Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority

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Abstract

This Article offers a theory of mutual fund voting to answer when mutual funds should vote on behalf of their investors and when they should not. It argues that voting authority for mutual funds ought to depend upon: (1) whether the fund possesses a comparative informational advantage, and (2) the ability of the fund to assume a common investor purpose. The strongest case for mutual fund voting is one in which high-quality information is produced and the fund is able to assume a common investor purpose. The case for mutual fund voting is weaker when low-quality information is produced or where funds cannot assume a common investor purpose.

Applying this theory answers whether and how mutual funds should vote on recurring issues. Mutual funds ought to vote on "contests"—that is, proxy fights and M&A—because meaningful information is produced and because the fund can assume a common interest on the part of its investors. By the same token, funds ought not to exercise voting discretion over environmental, social, and governance issues. With respect to environmental and social issues, meaningful information is not produced nor can mutual funds assume a common investor purpose. With respect to governance issues, although funds can assume a unified investor purpose, they do not have adequate information to decide the matter. As a result, mutual funds should follow the voting recommendations of unconflicted managers, as will typically be the case with regard to environmental and social proposals. However, when management is conflicted, as will often be the case with regard to governance proposals, funds should abstain from voting rather than defer to management.

This analysis provides a clear rubric for ensuring that mutual fund voting serves investor interests. However, the possibility remains that mutual funds may use voting to pursue their own interests rather than those of their investors. Regulators should therefore act to reset the default allocations of voting authority between mutual funds and their investors.

Keywords: mutual funds, voting, proxy voting, index funds, stewardship, ESG, activism, M&A, shareholder proposals, shareholder voting, rational apathy, institutional investors, environmental and social, purpose, SEC, department of labor, fiduciary duty

JEL Classifications: G23, G34, K22

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This Article offers a theory of mutual fund voting to answer when mutual funds should vote on behalf of their investors and when they should not. It argues that voting authority for mutual funds ought to depend upon: (1) whether the fund possesses a comparative informational advantage, and (2) the ability of the fund to assume a common investor purpose. The strongest case for mutual fund voting is one in which high-quality information is produced and the fund is able to assume a common investor purpose. The case for mutual fund voting is weaker when low-quality information is produced or where funds cannot assume a common investor purpose.

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I. Introduction

Mutual funds are now the center of power in corporate governance. After decades of strong growth, mutual funds now own about one-quarter of the total U.S. stock market.[1] The "Big Three" mutual fund families—BlackRock, Vanguard, and State Street—are the largest shareholders in the vast majority of large publicly traded companies.[2] Vanguard alone owns blocks of 5% or more in 468 of the companies in the S&P 500.[3] And they vote. Although they do not receive the economic benefit of the shares they hold—their investors do—mutual funds are empowered to vote them.[4] This aggregated voting power makes mutual funds the ultimate arbiters of corporate governance. Accordingly, hedge fund activists stake their campaigns on winning mutual fund support.[5] And policy entrepreneurs lobby mutual funds to favor their causes.[6]

Mutual funds' voting power has recently been seen as cause for alarm. Some argue that broad ownership of public companies by index funds will

1. M. Szmigiera, *Share of Market Securities Held by Mutual Funds in the U.S. in 2018, by Security Type*, STATISTA (May 15, 2019), https://www.statista.com/statistics/255547/percentage-of-total-market-securities-held-by-investment-companies/ [https://perma.cc/Q6NJ-T8JD] (providing data showing U.S. mutual funds held 23% of all U.S. corporate equities in 2018).

2. *See* Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017) (finding that the Big Three combined own the largest stakes in 40% of all U.S. listed companies and in 88% of the S&P 500).

3. Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016, 10:41 AM), https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101 [https://perma.cc/HJJ5-PPZC].

4. *See infra* notes 46–48 and accompanying text.

5. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 896 (2013) (describing an activist campaign as a process that "critically depends on . . . institutional support"); Justin Baer & Dawn Lim, *Mutual Fund Managers Try a New Role: Activist Investor*, WALL ST. J. (Dec. 30, 2018, 5:55 PM), https://www.wsj.com/articles/mutual-fund-managers-try-a-new-role-activist-investor-11546174800 [https://perma.cc/PWA6-NPFJ] (chronicling the increase in mutual fund managers' pushing for corporate change); David Benoit & Kirsten Grind, *Activist Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015, 10:38 PM), https://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910 [https://perma.cc/9VF6-VGLC] (detailing the increase in mutual fund activism).

6. For example, a proposal by the Sisters of the Holy Names of Jesus and Mary to force the manufacturer of Smith & Wesson firearms to report on its efforts to control gun violence succeeded with the support of BlackRock. David Meyer, *Nuns vs. Guns: How These Sisters Took on Smith & Wesson—And Won*, FORTUNE (Sept. 26, 2018), http://fortune.com/2018/09/26/nuns-gun-violence-report-proposal-smith-wesson/ [https://perma.cc/EK4T-UN38]. Likewise, environmental groups regularly enlist the support of BlackRock, State Street, and Vanguard to press energy companies to report on climate change. *See, e.g.*, Eric Rosenbaum, *Exxon Mobil Loses Support of a Powerful Voice in Climate Change Policy*, CNBC ONLINE (Sept. 5, 2017, 2:38 PM), https://www.cnbc.com/2017/08/31/investing-power-vanguard-votes-against-exxon-mobil-on-climate-change.html [https://perma.cc/3UTZ-DBKC] (describing Vanguard's vote to require a report on climate change and noting both BlackRock's and State Street's commitments to environmental issues).

dampen corporate incentives to perform.[7] Others worry over the accumulation of too much power in too few hands[8] and warn that it may lead to politics by other means.[9] These concerns have spurred congressional hearings[10] and fueled initiatives for regulatory reform.[11]

7. *See* Inigo Fraser-Jenkins et al., *The Silent Road to Serfdom: Why Passive Investing Is Worse than Marxism*, BERNSTEIN RES. (Aug. 23, 2016) (arguing that large-scale indexing harms price discovery); *see also* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1267–70 (2016) (discussing the anticompetitive incentives created by horizontal shareholding); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026, 2030–31 (2018) (arguing that large shareholders have both the incentive and ability to "soften the intensity of competition"); Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669, 677 (2017) (working from the premise that institutional investors "have reduced competition in some sectors of the U.S. economy"). *But see* Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221, 271 (2018) (proposing a safe harbor to insulate institutional investors from antitrust concerns); Alessandro Romano, Horizontal Shareholding: The End of Markets and the Rise of Networks 3–4 (Sept. 26, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3255948 [https://perma.cc/4LS2-EYLH] (disputing the claims of the concentrated ownership literature by arguing that spillovers across markets prevent the blunting of incentives).

8. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harvard Law Sch., Pub. Law Working Paper No. 19-07, 2018), https://ssrn.com/abstract=3247337 [https://perma.cc/BR7U-DHYG]. The founder of the index fund has raised similar concerns. John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018, 10:15 AM), https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551 [https://perma.cc/HL7X-VAY5] (warning that the Big Three will soon have effective control of the U.S. stock market and stating that he "do[es] not believe that such concentration would serve the national interest").

9. Phil Gramm & Mike Solon, *Keep Politics Out of the Boardroom*, WALL ST. J. (July 18, 2018, 6:28 PM), https://www.wsj.com/articles/keep-politics-out-of-the-boardroom-1531952912 [https://perma.cc/JA6B-M2HR] ("The rise of index funds, which own an ever-greater portion of U.S. stocks, raises the specter of a vast number of shares being voted by fund managers and their proxy advisers who don't own the shares and may have a conflict of interest with the people who do.").

10. *See, e.g.*, *The Application of Environmental, Social and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors and Other Intermediaries: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 116th Cong. 1–2 (2019) (statement of Sen. Mike Crapo, Chairman, S. Comm. on Banking, Hous. and Urban Affairs) (stating that the focus of the hearing was on issues associated with voting by institutional investors).

11. The SEC signaled an interest in reforming the proxy process, first by withdrawing interpretive letters providing comfort to institutions relying on proxy advisory firms' voting recommendations, and second by hosting a roundtable of industry leaders to explore regulatory reform. *See* Jay Clayton, *Statement Announcing SEC Staff Roundtable on the Proxy Process*, SEC. & EXCH. COMM'N (July 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process [https://perma.cc/KD6N-87SN] (announcing the roundtable to be held in Fall 2018 and its tentative agenda); *Statement Regarding Staff Proxy Advisory Letters*, SEC. & EXCH. COMM'N (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters [https://perma.cc/6P45-STT5] (announcing withdrawal of the interpretive letters); *see also* Cydney Posner, *What Happened at the SEC's Proxy Process Roundtable?*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REGULATION (Nov. 21, 2018), https://corpgov.law.harvard.edu/2018/11/21/what-happened-at-the-secs-proxy-process-roundtable/ [https://perma.cc/G86N-JTUB] (summarizing discussion at the November roundtable). The SEC also issued recent guidance suggesting that proxy advisory services may constitute a "solicitation" subject to the proxy rules. *See* Commission Interpretation

These concerns have also launched a second wave of academic commentary on institutional ownership.[12] The first wave had offered institutional ownership as a solution to the problem of rational apathy—that is, the information and incentive problems that make individual investors lax monitors of corporate governance.[13] Institutional investors, in theory at least, hold large enough blocks to care about monitoring.[14] Unfortunately, first-wave commentators soon found themselves explaining why institutional investors nevertheless failed to monitor.[15] They chalked it up to collective-action problems,[16] conflicts of interest,[17] regulatory

and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 34-86721, 17 C.F.R. pt. 241 (Sept. 10, 2019).

12. *E.g.*, Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033–36 (2019); Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP., Summer 2017, at 89, 89–90; Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. ILL. L. REV. 223, 225 (2019); Jill Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 20–22 (2019); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1157 (2019) [hereinafter Griffith & Lund, *Conflicted Mutual Fund Voting*]; Sean J. Griffith & Dorothy S. Lund, *A Mission Statement for Mutual Funds in Shareholder Litigation*, 87 U. CHI. L. REV. (forthcoming 2020) (manuscript at 5), https://ssrn.com/abstract=3422910 [https://perma.cc/KJ6S-WGLU] [hereinafter Griffith & Lund, *Mission Statement*]; Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175, 176–78 (2017); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 494 (2018); Amir Licht, *Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review* 46 (European Corp. Governance Inst., Law Working Paper No. 439, 2019), https://ssrn.com/abstract=3331097 [https://perma.cc/86JR-MKJN]; Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 10–11 (N.Y. Univ. Sch. of Law, Working Paper No. 18-39, 2019), https://ssrn.com/abstract=3295098 [https://perma.cc/SR77-CRSR].

13. *See* ROBERT CHARLES CLARK, CORPORATE LAW 390–92 (1986) (describing the low rate of individual-investor participation in shareholder elections as a rational response to their inability to influence corporate decision-making relative to the costs of becoming informed and voting on that basis). For a more detailed discussion of rational apathy, see *infra* text accompanying notes 60–63.

14. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 524 (1990) (noting that "apathy makes *exponentially* less sense as shareholdings grow, as long as there is a critical mass of other large shareholders").

15. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992) (noting that "shareholders then face severe collective action problems in monitoring corporate managers"); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 880 (1991) (discussing how "institutional investors lack the expertise to monitor on their own"); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795 (1993) (discussing how "public pension funds face distinctive investment conflicts that limit the benefits of their activism").

16. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453–55 (1991) (emphasizing problems of collective action underlying institutional investor passivity).

17. Black, *supra* note 14, at 598–602, 604 (separating institutional shareholders into different types and identifying conflicts for each, noting that mutual funds have conflicts arising from their interest in pursuing corporate 401(k) accounts and in preserving access to "soft" information).

interference,[18] and a preference for exit over voice.[19] Why, given the thorough treatment of these issues in the prior literature, are academics now revisiting these questions? Because of two major changes since the first wave: the rise of the index and the rise of stewardship.

The rise of the index represents a significant change because institutional investors were often treated by first-wave commentators as active or, at least, selective in their investment strategies, designing portfolios that sought to overweight good performers.[20] In contrast, indexes, ETFs, and other passive funds simply track the performance of an index, such as the S&P 500 or the Russell 2000,[21] competing on cost more than return.[22] Yet index funds routinely outperform active funds, especially after fees are taken into account.[23] Accordingly, index funds now account for a larger share of the U.S. mutual fund market than active funds.[24] This has important implications for monitoring. Most notably, in light of the fact that they are not trying to pick winners,[25] index fund managers might be largely

18. Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 89–90 (1990); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991).

19. John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1280 n.8, 1281 (1991) (arguing that in the absence of a controlling stake institutional investors prefer liquidity to control and therefore fail to monitor).

20. *See generally* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2048 (1994) ("*Overweighting* means that the institution owns a greater share of the specific company than it owns of the market generally. An overweighted firm has a greater incentive to intervene, because it will gain more from success than its competitors.").

21. For brevity, I will refer to ETFs, index funds, and other passive mutual funds that seek to track the performance of an index as "index funds."

22. John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 153 (2007) ("[P]rice competition is in fact a strong force constraining fund advisers . . . ."). On this point, it is worth noting that Fidelity recently launched no-fee index funds. *See* Tim McLaughlin & Ross Kerber, *Fidelity Offer of No-Fee Index Funds Hurts Shares of Rivals*, REUTERS (Aug. 1, 2018), https://www.reuters.com/article/us-fidelity-funds-fees-idUSKBN1KM5D5 [https://perma.cc/Q252-4V2D] (describing BlackRock's negative share-price reaction to Fidelity's announcement that it would offer no-fee index funds).

23. MORNINGSTAR MANAGER RESEARCH, MORNINGSTAR'S ACTIVE/PASSIVE BAROMETER 2 (2018) (finding that only "36% of active managers . . . both survived and outperformed their average passive peer over the 12 [prior] months through June 2018" and that "43% of active managers achieved this feat" in 2017).

24. Dawn Lim, *Index Funds Are the New Kings of Wall Street*, WALL ST. J. (Sept. 18, 2019, 5:30 AM), https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004 [https://perma.cc/Z2XV-WWM4] ("Funds that track broad U.S. equity indexes hit $4.27 trillion in assets as of Aug. 31, . . . giving them more money than stock-picking rivals for the first ever monthly reporting period. Funds that try to beat the market had $4.25 trillion as of that date.").

25. *But see* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. ON REG. 795, 808–09 (2019) (arguing that index construction involves substantial discretion and that therefore index investing is best understood as investment management by the index creator rather than a fund manager).

indifferent to the performance of individual portfolio companies and therefore unlikely to invest in monitoring.[26] Alternatively, insofar as index funds are concerned about the performance of the portfolio as a whole, they might pressure individual companies to forego profit opportunities that come at the expense of other companies in the portfolio.[27] The index fund thus presents a new kind of institutional intermediary with different incentives in monitoring.

The second major change underlying renewed interest in institutional investors is the rise of stewardship—that is, the willingness of funds to engage with portfolio companies, principally through voting.[28] Each of the Big Three touts its commitment to proxy voting as an essential component of its mission.[29] And the data show that mutual funds do indeed vote their proxies.[30] Whether active voting translates into meaningful monitoring is a topic debated by new-wave commentators. The enormity of the task provides ample grounds for skepticism.[31] In the 2018 proxy season, for example, Vanguard voted on over 168,000 proposals at over 19,000 meetings for more than 12,000 companies.[32] Moreover, the data show that

26. *See* Bebchuk & Hirst, *supra* note 12, at 5 (discussing incentives to underinvest in stewardship); Lund, *supra* note 12, at 495 (arguing that passive fund managers are less likely to engage thoughtfully with portfolio companies). *But see* Rock & Kahan, *supra* note 12, at 20–21 (arguing that the ownership stake of the Big Three is sufficiently large for them to care about portfolio company performance).

27. Such anticompetitive concerns are the focus of the recent debate in the antitrust literature. *See* sources cited *supra* note 7.

28. Engagement comes in many forms—phone calls, public letters, and private meetings—but each depends ultimately upon the institution's voting power.

29. *See* VANGUARD, 2018 INVESTMENT STEWARDSHIP ANNUAL REPORT 3 (2018) [hereinafter VANGUARD REPORT] (emphasizing "four pillars" of engagement: board composition, executive compensation, oversight of risk and strategy, and governance structures); *Asset Stewardship*, ST. STREET GLOBAL ADVISORS, https://www.ssga.com/about-us/asset-stewardship.html [https://perma.cc/H8TM-VMSY] ("Our approach to stewardship is designed to have an impact through thought leadership, engagement, proxy voting and client disclosure."); Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (Jan. 16, 2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/98BC-EYNB] (noting that "our responsibility to engage and vote is now more important than ever").

30. *See* BROADRIDGE, 2018 PROXY SEASON REVIEW 4 (2018), https://www.broadridge.com/_assets/pdf/gated/broadridge-2018-proxy-season-review.pdf [https://perma.cc/ACZ2-3S6G] (reporting institutional investor participation at 91%, compared to 28% for ordinary "retail" investors). For discussion of the reasons why mutual funds are now actively voting, see *infra* subpart II(B).

31. *See* Lund, *supra* note 12, at 516 ("Vanguard employs fifteen people devoted to engagement and voting at about 13,000 companies based around the world, BlackRock employs about twenty people who work on governance issues at some 14,000 companies, and State Street employs fewer than ten people devoted to governance issues at around 9,000 companies.").

32. VANGUARD REPORT, *supra* note 29, at 9. Over roughly the same period, BlackRock and State Street each voted at over 17,000 meetings on over 154,000 proposals. BLACKROCK, INVESTMENT STEWARDSHIP REPORT: 2018 VOTING AND ENGAGEMENT REPORT 4 (2018); STATE ST. GLOB. ADVISORS, STEWARDSHIP 2017, at 4 (2017).

mutual funds cast their votes overwhelmingly in favor of management.[33] In order to be effective monitors, some argue, mutual funds must invest more in stewardship.[34]

But how much? What is the right amount of resources for mutual funds to invest in stewardship? How often should they vote contrary to management's recommendations? And when should mutual funds choose simply not to vote at all? What is the limiting principle of mutual fund stewardship, for index funds in particular? How much should we really expect of stewardship programs, and with regard to what issues should we expect more or less? These questions have gone unasked and unanswered in the current debate. Yet, they are central questions in understanding what stewardship programs can and cannot deliver.

This Article aims to answer those questions by grounding them in a theory of delegated voting. Unlike the citizens of a democracy, shareholders do not vote to enact their freedoms or to fulfill their civic duty. They vote to inform corporate managers of their preferences and to constrain managerial agency costs.[35] The union of voting rights with economic returns is fundamental to the operation of this system, yet mutual funds separate economic returns (which go to the investors) from voting rights (which go to the fund).[36] This introduces an intermediary and, therefore, the potential for conflict.[37] The question thus becomes one of specifying when and whether a rational investor would prefer to delegate voting rights to a mutual fund intermediary rather than keeping them for herself.

The decision to delegate voting rights depends upon information and purpose. A rational investor will delegate voting rights to an intermediary if and only if the intermediary possesses a comparative advantage in acquiring or analyzing the information necessary to vote intelligently. This comparative advantage in information is the basis for scholars' belief that institutional investors can solve the rational apathy problem. The second essential consideration, often neglected, is purpose. A rational investor will delegate voting rights to an intermediary if and only if the intermediary shares the investor's purpose. Both elements are necessary. If the intermediary's purpose is somehow opposed to the investor's, the delegation of voting rights does not make sense even if the intermediary has an informational advantage.

33. *E.g.*, Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds 3 (Feb. 14, 2018) (unpublished manuscript), https://ssrn.com/abstract=3124039 [https://perma.cc/ZBY6-TRS3]. *See generally* Davidson Heath et al., *Do Index Funds Monitor?* (European Corp. Governance Inst., Finance Working Paper No. 638, 2019) (finding that index funds rarely vote against firm management and do not seem to engage with firm management). For more detailed discussion of mutual fund voting patterns, see *infra* notes 96–113 and accompanying text.

34. Bebchuk & Hirst, *supra* note 12, at 1–2.

35. *See infra* subpart III(A).

36. *See infra* notes 42–49 and accompanying text.

37. Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 577 (2015).

The Article applies this theory of delegated voting to design a set of default rules for mutual fund voting covering each of the paradigmatic issues on which shareholders vote. The principal situation in which mutual funds ought to exercise discretion in voting on their investors' behalf is in "contests"—that is, proxy fights and M&A. In contests, meaningful information is produced, and the mutual fund has a comparative advantage over most ordinary investors in analyzing this information. As importantly, in contests, the mutual fund intermediary can assume a common interest on the part of its investors. The opposite situation is presented by environmental and social proposals. There, mutual funds are *not* presented with meaningful information nor are they able to assume a common purpose on the part of their investors. Fortunately, unlike contests, there is no reason to suppose that management is conflicted in assessing environmental and social proposals. Mutual funds should therefore defer to management's recommendation when voting on issues. However, investors with differing objectives should be given an opportunity to opt out, either *ex ante* (through special funds) or *ex post* (through a form of pass-through voting).

Governance issues are distinguishable from both contests and from environmental and social proposals.[38] Like contests (and unlike environmental and social issues), mutual funds *can* assume a common investor purpose with respect to governance. Investors will favor governance reforms that increase corporate value and oppose governance changes that decrease it. Also like contests (and unlike environmental and social issues), a manager's recommendation with respect to governance reforms may be tainted by her own interests. Managers can be expected to disfavor governance reforms that restrict their authority or reduce their tenure. However, considering the unproven link between governance and performance, mutual funds do not have a comparative informational advantage in voting intelligently on governance. Therefore, in the absence of meaningful information concerning the effect of a given governance reform on the performance of a specific firm, mutual funds should abstain from voting on governance proposals. Instead, the votes should either be passed through to investors or not voted at all.

The theory of delegated voting articulated here should serve both to ground scholarly debate and to guide policy makers considering revisions to the proxy voting system. From this introduction, the Article proceeds as follows. Part II describes the structure of mutual fund voting, how it has evolved from its contractual and technological foundations, and how it has been affected by regulatory interventions. Part III then reviews theories of corporate voting and adapts these to build a theory of delegated voting.

38. These three types of issues—environmental, social, and governance—are collectively referred to as "ESG."

Next, Part IV applies the theory of delegated voting to articulate an optimal set of default voting rules for each of the recurring issues on which a mutual fund might be asked to vote. Part V analyzes how law and regulation must change in order to bring mutual fund voting practices into better alignment with the preferences of their investors. The Article then closes with a brief summary and conclusion.

II. The Structure of Mutual Fund Voting

The structure of mutual fund voting is derived from the contractual relationship between mutual funds and their investors as overlain by law and regulation. The technology of shareholder voting plays a complicating role. However, the structure of mutual fund voting has been more responsive to shifts in the regulatory environment than the evolution of voting technologies. This Part reviews the structure of mutual fund voting, focusing on its contractual origins, regulatory interventions, and the voting policies and practices that have resulted from this dynamic.

A. Contractual Foundations

Mutual funds pool investor assets to buy a portfolio of debt, equity, or other investment securities.[39] Day-to-day operations of mutual funds are managed by professional advisors who provide contractual services to funds, including portfolio selection and management, in exchange for a fee based on the fund's assets under management (AUM).[40] Advisors typically offer a variety of mutual funds within the same advisory firm or "fund family."[41] An advisory firm's return is based exclusively on its contractual fees.[42] Fees are assessed as a percentage of AUM,[43] and are significantly

39. WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 19 (2016) ("A mutual fund is a financial tool that gathers money from several different investors and uses the combined pool of assets to buy a portfolio of stocks, bonds, or other investments."); *see also* Investment Company Act of 1940, Pub. L. No. 76-768, § 3(a)(1), (3), 54 Stat. 789, 797 (codified as amended at 15 U.S.C. § 80a-3(a)(1)(A), (C) (2012)) (defining an investment company, popularly known as a mutual fund, as an issuer that "is . . . engaged primarily . . . in the business of investing, reinvesting, or trading in securities," or which "owns . . . investment securities having a value exceeding 40 per centum of the value of such issuer's total assets").

40. *See* BIRDTHISTLE, *supra* note 39, at 46–47 (explaining that management fees are based upon investor assets); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 92, 98–99 (2010) (further explaining advisors' compensation).

41. Lipton, *supra* note 12, at 181. For example, BlackRock markets nearly 150 different funds, including a wide variety of index funds and ETFs as well as actively managed funds. *All BlackRock Funds*, MORNINGSTAR, http://quicktake.morningstar.com/fundfamily/blackrock/0C000034YC/fund-list.aspx [https://perma.cc/8W7E-MW4Z].

42. By law, mutual fund advisory fees cannot include a performance component. *See* Investment Advisers Act of 1940, Pub. L. No. 76-768, § 205(1), 54 Stat. 847, 852 (codified as amended at 15 U.S.C. § 80b-5(a)(1) (2012)) (prohibiting compensation for investment advisors based on capital gains or capital appreciation within the funds); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J.

higher for actively managed funds than they are for index funds.[44] Most fund families offer both actively managed and index funds,[45] and even those that offer more index than active funds may derive the bulk of their fee revenue from active funds.[46]

In contrast to the advisory firms, mutual fund investors' returns are derived entirely from the performance of portfolio assets, expressed as Net Asset Value (NAV).[47] However, in spite of receiving the full economic return, net of fees, of the portfolio companies in which the fund invests, mutual fund investors do not receive the right to vote portfolio company shares. Instead, advisory firms require investors to delegate their voting rights as a condition to investing in the fund.[48] Although some large institutional investors—most notably, large pension funds—are able to negotiate exceptions to this rule, smaller investors have no choice.[49] As a result, most mutual fund investors receive the economic returns of portfolio company shares but no right to vote their proportional interest in them.

The separation of economic returns and voting rights inherent in mutual fund investing likely reflects the underdeveloped infrastructure of

1228, 1257 n.72 (2014) (describing regulations that limit the ability of mutual fund advisers to charge performance fees).

43. In addition to management fees assessed as a percentage of AUM, mutual funds may assess fees on sales ("loads"), redemptions, and other administrative expenses. *See* OFFICE INV'R EDUC. & ADVOCACY, SEC. & EXCH. COMM'N, MUTUAL FUNDS AND ETFS: A GUIDE FOR INVESTORS 26–28 (2016), https://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [https://perma.cc/F4K9-PQHS] (categorizing fees).

44. *See* Timothy Strauts, *5 Charts on U.S. Fund Flows that Show the Shift to Passive Investing*, MORNINGSTAR BLOG (Mar. 12, 2018), https://www.morningstar.com/blog/2018/03/12/fund-flows-charts.html [https://perma.cc/FLW3-TJQQ] (showing active equity funds on average have fees fifty basis points higher than passive equity funds). Fees are also typically higher for "socially responsible" funds. *See* Dana Brakman Reiser & Anne Tucker, Buyer Beware: The Paradox of ESG & Passive ESG Funds 15 (Aug. 23, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3440768 [https://perma.cc/H94Q-VWGY] (showing data for "socially responsible" funds).

45. Lund, *supra* note 12, at 519 (noting that each of the Big Three is known predominantly for index funds, while Fidelity and T. Rowe Price, for example, are known predominantly for their active funds).

46. *See* Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1177 (noting that "BlackRock's smaller share of active funds generates an equal amount of revenue as its passive funds—approximately $1.3 billion each quarter").

47. NAV is the total value of the fund's assets minus its liabilities divided by the number of mutual fund shares outstanding. It is calculated at the end of each trading day. *See* Quinn Curtis & John Morley, *The Flawed Mechanics of Mutual Fund Fee Litigation*, 32 YALE J. ON REG. 1, 15 (2015) ("Redemption rights allow [mutual fund] shareholders to turn over their shares directly to their funds and receive in exchange a cash payout equal to the shares' net asset value or 'NAV.' The NAV is simply the portion of a fund's total net assets that corresponds to each share.").

48. *See* George Braxton Raine & John M. Loder, *Proxy Voting: US Issues*, *in* INVESTMENT MANAGEMENT: LAW AND PRACTICE 474, 474 (Timothy Spangler ed., Oxford Univ. Press 2010) ("An investment adviser's responsibilities and authority regarding proxy voting may be specified in the investment adviser's contracts with its clients . . . .").

49. *Id.* ("[F]requently contractual provisions relating to proxy voting do little more than authorize the adviser to vote proxies relating to securities held in the client's account.").

shareholder voting. The shareholder-voting system developed around late-nineteenth- and early-twentieth-century technologies for tracking share ownership, which originally focused on physical certification or registration of ownership on the corporation's stock ledger.[50] Now, due in part to regulatory encouragement,[51] most corporate shares are held in depository accounts through banks or brokerage firms and beneficial ownership is recorded in corporate ledgers in "street name" only.[52] This arcane system complicates shareholder voting largely as a result of the number of agents a company or a proxy contestant must work through in order to find the ultimate beneficial owner entitled to vote.[53] Imposing this system on mutual funds—requiring funds to track beneficial ownership, distribute proxy materials to investors, and tabulate their votes—would have entailed enormous record-keeping costs, potentially swamping the benefits of low-cost diversification. Faced with such costs, investors might have opted to diversify on their own, and the mutual fund industry might never have gotten off the ground. Funds therefore took on voting as an administrative necessity to minimize expenses.

Does the delegation of voting rights to mutual funds remain an administrative necessity? A number of points are worth raising here. First, if mutual funds were to pass votes through to their investors, there is no reason to suppose they would be forced to do so in the same way as banks and brokerage firms. Unlike the intermediaries in the depository holding system, mutual funds are the legal owners of the shares. Because mutual funds know what they own, some basic problems of that system—tracking ownership and tallying votes—are avoided. Moreover, there is no reason to force mutual funds to communicate with their investors in the same highly regulated way that corporations communicate with their shareholders. A much simpler process could be imagined.[54] For example, a mutual fund

50. U.C.C. art. 8 prefatory note (AM. LAW INST. & UNIF. LAW COMM'N 1994) (describing the paperwork required to track ownership of corporate shares which had "reached crisis proportions by the late 1960s").

51. *See* Securities Acts Amendments of 1975, Pub. L. No. 24-29, 89 Stat. 97, 146 (codified as amended at 15 U.S.C. § 78q-1(e) (2012)) (directing the SEC to end physical movement of securities certificates in connection with settlement of transactions, thereby effectively compelling the current system of street-name ownership).

52. Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1237–38 (2008).

53. *Id.* at 1249 (developing a typology of "pathologies" introduced into shareholder voting by the system for tracking share ownership); *see also* J. Travis Laster & Marcel T. Rosner, *Distributed Stock Ledgers and Delaware Law*, 73 BUS. LAW. 319, 332–33 (2018) (discussing the complication introduced into the system of shareholder voting by the multitude of banks and brokers spread throughout the country without a centralized database).

54. For a more detailed discussion of how pass-through voting might be adapted to the mutual fund context and issues arising therefrom, see Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, MD. L. REV. (forthcoming 2020) (manuscript at 33–35), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365222 [https://perma.cc/3ZCC-VL8E].

could notify its investors that a proxy statement has been posted with regard to a particular portfolio company and invite them to register their preferences via the Internet. The burden would then be on the investor to download and read the proxy statement and upload their preferences. An investor that did not upload a preference would effectively delegate authority to the mutual fund to vote or abstain, depending upon the relevant default. Nor does investing in a mutual fund through agents necessarily complicate the process.[55] The mutual fund would satisfy its burden by notifying its investor of the opportunity to upload a voting preference. If that investor is an intermediary agent of another investor, the burden of gathering and uploading investor preferences would fall on the agent.[56] All the mutual fund would have to do is notify its investors of the opportunity to upload a voting preference, digitally tally them once the period for doing so had closed, then transmit the ultimate voting result to the company.

Advances in digital technology might lighten this burden still further.[57] In particular, some have argued that blockchain technology promises to substantially improve the system of shareholder voting.[58] Maybe so. But for these purposes, an old-fashioned computer would do. Determining an investor's proportional voting interest is not dramatically different from determining NAV, something funds do every day. It is not higher math. As a result, although pass-through voting has been dismissed as "expensive and unmanageable,"[59] it need not be so, especially in light of technologies at our disposal.

The real question with pass-through voting is thus not whether it can be done, but whether it should be. Here, the problem is not technology.[60] It

55. Many investors invest in mutual funds through a broker rather than through the fund family directly. This is often a mistake. *See, e.g.*, Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129, 4130 (2009) (comparing the returns of mutual funds sold by brokers with mutual funds sold directly by fund complexes).

56. In this way, the "agents all the way down" problem need not be a problem for the mutual fund. It would perform by notifying the entity through which the investor had invested with it.

57. *See generally* John Armour et al., *Putting Technology to Good Use for Society: The Role of Corporate, Competition and Tax Law*, 6 J. BRIT. ACAD. 285 (2018) (reviewing ways in which technological advances can be used to improve business law); Mark Fenwick et al., *Why Blockchain Will Disrupt Corporate Organizations: What Can Be Learned from the "Digital Transformation,"* JBBA, Nov. 15, 2018, at 91 (analyzing new digital technologies to advance a shift in corporate organizations); Mark Fenwick et al., *The End of 'Corporate' Governance: Hello 'Platform' Governance*, 20 EUR. BUS. ORG. L. REV. 171 (2019) (discussing strategies for using technology in organizations).

58. George S. Geis, *Traceable Shares and Corporate Law*, 113 NW. U. L. REV. 227, 227 (2018); David Yermack, *Corporate Governance and Blockchains*, 21 REV. FIN. 7, 8 (2017).

59. Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 889 (2009).

60. *See* Griffin, *supra* note 54 (describing possible technological protocols for pass-through voting).

is rational investor apathy.[61] Individual investors vote their shares less than 30% of the time.[62] For mutual fund investors, voting turnout would likely be far lower. Individual mutual fund investors can be expected to tire quickly of being asked each year to evaluate and vote on thousands of matters over which their miniscule voting stakes likely make no difference at all. This fractionalization of voting power combined with the information overload inherent in being asked to weigh in on so many matters suggests that pass-through voting threatens to vastly increase the problem of rational apathy and lead to less voting.

Rational apathy is an information problem with up to three distinct components. First, ordinary investors may not possess the information they need to vote intelligently. Second, ordinary investors may not possess the financial sophistication necessary to understand available information. And third, ordinary investors may not have an incentive to devote the time and attention necessary to understand available information. The second and third components are related: an ordinary investor who devoted a sufficient amount of time and attention could acquire financial sophistication as well, but nonprofessionals may lack the incentive to do so. Institutional intermediation promises to address all three problems. Institutions know what information to ask for. They know what it means. And they hold sufficiently large stakes to care.

Still, at the level of theory, separating economic returns from voting rights sets off alarm bells. Scholars uncovering instances in which hedge funds decoupled economic and voting rights through financial engineering famously labeled the practice "empty voting."[63] Yet mutual funds decouple economic and voting rights every day. Scholarly acquiescence to this arrangement depends upon the fund managers proving better monitors of the corporation than the investors themselves. This may not always be the case.[64]

Rational apathy likely explains why investors are so willing to hand over voting rights as part of investing in a mutual fund. If investors do not care to vote, they are not likely to protest against signing their voting rights over to the fund. Still, rational apathy does not explain why mutual funds vote so often—over 90% of the time. Indeed, it seems that a rationally

61. Gilson & Gordon, *supra* note 5, at 901 n.132 (rejecting pass-through voting as "likely to fail because of the original Berle-Means problem: the passivity of dispersed owners"); Taub, *supra* note 59, at 889 (concluding that pass-through voting would be "ineffective" due to investors' failure to vote).

62. BROADRIDGE, *supra* note 30, at 4 (reporting retail investor turnout at less than 30% each year 2014–2018).

63. *See generally* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) (coining the phrase and providing examples of situations in which empty voting produces outcomes that reduce the company's share price).

64. *See infra* subpart III(B).

apathetic investor would be just as happy for mutual funds not to vote their shares. If their investors care so little, why do mutual funds care so much? The answer, the next section argues, has to do with the regulation of mutual funds.

B. Regulatory Interventions

Mutual funds have a centuries-long history in Europe.[65] In the United States, they arose in the mid-1920s, just in time to attract investors for the stock-market crash of 1929.[66] The response to that crash led to federal regulation of the securities industry, with the Securities Act of 1933[67] and the Exchange Act of 1934,[68] and also of the mutual fund industry, with the Investment Company Act (ICA)[69] and the Investment Advisor Act (IAA), both passed in 1940.[70] The ICA provides rules governing the organization and structure of mutual funds.[71] The IAA provides rules governing the individuals and firms providing advisory and management services to funds and investors.[72] Both are administered by the SEC.[73]

In spite of their long history, the growth of mutual funds did not begin in earnest until the 1970s. The catalyst was passage of the Employee Retirement Income and Security Act of 1974 (ERISA).[74] ERISA created incentives for employers to move employee retirement savings from defined benefit plans to defined contribution plans.[75] For employees, the

65. The beginnings trace to the 1770s in Holland, when a Dutch merchant created an early version of the closed-end mutual fund, which he sold to the public under the name of "Eendragt Maakt Magt" or "unity creates strength." *The History of Mutual Funds*, INV. FUNDS INST. CAN., https://www.ific.ca/en/articles/who-we-are-history-of-mutual-funds/ [https://perma.cc/FS7K-SZUG].

66. William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1412–13 (2006) (providing a historical overview).

67. Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa).

68. Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm).

69. Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64).

70. Pub. L. No. 768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

71. *See* John Morley, *Why Do Investment Funds Have Special Securities Regulation?*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS 9, 10 (William A. Birdthistle & John Morley eds., 2018) (explaining there is support from "no less an authority than the Investment Company Act of 1940").

72. Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11, 14–16 (2006).

73. *Id.*

74. 29 U.S.C. §§ 1001–1461 (2012).

75. On the distinction between the two, Edward Zelinsky explains that:

> A defined benefit pension, as its name implies, specifies an output for the participant. Traditionally, such plans defined benefits for particular employees based on the employees' respective salary histories and their periods of employment. . . .
>
> In contrast, a defined contribution arrangement, as its equally apt moniker indicates, specifies an input for the participant. Commonly, the plan defines the employer's contribution for each participant as a percentage of the participant's salary for that year. Having made that contribution, the employer's obligation to fund

upside was portability and greater choice of investments.[76] For the fund industry, the upside was a vast inflow of assets into mutual funds from defined contribution plans.[77]

When mutual funds manage retirement plan assets, they become subject to regulation by the Department of Labor (DOL), which is charged with enforcing ERISA.[78] For such funds, DOL regulation is in addition to SEC regulation.[79] Of course, not all mutual funds are sold within retirement plans, and not all fund advisors act as plan fiduciaries under ERISA. Nevertheless, within large mutual fund families, especially those with centralized policies, the voting practices of funds that do not manage plan assets are likely to be influenced by the family's need to comply with DOL requirements for those funds that do manage plan assets.[80]

The regulatory requirements imposed by the DOL and by the SEC differ on the subject of voting. The DOL unambiguously requires managers of plan assets to vote portfolio company shares.[81] Still, some ambiguity remains over the factors plan fiduciaries can weigh in proxy voting. In Obama-era guidance, the DOL had taken the position that it would be

> is over because the employee is not guaranteed a particular benefit, just a specified input.

Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 455 (2004).

76. The downside was that the employee instead of the employer bore investment risk, transforming every American worker, through her defined contribution account, into a capitalist. *See* Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 911 (2013) (arguing that pension-system reform broadly transformed middle class interests from pro-labor to pro-capital).

77. Inflows accelerated upon the realization that § 401(k), added to the Internal Revenue Code in 1978, allowed tax deferral on investment gains until retirement. *See* BIRDTHISTLE, *supra* note 39, at 22–23 (describing the birth of the 401(k) and the rise of individual investing). Inflows increased further with subsequent changes to tax laws affecting Individual Retirement Accounts (IRAs) in the early 1980s. *See* Zelinsky, *supra* note 75, at 485–88.

78. BIRDTHISTLE, *supra* note 39, at 142 ("Fidelity Investments, Vanguard Group, and TIAA-CREF are among the biggest and most prominent vendors of defined-contribution plans and IRAs. Often, the firms that advise mutual funds also provide the 401(k) plans to U.S. corporations.").

79. Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 340–41 (2017) (describing how the DOL under ERISA operates as a kind of shadow-regulator to the SEC).

80. Most mutual fund families formulate centralized voting policies. *See infra* notes 109–18 and accompanying text.

81. The DOL first articulated its position in a series of letter rulings. *See* Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988) (Feb. 29, 1988) (reprinted in 15 PENSION REP. (BNA) 71, 391) ("The decision[s] as to how proxies should be voted . . . are fiduciary acts of plan asset management . . . ."); Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Dep't of Labor, to Robert Monks, Institutional S'holder Servs., Inc. 3 (Jan. 23, 1990) (reprinted in 17 PENSION REP. (BNA) 244) ("The fiduciary act of managing plan assets which are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock."). These rulings were later reaffirmed in guidelines stating that "[t]he fiduciary act of managing plan assets which are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock." Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 73 Fed. Reg. 61732, 61732 (Oct. 17, 2008) (codified at 29 C.F.R. pt. 2509).

appropriate for managers of plan assets to weigh ESG issues in proxy voting.[82] More recent DOL guidance issued under the Trump administration, however, qualifies their freedom to consider factors not clearly related to investment returns.[83] Any lingering ambiguity in the DOL's regulation of proxy voting thus reflects conflicting positions taken by successive administrations on the weight that plan fiduciaries may accord to ESG factors—that is, *how* they vote. The more fundamental rule—that plan fiduciaries must vote—remains unchanged.

The SEC has attempted to permit greater flexibility in voting arrangements. In 2003, the SEC issued a series of rules designed to clarify intermediaries' voting responsibilities.[84] This rulemaking arose out of

82. 29 C.F.R. § 2509.2016-01 (2016) (stating that plan fiduciaries may engage through voting on a range of issues, including "policies and practices to address environmental or social factors that have an impact on shareholder value, and other financial and non-financial measures of corporate performance"). Other Obama-era guidance held that plan fiduciaries could choose investments on the basis of ESG goals, provided that the choice of the better ESG investment had shareholder returns at least as good as the alternative. ESG factors, in other words, could serve as the tiebreaker between two otherwise equal investments. Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135, 65136 (Oct. 26, 2015) (codified at 29 C.F.R. § 2509) (stating that "plan fiduciaries may invest [on the basis of] . . . collateral benefits so long as the investment is economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits").

83. Memorandum from John J. Canary, Dir. of Regulations & Interpretations, Emp. Benefits Sec. Admin., U.S. Dep't of Labor, to Mabel Capolongo, Dir. of Enf't, Emp. Benefits Sec. Admin., U.S. Dep't of Labor, Field Assistance Bulletin No. 2018-1 (Apr. 23, 2018) [hereinafter FAB 2018-1] (noting that the "expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan's investment manager" would warrant "a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon"). FAB 2018-1 also qualified IB 2015-1 in advising that investments could be chosen on the basis of their environmental and social attributes only when those considerations increase investment returns—for example, by mitigating a risk that would have an economic effect on the subject company. The bulletin states:

> To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors. Fiduciaries must not too readily treat ESG factors as economically relevant . . . . Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.

Id. In this way, the Trump-era guidance from the DOL allows plan fiduciaries to consider ESG issues only insofar as they can be shown to have a positive effect on investment returns, not as an otherwise desirable attribute that can be used to distinguish between two economically equal investments.

84. *E.g.*, Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) [hereinafter Advisers' Voting Rule] (codified at 17 C.F.R. pt. 275 (2003)); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) [hereinafter Voting Disclosure Rule] (codified at 17 C.F.R. pts. 239, 249, 270, 274 (2003)).

perceived conflicts of interest in the voting of proxies and made three changes relevant here.[85] First, it required investment advisors, as fiduciaries, to adopt and implement a voting policy consistent with the "best interest of its client."[86] Second, it required funds to disclose voting policies and procedures to investors.[87] Finally, it required funds to disclose how they voted on portfolio company shares.[88]

These rules do not necessarily require mutual funds to vote. They merely require funds to adopt a policy and follow it.[89] The SEC affirmed this principle in guidance issued in 2018.[90] The voting arrangement adopted by funds and their advisors may mean that some votes are not cast. According to the SEC's guidance:

> [A]n investment adviser is not required to accept the authority to vote client securities, regardless of whether the client undertakes to vote the proxies itself. If an investment adviser does accept voting authority, it may agree with its client, subject to full and fair disclosure and informed consent, on the scope of voting arrangements, including the types of matters for which it will exercise proxy voting authority.[91]

85. The conflict here is what Dorothy Lund and I have elsewhere referred to as "Corporate Client Conflict." Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1157.

86. 17 C.F.R. § 275.206(4)–6 (2003) (including a requirement that the policy describe how the advisor resolves "material conflicts that may arise between your interests and those of your clients").

87. Voting Disclosure Rule, *supra* note 84, at 6566 (requiring funds to disclose voting policies and procedures as part of their "statement of additional information," filed on EDGAR and provided to investors upon request).

88. *Id.* at 6569 (adopting Investment Company Act rule 30b1-4 to require funds to disclose their complete proxy voting record on an annual basis on Form N-PX).

89. Other rules relieved advisors of liability for voting according to a predetermined policy delegating voting determinations to third-party proxy advisors. According to the SEC:

> An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party.

Advisers' Voting Rule, *supra* note 84, at 6588. This rule and related letter rulings that form the basis of the proxy advisory businesses of such firms as ISS and Glass Lewis are currently under review as the SEC reconsiders the proxy voting process. *See* Joe Mont, *Withdrawal of Past Guidance Signals a Contentious Start to SEC's Proxy Process Review*, COMPLIANCE WEEK (Sept. 25, 2018, 9:45 AM), https://www.complianceweek.com/withdrawal-of-past-guidance-signals-a-contentious-start-to-secs-proxy-process-review/2130.article [https://perma.cc/H6E7-66U4] (examining the topics to be discussed at an SEC roundtable, including "whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded, or supplemented").

90. Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release Nos. IA-5325, IC-33605, 17 C.F.R. Parts 271, 276 (Aug. 21, 2019).

91. *Id.* at 9.

The guidance goes on to suggest circumstances in which voting authority is limited on the basis of cost or confined to a specific set of instructions and matters.[92] However, by stressing the importance of an *express* agreement, the SEC's attempt to create flexibility may in fact do little to alter default voting arrangements. Voting, for reasons discussed above and below, is not the most salient feature of the investment contract.[93] As a result, advisors, funds, and investors may fail to enter into express agreements to allocate voting authority.[94] And in the absence of an express agreement, the default expectation—that advisors vote every proxy—will continue to hold.

What has become the standard practice of mutual funds—to vote all of their shares all of the time—may thus be understood as a response to this regulatory environment. Funds regulated by the DOL have no choice in the matter.[95] But even funds not regulated by the DOL may vote as a form of risk management. Consider the regulatory risk of a mutual fund advisor: SEC rules clearly make investment advisors fiduciaries with regard to voting, yet unlike the DOL, the SEC does not specify the content of an advisor's fiduciary duties with respect to voting. An advisor may therefore reason that given the absence of a good distinction between retirement fund fiduciary duties and mutual fund fiduciary duties, voting is the safest course. Furthermore, a mutual fund advisor may reason that failing to vote would waste an important element of share value—i.e., the voting rights inherent in the share—and, because waste plainly does not comport with fiduciary duty, vote. Although the theory of delegated voting articulated in this Article supports neither of these interpretations of fiduciary duty, an advisor could be excused for voting to minimize regulatory risk. The situation is made worse by the SEC's failure to clearly state that not voting is an acceptable default option in the absence of express authorization. Under the current regulatory structure, mutual funds may reasonably conclude that they had better vote all of their shares all of the time.

92. *Id.* at 10–12. On these points the Commission's guidance largely follows earlier staff guidance. *See* SEC Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm [https://perma.cc/LTF2-GNUX]. Staff Legal Bulletin 20 noted that advisors and clients could expressly agree: (1) to conserve resources by not voting on specific types of proposals or companies; (2) to cast all votes in favor of management; (3) to abstain from voting any proxies at all; or (4) to focus exclusively on particular types of proposals. *Id.*

93. Among the reasons discussed above is the rational apathy of most investors. *See supra* notes 61–64. Among the reasons discussed below is the finding that voting seems to contribute to shareholder value only in the context of an acquisition proposal or an activist intervention. *See infra* note 228 and accompanying text.

94. Voting, in other words, is a sticky default. *See infra* note 305 and accompanying text.

95. *See supra* note 81 and accompanying text.

C. Stewardship Groups

Formerly, mutual funds managed the burden of voting portfolio company shares largely by outsourcing voting decisions in whole or in part to the judgment of a proxy advisor.[96] More recently, in response to widespread criticism of proxy advisory firms and regulatory pressure to move away from that model,[97] fund families have brought voting decisions in-house, often allocating voting responsibilities to a centralized "stewardship" group.[98] Stewardship groups are small relative to the enormity of their charge. As of October 2016, at the Big Three, for example, the ratio of portfolio company investments per stewardship group member was approximately 700:1 at BlackRock, 867:1 at Vanguard, and 900:1 at State Street.[99] The numbers are especially striking compared to the 5–15 companies covered by a typical equity analyst.[100]

Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues.[101] The voting guidelines of each of the Big Three, for example, announce voting positions *against* staggered boards,[102] poison pills[103] and dual-class shares.[104] These

96. *See* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 871 (2010) (examining empirically the influence of proxy advisor recommendations on mutual fund voting).

97. Scholars have critiqued the proxy advisory model. *See, e.g.*, Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*, 64 MGMT. SCI. 2951, 2969 (2016) (providing evidence of conflicts in the proxy advisory industry); Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. FIN. 2441, 2462 (2019) (showing that proxy advisory services generally do not lead to more informed voting). On the SEC's movement away from the proxy advisory model, see *supra* note 11.

98. *See, e.g.*, GLENN BOOREAM, VANGUARD, WHAT WE DO. HOW WE DO IT. WHY IT MATTERS. 3 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf [https://perma.cc/C3F9-B3ED] (describing the structure and goals of stewardship).

99. Krouse et al., *supra* note 3.

100. *See, e.g.*, *Investment Banking vs Equity Research*, WALL ST. PREP, https://www.wallstreetprep.com/knowledge/investment-banking-vs-equity-research/ [https://perma.cc/DK8C-EZFT] ("Since equity research analysts generally focus on a small group of stocks (5-15) within particular industries or geographic regions, they become experts in the specific companies and industry or 'coverage universe' that they analyze.").

101. BLACKROCK, PROXY VOTING GUIDELINES FOR U.S. SECURITIES 1 (2019), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [https://perma.cc/8L44-CHA9] [hereinafter BLACKROCK GUIDELINES]; STATE ST. GLOB. ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES: NORTH AMERICA (UNITED STATES AND CANADA) 2 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/us-canada-proxy-voting-and-engagement-guidelines.pdf [https://perma.cc/XG8E-34HA] [hereinafter STATE STREET GUIDELINES]; VANGUARD, PROXY VOTING GUIDELINES FOR U.S. PORTFOLIO COMPANIES 2 (2019), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf [https://perma.cc/9ZL6-ZRWT] [hereinafter VANGUARD GUIDELINES].

102. *See* BLACKROCK GUIDELINES, *supra* note 101, at 5 ("We believe that directors should be re-elected annually . . . . While there may be exceptions, we will typically support proposals

positions lack nuance.[105] In spite of recent research showing that poison pills, staggered boards, and dual-class shares can create value for some firms,[106] stewardship group guidelines apply a one-size-fits-all approach to governance terms,[107] tempered only by the discretion to depart from the guidelines on a case-by-case basis.[108]

requesting board declassification."); STATE STREET GUIDELINES, *supra* note 101, at 4 ("We generally support annual elections for the board of directors."); VANGUARD GUIDELINES, *supra* note 101, at 16 ("A fund will vote for proposals to declassify an existing board and vote against management or shareholder proposals to create a classified board.").

103. *See* BLACKROCK GUIDELINES, *supra* note 101, at 9 ("We generally vote in favor of shareholder proposals to rescind poison pills."); STATE STREET GUIDELINES, *supra* note 101, at 6 ("We will support mandates requiring shareholder approval of a shareholder rights plans . . . and repeals of various anti-takeover related provisions. In general, we will vote against the adoption or renewal of a US issuer's shareholder rights plan . . . ."); VANGUARD GUIDELINES, *supra* note 101, at 17. Vanguard's guidelines are the same:

> A fund will generally vote against adoption of poison pill proposals and for shareholder proposals to rescind poison pills, unless company-specific circumstances necessitate providing the board and management reasonable time and protection to guide the company's strategy without excessive short-term distractions. This analysis would typically require engagements with both the company and the acquirer/activist.

Id. The BlackRock statement on poison pills includes an interesting variation:

> Although we oppose most plans, we may support plans that include a reasonable "qualifying offer clause." . . . These clauses . . . tend to specify that an all cash bid for all shares that includes a fairness opinion and evidence of financing does not trigger the pill, but forces either a special meeting at which the offer is put to a shareholder vote, or the board to seek the written consent of shareholders where shareholders could rescind the pill at their discretion.

BLACKROCK GUIDELINES, *supra* note 101, at 9.

104. *See* BLACKROCK GUIDELINES, *supra* note 101, at 8 ("BlackRock believes that shareholders should be entitled to voting rights in proportion to their economic interests. . . . Companies should receive shareholder approval of their capital structure on a periodic basis via a management proposal on the company's proxy."); STATE STREET GUIDELINES, *supra* note 101, at 5 ("We will not support proposals authorizing the creation of new classes of common stock with superior voting rights and will vote against new classes of preferred stock with unspecified voting, conversion, dividend distribution, and other rights."); VANGUARD GUIDELINES, *supra* note 101, at 17 (noting philosophical approval of "one-share, one-vote" structures while remaining "mindful of the need to not hinder public capital formation" therefore announcing support of sunset provisions for newly public, dual-class stock, and stating that funds will "vote case-by-case on proposals to eliminate dual-class share structures").

105. Exceptions may include BlackRock's discussion of "qualifying offer clause" poison pills and Vanguard's discussion of dual-class stock. *See supra* notes 103–04.

106. *See infra* notes 261–64 and accompanying text (describing current research on staggered boards), notes 269–70 and accompanying text (describing current research on poison pills), and notes 265–67 and accompanying text (describing current research on dual-class shares).

107. In this, they mimic the guidelines of proxy advisory firms, from which they are largely derived. *See, e.g.*, Charles M. Nathan, *Proxy Advisory Business: Apotheosis or Apogee?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 23, 2011), https://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee/ [https://perma.cc/2BCC-DHLH]. In his own words:

> [A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits-all voting policies and simplistic analytic models designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.

Stewardship groups aim to achieve uniformity in voting across all funds within the family,[109] often without distinguishing between active and passive funds or other differences in fund strategy.[110] Fund families defend uniform voting policies for reasons of "consistency and efficacy" and also because they "minimize potential conflicts of interest . . . [which] arise when views of internal portfolio managers differ between each other and with the stewardship team."[111] Consistent with these preferences, fund families deliver impressive uniformity in voting. For example, in 2015, only 195 out of 100,000 (or less than 0.2%) proposals at State Street featured a fund voting differently than its other funds; at Vanguard, only 6 per 100,000 (0.006%) proposals received differing votes.[112]

Other fund complexes maintain a preference for consistency but allow for divergent voting.[113] At BlackRock, for example, active fund managers can depart from the stewardship group's view if they disagree with it.[114]

Id.

108. BLACKROCK GUIDELINES, *supra* note 101, at 1 (stating that the guidelines "share our view about corporate governance issues generally, and provide insight into how we typically approach issues that commonly arise . . . . They are applied with discretion, taking into consideration the range of issues and facts specific to the company . . . ."); VANGUARD GUIDELINES, *supra* note 101, at 2 ("It is important to note that these are only guidelines, and that Vanguard's Investment Stewardship team, on behalf of the funds, may vote differently to the extent it is in the best interests of a fund and its shareholders.").

109. Stewardship groups typically consult with active managers, not with index managers. *See* MORNINGSTAR MANAGER RESEARCH, PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP 24–31 (2017) [hereinafter MORNINGSTAR REPORT] (analyzing the stewardship activity of index managers). *See also* Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 48 (2013) (finding evidence that mutual funds tend to economize by centralizing their voting decisions when it comes to director elections); Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 921 (2011) (finding that 49 out of 94 mutual fund families coordinate voting at the family level such that the average number of proposals voted identically by funds in a family is 90%, although some fund families have much higher levels of divergence in voting); Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157, 162 (2006) (studying the voting practices of the top ten mutual fund families and noting that all fund families but one voted their shares in a uniform block for each issue).

110. There is some indication, however, that this may be changing at least at some firms. *See* Dawn Lim & Cara Lombardo, *Vanguard Is Handing Over Some of Its Voting Power*, WALL ST. J. (Apr. 25, 2009, 7:02 AM), https://www.wsj.com/articles/vanguard-is-handing-over-some-of-its-voting-power-11556190120 [https://perma.cc/45W5-PJHJ] (reporting that Vanguard is handing independent authority over to some active managers to vote shares held by their funds). Moreover, stewardship groups often derive their voting recommendations in contested votes upon consultation with the portfolio managers of their active funds, but typically not index managers. MORNINGSTAR REPORT, *supra* note 109, at 24–31.

111. *Id.* at 14.

112. Fichtner et al., *supra* note 2, at 317.

113. *See* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 560 (2007) (noting the large fund families that are permitted to vote differently from each other on some of the same company proposals).

114. *See* BLACKROCK, PROXY VOTING AND SHAREHOLDER ENGAGEMENT FAQ 2–3 (2020) ("We cast informed votes aligned with clients' long-term economic interests. Our governance and

Nonetheless, at BlackRock in 2015, in only 18 per 100,000 (or .018%) proposals did one of its funds vote differently from the others.[115] Similarly, T. Rowe Price's fund managers have discretion to cast the funds' votes contrary to the recommendation of the stewardship group, but a manager who exercises this discretion must document her reasons for doing so.[116] At the more extreme end of the spectrum is AIM/Invesco, which not only allows its funds to vote differently from each other, but which also allows funds to promulgate and follow different voting policies.[117] Another exception is Fidelity, the sole mutual fund complex that delegates its voting for its index funds to a subadvisor and, perhaps as a result, displays higher levels of disagreement in its proxy voting, with funds diverging in 3,144 per 100,000 (or 3.14%) of votes.[118]

Uniform voting may be in the fund family's interest even if it is not in the interest of individual funds and their investors.[119] Fund families maximize their influence through uniform voting. If funds voted on their own, with some voting one way on an issue while others voted the other way, their votes would cancel each other out, reducing the influence of the fund complex over the outcome. Instead, by delivering large uniform blocks of votes, mutual fund complexes, especially the Big Three, often dictate the outcome of contested votes[120] and shareholder proposals.[121]

voting guidelines provide a framework for us in making those decisions; we may divert from those guidelines if there is a compelling reason."); MORNINGSTAR REPORT, *supra* note 109, at 14 (noting that at "BlackRock, Amundi, and UBS, the policy is for active fund managers to vote consistently across all funds, but they retain the authority to vote differently from the house view").

115. Fichtner et al., *supra* note 2, at 317.

116. *See* Donna F. Anderson, *T. Rowe Price's Investment Philosophy on Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 18, 2018), https://corpgov.law.harvard.edu/2018/06/18/t-rowe-prices-investment-philosophy-on-shareholder-activism/ [https://perma.cc/A7S7-WZP9] (noting that individual portfolio managers maintain autonomy to vote as they see fit for their clients' portfolios).

117. Davis & Kim, *supra* note 113, at 561 (noting that AIM/Invesco funds follow different policies); Rothberg & Lilien, *supra* note 109, at 162 (noting that AIM was the only fund company to specify that different funds might be able to vote oppositely on a proxy).

118. Fidelity delegates full management and voting responsibilities of its index funds to Geode. MORNINGSTAR REPORT, *supra* note 109, at 30; *see also* Fichtner et al., *supra* note 2, at 317 (providing statistics on voting).

119. *See infra* notes 173–79 and accompanying text.

120. *See, e.g.*, Michael Blanding, *Vanguard, Trian and the Problem with "Passive" Index Funds*, HARV. BUS. SCH. WORKING KNOWLEDGE (Jan. 30, 2017), https://hbswk.hbs.edu/item/passive-index-fund-leaders-push-for-shareholder-reforms [https://perma.cc/TC24-XS3G] ("Trian, recognizing the growing power of index funds, tried to persuade three index investors in DuPont—Vanguard, BlackRock, and State Street—to support its management reform package. All three funds refused to go along, although the assent of just one of them would have tipped the balance in favor of Trian's plan.").

121. Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST (May 31, 2017), https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?utm_term=.1ef320d8e797 [https://perma.cc/F68X-QXNX] (reporting that

Stewardship programs may serve fund families' interests in another way as well. Although leanly staffed, stewardship programs are costly. Stewards must be paid. Moreover, the costs of stewardship do not scale with AUM. All broadly diversified mutual funds face similar costs in researching and developing positions on governance and voting, regardless of whether the fund has millions of dollars under management or billions. Nonscalable costs are easier for large fund families to absorb than small ones. This makes stewardship a potential barrier to entry. By pushing the fund industry (and its regulators) towards stewardship and away from more cost-effective voting solutions such as proxy advisors or simply not voting, large mutual fund families may be able to protect themselves against new entrants and smaller competitors.[122]

The extent to which stewardship programs may be worthwhile from the perspective of mutual fund investors, as opposed to fund families, is a question that remains to be answered. Before grappling with it, however, one needs a sense of what mutual fund investors might hope to achieve through the voting rights inherent in portfolio company shares. This requires a theory of shareholder voting and, more specifically, a theory of *delegated* voting. These are the subjects of the next Part.

III. Toward a Theory of Delegated Voting

Understanding investors' preferences with respect to voting entails a vision of what shareholder voting is for. What end is sought by giving shareholders voting rights? And what can shareholders hope to accomplish through voting? The answers to these questions will guide the analysis of when and whether mutual fund investors would prefer to delegate their votes to a mutual fund intermediary. Answering them, however, requires a theory of shareholder voting. This Part first uncovers the basis of mainstream theories of shareholder voting, including principle criticisms of those theories, then applies those theories to voting by mutual fund intermediaries.

A. A Baseline Account of Shareholder Voting

Asking what shareholder voting is for necessarily imports a vision of purpose—what corporate investors want from voting. In the words of Easterbrook and Fischel:

BlackRock and Vanguard owned 13% of ExxonMobil and that their votes were pivotal in the passage of a shareholder proposal seeking improved disclosure about the effects of climate change).

122. The prospect that stewardship programs are used as a barrier to entry puts the SEC's movement away from reliance on proxy advisory firms in a more ominous light. *See supra* note 11.

> "Why do shareholders vote?" is three questions in one. First, why do any investors have voting rights? Second, why do shareholders *alone* have voting rights? Third, why do shareholders exercise their voting rights?[123]

Corporate voting, in other words, must be understood in the context of the investment relationship as a whole, in which voting is linked with residual risk. Ultimately, shareholders bear the marginal cost and receive the marginal gains of corporate actions.[124] Although other stakeholders, most notably creditors and employees, also bear risk, their risk is fixed by contract and thus limited by terms to which they have agreed.[125] As residual risk bearers, shareholders are exposed to the consequences of all corporate actions going forward.[126] This gives shareholders the best incentive of all corporate constituents to monitor corporate decision-making.[127] Hence, shareholders alone vote.[128]

In closely held corporations—firms in which shareholders are few and well-informed—shareholders may decide everything through voting.[129] But for widely held firms, and especially publicly traded firms, this form of decision-making is impossible. When there are a great many shareholders, many of them are likely to be uninformed about corporate matters, and their general preferences are likely to diverge, making it impossible for them to cohere around a stable course of action.[130] Publicly traded firms therefore

123. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 398–99 (1983).

124. In an efficient capital market, the marginal cost and marginal gains of corporate ownership are reflected in share price.

125. Easterbrook & Fischel, *supra* note 123, at 404; *accord* Randall S. Thomas & Paul H. Edelman, *The Theory and Practice of Corporate Voting at US Public Companies*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 459, 462 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (summarizing theories of shareholder voting and arguing that shareholder voting is justified by the fact that shareholders are the only stakeholders "whose sole certainty of returns on their investment is tied directly to changes in the stock price of the corporation").

126. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984) (arguing that the board of directors should be regarded as a governance instrument of stockholders because its "principal purpose is to safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way").

127. Easterbrook & Fischel, *supra* note 123, at 403.

128. Thomas & Edelman, *supra* note 125, at 466 ("[Shareholders] should be able to express their views on issues affecting [stock] price as clearly as they can, without having them diluted through an election process that includes the views of stakeholders who are less exposed to stock price variations.").

129. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 602 (2006) (noting that in closely held firms, "voting is effectively an exercise of managerial power").

130. Easterbrook & Fischel, *supra* note 123, at 405 ("[W]hen voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices."). *But see* Grant Hayden & Matthew Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1217, 1219 (2009) (arguing that shareholder primacy arguments based on Arrow's theorem overstated concerns raised by the aggregation of diverse preferences).

delegate corporate decision-making to directors and managers.[131] Voting input is then provided over a much smaller range of issues—the election of directors,[132] the amendment of the charter or bylaws,[133] the approval of fundamental changes such as mergers,[134] sales of substantially all assets,[135] and dissolution,[136] as well as advisory votes and precatory proposals.[137]

From these foundations, two basic conceptions of the role of shareholder voting in publicly traded corporations have emerged, which I will refer to as "minimalist" and "maximalist." According to the minimalist conception, shareholder voting serves merely as a mechanism to contain managerial agency costs.[138] Shareholders vote only to prevent managers from straying too far from shareholders' best interests. Meanwhile, a "maximalist," or at least nonminimalist, conception of shareholder voting sees it as a means of surfacing information concerning investor preferences to managers so that managers may steer corporate actions closer to the interests of their investor base.[139] Shareholders may possess better information than management with regard to their own preferences, including, for example, the reservation value at which they hold corporate shares, their investment time horizons, and tax preferences.[140] Voting may be an efficient way to gather information on diffusely held preferences.[141]

Nevertheless, both minimalist and maximalist accounts of shareholder voting are aligned on an underlying, often implicit, vision of purpose. Disparate though their other preferences may be, shareholders are presumed

131. Bainbridge, *supra* note 129, at 605–06. Regarding Kenneth Arrow's analysis, Professor Bainbridge explained:

> Kenneth Arrow's analysis of the two basic ways in which organizations make decisions [are] consensus and authority. Consensus requires that each member of the organization have identical information and interests so that preferences can be aggregated at low cost. In contrast, if group members have different interests and information, authority-based decisionmaking structures arise.

Id. (citing KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 63–79 (1974)).

132. DEL. CODE ANN. tit. 8, § 216 (2018).

133. *Id.* §§ 109, 242.

134. *Id.* § 251.

135. *Id.* § 271.

136. *Id.* § 275.

137. *See infra* subpart IV(D).

138. Easterbrook & Fischel, *supra* note 123, at 427 (concluding that "the common law rules of shareholders' voting can, in the main, be analyzed as attempts to reduce agency costs").

139. *See* Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQUIRIES IN L. 815, 817–18 (2001) (discussing how shareholder voting extracts information concerning the group's preferences); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 152 (2009) (discussing how shareholder votes inform actions taken by a corporation's board).

140. Thomas & Edelman, *supra* note 125, at 468 (providing examples).

141. *See generally* F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945) (arguing that when information is dispersed, decisions are best made by those with localized knowledge rather than a central authority).

to have a uniform interest in maximizing their own wealth.[142] The assumption facilitates both management and monitoring—management because shareholder wealth maximization gives corporate agents an unambiguous mandate, and monitoring because it gives shareholders a simple metric by which to judge the performance of management. Shareholder wealth maximization is reducible, essentially, to return on equity, which in efficient markets can be simplified even further to share price. Because such metrics are easily observable, they greatly facilitate shareholders' task of gathering and analyzing information necessary to vote intelligently. Such easy metrics also make it harder for managers to conceal poor performance relative to peer firms, thus facilitating shareholder decisions on such matters as takeovers and proxy contests.

Commentators have long objected to this pinched vision of corporate purpose.[143] Recently, a strand of law and economics scholarship has also argued that this account of purpose is both descriptively inaccurate and normatively undesirable.[144] These scholars point out that the law does not require shareholder wealth maximization but rather creates discretion for managers to sacrifice profits in favor of other interests.[145] Insofar as

142. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 62 (1996); Easterbrook & Fischel, *supra* note 123, at 405–06. Easterbrook and Fischel noted that:

> [F]irms with single classes of voters are likely to be firms with single objectives, and single-objective firms are likely to prosper relative to others. This suggests not only why only one class holds the controlling votes at a time but also why the law makes no effort to require firms to adhere to any objective other than profit maximization . . . .

Id.

143. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1162 (1932) ("Business—which is the economic organization of society—is private property only in a qualified sense, and society may properly demand that it be carried on in such way as to safeguard the interests of those who deal with it either as employees or consumers even if the property rights of its owners are thereby curtailed."); *see also* COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD 12 (2019) (rejecting the claim that the purpose of a corporation is to produce profits, instead viewing "the purpose of business as producing profitable solutions for the problems of people and planet"); LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC, at vi (2012) (arguing that the exclusive focus on the shareholder's interest can be harmful for the corporation as a whole); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEXAS L. REV. 579, 583 n.17 (1992) (noting the recursive nature of debates over purpose).

144. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 736, 738 (2005); Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value* 28 (European Corp. Governance Inst., Finance Working Paper No. 521, 2017), http://ssrn.com/abstract_id=3004794 [https://perma.cc/3K9R-HZKV].

145. Elhauge, *supra* note 144, at 744. Professor Elhauge observes:

> By sacrificing profits "in the public interest," I simply mean to describe cases where managers are sacrificing corporate profits in a way that confers a general benefit on others, as opposed to conferring the sorts of financial benefits on themselves, their families, or friends that courts police under the duty of loyalty.

Id.

corporate managers do put other goals ahead of wealth maximization, they are constrained principally by nonlegal means.[146] Furthermore, given that their shareholders undoubtedly have nonpecuniary interests and motivations,[147] it may be efficient for shareholders to satisfy these interests through their investments.[148] As described by Hart and Zingales:

> [M]oney-making and ethical activities are often inseparable. Consider the case of Walmart selling high-capacity magazines of the sort used in mass killings. If shareholders are concerned about mass killings, transferring profit to shareholders to spend on gun control might not be as efficient as banning the sales of high-capacity magazines in the first place.[149]

This challenge is generalizable to an array of corporate activities that offend some social interest: from the manufacture and sale of guns to the manufacture and sale of abortifacients. For Hart and Zingales, the solution is voting. They would expand the ability of shareholders to vote to push management to act on a broader set of interests.[150] Their solution, in other words, is a maximalist conception of voting but with a broader mandate—welfare instead of wealth. Other theorists go further, arguing that a broad conception of corporation, imbued with social purpose, should be implemented by regulation.[151]

But these objections misconstrue the role of wealth maximization in two ways. First, shareholder wealth maximization is often posited or assumed not because it is the highest and best thing for real-life

146. *Id.* at 741 ("In fact, the risk of such excessive [sacrificing of profits in favor of other interests] is constrained by product markets, capital markets, labor markets, takeover threats, shareholder voting, and managerial profit-sharing or stock options."). This may overstate the point, however, since managers who put other interests ahead of the corporation itself may act in bad faith. *See* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) ("By 'bad faith' is meant a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare . . . ."). *See generally* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005) (articulating a rhetorical model that explains the function of the emerging principle of "good faith" in corporate law). Moreover, insofar as managers hesitate to put other interests ahead of shareholder wealth maximization because they fear getting voted out in a proxy fight or a takeover, it is worth noting that both the voting and the selling of shares are legally constructed and protected. The law, in other words, is not merely about litigation.

147. *See, e.g.*, Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 777–78 (arguing that the basis of canonical corporate-law theory with regard to shareholder voting might be undermined by divergent shareholder preferences).

148. Externalities generated as a result of production—pollution, for example—may be efficiently addressed by regulation designed to cause the firm to internalize the cost. But when the externality is the product itself, regulation may not be as effective. Hart & Zingales, *supra* note 144, at 3 ("In this paper we will be particularly interested in non-separable activities, where profit and damage are inextricably connected for technological reasons.").

149. *Id.*

150. *See id.* at 20 ("Directors can poll their members on some fundamental choices and then decide accordingly.").

151. MAYER, *supra* note 143, at 232.

shareholders but because it is the most that can be assumed about shareholders as a class.[152] It does not rest upon the results of a poll of shareholder passions, but rather operates as a kind of lowest common denominator solution to their inability to coalesce around other objectives.[153] Indeed, government failures to advance particular social objectives, frustrating to critics of wealth maximization, may reflect the divergent preferences of the political electorate,[154] but these critics have supplied no reason to suppose that corporate electorates will not have similarly divergent preferences. Unless and until such preferences coalesce around a constituency sufficiently stable to challenge the leadership of the firm, they are disregarded. This explains what Lipton has described as the "central, unresolved tension" underlying the corporate structure:

> [D]irectors are (nominally) selected by shareholders and tasked with advancing shareholders' desire for wealth maximization, but shareholders themselves may not share that goal. At the same time, the shareholder franchise is justified by their (presumed) preference for wealth maximization, but they are also kept subordinate and powerless, because they may not favor wealth maximization.[155]

This is not a bug but a feature. Wealth maximization operates as a form of agenda control.[156] It is not shareholders' most cherished goal but rather, to paraphrase Churchill's famous dictum about democracy, the least bad of the alternatives.[157]

Second, positing shareholder wealth as the basic corporate maximand does not restrict shareholders, who remain free to invest or vote in any way they like. Rather, it restricts their agents, who are rendered accountable to a clear constituency according to a clear set of metrics. Managers cannot openly depart from this maximand without facing fiduciary-duty litigation,[158] a takeover,[159] or a proxy fight.[160] Shareholders, by contrast,

152. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 961 (1984) (observing that "profit maximization is the only goal for which we can at least theoretically posit shareholder unanimity" and suggesting that "the presumption of profit maximization could be changed by express shareholder approval"). *See also* HANSMANN, *supra* note 142, at 62 ("Investor-owned firms . . . generally share a single well-defined objective: to maximize the net present value of the firm's earnings.").

153. *See supra* notes 130–31 and accompanying text.

154. *See, e.g.*, Hart & Zingales, *supra* note 144, at 4, 28 (explaining limitations on the government's ability to eliminate externalities).

155. Ann M. Lipton, *Shareholder Divorce Court*, 44 J. CORP. L. 297, 308 (2018).

156. *See* HANSMANN, *supra* note 142, at 35–44 (discussing the various agency and collective-action costs of a firm).

157. *See* Winston S. Churchill, Speech on Parliament Bill (Nov. 11, 1947), *in* 7 WINSTON S. CHURCHILL: HIS COMPLETE SPEECHES 1897–1963, at 7563 (Robert Rhodes James ed., 1974) ("[I]t has been said that democracy is the worst form of Government except all those other forms that have been tried . . . .").

158. *See, e.g.*, eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) (rejecting "a corporate policy that . . . seeks *not* to maximize the economic value . . . of its

remain free to invest and vote according to other interests and objectives.[161] Recently, for example, a group of nuns won a shareholder proposal opposed by the parent company of gun manufacturer Smith & Wesson to force the company to report back to shareholders on efforts to curtail gun violence.[162] In doing so, the nuns acted appropriately as principals, and the managers, in resisting them, acted appropriately as agents. The assumption of shareholder wealth maximization constrains agents, not principals.

It is notable, however, that the nuns' proposal was successful in large part because of the support of large mutual fund families, including BlackRock, which voted with the nuns.[163] Mutual fund intermediaries are agents of their investors. Because the assumption of shareholder wealth maximization is meant to bind agents, in voting as they did, the mutual fund intermediaries may have departed from their proper bounds. These and other complications introduced by intermediary voting are discussed in further detail below.

B. The Delegation of Voting Rights to Mutual Funds

Mutual funds are intermediaries with voting rights. As large block-holders, institutional intermediaries have the potential to address the monitoring deficiencies of rationally apathetic individual investors.[164] At the same time, because mutual funds do not receive the economic benefit of the shares they hold, conferring voting authority on mutual fund intermediaries introduces agency costs and conflicts.[165] A delegation of

stockholders" because "directors [of a for-profit corporation] are bound by the fiduciary duties and standards that accompany that form").

159. John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1493–94 (1991).

160. *Id.* at 1477.

161. The vision of shareholder voting articulated by Hart and Zingales is thus wholly consistent with existing law and theory, as long as it remains focused on the ultimate beneficial owner. *See* Hart & Zingales, *supra* note 144, at 2–3 (describing the way in which consumers are guided by nonmonetary principles and indicating that shareholders are likewise interested in nonmonetary goals).

162. Meyer, *supra* note 6.

163. *Id.*; Richard Morgan, *Smith & Wesson Loses Duel with Nuns over Gun Safety*, N.Y. POST (Sept. 26, 2018, 4:47 PM), https://nypost.com/2018/09/26/smith-wesson-loses-duel-with-nuns-over-gun-safety/ [https://perma.cc/B3JU-PJBU].

164. *See supra* notes 13–14 and accompanying text.

165. *See, e.g.*, Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 881 (2010). Professor Fisch observes:

> [I]ntermediaries' interests are often different from those of other shareholders and may not involve the exclusive goal of maximizing firm value. Passive investors, like indexed mutual funds, may prefer to minimize cost in an effort to match the returns of their benchmark rather than to engage in more costly activism.

Id. Departures between the interests of the fund and its investors may be greater when there are additional intermediaries, such as brokers, involved in the ownership chain. *See* Judge, *supra* note 37, at 607 ("When intermediaries enjoy a high level of influence over client decisions, we can expect intermediaries to use that influence to promote relatively high-fee transactions.").

voting authority to mutual funds must therefore balance the downside of disintermediation (rational apathy) with the downside of intermediation (agency costs and conflicts).[166]

Agency costs arise from agents' incentives to work less diligently for someone else than they would if they captured the full value of their work for themselves.[167] Agency cost problems are a central concern between shareholders and managers in the corporate context,[168] but there the potential of agency defections is mitigated by a relatively robust array of incentives and constraints.[169] Conflicts are also pervasive between mutual fund intermediaries and their investors.[170] But in the mutual fund context, the mechanisms to align incentives are weak or nonexistent.[171] As a result, Bebchuk and Hirst explain the apparent laxity in mutual fund stewardship programs as a function of agency costs.[172]

166. *See generally* Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359 (2014) (developing a theory of intermediary voting that distinguishes between high-value votes and low-impact votes).

167. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (foundational work applying this insight to the operation of firms).

168. Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1809 (2008) ("The key focus of U.S. corporate law and corporate governance systems is what is referred to as an agency problem: an organizational concern that arises when the owners—in a corporation, the shareholders—are not the managers who are in control.").

169. For example, private rights of action to enforce investor rights, an important monitoring mechanism in the corporate context, are limited in the mutual fund context. *See* Marc F. Spagnoletti, Note, *The Need for a Formidable Private Right of Action in the Mutual Fund Context: An Analysis of* Janus*' Categorical Limitation on Primary Liability Under Rule 10b-5*, 6 BROOK. J. CORP. FIN. & COM. L. 703, 703–04 (2012) (lamenting how the Supreme Court has continued to narrow the scope of managerial liability under the Exchange Act). Moreover, incentive compensation is also unavailable to managers of mutual funds. *See supra* note 42 and accompanying text. When monitoring and bonding mechanisms fail, residual loss results. Jensen & Meckling, *supra* note 167, at 308, 319 (providing an example in which residual loss occurred because monitoring and bonding mechanisms were not allowed).

170. Lipton, *supra* note 155, at 314 ("Today's conflicts . . . represent a pervasive, baseline characteristic of the market, and they are growing.").

171. *See, e.g.*, Anita K. Krug, *Toward Better Mutual Fund Governance*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS, *supra* note 71, at 185, 186 (discussing the critique that the prevailing model of mutual fund regulation is inadequate); Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS, *supra* note 71, at 79, 79 (noting the lack of "meaningful guidance" on the duties of investment managers); Morley & Curtis, *supra* note 40, at 91, 96, 98 (noting the weakness of litigation as a constraint on mutual funds).

172. Bebchuk & Hirst, *supra* note 12, at 5 (arguing that index funds will underinvest in stewardship that increases portfolio company value due to the proportionally small amount of AUM invested in any one company). *But see* Rock & Kahan, *supra* note 12, at 12–13 (arguing that for large index funds, even a small percentage of AUM might translate to a large absolute return). *See also infra* Part IV (articulating a theory of optimal stewardship differing from both Bebchuk & Hirst and Kahan & Rock).

In other work, Dorothy Lund and I have grouped recurrent mutual fund conflicts into three paradigmatic forms: "Cross-Ownership Conflict," "Corporate Client Conflict," and "Uniform Policy Conflict."[173] The first, Cross-Ownership Conflict, involves situations in which a fund holding interests on both sides of a transaction votes contrary to one side in order to increase the return to the side in which it has a larger economic stake.[174] The second, Corporate Client Conflict, involves situations in which fund managers' voting decisions are influenced by their own interest in currying favor with the managers of subject companies, perhaps driven by the desire to become the company's 401(k) provider or sell other advisory services.[175] The third, Uniform Policy Conflict, arises from the fact, noted above, that mutual fund complexes typically vote their portfolio shares uniformly without regard to the potentially differing objectives of the various funds through which they hold shares.[176] Because funds often have divergent interests, Uniform Policy Conflict gives rise to a predictable set of subconflicts, some of which arise between the complex and its investors directly, others of which arise between investors in different funds.

Conflicts between funds in the same family can arise from investment objectives—growth versus income, for example, or the differing time horizons of various target-date funds[177]—or they may arise between different fund types—for example, debt versus equity.[178] Uniform-voting policies also create conflicts between fund complexes and their investors. As one example, consider a merger vote creating divergent returns for the active and index funds managed by a fund complex. Considering that fund complexes typically derive more fee income from their active funds, it may

173. Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1172.

174. *Id.* at 1153–54 (citing the example of the Tesla–Solar City merger). Although conflicting interests among shareholders may create a problem for corporate law, because fund investors want fund managers to vote portfolio shares to maximize fund value, Cross-Ownership Conflict does not raise conflicts between investors and fund managers relevant to this Article unless the fund's shares are voted according to a uniform policy enforced across the fund family, in which case it raises Uniform Policy Conflict.

175. *Id.* at 1176–81. Aspects of Corporate Client Conflict have been noted by various scholars going back at least to the first wave of commentary on institutional investors. *See, e.g.*, Black, *supra* note 14, at 602 (noting the conflict from mutual fund advisors' interest in providing corporate 401(k) accounts).

176. Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1182–86.

177. Vanguard, for example, offers 129 different mutual funds, including target-date funds that span retirement dates from 2015 to 2065. *Vanguard Mutual Funds*, VANGUARD, https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns [https://perma.cc/49MA-8TN8].

178. Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1183–85; *see also* Aneel Keswani et al., *Institutional Debt Holdings and Governance* 1 (European Corp. Governance Inst., Finance Working Paper No. 613, 2019), https://ssrn.com/abstract=3282394 [https://perma.cc/DEL3-B3EY] (finding that "the greater the fraction of debt a fund family holds in a given firm, the greater its propensity to vote in line with the interests of firm debt holders at shareholder meetings").

be in the interest of the complex to cast index fund votes to maximize active fund returns, thereby harming the interests of index fund investors.[179]

Another conflict between funds and their investors may arise when fund families adapt social issues to their own ends. Most notable in this regard may be BlackRock's 2018 letter to investors in which the CEO took the position that "every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[180] Although some commentators have dismissed the letter, it is broadly consistent with BlackRock's commitment to act on shareholder proposals concerning social issues, especially gun policy.[181] As noted above, BlackRock's support was essential in passing the nuns' proposal on guns.[182]

Putting aside one's own position on the substance of such issues, one can posit several potential reasons why a mutual fund complex might stake out a strong voting position on social issues. First, such a position might serve the personal interest of the CEO, either in advancing her own preferences or in winning praise in the elite circle she inhabits.[183] Second, taking a strong position on social issues might help the fund family attract clients, such as university endowments, for whom a demonstration of social values is important. Likewise, displaying such values might also aid the fund family in employee recruitment and retention. Third, having a

179. Griffith & Lund, *Conflicted Mutual Fund Voting*, *supra* note 12, at 1182–83. Lest this seem speculative, there is evidence that mutual fund complexes coordinate voting in precisely this way. *See* José-Miguel Gaspar et al., *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73, 102 (2006) (arguing that mutual fund complexes have incentives to maximize the performance of high-value funds at the expense of low-value funds and showing empirically that mutual fund complexes' observed behavior is, in fact, consistent with the aforementioned incentives).

180. Larry Fink, *A Sense of Purpose*, BLACKROCK (2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/2WY2-KAWF] [hereinafter Fink, *Sense of Purpose*]; *see also* Larry Fink, *Purpose & Profit*, BLACKROCK (2019), https://www.blackrock.com/americas-offshore/2019-larry-fink-ceo-letter [https://perma.cc/E9TF-T4D5] (sounding similar themes but insisting that "[p]rofits are in no way inconsistent with purpose").

181. *See* sources cited *supra* note 6; *see also BlackRock's Approach to Companies that Manufacture and Distribute Civilian Firearms*, BLACKROCK (Mar. 2, 2018), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms [https://perma.cc/H8C3-DDUT] (announcing that BlackRock would avoid investment in firearms manufacturers).

182. *See supra* notes 162–63 and accompanying text.

183. The BlackRock CEO's 2018 letter, Fink, *Sense of Purpose*, *supra* note 180, was released in the days leading up to the World Economic Forum at Davos, and the CEO did television interviews from Davos on the topic of the letter. *See, e.g.*, Interview by Andrew Ross Sorkin with Larry Fink, Chairman & CEO, BlackRock, CNBC (Jan. 24, 2018, 5:32 PM), https://www.cnbc.com/2018/01/24/cnbc-transcript-blackrock-chairman-ceo-larry-fink-speaks-with-squawk-box-from-davos-today.html [https://perma.cc/TRR8-2FVN] (discussing the CEO's letter and BlackRock's "social purpose").

reputation for social responsibility might help the fund family avoid government regulation.[184] It is notable, for example, that the BlackRock CEO's letter in January 2018 foreshadowed themes of Senator Elizabeth Warren's Accountable Capitalism Act, announced in August of that year.[185] It may be that by articulating the same goals a few months in advance, the CEO sought to spare the fund industry, or at least his own firm, the political pressure then being directed at public companies.[186]

Whatever the case may be, it is important to note that none of these potential motivations advances the interests of mutual fund investors.[187] Many investors will, of course, disagree with the substance of these positions, and to the extent that BlackRock casts not only its "social responsibility fund" votes but rather votes uniformly on such issues, it necessarily votes contrary to some investors' interests.[188] Moreover, the impact of such votes is not merely political. It is economic. For example, to the extent that pressure from BlackRock persuades retailers not to sell firearms to anyone under the age of 21, the fund complex effectively reduces portfolio company revenues from sales in states where younger persons can legally buy firearms.[189] This harms not only "pro-gun"

184. *See also* Rock & Kahan, *supra* note 12, at 29.

185. *See* Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, WALL ST. J. (Aug. 14, 2018, 7:01 PM), https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687 [https://perma.cc/4VXX-CDPH] (announcing the proposed legislation).

186. Or perhaps the themes of the letter improved the CEO's standing as a candidate for Secretary of the Treasury under a Democratic administration. *See* Stephen Gandel, *BlackRock's Larry Fink May Be Stepping Up His Play for Treasury Secretary*, FORTUNE (Feb. 4, 2016, 8:32 PM), https://fortune.com/2016/02/04/blackrock-larry-fink-treasury-secretary/ [https://perma.cc/7MDB-WQZ4] (identifying consistencies between BlackRock letters and the policy concerns of Democratic presidential candidates and speculation on Wall Street and in Washington that Fink was putting himself forward as a candidate for Treasury Secretary).

187. Consistent with the divergence between fund and investor incentives with regard to voting, recent research finds that institutional investor voting patterns differ substantially from those of retail investors, especially with regard to environmental and social proposals, which institutional investors are substantially more likely to support. Alon Brav et al., Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting 4 (May 15, 2019) (unpublished manuscript), https://ssrn.com/abstract=3387659 [https://perma.cc/3QSW-4ZJ6].

188. Fund families offer "social responsibility funds" to invest and vote according to social commitments. *See, e.g.*, *Socially Conscious Funds List*, CHARLES SCHWAB (2019), https://www.schwab.com/public/file/P-9561751/ [https://perma.cc/FQD6-KKWH] (listing funds that invest selectively based on noneconomic criteria). It is unclear, however, whether the voting of social responsibility funds tracks these social commitments. *See* Reiser & Tucker, *supra* note 44, at 25 (finding that the voting patterns of socially responsible funds do not always track social objectives). *See also* Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL ST. J. (Nov. 11, 2019, 4:29 PM), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200 [https://perma.cc/D8DG-AGA9] (reporting that eight of the largest ten ESG funds remain invested in oil and gas in spite of ESG concerns regarding that industry).

189. *See generally* NICHOLAS J. JOHNSON ET AL., FIREARMS LAW AND THE SECOND AMENDMENT: CASES AND MATERIALS (2017) (summarizing the firearms laws of various states).

investors, it harms all shareholders concerned with wealth maximization. Again, whatever one's position on the underlying policy issue, when mutual fund complexes leverage their investors' votes to advocate for interests on one side, they necessarily act contrary to the interests of other investors.

The simplest approach to these problems is to realign mutual fund voting with the baseline theory of shareholder voting described above. When agents act for shareholders, they must assume a common purpose of shareholder wealth maximization. Shareholder–principals, like the nuns holding shares of gun makers, are free to act according to any preference they may hold.[190] But mutual funds are agents, not principals, and as such, they should therefore be constrained by wealth maximization as the only preference that can plausibly be assumed to be shared by all investors.[191] Mutual funds should therefore vote only to maximize shareholder wealth.

One might object that mutual fund investors are not ordinary shareholders. Insofar as they invest in broadly diversified investment vehicles, they are, by definition, diversified investors.[192] Because they are diversified, mutual fund investors care about portfolio value, not individual firm value. Thus, insofar as a pro-social agenda (e.g., the prevention of climate change) would increase the value of the portfolio as a whole—even if it reduced value of individual firms in the portfolio—mutual fund investors should favor it, and mutual fund intermediaries, as agents of those principals and voting purely on the basis of investor wealth maximization, should favor it too.

The objection fails, however, because it imputes to mutual fund beneficiaries knowledge that they could not possibly possess. To see this, consider that pro-social actions may increase or reduce value, either of firms or of portfolios. This creates a set of possibilities that can be mapped onto the following matrix:

(1) Benefit Firm, Benefit Portfolio	(2) Benefit Firm, Harm Portfolio
(3) Harm Firm, Benefit Portfolio	(4) Harm Firm, Harm Portfolio

The first observation to make from this matrix is that boxes (1) and (2), both of which involve actions to increase firm value, will occur without the need for shareholder engagement.[193] Management has strong incentives to

190. *See supra* note 162 and accompanying text.

191. *See supra* notes 184–89 and accompanying text.

192. *See* Gregory Scott Crespi, *Maximizing the Wealth of Fictional Shareholders: Which Fiction Should Directors Embrace?*, 32 J. CORP. L. 381, 426–27 (2007) (arguing that differences in conceptualizing the ideal-type corporate shareholder, especially with regard to diversification, have important implications for corporate law and theory).

193. Box (2) may be difficult to imagine as pro-social. But it is at least possible that some pro-

implement actions that will increase firm value and, given its access to private information about the firm, a comparative advantage vis-à-vis shareholders, whether individual or institutional, in knowing how to do so.[194] Likewise, management will refuse to implement actions in boxes (3) and (4) on the basis of its own incentives because these actions harm the firm.

The crux of the objection, then, turns on the distinction between box (3) and box (4). On its own, management will pursue neither. However, insofar as actions harm the firm but benefit the portfolio, portfolio-holders would presumably prefer that those actions be taken. Hence there may be a role for portfolio-holders in pushing managers towards box (3). But two questions arise here. First, is voting to bring about box (3) ever appropriate? In other words, is it ever permissible to vote to harm one firm in order to benefit another? And second, who is in the best position to decide whether a prospective action falls in box (3) or box (4)? Who has the comparative advantage in deciding how an action will affect the portfolio as a whole?

With regard to the first question, it is worth noting that there are portfolios and then there are portfolios. Mutual funds are not the only shareholders who assemble portfolios. Banks, brokerage firms, insurance companies, pension funds, hedge funds, and individual shareholders also assemble and manage portfolios. Not all of these portfolio-holders are broadly diversified. Indeed, not all mutual funds, even index funds, are broadly diversified. Many focus on a few firms or an industry sector. Even funds based on broadly diversified indices, including the S&P 500, are weighted by market capitalization such that much of their return is driven by a few large firms.[195] Broadly diversified fund portfolios may also overweight particular industries. Again, this is true of the S&P 500, approximately half of which consists of information technology, health care, and financial companies.[196] The voting incentives for holders of such

social change (e.g., banning fossil fuels) would help an individual firm (e.g., a maker of solar panels) but harm the portfolio as a whole. In any event, nothing in the argument turns on box (2).

194. This may not apply when the relevant action is a governance change that would have the effect of weakening management's authority or shortening management's tenure—for example, by rendering the firm more contestable. *See infra* subpart IV(A) (arguing that the potential for such conflicts mitigates management's informational advantage vis-à-vis governance). However, such conflicts seem unlikely to arise from typical pro-social agenda items, be they climate change, board diversity, or guns, none of which threaten management's tenure.

195. S&P DOW JONES INDICES, S&P U.S. INDICES METHODOLOGY 9 (2019) ("Each index is weighted by float-adjusted market capitalization."). There is also considerable discretion embedded in the selection of companies for the index, rendering its value as a benchmark of "passive" investing highly questionable. *See* Adriana Z. Robertson, The (Mis)Uses of the S&P 500, at 21–22 (Sept. 6, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205235 [https://perma.cc/A52L-A9BF] (arguing that the Index itself selects the portfolio thereby calling into question its status as a "passive" fund).

196. *S&P 500*, S&P DOW JONES INDICES, https://us.spindices.com/indices/equity/sp-500 [https://perma.cc/GN6Y-RSPG] (providing sector breakdown, including as of July 2019: 21.5% information technology, 14.2% health care, and 13.1% financials).

portfolios would seem to favor the interests of industries in which they are overweight.[197] Because few if any mutual funds, even indexes, hold "the market," the market-wide perspective exists in hypothetical form only. However, because mutual fund fiduciary duties are owed to real-life investors of specific funds, managers are compelled to maximize on the basis of the actual portfolios they have assembled, not on the basis of a hypothetical perspective that exists nowhere in reality. The elision of portfolio voting with a market-wide perspective and the potential further elision of a market-wide perspective with pro-social perspective turns out to be illusory as applied to the real world of mutual funds.

More broadly, when if ever, is it appropriate for a portfolio-holder to vote intentionally to damage a company in favor of another interest or another company in the portfolio? The question raises concerns at the heart of the classic Perry–Mylan example, in which a hedge fund with shares on both sides planned to vote its buy-side shares in favor of a deal that was extremely disadvantageous to the buyer because the fund had hedged away its buy-side exposure and was overweight on the sell-side.[198] Voting intentionally to harm a company is contrary to public policy,[199] inconsistent with the core rationales for shareholder voting, whether minimalist or maximalist,[200] and likely contrary to Delaware law.[201] Yet it is the crux of box (3) voting. The dubious legality of voting to harm a portfolio company may explain why no mutual fund manager acknowledges doing so but claims instead to consider social and environmental issues only in furtherance of the company's best interests—in other words, as a box (1) issue.[202] But, as already noted, given management's own incentives to

197. This may lead to more antisocial preferences for S&P 500 holders than many suppose—for example, less protection of data privacy, less control of health-care costs, and less financial regulation.

198. The Perry–Mylan situation is the canonical example of "empty voting." *See* Hu & Black, *supra* note 63, at 828–29 (describing the Perry–Mylan transaction).

199. *See* Martin & Partnoy, *supra* note 147, at 788, 792 (providing a taxonomy and set of examples to describe situations in which equity holders may vote to impose harm on the corporation and arguing that "giving voting rights to such share-holders results in an inefficient decision-making process").

200. *See supra* notes 138–41 and accompanying text (discussing the minimalist rationale as aimed at controlling managerial agency costs and the maximalist rationale as aimed at providing managers with information concerning shareholder preferences).

201. The seminal case is *Schreiber v. Carney*, a vote-buying case in which the Delaware Court of Chancery held that vote buying is not illegal provided that it does not disenfranchise shareholders or accomplish a fraudulent intent but rather is "for the purpose of furthering the interest of all . . . stockholders." 447 A.2d 17, 25–26 (Del. Ch. 1982). Another way to the same result would be to treat the intentional imposition of harm as the equivalent of waste, which, because it cannot be ratified except by unanimous shareholder consent, could not be imposed on the corporation by shareholders without unanimity. *See* Michelson v. Duncan, 407 A.2d 211, 219 (Del. 1979) (explaining that waste claims require unanimity in shareholder votes in order to constitute a full defense).

202. *See infra* notes 242–46 and accompanying text. Alternatively, fund managers may take this position in voting on environmental and social issues because pension-plan assets are an

maximize firm value, box (1) issues generally do not need shareholder champions.

Setting the legal question aside, the second issue arises—that is, figuring it all out. Who, if anyone, is in the right position to determine when an action, taken at the expense of one company, will nevertheless benefit others and increase the value of the portfolio as a whole? Getting this wrong—confusing box (3) and box (4)—means harming the portfolio along with the company. Who is in the best position to sort this out?

Not mutual funds. To see this, consider a climate-change proposal that might be bad for Exxon but good for other companies. To determine the portfolio-wide effect of the proposal, the fund would have to calculate: (a) the benefit of the proposal if enacted (the proposal's actual effect on climate change); (b) the cost to Exxon of enacting the proposal (net of the benefit to Exxon); and (c) the weighted marginal impact (whether benefit or harm) of the action on every other firm in the portfolio. Only a fund capable of producing and processing all of this information would be in a position to determine whether a proposal created more benefit than cost throughout the portfolio.[203] But, of course, this information is entirely unavailable.[204]

Another way to see such proposals, in the absence of data about their ultimate effects, is as tradeoffs between competing values. It is not that pro-growth investors hate the environment or that pro-social investors are indifferent to growth. Rather, different investors make this tradeoff in different ways, as they do with respect to diversity, guns, and other issues on which reasonable people differ. As a result, the relevant information to decide these issues is not held centrally by fund managers but rather is diffused with their investors. Thus, given that fund managers have no meaningful advantage in distinguishing box (3) and box (4), the choice should remain with the individual investor.

None of this is to claim that externalities do not exist. Individual firms often do take actions that harm other firms or other individuals. In addition to guns and climate, think of oxycodone or the 737 MAX 8. But there are tools for dealing with such externalities, including both *ex ante* regulation and *ex post* tort liability. These are no doubt imperfect. But empowering mutual fund managers to impose costs on portfolio companies in the absence of information and contrary to the preferences of many of their

important source of mutual fund inflows and the DOL requires plan fiduciaries to subordinate such concerns to value maximization. *See supra* notes 82–83.

203. Indeed, thinking in this way asks mutual fund stewards to approach issues in much the same way as the Board of Governors of the Federal Reserve. *See* Crespi, *supra* note 192, at 397 (noting that if economy-wide business decisions were considered, "deliberations would increasingly come to resemble Federal Reserve Board macroeconomic policy deliberations . . . and informed consensus could be quite difficult or even impossible to achieve").

204. This is not to deny evidence of climate change. It is merely to deny that anyone knows how firm-specific climate-change proposals will affect climate change, the value of the firms that enact them, or indeed, any other firm.

investors seems unlikely to make the situation any better. Indeed, it would likely make it worse. The best mutual fund intermediaries can do is incorporate a strong shareholder wealth maximand at the firm level and recognize the limitations of their own knowledge.

Of course, clarifying a problem at the level of theory does not mean that it is solved. Still, knowing the limits of what mutual fund managers can assume about their investors advances our understanding of when and how fund managers should vote on their investors' behalf. The next Part applies these insights to develop a set of default preferences for mutual fund voting.

IV. Optimal Defaults

What do investors want from their mutual fund intermediaries with respect to voting? The analysis so far suggests two basic propositions. First, mutual funds should vote on their investors' behalf when the intermediary possesses a comparative informational advantage. This advantage may come from the fund's superior ability to discover or analyze information, or it may simply come from the fund's greater incentive to invest the resources necessary to process available information. Second, mutual fund intermediaries' claim to act on their investors' behalf is strongest when they use their voting authority to hold managers accountable to the principle of shareholder wealth maximization. Although shareholders certainly have many other motivations, it is likely impossible for an intermediary to identify a stable common interest from a wider set of offsetting, often inconsistent goals.

Starting from these basic propositions, this Part surveys the range of issues on which intermediaries might be asked to vote. It breaks them into four recurring patterns: contests, environmental and social proposals, governance proposals, and everything else. Each pattern presents a different situation with respect to the fund's informational advantages and its investors' common interests. Each pattern therefore leads to a potentially different default approach.

In modeling investor preferences with respect to mutual fund voting, this Part will be guided by three basic considerations concerning default rules. First, the general principle of default-rule design is to achieve the "majoritarian" or "benefit-of-the-bargain" default—that is, the rule that puts the parties in the position they would have been in had they been able to bargain costlessly over the issue.[205] An exception to this principle arises,

205. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) (arguing that "corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low"); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1819–21 (1991) (explaining the need for default rules in contract interpretation that hypothesize an ideal bargain); Easterbrook & Fischel, *supra* note 123, at 398 (arguing that states' rules on corporate voting give investors the arrangements they would

however, for rules aimed at forcing parties to share private information—so-called "penalty" or "information-forcing" defaults.[206] A third factor to consider is the "stickiness" of the default—that is, barriers to opting out of an inefficient rule arising from factors other than bargaining costs.[207]

Ultimately, this Part advances the following framework for allocating voting authority to mutual fund intermediaries: First, with respect to contests, it argues that investors would delegate discretionary voting authority to mutual fund intermediaries due to the funds' informational advantage and their ability to assume a unified shareholder purpose. Second, with respect to environmental and social proposals, because there is neither an informational advantage on the part of funds nor a stable common objective among investors, rational investors would not prefer to delegate discretionary voting authority to the mutual fund intermediary. Instead, because there is no reason to suppose that portfolio company managers do not approach environmental and social issues from a wealth-maximizing perspective, investors would prefer that funds follow management's recommendations in voting on these issues. Third, with respect to governance, although there is a shared interest among investors in favor of wealth maximization, there is unlikely to be a significant information asymmetry favoring the fund. This is not because investors are as good as fund advisors in analyzing how corporate governance affects firm performance, but rather because fund advisors are as bad as their investors at analyzing these questions. Because neither investor nor fund has the requisite information to vote intelligently on governance proposals, investors' default preferences would not favor mutual fund voting. Furthermore, because most governance reforms conflict with management's interest, most often by limiting their authority or their tenure, investors also would not prefer a rule that simply voted governance issues as

choose if they could bargain at low cost).

206. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 94 (1989) (arguing that penalty defaults can induce parties to reveal information when they contract around the default to avoid the penalty); Lucian Arye Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J.L. ECON. & ORG. 284, 285 (1991) (providing a formal analysis of the default rule limiting liability for breach of contract to foreseeable consequences and the rule's positive effect on information sharing); Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1397–99 (1992) (book review) (discussing various examples of information-forcing penalty defaults).

207. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 492 (2002) (emphasizing difficulties associated with opting out of pro-management terms given management's power to control the voting generally and therefore advocating pro-shareholder default terms). *See generally* Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383 (2007) (discussing implications of sticky default rules for corporate-law theory); Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006) (discussing sticky default rules generally).

recommended by management. The right default approach to governance proposals is therefore to abstain from voting on them. Again, investors who felt strongly might wish to have some mechanism for entering a vote on an ad hoc basis. Finally, with respect to everything else—corporate housekeeping matters and uncontested elections—investors are likely to prefer that their shares be voted with management. The sections that follow discuss each of these areas in greater detail.

A. Contests

Contests decide disputes over the future of a company. In a contest there are two sides: incumbent management versus an insurgent activist or would-be acquiror. The subject of the dispute is how best to maximize the value of the company. The insurgent contends that management is destroying value and offers another way forward.[208] Incumbent management answers that its policies are best for the company, often claiming a long-term perspective that the market, judging by the current stock price, does not appreciate or comprehend.[209] The contest decides whether there will be an acquisition, a change in management, or a change in the governance or business of the company.[210]

Contests are fought with information. Contestants present evidence supporting their vision and seek to discredit evidence introduced by the other side.[211] In this, the dynamic mirrors the adversarial system. The

208. *See generally* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) (describing the basic goals and tactics of activist hedge funds). Activists may not need to actually launch a public intervention in order to successfully influence a company. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1402–08 (2007) (distinguishing between situations in which an activist threatens intervention and situations in which an activist actually intervenes); Vyacheslav Fos & Charles M. Kahn, *The Threat of Intervention* 5 (European Corp. Governance Inst., Finance Working Paper No. 602, 2019), https://ecgi.global/sites/default/files/working_papers/documents/finalfoskahn.pdf [https://perma.cc/BZ3N-RDJX] (modeling the disciplinary effect of a threatened activist intervention).

209. *See generally* Leo E. Strine, Jr., *Corporate Power Is Corporate Purpose I: Evidence from My Hometown*, 33 OXFORD REV. ECON. POL'Y 176 (2017) (describing the activist intervention at DuPont and its consequences as a paradigmatic example).

210. For purposes of this discussion, governance matters that arise in connection with contests, such as bylaw amendments or challenges to governance designed to facilitate the challenge, are treated as contests, not governance proposals. The key is the adversarial nature of the challenge. *See, e.g.*, David Benoit & Liz Hoffman, *Allergan Defends Bylaws Amid Effort to Resist Valeant*, WALL ST. J. (July 30, 2014, 5:13 PM), https://www.wsj.com/articles/allergan-defends-bylaws-amid-effort-to-resist-valeant-1406754833 [https://perma.cc/Y2M7-9PQH] (discussing shareholder pressure on corporate bylaws inhibiting activist intervention).

211. Contestants produce voluminous financial analyses into evidence and counteranalyses seeking to discredit the analyses of their opponents. *See, e.g.*, Starboard Value LP, Transforming Darden Restaurants (Schedule 14A) (Sept. 11, 2014), https://sec.report/Document/0000921895-14-002031/ex991dfan14a06297125_091114.pdf/ [https://perma.cc/CDT9-J8GV] (attacking incumbent management in a 294-page slide presentation). This prompted multiple responses from Darden over the following weeks. *See, e.g.*, Darden Rests., Inc., Operating Darden with the Right

contestants are litigants before shareholder judges, with securities law operating as the rules of evidence.[212] The process forces the disclosure of information and tests its credibility.

Contests are judged according to the principle of shareholder wealth maximization. Management claims its plans will lead to better shareholder returns than the insurgents, who make the opposite claim. Would-be acquirors, meanwhile, make the simplest claim of all: a number. Their bid puts management in the position of having to defend two theses: first, why their planned future for the company is better, and second, why the market does not reflect the value of their plan. In both cases, the stock price crystallizes the goal. The winner of the dispute will be the side that can make the most persuasive case on how best to maximize shareholder value.

This is not to say that contests are easy to decide. The information presented in contests is often highly technical. For example, the activist challenge to DowDuPont's plans to restructure into three businesses would have required investors to evaluate whether to divide the combined company and, if so, into how many spinoff entities holding which combination of assets to best potentiate growth or acquisition.[213] Understanding this information may require some degree of financial sophistication, and it certainly requires a substantial investment of time and attention.

Are ordinary investors up to the task? Contests solve the production problem embedded within rational apathy.[214] The adversary dynamic underlying contests assures that information will be produced to shareholders. But contests alone do not solve the sophistication or incentive problems.[215] Ordinary investors may not be sufficiently sophisticated to understand the information presented to them in a contest, at least not without devoting substantial time and attention to it, which they lack the incentive to do. As a result, even in contest settings, ordinary investors

Talent, Plan, and Priorities (Schedule 14A) (Sept. 15, 2014) (defending incumbent management in a 24-page slide presentation); Darden Rests., Inc., Update on Successful Red Lobster Sales Process (Schedule 14A) (Sept. 15, 2014) (further defending management by highlighting asset sale). More recently, compare Marcato Capital Mgmt. LP, Presentation on Buffalo Wild Wings (Schedule 14A) (Feb. 22, 2017) (attacking), with Buffalo Wild Wings, Inc., Investor Presentation (Schedule 14A) (May 15, 2017) (defending).

212. For example, rules under Regulation 13D-G of the Exchange Act prescribe when and how contestants must provide information to shareholders, 17 C.F.R. §§ 240.13d-1 to 240.13d-102 (2019), and rules under Regulation 14A set forth requirements for the accuracy of information contained in proxy solicitations, *id.* § 240.14a-9.

213. *See* Prashant S. Rao & Chad Bray, *DowDuPont Revises Breakup Plan Opposed by Activist Investors*, N.Y. TIMES: DEALBOOK (Sept. 12, 2017), https://www.nytimes.com/2017/09/12/business/dealbook/dowdupont-activist-trian-third-point.html [https://perma.cc/9ZQW-35MR] (noting that some activist investors urged that the company be split into six businesses). Ultimately, activists settled their challenge to DowDuPont before the matter was put to a vote. *Id.*

214. *See supra* text accompanying note 62.

215. *Id.*

remain afflicted by rational apathy. They will not vote, or they will be inadequately informed when they do vote. Moreover, insofar as their failure to participate leads to the wrong choice in the contest, they will be harmed.

Mutual fund intermediaries possess a comparative informational advantage in deciding contests. Gilson and Gordon articulate this model as a form of specialization:

> Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in . . . evaluating proposals presented by activist investors. This specialization is more efficient than having a single actor play both roles. Each requires a different business model, and combining them may degrade the performance of both.[216]

The model depends upon activist hedge funds or bidders taking on the difficult job of identifying promising targets—that is, identifying companies that are presently undervalued and that can be improved. Gilson and Gordon call these funds "governance entrepreneurs."[217] The governance entrepreneur identifies the target and presents its analysis to institutional investors, to whom the targeted company makes the opposite case. All the mutual funds have to do is decide who's right.[218]

The likelihood that the funds will decide correctly depends upon their incentives and their informational resources. Managers of active funds have both. Increasing the return on portfolio companies increases AUM—through both portfolio growth and fund flows—and therefore fees. Given the substantial fees they charge, active funds have powerful incentives to vote to increase portfolio company value. Moreover, because their business model depends upon analyzing companies for their portfolio, active funds will have staff and expertise capable of analyzing both sides in the contests brought before them. The additional burden, in any event, is not great. Scholars count the number of important contests each year in the dozens.[219]

216. Gilson & Gordon, *supra* note 5, at 897; *accord* Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915, 942 (2019) (offering a similar model and positing traditional investment advisors as proper referees between hedge funds and management).

217. Gilson & Gordon, *supra* note 5, at 897.

218. This is not all a fund can do. A fund that suspects underperformance can alert an activist, a tactic known in the industry as an "R.F.A." or "request for activist." David Gelles & Michael J. de la Merced, *New Alliances in Battle for Corporate Control*, N.Y. TIMES (Mar. 18, 2014, 9:40 PM), https://dealbook.nytimes.com/2014/03/18/new-alliances-in-battle-for-corporate-control/ [https://perma.cc/9THK-EFM7] (quoting activist Bill Ackman stating that "[p]eriodically, we are approached by large institutions who are disappointed with the performance of companies they are invested in to see if we would be interested in playing an active role in effectuating change"). Beyond notification, however, regulatory rules may inhibit closer coordination among funds. *See* John Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407, 1412–13 (2019) (describing how Exchange Act Rule 13D and other regulatory rules inhibit coordination among funds).

219. Rock & Kahan, *supra* note 12, at 33 ("How many potentially consequential votes are there? It is a little hard to tell because of settlements before a proxy contest comes to a conclusion

Index funds differ with respect to both incentives and information resources. First, with regard to incentives, index funds charge a much smaller percentage fee than active funds: zero or close to it.[220] They thus have less to gain directly from improvements in portfolio company value.[221] Moreover, because all index funds are playing the same game, at least within a relevant sector, they would seem to have little to gain indirectly by increasing portfolio company performance.[222] However, Kahan and Rock argue that the direct gains to index funds from improved portfolio company performance can be large in absolute dollar terms even if they are small as a percentage of AUM, demonstrating at least for the Big Three, that such gains are likely large enough to incentivize thoughtful voting in contests.[223]

Second, with respect to information resources, index funds would seem to be at a disadvantage. In contrast to active managers, portfolio selection is not part of an index fund's business model.[224] As a result, index funds may lack the in-house expertise to judge between the competing arguments made in contests. But index funds are typically offered by fund families that also offer actively managed funds. As a result, in voting on contests, index funds may be able to avail themselves of the investment expertise of active managers in the same family, an advantage Kahan & Rock refer to as "spillover knowledge."[225]

Finally, it is worth noting that empirical evidence demonstrates that shareholders value their voting rights principally in connection with contests. Ordinarily, the value of voting rights is deeply discounted and often not priced at all.[226] However, studies that compare the value of voting

but the number is likely a two-digit figure (and likely in the low two-digits).").

220. *See* McLaughlin & Kerber, *supra* note 22 (noting fee competition among index funds and the fact that at least one fund family, Fidelity, now charges 0% on index funds).

221. Lund, *supra* note 12, at 511–12.

222. There is some debate on this point. *Compare* Fisch et al., *supra* note 12, at 2, 3, 10 (arguing that index funds gain from improving governance through greater fund flows at the expense of actively managed funds), *with* Rock & Kahan, *supra* note 12, at 23–28 (answering this argument by noting that designing an index fund's governance strategy to profit at the expense of active managers would be self-defeating, given that fund families house both active and index funds and derive a larger share of their revenue from active funds).

223. *See* Rock & Kahan, *supra* note 12, at 14. Professors Kahan and Rock demonstrated that:

> Vanguard's direct financial incentives would be equivalent to those of an individual shareholder who owns about 1/12 of the number of shares held by Vanguard. For P&G, this implies that Vanguard's financial incentives to cast an informed vote are equivalent to the incentives of an individual shareholder with a staggering $1.3 billion investment.

Id.

224. Selection of the relevant index, however, is. The design and selection of the index may mirror the task of selecting a portfolio. *See* Robertson, *supra* note 25, at 4 (comparing indices with managed portfolios).

225. Rock & Kahan, *supra* note 12, at 51.

226. Studies valuing voting rights follow various methodologies. Some compare the value of voting and nonvoting shares. *See, e.g.*, Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1702, 1720 (2009) (finding a 3.6% premium for voting rights in a

shares to a synthetic (nonvoting) security designed to mimic the cash-flow rights of a common share find that votes may be valued only when they are contested.[227] In other words, voting rights are valuable only when an issue is put into dispute by the calling of a special meeting, a takeover offer, or an activist attack.[228] Otherwise, it seems, voting does not matter to shareholders.

In sum, contests present a situation in which voting authority should be delegated to the discretion of a mutual fund intermediary. The information content of contests is high, and investors share the common goal of wealth maximization. Most mutual funds possess an advantage, compared to rationally apathetic investors, in processing this information, and the common goal makes it possible for them to act on behalf of investors generally. Therefore, it makes sense to allocate default voting authority in contests to the mutual fund intermediary. The ability to opt out on a case-by-case basis might be preserved for investors who feel strongly to the contrary. Given the dynamics of rational apathy, however, such investors are likely rare in mutual funds. The burden of opting out of mutual fund voting in contests should therefore rest with investors.

B. E(nvironmental) and S(ocial)

In contrast to contests, environmental and social (ES) issues present voting situations that involve neither an informational advantage on the part

study of 457 companies with dual-class shares from 1995 to 2003); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 328, 334 (2003) (finding a 2% premium for voting rights in a study of 39 companies with dual-class shares in 1997); Luigi Zingales, *What Determines the Value of Corporate Votes?*, 110 Q. J. ECON. 1047, 1057, 1059 (1995) (finding a 10.5% premium for voting rights in a study of 94 companies with dual-class shares from 1984 to 1990). Others compare the price of privately negotiated block sales to the price of publicly traded minority shares. *See, e.g.*, Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 538, 551 (2004) (finding a 1% premium on control block transfers for 46 companies between 1990 and 2000). Still others focus on the equity-lending fee around shareholder record dates (when voting rights are set). *Compare* Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2898–99, 2912–13 (2007) (using a bank database of equity lending fees and finding no value attributable to voting rights), *with* Reena Aggarwal et al., *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 70 J. FIN. 2309, 2310, 2313, 2316 (2015) (finding that equity lending fees increase on record dates when supply is restricted).

227. Avner Kalay et al., *The Market Value of Corporate Votes: Theory and Evidence from Option Prices*, 69 J. FIN. 1235, 1237 (2014) (devising the methodology and emphasizing its advantages in applying to a larger number of stocks and suffering less from selection effects).

228. *Id.* at 1239–40, 1247 (finding an average voting premium of 0.16% across the sample but significant increases in the context of special meetings, hedge fund activism, and merger announcements, which result in 0.15%, 0.07%, and 0.22% increases, respectively); *see also* Sean J. Griffith & Natalia Reisel, *Dead Hand Proxy Puts and Shareholder Value*, 84 U. CHI. L. REV. 1027, 1066 (2017) (studying defenses to activism and finding evidence that shareholders discount the value of their voting rights and, by implication, the cost of any impingement to their voting rights, unless the voting rights are made salient).

of the mutual fund intermediary nor the ability to assume a common purpose on the part of all mutual fund investors.

ES issues typically arise not as contests,[229] but as "shareholder proposals," a regulatory creation enabling shareholders to request corporate action on an issue of interest to them.[230] Proposals must generally be precatory in nature—typically phrased as requests that the company form a committee or issue a report—in order to successfully run the gauntlet of regulatory requirements and exclusionary challenges.[231] As a result, even the rare proposal that makes it onto the company's proxy statement and then wins majority shareholder support need not be implemented.[232] But implementing the proposal is not the point. Raising the issue is.

Shareholder proposals do not provide much information about the issues they raise. In contrast to the voluminous filings and sharp exchanges that characterize contests, shareholder proposals are limited to 500 words.[233] Moreover, because shareholder proposals rarely win majority support, apart from seeking to exclude them from the proxy, companies exert minimal effort and release minimal information in countering them.[234] Shareholder proposals, in other words, do not provide meaningful information or decide disputes. They rally the like-minded.

ES proposals reflect a broad array of agendas,[235] but shareholder wealth maximization is often not among them.[236] Nevertheless, three kinds

229. This is true by definition. Contests are defined above as disputes involving a takeover bid or a board challenge. Any governance (or environmental/social) issue arising as a relevant part of that challenge was treated as part of the contest. Such issues arising outside of that context are, by definition, distinct.

230. 17 C.F.R. § 240.14a-8 (2019).

231. A shareholder proposal that required board action would likely run afoul of SEC rules allowing companies to exclude proposals that are "[i]mproper under state law." *Id.* § 240.14a-8(i)(1). However, because shareholders typically do have the authority directly to amend corporate bylaws, shareholder-proposed bylaw amendments need not be structured as precatory proposals. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109 (2019) (giving shareholders "the power to adopt, amend or repeal bylaws").

232. Because corporate action can only be taken by the board, a successful proposal only prompts the board to consider whether it ought to implement the requested action. *See* DEL. CODE ANN. tit 8, § 141(a) (2019) (granting control over a corporation's "business and affairs" only to a board of directors).

233. *Id.* § 240.14a-8(d). In contests, by contrast, both sides aggressively court shareholder support in presentations and analyst calls, and management discloses information to counter the claims of activists. *See* sources cited *supra* note 211 (providing examples from Darden and Buffalo Wild Wings contests).

234. For example, in its 2019 proxy statement, Exxon offered 500-word replies to each of two climate-related proposals, recommending that shareholders vote against each. EXXON MOBIL, NOTICE OF 2019 ANNUAL MEETING AND PROXY STATEMENT 63–65 (2019), https://corporate.exxonmobil.com/-/media/Global/Files/investor-relations/annual-meeting-materials/proxy-materials/2019-proxy-statement.pdf [https://perma.cc/B8S8-ME9V].

235. For example, the 2018 proxy season featured proposals relating to issues ranging from environmental concerns, diversity, discrimination, human rights, animal rights, gun violence, and "fake news." SULLIVAN & CROMWELL LLP, 2018 PROXY SEASON REVIEW 7–10 (2018), https://

of claims may be advanced to support voting on ES proposals. First, many shareholders may have preferences other than the maximization of their wealth. Second, ES proposals may actually increase corporate value. Third, even if ES proposals do not increase corporate value, they may increase portfolio value. I address each of these in turn.

With respect to the first claim, there is no doubt that ES proposals aimed at an agenda other than shareholder wealth maximization—whether climate change, gun control, or board diversity—will reflect the preferences of *some* shareholders. However, it is equally certain that such proposals do not reflect the preferences of *all* shareholders. As a result, when mutual funds vote on ES proposals, they necessarily act contrary to the interests of at least some of their investors.[237] It is a strained interpretation of fiduciary duty that would allow a mutual fund intermediary to sacrifice the college or retirement savings of one investor in favor of a social policy favored by another.

To the extent that ES proposals may reflect actual investor preferences, the comparative informational advantage belongs to individual shareholders, each of whom knows what her preferences are, not to institutional investors. Institutions may organize shareholders by their ES preferences *ex ante*—for example, by selling them "socially responsible" funds that fully disclose the agendas they may pursue in the place of wealth maximization.[238] Alternatively, they may poll them *ex post*, as ES issues arise, by implementing a form of pass-through voting.[239] In the absence of either, however, it seems clear that an intermediary fails to act according to the best interests of its investors by pursuing some objective other than shareholder wealth maximization. Moreover, pursuing such interests introduces conflicts and accountability problems.[240] The more "other

www.sullcrom.com/files/upload/SC-Publication-2018-Proxy-Season-Review.pdf [https://perma.cc/5S3Q-C5XZ].

236. *See supra* note 145 and accompanying text.

237. Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 219 (2018) ("Because funds vote 'all-or-nothing' for, against or abstain, even where funds vote the way a majority of their investors are likely to prefer, there will be a divergence from the preferences of a minority of their investors.").

238. There are plenty of problems with these funds as well. *See, e.g.*, Reiser & Tucker, *supra* note 44, at 15 (noting the lack of transparency in the ESG investment market and the problems it creates for investors).

239. On complications introduced by pass-through voting, see *supra* notes 55–61. It is worth noting here that rational apathy may exert less of a role in ES voting, given findings that investors are more likely to vote actively when they have heterogeneous preferences. *See* Dragana Cvijanović et al., Free-Riders and Underdogs: Participation in Corporate Voting 2 (Jan. 2017) (unpublished manuscript), https://ssrn.com/abstract=2939744 [https://perma.cc/9JEG-5ASA] (finding that voters who do not agree with the majority of voters tend to vote more actively).

240. Consider, for example, the gun-policy proposals discussed above. Although it is possible to conceive of many ways in which advisory firms serve their own interests through such initiatives, it is harder to see how they serve their investors. *See supra* notes 181–89 and accompanying text.

interests" a mutual fund manager can cite to justify her conduct, the more she can serve her own interests.[241]

Second, it may also be the case that an ES proposal, if adopted, would increase shareholder wealth. In theory, ES proposals might increase or destroy shareholder wealth. The question is who is in the best position to know which is which: will a given proposal create wealth or destroy it? The obvious answer is management. Managers have access to private, company-specific information to determine the likely effect of any initiative on shareholder value. Shareholder proponents and institutional investors do not. As a result, in the absence of conflict, management is in the best position to decide whether the proposal is in the corporation's best interest. Although there are obvious conflicts involved in contests (where managers' jobs are on the line) and potential conflicts involved in governance reforms (insofar as these have the effect of limiting managers' authority or shortening their tenure), there is no apparent conflict involved in deciding whether an ES proposal is value maximizing or not. Management has as strong an incentive to increase corporate value through ES as through any other initiative. Given the adequacy of its incentives and the superiority of its information, management would seem to be in a better position than any shareholder, individual or institutional, to decide whether an ES proposal will increase or destroy shareholder value.

Third is the claim that broadly diversified mutual funds have a special advantage in assessing the portfolio-wide effects of ES proposals that, although they may reduce value at an individual firm, enhance the value of the portfolio as a whole. As discussed above, this claim attributes far too much knowledge on the part of the mutual fund intermediary, assuming that the fund can calculate the effect of the proposal on every firm within the portfolio and then offset these effects according to the weight of each firm within the portfolio in order to determine the overall effect. Each fund family would have to do this for each of its funds individually, since their portfolios differ, all without access to private, company-specific information with respect to any of the firms in any of their portfolios. This is clearly too much to ask of an index fund. A better approach to social externalities lies in regulation or in the civil or criminal justice system.

It is also notable that funds do not in fact claim to treat ES issues as externalities to be balanced on a portfolio-wide basis. Even BlackRock, which among the Big Three is perhaps best known for advancing an outspoken position on social issues,[242] clearly states in its stewardship policy that its approach to ES issues is "to protect and enhance [our clients']

241. *See* EASTERBROOK & FISCHEL, *supra* note 205, at 38 ("[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.").

242. *See supra* note 180 and accompanying text.

economic interest in the companies in which we invest on their behalf."[243] BlackRock thus conceives the voting decision as "economic," not value-driven or ethical,[244] and emphasizes the *company* perspective, not the portfolio perspective.[245] State Street and Vanguard adopt the same fundamental perspective.[246] Moreover, it is worth noting that the stewardship guidelines of all three emphasize case-by-case voting on ES issues, contradicting any claim that by investing with one or the other fund family, investors are effectively opting in to a specific level of engagement on ES issues.[247] None of the Big Three claims to put any other value ahead of wealth maximization in its approach to ES issues.

In conclusion, a rational investor would prefer mutual funds to follow management's recommendations in voting on ES issues. Management has superior information in determining the effect of ES proposals on shareholder wealth. Furthermore, outside of the context of special "socially responsible" funds and in the absence of pass-through voting mechanisms, shareholder wealth maximization is the only investor purpose that mutual funds can validly assume. Because management has adequate incentives to use its informational advantage to advance this purpose, mutual funds should defer to management in voting on ES proposals.

This conclusion might seem to limit mutual fund authority, but it is likely that many if not all fund families would happily forego the burden of voting on ES proposals. Voting on ES issues makes funds a target for lobbying from cause investors and political interest groups, and failing to vote the "correct" way on a social issue may put the industry at risk politically or economically.[248] Funds might therefore prefer to avoid ES voting altogether, but being the first to do so might render a fund family vulnerable to punishment from interest groups threatening to shift assets to competitors who, perhaps cynically, remain "engaged" on such issues. Funds might therefore prefer an industry-wide rule imposing deference to management on ES issues. Furthermore, moving away from ES voting

243. BLACKROCK GUIDELINES, *supra* note 101, at 12.

244. *Id.* at 13 ("We do not see it as our role to make social, ethical, or political judgments on behalf of clients, but rather, to protect their long-term economic interests as shareholders.").

245. *Id.* at 12.

246. *See, e.g.*, STATE STREET GUIDELINES, *supra* note 101, at 8 ("When voting [on ES proposals], we fundamentally consider whether the adoption of [the] proposal . . . would promote long-term shareholder value in the context of the company's existing practices and disclosures as well as existing market practice."); VANGUARD GUIDELINES, *supra* note 101, at 10 (emphasizing the case-by-case approach to ES voting aimed at long-term corporate value).

247. *See supra* note 108 and accompanying text.

248. *See, e.g.*, Chris Morris, *Parkland Survivor Wants Investors to Boycott BlackRock and Vanguard*, FORTUNE (Apr. 18, 2018), https://fortune.com/2018/04/18/parkland-survivor-boycott-blackrock-vanguard-david-hogg/ [https://perma.cc/KQ9A-44AV] (reporting on David Hogg's lobbying for a boycott of BlackRock and Vanguard funds as a result of their holdings of gun companies).

would reduce the cost of stewardship to smaller funds, lowering the barrier to entry, thereby improving the competitiveness of the industry.[249]

C. G(overnance)

"Governance" is the set of rules, policies, and procedures that determine how a firm is run.[250] Governance issues occupy an interesting middle position with respect to contests, on the one hand, and ES proposals, on the other. Like contests (and unlike ES issues), mutual fund intermediaries can evaluate governance issues from the common investor interest in wealth maximization. Also similar to contests (and dissimilar to ES), management is not disinterested in deciding on governance issues since most governance reforms would either limit managerial authority or shorten management's tenure. However, like ES issues (and unlike contests), governance issues arise through shareholder proposals and contain little meaningful information content. As a result, this Part argues that mutual funds should generally *abstain* from voting on governance proposals relating to portfolio companies, unless specifically instructed to do so.

Governance proposals typically seek to amend corporate bylaws or implore boards to amend the charter to add or eliminate a particular term, such as a staggered board or dual-class shares.[251] Governance terms are proposed in order to increase shareholder wealth, and offending terms are targeted because they allegedly reduce shareholder wealth.[252] Mutual fund intermediaries are therefore not constrained by the principle of wealth maximization in acting on behalf of their investors with respect to governance proposals. Furthermore, governance proposals, unlike ES proposals, are often effective at achieving their ultimate ends. For example,

249. *See supra* text accompanying note 122.

250. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 2 (2012) ("Corporate governance, broadly defined, consists of the institutional structures, legal rules, and best practices that determine which body within the corporation is empowered to make particular decisions, how the members of that body are chosen, and the norms that should guide decision making."); MARGRET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 3 (1995) (defining corporate governance as "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated").

251. For example, the Illinois State Board of Investment offered the following precatory proposal to Quest Diagnostics:

> RESOLVED, that shareholders of Quest Diagnostics Incorporated urge the Board of Directors to take all necessary steps (other than any steps that must be taken by shareholders) to eliminate the classification of the Board of Directors and to require that all directors elected at or after the annual meeting held in 2013 be elected on an annual basis.

Quest Diagnostics Inc., Definitive Proxy Statement 59–60 (Schedule 14A) (Apr. 2, 2012).

252. The Illinois State Board of Investment, for example, emphasizes that destaggering "could . . . contribute to improving performance and increasing firm value." *Id.* at 60.

many corporations destaggered their boards following the passage of precatory proposals urging them to do so.[253] And many others agreed to destagger after being approached with the threat of a shareholder proposal.[254]

With respect to the quality of information presented, however, governance proposals are much closer to ES proposals than they are to contests. Governance proposals are subject to the same 500-word limit as other proposals.[255] As a result, and in marked contrast to the wealth of firm-specific information marshaled by both sides to a contest, governance proposals typically describe the provision under consideration in general terms without seeking to apply it to the specific situation of the company at which it is being proposed.[256] Governance proposals, in other words, are "issue-specific" rather than "firm-specific."[257]

Unfortunately, although issue-specific information may supply some insight into the general effect of a given governance provision, it cannot assist mutual funds (or anyone else) in deciding how to vote on a particular governance proposal at a specific firm. There are no "one-size-fits-all" governance solutions.[258] Instead, optimal governance arrangements are

253. *See, e.g.*, Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 DEL. J. CORP. L. 149, 152 (2008) (analyzing 2004–2005 data and finding that precatory resolutions increase the likelihood of destaggering). *See generally* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368 (2007) (studying the 2002–2004 proxy season and finding increasing willingness to remove important anti-takeover defenses, such as the classified board and poison pill, in response to shareholders' requests).

254. *See 121 Companies Agreed to Move Towards Annual Elections*, SHAREHOLDER RIGHTS PROJECT, http://www.srp.law.harvard.edu/companies-entering-into-agreements.shtml [https://perma.cc/99EY-TJNH] (listing successful engagements).

255. *See supra* note 233 and accompanying text.

256. For example, the Illinois State Board of Investment's proposal to destagger the Quest Diagnostics board included a general statement that "[h]aving directors stand for elections annually makes directors more accountable to shareholders," a review of data suggesting that large companies have increasingly been destaggering boards, a citation to "empirical studies reporting that classified boards could be associated with lower firm valuation and/or worse corporate decision-making," and an exhortation to vote in favor of the proposal. Quest Diagnostics Inc., Definitive Proxy Statement 60 (Schedule 14A) (Apr. 2, 2012).

257. Rock & Kahan, *supra* note 12, at 33–34. In their words:

> [C]orporate governance arrangements . . . may turn largely on issue-specific information (such as whether cumulative voting is generally desirable), on company-specific information that is either not the focus of stock-pickers (such as how incentive compensation should be designed or whether a director nominee is independent and regularly attends meetings), or on company-specific information that is easily observable and programmable (such as company size, industry, and stock price performance) – rather than on, or in addition to, company-specific information to which only stock-pickers are privy (such as informal cash flow projections and in-depth[] assessments of managerial quality).

Id. at 36.

258. Bhagat et al., *supra* note 168, at 1862 ("[T]he research we have analyzed on the relation between corporate governance and performance most definitely does not support a one-size-fits-

endogenous to firms.[259] The general effect of a provision is of little use in understanding how it will affect value at a particular firm.

Moreover, not only is issue-specific knowledge general and therefore unhelpful, it is also frequently wrong. Recent empirical scholarship demonstrates that many widely held views concerning the effects of corporate governance are wrong or, at least, overstated. Consider the example of staggered boards. Bedrock corporate-law theory supports the proposition that staggered boards increase agency costs and harm shareholders by insulating managers from the market for corporate control.[260] Demonstrating the impact of this theory on actual companies, however, has been a challenge. Although prominent studies find that staggered boards have a negative effect on corporate value,[261] other studies challenge this conclusion, using alternative statistical techniques to show that staggered boards may in fact increase value for some firms.[262] Studies also suggest that enacting shareholder proposals to destagger boards may

all approach to governance mandates.").

259. *See* Gilson & Gordon, *supra* note 5, at 891 ("Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by institutional investors."); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 772 (2017) ("The firm-specific nature of the tradeoff between principal costs and agent costs is the reason that firms adopt a wide variety of governance structures, each of which offers a different division of control between investors and managers.").

260. The basic insight goes back to Henry Manne. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (stating that a fundamental premise that underlies the market for corporate control is the correlation between corporate managerial efficiency and the market price of a company's shares); *see also* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 58–59 (1986) (explaining how the threat of takeovers may reduce agency costs); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1178 (1981) (arguing that target boards should remain largely passive in response to unsolicited tender offers); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841 (1981) (arguing that "where that favoritism is expressed in subtle ways, the market for corporate control may be the only potentially serious force for limiting management discretion"); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 6 (1983) (stating that the market for corporate control "limits [management's] divergence from shareholder wealth maximization").

261. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 418–30 (2005) (discussing the deleterious effect of staggered boards on shareholders); Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 784–85 (2009) ("[S]taggered boards . . . limit the extent to which a majority of shareholders can impose their will on management.").

262. K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 70–71 (2016); *see also* Seoungpil Ahn & Keshab Shrestha, *The Differential Effects of Classified Boards on Firm Value*, 37 J. BANKING FIN. 3993, 4011 (2013) (finding that in complex firms the benefits of staggered boards may outweigh the costs); K.J. Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422, 440 (2017) (showing that staggered boards increase value at firms with greater research and development needs and a higher proportion of intangible assets).

destroy shareholder value.[263] Scholarly dispute remains, but it seems fair to say that the company-specific effect of staggered boards is unproven and now hotly contested.[264]

As with staggered boards, so too with many other corporate governance provisions. For example, scholars often criticize dual-class share structures for insulating managers and permitting the expropriation of shareholder wealth.[265] Accordingly, the Big Three, along with other institutional investors, have pushed to impose a ban on dual-class structures.[266] Yet empirical studies have generally failed to demonstrate a negative-share-price effect from dual-class shares.[267] Empirical studies have also failed to prove a link between board independence and share price.[268]

263. K.J. Martijn Cremers & Simone M. Sepe, Board Declassification Activism: The Financial Value of the Shareholder Rights Project 6 (June 2, 2017) (unpublished manuscript), https://ssrn.com/abstract=2962162 [https://perma.cc/NK7L-ZFVY].

264. *Compare* Lucian A. Bebchuk & Alma Cohen, Recent Board Declassifications: A Response to Cremers and Sepe 1 (May 1, 2017) (unpublished manuscript), https://ssrn.com/abstract=2970629 [https://perma.cc/5J8Q-BZAK] (responding to the declassification study), *with* K.J. Martijn Cremers & Simone M. Sepe, Board Declassification Activism: Why Run Away from the Evidence? 1 (June 23, 2017) (unpublished manuscript), https://ssrn.com/abstract=2991854 [https://perma.cc/7E2W-XCB6] (responding to the response). *See also* Miroslava Straska & H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J. FIN. & QUANTITATIVE ANALYSIS 933, 950 (2014) (broadly surveying the literature on the effects of antitakeover provisions on shareholders and concluding that in spite of a large volume of studies, "the net effects of these provisions on shareholder wealth remain uncertain").

265. *See, e.g.*, Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 597 (2017) (documenting the prevalence of dual-class stock initial public offerings and concerns over control lock-in).

266. Joann S. Lublin, *Big Investor Group to Push for End to Dual-Class Shares*, WALL ST. J. (Jan. 31, 2017, 11:50 AM), https://www.wsj.com/articles/big-investor-group-to-push-for-end-to-dual-class-shares-1485817380 [https://perma.cc/8P6M-AGLZ].

267. Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 84 (2008) (surveying the empirical literature on dual-class share structures and concluding that "the findings . . . on ownership disproportionality often disagree" and concluding that dual-class structures "may destroy the value of outside equity in some contexts, but not in others"); *see also* Renée B. Adams & João A.C. Santos, *Identifying the Effect of Managerial Control on Firm Performance*, 41 J. ACCT. & ECON. 55, 81 (2006) (concluding that there is "some evidence that firm performance may decrease when managers obtain too much control" but that there is "robust evidence that some voting control in the hands of managers may be beneficial for shareholders"); Albert H. Choi, *Concentrated Ownership and Long-Term Shareholder Value*, 8 HARV. BUS. L. REV. 53, 57 (2018) (seeking to explain the prevalence of dual-class stock IPOs and concentrated ownership more broadly); M. Megan Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. FIN. ECON. 313, 314 (1987) ("[T]he evidence suggests that shareholder wealth is not affected by the creation of a class of limited voting common stock.").

268. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 262–63 (2002); *accord* Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 7, 12 (arguing there are so many factors "it is difficult to imagine that the occasional board meetings . . . would be detectable").

Many studies find no negative wealth effect from poison pill adoptions,[269] and at least one study found a significant *increase* in share value attributable to poison pills.[270] Furthermore, the price effect of various indices of good corporate governance, once documented in the literature,[271] has since disappeared.[272] More anecdotally, it is worth recalling that Enron had exemplary corporate governance.[273]

These results are too common and too consistent to be attributable to measurement error.[274] Instead, Goshen and Squire contend that such results demonstrate an inevitable tradeoff between empowering versus constraining managers, what they call "principal costs."[275] In this conception, the role of corporate governance is to mediate the right balance of authority and

269. *See, e.g.*, James A. Brickley et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371, 388 (1994) (finding "that the average stock-price reaction to the announcement of the adoption of a poison pill is positive and significant when outside directors comprise a majority of the board and negative and significant when they do not"); Emiliano M. Catan, *The Insignificance of Clear-Day Poison Pills*, 48 J. LEGAL STUD. 1, 38–39 (2019) (analyzing poison-pill adoptions and renewals and finding no discernible economic effect); Sudip Datta & Mai Iskandar-Datta, *Takeover Defenses and Wealth Effects on Securityholders: The Case of Poison Pill Adoptions*, 20 J. BANKING & FIN. 1231, 1232–33 (1996) (showing that "the impact [of the announcement of adoption of a poison pill] on stockholders is insignificant"); Wallace N. Davidson III et al., *The Importance of Board Composition and Committee Structure: The Case of Poison Pills*, CORP. OWNERSHIP & CONTROL, Spring 2004, at 81, 81 (suggesting that "whether poison-pill adoption hurts or benefits shareholders may be situationally dependent").

270. Gary L. Caton & Jeremy Goh, *Corporate Governance, Shareholder Rights, and Shareholder Rights Plans: Poison, Placebo, or Prescription?*, 43 J. FIN. & QUANTITATIVE ANALYSIS 381, 389–90 (2008).

271. Bebchuk et al., *supra* note 261, at 784–90 (constructing a more concise governance index focused on six key entrenchment terms, the "E index," and finding an effect on firm value); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 109 (2003) (constructing a governance index, the "G-index," from twenty-four variables and finding an effect on firm value).

272. Lucian A. Bebchuk et al., *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323, 324 (2013).

273. Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 806 (2007) (noting that Enron might be seen as "a model of 'good corporate governance,' with a large majority of (supposedly) independent directors, an independent audit committee, no staggered board provision, and stock option compensation to tie both director and executive pay to 'performance'"); *accord* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241 (2002) (noting that Enron had "a splendid board on paper, fourteen members, only two insiders. Most of the outsiders had relevant business experience, a diverse set including accounting backgrounds, prior senior management and board positions, and senior regulatory posts. . . . The Audit Committee had a state-of-the-art charter . . . .").

274. Studies of corporate governance are prone to methodological problems, most notably endogeneity. The endogeneity problem arises from the difficulty of separating the propensity of bad firms to select a particular corporate governance term from the bad effects of the term itself. *See* Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58, 59 (2010) (highlighting the endogeneity problem in corporate governance).

275. Goshen & Squire, *supra* note 259, at 767.

accountability on a firm-by-firm basis.[276] The appropriate balance is resolutely company-specific. Mere familiarity with the general issues presented is unhelpful and often misleading as applied to a particular case.

The governance staff and stewardship groups that advise mutual funds on voting can be excused for not thinking of governance proposals in this way. They are non-academics, and as such, are likely often unaware of the extent to which various governance provisions are contested in the literature. Moreover, they are faced with a monumental task—voting on hundreds of thousands of proposals at tens of thousands of companies each year.[277] Much more than papers offering subtle analyses and sophisticated statistical models, these professionals need a simple set of heuristics to keep their task from becoming overwhelming. These heuristics are reflected in their voting guidelines, in which each of the Big Three states that it will generally vote against staggered boards, poison pills, and dual-class shares, all without taking into account characteristics suggesting that a firm may benefit from such provisions.[278] This reduces to an unnuanced, one-size-fits-all approach to governance. While such an approach might make sense for the agents that make up stewardship groups, it makes no sense for the ultimate beneficial owners that invest in mutual funds. An approach to stewardship that destroys portfolio company value is no way to maximize shareholder wealth.

The foregoing analysis implies that index funds should not vote on governance proposals any more than they should vote on environmental and social proposals. A better way for index funds to play a role in governance would be for funds to design governance-focused indexes, much as they do for their social responsibility funds.[279] So a fund complex could create, for example, the S&P 500 Unstaggered Board Index or the Russell 2000 One-Share-One-Vote Index. Although investors might seem less interested in the obscure workings of corporate governance than in pressing social and environmental issues, they will likely pay close attention if good-

276. In their words:

> Principal costs and agent costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other. The rate of substitution is firm-specific, based on factors such as the firm's business strategy, its industry, and the personal characteristics of its investors and managers. Therefore, each firm has a distinct division of control rights that minimizes total control costs. Because the cost-minimizing division varies by firm, the optimal governance structure does as well. The implication is that law's proper role is to allow firms to select from a wide range of governance structures, rather than to mandate some structures and ban others.

Id. at 771.

277. *See supra* note 32 and accompanying text.

278. *See supra* notes 102–06 (discussing the stewardship policies of BlackRock, State Street, and Vanguard).

279. *See supra* note 188 and accompanying text (acknowledging the voting pattern related to social responsibility funds).

governance indexes outperform ordinary indexes. The message of the empirical literature, of course, is that one should not hold one's breath for this to occur. But if that really is the message, then index funds should not be voting on governance.

Perhaps this argument disregards "spillover knowledge"—that is, the possibility that active managers will share sufficient company-specific information with index funds in the same fund family to make them competent stewards of corporate governance.[280] Spillover knowledge may work in contests, but there the necessary information to decide the contest was produced and rigorously challenged by each of the two sides to the dispute.[281] Governance proposals, by contrast, are 500 words long and contain no company-specific information. Still, maybe active funds have adequate company-specific information to vote intelligently on governance and can pass this knowledge to index funds in the same family. On closer inspection, however, this is not so.

Voting intelligently requires an investment in acquiring and analyzing information. Whether a vote on a particular issue is worth the investment depends upon the cost of the investment relative to the expected return. With regard to contests, at least, these returns can be large: acquirors offer significant premiums and activists promise steep gains from the adoption of their plans. Moreover, in contests, information is *pushed* to voters. Both sides develop evidence for their position (and counterarguments to the position of their opponents) and submit it all to voters, thereby reducing the voters' cost of information. As a result, in contests, the voters' expected return from information is high and the cost of the investment in it is low.

Governance votes present the opposite situation: low expected returns and high information costs. As discussed above, the empirical literature implies that expected returns from governance reform are low, often zero, and sometimes negative.[282] Furthermore, the cost of acquiring and analyzing information to vote intelligently is higher for governance reforms than it is for contests. The information produced in connection with governance proposals is minimal, general, and unchecked by the adversarial process. As a result, the voter must *pull* the necessary information from her own research and analysis. This is likely to be a laborious exercise, prone to error, and considering the uncertain value of the governance reform, likely not worth the effort. Given the low expected return and the high information costs, active funds are not much more likely than index funds to vote intelligently on governance reforms.

Finally, there is a more profound challenge to spillover governance knowledge. The essential difference between active funds and indexes is

280. Rock & Kahan, *supra* note 12, at 43.

281. *See supra* note 225 and accompanying text.

282. *See supra* notes 254–57 and accompanying text.

that active funds are selective while broad-based indexes own essentially everything. Many take the lesson of modern portfolio theory to be that the performance of active funds does not beat indexes because active returns, on the whole, regress to a mean that is essentially the same as the index return and, once fees are taken into account, worse.[283] But this assumes that the index return and the average return of active funds are related. They are not. Active managers are not trying to replicate the index. They are trying to pick winners.

Winners exist, but active managers often fail to pick them.[284] This is why actively managed funds generally *underperform*, not equal, broad-based index returns.[285] The index includes all the winners the active managers missed. Again, selectivity is the cause. Recent research suggests that index returns overall are driven by a small subset of companies that outperform their peers.[286] Because indexes hold everything, the outperformers are in the index. But because active managers are selective, they may or may not hold the outperformers. If active managers overweight the outperformers, they beat the index. If they do not, they underperform the index. That active managers *underperform* the index on average means

283. *See generally* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973) (developing the theory that asset prices do not consistently outperform market averages over time).

284. Malcolm Baker et al., *Can Mutual Fund Managers Pick Stocks? Evidence from Their Trades Prior to Earnings Announcements*, 45 J. FIN. & QUANTITATIVE ANALYSIS 1111, 1119–20 (2010) ("[T]he average mutual fund . . . does not appear to possess stock-picking ability."). *But see* Robert Kosowski et al., *Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551, 2553 (2006) (finding that, "while most funds cannot compensate for their expenses and trade costs, a subgroup of funds exhibits stock-picking skills that more than compensate for such costs").

285. Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 80 (1997) (finding that although top-performing mutual funds earn returns in excess of costs, most do not, and many significantly underperform on a cost-adjusted basis); Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915, 1916 (2010) (finding that most actively managed funds underperform indices and that "if many managers have sufficient skill to cover costs, they are hidden by the mass of managers with insufficient skill"); Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783, 789 (1996) (finding that actively managed mutual funds underperform indices in excess of costs).

286. *See* J.B. Heaton et al., *Why Indexing Works*, 33 APPLIED STOCHASTIC MODELS BUS. INDUS. 690, 693 (2017) (arguing that "the much higher cost of active management may be the inherently high chance of underperformance that comes with attempts to select stocks, since stock selection itself increases the chance of underperformance relative to the chance of overperformance in many circumstances"). *See generally* David L. Ikenberry et al., *Why Active Managers Often Underperform the S&P 500: The Impact of Size and Skewness*, J. PRIV. PORTFOLIO MGMT., Spring 1998, at 13 (examining the empirical record of active mangers' performance and the factors that affect such performance). *See also* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 456–57 (2018) (finding that the best-performing 4% of listed companies explain the net gain for the entire U.S. stock market over Treasury bills and noting that these results help to explain why poorly diversified active strategies most often underperform market averages).

that active managers are wrong most of the time about which stocks to overweight.[287]

The fact that active managers are mostly wrong about which stocks to pick has profound consequences for the amount of knowledge that can be attributed to fund intermediaries, active or passive. Basically, not much. If active managers are typically wrong about the basic corporate attributes driving performance—the analysis of which is an essential premise of their business model—it seems foolish to expect them to analyze accurately the subtleties of how a particular governance package will affect corporate performance. The situation is analogous to the distinction between gross motor skills and fine motor skills. Children ordinarily must show that they can roll over and crawl before being asked to play Liszt. Active managers' returns suggest that close analyses of how governance terms affect corporate performance are well beyond their developmental stage. And if active funds cannot do it, index funds, with far weaker incentives and far smaller information resources, certainly cannot.

What then to do about mutual fund voting on corporate governance? Although they can assume a common wealth-maximizing purpose for their investors, mutual funds do not have adequate information to act as stewards of governance. At the same time, mutual funds cannot simply defer to management on governance because management will often be conflicted in evaluating governance reforms. Unlike ES proposals or ordinary business decisions, governance reforms threaten to restrict managerial authority or shorten managers' tenure. In light of this conflict, investors would not want their funds simply to defer to management. A better outcome, therefore, would be for mutual funds to *abstain* from voting on governance—that is, not to vote at all. These abstentions would be tallied as present but not cast, as in the case of "broker non-votes."[288] If the corporation determined success as the percentage of votes cast, the absence of mutual fund votes would have no effect on the result, having been effectively removed from both the numerator and denominator.[289] An alternative way of producing

287. *See* Heaton et al., *supra* note 286, at 693. Professor Heaton observes:

> To the extent that those allocating assets have assumed that the only cost of active investing above indexing is the cost of the active manager in fees, that assumption should be revisited. Active managers do not start out on an even playing field with passive investing. Rather, active managers must overcome an inherent disadvantage. The stakes for identifying the best active managers may be higher than previously thought.

Id.

288. Broker non-votes are triggered by rules allowing brokers to vote on behalf of beneficial owners in routine matters but requiring them only to vote as instructed in nonroutine matters. *See* NYSE, OPERATION OF MEMBER ORGANIZATIONS r. 452 (2019), http://wallstreet.cch.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_5&manual=/nyse/rules/nyse-rules/ [https://perma.cc/PTX3-XL2J?type=image] (designating matters as routine or nonroutine in order to determine broker authority to vote client shares).

289. If, on the other hand, the corporation determined success on the basis of the percentage

abstention is through "mirror voting," in which mutual funds cast their votes on an issue in a proportion mirroring the votes cast by retail investors.[290] Because it produces the same outcome as abstention without complicating portfolio companies' processes for counting votes, mirror voting may be a simpler means to the same end. However it is achieved, the principle of abstention recognizes that mutual funds lack the information to decide governance issues and, due to structural conflicts, cannot simply defer to management.

As with delegation to management in the context of ES proposals, mutual fund abstention from voting on governance should be treated as a default rule. Mechanisms ought to be made available for individual shareholders to notify mutual funds of their preferences on governance votes as they arise. In the (probably rare) event that funds receive such instructions from their investors, they should be permitted to vote a proportional number of shares accordingly. Similarly, in the (perhaps more likely) event that a mutual fund arrives at a particular view concerning the corporate governance structure of a specific company in the portfolio, the fund ought to be able to express its view to investors and solicit their consent to vote in a particular manner. In either case, abstention remains the default such that a fund seeking to vote bears the burden of soliciting consent from its investors.

This default-rule structure operates as a rebuttable presumption in favor of abstention, reflecting the information problems afflicting both mutual funds and their investors with respect to governance. The burden on rebuttal—that is, the burden of shifting the default—rests upon the party seeking to vote. If the investor wishes to vote, she must notify the fund, and if the fund wishes to vote, it must receive the consent of its investor. It is likely, as a result, that voting on governance proposals will be rare from either investors or funds, an outcome that will save stewardship costs

of shares present or shares outstanding, then the abstention would effectively count as a vote against the proposal. Either method is appropriate under state corporate law, though the default rule (whether calculated as a percentage of votes present or votes cast) differs from state to state. In Delaware, the default voting standard for shareholder proposals is "majority of shares present . . . and entitled to vote . . . ." DEL. CODE ANN. tit. 8, § 216(2) (2019) ("In all matters other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders . . . ."). As a result, for Delaware corporations, abstentions count as votes against (because they are present and entitled to vote) but broker non-votes do not (because they are present but not entitled to vote). In New York, by contrast, the default standard focuses only on votes for and against. N.Y. BUS. CORP. LAW ANN. § 614(b) (McKinney 2003) (counting votes, other than election of directors, on the basis of "a majority of the votes cast in favor of or against such action . . . by the holders of shares entitled to vote thereon"). As a result, for New York corporations, neither abstentions nor non-votes count as votes against.

290. "Mirror" or "echo" voting, in which a fund votes portfolio company shares in the same proportion as other holders of those shares, is recognized expressly in the Investment Company Act. *See* 15 U.S.C. § 80a-12(d)(1)(E)(iii)(aa) (recognizing that a fund may "vote the shares held by it in the same proportion as the vote of all other holders of such security").

without doing violence to portfolio companies or their governance arrangements.

An alternative, noted above, would be to offer more active stewardship funds to investors. In addition to the current array of low- or no-cost index funds, mutual fund providers might offer higher-fee "Stewardship Funds" with substantially greater investments in stewardship, allowing them to more rigorously analyze governance issues and perhaps even make governance proposals of their own.[291] Investors would thus have the opportunity to opt-in to a robust form of stewardship in the place of the minimal form outlined here. But one might well ask why private ordering has not produced such alternatives already. It is not because there is anything stopping fund families from offering high-fee, high-stewardship funds. Stewardship Funds could be offered today, and if they outperformed no-frills index funds, they would no doubt find a market. Rather, the reason that low-stewardship funds do not compete for fund flows with high-stewardship funds is the artificial floor imposed by the regulatory pressure on funds to vote on all matters at all times.[292] Regulatory expectations inhibit the development of low-cost voting structures like the one I have outlined here, thereby taxing all funds with the cost of super-optimal stewardship.[293]

These arguments are taken up in greater detail in Part V. Before getting to them, however, it is necessary to address the odds and ends of shareholder voting.

D. Everything Else

The rest of the matters on which shareholders are regularly asked to vote consist largely of management proposals, uncontested elections, and "say-on-pay" advisory votes.[294] The stakes are lower in these votes because

291. *See, e.g.*, Bebchuk & Hirst, *supra* note 12, at 2 (advocating a larger mutual fund investment in stewardship so that funds can participate more actively in corporate governance).

292. For discussion of the regulatory environment, see *supra* subpart II(B).

293. One might object to this charge by claiming that mutual fund fees, even with present levels of stewardship, can hardly be characterized as excessive. Vanguard, for example, charges fees of only four basis points on funds invested in its S&P 500 Index Fund. Not much, to be sure. But how do we know the bottom? Fund families make substantial revenues from lending securities to short sellers. *See generally* Darius Palia & Stanislav Sokolinski, Passive Asset Management, Securities Lending and Stock Prices (Apr. 2019) (unpublished manuscript), https://www.law.nyu.edu/sites/default/files/Paper_P%26S_Darius.pdf [https://perma.cc/7YYP-RKUA] (analyzing primary funds as providers of lendable shares to short sellers and describing fees from securities lending activities). How do we know that funds, stripped of administrative expenses relating to unnecessary voting, cannot fully cover their costs from securities lending fees? Fidelity has already driven the cost of some of its index funds to zero. McLaughlin & Kerber, *supra* note 22. Perhaps they can be driven lower still. Indeed, why should index fund investors not be paid to invest, as depositors at banks are?

294. All U.S. public companies must hold nonbinding advisory votes giving shareholders the right to approve or disapprove of management compensation—that is, say-on-pay. Dodd-Frank

there is no real alternative presented. The choice is simply yes, no, or abstain. Although each context raises slightly different issues, mutual funds should generally vote in favor of each, but should retain the ability to cast protest votes in board elections and in say-on-pay votes for those companies that severely underperform.

First, with regard to management proposals, mutual funds should vote in favor of management proposals that do not expand management's authority vis-à-vis shareholders or otherwise shrink managerial accountability to shareholders. Such proposals often relate to uncontroversial housekeeping items, such as the appointment of independent auditors, or other ordinary business matters for which shareholder approval may be necessary, such as a large issuance of equity securities.[295] Given that unconflicted management has strong incentives to propose only those projects that will increase shareholder value, mutual funds should generally vote in favor of management proposals. However, proposals that do raise conflicts between shareholders and managers—such as those that empower managers at the expense of shareholders or that reduce managerial accountability to shareholders—raise the same governance concerns addressed above and should therefore be treated in the same way at the ballot box.[296] Mutual funds cannot defer to conflicted management nor can they decide the matter themselves due to the lack of information. They should therefore abstain.

Second, with regard to uncontested elections, mutual funds are again presented with a binary choice: vote for or against the nominee. In the absence of a contest, there is no alternative candidate, nor is there an adversarial process to develop information necessary to evaluate the nominee.[297] The mutual fund learns only what management discloses. However, given intra-firm incentives to maximize shareholder value, there is no a priori basis to suspect that the company would nominate incompetent directors and, unless the company significantly underperforms its peers, no reason to suppose they have done so. Therefore, in the absence

Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78n-1(a)(1) (2012). Auditor ratification, meanwhile, is not a required voting item, but because it is designated as a "routine" item by stock exchange rules on which brokers are therefore entitled to vote, it typically appears on annual proxy statements in order to guarantee that quorum requirements are met though the ability to count broker votes. *See* NYSE, *supra* note 288 and accompanying text.

295. NYSE, LISTED COMPANY MANUAL § 312.03(c) (2019), https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D—WKUS_TAL_5667%23teid-94 [https://perma.cc/7QDX-DBQK] (requiring shareholder approval of the issuance of common stock constituting 20% or more of the company's pretransaction outstanding common stock under specified circumstances).

296. *See supra* subpart IV(C).

297. This is true by definition because, if a director's reelection were challenged by an activist or an acquirer, the matter would be treated as a contest subject to the analysis in subpart IV(A) above.

of a contest, mutual funds should generally vote *for* the board's nominees. An exception to this rule, however, is the casting of protest votes, discussed in greater detail below.

Say-on-pay votes are similar to uncontested elections in that they present a binary choice—approve or disapprove—with no real alternative. Again, the company provides the information required by regulators as well as any additional information management might wish to disclose. The most relevant information appears in the "Compensation Discussion and Analysis" section of the proxy,[298] and in particular, in the tabular disclosure of compensation and benefits.[299] While this may not be enough information for mutual funds to evaluate the finer points of management's compensation package, its principal value lies in facilitating comparisons with other firms. How were managers at this company compensated relative to their peers? How were managers compensated relative to similarly situated companies that performed well versus similarly situated companies that performed poorly? These comparisons provide a further opportunity to cast protest votes.

Protest votes on say-on-pay and director elections provide an opportunity for long-only investors, especially index funds, to discipline management. Even if the board is ultimately reelected and management's compensation is ultimately approved, receiving a high number of protest votes signals discontent in the investor base. Investor discontent may negatively impact the reputations of individual directors and managers. It may also signal that a company is ripe for activism or takeover. Boards and managers are therefore eager to avoid protest votes. Long-term investors' ability to cast a protest vote thus serves to render managers more accountable to their interests.

Mutual funds have an advantage over ordinary investors in determining whether to cast a protest vote. It is not that the relevant information is hard to find. The essential facts concerning compensation and corporate performance are publicly available. It is rather that ordinary investors lack the time and attention necessary to make the relevant comparisons, especially when they must do so for the hundreds or thousands of firms in a broadly diversified index. Mutual funds, by contrast, can make meaningful use of this information and even automate comparisons between firms and groups of firms. Spillover knowledge, shared between the actively and passively managed funds in a family, may also facilitate these comparisons.[300] Indeed, some mutual funds design their say-on-pay voting in precisely this way. For example, Vanguard articulates a set of red and yellow flags to guide its voting on compensation, including

298. 17 C.F.R. § 229.402(b) (2019).

299. *See, e.g.*, *id.* § 229.402(c) (mandating disclosure of a summary compensation table).

300. *See supra* note 225 and accompanying text.

evaluations of pay relative to the performance of peer firms.[301] In this way, votes on compensation packages may be used to punish underperforming companies.[302] Likewise, withholding votes from an incumbent board of directors can be used as a protest vote against companies that significantly underperform their peers.

Mutual funds should reserve protest votes to punish underperformance, not to push companies on environmental, social, or other issues. Again, this is not because investors do not care about environmental or social issues.[303] Some certainly do. However, unless investors have opted into an investment vehicle, such as a social responsibility fund, that expressly puts these concerns on the same level as performance, the most that mutual fund managers can assume of their investors is that they prefer high returns to low ones. Furthermore, in the context of uncontested elections and say-on-pay, mutual funds do not have the information to perform subtle, multifactor analyses. The best they can do is bluntly compare the returns of peer firms. Because of the necessarily rough nature of these comparisons, protest votes should be cast only against the worst performers—perhaps the bottom decile or firms that are repeatedly in the lowest quartile. It would do no good for such a firm to defend its underperformance on the basis of its pro-social policies, which ought to be treated as wholly irrelevant by all funds except those specifically organized to promote that goal. Protest votes, in sum, should track underperformance alone and even then should be relatively rare.

V. Resetting the Default Rule

This Article has argued that a rational investor would prefer that mutual funds vote on her behalf in contests but not in ESG proposals. Yet this default voting arrangement does not in fact occur. Instead, mutual funds

301. VANGUARD GUIDELINES, *supra* note 101, at 12 (noting, in addition, other compensation metrics, including target pay above peer-group medians and misaligned benchmarks). Other funds follow similar practices. *See, e.g.*, BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP'S APPROACH TO EXECUTIVE COMPENSATION 3 (2019), https://www.blackrock.com/corporate/literature/publication/blk-commentary-our-approach-to-executive-compensation.pdf [https://perma.cc/7HCA-5HXP] (articulating an analytic framework focusing on alignment between pay and performance, time horizons, and benchmarks); STATE STREET GUIDELINES, *supra* note 101, at 7 ("We support management proposals on executive compensation where there is a strong relationship between executive pay and performance over a five-year period.").

302. Studies suggest that shareholders have used their say-on-pay votes in precisely this way. *See* Jill Fisch et al., *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101, 129 (2018) (finding that the firm's economic performance is a critical driver of say-on-pay voting). *But see* Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives* 22 (European Corp. Governance Inst., Finance Working Paper No. 511, 2018), https://ssrn.com/abstract=2802332 [https://perma.cc/T5QL-JQ8G] (arguing that concentrated ownership decreases institutional intermediaries' incentive to correlate pay and performance).

303. For further discussion of purpose and the assumption of wealth maximization as a unifying goal of investors, see *supra* notes 142–61 and accompanying text.

typically take the authority to vote for their investors on all matters. And, having taken this authority, they exercise it. If this is not what a rational investor would want, why do mutual funds take and exercise voting rights contrary to investors' preferences?

Path dependency is part of the answer. For most of their history, mutual funds took broad voting authority in order to save administrative costs, which they then minimized still further by not bothering to vote.[304] Rational apathy likely prevented investors from insisting on a different arrangement. For the same reasons that individual shareholders are unlikely to vote, they are unlikely to demand the right to vote when they invest in mutual funds. The dynamics of rational apathy thus make voting allocations "sticky" when not assigned by default to the ultimate beneficial owner.[305]

But path dependency and rational apathy cannot explain why mutual funds *exercise* voting authority. If anything, they suggest that mutual funds would take the right to vote but generally not exercise it. Instead, mutual funds now vote regularly in all electoral matters. These voting patterns are explained by regulation.

Law and regulation push mutual funds to vote.[306] Although the SEC has suggested that funds and their investors can delegate voting rights in any way they choose,[307] fund managers likely feel compelled by fiduciary duty to vote.[308] This is surely an incorrect interpretation of fiduciary duty. A fund fiduciary does not advance its investors' interests by voting when they would prefer that it not. Nor do funds waste shareholder value by not casting votes.[309] Yet the DOL clings to this interpretation,[310] and it continues to inform the SEC's default position on voting.[311]

A better interpretation of a fund intermediary's fiduciary duty is the framework articulated by this Article.[312] Fund managers should vote only to maximize shareholder wealth and only when they have an informational advantage in doing so. As I have argued above, this implies that mutual funds should have discretionary voting authority over contests, but not over other matters. Both the SEC and the DOL should adopt this perspective on fiduciary duty.

304. *See supra* notes 50–53 and accompanying text.

305. *See* sources cited *supra* note 207 (discussing "sticky" default rules).

306. *See supra* subpart II(B).

307. *See supra* notes 92–93 and accompanying text.

308. *See supra* text accompanying note 95.

309. *See supra* notes 226–28 and accompanying text (citing empirical research showing that votes have value principally in connection with contests).

310. *See supra* note 81 and accompanying text.

311. *See supra* text accompanying notes 93–94.

312. This Article has focused on mutual funds, but insofar as its analysis applies to fund intermediation generally, it is applicable to benefit plans and pension funds regulated by the DOL.

But announcing a new approach to fiduciary duty may not be enough. Because mutual fund voting is a paradigmatic sticky default, investors are unlikely to ask to change the prevailing arrangement. Moreover, those that do ask may meet with resistance from mutual fund families that have found ways to use the current rules to benefit themselves—for example, by deploying them as a barrier to entry or as a means of marketing themselves to various constituencies.[313] Because the default allocation is sticky and because funds may not relinquish their authority easily, regulators need to do more than clarify fiduciary duty.[314] They need to reset the default rules of mutual fund voting.

Mutual funds should have discretionary voting authority over contests only.[315] In ES proposals, mutual fund votes should default to management's recommendation. In governance proposals, mutual fund votes should default to abstentions, either through mirror voting or by a mechanism analogous to broker non-votes. Setting the default rules in this way would allow the market to determine the value of stewardship. Fund families could alter the default rules *ex ante* by organizing "Stewardship Funds" to compete against minimally voting index funds. If stewardship has value, such funds will attract investors. Such competition is impossible at present, however, given the baseline voting infrastructure currently demanded by regulators.

Furthermore, resetting the default rule for intermediary voting as described in this Article creates incentives for funds to develop technologies to facilitate pass-through voting. If voting on ESG is valuable to investors, funds will invest in pass-through voting systems so that their investors can express their preferences on these issues. If not, they will not, but in this case nothing of any value is lost. In contrast, the stickiness of the current arrangement along with the temptation of funds to serve their own interests through voting creates far weaker incentives to develop innovative voting solutions. Eliminating funds' default voting rights over ESG will encourage funds to develop an efficient system for soliciting and complying with investor voting preferences.

313. *See supra* text accompanying note 122 (on the use of stewardship as a barrier to entry) and notes 184–89 and accompanying text (on the use of voting to flatter their managers' vanity, to attract and retain employees, to appeal to investors, and to manage regulatory risk).

314. The stickiness of the default entitlement is the reason that the endorsement of contractual freedom announced in the SEC's recent guidance is insufficient to address the problem. *See supra* notes 90–92 and accompanying text.

315. One way of approximating this outcome would be to repeal SEC Rule 14a-8, which would have the effect of eliminating shareholder proposals altogether. *See* 17 C.F.R. § 240.14a-8 (2019) (codifying the process of shareholder proposals). Although such a reform would be largely consistent with the overall argument sketched here, leaving contests as the principal shareholder-voting concern, it may also raise issues not covered here. Such a reform is therefore beyond the scope of this Article.

Realigning the default delegation of voting authority with investor preferences promises to address many of the problems arising from mutual fund voting, but it does not solve them all. As long as mutual funds retain the authority to vote on behalf of their investors—as, for example, in contests—the potential for conflict remains. Regulators should therefore consider two additional rule changes to address Corporate Client Conflict and Uniform Policy Conflict.[316]

First, with respect to Corporate Client Conflict, the SEC should require disclosure of all situations in which a mutual fund provides 401(k) or other advisory business to a portfolio company and bar funds from voting in situations of substantial conflict. Funds should not be barred from seeking advisory business from a portfolio company. Such a rule would erect a mutual fund version of Glass-Steagall, artificially separating index funds from the rest of the advisory business. Nevertheless, because such business relationships may lead funds to vote contrary to investor interests in contested elections, funds should be barred from voting on investors' behalf when conflicts are severe. In such cases, conflicted funds should be made to abstain, eliminating their votes from both the numerator and the denominator, through mirror voting or some other method. In order to monitor compliance with this principle, funds should also be required to track potential conflicts and disclose them to the SEC.[317]

Second, to address Uniform Policy Conflict, the SEC should mandate the devolution of voting authority to the fund level. As described above, centralization of voting at the family level often means disregarding investor interests at the fund level. Although the scope of the problem is smaller if mutual funds are given discretionary voting authority only for contests, it does not disappear entirely.[318] Fortunately, there is a simple fix: decentralization.[319] Different funds within a family would be required to register their votes independently according to fund objectives, which would be stated in advance and clearly advertised to investors. Under this regime, a value fund could vote in favor of risky mergers and shareholder activism that would allow those companies to unlock value. At the same time, an income or capital appreciation fund in the same complex could support management teams that promise steady dividends, and vote against risky projects proposed by activists or prospective acquirers that threaten to compromise that goal. There is some evidence that mutual fund families are

316. *See supra* notes 173–75 and accompanying text.

317. *See* Bebchuk & Hirst, *supra* note 12, at 59 (highlighting the low incidence of engagement by funds with their portfolio companies).

318. Centralized voting in contests may mean disregarding time horizons and investment objectives of other funds held in the same family. *See supra* notes 169–71 and accompanying text.

319. *See also* Lipton, *supra* note 155, at 329 (discussing the problem of centralization and recommending decentralization); Lipton, *supra* note 12, at 197–202 (same).

beginning to move in this direction.[320] Pushing them further in this direction would ensure that a fund investor's vote is cast according to her interests, not according to the interests of investors in other funds or according to the interests of the fund complex itself.

This is an opportune time for regulators to act to address the problems created by mutual fund ownership. Moreover, mutual funds should welcome the change. The reforms articulated here will not only allow funds to economize on the infrastructure of proxy voting, they will also help the industry allay some of the larger concerns recently raised about ownership incentives and the concentration of too much economic and political power in too few hands. Returning to the fundamental question of whether and when rational investors would prefer to delegate discretionary voting authority implies voting structures to allay many of these concerns.

VI. Conclusion

This Article has articulated a theory of mutual fund voting and used it to frame a system of default rules for frequently recurring issues. Funds should exercise discretion in voting on investors' behalf in contests. They should vote with management on environmental and social proposals, and they should abstain from voting on governance proposals. This Article has further argued that regulators should reset the default allocation of voting authority between mutual funds and their investors accordingly.

Among academics, I suspect, the most controversial argument advanced by this Article is the claim that mutual funds should stop voting on governance issues. But the connection between governance and performance remains elusive. Corporate governance scholars have consistently failed to demonstrate a price impact of specific governance terms, and stock pickers have consistently failed to beat indexes. If we governance scholars could get rich by shorting companies with staggered boards and going long on companies that destaggered, we could retire and never attend another faculty meeting. Alas, we cannot. Neither can mutual fund managers, active or passive. Hence, this Article is an admonishment to eat our own cooking. We should not expect mutual fund intermediaries to put into practice research hypotheses that we cannot prove.

320. *See* Lim & Lombardo, *supra* note 110 (noting Vanguard's announcement that it would devolve voting authority to some actively managed funds).

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