Comments on Bebchuk & Hirst, Incentives of Index Funds

Bernie Black
Northwestern University (Pritzker Law School, Kellogg School of Management)
Visiting TAU Faculty of Law

A Weird Approach to a Discussion

- I decided to do the following
- The Research Question is “Index Fund Incentives”
- What Answers Would I Give?
  - Based on My Own Knowledge, Prior Work, Prejudices Etc.
  - Before Reading the Paper!
- Then Compare My Answers to Bebchuk-Hirst
  - As a Guide to What is Newer/Less Obvious
  - And to What is Missing

Institutional Investor Incentives

- I've been thinking about institutional investor incentives for a long time:
  - *Shareholder Passivity Reexamined*, 89 **Michigan Law Review** 520-608 (1990)
  - *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 **UCLA Law Review** 811-893 (1992)
  - Bernard Black and John Coffee, *Hail Britannia?: Institutional Investor Behavior under Limited Regulation*, 92 **Michigan Law Review** 1997-2087 (1994)
  - *Shareholder Activism and Corporate Governance in the United States*, in Peter Newman, ed., 3 **The New Palgrave Dictionary of Economics and the Law** 459-465 (1998)
  - Henry Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden Ownership*, 79 **Southern California Law Review** 811-908 (2006)

Great Respect for Lucian

- Who has been in the corporate governance game since 1982!
  - Bebchuk, The Case for Facilitating Tender Offers (1982)
  - Continues to have furious energy in it
  - Has trained much of a new generation of corporate governance scholars
    - Several present at this conference
- Unlike me
  - I’ve drifted off into health policy and causal inference methods
- But what would I say, as a once-active participant in this space?

What I wrote 20 years ago

- **Abstract:** A small number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. They don't conduct proxy fights, and rarely try to elect their own candidates to the board of directors. Legal rules, agency costs within the institutions, information costs, collective action problems, and limited institutional competence are all plausible partial explanations for this relative lack of activity. The currently available evidence, taken as a whole, is consistent with the proposition that the institutions achieve the effects on firm performance that one might expect from this level of effort -- namely, not much.

What One Might Say Today

- **Abstract:** A small number of American institutional investors, mostly public pension plans **and index funds**, spend a trivial amount of money on overt activism efforts. They don't conduct proxy fights, and rarely try to elect their own candidates to the board of directors. [**Reasons omitted**]. . . The currently available evidence, taken as a whole, is consistent with the proposition that the institutions achieve the effects on firm performance that one might expect from this level of effort -- namely, not much.
- They do, however, provide crucial support to "activist" hedge funds, who engage in overt activism, by voting and (for public pension plans) investing in activist funds. The evidence on value added by these funds is mostly positive. The activists let the passive funds achieve indirectly part of what they cannot achieve directly.

So What’s New and Different in Bebchuk-Hirst?

- Collect evidence on what index funds actually do
  - That’s important even if much of it matches my priors.
  - As an empirical scholar, I **hate** referee letters that say:
    - “The authors present new evidence on X. X might be an important topic, but I’m not excited, because this doesn’t change my priors. Reject.” Not all new evidence supports priors, after all.
- Index funds are **more passive** than public pension funds (though not completely passive). That is new information.
  - Unknown: when the index funds act, do they act more sensibly than the public funds?
- Consistent with their incentives, cautious about supporting activist funds
  - Unknown: are the indexer decisions on supporting activists sensible at the margin?
- Develop **reasons** for the near-passivity that are specific to index funds
  - Partial overlap with public pension funds
  - The most important new reason is their fear of political reaction to their power
    - Related to Mark Roe’s work on political behind American rules weakening financial institutions (as you realize)
    - So is his view that Delaware’s principal competition is the federal government, not other states

What's Missing or Underplayed I

- Bebchuk-Hirst study complements case studies of particular investors
  - Marco Becht and Julian Franks have been notably active in this space
  - Overlap and complementarity not discussed
- (Maybe separate project): Soft, interview-based evidence on index fund engagements
  - Compare Black Coffee approach (1994)
  - Even if the indexers won't tell you much, company managers might
- What is optimal **overall level** of investor activism?
  - Given the existence of activist hedge funds
  - And some moderately active "regular" institutions
  - If we could get the index funds to do more, would we want this?
    - Given their weak incentives, not clear

What's Missing or Underplayed II

- Index fund incentives are lousy, and can't be fixed
  - They don't beat their direct competitors (other index funds) by making good governance decisions
  - Cf. Black Coffee (1994): UK activism comes from the "overweighted" institutions; never the "underweighted" ones
  - Given these incentives, how much do we want "equal-weighted" indexers to do?
- Can see activist funds, who compete for support from traditional institutions, as market solution to passivity of traditional institutions
  - Maybe ***sometimes*** supporting activists is best we can expect from index funds
  - How often is that support optimal: **Unknown**
  - This role of index funds in supporting activists is peripheral to Bebchuk-Hirst story
    - I'd make it central