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

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What We Do

- Develop agency-cost theory of index fund stewardship decisions
- Put together hand-collected and pubic data to piece together evidence on the full range of stewardship activities of the Big Three, and find that the evidence is consistent with the agency-costs view.
- Identify a range of policy implications.

Part of a Larger Project on the Agency Problems of Institutional Investors

Related work:

- We build on the analytical framework for analyzing institutional investor agency problems introduced in Bebchuk, Cohen & Hirst (2017), The Agency Costs of Institutional Investors, *Journal of Economic Perspectives*.

- We provide supplemental empirical evidence on the rise of the Big Three,, estimating that the Big Three could well cast as much as 40% of the votes in S&P 500 companies within two decades, in Bebchuk & Hirst (2019), The Specter of the Giant Three, *Boston University Law Review*.

- Bebchuk & Hirst (2019), The Misguided Attack on Common Ownership, considers implications for the common ownership debate.

- Additional working drafts still to be circulated…

The Agency-Costs View of Investment Fund Stewardship

- Stewardship decisions are made not by the fund's beneficial investors but by investment fund managers => agency problems.
- The benchmark is the decisions that would be optimal for beneficial investors.

  -- we do not argue that index fund stewardship necessarily produce worse governance outcomes compared to a state of the world in which the shares were instead held by individual investors and/or active funds.

- We argue that

(i) agency problems are a **first-order driver** of stewardship decisions index funds, and

(ii) understanding these problems can help identify ways to **limit/reduce** their costs.

Two Types of Incentive Problems.

- Index funds (as well as active funds) have incentives to under-invest in stewardship.

(relative to what would be optimal for beneficial investors).

- Index fund (as well as active funds) have incentives to be excessively deferential to corporate managers.

(relative to what would be optimal for beneficial investors).

Investments in Stewardship

- Each of the Big Three has hundreds of $1 billion+ positions in portfolio companies.
  - ⇨ This could justify multiple professionals dedicating substantial part of their time to monitoring and interacting with such a portfolio company.
- Whereas supporters of index fund stewardship have focused on recent increases in stewardship staff, we estimate the personnel resources (hours and cost) devoted to each portfolio company.

Stewardship Investments Relative to Equity Investments and Estimated Fees

	BlackRock	*Vanguard*	*SSGA*
Stewardship Personnel (2017)	33	21	11
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%**

Evidence: What the Big Thee Do and How They Do It

Stewardship per Portfolio Company

	BlackRock	*Vanguard*	*SSGA*
Stewardship Time (Person-Days) (2017)			
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

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 business performance of the company;
- 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; and
- Assessments of the directors’ performance.

However, the stewardship staffing of the Big Three enables only limited and cursory review 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."

Private Engagement (2)

	BlackRock	*Vanguard*	*SSGA*
Portfolio Companies with No Engagement (2017)	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)

- Thus, each of Big Three had no engagement with the great majority of companies:
  - ⇨ For these companies private engagement cannot serve as substitute for the use of other stewardship tools.

Governance-Principles-Based Stewardship

- We document that Big Three stewardship focus on the existence of deviations from their governance principles.
- Serves the private interests of the Big Three:
  - Enables economies of scale that reduce required investments in stewardship; and
  - Makes the potential power of the Big Three less salient.

* <u>But</u> does not take advantage of potential benefits from stewardship based on attention to business performance and/or individual director qualifications

(More on this below)

Little Attention to Performance

- Financial performance is important to investors.
  - ⇨ Index fund investors would significantly benefit from index funds (i) monitor financial underperformance, and (ii) examining what personnel or other changes could address identified underperformance.

Limited Attention to Performance (2)

- Examining the many examples of behind-the-scenes engagements in Big Three Stewardship Reports, we find <u>no</u> cases in which engagement was motivated by financial underperformance.
- Examining the proxy voting guidelines of each of the Big Three for deciding whether to withhold support from director/s, we find that <u>all</u> focus on governance aspects and <u>do not</u> include financial underperformance as relevant criterion.

Limited Attention to Performance (3)

- Could it be argued that this is because the Big Three "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 should not be taken as given – it is an endogenous choice made by index fund managers:
  - Index fund managers have the resources and could improve their ability to identify and remedy financial underperformance if they had incentives to do so.

Limited Attention to Performance (4)

- Could it be argued that index fund managers rationally avoid monitoring and addressing underperformance because activist hedge fund are already doing it?

  (Gilson and Gordon (2013) make a version of this argument)
- Not a valid justification because:
  - Activist hedge funds will only engage where underperformance is very large and can be fixed quickly; and
  - Activist hedge funds may take some time to arrive.

Little Attention to Many Important Director Characteristics

- How well a given director suits a board may depend not just on governance dimensions (are they independent? chosen through an appropriate governance process?) but also on various individual & company specific characteristics (e.g., how much and what kind of experience a director has in the company's industry? what talents, tools, and education they have?).
  - ⇨ Assessing these characteristics could lead to conclusion that the beneficial investors of a Big Three manager would benefit from removing/adding a given director.

Little Attention to Many Important Director Characteristics (2)

- However, we provide evidence that, outside the small number of activist proxy fight, the Big Three pay little attention to such characteristics.

- Examining the proxy voting guidelines of each of the Big Three for deciding whether to withhold support from director/s, we find that they all focus on general governance principles do not call for taking the considered qualifications/characteristics into account.

Little Attention to Many Important Director Characteristics (3)

- Could it be that the Big Three use such characteristics in their behind-the-scenes communications with companies? Our evidence indicates that the answer is <u>no</u>.
- We gather data on over 4000 5% positions held by the Big Three during 2008-2017.

  (Blackrock had 2,455 positions, Vanguard 1,839, SSGA 221)
- Communications re individual director selection by a 5% holder would require a Schedule 13D filing.
- However, the Big Three did not file *any* Schedule 13Ds during 2008-2017

  ⇨ We can infer that they avoided such communications.

Little Attention to Many Important Director Characteristics (4)

Can the Big Three simply free-ride on activist hedge funds? No:

- 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 about director selection with the numerous portfolio companies where hedge funds are not active.

- However, avoiding involvement in the selection of particular directors is consistent with the agency-cost view. Doing so:
  - ⇨Would require significant stewardship investment.
  - ⇨Would involve non-deference to corporate managers.

No Submission of Shareholder Proposals for Changes the Big Three Desire

- Proposals submitted by shareholders that receive majority support have led to considerable improvements in numerous companies (e.g., with respect to majority voting, annual elections)
- Use of shareholder proposals to get changes they favor would be natural for the Big Three: :
  - Focus on conformity with governance principles.
  - Large numbers of their portfolio companies aren't in compliance with the Big Three's <u>own</u> governance principles.
- However, we document that ,among the almost 4,000 corporate governance proposals submitted during 2008-2017, including among the <u>large</u> subset of proposals uniformly supported by the Big Three, <u>none</u> was submitted by the Big Three.

No Submission of Shareholder Proposals for Changes Desired by the Index Funds (2)

Can avoidance of shareholder proposal submission be explained on grounds that the Big Three don't need to submit proposals for governance changes they desire because other (smaller) investors are doing so?

But:

- Because of the limited resources of smaller investors, proposals for many changes that the Big Three would favor are not submitted at all, or are submitted only after many years of delay.
- As a result, a large proportion of the Big Three's portfolio companies lack annual elections or majority voting, which the Big Three support.
  - Submission of shareholder proposals on those issues by one of the Big Three would likely have significant positive effects for their beneficial investors.

Staying on the Sidelines in Corporate Governance Reforms

- Because the Big Three hold positions in many companies, wide-scale governance reforms (even with a small effect per company) could significantly benefit their portfolios.
- But the evidence we hand-collect shows a pattern of limited involvement.

Staying on the Sidelines in Corporate Governance Reforms (2)

- We examine all comment letters submitted on all 80 SEC proposed rule changes regarding corporate governance during 1998-2017.
- With over 20% of corporate equities, one could expect the Big Three to state regularly whether the proposed rule is (i) desirable, (ii) undesirable, or (iii) not practically important and worthy of SEC attention.
- However, the Big Three submitted comments regarding less than 10% of (i) the set of all proposed rules , as well as (ii) the set of proposals getting most attention.

Staying on the Sidelines in Corporate Governance Reforms (3)

- We also examined 10 important cases of precedential securities litigation during 1998-2017 that attracted significant amicus curiae briefs (more than 100 in total) (which were often cited by the subsequent judicial decision).
- 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.
- However, the Big Three remained fully on the sidelines – none of them filed a single amicus curiae brief in any of these ten precedential litigations.

Staying on the Sidelines in Corporate Governance Reforms (4)

- 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 would make their deference salient.

  ⇨ The private interests of index fund managers, but not the interests of their beneficial investors, are likely to be served by staying on the sidelines.

Policy Implications

- Part III of our paper discusses several policy measures that should be considered, and some that should not be considered, for addressing the incentive problems we identify.

- We consider measures with respect to:
  --Encouraging investments in stewardship;
  --Business relationships with public companies;
  --Transparency of private engagements;
  --Rethinking Rule 13D; and
  --Size limits.

Implications for Hedge Fund Activism (1)

- 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.

Implications for Hedge Fund Activism (2)

- But hedge fund activism is not a substitute for index fund stewardship – we argue that the hedge funds-index funds combination cannot generally address effectively corporate governance failures.
- First, hedge fund activism requires the support of index fund managers (against their deference incentives).
  - ⇨ Insufficient support by index fund managers may impede or discourage hedge fund activist engagement (Brav, Jiang & Li, 2018).
- Second, activist hedge funds will only engage if they expect to make large and rapid returns.
  - ⇨ They will ignore many opportunities for smaller gains whose realization would be valuable for index fund investors.

Implications for the Common Ownership Debate

- We argue that common ownership criticism are counterproductive: The first-order concern is that the Big Three do too little and have too little influence, not that they do too much and have too much influence – the push for greater scrutiny of index fund stewardship would likely produce counterproductive effects.

Recognition and Reality

Index fund managers have significant incentives to be perceived as responsible stewards.

- ⇨ Greater recognition by beneficial investors and the public of the incentive problems we identify can by itself lead to improved stewardship.
- ⇨ We hope that our work will contribute to bringing about such changes!

Conclusions

- The evidence we have collected is consistent with the agency-costs view of investment fund stewardship that we put forward.

- Given the rise of investment fund ownership, the two agency problems that we have identified deserve the close attention of policymakers, market participants, and corporate governance scholars.

Thanks!