will become less efficient.²¹⁹

Research has shown that index inclusion can lead to stock price changes that do not necessarily reflect fundamentals,²²⁰ that the prices of stock included in an index exhibit comovement, as passive funds buy and sell all the stock comprising an index in response to fund inflows and outflows,²²¹ and that passive investment can produce some temporary pricing distortions.²²² There is scant evidence, however, on the direct effect of passive investors on the informational efficiency of stock prices.²²³

At this time, however, the case that passive investors undermine the informational efficiency of stock prices has not been made. Additionally, empirical and theoretical research

²¹⁷ See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (independent directors look to stock prices as a signal of company value); Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 2018 WL 922139 (Del. Ch. Feb. 15, 2018) (holding, in an appraisal case, that the target's unaffected stock price could serve as a proxy for its fair value). See also Philip Bond, Alex Edmans, Itay Goldstein, *The Real Effects of Financial Markets*, 4 ANN. REV. FIN. ECON. 339 (2012).

²¹⁸ Trading by institutional investors is associated with informational efficiency of stock prices. See Ekkehart Boehmer & Eric K. Kelley, *Institutional Investors and the Informational Efficiency of Prices*, 22 REV. FIN. STUD. 3563 (2009); Edmans, *supra* note __ (blockholders' informed exit can lead share price to reflect firm value). See also McCahery, et al., *supra* note __ (reporting survey findings suggesting that selling shares because of dissatisfaction with performance or governance is quite prevalent; 49% of respondents sold because of the former and 39% the latter).

²¹⁹ See, e.g. Steven D. Bleiberg, William W. Priest & David N. Pearl, *The Impact of Passive Investing on Market Efficiency*, white paper dated May 2017, <http://www.nylinvestments.com/polos/MSEP38II-051768130.pdf> (reporting results of three studies claiming that the increase in passive investing is reducing the efficiency of market prices).

²²⁰ See, e.g., Stijn Claessens & Yishay Yafeh, *Comovement of Newly Added Stocks with National Market Indices: Evidence from Around the World*, 17 REV. FIN. 203 (2012); Eric Belasco, Michael Finke & David Nanigian, *The Impact of Passive Investing on Corporate Valuations*, 38 MANAGERIAL FIN. 1067 (2012) (flows into S&P 500 index funds affect valuations of companies within this index).

²²¹ See Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, BIS QUARTERLY REV. 113, 119 (March 2018).

²²² See, e.g., Jeffrey L. Coles, Davidson Heath & Matthew C. Ringgenberg, *On Index Investing* (Oct. 19, 2017), available at <https://papers.ssrn.com/abstract=3055324> (finding that index investing introduces noise into stock prices, but does not impact long-term price efficiency or trading by arbitrageurs)

²²³ One study, for example, found that an increase in holding by exchange traded funds is associated with less firm-level price efficiency. See Doron Israeli, Charles M. C. Lee & Suhas A. Sridharan, *Is There a Dark Side to Exchange Traded Funds? An Information Perspective*, 22 REV. ACCT. STUD. 1048 (2017) (finding that an increase in ETF is associated with increased trading costs and reduced firm-level pricing efficiency). Another study arrived at more positive findings: that passive investors lead to better incorporation of systematic earning information. See Lawrence R. Glosten, Suresh Nallareddy & Yuan Zou, *ETF Activity and Informational Efficiency of Underlying Securities* (Jan. 5, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2846157 (ETF activity increases informational efficiency as a result of timely incorporation of systematic earnings information).

have shown that price discovery and efficiency only require a small number of active traders.²²⁴ Even if passive investing comprised 60% or 70% of the market there would still be sufficient trading for price discovery.²²⁵

In addition, consistent with our theory, as a substantial percentage of the market becomes indexed, the gains from having an informational advantage increase.²²⁶ Actively-traded mutual funds and hedge fund can exploit these gains²²⁷ and, as a result, increase the fees that they charge relative to the fees charged by passive funds.²²⁸ These potential gains increase the incentive of active funds to acquire information that will give them a trading advantage over index funds,²²⁹ and further increase the competition between active and passive funds.²³⁰

C. Regulatory Implications

Our analysis thus far has identified several concerns about passive investors' use of their considerable influence over public companies. Do these concerns warrant a regulatory response? We note, in particular, that Delaware law provides shareholders with the right to vote their shares

²²⁴ See Jonathan Berk & Jules H. van Binsbergen, *Mutual Funds in Equilibrium* (February 9, 2017), available at <https://ssrn.com/abstract=2914669>; Bradford Cornell, *Passive investing and Market Efficiency*, J. OF INVESTING 7 (2017)

²²⁵ Cf. Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J. BLOG, Aug. 26, 2016, <http://jasonzweig.com/are-index-funds-eating-the-world/> (claiming that, because active funds trade so frequently, they will still set market prices even if the levels of passive ownership continue to rise).

²²⁶ See *id.* (“in a market in which everyone has equal information, it must pay off for someone to make the extra effort to obtain superior information. So active management is unlikely ever to disappear”).

²²⁷ See Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, BIS QUARTERLY REV. 113, 120 (March 2018) (“greater anomalies in individual security prices would be expected to increase the gains from informed analysis and active trading, and thus spur more active investment strategies.”). See also Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 Am. Econ. Rev. 393 (1980) (a model showing that market efficiency depends on the availability of gains from acquiring information).

²²⁸ Several studies document the ability of some fund managers to outperform the market consistently. See, e.g., Robert Kosowski et al., *Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551, 2553 (2006) (finding that a sizeable minority of mutual fund managers pick stocks well enough to cover their costs); Malcolm Baker, Lubomir Litov, Jessica A. Wachter & Jeffrey Wurgler, *Can Mutual Fund Managers Pick Stocks? Evidence from Their Trades Prior to Earnings Announcements*, 45 J. FIN & QUANT. ANAL. 1111 (2010) (finding evidence that mutual fund managers can trade profitably due to their ability to forecast earnings-related fundamentals). Importantly, the finance literature finds that talented fund managers are able to capture the value of their skill through the fees they charge. See, e.g., Berk & van Binsbergen, *supra* note 56 at 11.

²²⁹ We note that the emergence of such trading opportunities is unclear, in part because it is unlikely that the level of indexing is sufficient to generate a price effect. See, e.g., Adam Zoll, *Does the Growth of Passive Investing Make Opportunities for Active Investors?*, MORNINGSTAR, Jan. 22, 2014, <http://www.morningstar.com/articles/631398/does-the-growth-of-passive-investing-make-opportun.html> (quoting Morningstar analyst James Xiong as stating that “the question of whether increased indexing creates exploitable opportunities for active investors remains open”).

²³⁰ As one study observes, competition among similar funds reduces the ability of mutual fund managers to generate consistent outperformance. See Gerard Hoberg, Nitin Kumar & Nagpurnanand Pabhala, *Mutual Fund Competition, Managerial Skill, and Alpha Persistence*, REV. FIN. STUD. (forthcoming 2018). As a result, to the extent that active managers face less competition in a world in which a substantial percentage of assets are indexed, they should be able to outperform and to charge higher fees. See *id.*

as they see fit and does not impose any obligation on shareholders to vote unselfishly or to further the economic interests of the corporation.²³¹ The rationale for this approach is that, by and large, shareholders generally have appropriate incentives to behave in ways that are calculated to maximize firm value, but also that shareholders' capacity to influence operational decision-making is limited. Indeed, Delaware law imposes fiduciary obligations on controlling shareholders precisely in situations in which they exercise their power to exert greater influence over firm decisions.²³²

The case has not yet been made, that the more complex incentives of passive owners present a challenge to the existing model of corporate governance. In particular, the most powerful response to the foregoing discussion is the recognition that the incentives of both passive funds and their sponsors are not monolithic but vary substantially depending on the composition of the fund, and the business model and other business activities of the fund's sponsor.²³³ As a result, there is little reason to believe that the big three or passive funds more generally will vote or otherwise act as a block.

Nonetheless as we discussed in the prior subsection we ultimately believe that this is a monitoring issue for regulators and not a cause for regulatory intervention at the present time. The voting behavior and other engagement of passive investors warrants continued oversight. The rise of passive investors may offer a reason at least to reexamine the traditional deference to shareholders when they act in their capacity as shareholders. In particular, shareholders with sufficient voting power and that exercise that power in ways that substantially impact firm decision-making may be held to fiduciary standards in the exercise of that power.²³⁴ Alternatively, policymakers may consider more limited doctrines that entail oversight of the shareholders' objectives in the exercise of that power such as the U.K.'s abuse of the majority principle.²³⁵

D. Corporate Governance in the IPO Market

In this article we have examined how passive investors affect corporate governance through voice – primarily through voting and engagement. However, these are mid-stream

²³¹ See, e.g., *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441, 447 (Del. 1947) (“Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders.”).

²³² See, e.g., Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1269 (2008) (observing that the circumstances in which courts have imposed fiduciary duties on shareholders have been limited both to controlling shareholders and to cases involving “corporate ‘freeze-outs’ and closely held corporations”).

²³³ See, e.g., Fichtner, et al, *supra* note 4 at 307 (“These portfolios may have different interests when it comes to shareholder vote.”).

²³⁴ Cf. Anabtawi & Stout, *supra* note 232 (suggesting the application of fiduciary duties to actions by activists, but not to those by passive investors).

²³⁵ See, e.g., Edward Rock, *Corporate Law Doctrine and the Legacy of American Legal Realism*, 163 U. PA. L. REV. 2019, 2046 (2015) (discussing application of abuse of majority principle in U.K. case of *Asset Mgmt. S.A. v. Irish Bank Resolution Corp.*, [2012] EWHC (Ch) 2090, [6] (Eng.)).

activities. The rise of passive investors also raises concerns about corporate governance in the IPO market.

Existing law has been deferential to firm governance decisions at the IPO stage.²³⁶ This approach has relied on the premise that governance arrangement that firms adopt at the IPO stage are subject to market discipline. IPO investors can, in theory, price issuers' governance structure or, in the alternative, refuse to invest in issuers that have bad corporate governance.²³⁷

Commentators have challenged this description of the IPO process as factually inaccurate.²³⁸ Studies suggest that IPO-stage investing is driven primarily by an issuer's cash flow and revenue projections, and that IPO investors might not price governance terms.²³⁹ The growth of passive investors may further reduce IPO-stage market discipline, however. Passive investors cannot avoid purchasing the shares of an issuer that is to become part of their index, whatever the quality of its corporate governance.²⁴⁰ Passive investors, therefore, are forced buyers. Moreover, because the terms of inclusion in an index are predetermined and public, some companies can predict, at the time they go public, that their shares will become part of a popular index.²⁴¹ These companies can rely on substantial "fixed" demand for their shares regardless of their quality of governance arrangements or other features.²⁴²

²³⁶ See debate over dual class, staggered boards, even arbitration bylaws. [TBC]

²³⁷ See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (discussing the founders' incentives to choose efficient corporate governance arrangements at the IPO stage); Frank E. Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

²³⁸ See, e.g., Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U PA. L. REV. 713 (2003).

²³⁹ See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001).

²⁴⁰ The Council of Institutional Investors, for example, has noted that its members follow passive investment strategies and therefore cannot simply decline to buy shares of such companies. See *Council of Institutional Investors Letter to NYSE Chief Regulation Officer*, Oct. 2, 2012 ("[T]he importance of one-share, one vote is particularly critical to Council members as heavy users of passive investment strategies. With the average Council member indexing approximately 47 percent of its U.S. stock portfolio and approximately 16 percent of its U.S. bonds, our members can not simply sell their stock in companies with a multi-class stock structure."). In the United Kingdom, investors asked the listing authority to take indexing into account in setting governance standards. See Financial Services Authority, *Enhancing the Effectiveness of the Listing Regime and Feedback on CPI2/2* (Oct. 2012) ("indexation and its link to the Listing Regime has been seen as integral to the governance debate, particularly in relation to non-UK issuers. This reflects the perception that some investors are 'forced' into buying the securities of these issuers by virtue of these issuers' inclusion in the FTSE indices and the terms of the mandates under which the investments are managed, for example in relation to index-tracking.")

²⁴¹ A similar concern arises with respect to passive investment in corporate bonds. A recent study suggests that the rise of passive bond funds induces bond issuers to take on more leverage, as the inclusion in bond indices is based on the market value of outstanding bonds. Thus, issuing more debt may increase the demand for the issuer's bonds. See Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, BIS QUARTERLY REV. 113, 121-122 (March 2018).

²⁴² Passive funds normally do not buy shares at the IPO or immediately thereafter, because issuers typically qualify for index inclusion only several months after their IPO. See Ari I. Weinberg, *Why Index Funds Have a Limited Presence in the IPO Market*, WALL ST. J., Sept. 4, 2017; S&P U.S. Indices Methodology 5 (Aug. 2017) (initial public offerings should be traded on an eligible exchange for at least 12 months before being considered for addition to an S&P index). This feature of index funds might lead their investors to lose access to attractively priced IPOs. See Steve Johnson, *Index Funds Will Be Higher Priority in Future UK IPOs*, FIN. TIMES, Jan. 4, 2015.

In addition, governance provisions introduced at the IPO stage may subsequently limit passive investors ability to use their voice. For example, dual class stock has become increasingly popular in technology companies at the IPO stage.²⁴³ Dual class stock greatly reduces passive investors' power to influence corporate decision-making through voting. The concern is even greater with non-voting stock, which completely eliminates the potential for investors to express concern through the exercise of their voting power.

The IPO of SNAP on March 2, 2017 is perhaps an extreme example.²⁴⁴ SNAP was the first no-vote IPO listed on the New York Stock Exchange since 1940.²⁴⁵ A number of institutional investors had been objecting the dual class structure, and the SNAP IPO raised the intensity of these objections. As State Street explained, even passive investors who prefer engagement over confrontation are concerned that limited voting rights will lead their concerns to “carry less weight with management.”²⁴⁶

Several institutional investors responded by seeking to reduce the risk that they would be forced to invest in companies with dual class structures. Following the SNAP IPO, they asked leading index providers to exclude dual class companies.²⁴⁷ In response, two of the largest index providers, the S&P and the FTSE Russell, agreed to exclude certain multiple class companies from their major indexes.²⁴⁸ Notably, however, not all passive investors supported this approach. BlackRock, objected to the exclusion, expressing the concern that its passive funds would be deprived of investments in high growth technology stocks which active funds could still purchase.²⁴⁹ At present, a number of institutions are seeking an alternative approach in which

²⁴³ For example, FINRA reports that “between 2013 and late 2015, 98 companies newly listed on U.S. exchanges had dual class IPOs.” FINRA Staff, *Supervoters, Stocks and Silicon Valley: What Investors Should Know About Dual Class Voting Structures*, Dec. 1, 2015, available at <http://www.finra.org/investors/supervoters-stocks-and-silicon-valley-what-investors-should-know-about-dual-class-voting>

²⁴⁴ Ken Bertch, *Snap and the Rise of No-Vote Common Shares*, HARV. LAW SCHOOL FOR. ON CORP. GOV. & FIN. REG., May 26, 2017k <https://corpgov.law.harvard.edu/2017/05/26/snap-and-the-rise-of-no-vote-common-shares/>
²⁴⁵ *Id.*

²⁴⁶ Rakki Kumar, et al., State Street Global Advisors, *Shareholder Rights in the Age of Snap*, Market Commentary, 2017, <https://www.ssga.com/investment-topics/environmental-social-governance/2017/Shareholder-Rights-in-the-Age-of-Snap.pdf>.

²⁴⁷ See *Council of Institutional Investors, Letter to MSCI Equity Index Committee*, Aug. 3, 2017 (“CII’s membership includes strong supporters of passive index strategies, and we believe that major index providers have a critical role to play in preventing non-voting and multi-class equity structures from gaining unstoppable momentum”).

²⁴⁸ See, e.g., CamberView Partners, *S&P and FTSE Russell on Exclusion of Companies with Multi-Class Shares*, Harv. L. School Forum on Corp. Gov. & Fin. Reg., Aug. 4, 2017, <https://corpgov.law.harvard.edu/2017/08/05/sp-and-ftse-russell-on-exclusion-of-companies-with-multi-class-shares/> (describing the index providers’ new policies); Chris Dieterich, Maureen Farrell & Sarah Krouse *Stock Indexes Push Back Against Dual-Class Listings Stock Indexes Push Back Against Dual-Class Listings*, WALL ST. J., Aug. 2, 2017, <https://www.wsj.com/articles/stock-indexes-push-back-against-dual-class-listings-1501612170> (reporting S&P’s decision that Snap and other dual class companies would not be eligible for inclusion in the S&P 500 index). See also Speech of SEC Commissioner Robert Jackson, *Perpetual Dual-Class Stock: The Case Against Corporate Royalty*, Feb. 15, 2018, <https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty> (reporting that a third index provider, the “MSCI will reduce the weight that dual-class firms occupy in its indexes.”).

²⁴⁹ Ning Chiu, *BlackRock Wants Equal Voting Rights but Opposes Exclusion from Indexes*, Davis Polk Briefing: Governance, Oct. 23, 2017, <https://www.briefinggovernance.com/2017/10/blackrock-wants-equal-voting-rights-but-opposes-exclusion-from-indexes/> (citing BlackRock’s concern that excluding dual class companies from the index would deprive their index-based clients of “opportunities for return.”).

the stock exchanges, rather than index providers, would impose limits on issuer use of dual class structures. This would enable passive funds to invest in these companies on similar terms as active funds.²⁵⁰ Another approach, which SEC Commissioner Robert Jackson has advocated, is to require sunset provisions that reduce or eliminate the voting advantage for dual class shares after a number of years.²⁵¹ Although, it is too early to tell whether the rise of passive investment should make lawmakers rethink the permissive approach to private ordering at the IPO stage,²⁵² the rise of passive investing may increase the pressure for regulators to reexamine the traditional deference to IPO governance provisions and heighten the recognition that those provisions are not the product of an engaged market or contracting process.²⁵³

Conclusion

Passive investors are the new king of our capital markets, at least for the time being. The recent and continued growth of passive investing will no doubt change our capital markets and firm governance and is a development which requires further empirical study and research. In this Article, we provide the first theoretical framework for passive investment as a basis for this further study.

The core of our analysis is a new theoretical understanding of the institutional context in which passive investors operate. In particular, we explain that, although index funds are locked into their investments, the shareholders who invest in these funds are not. This creates incentives for passive funds to retain and grow capital and to engage actively with firms and other market participants such as activist hedge funds. Moreover, the existing literature analyzes the behavior and incentives of passive investors at the level of the individual mutual fund but fails to recognize that fund sponsors are the drivers of fund behavior and that they have incentives to maximize revenue across their entire menu of funds. For these reasons, recent criticism of passive investors and their incentives is incomplete.

Our fundamental insight is that because of the competition between active and passive funds, index funds need to monitor their portfolio companies and to exercise their governance rights in an informed manner to promote firm value. Passive investors must do this by relying on

²⁵⁰ See, e.g., Council of Institutional Investors, *Dual Class Stock*, available at https://www.cii.org/dualclass_stock (explaining that “Stock exchanges could address the problem by ensuring their listing standards bar companies with dual-class structures.”).

²⁵¹ Jackson, *supra* note 248.

²⁵² Note that the problem may be more severe in non-U.S. markets, where it may be easier for companies to get included in major stock indices. In the UK, for example, listings of foreign poorly governed large-cap companies with from Russia and Indonesia led to their inclusion in a leasing FTSE index. This in turn led UK institutional investors to push for new listing rules that would govern premium-listed companies. See Richard Wachman, *FTSE Makes Room for more Russians*, THE GUARDIAN (Dec. 6, 2011), <https://www.theguardian.com/business/2011/dec/06/ftse-russian-miners-governance-concerns>.

²⁵³ See also Scott Hirst, *Frozen Charters*, 34 YALE J. ON REG. 93 (2017) (explaining how voting rules can limit issuers’ ability to amend disfavored charter terms); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, __ CAL. L. REV. __ (forthcoming 2018) (identifying various limitations on effective shareholder voting that are inconsistent with a contractual understanding of the corporation).

voice, rather than exit. We highlight the structural advantages of passive with respect to certain types of engagement, including the focus on improving governance at underperforming companies. We also explain the role that passive investors can play in mediating shareholder activism. We document the growing evidence that passive investors are behaving in ways that are consistent with this theory.

At the same time, we note that the rise of passive investing raises a number of concerns, many of which have not been identified by prior critics. We outline several key concerns, including conflicts of interest, ownership concentration and the effect of passive investing on the capital markets. However, we caution for regulators to monitor the situation rather than acting before the role and ownership scope of passive investors are more fully understood. While it is too early to resolve the net effect of passive investors on economic outcomes, this Article provides a theoretical framework for analyzing future passive investor conduct and any proposed policies to address their extraordinary rise.