Index Funds and the Future of Corporate Governance: Theory, Evidence & Policy

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ECGI and Bar-Ilan Conference
December 13, 2018

Our Focus

- We focus on the stewardship decisions of index funds
  - How they monitor, vote in, and engage with portfolio companies
- This has a major impact on the governance and performance of public companies and the economy
- We provide a systematic theoretical, empirical and policy analysis of index fund stewardship

Theory

- We describe two competing theories of index fund stewardship:
  1. No-agency-costs view
  2. Agency-costs view

     ⇨ Suggests that that index funds managers have strong incentives to:

     (i) under-invest in stewardship; and

     (ii) defer excessively to corporate managers

Evidence

- We provide the first comprehensive evidence of the full range of stewardship choices made by index fund managers, especially the Big Three
- The evidence is, on the whole, consistent with the agency-costs view

Policy

- We explore the policy implications of the incentive problems of index fund managers
  - We put forward a number of policy measures to address these
  - We explain how these problems shed light on important ongoing debates

Theory

The Big Three's Stewardship Aspirations

Big Three executives have repeatedly stressed the importance of responsible stewardship, and their strong commitment to it:

- Vanguard's CEO: "We care deeply about governance."
- Blackrock's CEO: "Our responsibility to engage and vote is more important than ever" and "the growth of indexing demands that we now take this function to a new level."
- SSGA's CIO: "SSGA's asset stewardship program continues to be foundational to our mission."

The Big Three's Stewardship Aspirations (2)

- Big Three executives have also stated both their willingness to devote the necessary resources to stewardship, and their belief in the governance benefits that this produces:
  - Vanguard's CEO: "We're good at [governance]. Vanguard's Investment Stewardship program is vibrant and growing."
  - BlackRock's CEO: BlackRock "intends to double the size of [its] investment stewardship team over the next three years. The growth of [BlackRock's] team will help foster even more effective engagement."

The Promise of Index Fund Stewardship

The Big Three and supporters of index fund stewardship focus on three characteristics that give the Big Three potential advantages as stewards:

1. Large stakes in each portfolio company
   - ⇨ Provide the Big Three with significant potential influence
   - ⇨ Means that their portfolio captures significant gains from improving the value of a given portfolio company

The Promise of Index Fund Stewardship (2)

2. Lack of "exit" option from positions in portfolio companies (while they remain in the index)
   ⇨ Protecting/improving value is their only option
3. Holding shares for the long term gives them a long-term perspective
   ⇨ BlackRock's CEO: "BlackRock cannot express its disapproval by selling the company's securities … [a]s a result, our responsibility to engage and vote is more important than ever."
   ⇨ SSGA and Vanguard's CEOs refer to their funds as "near-permanent capital" or "permanent shareholders."

The No-Agency-Costs View

- The premise of the Big Three leaders and supporters of index fund stewardship (e.g., Fisch, Hamdani & Davidoff Solomon 2018) is that index funds maximize the value of their portfolios
  - i.e., Their decisions do not substantially diverge from the decisions that would best serve index fund beneficial investors
- This view does not view agency problems as a first-order determinant of stewardship decisions
  - ⇨ We refer to this view as the *no-agency-costs* view

The Agency-Costs View

- We suggest that the private interests of index fund managers create agency problems that are a first-order driver of stewardship decisions
  – Stewardship decisions for an index fund are made by the index fund manager, not the index fund's beneficial investors
- Two types of incentive problems push the stewardship decisions of index fund managers away from those that would be best for index fund investors

Incentives to Under-Invest in Stewardship

- Assume (initially) that stewardship has no effect on assets under management or on fees
- Consider an investment in stewardship that will materially increase the expected value of a portfolio company
- The index fund manager will capture only a very small fraction of the produced gains in terms of increased fees
  - Likely less than 1%

  ⇨ Has an incentive to under-invest

Incentives to Under-Invest in Stewardship (2)

- e.g.: Consider a $1 bn position in a portfolio company held by an index fund
  - (Each of the Big Three has hundreds of $1 bn+ positions)
  - Assume a certain stewardship investment would produce a modest expected increase in value of 0.1%
  - ⇨ The no-agency costs benchmark calls for making stewardship investments up to $1m
  - Assume that the index fund manager charges fees of 0.5%
  - ⇨ The manager has an incentive to spend no more than $5,000

Incentives to Under-Invest in Stewardship (3)

Can an interest in expanding assets or increasing fees provide extra incentives to invest in stewardship?

- Investments in stewardship that increase the value of a portfolio company increase index fund performance
- But rival index funds tracking the same index get the benefit of the increase in value without any expenditure of their own

⇨ Stewardship investments will not enable index funds to attract additional funds or increase fees

Incentives to be Excessively Deferential

- For any given investment level, index fund managers face qualitative stewardship decisions
  - ⇨ Be more/less deferential to corporate managers?
- Index fund managers bear private costs from nondeference (or capture private benefits from deference)
  - ⇨ Private incentives to be excessively deferential

Private Interests Served by Deference

1. Maintaining/developing existing or potential business relationships between index fund managers and their portfolio companies

   ⇨ Index fund managers have incentives to adopt principles, policies, and practices that defer to corporate managers to avoid frictions that could undermine business development

Private Interests Served by Deference (2)

2. Avoiding the Costs of 13D Filings and Poison Pills
   - Where the Big Three have positions of 5% or more, nondeference may trigger 13D disclosure obligations or poison pill imposition

   ⇨ This would impose substantial additional (private) costs on the index fund manager

Private Interests Served by Deference (3)

3. Reducing the Risks of Political Backlash
   – Given the growing power of the Big Three, and recalling reactions to past episodes of concentrated power in the hands of financial interests, Big Three leaders have reasons to worry about regulatory backlash

   ⇨ Non-deference would likely encounter significant resistance from corporate managers, and increase the salience of Big Three power, increasing the risk of regulatory backlash

Constraints on the Effects of Agency Problems

- Fiduciary norms or a desire to do the right thing
  - ⇨ Might lead index fund managers to take actions that differ from those suggested by a pure incentive analysis
- Incentives to be perceived as responsible stewards by their beneficial investors and by the public
  - ⇨ Might avoid actions that would make salient their under-investing in stewardship and their deference to corporate managers
- This might limit the force of the structural problems we identify
- But they should not be expected to eliminate the problems, as is suggested by the evidence we present

Evidence

Investments in Stewardship

- Given the size of their portfolio positions, the no-agency-costs view would predict that index fund managers would make significant stewardship investments
  - An expected 0.1% increase in a $1bn position would justify up to $1m investment in stewardship
  - ⇨ This could justify multiple professionals dedicated to monitoring and interacting with *each* such portfolio company
- Supporters of index fund stewardship have focused on recent increases in stewardship staff of the Big Three
- We estimate the personnel resources (hours and cost) devoted to each portfolio company

Stewardship Personnel and Portfolio Companies

	BlackRock	*Vanguard*	*SSGA*
Stewardship Personnel	33	21	11
Portfolio Companies (Worldwide)	17,309	18,900	17,337
Portfolio Companies (U.S.)	4,084	3,946	3,762*

* Estimated

Stewardship Investments Relative to Equity Investments and Estimated Fees

	BlackRock	*Vanguard*	*SSGA*
Stewardship Personnel (2017)	33	21	11
Stewardship Investment as % of Equity AUM			
Estimated Stewardship Investment ($m)	$9.9	$6.3	$3.3
Equity AUM ($m)	$3,364,184	$3,507,649	$1,835,917
Stewardship as % of Equity AUM	0.00029%	0.00018%	0.00018%
Stewardship Investment as % of Estimated Fees			
Estimated Stewardship Investment ($m)	$9.9	$6.3	$3.3
Estimated Fees & Expenses ($m)	$8,410	$3,508	$2,937
Stewardship as % of Fees & Expenses	0.12%	0.18%	0.11%

Stewardship Per Portfolio Company

	BlackRock	*Vanguard*	*SSGA*
Stewardship Time (Person-Days)			
Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)	0.48	0.28	0.16
Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company	1.52	1.00	0.55
Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide	2.45	1.50	1.50
Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies	3.17	1.84	1.69

Stewardship Per Portfolio Company (2)

	BlackRock	*Vanguard*	*SSGA*
Stewardship Investment ($)			
Scenario 1: Equal Allocation of Stewardship Time, per Portfolio Company (Worldwide)	$572	$333	$190
Scenario 2: Stewardship Allocated 75% to U.S. Companies, per U.S. Company	$1,818	$1,197	$658
Scenario 3: Proportional Stewardship Allocation, per $1bn Position Worldwide	$2,943	$1,796	$1,797
Scenario 4: Proportional Stewardship Allocation, per $1bn Position in U.S. Companies	$3,805	$2,213	$2,025

Investments in Stewardship (2)

Evaluating the governance and performance of a public company requires evaluating hundreds of pages of documents (or more):

- The company's annual report and proxy statement
- The performance of the company with respect to long-term plans
- The company's executive pay arrangements
- Management proposals and shareholder proposals up for a vote
- The views of the company's directors on these matters
- Assessments of the directors' performance

Investments in Stewardship (3)

Conclusions: Consistent with the agency-costs view:

– The Big Three devote an economically negligible fraction of their fee income to stewardship

⇨ Their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies

Private Engagement

- The Big Three have stressed that private engagement is a central and superior tool that allows them to avoid using other shareholder tools:
  - Vanguard: Private engagement is the "perhaps more important … component of [Vanguard's] governance program"; "engagement is where the action is."
  - BlackRock: "[M]eetings behind closed doors can go further than votes against management."
- We look at the proportion of portfolio companies that the Big Three engage with, and have more than one conversation with

Private Engagement (2)

	BlackRock	*Vanguard*	*SSGA*
Portfolio Companies with No Engagement	89.3%	82.8%	90.4%
Portfolio Companies with Engagement:			
Portfolio Companies with Engagement Limited to a Single Conversation	7.2%	10.3%	8.9%
Portfolio Companies with Engagement Including More Than a Single Conversation	3.5%	6.9%	0.7%
Total Portfolio Companies with Engagement	10.7%	17.2%	9.6%

Private Engagement (3)

- Each of Big Three had no engagement in the great majority of companies
  - ⇨ For these companies private engagement be a substitute for the use of other stewardship tools
- Where private engagement does occur its effectiveness is reduced by the Big Three’s reluctance to use other stewardship tools

Limited Attention to Performance

- Financial performance is important to investors
  - Index fund investors would benefit from fund managers focusing on the financial performance of portfolio companies
  - ⇨ In the no-agency-costs benchmark, index funds would monitor financial underperformance and examine what personnel or other changes could address it

Limited Attention to Performance (2)

- But Big Three stewardship focuses on governance best practices, with limited attention to underperformance, or to remedying it
  - SSGA: Seeks to provide "principles-based guidance"
  - BlackRock: Engages where a company lags behind its peers on environmental, social, or governance matters, or in sectors with thematic governances issues
  - Vanguard: Focuses on board composition issues, governance structures, executive compensation, and risk oversight

Limited Attention to Performance (3)

- We examine the many examples of behind-the-scenes engagements in Big Three Stewardship Reports:
  - ⇨ No cases in which engagement was motivated by financial underperformance
- We examine the proxy voting guidelines of each of the Big Three for withholding support from directors
  - ⇨ All focus on governance aspects and none include financial underperformance

Limited Attention to Performance (4)

- Supporters of index fund stewardship argue that they "lack the expertise and access to information to identify operational improvements … to improve the performance of companies in their portfolio." (Fisch, Hamdani & Davidoff Solomon, 2018)
- But lack of in-house expertise is not a given, it is a choice made by index fund managers
  - Index fund managers have the resources to could improve their ability to identify and remedy financial underperformance

Limited Attention to Performance (5)

- Could index fund managers rationally avoid doing so because "activist hedge fund are already doing it" and thus it is unnecessary for them to do it?
- Not a valid justification because:
  - Activist hedge funds will only engage where underperformance is very large and can be fixed quickly
  - Activist hedge funds may take some time to arrive

Pro-Management Voting

- In proxy fights, index funds voted in favor of managers more often than did other investment funds

  To an extent that is economically and statistically significant (Brav, Jiang, and Li, 2018)
- We gather data on the say-on-pay votes of index fund managers

"No" Votes in S&P 500 Say-on-Pay Votes

	BlackRock	*Vanguard*	*SSGA*	Avg.
2012	2.5%	3.6%	3.1%	3.1%
2013	2.3%	2.1%	4.2%	2.9%
2014	2.3%	2.9%	6.4%	3.9%
2015	1.0%	1.8%	4.5%	2.4%
2016	2.0%	1.8%	5.1%	3.0%
2017	3.6%	3.3%	5.9%	4.3%
Avg.	2.3%	2.4%	4.9%	3.2%

Pro-Management Voting (2)

- The Big Three *rarely* oppose say-on-pay votes
- Pro-management voting is consistent with the agency-costs view

Avoiding Shareholder Proposals

- Proposals submitted by shareholders under Rule 14a-8:
  - Have improved shareholder rights at many companies
  - In ways that the Big Three supports (e.g., Majority voting, annual elections, proxy access)
- Use of shareholder proposals would be natural for index funds:
  - Focus on conformity with governance best practices
  - Numerous portfolio companies aren't in compliance
- 3,912 shareholder corporate governance proposals were submitted from 2008 to 2017

Submission of Shareholder Proposals

Year	*Shareholder Proposals*
2008	409
2009	477
2010	456
2011	310
2012	359
2013	344
2014	300
2015	396
2016	322
2017	261
Total	3,912

Avoiding Shareholder Proposals (2)

- *None* of these proposals were submitted by any of the Big Three.
- Avoiding shareholder proposals is consistent with the agency-cost view

Avoiding Shareholder Proposals (3)

Can their avoidance of shareholder proposals be justified on grounds that the Big Three don’t need to submit proposals because others (smaller) investors are doing so?

- Because of the limited resources of smaller investors, proposals that the Big Three would support are not submitted at all, or are submitted only after many years delay
- e.g., A large proportion of the Big Three’s portfolio companies lack annual elections, proxy access, or majority voting, which the Big Three support
  - Had any of the Big Three submitted shareholder proposals on those issues they are likely to have had significant practical effects.

Avoiding Involvement in Director Selection

- A portfolio company's directors may not be well suited to the needs of the company
  - ⇨ Index fund investors would benefit from index fund managers facilitating desirable changes in the directors on the board
- We examine whether the Big Three ever nominate director candidates
- We find 2,373 total director nominations from 2008 to 2017

Actual and Proposed Director Nominations

Year	*Director Nominations*
2008	255
2009	235
2010	190
2011	177
2012	206
2013	198
2014	229
2015	266
2016	195
2017	209
Total	2,373

Avoiding Involvement in Director Selection (2)

- *None* of these nominations were made by any of the Big Three
- Index fund investors would benefit from communications to companies re individuals that should be added to / removed from the board
- We review engagements described in the Big Three's Stewardship Reports
  - ⇨ No mention of private communications to influence choice of directors

Avoiding Involvement in Director Selection (3)

- We gather data on 5% positions held by the Big Three 2008-2017
- Blackrock had 2,455 positions, Vanguard 1,839, SSGA 221
- Suggestions re director selection by a 5% holder would require a Schedule 13D filing
- The Big Three did not file *any* Schedule 13Ds 2008-2017

Big Three Positions of 5% or More

	BlackRock	*Vanguard*	*SSGA*	*Total*
2008	1,175	31	83	1,289
2009	1,383	83	71	1,537
2010	1,464	176	82	1,722
2011	1,495	438	107	2,040
2012	1,629	833	153	2,615
2013	1,818	992	173	2,983
2014	1,926	1,283	210	3,419
2015	2,038	1,489	150	3,677
2016	2,281	1,631	200	4,112
2017	2,454	1,839	221	4,514

Avoiding Involvement in Director Selection (3)

- Suggestions re director selection by a 5% holder would require a Schedule 13D filing
- The Big Three did not file *any* Schedule 13Ds 2008-2017
- Avoidance of involvement in the selection of particular directors is consistent with the agency-cost view
  - ⇨Would require significant stewardship investment
  - ⇨Would involve non-deference to corporate managers

Avoiding Involvement in Director Selection (4)

Can the Big Three simply free-ride on activist hedge funds?

- The Big Three's preferred directors may differ from those that activist hedge funds nominate

  (e.g., SSGA criticizing agreements with activist hedge funds)
- The Big Three could communicate with its portfolio companies about which directors would be best for the company

Limited Involvement in Corporate Governance Reforms (1)

- The Big Three could serve their investors' interests by seeking to facilitate desirable corporate governance rule changes
- Because they hold positions in many companies, wide-scale governance reforms could significantly benefit the portfolio if they have even a small positive effect in each company.
- We examine comment letters submitted on 80 SEC proposed rule changes regarding corporate governance

Involvement in SEC Proposed Rules Regarding Corporate Governance

	Index Fund Managers				Large Asset Owners		
	BlackRock	*Vanguard*	*SSGA*	*Total*	*CalPERS*	*CalSTRS*	*Total*
Most Commented 25% of Proposed Rules (20)							
Total Comments Submitted	1	4	2	7	16	11	26
Comments per Proposed Rule	0.05	0.20	0.10	0.35	0.80	0.55	1.30
Proposed Rules Commented On	1	2	2	5	11	7	17
Proportion of Proposed Rules Commented On	5%	10%	10%	25%	55%	35%	85%
Remaining 75% of Proposed Rules (60)							
Total Comments Submitted	2	4	1	7	10	11	20
Comments per Proposed Rule	0.03	0.07	0.02	0.12	0.17	0.18	0.33
Proposed Rules Commented On	2	4	1	7	9	8	16
Proportion of Proposed Rules Commented On	3%	7%	2%	12%	15%	13%	27%

Limited Involvement in Corporate Governance Reforms (2)

- Each of the Big Three submitted comments on many fewer proposals than large asset owners
- We examine submission of amicus briefs in ten important cases regarding investor protection (2008-17) in which the Council of Institutional Investors submitted amicus briefs.

Amicus Curiae Briefs, 2008–2017

Case	*Amicus Briefs*	*Briefs by Two Largest Asset Owners*
Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008)	29	✓✓
Free Enterprise Fund v. Public Company Accounting Oversight Board, 537 F.3d 667 (D.C. Cir. 2008)	22	**
Free Enterprise Fund v. Public Company Accounting Oversight Board, 561 U.S. 477 (2010)	17	**
Merck & Co. v. Richard Reynold, 559 U.S. 633 (2010)	15	
New York State Teachers' Retirement System v. The Mercury Pension Fund Group, 618 F.3d 988 (9th Cir. 2010)	1	
Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011)	13	
Business Roundable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011)	6	**
New Jersey Carpenters Health Fund v. RALI Series 2006-QO1 Trust, 477 Fed. Appx. 809 (2d Cir. 2012)	6	
Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 13 (2014)	25	**
Corre Opportunities Fund, LP v. Emmis Communications Corp., 792 F.3d 737 (7th Cir. 2015)	2	

✓✓ Briefs filed separately by both of asset owners

** Brief filed by both of the asset owners, jointly with CII

Limited Involvement in Corporate Governance Reforms (2)

- The two largest public pension funds filed or joined amicus briefs in 5 of 10 cases, alone or jointly with another party, despite being many times smaller than the Big Three
- None of the Big Three filed a single amicus curiae brief in any of these ten precedential litigations

Limited Involvement in Corporate Governance Reforms (3)

- The limited involvement of the Big Three in both SEC comments and amicus briefs is consistent with the agency-costs view
  - Explicitly supporting pro-shareholders reforms would not be deferential to company managers
  - Explicitly opposing reforms reduces the salience of their deference
  - ⇨ Private interests might be best served by staying on the sidelines

Avoiding Lead Plaintiff Positions

- The Private Securities Litigation Reform Act looks to institutional investors with the most “skin in the game” to be lead plaintiffs
  - ⇨ They have an incentive to monitor class counsel and ensure optimal settlements (including corporate governance reforms)
- We examine the lead plaintiffs in securities class actions 2008-2017 settled for more than $10m
- 219 cases such cases

Securities Class Action Cases

Year	*Cases Settled for over $10m*	*Total Recovery in Cases Settled for over $10m ($m)*
2008	58	$6,913
2009	38	$6,542
2010	20	$1,971
2011	20	$1,711
2012	20	$1,300
2013	15	$497
2014	29	$4,633
2015	11	$463
2016	7	$383
2017	1	$40
Total	219	$24,453

Avoiding Lead Plaintiff Positions (2)

- The Big Three did not serve as a lead plaintiffs in *any* securities class action 2008-2017
- Serving in lead plaintiff positions in many cases:
  - Would require material expenditures, and
  - Would require non-deferential action against portfolio company managers

  ⇨ Avoiding such positions is consistent with the agency-costs view.

Policy

Policy Implications

- Policymakers should recognize the incentives of index fund managers to under-invest in stewardship and defer to corporate managers
- We discuss a number of potential policy measures
  - ⇨ We highlight the need for a policy reexamination of the legal rules in this area, with an openness to fresh ideas
- We consider the implications of our analysis for important ongoing debates

Potential Policy Measures

The policy measures that we consider as potential solutions are:

- Encouraging investment in stewardship
- Limiting or disclosing index fund manager relationships with portfolio companies
- Bringing transparency to private engagements
- Size limits for investment fund families

Encouraging Investment in Stewardship

- Policymakers should explore ways to encourage index fund managers to increase levels of stewardship investment, including:
  - Charging Stewardship Costs to the Index Fund.
  - Sharing Outside Research Services
  - Making Stewardship Expenses Mandatory

Business Relationships with Portfolio Companies

- Policymakers should explore measures to address problems resulting from index fund managers' business relationships with portfolio companies, including:
- Limits on Business Relationships
  - e.g., prohibiting investment administration of 401(k) plans
  - Determine whether efficiencies from combining businesses outweighs the adverse effects on incenives
- Requiring detailed disclosure of business relationships with portfolio companies

Bringing Transparency to Private Engagements

- BlackRock and Vanguard currently do not disclose details of the companies they engage with or the nature of those engagements
- Transparency would provide all investors with material information, including:
  - Commitments by companies to make changes
  - The changes that the Big Three desire at particular companies
- Transparency would lead to more meaningful engagement
  - The Big Three would be motivated because their investors could assess the effectiveness of their private engagements

Bringing Transparency to Private Engagements (2)

- Regulation FD could be interpreted to require disclosure of engagements, as they may be material
- If it does not, it could be amended to do so
- Would transparency make private engagements more difficult or less effective?
  - SSGA already discloses its engagements, without any apparent chilling effect
  - Fear of disclosure of failures to engage would motivate company managers
  - Disclosing index funds' requests to companies may make them more likely to follow those requests

Size Limits

Should the Big Three be permitted to continue growing freely?

- As a thought experiment, suppose that:
  - The proportion of U.S. equity in index funds grows to 45%
  - The Big Three become the "Giant Three," each with 15% of the shares of each large public company; and
  - Regulation could prevent investment fund managers from managing more than 5% of any particular company

  ⇨ Holdings would be divided among nine index fund managers—the "Big-ish Nine"—each holding about 5%
- We explain that there are good reasons to prefer the Big-ish Nine scenario over the Giant Three scenario.

The Debate on Common Ownership

- Index funds increase common ownership, whereby an investment manager holds positions in all the companies in a given sector of the economy
- Some scholars have claimed that that common ownership has substantial anti-competitive effects
- Those scholars fail to take account of index manager incentives
  - No incentives to engage in stewardship focused on the operations of particular companies

Implications for Ongoing Debates

We consider the implications of our analysis for the following debates

- The debate on common ownership
- The debate on hedge fund activism

The Debate on Common Ownership (2)

- Alarmism over common ownership has negative consequences:
  - ⇨ It may push index fund managers to be even more deferential
  - ⇨ Common ownership is a red herring for anti-trust officials, who should focus on the decisions of corporate managers rather than index fund managers

The Debate on Hedge Fund Activism

- Opponents of hedge fund activism view "long-termist" index fund stewardship as a preferable substitute for the "short-termist" activist hedge funds
- Our analysis shows that index fund stewardship cannot serve as an effective substitute.
- Because of the incentive problems of index fund managers, hedge fund activism has a critical role in stewardship
  - Hedge fund managers do not have incentives to underspend or to be excessively deferential
  - Hedge fund managers invest substantially in stewardship, focus on underperformance, and use the full toolkit of shareholder powers

The Debate on Hedge Fund Activism

- But hedge fund activism is not a complete substitute for index fund governance
- It requires the support of index fund managers (against their deference incentives)
- Lack of index fund manager support may discourage hedge fund activist engagement (Brav, Jiang & Li, 2018)
- Activist hedge funds will only engage if they expect to make large and rapid returns
  - ⇨ They will ignore many opportunities for smaller gains will be ignored

Recognition and Reality

The Big Three have significant incentives to be perceived as responsible stewards

⇨ Greater recognition by investors and the public of the incentive problems of index fund managers can lead to improved stewardship by the Big Three

– e.g., Recognition of their relatively small stewardship budgets ⇨ pressure to increase investments in stewardship

– e.g., Recognition of their failure to use valuable stewardship tools ⇨ pressure to use such tools

Conclusions

- The evidence that we have collected is consistent with the agency-costs view of index funds stewardship that we put forward
- The agency problems and policy implications that we have identified deserve the close attention of policymakers, market participants, and corporate governance scholars

Questions?