BIG THREE POWER, AND WHY IT MATTERS

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ABSTRACT

This Article focuses on the power and corporate governance significance of the three largest index fund managers commonly referred to collectively as the "Big Three." We present current evidence on the substantial voting power of the Big Three and explain why it is likely to persist and, indeed, further grow. We show that, due to their voting power, the Big Three have considerable influence on corporate outcomes through both what they do and what they fail to do. We also discuss the Big Three's undesirable incentives both to underinvest in stewardship and to be excessively deferential to corporate managers.

In the course of our analysis, we reply to responses and challenges to our earlier work on these issues that have been put forward by high-level officers of the Big Three and by a significant number of prominent academics. We show

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[**] Associate Professor, Boston University School of Law. This Article is part of a larger project on stewardship by index funds and other institutional investors. The three earlier parts that have already been published are Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89 (2017); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019); and Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019).

In the course of our work on this Article and our larger project, we have accumulated significant debts that we wish to acknowledge. We have benefitted from valuable suggestions from—and discussions with—many individuals, including Ian Appel, Michal Barzuza, Bernie Black, Alon Brav, John Coates, Alma Cohen, Stacey Dogan, Asaf Eckstein, Einer Elhauge, Luca Enriques, Jill Fisch, Steve Fraidin, Jesse Fried, Stavros Gadinis, Wendy Gordon, Assaf Hamdani, Henry Hu, Keith Hylton, Marcel Kahan, Louis Kaplow, Kobi Kastiel, Dorothy Shapiro Lund, Pedro Matos, Mike Meurer, Stephen O'Byrne, Elizabeth Pollman, Edward Rock, Mark Roe, Eric Roiter, Martin Schmalz, Bernard Sharfman, Steve Shavell, Ted Sims, David Skeel, Steven Davidoff Solomon, Holger Spamann, Leo Strine, Roberto Tallarita, Andrew Tuch, Fred Tung, David Walker, and David Webber. We have also benefited from conversations with many members of the institutional investor and corporate governance advisory communities and from invaluable research assistance by Aaron Haefner. Finally, we gratefully acknowledge financial support from Harvard Law School and Boston University School of Law.

All tables were created by the authors as described in this Article and any errors are the responsibility of the authors alone. The *Boston University Law Review* has not independently reviewed the data and estimates described herein.

that these attempts to downplay Big Three power or the problems with their incentives do not hold up to scrutiny. We conclude by discussing the substantial stakes in this debate—the critical importance of recognizing the power of the Big Three, and why it matters.

CONTENTS

INTRODUCTION

The three largest index fund managers—BlackRock, Inc. ("BlackRock"); State Street Global Advisors, a division of State Street Corporation ("SSGA"); and the Vanguard Group ("Vanguard")—collectively known as the "Big Three," own an increasingly large proportion of American public companies.[1] Consequently, the stewardship decisions of index fund managers—how they monitor, vote, and engage with their portfolio companies—are likely to have a profound impact on the governance and performance of public companies and the economy. The nature and quality of Big Three stewardship are therefore now the subject of a heated ongoing debate.[2]

Under a traditional "value-maximization" account of Big Three stewardship, the stewardship decisions of index fund managers are premised to be largely focused on maximizing the long-term value of their investment portfolios, and agency problems are thus assumed not to be a first-order driver of those decisions. By contrast, in our earlier work we have sought to put forward an alternative "agency-costs" account of index fund stewardship: In a 2019 *Columbia Law Review* article, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* ("*Index Fund Incentives*"), we analyzed the incentives that shape, and the distortions that afflict, the stewardship choices made by the Big Three.[3] In addition, in a 2019 *Boston University Law Review* article, *The Specter of the Giant Three*, we provided empirical evidence on the rise of the Big Three and their likely future growth.[4] Our work, and especially the incentive analysis in *Index Fund Incentives*, built on the framework for analyzing the agency problems of institutional investors we had earlier put forward in a study with Alma Cohen.[5]

In this Article, we seek to contribute empirically and conceptually to the development of the agency-costs account. In particular, we seek to address a wide array of objections and challenges to the agency-costs view that have been put forward both by high-level officers of the Big Three and a number of leading academics.[6] Objections to our agency-costs view from the direction of the Big Three were expressed in a keynote address by BlackRock's then Vice Chairman

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[1] *See infra* notes 31-41 and accompanying text.

[2] *See infra* notes 7-15 and accompanying text.

[3] *See generally* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019) [hereinafter Bebchuk & Hirst, *Index Fund Incentives*].

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

[5] *See generally* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89 (2017) [hereinafter Bebchuk, Cohen & Hirst, *Agency Problems*].

[6] *See infra* notes 7-15 and accompanying text.

Barbara Novick.[7] Responses to our work included a study issued by BlackRock's then Vice Chairman Matthew Mallow,[8] conference presentations by SSGA's then Chief Investment Officer ("CIO") Richard Lacaille,[9] and by Vanguard's former Chief Executive Officer ("CEO") William McNabb.[10] Comments on our work were provided to the *Financial Times* and to *The Wall Street Journal* by SSGA's then Managing Director of Environmental, Social, and Governance Investments and Asset Stewardship, Rakhi Kumar, and by BlackRock and Vanguard spokespersons.[11] These responses by various Big Three officers sought to challenge our conclusions regarding the power of the Big Three, as well as our criticism of how the Big Three use their power.

Analysis taking issue with our agency-costs account of Big Three stewardship was put forward in articles by Marcel Kahan and Edward Rock (both from NYU);[12] by Jill Fisch (University of Pennsylvania), Assaf Hamdani (Tel-Aviv University), and Steven Davidoff Solomon (University of California, Berkeley);[13] and by Jeff Gordon (Columbia University).[14] Whereas these articles

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[7] *See generally* Barbara Novick, Vice Chairman, BlackRock, Inc., Keynote Address at Harvard Law School (Nov. 6, 2019), *in* BLACKROCK, REVISED AND EXTENDED REMARKS AT HARVARD ROUNDTABLE ON CORPORATE GOVERNANCE KEYNOTE ADDRESS: "THE GOLDILOCKS DILEMMA" (2019) [hereinafter Novick Keynote Address], https://www.blackrock.com/corporate/literature/publication/barbara-novick-remarks-harvard-roundtable-corporate-governance-the-goldilocks-dilemma-110619.pdf [https://perma.cc/VB55-3X55], *reprinted in* Barbara Novick, *"The Goldilocks Dilemma": A Response to Lucian Bebchuk and Scott Hirst*, 120 COLUM. L. REV. F. 80 (2020). A video of the address is also available online. Tami Groswald Ozery, Harvard L. Sch., *Barbara Novick's Keynote Address at Harvard Law School*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 11, 2019), https://corpgov.law.harvard.edu/2019/12/11/barbara-novicks-keynote-presentation-at-harvard-law-school/ [https://perma.cc/8AJ6-6RUG].

[8] *See* Matthew J. Mallow, Asset Management, Index Funds, and Theories of Corporate Control 29-33 (Nov. 12, 2019), (unpublished manuscript) (available at https://ssrn.com/abstract=3483573 [https://perma.cc/9H8D-XHT7]).

[9] For a video of Lacaille's comments, see ECGI, *Rethinking Stewardship*, YOUTUBE at 0:50:17-1:01:36 (Oct. 23, 2020), https://www.youtube.com/watch?v=mtMulZ9AOfE[hereinafter Lacaille Video].

[10] For McNabb's comments, see *id*. at 2:17:18-2:32:26.

[11] For the media articles reporting such comments in response to our work, see Owen Walker, *BlackRock, Vanguard and SSGA Tighten Hold on US Boards*, FIN. TIMES (June 15, 2019, 6:00 AM), https://www.ft.com/content/046ec082-d713-3015-beaf-c7fa42f3484a; and Simon Constable, *Index-Fund Firms Gain Power, but Fall Short in Stewardship, Research Shows*, WALL ST. J. (July 8, 2019, 10:05 PM), https://www.wsj.com/articles/index-fund-firms-gain-power-but-fall-short-in-stewardship-research-shows-11562637900.

[12] *See* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1787-88 (2020).

[13] *See* Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 20 (2019).

[14] *See* Jeffrey N. Gordon, *Systematic Stewardship*, J. CORP. L. (forthcoming 2022) (manuscript at 2) (available at https://papers.ssrn.com/abstract=3782814 [https://perma.cc/TXV9-BUTM]).

do not seek to downplay the power of the Big Three, they challenge our agency-costs account by putting forward a more favorable assessment of Big Three stewardship, or at least some key dimensions of it.[15]

This Article responds to this wide array of objections and challenges. To this end, we provide additional analysis and evidence in support of the agency-costs account of Big Three stewardship. Our analysis reinforces the view that, despite the protestations of the Big Three senior officers challenging our conclusions, the Big Three have considerable power and influence on corporate decisions and outcomes. Furthermore, notwithstanding the claims of our academic critics, our analysis reinforces the conclusions that the stewardship decisions of the Big Three are substantially afflicted by distorted incentives.

Our analysis proceeds as follows. Part I considers the arguments made by critics of our empirical analyses of the Big Three's power. We put forward evidence showing that our conclusions regarding the Big Three's substantial voting power remain intact after addressing the empirical issues and challenges raised by critics.[16] We also update the estimates reported in our previous work; in particular, we estimate that, as of the end of 2021, the Big Three collectively held a median stake of 21.9% in S&P 500 companies, which represented a proportion of 24.9% of the votes cast at the annual meetings of those companies. Finally, Part I also engages with objections regarding the likely future growth of the Big Three, and it shows that the power of the Big Three is likely to persist and even significantly grow in the foreseeable future.[17]

Part II examines how the Big Three's voting power and their use of that power has important effects on corporate decisions and outcomes. This analysis is divided into two parts. Section II.A analyzes how the Big Three's voting influences actual and potential voting results. In response to the objection that the proxy solicitor Institutional Shareholder Services ("ISS") exerts considerable influence on votes,[18] we explain that the proportion of votes that ISS influences is less than the proportion of shares held by the Big Three. In response to the objection that the Big Three do not act as a cohesive voting bloc and often vote differently,[19] we explain that the votes of the Big Three show significant correlation. Finally, in response to the objection that even a 10% voting block is unlikely to have significant influence because close votes are

[15] For another significant article worth noting, see generally John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Harvard Pub. L. Working Paper No. 19-07, 2018), https://papers.ssrn.com/abstract=3247337 [https://perma.cc/2UAB-PT2Q]. This study is critical of Big Three stewardship, as we are, but its concern is that the Big Three (and other large institutional investors) will make excessive use of their power. *See id.* at 2. Our conclusions in this Article regarding the Big Three's incentives to underinvest in stewardship and to be excessively deferential to corporate managers are also responsive to the analysis of this study.

[16] *See infra* notes 26-35 and accompanying text.

[17] *See infra* notes 57-64 and accompanying text.

[18] *See infra* notes 70-73 and accompanying text.

[19] *See infra* notes 75-80 and accompanying text.

infrequent,[20] we explain that there are significant situations in which index fund votes could determine whether a vote passes or not, both for proxy contests and for environmental, social, and governance ("ESG") matters. And even where votes are not close, the outcome of votes can play an important part in influencing the behavior of corporate managers.

Section II.B then analyzes how actual and potential voting outcomes, in turn, influence corporate decisions and outcomes. In response to the objection that vote outcomes have a limited effect on corporate outcomes because they are often advisory and because shareholder decisions are made by a collective group of thousands of different investors,[21] we explain that even advisory votes can influence the actions of corporate managers in important ways because it is important for incumbent directors to retain large support from shareholders and to avoid any visible disagreement with a substantial group of shareholders. Consequently, the voting decisions of shareholders holding large voting power, whether in advisory or binding votes, have substantial influence on corporate decisions.

Part III reviews how the power and importance of the Big Three is perceived and described by market participants. To the extent that market participants view Big Three positions as important, we explain, those views alone give the Big Three significant influence, irrespective of their actual ability to influence corporate elections. A belief in the power of the Big Three by corporate managers, even if misplaced, would make corporate managers make decisions that are influenced by the preferences of Big Three managers.

Section III.A documents that management advisors indeed view the Big Three as very important. Section III.B in turn documents that some of the communications by the Big Three themselves reflect this perception as well; for example, communications by the Big Three promoting the success of their engagements on subjects like board diversity make clear that they are aware of the significant influence they are able to exert over the directors and executives of corporations.[22] Our analysis of the perceptions of market participants thus reinforces our earlier conclusion that the Big Three exercise significant influence.

Part IV considers the two incentive problems of index fund managers, which—as we explain—have not been adequately addressed by those defending index fund managers.[23] The first incentive problem, which we discuss in Section IV.A, is that index fund managers have incentives to underinvest in stewardship activities. Index fund managers bear the costs of stewardship, but their own

[20] *See infra* notes 93-96 and accompanying text.

[21] *See infra* notes 120-27 and accompanying text.

[22] *See infra* notes 159-61, 165-66 and accompanying text.

[23] Our analysis of these incentive problems builds on our discussion in *Index Fund Incentives*, which in turn built on earlier analysis of these incentives in *The Agency Problems of Institutional Investors*. For a discussion of incentives to underinvest in stewardship and be excessively deferential, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2050-71; and Bebchuk, Cohen & Hirst, *Agency Problems*, *supra* note 5, at 96-104.

investors enjoy the gains that result from those activities. Index fund managers themselves only capture a very small part of those gains, in the form of the small proportion of their investors' assets that they charge as fees. As a result, index fund managers have an incentive to invest considerably less in stewardship than their own investors would prefer. We show that arguments raised by critics that investment managers benefit from stewardship by attracting additional assets, or because of the size or breadth of their holdings, are unlikely to provide the Big Three with sufficient incentives to undertake substantial stewardship.

The second incentive problem, which we discuss in Section IV.B, is that index fund managers also have incentives to be excessively deferential to corporate managers compared to what would be optimal for their own investors. This is because index funds are likely to bear several different types of costs from nondeferential actions, including lost business from corporate managers, compliance costs that would be borne by investment managers if they influence the control of portfolio companies, and the possibility of a corporate-led backlash to their considerable power. As we explain, the Big Three have expressed doubt regarding these claims, but neither they nor academic commentators have raised any arguments why this is unlikely to be the case.[24]

Finally, Part V discusses the significant stakes involved in this issue. The Big Three's growing power creates the promise that they could overcome the problems with dispersed ownership of corporations and the limited ability of small shareholders to influence corporate managers. The Big Three's incentive problems are important because they leave this promise unfulfilled. This is especially important because of the lack of any corrective mechanisms that would reward the Big Three for good stewardship decisions and thereby lead them to improve their stewardship performance. If they do not do so, corporate managers are likely to continue to be insulated from challenges by investors, even when such insulation is not warranted. This will be the case if attempts by the Big Three to downplay their power are taken at face value. Instead, the power and potential of the Big Three should be fully recognized, and the Big Three should be encouraged to fulfill that potential.

I. VOTING POWER

This Part presents evidence regarding the voting power of the Big Three, updating and expanding the estimates presented in our earlier work.[25] Section I.A considers the current voting power of the Big Three, and Section I.B considers how this voting power can be expected to change in the future. In the course of our discussion below, we pay especially close attention to the objections raised by BlackRock's Vice-Chairs Mallow and Novick and SSGA's CIO Lacaille.

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[24] *See infra* notes 201-19.

[25] In *Giant Three*, we presented estimates based on data through the end of 2019. In this Article, we present estimates based on data through the end of 2021.

A. *At Present*

Both Mallow and Novick include data regarding the current voting power of the Big Three. Novick claims that, as of December 2017, the Big Three collectively managed 10% of global equity.[26] However, the data cited by Novick relates to "global equity market capitalization."[27] Our focus is on understanding the U.S. corporate governance system, and we therefore focus on U.S. companies, S&P 500 companies in particular, which represent more than 70% of total stock market capitalization.[28]

Mallow argues that index mutual funds and exchange-traded funds ("ETFs") "represented only 17% of U.S. stock market capitalization as of year-end 2018."[29] However, this ignores the value of actively managed funds that are also controlled by the Big Three, which is likely to explain the discrepancy between Mallow's figures for all index mutual funds and ETFs and the figures below and in our prior work related to the holdings of the Big Three.[30]

Whereas our earlier work presented estimates through the end of 2019, we now have data for about two more years, through the end of 2021. Table 1 presents estimates of the median ownership percentage of each of the Big Three in S&P 500 companies from 2000 to 2021.[31]

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[26] Novick Keynote Address, *supra* note 7, at 2 exhibit 2 (showing Vanguard, BlackRock, and SSGA owned 4%, 4%, and 2% of global equity, respectively). The CIO of SSGA has also downplayed SSGA's voting power. *See* Lacaille Video, *supra* note 9, at 54:57-55:10 ("Collectively our clients are minority investors . . . we don't dominate, in any stretch of the imagination, decision-making from a proxy voting perspective.").

[27] Novick Keynote Address, *supra* note 7, at 2 exhibit 2.

[28] As of December 31, 2021, the market capitalization of S&P 500 companies constituted 71.4% of the total capitalization of U.S. companies, excluding exchange-traded funds ("ETFs") and closed-end funds. Data is calculated from the Center for Research in Securities Prices, LLC ("CRSP").

[29] Mallow, *supra* note 8, at 13-14.

[30] *See, e.g.*, Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2050 n.51 (presenting evidence that, in 2017, the proportion of assets invested by the Big Three in index funds fell short of 100%, at "79% for SSGA, 74% for Vanguard, and 66% for BlackRock").

[31] Table 1 aggregates holdings for all entities with a version of "BlackRock," "Vanguard," or "State Street" in their names, plus those of five other entities acquired by or associated with BlackRock (Barclays Global Asset Management, Barclays Global Investors UK Holdings Ltd., Merrill Lynch Investment Managers, Inc., State Street Research & Management Co., and iShares (DE) Invag Mit Teilgesellschaftsvermogen). Institutional ownership data is taken from the FactSet 13F Institutional Ownership database, and thus updates the data on which we relied in our earlier work. Positions for each year represented in the table are as of December 31 of that year. Data is limited to companies in the S&P 500 index as of that date. S&P 500 constituent data is taken from CRSP. The median position for each investment manager in that year is calculated as the median of their holdings in S&P 500 companies divided by the outstanding shares of those companies. Estimated medians are rounded to one decimal place; totals in the final column are the sum of the rounded medians.

Table 1. Estimated Median Big Three Ownership of S&P 500 Companies, 2000-2021.

Year	BlackRock	Vanguard	SSGA	Total
2000	3.7%	1.5%	1.9%	7.1%
2001	3.8%	1.7%	2.2%	7.7%
2002	3.8%	1.7%	2.6%	8.1%
2003	4.2%	2.0%	2.9%	9.1%
2004	4.4%	2.2%	3.0%	9.6%
2005	4.1%	2.4%	2.9%	9.4%
2006	4.2%	2.7%	2.9%	9.8%
2007	4.5%	3.0%	3.3%	10.8%
2008	5.1%	3.3%	3.9%	12.3%
2009	5.6%	3.6%	3.7%	12.9%
2010	5.5%	3.9%	3.8%	13.2%
2011	5.5%	4.3%	3.8%	13.6%
2012	5.5%	4.8%	4.2%	14.5%
2013	5.7%	5.5%	4.4%	15.6%
2014	5.9%	6.1%	4.5%	16.5%
2015	6.1%	6.6%	4.1%	16.8%
2016	6.4%	7.4%	4.5%	18.3%
2017	6.8%	8.4%	4.3%	19.5%
2018	7.0%	9.2%	4.3%	20.5%
2019	7.5%	9.5%	4.5%	21.5%
2020	7.4%	9.4%	4.3%	21.1%
2021	7.7%	9.7%	4.5%	21.9%

Novick faults our work for being based on Form 13F filings, which she claims are not reliable.[32] In particular, she claims that Form 13F filings are underinclusive because individuals are not required to submit Form 13F filings.[33] However, this criticism is unwarranted. We use Form 13F data for Big Three holdings, but *not* for the total number of shares of the company. That is, only the numerators of our estimates—the number of shares held by the Big Three—derive from Form 13F data. This is reasonable because, given that they are each well above the threshold for Form 13F filing, the Big Three are required to report their holdings on Form 13F.[34] The denominator in our estimates—the

[32] For this criticism by Novick, see Novick Keynote Address, *supra* note 7, at 3.

[33] *See id.* ("[N]ot all investors are required to file Form 13F. . . . The bottom line is 13F data problems potentially invalidate academic analyses that rely on this data.").

[34] *See* 17 C.F.R. § 240.13f-1 (2021) (requiring filing on Form 13F by "every institutional investment manager which exercises investment discretion with respect to accounts holding section 13(f) securities, as defined in paragraph (c) of this section, having an aggregate fair

total number of shares of the company, held by all investors—comes from the total number of outstanding shares reported by the corporation, which includes shares held by investors which do not file Form 13F.[35] We note that neither Mallow nor Novick engage with an important point: the voting power of the Big Three is actually substantially greater than the number of shares that they hold. This is because the Big Three consistently vote the shares they hold, whereas a substantial proportion of other investors do not vote their shares.[36] As a result, the Big Three's shares represent a much greater proportion of the shares that are actually voted at annual meetings. Table 2 shows the median of the estimated number of shares with voting power held by the Big Three represented as a proportion of the votes cast at each S&P 500 company's annual meeting from 2007 to 2021.[37] As of the end of 2021, we estimate that BlackRock and Vanguard held a median of 9.8% and 12.0%, respectively, of the votes cast at annual meetings, and the Big Three collectively held a median of 27.6% of votes cast at annual meetings.

market value on the last trading day of any month of any calendar year of at least $100,000,000").

[35] For further details on how our previous calculations were performed, see Bebchuk & Hirst, *Giant Three*, *supra* note 4, at 733 n.28.

[36] *See id*. at 738-40.

[37] Table 2 is calculated using the same ownership and S&P 500 constituent data and general approach as Table 1, *supra* note 31. For each of the Big Three, as of the end of each year from 2007 to 2021, Table 2 shows the average, across all of the companies in its portfolio at the end of that year, of the holding of the investment manager divided by the number of votes cast in director elections at the annual meeting of that company. To calculate this, the holdings of that manager in each company in the S&P 500 are first divided by the number of votes represented at the company's annual meeting (i.e., those voted for, against, and those that abstained) in the subsequent year, then those results are averaged for each manager and year. The number of votes cast at annual meetings of companies is obtained from FactSet SharkRepellent. Estimated medians are rounded to one decimal place; totals in the final column are the sum of the rounded medians.

Table 2. Estimated Median Big Three Ownership of S&P 500 Companies, as a Proportion of Total Votes at Annual Meetings, 2007-2021.

Year	BlackRock	Vanguard	SSGA	Total
2007	5.2%	3.5%	3.8%	12.5%
2008	6.1%	3.9%	4.5%	14.5%
2009	7.5%	5.0%	4.9%	17.4%
2010	7.3%	5.5%	5.0%	17.8%
2011	7.2%	6.0%	5.0%	18.2%
2012	7.3%	6.6%	5.5%	19.4%
2013	7.5%	7.5%	5.7%	20.7%
2014	7.6%	8.1%	5.7%	21.4%
2015	8.0%	8.9%	5.4%	22.3%
2016	8.3%	10.0%	5.8%	24.1%
2017	8.8%	10.9%	5.7%	25.4%
2018	9.2%	11.8%	5.5%	26.5%
2019	9.6%	12.4%	5.7%	27.7%
2020	9.5%	11.8%	5.5%	26.8%
2021	9.8%	12.0%	5.7%	27.5%

Both Mallow and Novick argue that, in assessing the power of the Big Three, it is important to take into account that some institutional investors investing through large separate accounts with BlackRock retain their voting rights.[38] However, there are reasons to believe that, during the period that we study, this point has applied to a relatively small minority of the shares held by the Big Three. To begin, much of the assets of the Big Three come from investors in ETFs or from retail investors investing in mutual funds that do not retain the right to vote. To illustrate, at the end of 2021, 46% of BlackRock's assets under management were from retail investors or were in ETFs.[39] The votes of these mutual funds and ETFs are cast by the investment managers.[40] Furthermore,

[38] *See* Mallow, *supra* note 8, at 10 ("Institutional clients with segregated accounts can delegate voting to the asset manager or they can retain the right to vote themselves, as many institutions do."); Novick Keynote Address, *supra* note 7, at 3 ("[Q]uite a few large institutional asset owners outsource the management of their assets while choosing to vote proxies for themselves.").

[39] BlackRock, Annual Report (Form 10-K) 3-4 (Feb. 25, 2022) (stating that at the end of 2021 retail represented 11% of long-term assets under management and ETFs represented 35%).

[40] Votes cast by these funds are generally recommended by the investment manager, who also implements the votes after they have been approved by the directors or trustees of the mutual fund or ETF. *See* Dawn Lim & Paul Kiernan, *SEC Proposal Seeks Transparency in How Money Managers Wield Vast Voting Power*, WALL ST. J. (Sept. 29, 2021, 4:10 PM), https://www.wsj.com/articles/sec-proposal-seeks-transparency-in-how-money-managers-wield-vast-voting-power-11632928496.

even for non-ETF assets that are invested by institutional investors with the Big Three, some of those assets are invested in commingled funds, rather than through separate accounts. And even for the assets that *are* invested in separate accounts, Novick estimated that only 25% of those separate accounts were managed for clients that managed their own shares.[41]

Notably, Novick does not provide any estimate of the fraction of assets managed by BlackRock whose votes are directed by beneficial investors. And to the best of our knowledge, during the period we examine, none of the Big Three disclosed what this fraction was for their assets under management. Given the incentives that the Big Three have to downplay their voting power, which we discuss in Section V.D, the choice of the Big Three not to disclose the percentage of assets for which votes are directed by beneficial investors is consistent with the possibility that the amount represents a relatively small minority of their assets under management. We note that earlier this year, BlackRock implemented a new program aimed at facilitating and expanding voting decisions by institutional clients that invest with BlackRock.[42] But even after the introduction of this program, entitled "Voting Choice," and the resulting expansion in the number of institutional clients providing voting instructions, BlackRock indicated that only about 10% of its index equity assets under management are in the hands of beneficial investors that provide instructions for how shares should be voted.[43] Furthermore, some of these beneficial investors employ a "hybrid" approach under which they provide voting instructions only in selected cases, leaving voting to BlackRock in the remaining cases.[44] Vanguard and SSGA do not have such programs, so the fraction of their index equity investments with client-directed voting is likely to be even smaller.

[41] Novick Keynote Address, *supra* note 7, at 3 ("We estimate that 25% of BlackRock's large separate account mandates are managed for clients who vote their own shares.").

[42] *See* Dawn Lim, *BlackRock Gives Big Investors Ability to Vote on Shareholder Proposals*, WALL ST. J. (Oct. 7, 2021, 1:21 PM), https://www.wsj.com/articles/blackrock-gives-big-investors-ability-to-vote-on-shareholder-proposals-11633617321.

[43] *See BlackRock Expands Voting Choice to Additional Clients*, BLACKROCK (June 13, 2022), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/2022-blackrock-voting-choice [https://perma.cc/QXS5-MWBP] ("Clients representing 25% ($530 billion) of eligible index equity assets ($2.3 trillion) have elected to participate in BlackRock Voting Choice."). This represents 11% of BlackRock's $4.9 trillion in total index equity assets under management at the time. *See* BLACKROCK, IT'S ALL ABOUT CHOICE 7 (2022), https://www.blackrock.com/corporate/literature/publication/its-all-about-choice.pdf [https://perma.cc/YL8E-3JLK]. That denominator does not include non-index equity assets managed by BlackRock, so as a proportion all of their assets under management the proportion will be smaller than 11%.

[44] For a description of the Voting Choice program's hybrid approach to voting, see BLACKROCK, *supra* note 43, at 15.

B. *In the Future*

This Article has so far focused on the current power of the Big Three. In this Section we focus on how the power of the Big Three can be expected to change in the future. In our prior work, we estimated the mean percentage of S&P 500 shares likely to be held by the Big Three over the next two decades and the proportion that these shares are likely to represent out of the total number of shares voted at the meetings of those companies.[45] The proportion of the equity of S&P 500 companies *not* managed by the Big Three has declined from 86.5% in 2008 to 79.5% in 2017, an average annual decline of 0.84%.[46] Extrapolating this decline into the future, the Big Three can be expected to hold an estimated 27.6% of the shares of S&P 500 companies in 2028 and 33.4% in 2038.[47] Similar increases hold for the Russell 3000—if current trends continue, the Big Three can be expected to hold an estimated 23.9% of the shares of Russell 3000 companies in 2028 and 30.1% in 2038.[48]

When the fact that many other shareholders do not vote at annual meetings is taken into account, the voting power exercised by the Big Three is likely to be even greater.[49] In our prior work, we calculated that an average of 73% of shares not held by the Big Three were voted in director elections from 2008 to 2017.[50] Assuming that proportion remains constant, we further estimated that the Big Three will hold 34.3% of S&P 500 votes in 2028 and 40.8% of S&P 500 votes in 2038.[51] We obtained similar estimates for the Russell 3000: 29.8% of Russell 3000 votes in 2028 and 36.7% of Russell 3000 votes in 2038.[52]

Mallow and Novick cast doubt on our predictions regarding the growth of index funds. In particular, Novick stated the following:

> In the *Specter of the Giant Three*, Bebchuk and Hirst assume that these managers will continue to grow at the rate they have for the past few years. While their projections are arithmetically correct, this assumption ignores multiple external variables that can change what products, asset classes, or managers are in or out of favor at a given time, and that translates into changes in growth rates.[53]

Novick argues that many organizations that were among the largest in 1990 are no longer in existence, and many of the largest asset managers in 2000, including Deutsche Asset Management and PIMCO, are no longer among the

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[45] *See* Bebchuk & Hirst, *Giant Three*, *supra* note 4, at 737-41.
[46] *Id*. at 737.
[47] *Id*.
[48] *Id*.
[49] *See supra* notes 36-37 and accompanying text.
[50] Bebchuk & Hirst, *Giant Three*, *supra* note 4, at 739.
[51] *Id*.
[52] *Id*.
[53] Novick Keynote Address, *supra* note 7, at 3 (footnote omitted).

largest.[54] Both Mallow and Novick point to evidence that the growth rate of other asset managers in 2018 surpassed that of the Big Three.[55] Mallow and Novick thus imply that the proportion of votes cast by the Big Three might not trend upwards as much as we have predicted, or that it might decline.[56]

We agree that the growth rates we use for our predictions are not certain; indeed, we emphasized in *The Specter of the Giant Three* the old adage that "it is difficult to make predictions, especially about the future."[57] However, as we discuss below, continued growth of the Big Three is very plausible, even if not completely certain, and this is a scenario that policymakers should seriously consider. Mallow and Novick highlight the uncertainty of the growth rates we use, but they do not question the plausibility of the scenario we put forward.

There have been two steady and persistent trends over the past twenty-five years—the growth of institutional investors and the increasing proportion of institutional investment managed through index funds.[58] Given that both of these trends have been so steady and consistent, there is a substantial chance that they will continue for some time. This is especially the case where the trends can be explained by clear drivers.

One such driver is the advantage that index investing holds over other strategies. Mallow himself recognizes these benefits as reasons for investors to invest in index funds, explaining that "[d]iversification, and obtaining it at a low cost, is the fundamental benefit and a primary reason for the popularity of index investing,"[59] and that "the use of index funds as a core investment vehicle has significantly increased, in part because they provide diversification and benchmark returns at a low cost."[60]

We agree with Mallow that these factors are likely to lead to the increase in the amount of investment using an indexing strategy. It is of course possible that the Big Three may lose their dominance of index fund management and, as Mallow suggests, that the inflows to indexing may go instead to other index fund

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[54] *Id.* (noting certain top-ten asset managers by assets under management in 1990 and 2000 that are no longer in the top ten).

[55] *See* Mallow, *supra* note 8, at 13 (explaining that in 2018 the Big Three "were not, however, the fastest growing among well-known top 30 asset managers," and providing examples of other large asset managers with higher growth rates that year); Novick Keynote Address, *supra* note 7, at 3 (discussing Dimensional Fund Advisors' 9% growth rate).

[56] *See* Mallow, *supra* note 8, at 13 (noting that "future growth [in asset management] is neither certain nor predictable, especially with regards to individual firms over time"); Novick Keynote Address, *supra* note 7, at 3 (discussing estimates in *Giant Three* and noting that those statistics could change based on multiple external variables).

[57] Bebchuk & Hirst, *Giant Three*, *supra* note 4, at 737.

[58] *See id.* at 725-28 (discussing the rise of institutional investors since 1950 and the increasing share of institutional investment managed through index funds from 1995 to 2015).

[59] Mallow, *supra* note 8, at 9.

[60] *Id.* at 14.

managers.[61] However, as we discuss in our prior work, this is unlikely to occur for structural reasons.

To begin, there are significant economies of scale to index fund operations.[62] These not only benefit the Big Three at the expense of potential entrants, but they incentivize the Big Three to continue growing. A second, related reason is that larger ETFs can be expected to have greater liquidity (shown in their lower bid-ask spreads) and thus lower costs to investors.[63] This further incentivizes investors to invest in ETFs that are already larger and that are generally managed by the Big Three. This can also be expected to lead to the continuing growth of those ETFs.[64] Finally, the nature of index fund offerings means that even if an upstart rival were to offer a new product to compete with the Big Three, the Big Three could swiftly replicate that product, making it difficult for the potential competitor to take market share from them. Mallow and Novick do not address these structural factors which provide a basis for believing that the Big Three's dominance of the growing sector of index investing is likely to persist.

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This Part has demonstrated that the Big Three currently control substantial stakes in U.S. corporations and even greater proportions of the voting power in those corporations. Furthermore, their power can be expected not just to continue, but to potentially grow even stronger—possibly transforming them into the "Giant Three."[65] For the reasons we explain in this Article's subsequent parts, this considerable power means that the behavior and incentives of the Big Three have significant implications for corporate outcomes and for corporate governance, and so should attract special attention from scholars and policymakers.

II. INFLUENCE ON CORPORATE OUTCOMES

In seeking to downplay the power of the Big Three, BlackRock's Mallow and Novick and SSGA's Lacaille argue that, notwithstanding the significant share of votes cast by the Big Three, our work overstates the extent to which the Big Three can influence corporate outcomes.[66] Lacaille argues that the Big Three

[61] *See supra* note 56.

[62] *See* Bebchuk & Hirst, *Giant Three*, *supra* note 4, at 729 (explaining how larger ETFs have lower operational costs as a percentage of assets).

[63] *See id.* (describing how larger ETFs offer investors significant liquidity advantages).

[64] *See id.* at 729-30 (explaining how economies of scale and greater liquidity are likely to enable the Big Three to retain their dominance over time).

[65] *See id.*

[66] *See* Mallow, *supra* note 8, at 5; Novick Keynote Address, *supra* note 7, at 1; Lacaille Video, *supra* note 9, at 54:15-55:40.

"don't dominate . . . decision-making from a proxy voting perspective."[67] Mallow and Novick provide a detailed analysis suggesting that the Big Three have a limited effect on the results of corporate votes[68] and that corporate outcomes are largely determined by factors other than the results of corporate votes.[69] We discuss both types of claims in turn. Section II.A discusses claims that the Big Three have limited power to influence voting results. Section II.B discusses claims that those voting results have limited effects on corporate outcomes.

A. *The Effect of the Big Three on Voting Results*

Mallow and Novick make three arguments in an effort to downplay the impact of the Big Three on voting results. In each of the three subsections below we discuss, in turn, the arguments that (1) proxy advisors play a significant role in affecting voting results, (2) investment managers do not coordinate their voting, and (3) close votes where Big Three votes may be particularly influential are relatively rare.

1. Dominated by the Influence of Proxy Advisors?

Mallow and Novick argue that proxy advisors, especially ISS, exert significant control over the outcomes of corporate votes. For instance, Mallow argues that "many other stakeholders play a role in corporate governance, including most prominently, proxy advisors and compensation consultants."[70] Novick points to evidence that "negative [ISS] recommendations drive a 25% decrease in support for say-on-pay proposals."[71] Mallow suggests that "proxy advisory firms' recommendations determine between 20-30% of the vote among institutional investors who lack their own investment stewardship teams."[72] Other releases by BlackRock echo this view.[73]

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[67] *See* Lacaille Video, *supra* note 9, at 54:57-55:10 (stating, in reference to the Big Three, that "collectively our clients are minority investors" and "we don't dominate, in any stretch of the imagination, decision-making from a proxy voting perspective").

[68] *See, e.g.*, Mallow, *supra* note 8, at 19-22 (arguing that "[a]sset managers are minority shareholders with limited voting power and corporate control"); Novick Keynote Address, *supra* note 7, at 5-7 (downplaying BlackRock's influence on executive compensation votes).

[69] *See, e.g.*, Mallow, *supra* note 8, at 29 ("Focusing solely on [index fund managers] . . . omit[s] the pronounced role of company executives in running our nation's public companies and boards of directors in holding company management accountable."); Novick Keynote Address, *supra* note 7, at 5 (noting that there are over 28,000 unique individuals involved in running and setting strategy at US companies, including nearly 4,000 CEOs and over 24,000 board directors).

[70] Mallow, *supra* note 8, at 14.

[71] Novick Keynote Address, *supra* note 7, at 6.

[72] Mallow, *supra* note 8, at 23.

[73] *See, e.g.*, BLACKROCK, EXECUTIVE COMPENSATION: THE ROLE OF PUBLIC COMPANY SHAREHOLDERS 4 (2019), https://www.blackrock.com/corporate/literature/whitepaper/policy-

However, there is evidence to suggest that the actual power of proxy advisors is less than Mallow and Novick suggest. Stephen Choi, Jill Fisch, and Marcel Kahan have presented evidence that proxy advisors have substantially less influence than Novick claims.[74] Of course, if Mallow and Novick argue that the ability of proxy advisory firms to influence 25% of votes cast in elections is "significant" then they should also admit that the collective power of the Big Three, which hold about the same proportion of shares voted in corporate elections, is also "significant."

2. Undermined by Lack of Big Three Coordination?

Mallow and Novick also argue that investment managers do not coordinate their voting, and that as a result, there is considerable variation in their voting decisions.[75] They explain that Section 13(d) of the Securities Exchange Act would require investors who collectively held more than 5% of a company's shares to file a Form 13D if they coordinated their approach to voting that company's shares.[76] Because of difficulties that this would entail for the investment fund manager, they "have a strong incentive not to coordinate with each other on voting specific company shares."[77] Mallow also points to evidence we present to support his claim that "in practice asset managers do not coordinate their voting."[78]

Both Mallow and Novick argue that there is substantial variation in the voting behavior of asset managers.[79] Lacaille has also advanced a similar claim, arguing

spotlight-executive-compensation-the-role-of-public-company-shareholders-april-2019.pdf [https://perma.cc/PK7T-WFD4] (suggesting that proxy advisors could influence between 15% and 25% of shareholder votes cast on say-on-pay proposals).

[74] *See* Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 906 (2010) (concluding that ISS recommendations influence between 6% and 10% of shareholder votes).

[75] *See* Mallow, *supra* note 8, at 22-25 (demonstrating that there is significant variation in voting across asset managers, in part because asset managers do not coordinate their votes); Novick Keynote Address, *supra* note 7, at 5 (explaining that "index fund managers are discouraged, by virtue of the regulatory hurdles they would encounter, from telling management what to do and from coordinating stewardship activities with other managers").

[76] *See* 17 C.F.R. § 240.13d-5(b) (2021); *see also* Mallow, *supra* note 8, at 24 ("If two or more holders coordinate their approach to voting specific company shares, they . . . need to jointly file disclosures with the Securities and Exchange Commission if they together hold more than 5% of a company . . . ."); Novick Keynote Address, *supra* note 7, at 16 (explaining that "[e]ligibility to file Schedule 13G is a key reason why index fund managers do not coordinate voting of proxies, as doing so would require they file Schedule 13D instead").

[77] Mallow, *supra* note 8, at 25.

[78] *Id*. (citing Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 7-8, 73-74, 102-03).

[79] For instance, Mallow claims that "there is significant variation in voting across asset managers of all types and sizes." *See* Mallow, *supra* note 8, at 23. Similarly, Novick explains that "different asset managers vote differently." *See* Novick Keynote Address, *supra* note 7, at 11.

that each of the Big Three vote differently from each other.[80] The implication of this claim is that observers should not aggregate the voting power of the Big Three. For instance, if BlackRock and Vanguard each held about 5% of votes at a particular corporation and voted in different ways on a proposal at that corporation, then their voting decisions would effectively cancel each other out and not influence the outcome of the vote.

However, while the votes of the Big Three are generally not identical, they are significantly correlated. In part, this is because the incentives that we identify apply to all of the Big Three and therefore result in similar voting policies and individual voting decisions.[81] Consistent with the prediction of this analysis, two studies of investment manager voting have found that the Big Three's votes are closely correlated with each other and less correlated with the votes of other investment managers.

Ryan Bubb and Emiliano Catan use investment manager voting data to generate a "spatial map" of the voting behavior of different investment managers.[82] They find that investment manager voting behavior is clustered into three groups of investment managers with similar voting behavior—referred to as "parties"—with each party following a distinctive philosophy concerning corporate governance and the role of shareholders.[83] Professors Bubb and Catan find that BlackRock, Vanguard, and SSGA are all members of the same party, which they refer to as the "Traditional Governance Party."[84]

In a second study, Patrick Bolton, Tao Li, Enrichetta Ravina, and Howard Rosenthal use investment manager voting records to identify the "ideology" of different investors.[85] They find that BlackRock and Vanguard not only share the same (center-right) ideology but that the views of both are similarly "more profit-oriented and more management-disciplinarian."[86] Both studies therefore find that the voting behavior of each of the Big Three is closely correlated with the others and much less correlated with the voting behavior of other investors.

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[80] *See* Lacaille Video, *supra* note 9, at 55:10-55:18 (stating that the Big Three "also vote differently from one another, and those who've studied this, I think, have observed that the Big Three take different viewpoints on important issues").

[81] For a discussion of these incentives, see *infra* Part IV.

[82] *See generally* Ryan Bubb & Emiliano M. Catan, *The Party Structure of Mutual Funds*, 35 REV. FIN. STUD. 2839 (2022).

[83] *See id.* at 2840-41 (identifying three "parties": Traditional Governance Party, Shareholder Reform Party, and Shareholder Protest Party).

[84] *See id.* at 2841 (describing funds in the Traditional Governance Party—including the Big Three—as "distinctly deferential to management on issues that are traditionally understood as a matter for the board, and not shareholders, to decide").

[85] *See generally* Patrick Bolton, Tao Li, Enrichetta Ravina & Howard Rosenthal, *Investor Ideology*, 137 J. FIN. ECON. 320 (2020).

[86] *Id.* at 322. Bolton, Li, Ravina, and Rosenthal also find that BlackRock and Vanguard have similar "ideal points," which are different from those of proxy advisors ISS and Glass, Lewis & Co. ("Glass Lewis") and presumably other investors (SSGA is not mentioned in these analyses). *See id.* at 333.

As a result, it makes sense to aggregate the voting power of the Big Three in order to properly understand their power.

In our own prior work, we provide evidence that each of the Big Three is more deferential to corporate managers on votes on executive compensation than are the three largest active managers: Capital Group, Fidelity Investments, Inc., and T. Rowe Price Group, Inc.[87] That data shows that the frequency of "no" votes by the Big Three in say-on-pay proposals evaluating executive compensation plans is less than half (and closer to one-third) of the frequency of the largest three active managers.[88] This finding is not just driven by the voting behavior of the three largest active managers; the same result is obtained from comparing the Big Three's voting to the ten largest active managers.[89]

Indeed, Novick herself presents data on the level of support of different investment managers for shareholder proposals.[90] This data provides further evidence of the substantial correlation in the voting behavior of the Big Three. BlackRock and Vanguard have the lowest level of support for shareholder proposals, at 15% and 17% respectively.[91] SSGA's level of support is higher, at 29%, but was still 13th out of 19 investment managers listed—separated by only four investment managers from BlackRock and Vanguard at 18th and 19th.[92]

3. Curtailed by the Infrequency of Close Votes?

A third argument put forward by Mallow and Novick, as well as by Professors Kahan and Rock, downplays the voting power of the Big Three by arguing that the infrequency of close votes in corporate elections means that even a voting bloc of 20% does not give the Big Three much influence over corporate outcomes.[93] Both Novick and Mallow present evidence of the proportion of Russell 3000 direct elections that were won by margins above and below 30% and 10%.[94] Novick draws the conclusion that "no individual manager has

[87] *See* Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2093.

[88] *See id.* at 2093 tbl.6 (showing that, on average, the Big Three voted against an average 3.1% of say-on-pay votes between 2012 and 2018, compared to 9.0% for the largest three active managers).

[89] *See id.* (showing that, on average, the ten largest active mangers voted against 9.1% of say-on-pay votes between 2012 and 2018).

[90] *See* Novick Keynote Address, *supra* note 7, at 11 exhibit 8 (presenting data regarding support for Russell 3000 shareholder proposals for selected investment managers for the period from July 1, 2018, through June 30, 2019).

[91] *Id.*

[92] *Id.*

[93] For instance, Novick states that "[i]n reality, very few votes are contentious." *Id.* at 7. Mallow argues that there is a limited number of circumstances in which any of the Big Three could operate as "a swing vote." Mallow, *supra* note 8, at 20.

[94] *See* Mallow, *supra* note 8, at 20 (noting that 95% of Russell 3000 director elections are won by a margin greater than 30% and less than 1% of Russell 3000 director elections are won or lost by a margin greater than 10%); Novick Keynote Address, *supra* note 7, at 7-8

anything close to a swing vote."[95] Similarly, Professors Kahan and Rock argue that "[t]he number of potentially consequential individual contests" is very small.[96] However, these arguments regarding close votes suffer from two serious problems.

To begin, there are important situations where the voting decisions of index fund managers *do* have a significant impact on whether the vote passes or not.[97] For example, in 2015 there was a proxy contest at E.I. du Pont de Nemours and Company ("DuPont"), when Trian Partners, L.P. nominated directors to contest the election against the incumbent directors.[98] All of the Big Three voted in favor of the incumbent directors rather than the nominees put forward by Trian Partners, and none of Trian Partners' nominees were elected.[99] The margin between the Trian Partners nominee receiving the most votes (Nelson Peltz) and the DuPont nominee receiving the fewest votes (Lois Juliber) was 53.8 million votes.[100] At the time of the meeting, BlackRock held 57.2 million DuPont shares, and Vanguard held 50.1 million shares.[101] Had *either* BlackRock or Vanguard voted for Nelson Peltz then he would have been elected.[102]

The voting decisions of the Big Three can also be decisive in shareholder proposals. As BlackRock's own data shows, it regularly votes against many shareholder proposals.[103] BlackRock and Vanguard have among the lowest

(presenting data on how many Russell 3000 votes on management proposals are won or lost by a 10% or 30% margin).

[95] Novick Keynote Address, *supra* note 7, at 8.

[96] *See* Kahan & Rock, *supra* note 12, at 1777-78 (stating that most of BlackRock's votes cast in 2019 had no significant effect on firm value).

[97] This is consistent with the observation of Kahan and Rock, who note there are a "small number of high-profile proxy contests" where institutional investor efforts "are likely to affect firm value." *Id*.

[98] *See generally* E.I. du Pont de Nemours & Co., Proxy Statement (Schedule 14A) (Mar. 23, 2015).

[99] *See* SULLIVAN & CROMWELL LLP, SHAREHOLDER ACTIVISM UPDATE: DUPONT ANNOUNCES VICTORY IN PROXY FIGHT WITH TRIAN 1 (2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Shareholder_Activism_Update.pdf [https://perma.cc/4QTM-4VYJ] ("DuPont announced . . . that all 12 of its incumbent directors were reelected . . . . DuPont's three largest institutional shareholders, The Vanguard Group, Blackrock, Inc. and State Street Corporation, all voted in favor of DuPont's slate.").

[100] *See* E.I. du Pont de Nemours & Co., Current Report (Form 8-K/A) 2-3 (June 9, 2015) (indicating that Peltz received 320.2 million votes, and Juliber received 374.0 million votes).

[101] *See* E.I. du Pont de Nemours & Co., *supra* note 98, at 35.

[102] Although Vanguard's holding of 50.1 million shares was less than Peltz's margin of defeat, if Vanguard did vote for one or more of the DuPont nominees, then switching from that nominee to Peltz would have created a swing of double its shareholding, or approximately 100.2 million votes.

[103] *See* Novick Keynote Address, *supra* note 7, at 11 exhibit 8 (listing support by various investment managers for shareholder proposals at Russell 3000 companies in 2019 and showing BlackRock as having the lowest level of support of the group).

levels of support for shareholder proposals of any of the largest investors.[104] BlackRock and Vanguard have rarely supported shareholder proposals requesting changes in the social and environmental policies or disclosures of their portfolio companies.[105]

Furthermore, even without support from BlackRock or Vanguard, many proposals nonetheless receive substantial support from other investors. For instance, BlackRock and Vanguard generally vote against disclosure of political spending and lobbying activity, but many of these proposals receive substantial support from shareholders.[106] At Exxon's annual meeting in 2019, a shareholder proposal in favor of lobbying transparency received the support of 37% of votes cast.[107] Had BlackRock and Vanguard both voted their sizable stakes in favor of that proposal it would have passed.[108]

A report by Morningstar provides evidence of the potential effect of BlackRock and Vanguard's voting decisions.[109] The report identified 23 shareholder proposals that failed by 10% or less.[110] Either BlackRock or Vanguard voted against all of these proposals, and both of them voted against 20 of the 23 proposals.[111] In all of these cases, either or both BlackRock and Vanguard held positions of more than 5% of the company's stock and often held more than 10% of the company's stock.[112] Therefore, had either BlackRock or Vanguard switched their vote to support the proposal, it would have passed.

Moreover, in many cases, even proposals that obtain substantial support but are not successful can create significant pressure for directors and managers to respond to shareholder concerns. Both of the two largest proxy advisors have policies to apply extra scrutiny to board actions where substantial minorities have voted for shareholder proposals or against management proposals.[113]

[104] *See* MORNINGSTAR, PROXY VOTING BY 50 U.S. FUND FAMILIES 8 exhibit 3 (2020) (listing Vanguard and BlackRock as fourth- and fifth-least-supportive fund groups during 2015 through 2019); *see also* Novick Keynote Address, *supra* note 7, at 11 exhibit 8 (showing Vanguard as having the second-lowest level of support for shareholder proposals at Russell 3000 companies in 2019, after BlackRock).

[105] For evidence of BlackRock and Vanguard's limited support of social and environmental proposals, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 225-28, 244 (2018); and MORNINGSTAR, *supra* note 104, at 12-14.

[106] For data on BlackRock and Vanguard's voting behavior on proposals regarding political spending, see Hirst, *supra* note 105, at 226-27, 244.

[107] *See* MORNINGSTAR, *supra* note 104, at 22.

[108] *See id*.

[109] *See id*. at 23 exhibit 11.

[110] *See id*.

[111] *See id*.

[112] *See id*.

[113] *See* GLASS LEWIS, 2022 UNITED STATES POLICY GUIDELINES 19 (2022), https://www.glasslewis.com/wp-content/uploads/2021/11/US-Voting-Guidelines-US-GL-2022.pdf?hsCtaTracking=257fcf1c-f11e-4835-81a3-d13fbc7b1f4c%7C1dad2378-213f-45f6-8509-788274627609 [https://perma.cc/43U7-2CZ2] (describing expectations when at

Accordingly, advisors often advise companies that they should regard say-on-pay votes where less than 80% of shareholders vote in favor as a strong negative signal, requiring some response by directors.[114] Consistent with this advice, a study by Yonca Ertimur, Fabrizio Ferri, and David Oesch found that "firms generally respond to high voting dissent" on say-on-pay votes, even where firms received majority support.[115] Of the companies in that study that received between 70% and 75% support on say-on-pay proposals, 32% responded with changes to their compensation plans.[116] And of the firms receiving between 65% and 70% support, 72% responded with changes.[117]

As discussed in Section I.A, the Big Three collectively held, on average, 24.9% of the votes cast at annual meetings of S&P 500 companies in 2021.[118] Had all of the Big Three switched from supporting a say-on-pay proposal to withholding, the proposal would be in the range of those described by Professors Ertimur, Ferri, and Oesch, where directors are likely to respond with changes.[119] The substantial holdings of the Big Three thus give them the power to exert substantial influence over directors and managers through their voting decisions, irrespective of the decisions of other investors.

B. *The Effect of Vote Results on Corporate Outcomes*

Mallow and Novick also argue that even if the Big Three were able to exert significant influence on the outcomes of shareholder votes, those vote outcomes have limited effects on how corporations are managed.[120] They give two reasons

least 20% of votes are cast in favor of a shareholder proposal or against a management proposal); ISS, UNITED STATES PROXY VOTING GUIDELINES 12 (2021), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf [https://perma.cc/MV36-2ZE5] (describing ISS responses where a say-on-pay vote received less than 70% of votes cast).

114 *See, e.g.*, Edward A. Hauder, Exequity, LLP, *Bouncing Back from a Low Say-on-Pay Vote*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 5, 2018), https://corpgov.law.harvard.edu/2018/11/05/bouncing-back-from-a-low-say-on-pay-vote/ [https://perma.cc/4J84-L7ZL] ("If your company's say-on-pay . . . vote received less than 80% support, you will need to respond appropriately in next year's proxy . . . .").

115 *See* Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RSCH. 951, 983-86 (2013).

116 *See id.* at 985 fig.1.

117 *See id.*

118 *See supra* Table 2 and accompanying text.

119 *See* Ertimur et al., *supra* notes 115-17 and accompanying text.

120 For arguments by Mallow and Novick that shareholder votes are merely advisory, see Novick Keynote Address, *supra* note 7, at 5 (arguing that say-on-pay votes are advisory votes); and Mallow, *supra* note 8, at 28 (pointing out that say-on-pay votes are "non-binding, advisory" votes). For arguments that corporations are managed by directors, executives, and advisors, see Mallow, *supra* note 8, at 28 (arguing that compensation is determined by a board committee, on the advice of advisors, and that 90% of large U.S. public companies hire such advisors); and Novick Keynote Address, *supra* note 7, at 5 (highlighting the role of

for this, which we discuss in turn: that many votes are merely advisory; and that directors, executives, and their advisors are the ones who determine how the corporation will be managed.

First, Mallow and Novick argue that say-on-pay proposals are merely advisory, and therefore, even if BlackRock or others were to cause those proposals to fail, directors and managers would not be required to follow the recommendation of the vote.[121] Mallow and Novick are correct in pointing out that say-on-pay votes are not binding.[122] However, negative say-on-pay votes can still have a significant impact. Directors and managers prefer to avoid vote outcomes that indicate a significant lack of support, even if those proposals nonetheless pass.[123] In deciding which compensation arrangements to approve, directors are therefore likely to have regard for the level of support that those compensation arrangements are expected to receive in future say-on-pay votes. That is, directors are likely to avoid compensation arrangements that they expect will attract significant opposition in future say-on-pay votes, or to otherwise take steps to avoid such opposition.[124]

Second, Mallow and Novick argue that corporate decisions are not made by shareholders, but instead are made by directors, managers, and advisors.[125] As a result, rather than most U.S. corporations being substantially influenced by the Big Three through their very large shareholdings, Mallow and Novick argue that there are thousands of individuals who collectively manage these corporations. Novick states that "there are over 28,000 unique individuals involved in running and setting strategy at US companies."[126] Mallow elaborates, explaining that these include "approximately 3,900 CEOs . . . and 24,100 board directors."[127]

However, this overlooks an important fact regarding the power of shareholders in general and the Big Three in particular. Shareholders have significant influence because they can ultimately remove directors.[128] Directors

management, the role of the board, and how the board engages with people like compensation consultants in discussing how public companies are run).

[121] *See* Mallow, *supra* note 8, at 28; Novick Keynote Address, *supra* note 7, at 5.

[122] *See* 17 C.F.R. § 240.14a-21 (2021) (requiring corporations to include advisory votes on executive compensation).

[123] *See, e.g.*, Hauder, *supra* note 114 (advisors often advise companies that they should regard say-on-pay votes where less than 80% of shareholders vote in favor as a strong negative signal).

[124] *See, e.g.*, David Whissel, MacKenzie Partners, Inc., *Responding to a Negative Say-on-Pay Outcome* (Oct. 27, 2016), https://corpgov.law.harvard.edu/2016/10/27/preparing-for-and-responding-to-a-negative-say-on-pay-outcome/ [https://perma.cc/Z75J-TCLD] (advising corporations to plan ahead to "overcome the setback of a negative recommendation and earn the support of their investors" and emphasizing the importance of "responsive action" following a negative say-on-pay vote).

[125] *See* Mallow, *supra* note 8, at 28; Novick Keynote Address, *supra* note 7, at 5.

[126] Novick Keynote Address, *supra* note 7, at 5.

[127] Mallow, *supra* note 8, at 29.

[128] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675,

wish to retain the support of shareholders, and especially large shareholders, to reduce the odds of a challenge to directors by an activist hedge fund, which could ultimately lead to a proxy contest.[129] As a result, the decisions of the thousands of directors that Mallow and Novick mention are made against the background of those directors' incentives not to make choices that would be viewed unfavorably by BlackRock, SSGA, or Vanguard. This discourages decisions by directors that they believe would be viewed unfavorably by these major investors.

III. MARKET PERCEPTIONS OF BIG THREE POWER

Thus far this Article has focused on the substantial power and influence of the Big Three over corporate managers and on addressing claims by Mallow and Novick that the Big Three's influence may not be so significant. In this Part, we turn from the actuality of the Big Three's power to the *perception* of the Big Three's power by market participants. Considering market participants' perceptions of the Big Three's power is important for two reasons. First, market participants are likely to be rational and well-informed and to have strong incentives to clearly understand the power of other market actors. There is thus a substantial likelihood that their perceptions provide a telling account of the actual power of the Big Three.

Furthermore, and importantly, even disregarding the accuracy of market participants' perceptions of the Big Three's power, those perceptions themselves function to give power and influence to the positions and practices of the Big Three. If market participants perceive the Big Three as having substantial power and influence, then that perception will increase the *actual* power and influence of the Big Three, as issuers and advisors will give considerable attention to the preferences, policies, and positions of the Big Three. Section III.A below therefore examines evidence of other market participants' perceptions of the Big Three's power. Section III.B then discusses the Big Three's own communications which, we show, recognize the very power that Big Three officers now seek to deny in challenging our work.

A. *Communications by Management Advisors*

This Section considers how those who advise corporate directors and executives—lawyers, governance advisors, proxy solicitors, investment bankers, and others—consider the power and influence of the Big Three. Statements made by these advisors commonly reflect, explicitly or implicitly,

680-82 (2007) (describing the critical role of shareholders' ability to replace directors in corporate law).

[129] For a review of research on hedge fund activism, see Alon Brav, Wei Jiang & Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence* (Eur. Corp. Governance Inst. – Fin. Working Paper No. 797, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3991289 [https://perma.cc/88PZ-KTT5].

their recognition of the Big Three's power. This recognition is reflected in the close attention that these advisors pay to the actions and policy statements of the Big Three and the great frequency and considerable detail with which they bring these actions and statements to the attention of corporate managers.[130]

As this Section documents, each time one of the Big Three revises its voting guidelines, issues a policy statement, or sends a letter to a group of portfolio companies, law firms and other advisors release memos to their clients describing and analyzing such actions; this focus dwarfs the attention these advisors pay to other investors. This is illustrated, for example, in the particular attention that management advisors have paid to recent changes in the Big Three's policies to provide greater support for ESG proposals, and in some cases, to engage with directors and executives to promote corporate changes regarding environmental and social objectives.

Lawyers advising corporate managers have spoken clearly on the power and influence of the Big Three. An interview with prominent lawyer Martin Lipton describes his view that "[t]he large stakes held by [the Big Three], along with their long-term investment horizons, make them a centerpiece of good governance."[131] Other prominent law firms have echoed this sentiment.[132]

Accordingly, law firms pay close attention to changes in the Big Three's policies, as well as their engagement and voting behavior. In an annex to a client memo concerning changes in voting policies and decisions by investors, law

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[130] *See infra* notes 131-51.

[131] John Jannarone, *Martin Lipton Says Latest Steps by Big Institutions Align Well with "The New Paradigm,"* YAHOO! FIN. (May 13, 2019), https://finance.yahoo.com/news/exclusive-martin-lipton-says-vanguard-202453971.html [https://perma.cc/LC3S-HUPG].

[132] For example, Sullivan & Cromwell LLP states that:

> Concentration of equity ownership, particularly among the largest three index fund providers, continues to be a key component in the activism landscape. As of December 2018, one of BlackRock, Vanguard or State Street was the largest shareholder in 438 of the S&P 500 companies, roughly 88%, and collectively the three firms owned 18.7% of all shares in the S&P 500.

Melissa Sawyer, Sullivan & Cromwell LLP, *Annual Review and Analysis of 2019 U.S. Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 20, 2019), https://corpgov.law.harvard.edu/2019/11/20/annual-review-and-analysis-of-2019-u-s-shareholder-activism/ [https://perma.cc/5MK2-EA3L]. Kirkland & Ellis has also emphasized the "position of strength" of the Big Three, stating that "BlackRock, State Street and Vanguard—the three largest 'passive' managers—now control approximately 20 percent of the value of the S&P 500 and collectively constitute the single largest shareholder in almost 90 percent of S&P 500 firms." David Feirstein, Sarkis Jebejian & Shaun J. Mathew, Kirkland & Ellis LLP, *Purpose, Culture and Long-Term Value—Not Just a Headline*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2019), https://corpgov.law.harvard.edu/2019/02/26/purpose-culture-and-long-term-value-not-just-a-headline/ [https://perma.cc/PV9U-JB5L].

firm Wachtell, Lipton, Rosen & Katz lists 15 different investors' policies.[133] But the body of the memo discusses only SSGA and Vanguard and spends a majority of its discussion on an in-depth analysis of their policies.[134] Many law firms publish releases describing the annual letters issued by the Big Three.[135] Many law firms have also published releases describing changes in the Big Three's

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[133] *See* Andrew R. Brownstein, Sabastian V. Niles & Justin C. Nowell, Wachtell, Lipton, Rosen & Katz, *Institutional Investors Signal: A Mix of Tougher Standards and Heightened Flexibility for the 2020 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 2, 2020), https://corpgov.law.harvard.edu/2020/05/02/institutional-investors-signal-a-mix-of-tougher-standards-and-heightened-flexibility-for-the-2020-proxy-season/ [https://perma.cc/N3HK-BKHV].

[134] *Id.*

[135] *See, e.g.*, Ning Chiu, Davis Polk & Wardell LLP, *State Street and Corporate Culture Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE. (Feb. 4, 2019), https://corpgov.law.harvard.edu/2019/02/04/state-street-and-corporate-culture-engagement/ [https://perma.cc/C4Z8-F3TM] (summarizing SSGA's letter to board members); David A. Katz & Laura McIntosh, Wachtell, Lipton, Rosen & Katz, *Sustainability in the Spotlight*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 27, 2020), https://corpgov.law.harvard.edu/2020/01/27/sustainability-in-the-spotlight/ [https://perma.cc/92DX-LDW3] (analyzing BlackRock's 2020 letter to CEOs); Holly J. Gregory, Sidley Austin LLP, *Looking Ahead: Key Trends in Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 10, 2019), https://corpgov.law.harvard.edu/2019/01/10/looking-ahead-key-trends-in-corporate-governance/ [https://perma.cc/7PJY-LV5K] (referencing BlackRock's annual letter to CEOs); Amy Simmerman & Katherine Henderson, Wilson Sonsini Goodrich & Rosati, *A Guidebook to Boardroom Governance Issues*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 8, 2019), https://corpgov.law.harvard.edu/2019/11/08/a-guidebook-to-boardroom-governance-issues/ [https://perma.cc/7PJY-LV5K] (referencing BlackRock's recent annual letters to CEOs); Pamela L. Marcogliese, Elizabeth K. Bieber & Brennan K. Halloran, Cleary Gottlieb Steen & Hamilton LLP, *Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 28, 2019), https://corpgov.law.harvard.edu/2019/02/28/synthesizing-the-messages-from-blackrock-state-street-and-t-rowe-price/ [https://perma.cc/39E3-6B3B] (referencing BlackRock and SSGA's letters to companies).

policies, engagement, and voting on topics such as board composition,[136] board diversity,[137] and environmental matters.[138]

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[136] *See, e.g.*, Sabastian V. Niles, Wachtell, Lipton, Rosen & Katz, *Board Development and Director Succession Planning in the Age of Shareholder Activism, Engagement and Stewardship*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 7, 2019), https://corpgov.law.harvard.edu/2019/06/07/board-development-and-director-succession-planning-in-the-age-of-shareholder-activism-engagement-and-stewardship/ [https://perma.cc/GR5Y-V2C7] (summarizing BlackRock, SSGA, and Vanguard's commentary on board development); Marc S. Gerber, Skadden, Arps, Slate, Meagher & Flom LLP, *US Corporate Governance: Turning Up the Heat*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 10, 2019), https://corpgov.law.harvard.edu/2019/02/10/us-corporate-governance-turning-up-the-heat/ [https://perma.cc/B2FE-LJK6] (describing Vanguard's "concern over [board composition] as an economic imperative" and BlackRock's voting guidelines, which state that "it expects to see at least two female directors on every board").

[137] *See, e.g.*, Gail Weinstein, Warren S. de Wied & Philip Richter, Fried, Frank, Harris, Shriver & Jacobson LLP, *The Road Ahead for Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 13, 2019), https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/ [https://perma.cc/5S7M-GVG7] (noting that several institutional investors, including BlackRock and SSGA, have added board diversity to their voting policies); Betty Moy Huber & Paula H. Simpkins, Davis Polk & Wardell LLP, *Women Board Seats in Russell 3000 Pass the 20% Mark*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 5, 2019), https://corpgov.law.harvard.edu/2019/10/05/women-board-seats-in-russell-3000-pass-the-20-mark/ [https://perma.cc/L8VL-CE77] (commenting on the Big Three's recent release of their annual stewardship reports and noting that "some report their voting record against directors on boards that fail to meet certain standards"); Andrew Brownstein, Steven Rosenblum & Victor Goldfeld, Wachtell, Lipton, Rosen & Katz, *Mergers and Acquisitions—2019*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 15, 2019), https://corpgov.law.harvard.edu/2019/01/15/mergers-and-acquisitions-2019/ [https://perma.cc/NK7Y-ZXJE] (noting that several institutional investors, including BlackRock and SSGA, now include board diversity in their voting policies); Douglas Schnell, Lisa Stimmell & Jose Macias, Wilson Sonsini Goodrich & Rosati, *Preparing for the 2020 Reporting Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE. (Dec. 26, 2019), https://corpgov.law.harvard.edu/2019/12/26/preparing-for-the-2020-reporting-season/ [https://perma.cc/F6MF-5GBY] (citing engagement by SSGA and BlackRock as examples of different stakeholders making gender diversity on public boards a priority).

[138] *See, e.g.*, Elizabeth A. Ising & Gillian McPhee, Gibson, Dunn & Crutcher LLP, *Considerations for 2020 Proxy Statement Preparations*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 20, 2020), https://corpgov.law.harvard.edu/2020/02/20/considerations-for-2020-proxy-statement-preparations/ [https://perma.cc/77WZ-9QAJ] (describing comments by BlackRock CEO Larry Fink regarding disclosure of climate-related risks); William Savitt, Wachtell, Lipton, Rosen & Katz, *Tectonic Forces to Watch in Corporate Litigation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2020), https://corpgov.law.harvard.edu/2020/01/30/tectonic-forces-to-watch-in-corporate-litigation/ [https://perma.cc/83QX-WAMV] (noting increasing calls from influential investors, including Blackrock, for "more robust disclosure of climate risk, and more corporate action to address it"); Catherine M. Clarkin, Melissa Sawyer & Joshua L. Levin, Sullivan & Cromwell LLP, *The Rise of Standardized ESG Disclosure Frameworks in the United States*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 22, 2020), https://corpgov.law.harvard.edu/2020/06/22/the-rise-of-standardized-esg-disclosure-

Governance advisors who assist managers in engaging with investors and in preparing disclosures for investors have also called attention to the importance and influence of the Big Three and closely followed changes in Big Three policies and activities. For instance, leading governance advisor CamberView Partners (now PJT Camberview) stated in 2017 that "passive investors are increasingly important" because "one of the three biggest index funds (BlackRock, Vanguard and State Street) is the largest single shareholder in 88% of companies in [the S&P 500] index."[139] As a result of this power, CamberView explains, the topics of concern to the Big Three have become "a critical focal point in activism campaigns."[140]

CamberView also describes how the voting decisions of the Big Three have become central to say-on-pay votes, with changes in the Big Three's voting policies "heighten[ing] the need to engage with investors to bring them along."[141] CamberView and other governance advisors—such as Ernst & Young ("EY"), PricewaterhouseCoopers ("PwC"), and Deloitte—have paid close attention to the annual letters released by the Big Three regarding their priorities,[142] as well as on particular changes in the Big Three's voting policies,

frameworks-in-the-united-states/ [https://perma.cc/FDH9-CJQX] (mentioning trend of institutional investors, including BlackRock, Vanguard, and SSGA, indicating support of companies making ESG disclosures).

139 Peter Michelsen & Derek Zaba, CamberView Partners, LLC, *The Rise of Investor-Centric Activism Defense Strategy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 25, 2017), https://corpgov.law.harvard.edu/2017/10/25/the-rise-of-investor-centric-activism-defense-strategy/ [https://perma.cc/L5ZG-9N9Q].

140 *Id.*

141 Chris Wightman & David Martin, CamberView Partners LLC, *The Investor View on Executive Compensation in 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 18, 2018), https://corpgov.law.harvard.edu/2018/04/18/the-investor-view-on-executive-compensation-in-2018/ [https://perma.cc/Z2LY-WKLB] (discussing impact of changes in SSGA's voting policies on executive compensation).

142 *See, e.g.*, Abe M. Friedman, CamberView Partners, LLC, *BlackRock's Call for Companies to Deliver Financial & Social Value*, HARV. L. SCH. F. ON CORP. GOVERANCE (Feb. 6, 2018), https://corpgov.law.harvard.edu/2018/02/06/blackrocks-call-for-companies-to-deliver-financial-social-value/ [https://perma.cc/X3BG-6F7F] (discussing BlackRock's 2018 annual letter to CEOs); Steve Klemash, Jennifer Lee & Amy Brachio, EY Ctr. for Bd. Matters, *Board Members Preparedness for Major Risk Event Like COVID-19*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 6, 2020), https://corpgov.law.harvard.edu/2020/05/06/board-members-preparedness-for-major-risk-event-like-covid-19/ [https://perma.cc/59FM-MNTB] (discussing BlackRock's 2020 annual letter to CEOs).

engagement, and voting decisions on topics such as board composition,[143] board diversity,[144] and the environment.[145]

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[143] *See, e.g.*, Paula Loop & Paul DeNicola, PricewaterhouseCoopers LLP, *Investors and Board Composition*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 26, 2016), https://corpgov.law.harvard.edu/2016/05/26/investors-and-board-composition/ [https://perma.cc/JV56-2AJC] (explaining how some institutional investors have expressed concern about board composition and providing BlackRock and SSGA's views on topic); Ruby Sharma & Ann Yerger, Ernst & Young LLP, *Three Things Nominating Committees Need to Know*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 14, 2016), https://corpgov.law.harvard.edu/2016/02/14/three-things-nominating-committees-need-to-know/ [https://perma.cc/5L49-AGE8] (describing how institutional investors are increasingly concerned with board composition and citing BlackRock, Vanguard, and SSGA materials to support).

[144] *See, e.g.*, Chuck Callan & Paul DeNicola, Broadridge Fin. Sols., Inc. & PwC, *2019 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 28, 2019), https://corpgov.law.harvard.edu/2019/10/28/2019-proxy-season-review/ [https://perma.cc/8V4D-S2PQ] (discussing SSGA and BlackRock's engagement with board diversity); Deb DeHaas, Linda Akutagawa & Skip Spriggs, Deloitte LLP, *Missing Pieces Report: The 2018 Board Diversity Census of Women and Minorities on Fortune 500 Boards*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 5, 2019), https://corpgov.law.harvard.edu/2019/02/05/missing-pieces-report-the-2018-board-diversity-census-of-women-and-minorities-on-fortune-500-boards/ [https://perma.cc/Z5MJ-UN46] (referencing BlackRock's 2018 letter to Russell 1000 companies with fewer than two women on their boards asking them to explain their "lack of progress"); Friedman, *supra* note 142 (discussing BlackRock's annual letter which emphasized that boards "should include a diversity of gender, ethnicities, experience and ways of thinking"); Mark Manoff & Stephen W. Klemash, EY, *2017 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 9, 2017), https://corpgov.law.harvard.edu/2017/07/09/2017-proxy-season-review/ [https://perma.cc/LFG2-GRP6] (referencing SSGA's new guidance designed to increase number of women on boards).

[145] *See, e.g.*, Abe Friedman & Robert McCormick, CamberView Partners, *BlackRock's 2017-2018 Engagement Priorities*, HARV. L. SCH. F. ON CORP. GOVERNANCE (March 17, 2017), https://corpgov.law.harvard.edu/2017/03/17/blackrocks-2017-2018-engagement-priorities/ [https://perma.cc/E438-99R3] (discussing BlackRock's 2017-2018 engagement priorities which emphasize that it "expects all directors of companies that are significantly exposed to climate risk to be 'climate competent'"); Manoff & Klemash, *supra* note 144 (explaining that "BlackRock and State Street . . . have made clear that environmental issues are integral to their stewardship activities"); Paula Loop, PricewaterhouseCoopers LLP, *Insights from PwC's 2017 Annual Corporate Directors Survey*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 31, 2017), https://corpgov.law.harvard.edu/2017/10/31/insights-from-pwcs-2017-annual-corporate-directors-survey/ [https://perma.cc/XY8P-ZEAJ] (describing the effect of support from BlackRock and Vanguard on the success of shareholder proposals on environmental issues); Jennifer Burns, Christine Robinson & Kristen Sullivan, Deloitte & Touche LLP, *The Atmosphere for Climate-Change Disclosure*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 5, 2020), https://corpgov.law.harvard.edu/2020/04/05/the-atmosphere-for-climate-change-disclosure/ [https://perma.cc/SJR9-LKLU] (discussing BlackRock's statement that they "will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them").

In advising their clients, investment banks have also emphasized the power of the Big Three, and, with it, the importance of the Big Three's activities. For instance, in a release describing activism developments in 2018, investment bank Lazard stated that the "[i]nfluence of passive investors continued to strengthen as Vanguard, BlackRock, and State Street now own ~18% of the S&P 500 vs. ~14% in 2012."[146] In other releases Lazard emphasized the influence of the Big Three in proxy contests, describing a proxy contest involving Taubman Centers, Inc., in which "[c]ompany engagement with Vanguard and BlackRock reportedly swung the . . . proxy contest in management's favor."[147] Lazard has also emphasized the importance of the Big Three's focus on corporate purpose and their ESG efforts.[148]

Finally, we note that even proxy advisors ISS and Glass, Lewis & Co. ("Glass Lewis"), who advise investors but have considerable influence on the corporate governance landscape as a whole, have devoted particular attention to the Big Three's policies, voting, and engagement on environmental and social issues. ISS discussed the importance of BlackRock's focus on sustainable investment and the likely effect that BlackRock's new focus would have because of BlackRock's size.[149] Both ISS and Glass Lewis commented on BlackRock's

[146] Jim Rossman, Lazard, *Lazard's 1Q 2018 Activism Review*, HARV. L. SCH. F. ON CORP. GOVERANCE (Apr. 20, 2018), https://corpgov.law.harvard.edu/2018/04/20/lazards-1q-2018-activism-review/ [https://perma.cc/S77T-7J3M].

[147] Jim Rossman, Lazard, *Review of Shareholder Activism—1H 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 25, 2017), https://corpgov.law.harvard.edu/2017/07/25/review-of-shareholder-activism-1h-2017/ [https://perma.cc/4V8U-R8Q7].

[148] For Lazard releases discussing the Big Three's focus on corporate purpose, see Jim Rossman, Lazard, *Lazard's 1Q 2019 Activism Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 22, 2019), https://corpgov.law.harvard.edu/2019/04/22/lazards-1q-2019-activism-review/ [https://perma.cc/YZM7-488X] (discussing how "[p]assive managers are using their increasing influence to discuss how corporate culture and purpose can affect long-term performance" and referencing BlackRock and SSGA statements as illustrations); Jim Rossman, Lazard, *2018 Review of Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 28, 2019), https://corpgov.law.harvard.edu/2019/01/28/2018-review-of-shareholder-activism/ [https://perma.cc/7GX6-QB8N] ("BlackRock's Larry Fink set the tone for the year, calling on companies to identify and follow through on their social purpose."); and Rossman, *supra* note 146 (referencing the growing ownership stake of the Big Three in S&P 500 companies and stating how "ESG issues have attracted significant attention by passive investors, who are pushing companies to serve a broader social purpose in their communities"). For a Lazard release focusing on the Big Three's ESG efforts, see Rossman, *supra* note 146 ("Increasing importance has driven these firms to materially expand their ESG efforts, with BlackRock pledging to double its stewardship team's headcount and Vanguard establishing a European stewardship presence.").

[149] *See* Michael Laff, *BlackRock Announces New Strategy of Sustainable Investing*, ISS: INSIGHTS (Mar. 16, 2020), https://insights.issgovernance.com/posts/blackrock-announces-new-strategy-of-sustainable-investing/ [https://perma.cc/39UC-QMEM].

engagement with firearms manufacturers and retailers.[150] Both proxy advisors have also commented on SSGA's engagements with issuers regarding board diversity, as well as on the voting policies and practices of BlackRock, Vanguard, and SSGA in supporting increased board diversity.[151]

The above discussion highlights the considerable frequency and detail with which lawyers, governance advisors, investment bankers, and proxy advisors pay attention to and advise their clients on the Big Three's policy changes, voting guidelines and behavior, and engagement efforts. These advisors clearly attach considerable importance to the power and influence of the Big Three, and this importance could well be transmitted to the managers of the companies in which the Big Three invest.

These releases are phrased as statements of fact and analyses of consequences rather than as detailed substantive consideration of the merits of the Big Three's decisions. This is because the releases are not concerned with any intellectual innovation underlying the Big Three's actions; instead, they are merely concerned with the fact of those actions themselves and the power and influence of the actors making them. The attention that these actions receive, both from advisors and from the general media, demonstrates the importance that the market attaches to them.

This attention is reserved for the Big Three; advisors do not pay such attention to changes in the voting guidelines or policies of other institutional investors. For instance, as Section III.B describes, the California State Teachers' Retirement System ("CalSTRS") has been advocating for greater gender diversity on corporate boards since 2009 and has received limited attention from advisors and the media.[152] But the announcement by SSGA and BlackRock that gender diversity on boards would become one of their primary focal points generated considerable media coverage and garnered close attention and

[150] *See, e.g.*, Damien Fruchart, Michael Jenks & Verena Simmel, ISS, *Firearms—Investor Responses amid Political Inaction*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 19, 2019), https://corpgov.law.harvard.edu/2019/09/09/firearms-investor-responses-amid-political-inaction/ [https://perma.cc/JAC8-GUV7] (discussing BlackRock's announcement of its engagement with firearms manufacturers and retailers); Courteney Keatinge, Glass, Lewis & Co., *Investor Pressure on Firearms Manufacturers*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 18, 2018), https://corpgov.law.harvard.edu/2018/03/18/investor-pressure-on-firearms-manufacturers/ [https://perma.cc/5QRG-ANCE].

[151] *See* Brianna Castro, Glass, Lewis & Co., *Raising the Stakes on Board Gender Diversity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 8, 2018), https://corpgov.law.harvard.edu/2018/01/08/raising-the-stakes-on-board-gender-diversity/ [https://perma.cc/9B2T-APQP] (commenting on SSGA's engagement campaign and voting regarding board diversity, BlackRock's support for board diversity proposals, and Vanguard's letter advocating for greater board diversity); Subodh Mishra, ISS, *Governance Improvements in 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 29, 2017), https://corpgov.law.harvard.edu/2017/11/29/governance-improvements-in-2017/ [https://perma.cc/L5EV-TVGG] (describing SSGA, BlackRock, and Vanguard's actions and policies supporting board diversity).

[152] *See infra* notes 167-68 and accompanying text.

analysis from corporate advisors, both far beyond what the positions of CalSTRS ever attracted.[153] The focus of advisors and the media on the Big Three—far more than on any other investors—is not because they are the first to address these issues, but because of the considerable power and influence they wield.

B. *The Big Three's Own Communications*

While the Big Three have generally sought to downplay their power, they also make claims about the successes and impact of their stewardship programs that are premised on corporations' viewing them as having power. These claims of success, which are the focus of this Section, are inconsistent with and undermine the Big Three's claims seeking to downplay their power.

Each of the Big Three claims that their engagements have had significant impact. For instance, about one-third of BlackRock's 2019 Investor Stewardship Report is devoted to "[e]ngagement and voting case studies" that describe various ways in which BlackRock has engaged with corporations and the impact that its engagements have had.[154] SSGA devotes an entire section of its Stewardship Report for 2018-2019 to the "Impact of [its] Stewardship: Voting and Engagement Stories."[155] And Vanguard's 2019 Stewardship Report is interspersed with many anecdotes about how Vanguard's engagements influenced the directors and executives of its portfolio corporations to address Vanguard's concerns.[156]

Three examples from BlackRock's own descriptions of its engagements serve to demonstrate its influence. First, BlackRock states: "In the US, director board commitments have been a longstanding engagement topic. We believe the focus on this topic has contributed to the reduction in the average number of boards on which directors sit . . . ."[157] BlackRock provides evidence to support this claim: "[T]he percentage of non-CEO directors sitting on more than four boards has decreased from 8.8% in 2008 to 6.7% in 2019. In addition, more than three-quarters of S&P 500 boards have established some limit on their directors' ability to accept other corporate directorships, an increase from 56% in 2008."[158]

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[153] *See supra* notes 137, 144 and accompanying text.

[154] *See* BLACKROCK, 2019 INVESTMENT STEWARDSHIP ANNUAL REPORT 10-22 (2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf [https://perma.cc/AJG9-MTJW].

[155] *See* STATE ST. GLOB. ADVISORS, STEWARDSHIP REPORT 2018-19, at 80-87 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf [https://perma.cc/9FW9-XSQN].

[156] *See* VANGUARD, INVESTMENT STEWARDSHIP 2019 ANNUAL REPORT 15, 21, 25, 27 (2019), https://www.wlrk.com/files/2019/Vanguard_2019_Annual_Report_Investment_Stewardship.pdf [https://perma.cc/XGC9-J4A3] (referencing and discussing engagements on board composition, strategy and risk, executive compensation, and governance structures).

[157] BLACKROCK, *supra* note 154, at 11.

[158] *Id.* (footnote omitted).

Second, BlackRock describes its "engage[ments] with many companies for multiple years on the relationship between board diversity and board effectiveness."[159] BlackRock explains:

> In 2018, [it] sent a letter to the companies within the Russell 1000 (approximately 30%) that had fewer than two women on their board. [In 2019], [it] began voting against the re-election of directors . . . at companies that did not publish a clear policy on board diversity or that hadn't improved diversity in the boardroom.[160]

BlackRock then points to improvements in boardroom diversity and explains that "[i]n our view, the acceleration in the increase in the number of women on public company boards is, in part, attributable to the engagement undertaken by investors, including voting on director elections."[161]

Finally, BlackRock explains how it engages with management in situations where another shareholder "uses its equity stake in a corporation to pressure management to make changes to the company's governance, operations, or strategy."[162] BlackRock "highlight[s] an example of an engagement that improved the terms offered to shareholders during an unusual reverse merger transaction," which involved "multiple engagements . . . and involved a number of conversations with management of the private company, various external advisors of the private company, and the two public companies party to the transaction."[163] Following these engagements, BlackRock explains, the companies put forward a

> revised deal [which] provided a US $5 billion overall value-add when compared to the original valuation. Additionally, the company agreed to appoint a new independent board member. Our engagements and the resulting value-add to this contested situation underscores [BlackRock's] role as an investment function focused on delivering value for our clients.[164]

Each of the Big Three make similar claims that their engagements with their portfolio companies have had significant effects on those companies. How can their engagement have such effect? It can only be because the directors and executives of those portfolio companies believe that the Big Three have significant power and therefore prefer to take the courses of action that the Big Three prefer.

Consider the example of gender diversity on corporate boards, mentioned among BlackRock's success stories above. SSGA has also devoted significant attention and engagement to its "Fearless Girl Campaign" for positive change

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[159] *Id.* at 12.
[160] *Id.*
[161] *Id.*
[162] *Id.* at 23.
[163] *Id.*
[164] *Id.*

on gender diversity, which it refers to as a "Core Campaign Focus."[165] In describing "The Impact of Fearless Girl in 2018/19," SSGA explains that

> [a]fter two years of productive engagements and voting, we are delighted to report that since the introduction of Fearless Girl in March 2017, 577 companies or approximately 43% of the companies we identified have responded to our call by adding a female director, with another six having committed to do so.[166]

SSGA thus suggests that their campaign has had a significant impact on the representation of women on boards. Assuming that this is correct, how were they able to have such an effect? A number of other institutional investors before them have attempted to advance the representation of women on corporate boards. For instance, starting in 2009, CalSTRS put forward a number of shareholder proposals seeking greater board diversity.[167] In 2014, CalSTRS wrote letters to the 131 companies in its portfolio that had no women on their boards, offering to help improve board diversity.[168] However, at least according to BlackRock and SSGA, their engagement on the issue of board diversity has had a much greater effect. This is consistent with the power and influence that comes from the Big Three's substantial stakes.

Just as the Big Three's decisions to push for reforms such as increased board diversity can have a substantial impact on their portfolio companies, the Big Three must recognize that their decisions *not* to push for improvements on other matters also have an effect on their portfolio companies and the corporate governance of those companies. Many of those changes are more likely to take place if the Big Three actively exercise their power and influence to support those changes. To take just one example, the voting policies of the Big Three currently support annual elections, and the Big Three generally vote to support shareholder proposals pushing for annual elections when they are put forward at companies.[169] However, 1,157 companies in the Russell 3000 (39% of such companies) had staggered boards rather than annual elections in 2019.[170]

Had the Big Three taken a more active stance in favor of annual elections, rather than simply supporting proposals put forward by others, there may have

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[165] STATE ST. GLOB. ADVISORS, *supra* note 155, at 34.

[166] *Id.* at 36.

[167] *See Firms Answer CalSTRS Call for Increased Diversity on Boards*, CALSTRS (Nov. 20, 2009), https://web.archive.org/web/20200831103343/https://www.calstrs.com/news-release/firms-answer-calstrs-call-increased-diversity-boards.

[168] *See CalSTRS Gets Rapid Response to Board Diversity Effort*, CISION PRWEB (Aug. 28, 2014), https://www.prweb.com/releases/2014/08/prweb12129836.htm [https://perma.cc/9Z7Y-LTN9].

[169] For the Big Three's voting guidelines expressing broad support for proposals to introduce annual elections, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2103 & n.193. For the Big Three's voting support for annual elections, see *id.* at 2103-04 (finding that BlackRock, SSGA, and Vanguard voted in favor of a majority of proposals to introduce annual elections from 2014 to 2018).

[170] *Id.* at 2104 (citing data as of June 30, 2019).

been greater moves towards annual elections. For instance, the Big Three could have threatened to withhold support from certain directors on any boards that did not have annual elections, as BlackRock and SSGA did for boards with no women directors.[171] Such a move is likely to have led to more corporations moving to annual elections. That more companies have not moved to annual elections cannot therefore be due to a lack of power on the part of the Big Three; rather, it is due to the Big Three's choice not to use the substantial power they have.

IV. DISTORTED INCENTIVES

Thus far this Article has focused on the power of the Big Three. We now turn to our concern that the Big Three's use of this power is seriously afflicted by two serious incentive problems. This Part discusses each of these two incentive problems in turn, along with the counterarguments (or lack thereof) presented by academic commentators and the Big Three themselves.

We begin in Section IV.A with the Big Three's incentive to underinvest in stewardship. Section IV.B then considers the incentive of the Big Three to be excessively deferential to corporate managers.

A. *Underinvestment in Stewardship*

1. The Underinvestment Problem

One type of undesirable incentive that we analyzed in detail in *Index Fund Incentives* concerns the incentive of each of the Big Three managers to underinvest in stewardship compared with the level of investment that would serve the interests of their beneficial investors.[172] Investment in stewardship will be desirable if, and only if, the marginal gain to that portfolio of the index fund exceeds the marginal cost of the investment. Even though this level will be optimal for the fund's investors, it is likely to be less than the optimal level for the corporation as a whole because the investors in the fund will only capture a small portion of gains to the company as a whole. However, even taking this into account, the substantial size of the index fund managers' stake may justify a similarly substantial investment in stewardship. But our analysis showed that the Big Three are likely to invest substantially less in stewardship than the amount that would be optimal for the fund's investors.

This is because the investment manager's sole return from investing in stewardship comes from a potential increase in their fee income from the assets

[171] *See supra* notes 159-61, 165-66 and accompanying text (regarding BlackRock and SSGA's engagements on board diversity).

[172] For a discussion of index fund incentives to underinvest in stewardship, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2050-59. For additional discussion, see Bebchuk, Cohen & Hirst, *Agency Problems*, *supra* note 5, at 96-97 (discussing incentives of index funds to invest much less on stewardship than would be value-maximizing for their portfolio).

they manage. And the percentage of the assets under management charged by the Big Three in fees is very small. The average fees charged by BlackRock, Vanguard, and SSGA in 2020 were 0.25%, 0.09%, and 0.16%, respectively.[173] Therefore, if BlackRock were to undertake stewardship activities that brought about an increase in the value of its portfolio by $1 million, BlackRock would earn an extra $2,500 in fees. If the increase could be sustained for some time, BlackRock could earn this additional amount for several years. But even if that is the case, the amount that BlackRock earns from undertaking stewardship is a tiny fraction of the $1 million benefit that its stewardship would bring to its portfolio. It would be optimal from the perspective of investors in the portfolio to spend up to $1 million to bring about the $1 million increase in the portfolio. But BlackRock itself will only be willing to invest up to $2,500 in stewardship.

A number of academic commentators have contested the underinvestment claim or put forward arguments that are inconsistent with it. In this Section, we consider and respond to four types of objections. First, we respond to arguments that index fund managers *do* have incentives to undertake stewardship (a) because doing so may allow them to compete more effectively with active managers, (b) because of the *size* of their portfolios, and (c) because of the *breadth* of their portfolios. Then, we turn to the argument that (d) index funds *do not* have incentives to undertake stewardship but that their lack of incentive is natural or appropriate.

2. Objections Based on Incentives to Attract Additional Funds

The first type of argument against underinvestment that has been raised by academics critical of our approach is that stewardship might allow index fund managers to attract additional investments. This is the case because the index fund managers compete with other investment fund managers based on returns.[174] There is evidence that investors "chase" past returns and may be willing to move their investments to investment fund managers that have recently outperformed their competitors.[175] Implicit in this claim is that, were the Big Three to undertake investor stewardship that increased their returns above that of their competitors, then they could attract additional funds from investors, which would bring with them greater fee revenue for the index fund manager. However, investment stewardship by one index fund manager is unlikely to create any such competitive advantage because funds managed by other index fund managers will capture exactly the same returns from the

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[173] *See* MORNINGSTAR, 2020 U.S. FUND FEE STUDY 15 (2021) (reporting average fees charged by the Big Three in 2020).

[174] *See, e.g.*, Fisch et al., *supra* note 13, at 32 (explaining that funds compete for investor assets based not only on fees, but also on performance).

[175] For evidence that investors "disproportionately flock to high performing funds," see Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1598-1601, 1619 (1998).

stewardship activity.[176] This is implicit in the nature of index fund investing; each index fund holds the same stocks, in the same proportion. So, a gain created by one manager will be shared by the funds of all managers tracking that index. If the costs of stewardship were taken into account, the index fund undertaking the stewardship would perform *worse* than its competitors.

Thus far our analysis has focused on competition among different index fund managers. But the same argument will apply to the many actively managed funds that hold the same stock in the same proportions as index funds, known as "shadow indexing" or "closet indexing."[177] An index fund undertaking value-increasing stewardship at a company would also perform *worse* than active managers who held a greater proportion of that company's stock than the index.[178]

Professors Fisch, Hamdani, and Davidoff Solomon argue that index fund managers have incentives to invest in stewardship activities because they compete for investors' funds, not only with other index fund managers, but also with actively managed funds.[179] They argue that investing in stewardship activities will eliminate potential advantages of such actively managed funds that might otherwise allow them to outperform index fund managers.[180]

However, even if index fund managers were to invest substantially in stewardship activities, this would not allow them to compete effectively with active managers because those same stewardship activities will cause some active managers to outperform the index fund managers. As noted above, active managers which disproportionately hold positions in companies that increase in value as a result of the stewardship activities will outperform the index fund managers undertaking the stewardship.[181] The investment stewardship activities will therefore not allow the index fund managers to capture any additional investment assets, and they may actually lose investment assets to the actively

[176] For a discussion of the effects of competition among index funds, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2057-58.

[177] For evidence that a substantial number of active funds have a high degree of shadow indexing, see generally K.J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009).

[178] For the reciprocal claim, that active managers that disproportionately hold positions in companies that outperform the index will outperform index funds, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2059.

[179] *See* Fisch et al., *supra* note 13, at 32 (arguing that index fund managers compete for funds "not only with each other but also with . . . active funds").

[180] *See id*. at 37 ("[Passive funds] lack the active funds' ability to generate alpha through investment choices. Passive investors also do not have the firm-specific information or expertise necessary to address operational issues. Instead, passive investors compete against active funds by using their voice and seeking to improve corporate governance.").

[181] *See supra* note 178.

managed funds that disproportionately hold the companies in which they undertake stewardship.[182]

3. Objections Based on the Size of Big Three Stakes

The second argument against underinvestment in stewardship is that index funds do have incentives to undertake stewardship because of the significant size of their holdings. Critics of underinvestment have argued that the large stakes that index fund managers hold in many companies is sufficient to incentivize them to undertake stewardship.[183] However, this argument is incorrect because it fails to recognize the very small fraction of the benefits produced by stewardship that index fund managers capture, due to the very low fees that they charge.[184] Our analysis shows that the small fraction of the benefits that index fund managers would capture from stewardship would be insufficient to lead them to invest in stewardship to the level that would best serve the interests of their own beneficial investors.

4. Objections Based on the Breadth of Index Fund Holdings

A third set of arguments made against underinvestment by academic commentators relates to the breadth of index funds' portfolios. One such argument is that the breadth of index fund portfolios creates economies of scale for index fund managers that would allow index fund managers to study a particular issue that is relevant to many companies in their portfolio, thereby spreading the cost of such study across all affected companies.[185] These authors

[182] For another criticism of the argument that competition with active funds might lead index fund managers to undertake stewardship, see generally J.B. Heaton, All You Need Is Passive: A Response to Professors Fisch, Hamdani, and Davidoff Solomon (July 7, 2018) (unpublished manuscript) (on file with Boston University Law Review).

[183] *See* Fisch et al., *supra* note 13, at 35-36 ("The size of the Big Three enables them to capture outsize benefits from [investments in corporate governance]."); Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 BUS. AND POL. 327, 338 (2019) ("[T]he Big Three asset managers have such large asset bases . . . that the cost of engagement is minimal when compared to the profits they generate."); Kahan & Rock, *supra* note 12, at 1785 (noting that because assets managed by the principal advisors to equity index funds are extraordinarily large," even index fund managers' low fees "generate incentives in the context of voting that compare favorably to those of most other shareholders").

[184] For a discussion of index fund fee levels, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2054-56.

[185] *See, e.g.*, Fisch et al., *supra* note 13, at 26 (arguing that passive funds "are able to aggregate the size of their substantial holdings as well as the information provided by all their investments and to spread the cost of obtaining information across their entire portfolio"); Kahan & Rock, *supra* note 12, at 1801 (arguing that "[i]nvestment advisers whose [assets under management] include shares in multiple companies benefit from the economies of scope related to issue-specific information"); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507, 515-16 (2020)

implicitly argue that index fund managers will be *more* likely to undertake investment stewardship than other investment managers. For example, Professors Fisch, Hamdani, and Davidoff Solomon suggest that these economies of scale lead index fund managers to be involved in rulemaking by the Securities and Exchange Commission ("SEC").[186]

Another version of the breadth argument made by academic commentators is that, because index funds hold stakes in so many corporations, they benefit the most from "spillover effects" that their stewardship activities at particular companies may have for other companies in their portfolio. As an example of an activity that has demonstrated economies of scale, SSGA has cited the effects of its "thought leadership work" on corporate behavior.[187] These arguments suggest that index fund managers are both well-placed to contribute to corporate governance improvements in many companies and that they are likely to make such improvements.[188]

A third breadth argument, made by Professor Gordon, is that investment managers have incentives to undertake "systematic stewardship," by which Professor Gordon refers to stewardship to reduce the systematic risk across companies in their portfolios, and thereby increase risk-adjusted portfolio returns.[189] Candidates for such stewardship would include climate change risk, financial stability risk, and social stability risk.[190]

These breadth-based objections fail for two reasons. First, there are many matters in which company-specific information is valuable, such as those relating to the corporation's specific business circumstances.[191] On these matters, investors must devote considerable time and attention to the company's specific circumstances, and economies of scale are less likely to be relevant. Similarly, there are some issues that cannot be expected to have significant spillover effects to other firms, in which broad portfolio holdings will not

(arguing that substantial aggregate ownership by investment managers is "likely to improve institutional investors' incentives and ability to monitor companies in which they invest when dealing with macro legal risks").

[186] *See* Fisch et al., *supra* note 13, at 54 ("Passive investors regularly comment upon and call for change to the rules adopted by the SEC under federal securities laws.").

[187] *See, e.g.*, Constable, *supra* note 11 (citing a SSGA officer stressing the "extensive thought-leadership work that [SSGA] believes influences corporate behavior").

[188] *See, e.g.*, Fisch et al., *supra* note 13, at 39 ("Passive investors are well-placed to evaluate such provisions and to determine whether these provisions are likely, as a general matter, to increase or decrease firm value at the majority of portfolio companies. They are also more likely to internalize any spillover effects that may arise from governance provisions." (footnote omitted)).

[189] *See* Gordon, *supra* note 14, at 13 (describing systematic stewardship as focusing on reducing systematic risk to increase risk-adjusted portfolio returns).

[190] *See id.* at 28-32 (describing candidates for systematic stewardship).

[191] *See, e.g.*, Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2090 (describing company-specific information required for stewardship decisions).

provide greater incentives to undertake stewardship. Professors Kahan and Rock, in particular, acknowledge these points.[192]

Second, our empirical evidence also provides a response regarding those types of activities for which there are economies of scale and for those activities that might provide spillover benefits to other portfolio companies. We agree that undertaking stewardship on these matters would be advantageous for the beneficial investors in index funds. However, the empirical evidence that we present in prior work shows that index fund managers do not undertake some of these activities at all, and they undertake other activities only in a very small proportion of their portfolio companies. That evidence shows that index fund managers do not, for instance, put forward shareholder proposals and do not contribute substantially to corporate governance legal reforms.[193] This is despite the fact that other organizations have achieved significant economies of scale through submitting shareholder proposals and regularly contribute to corporate governance reforms.[194]

Those economies of scale also mean that these tools could be very effective in reducing climate risk, financial stability risk, or social stability risk across the portfolios of index fund managers. Other work has shown that the Big Three, despite having portfolios that are the most diversified of all portfolios—and thus, presumably, the greatest incentive to reduce systematic risk—actually vote in favor of shareholder proposals addressing climate change risk much less often than many managers of less-diversified, actively managed portfolios.[195] The only activity that index fund managers do undertake at any scale is private engagement, and the evidence that we present suggests that the scale is much

[192] *See, e.g.*, Kahan & Rock, *supra* note 12, at 1800 ("The information required to cast an informed vote can be divided into two categories: company-specific information and issue-specific information.").

[193] *See* Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2101-05 (describing evidence that the Big Three did not submit any shareholder proposals on corporate governance matters between 2014 and 2018); *id.* at 2105-12 (describing evidence that the Big Three submitted many fewer comment letters on SEC rulemaking proposals than pension funds with much smaller amounts of assets under management and did not submit any amicus briefs in important cases regarding corporate governance).

[194] For a description of economies of scale achieved by some organizations in submitting shareholder proposals, see Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. 569, 586-88 (2021) (describing the substantial number of shareholder proposals submitted by the Shareholder Rights Project, the Boardroom Accountability Project, and the United Brotherhood of Carpenters Union). For evidence of the contribution of other organizations to corporate governance reforms, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2105-12.

[195] Jackie Cook & Tom Lauricella, *How Big Fund Families Voted on Climate Change: 2020 Edition*, MORNINGSTAR (Sept. 28, 2020), https://www.morningstar.com/articles/1002749/how-big-fund-families-voted-on-climate-change-2020-edition [https://perma.cc/JS7Q-VHJL] (presenting evidence that BlackRock, Vanguard, and SSGA supported 12%, 15%, and 32% of votes, respectively, on key 2020 climate resolutions, compared to 30% and 19% by active managers American Funds and Fidelity, respectively).

more limited than commentators would suggest.[196] This supports, rather than contests, our argument that index fund managers have incentives to underinvest in stewardship.

5. Objections Based on Lack of Skills and Expertise

A fourth and different argument made by some of those taking issue with our conclusions is that index fund managers lack the skills and expertise necessary to consider the specific business circumstances of the portfolio companies they invest in.[197] For instance, Professors Fisch, Hamdani, and Davidoff Solomon consider whether "passive investors will seek to identify and address firm-specific operational deficiencies"; they conclude that such investors "lack the expertise and the resources to do so effectively."[198] Professor Gordon similarly argues that the cost constraints of the business models of index fund managers "limit [their] capacity to do 'deep dive' analysis for many firms in the portfolio."[199]

However, these arguments ignore the fact that index fund managers have the resources to improve their skills and expertise, such as through hiring expert staff. If they wished to do so, they would be able to obtain the expertise and personnel necessary to undertake such analyses and stewardship. That they do not have such expertise and personnel should not be regarded as a given fact of nature, but rather as the product of choices made by the Big Three managers. These choices, in turn, are shaped by the incentives to underinvest in stewardship that our analysis identified. Thus, our academic critics are not justified in arguing that these incentives are not a serious concern because the Big Three lack the skills and expertise to pay close attention to company-specific dimensions anyway. It is the Big Three's incentives to underinvest, and their resulting choices to limit investments in skills and expertise, that are responsible for the Big Three's limited monitoring of their portfolio companies.

B. *Incentives To Be Excessively Deferential*

Many of the stewardship decisions of index fund managers involve choices whether or not to defer to the views and preferences of the managers of their portfolio companies. These include whether to vote on director elections, compensation matters, and shareholder proposals in the way that the managers

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[196] For empirical evidence of the Big Three's private engagements, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2084-88.

[197] *See, e.g.*, Charles M. Nathan, *On Governance: Institutional Investor Engagement: One Size Does Not Fit All*, CONF. BD. (July 18, 2018), https://www.conference-board.org/blog/postdetail.cfm?post=6826 [https://perma.cc/Y8JP-NRXJ] (explaining that the Big Three's stewardship teams "are principally focused on big picture [ESG] issues . . . [and] lack the skill-sets and manpower necessary to deal in depth with company specific issues of strategy design and implementation, capital allocation, M&A opportunities, and operational and financial performance").

[198] Fisch et al., *supra* note 13, at 43.

[199] Gordon, *supra* note 14, at 36.

of the corporation would prefer; whether to submit shareholder proposals to the company; and the index fund manager's choice of principles, practices, and policies, such as their voting guidelines. In many cases, where the preferences of managers are likely to be value-enhancing for the company, it would be best for the index fund manager to defer to those preferences. However, there may be some circumstances where deference to corporate managers may not be value-enhancing for the company, and where it would thus be better for the beneficial investors of the index fund that the index fund manager not defer to the preferences of corporate managers.

As we explained in detail in *Index Fund Incentives*, Big Three managers (as well as some other investment fund managers) have strong incentives to be excessively deferential to the preferences of corporate managers.[200] The reason is that index fund managers bear particular private costs from nondeference. Where these costs are greater than the fraction of the increase in the value of the corporation that the index fund manager is likely to capture, then the index fund manager will have an incentive to be deferential, even though this is not in the interests of their own investors.

One important factor that encourages Big Three managers to be excessively deferential to corporate managers is driven by significant business ties that the Big Three have with the companies in which they hold positions. The Big Three managers obtain substantial revenues from administering and managing the defined contribution plans ("401(k) plans") of many of their portfolio companies. Big Three managers could reasonably believe that if corporate managers viewed an index fund manager negatively, including because of the index fund manager's nondeference, then the index fund manager's revenue could also be negatively affected. This could lead to client favoritism, whereby index fund managers are more deferential to current or potential clients. More importantly, there could be general management favoritism, whereby index fund managers are deferential not just to their own clients, but to corporate managers in general.

The Big Three senior officers challenging the agency-costs account of their stewardship have denied the significance of the above concerns but have not provided an adequate basis for this position. For example, in one response to our arguments regarding non-deference reported by the *Financial Times*, Rakhi Kumar, the former Managing Director of Environmental, Social, and Governance Investments and Asset Stewardship at SSGA, expressed doubt with respect to our excessive deference concerns, stating that "I doubt you would be able to find a company that says State Street is a pushover."[201] Kumar's

[200] *See* Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2059-71; *see also* Bebchuk, Cohen & Hirst, *Agency Problems*, *supra* note 5, at 101-04 (discussing private costs to index funds from opposing corporate managers).

[201] Walker, *supra* note 11.

argument was echoed by SSGA's then CIO Richard Lacaille, who denied that SSGA is in any way reluctant to vote against management.[202]

However, Kumar's above response fails to recognize that, even if corporate managers were to consider SSGA to be a "pushover," those managers would be better served by not stating that belief or questioning the effectiveness of the investor oversight to which they are subject. Similarly, Lacaille's response does not engage with the empirical evidence that SSGA—as well as other Big Three managers—generally display substantial deference in their voting decisions on executive compensation as well as other matters.[203]

BlackRock's Mallow also dismisses the influence of potential conflicts of interest on stewardship decisions. He argues that BlackRock recognizes the potential for these conflicts and manages them, including both by maintaining the independence of its engagement group and by implementing policies to identify and mitigate potential conflicts.[204] In support of this claim, Mallow cites not only BlackRock's own conflict policies, but also those of SSGA, both of which seek to implement internal "walls" to manage conflicts.[205]

Mallow's arguments also fail to engage with the evidence on the voting decisions of Big Three managers and the substantial deference they display. Furthermore, and importantly, Mallow's focus on the Big Three procedures aimed at addressing conflicts fail to recognize that these procedures are designed to address the problem of client favoritism but cannot address the more important problem of general management favoritism. Because general management favoritism does not involve favoritism towards particular clients, it cannot be addressed by ethical walls and other mechanisms intended to address client favoritism.

Professors Kahan and Rock, as well as Professors Fisch, Hamdani, and Davidoff Solomon, acknowledge our concern regarding conflicts of interest. Professors Kahan and Rock recognize the incentives that the business operations of investment managers create for them not "to antagonize potential banking or insurance clients or companies that may engage them to run their pension funds" with their voting activities.[206] Similarly, Professors Fisch, Hamdani, and

[202] *See* Lacaille Video, *supra* note 9, at 59:35-1:00:20 ("We're quite comfortable with voting against management. . . . I think that there's a perception that if we vote against management, it somehow makes life difficult for us. We've done it. I've done it. . . . We've voted against the board in a disagreement with them on some issue, and it hasn't damaged the relationship. . . . The idea that that would somehow be an incentive for an excessive deference . . . doesn't stack up.").

[203] The evidence of index fund manager engagement that we present in *Index Fund Incentives* is generally consistent with the excessive deference hypothesis. *See* Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2075-116.

[204] *See* Mallow, *supra* note 8, at 30.

[205] *Id.* at 30 n.139 (citing sources providing BlackRock and SSGA's policies on prohibiting stewardship team from disclosing voting decisions to employees not involved in proxy voting).

[206] Kahan & Rock, *supra* note 12, at 1809.

Davidoff Solomon also acknowledge the possibility of potential conflicts arising from the business ties of investment managers, stating that "potential business ties between sponsors and companies' management may affect passive funds' voting behavior" and "create the risk that [investment managers] will vote the shares of their funds in favor of management rather than in the best interests of the fund shareholders."[207] However, these academic critics do not provide any support for believing that this problem is not substantial and do not meaningfully engage with the evidence on voting behavior that suggests this problem *is* consequential.

Whereas these critics of the agency-costs account fail to give adequate weight to the contribution of business ties between Big Three managers and their portfolio companies, they at least acknowledge this source of deference incentives. Importantly, however, these critics fail to address two other factors that contribute to the Big Three's tendency to be excessively deferential to corporate managers.

One such factor is the interest of Big Three managers in avoiding activities that could require them to file Schedule 13D disclosures, which would impose considerable private costs.[208] Where an investor obtains more than 5% of a public company, Section 13(d) of the Securities Exchange Act requires that it file certain disclosures, either on Schedule 13D or Schedule 13G.[209] Nondeferential actions that may be construed as having "the purpose [or] the effect of changing or influencing . . . control" of the company require filing on Schedule 13D.[210] However, filing on Schedule 13D must be done much more frequently and requires much greater detail than filing on Schedule 13G.[211] Because of the size and breadth of investment managers' holdings, all of which are subject to this disclosure, nondeference that requires filing on Schedule 13D would impose substantial costs on them.

In addition, possibly the most important factor that induces Big Three managers to be deferential to corporate managers, and one which is not addressed by the critics of our agency-costs account, is the private interest that the Big Three have in reducing the risk of public and political backlash against them.[212] The Big Three's dominant role in the growing index fund market gives

207 Fisch et al., *supra* note 13, at 65.

208 For a discussion of how requirements to file Schedule 13D forms lead to excessive deference, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2065-66.

209 *See* 15 U.S.C. § 78m(d), (g); 17 C.F.R. § 240.13d-1 (2021).

210 17 C.F.R. § 240.13d-1(b)(1)(i).

211 *Compare* 17 C.F.R. § 240.13d-101 (Schedule 13D), *with* 17 C.F.R. § 240.13d-102 (Schedule 13G). Schedule 13D must be filed within ten days after every acquisition and subsequent change in holdings, compared to once per year for Schedule 13G. *See* 17 C.F.R. § 240.13d-1(a), (b)(2). Schedule 13D filings also require particularized disclosure of each acquisition for each entity, compared to disclosure of aggregated positions for Schedule 13G. *See* 17 C.F.R. § 240.13d-101 (Schedule 13D); 17 C.F.R. § 240.13d-102 (Schedule 13G).

212 For a detailed discussion of how fear of backlash encourages deference, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2066-70.

them a lot to lose.[213] Similar concentrations of financial power have led to public and political backlash in the past.[214] The considerable power of corporate managers means that they could help provoke such a backlash against the Big Three if the Big Three's investor stewardship appeared likely to constrain the power, authority, compensation, or other private interests of corporate managers. The Big Three could limit these risks by being deferential to corporate managers. This factor is likely to contribute substantially to the pro-management voting patterns of the Big Three that have been documented.[215]

Finally, we would like to discuss the implications of our discussion of excessive deference for Professor Gordon's analysis of the "systematic stewardship" of the Big Three.[216] Recall that Professor Gordon presents a favorable view of Big Three stewardship on the grounds that the Big Three are able to produce (and do in fact produce) substantial benefits by focusing on general, systematic issues that are relevant to companies at large, such as environmental and social issues.[217]

Professor Gordon correctly argues that the system-wide nature of these issues enable the Big Three to produce benefits without expending substantial costs per company and that Big Three stewardship with respect to such issues is thus not undermined by the incentives to underinvest that we identified.[218] However, Professor Gordon fails to recognize that, even though the environmental and social stewardship of the Big Three is not undermined by incentives not to spend considerable resources on stewardship, such stewardship *is* undermined by the Big Three's incentives to be deferential to corporate managers. Because of these incentives, the Big Three should not be expected to push companies to make changes in their operations that corporate leaders strongly prefer to avoid.

To be sure, the Big Three have incentives to be perceived as good stewards in order to appeal to some of their beneficial investors. Furthermore, the Big Three have incentives to make their power seem acceptable and to reduce the odds of a backlash, by creating an impression that their use of power is primarily used to advance general goals that are widely supported, such as combating the risks of climate change and increasing gender and racial diversity. However, while the above considerations give the Big Three incentives to be viewed by their customers and the public as seeking to advance such causes, they will not

[213] For a discussion of the Big Three's current dominant market position and its likely durability, see *supra* Part I.

[214] For a history of backlash against concentrated financial power, see generally Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

[215] For evidence of the promanagement voting patterns of the Big Three, see *supra* notes 81-92 and accompanying text.

[216] *See* Gordon, *supra* note 14, at 13-24 (advocating for certain kinds of systematic stewardship by investment managers, but not discussing their incentives to be excessively deferential to corporate managers).

[217] *See id.* at 24-32 (describing the nature of systematic risk and providing "candidate risks" for targeting by institutional investors).

[218] *See supra* Section IV.A.1.

necessarily cause the Big Three to produce actual changes that corporate managers would strongly resist.

The above analysis indicates that the environmental and social stewardship of the Big Three is likely to be long on rhetoric and puffery but short on producing actual and meaningful changes. Our analysis of Big Three activities in recent years indicates that Big Three stewardship in this area has focused substantially on inducing companies to make more expansive disclosures in this area.[219] Corporate managers have not strongly resisted such expanded disclosure requirements, and changes to disclosure requirements do not necessarily lead corporate managers to make any changes in how they actually operate the company. Thus, although the systematic stewardship advocated and supported by Professor Gordon is not undermined by Big Three incentives to limit stewardship expenditures, Big Three incentives to be deferential and accommodating to corporate managers cast substantial doubt on the potential benefits of such stewardship.

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This Part has explained the two different sets of incentives that are likely to distort the investment stewardship activities of the Big Three. Part V turns to explain how the combination of these incentives and the substantial power of the Big Three significantly raises the stakes in the debate over the agency-costs account of Big Three stewardship.

V. THE STAKES

This Part examines what is at stake in the debate over our agency-costs account of Big Three stewardship. We explain below that there are three main reasons why the power and incentives of the Big Three matters. Section V.A explains the promise of the concentrated ownership and power held by the Big Three and how that promise will go unfulfilled if the Big Three avoid the responsibility that comes with their concentrated power. Section V.B explains that, in contrast to many other areas of corporate governance, if the Big Three shirk this responsibility, the corrective mechanisms by which investors could influence them to exercise their responsibility are very limited. Section V.C explains how the failure of the Big Three to use their power worsens the agency problems of corporate managers by insulating them from investor challenge. Finally, Section V.D explains why the Big Three have incentives to downplay

[219] This analysis was based on our review of both the voting record of the Big Three with respect to social and environmental shareholder proposals (available on FactSet) and the annual engagement reports of each of the Big Three managers. *See* BLACKROCK, *supra* note 154, at 11-13, 16-19 (discussing BlackRock's efforts to engage with companies regarding board diversity and climate risk, including efforts to increase disclosures about these issues); STATE ST. GLOB. ADVISORS, *supra* note 155, at 33-42 (reporting SSGA's efforts to increase disclosures related to climate risk and gender diversity); VANGUARD, *supra* note 156, at 23 (discussing the importance of disclosure frameworks).

their power, and why it is, therefore, important that scholars and policymakers see through their efforts to do so.

A. *The Unfulfilled Promise of Reconcentrated Ownership*

The main problem with the Big Three's investor stewardship is that it leaves unfulfilled the promise of reconcentrated ownership. In their classic 1930 book *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means described how the ownership of most large U.S. corporations was heavily dispersed among many small investors.[220] The small stakes held by investors meant that they had limited ability to influence the outcome of corporate elections, and also that their share of any gains from increasing the value of the corporation would be similarly small.[221] As a result, dispersed investors did not have incentives to invest in improving the value of the corporation. And to the extent that managers suffer from agency problems, these would be unconstrained by investors.

We do not claim that index fund stewardship is worse than stewardship by others or than the level of stewardship in a world of dispersed owners, such as that described by Berle and Means. In earlier work with Alma Cohen, we suggested that the increasing concentration of ownership by institutional investors offers promise that the structural problems of dispersed ownership could be overcome and that the agency problems of corporate managers could be constrained.[222] As investors' stakes grow, those investors will have a greater ability to undertake stewardship and influence managers to make value-increasing changes. And as their stakes grow, the returns to investors from undertaking such stewardship will also be greater, giving them greater incentive to undertake such stewardship.

The growing stakes of institutional investors therefore offer the promise of investors that will have both the ability and the incentive to constrain the agency problems of corporate managers. The large stakes in most large U.S. corporations held by the Big Three represent the apotheosis of this promise. As we have explained in Section II.A, the Big Three now hold the power to constrain the agency problems of corporate managers and to influence those managers to maximize the value of the corporations they manage.

The analysis of the incentives of index fund managers in Part IV shows that the Big Three have incentives not to deliver on the promise. While index fund managers have the power to influence corporate directors, they have incentives not to use this power to maximize the value of the corporations they invest in,

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[220] *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84, 94, 107-09 tbl.XII (1933) (providing evidence that, of the 200 largest companies in early1930, the majority had ownership that was very widely distributed).

[221] *See id.* at 87-89 (discussing the small stakes of dispersed owners, and their corresponding lack of control).

[222] For a description of this evidence, see Bebchuk, Cohen & Hirst, *Agency Problems*, *supra* note 5, at 91-93.

but rather to defer excessively to corporate managers and to underinvest in stewardship. The problem with the incentives of the Big Three is thus that they leave the promise of their concentrated ownership unfulfilled.

B. *Lack of Corrective Mechanisms*

The problem created by the Big Three's power and distorted incentives matters even more because of the lack of a corrective mechanism. We believe that this is a problem that has so far been largely overlooked in the debate regarding investor stewardship that we have discussed. This Section first explains how market mechanisms generally operate in other parts of the corporate and investment landscape to correct and improve managers' actions. It then explains why those mechanisms are not likely to function effectively with respect to the investor stewardship decisions of the Big Three and the impact this has on investor stewardship.

A fundamental principle of neoclassical economics is that well-functioning markets contain corrective mechanisms that lead underperforming market participants to either improve or be eliminated.[223] In competitive product markets, firms that produce goods and services that are less desirable to consumers than those of their competitors will lose their share of the market to those competitors. If they do not improve their offerings, then the underperforming firms will eventually be driven out of business. Similarly, companies that have returns worse than those of their competitors will have a higher cost of capital, and their managers will face pressure from their investors to improve their performance. If they do not improve, there is a threat that the managers may be replaced or that the company may be acquired.

However, there is no such market mechanism that would reward the Big Three for good stewardship decisions and would therefore lead them to improve their stewardship performance. The financial success of the Big Three depends on their ability to attract assets from investors who are looking for a manager. For index funds, this success comes from offering a portfolio of investments that track a specified index with the lowest possible cost. Success in this competition is unrelated to the level or quality of the investment stewardship activities of the index fund manager. Engaging more effectively with corporate managers will not result in any greater financial success; if that activity is costly, it may actually *reduce* the financial success of the index fund manager.[224] There is therefore no market check on the investor stewardship decisions of the Big Three.

This makes the distorted incentives of the Big Three, and their significant power, a much bigger problem. If there were a market mechanism that would

[223] For early work discussing corrective mechanisms in markets, see ALFRED MARSHALL, PRINCIPLES OF ECONOMICS: AN INTRODUCTORY VOLUME bk. 5 (8th ed. 1920) (discussing general relations of demand, supply, and value).

[224] *See supra* note 176 and accompanying text (describing how spending on value-increasing stewardship would cause index fund managers to perform worse than managers of other index funds using the same index).

lead to the Big Three improving their investment stewardship there would be less cause for concern regarding their significant potential power. But the absence of such a mechanism means that any flaws in the investment stewardship activities of the Big Three—flaws that are likely to occur, given the distorted incentives discussed above—will go uncorrected. And their substantial power means that these flaws are likely to have a significant impact on the corporate governance landscape.

C. *Insulating Corporate Managers*

The importance of the Big Three's power lies in how it is used with respect to corporate managers, and in particular, whether it is used to push corporate managers too much, or too little. As we explained in Section V.A, the Big Three's power offers significant promise because it could be used to maximize the value of the corporations in which they invest. But as Part IV discussed, and *Index Fund Incentives* documented, the Big Three are likely to underinvest in stewardship and to be excessively deferential to corporate managers. This means that the power of the Big Three is therefore more significant in its absence.

The effect of the Big Three's choices not to use the full force of their investment stewardship power to increase the value of corporations is that the managers of those corporations become effectively insulated from such improvements in value. If the Big Three do not push those managers to improve the value of the corporation, and do not support others who might push them to do so, then there is likely to be very little pressure on managers to take such actions. That is, if the Big Three defer to managers more than is optimal, then—because the Big Three are such a substantial part of shareholders as a whole—shareholders as a whole are also likely to be excessively deferential to managers. This provides managers with insulation from potential challenges, even when such insulation is not warranted.

Mallow dismisses these arguments by pointing out that the Big Three promote their goals through engagement rather than by proxy contests.[225] Our focus here is not only on their lack of proxy contests, but rather on the many ways in which the Big Three could take actions to increase the value of the corporations in which they invest, but do not. However, there is clear evidence of a number of ways in which the Big Three fail to take such actions.

In our earlier work, we provided evidence that the Big Three's engagements do not relate to the business performance of the companies that they invest in and that their engagements do not address the causes of managers' underperformance.[226] Although the identity of the directors of companies can be

[225] *See* Mallow, *supra* note 8, at 30 ("[Vanguard, BlackRock, and SSGA] promote [their] goals through engagement rather than hostile proxy contests.").

[226] *See* Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2095-97 (finding that none of the cases of private engagement studied focused on business underperformance and that no guidelines published by the Big Three list financial underperformance as a basis for withholding votes from directors).

expected to have a considerable effect on the performance of those companies, the Big Three also do not communicate with companies regarding directors they believe should be added to or removed from the board of directors of those companies.[227] And because of the very large number of companies in the portfolios of the Big Three and the limited resources they devote to stewardship, they are only able to devote a very small amount of time to each of the companies in their portfolio.

Indeed, in our prior work we estimate that, as of 2019, BlackRock spent fewer than four person-days per year, and less than $5,000 in stewardship costs, and that Vanguard and SSGA spent considerably less.[228] The limited amount of time and resources devoted to each company means they cannot undertake detailed reviews of those companies in ways that could allow them to apply pressure to increase the value of those companies.

Because of the insulation this provides to corporate managers, they have an incentive to maintain this state of affairs. The private interests of such managers benefit from having the Big Three, which are the three largest shareholders in numerous large public companies, underinvest in oversight and display excessive deference to the preferences of corporate managers. However, this state of affairs is detrimental to corporate performance, and thus, to the interests of beneficial investors of the Big Three.

D. *The Downplaying of Power*

Part I has described the significant power held by the Big Three, and this Part has described the implications of this power. However, as this Section explains, the Big Three have incentives to downplay this power and to contest claims of its significance, like those put forward in this Article. This Section describes evidence of the Big Three downplaying their power and explains how this is consistent with our predictions. We also explain why it is important to recognize the power of the Big Three, and the issues it creates, notwithstanding the Big Three's attempts to downplay that power.

Attempts by the Big Three to downplay their power can be seen most clearly in the claims of Mallow and Novick, themselves. For instance, substantial parts of Mallow's paper are devoted to arguing that "[a]sset managers are minority shareholders with limited voting power and corporate control," and that there is no coordination and substantial variation in how asset managers vote, so they should not be considered as a group.[229] Novick's keynote address starts by

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[227] *See id.* at 2097-101 (discussing how the Big Three generally "refrain from communications about particular individuals who they believe should be added to or removed from boards").

[228] *See id.* at 2079.

[229] For the section of Mallow's paper arguing that "[a]sset managers are minority shareholders with limited voting power and corporate control," see Mallow, *supra* note 8, at 19-22. For the sections arguing that asset managers do not coordinate their voting, see *id.* at 24-25, and for the sections arguing that there is substantial variation in their voting records, see *id.* at 22-24.

focusing on how even the Big Three hold a minority of each company's shares.[230] Later, she explains that very few corporate votes are close enough that any individual manager—including any of the Big Three—would have a "swing vote."[231]

BlackRock has also attempted to downplay its substantial power, and that of the Big Three, in general. In an April 2019 release, BlackRock argues that shareholders are "[d]ispersed and [d]iverse."[232] The release explains that "[Vanguard, BlackRock, and SSGA] represent a minority position in the $83 trillion global equity market. . . . [T]he combined [assets under management] of these three managers represents just over 10% of global equity assets."[233] The release goes on to describe how, even at BlackRock, there are many different individuals involved in managing these assets, and there are variations in the way that they vote BlackRock's shares.[234]

In another release that same month, BlackRock responded to concerns that "the growth of index investing will lead to a small handful of individuals effectively controlling all corporations in the near future."[235] The release focuses on how many individuals oversee public companies in the U.S.[236] It restates claims made in an earlier release, including that "[i]t is generally not possible for even the largest shareholders to determine the outcomes of proxy decisions," and that "voting records demonstrate significant variation in voting patterns amongst the largest fund managers."[237]

In yet another release, focused on executive compensation, BlackRock disputes the "claim that index fund managers may wield outsized influence over

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[230] *See* Novick Keynote Address, *supra* note 7, at 2 ("Examining the majority of US public companies—and certainly 'large cap' public companies—the largest shareholder holds only a single digit percentage of shares outstanding. . . . Furthermore, the Top 10 asset managers represent only 17% of equity ownership . . . ." (footnote omitted)).

[231] *Id.* at 8 ("However, [the data] demonstrate[s] that no individual manager has anything close to a swing vote . . . .").

[232] *See* BLACKROCK, POLICY SPOTLIGHT: SHAREHOLDERS ARE DISPERSED AND DIVERSE 1 (2019), https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-shareholders-are-dispersed-and-diverse-april-2019.pdf [https://perma.cc/5RQV-R6C4].

[233] *See id.*

[234] *See id.* ("[F]or any individual asset manager, [assets under management] represents a variety of investment strategies, each with different investment objectives, constraints, and time horizons. . . . [T]here is often some variation in the way shares are voted across portfolios, even among those managed by a single asset manager.").

[235] *See* BLACKROCK, THE ROLE OF SHAREHOLDERS IN PUBLIC COMPANIES 1 (2019), https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-the-role-of-shareholders-in-public-companies-april-2019.pdf [https://perma.cc/5F5L-GJQJ] (citing Coates, *supra* note 15, at 14 ("We are rapidly moving into a world in which the bulk of equity capital of large companies with dispersed ownership will be owned by a small number of institutions.")).

[236] *See id.* ("By our count, more than 28,000 individuals oversee public companies in the US alone.").

[237] *Id.* at 2.

corporations through their proxy voting and engagement."[238] This BlackRock release argues that "index fund managers are rarely the determining factor in say-on-pay votes" and that "the focus on say-on-pay is misplaced, since executive compensation is neither structured nor decided by shareholders," but rather by boards of directors, compensation committees, and compensation consultants.[239]

We have addressed many of these claims earlier in this Article, but we raise them again here to demonstrate that BlackRock has consistently sought to downplay its own power and influence over corporations. That BlackRock seeks to challenge recognition of their power is consistent with the incentives of the Big Three described in Part IV. In particular, recognition of the Big Three's substantial power puts them at risk of a public and political backlash that could constrain that power and that could impose substantial costs on the Big Three.[240] History provides a number of examples of substantial concentrations of financial power being met with such regulatory backlash.[241] The Big Three therefore have incentives to downplay and reduce the salience of their power as much as possible. These incentives explain the recent arguments made by BlackRock attempting to downplay its power and the power of the Big Three in general.

Because of the importance of the Big Three's power, it is also important that this power be recognized and that attempts by the Big Three to downplay this power be treated with appropriate caution. If the power of the Big Three can be successfully obscured, then there will be less pressure on them to exercise that power in the best interests of their own investors. Conversely, broader public recognition of the power of the Big Three, and recognition of that power by investors, policymakers, and researchers, will increase scrutiny of how the Big Three exercise—or fail to exercise—that power, and thereby give the Big Three incentives to improve how they do so. We hope that this Article may contribute to such recognition.

CONCLUSION

The Big Three collectively hold more than 20% of the shares of S&P 500 companies and almost 25% of the votes cast at the annual meetings of those companies. These substantial stakes give them correspondingly significant voting power, and with it, influence over the managers of the corporations in which they invest. Their stakes and influence are likely to continue to grow. The Big Three have attempted to downplay their own power, including in the recent works of Mallow and Novick. However, the close attention that market

238 BLACKROCK, *supra* note 73, at 1.

239 *Id.*

240 *See supra* notes 212-15 (discussing risk of public and political backlash).

241 For a well-known, historical account of backlash against financial power, see Roe, *supra* note 214, at 32-53. For a discussion of the relevance of such historical examples to the analysis of index funds, see Bebchuk & Hirst, *Index Fund Incentives*, *supra* note 3, at 2067-70.

participants pay to the engagements, voting policies, and actual voting behavior of the Big Three show that they consider the Big Three to have substantial influence. The Big Three's own claims regarding the effectiveness of their engagements are also inconsistent with their own attempts to downplay their influence.

The Big Three's significant power and influence represents a potential problem for corporate governance because of their distorted incentives. The Big Three have incentives to be more deferential to the managers of the companies in which they invest than would be optimal for their own investors and to invest less in stewardship than their own investors would prefer. These incentive problems mean that the substantial promise of large investors with the power to influence corporate managers goes unfulfilled. Worse, the deferential actions of the Big Three insulate corporate managers from challenges by others, and the structure of the index fund market means that it contains no corrective mechanism that would lead the Big Three to improve their stewardship performance.

One mechanism that is important for driving improvements in stewardship by the Big Three is awareness and recognition of their power and the problems caused by their distorted incentives. Because the Big Three have incentives to downplay their power, we should treat their attempts to do so with caution. This Article has shown the problems with recent arguments made by the Big Three attempting to downplay their power and has reinforced our earlier conclusions regarding the substantial power and influence that they do have. We hope that in doing so, this Article will help contribute to the recognition of the Big Three's power and of why it matters.