

THE POWER OF THE BIG THREE, AND WHY IT MATTERS

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

In the course of our analysis, we reply to responses and challenges to our earlier work on these issues that have been put forward by high-level officers of the Big Three and by a significant number of prominent academics. These attempts to downplay Big Three power or the problems with their incentives, we show, do not hold up to scrutiny. We conclude by discussing the substantial stakes in this debate, and the critical importance of recognizing the power of the Big Three matters and why it matters.

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

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INTRODUCTION

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

Under a traditional “value-maximization” account of Big Three stewardship, the stewardship decisions of index fund managers are premised to be largely focused on maximizing the long-term value of their investment portfolios, and agency problems are thus assumed not to be a first-order driver of those decisions. In earlier work we have sought to put forward an alternative “agency-costs” account of index fund stewardship.³ In this Article, which is intended to provide the final, capstone part of this line of work, we seek to contribute empirically and conceptually to the development of the agency-costs account and, importantly, address a wide array of objections and challenges to the agency-costs view that have been put forward by prominent critics.⁴

While our earlier work has received some acclaim,⁵ its analysis and conclusions have been challenged both by high-level officers of the Big

¹ See *infra* notes 29-3434 and accompanying text.

² See, e.g., sources cited in *infra* notes 3, 6-13, and accompanying text.

³ See generally Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, B.U. L. REV. 736 (2019) (hereinafter, *Giant Three*); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019) (hereinafter, *Index Fund Incentives*); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31(3) J. ECON. PERSP. 89 (2017) (hereinafter *Agency Problems*).

⁴ See sources cited in *infra* notes 6-13, and accompanying text.

⁵ One of our earlier articles, *Index Fund Incentives*, *supra* note 3, was awarded three prizes—the IRRC Institute’s 2018 Investor Research Award, the European Corporate Governance Institute’s 2019 Cleary Gottlieb Steen Hamilton Prize, and the VIII Jaime Fernández de Araoz Award on Corporate Finance. It was also selected as one of the year’s top 10 corporate and securities articles in an annual poll of corporate law professors. See

Three and a number of leading academics. Objections and challenges to our agency-costs view from the direction of the Big Three were expressed in keynote address by BlackRock Vice Chairman Barbara Novick;⁶ a study responding to our work issued BlackRock Vice Chairman Matthew Mallow;⁷ conference presentations by SSGA Chief Investment Officer (CIO) Richard Lacaille, and by Vanguard's former Chief Executive Officer William McNabb;⁸ and comments on our work provided to the *Financial Times* and to the *Wall Street Journal* by SSGA Managing Director of ESG and Asset Stewardship Rakhi Kumar and by BlackRock and Vanguard spokespersons.⁹ These responses by various Big Three officers sought to challenge our conclusions regarding the power of the Big Three, as well as to challenge our criticism of how the Big Three use their power.

Robert B. Thompson, *The Top 10 Corporate and Securities Articles of 2019*, CORPORATE PRACTICE COMMENTATOR (2020), http://www.professorthompson.com/uploads/2/1/4/7/21478240/best_articles_list_2019_final_.pdf (last visited Jun 16, 2020).

⁶ Barbara Novick Keynote Address at Harvard Law School, (2019), <https://corpgov.law.harvard.edu/2019/12/11/barbara-novicks-keynote-presentation-at-harvard-law-school/> (last visited Dec 13, 2019) (hereinafter *Novick Keynote Address*), subsequently published by BlackRock, *Revised and Extended Remarks at Harvard Roundtable on Corporate Governance Keynote Address: "The Goldilocks Dilemma"* (2019), <https://www.blackrock.com/corporate/literature/publication/barbara-novick-remarks-harvard-roundtable-corporate-governance-the-goldilocks-dilemma-110619.pdf> (last visited Feb 16, 2021). The text of the keynote address was reprinted by the Columbia Law Review Forum, Barbara Novick, *"The Goldilocks Dilemma": A Response to Lucian Bebchuk and Scott Hirst*, 120 COLUM. L. REV. F. (2020), <https://columbialawreview.org/content/the-goldilocks-dilemma-a-response-to-lucian-bebchuk-and-scott-hirst/>. A video of the address is available at <https://corpgov.law.harvard.edu/2019/12/11/barbara-novicks-keynote-presentation-at-harvard-law-school/> (last visited Dec 13, 2019).

⁷ MATTHEW MALLOW, *Asset Management, Index Funds, and Theories of Corporate Control* (2019), <https://papers.ssrn.com/abstract=3483573> (last visited Nov 15, 2019).

⁸ See Richard Lacaille, *Response to Lucian Bebchuk*, ECGI Conference on Rethinking Stewardship 0:50:47 (2020), <https://www.youtube.com/watch?v=mtMulZ9AOfE>; William McNabb, *Response to Jeff Gordon*, ECGI Conference on Rethinking Stewardship 2:17:13 (2020), <https://www.youtube.com/watch?v=mtMulZ9AOfE>.

⁹ See Owen Walker, *BlackRock, Vanguard and SSGA tighten hold on US boards*, FINANCIAL TIMES, June 15, 2019, <https://www.ft.com/content/046ec082-d713-3015-beaf-c7fa42f3484a> (last visited Jul 29, 2019) (reporting responses to our work by Rakhi Kumar of SSGA and spokespersons for BlackRock and Vanguard); Simon Constable, *Index-Fund Firms Gain Power, but Fall Short in Stewardship, Research Shows*, WALL STREET JOURNAL, July 9, 2019, <https://www.wsj.com/articles/index-fund-firms-gain-power-but-fall-short-in-stewardship-research-shows-11562637900> (last visited Jul 9, 2019) (reporting responses to our work by SSGA's Rakhi Kumar and by spokespersons for BlackRock and Vanguard).

Analysis taking issues with our agency-costs account of Big Three stewardship was put forward in an article by NYU Professors Marcel Kahan and Edward Rock;¹⁰ an article by Jill Fisch (University of Pennsylvania), Assaf Hamdani (Tel-Aviv University), and Steven Davidoff Solomon (University of California, Berkeley);¹¹ and an article by Professor Jeffery Gordon (Columbia University).¹² Whereas these articles do not seek to downplay the power of the Big Three, they challenge our agency-costs account by putting forward a more favorable assessment of Big Three stewardship, or at least some key dimensions of it.¹³

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

Our analysis proceeds as follows. Part I considers the arguments made by Mallow and Novick regarding our empirical analyses of the Big Three's power. Mallow and Novick argue that our empirical findings are inaccurate, because they are based on 13F filings, and because we focus only on U.S. companies.¹⁴ We present updated versions of the data published in our previous work, that shows that, as of the end of 2019, the Big Three collectively held, on average, 21.4% of the shares of S&P 500 corporations,

¹⁰ Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B.U. L. REV. 1771 (2020).

¹¹ Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019).

¹² JEFFREY N. GORDON, *Systematic Stewardship* (2021), <https://papers.ssrn.com/abstract=3782814> (last visited Feb 16, 2021).

¹³ Another significant academic article that is worth noting is JOHN C. COATES, *The Future of Corporate Governance Part I: The Problem of Twelve* (2018), <https://papers.ssrn.com/abstract=3247337> (last visited Nov 4, 2018). This study is critical of Big Three stewardship, as we are, but its concern is that the Big Three (and other large institutional investors) will make excessive use of their power. Our conclusions in this Article regarding the Big Three's incentives to under-invest in stewardship and to be excessively deferential to corporate managers are also responsive to the analysis of this study.

¹⁴ See Novick Keynote Address, *supra* note 6 at 4 (arguing that “[w]ith nearly half of US mutual funds using index strategies, this represents approximately 17% of US equities.”).

and that BlackRock and Vanguard each had positions of 5% or more in more than 95% of S&P 500 companies.¹⁵ We also put forward evidence showing that our conclusions regarding the Big Three’s substantial voting power remain intact after addressing empirical issues and challenges raised by Mallow and Novick. Finally, Part I also engages arguments made by Mallow and Novick regarding the likely future growth of the Big Three, and it shows that the power of the Big Three is likely to persist and even significantly grow in the foreseeable future.

Part II examines how the Big Three’s voting power and their use of that power has important effects on corporate decisions and outcomes. This analysis is divided into two parts. Section II.A analyzes how the Big Three’s voting influences actual and potential voting results. It addresses several arguments made by Mallow and Novick. They claim that the proxy solicitor Institutional Shareholder Services (“ISS”) exerts considerable influence on votes.¹⁶ However, we explain that the proportion of votes that ISS influences is less than that controlled by the Big Three. Mallow and Novick also argue that the Big Three do not act as a cohesive voting bloc, and often vote differently.¹⁷ However, we explain that the votes of the Big Three show significant correlation. Finally, Mallow and Novick argue that because close votes are infrequent, even a 10% voting block is unlikely to have significant influence.¹⁸ However, we explain that there are significant situations in which index fund votes could determine whether a vote passes or not, both for proxy contests, and for environmental, social, and governance matters (“ESG”). And even where votes are not close, the outcome of votes can play an important part in influencing the behavior of corporate managers.

Section II.B then analyzes how actual and potential voting outcomes in turn influence corporate decisions and outcomes. Mallow and Novick claim that vote outcomes have a limited effect on corporate outcomes, because they are often advisory, and because shareholder decisions are made by a collective group of thousands of different investors.¹⁹ However, as we

¹⁵ See *infra* Table 1, Table 3.

¹⁶ See MALLOW, *supra* note 7 at 13; Novick Keynote Address, *supra* note 6 at 6 (citing evidence that “negative ISS recommendations drive a 25% decrease in support for say-on-pay proposals”).

¹⁷ See MALLOW, *supra* note 7 at 22–25; Novick Keynote Address, *supra* note 6 at 11.

¹⁸ See MALLOW, *supra* note 7 at 20–22; Novick Keynote Address, *supra* note 6 at 7–8.

¹⁹ See MALLOW, *supra* note 7 at 20–22; Novick Keynote Address, *supra* note 6 at 10.

explain, even advisory votes can influence the actions of corporate managers in important ways because it is important for incumbent directors to retain large support from shareholders and to avoid any visible disagreement with a substantial group of shareholders. Consequently, the voting decisions of shareholders holding large voting power, whether in advisory or binding votes, have substantial influence on corporate decisions.

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

We document that, indeed, management advisors view the Big Three as very important, and that some of the communications by the Big Three themselves reflect this perception as well. Our analysis of the perceptions of market participants thus reinforces our earlier conclusion that the Big Three exercise significant influence. This influence is tacitly acknowledged in many communications of the Big Three themselves. Communications by the Big Three promoting the success of their engagements on subjects like board diversity makes clear that they are aware of the significant influence they are able to exert over the directors and executives of corporations.

Part IV considers the two incentive problems of index fund managers, which—as we explain—have not been adequately addressed by those defending index fund managers. First, index fund managers have incentives to under-invest in stewardship activities. Index fund managers bear the costs of stewardship, but their own investors enjoy the gains that result from those activities. Index fund managers themselves only capture a very small proportion of those gains, in the form of the small proportion of their investors' assets that they charge as fees. As a result, index fund managers have an incentive to invest considerably less in stewardship than their own investors would prefer. We show that arguments raised by critics that investment managers benefit from stewardship by attracting additional assets, or because of the size of their holdings, are unlikely to provide them with sufficient incentives to undertake substantial stewardship.

Index fund managers also have incentives to be excessively deferential to corporate managers, compared to what would be optimal for their own

investors. This is because index funds are likely to bear several different types of costs from nondeferential actions, including lost business from corporate managers, compliance costs that would be borne by investment managers if they influence the control of portfolio companies, and the possibility of a corporate-led backlash to their considerable power. As we explain, the Big Three have expressed doubt regarding these claims, but neither they nor academic commentators have raised any arguments why this is unlikely to be the case.

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

I. VOTING POWER

This Part presents evidence regarding the voting power of the Big Three. BlackRock's Vice-Chairs Mallow and Novick, and SSGA's CIO Lacaille sought to downplay the voting power of the Big Three, and in the course of our discussion below we pay especially close attention to the detailed claims made in this regard by Mallow and Novick. Section A considers the current voting power of the Big Three, and Section B considers how this can be expected to change in the future.

A. At Present

Both Mallow and Novick include data regarding the current voting power of the Big Three. Novick claims that, as of December 2017, the Big

Three collectively managed 10% of global equity.²⁰ However, the data cited by Novick relates to “global equity market capitalization.”²¹ Our focus is on understanding the U.S. corporate governance system, and we therefore focus on U.S. companies, S&P 500 companies in particular, which represent more than 80% of total stock market capitalization.²²

Mallow argues that “[i]ndex mutual funds and ETF’s represented only 17% of U.S. stock market capitalization as of year-end 2018.”²³ However, this ignores the value of actively managed funds that are also controlled by the Big Three, which is likely to explain the discrepancy between Mallow’s figures for all index mutual funds and ETFs, and the figures above and in our prior work related to the holdings of the Big Three.

Novick faults our prior work for being based on Form 13F filings, which she claims are not reliable.²⁴ In particular, she claims that Form 13F filings are underinclusive because individuals are not required to submit Form 13F filings, and because some investment managers look at their voting authority differently from others.²⁵ However, these criticisms are unwarranted, for two reasons.

First, we use Form 13F data for Big Three holdings, but *not* for the total number of shares of the company. That is, only the numerators of our analyses—the number of shares held by the Big Three—derive from Form 13F data. This is reasonable as the Big Three are required to report their holdings on Form 13F, because they are each well above the threshold for Form 13F filing.²⁶ The denominator in our analyses—the total number of

²⁰ Novick Keynote Address, *supra* note 6 at 2, citing data from Pensions & Investments, as of December 31, 2017. The Chief Investment Officer of SSGA has also downplayed SSGA’s voting power. *See also* Lacaille, *supra* note 8 at 4:48-5:05 (“Collectively our clients are minority investors . . . we don’t dominate, in any stretch of the imagination, decision making from a proxy voting perspective.”).

²¹ Novick Keynote Address, *supra* note 6 at 2, citing data from Pensions & Investments, as of December 31, 2017.

²² As of December 31, 2019, the market capitalization of S&P 500 companies constituted 82.8% of the total capitalization of U.S. companies, excluding ETFs. Data is taken from the Center for Research in Securities Prices (CRSP) (last visited June 29, 2020).

²³ MALLOW, *supra* note 7 at 12–13.

²⁴ Novick Keynote Address, *supra* note 6 at 3 (“[M]any academic studies use Form 13F data to measure ownership stakes, this data is not reliable.”).

²⁵ *See id.* at 3 (“[N]ot all investors are required to file Form 13F. . . . Additionally, asset managers have interpreted aspects of 13F differently. . . . The bottom line is 13F data problems potentially invalidate academic analyses that rely on this data.”).

²⁶ *See* 17 C.F.R. § 240.13f-1 (2019) (requiring filing on Form 13F by “every institutional investment manager which exercises investment discretion with respect to accounts

shares of the company, held by all investors—comes from the total number of outstanding shares reported by the corporation, which includes shares held by investors which do not file Form 13F.²⁷

Second, while Novick is correct that there are differences among investment managers regarding how their voting authority is recorded, these differences do not affect our results. This is the case because the dataset we use provides the aggregate number of shares listed in Form 13F that are controlled by the investment manager.²⁸

Table 1 presents data on the median ownership percentage of each of the Big Three in S&P 500 companies from 2000 to 2019.²⁹

holding section 13(f) securities, as defined in paragraph (c) of this section, having an aggregate fair market value on the last trading day of any month of any calendar year of at least \$100,000,000”).

²⁷ See Bebchuk and Hirst, *Giant Three*, *supra* note 3 at 733 n. 28.

²⁸ See *id.* at 733 n. 28.

²⁹ The data used in Table 1 is from the FactSet 13F Institutional Ownership database, last updated March 2020, and thus updates the data on which we relied in our earlier work. Positions for each year represented in the table are as of December 31 of that year. The median position for each investment manager in that year is calculated as the median of their holdings in S&P 500 companies divided by the outstanding shares of those companies.

Table 1. Median Big Three Ownership of S&P 500 Companies, 2000-2019

<i>Year</i>	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>	<i>Total</i>
2000	3.7%	1.5%	1.9%	7.1%
2001	3.8%	1.7%	2.2%	7.7%
2002	3.8%	1.7%	2.6%	8.2%
2003	4.2%	2.0%	2.9%	9.1%
2004	4.4%	2.2%	3.0%	9.6%
2005	4.1%	2.4%	2.9%	9.4%
2006	4.2%	2.7%	2.9%	9.9%
2007	4.5%	3.0%	3.3%	10.8%
2008	5.1%	3.3%	3.9%	12.3%
2009	5.6%	3.6%	3.7%	12.9%
2010	5.5%	3.9%	3.8%	13.2%
2011	5.5%	4.3%	3.8%	13.6%
2012	5.5%	4.8%	4.2%	14.6%
2013	5.6%	5.5%	4.4%	15.6%
2014	5.9%	6.1%	4.5%	16.5%
2015	6.1%	6.5%	4.1%	16.7%
2016	6.4%	7.4%	4.5%	18.3%
2017	6.8%	8.4%	4.4%	19.6%
2018	7.0%	9.1%	4.3%	20.4%
2019	7.4%	9.5%	4.5%	21.4%

*Table 2. Median Holding of S&P 500 Companies
Based on Schedule 13G Filings*

<i>Year</i>	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>	<i>Total</i>
2020	7.6%	9.8%	5.6%	23.0%

For comparison, Table 2 shows the median holding of S&P 500 companies by each of the Big Three for those companies in which they made Schedule 13G filings in the first half of 2020.³⁰ Filing of Schedule 13G is required where investment companies control more than 5% of a company's outstanding stock.³¹ The data is very similar to the 2019 data based on Form 13F.³²

Table 3 takes a different perspective on this data, showing the proportion of S&P 500 companies in which each of the Big Three held positions of 5% or more for each year from 2000 to 2019.³³

³⁰ The data used in Table 2 is based on Schedule 13G filings on the SEC's EDGAR database, updated June 26, 2020. The data is based on the latest Schedule 13G filings within the first half of 2020 for each of the Big Three for each S&P 500 company.

³¹ See 17 C.F.R. § 240.13d-1(b) (2019).

³² Because the medians are based only on those companies in which the investment manager held more than 5% (and not all companies, as with Form 13F) they are slightly higher.

³³ The data used in Table 3 is from the FactSet 13F Institutional Ownership database, last updated March 2020. Positions for each year represented in the table are as of December 31 of that year. The median position for each investment manager in that year is calculated as the median of the holdings reported on those Schedule 13G filings by that investment manager.

Table 3. Proportion of S&P 500 Companies with Big Three Ownership Above 5%, 2000-2019

<i>Year</i>	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>
2000	10.7%	0.0%	5.9%
2001	12.9%	0.0%	5.7%
2002	15.9%	0.0%	5.8%
2003	29.2%	0.0%	7.5%
2004	32.8%	0.4%	8.2%
2005	25.8%	1.0%	7.5%
2006	33.7%	2.0%	8.1%
2007	40.3%	2.7%	7.5%
2008	53.9%	7.1%	13.7%
2009	73.5%	11.5%	7.7%
2010	66.5%	23.9%	10.4%
2011	70.5%	37.9%	13.6%
2012	73.3%	47.6%	19.0%
2013	78.8%	62.2%	19.3%
2014	89.3%	90.7%	23.1%
2015	90.0%	94.3%	18.0%
2016	93.5%	96.8%	28.8%
2017	96.1%	98.8%	25.0%
2018	96.7%	99.2%	21.4%
2019	96.3%	98.6%	29.2%

Table 4. Proportion of S&P 500 Companies with Big Three Schedule 13G Filing

<i>Year</i>	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>
2020	92.0%	94.7%	29.9%

For comparison, Table 4 presents data on the proportion of S&P 500 companies where the Big Three filed a Schedule 13G in the first half of 2020, indicating that their mutual funds controlled more than 5% of the outstanding stock of that company. The data is very similar to the 2019 data based on Form 13F, with the small discrepancy likely explained by the differences in what the forms cover.³⁴

We note that neither Mallow nor Novick engages with an important point, that the voting power of the Big Three is actually substantially greater than the number of shares that they control. This is because the Big Three consistently vote the shares they hold, whereas a substantial proportion of other investors do not vote their shares.³⁵ As a result, the Big Three's shares represent a much greater proportion of the shares that are actually voted at annual meetings. Table 5 shows the mean of the estimated number of shares with voting power controlled by the Big Three represented as a proportion of the votes cast at each S&P 500 company's annual meeting from 2010 to 2019. As of the end of 2019, BlackRock and Vanguard controlled averages of 8.3% and 10.3%, respectively, of the votes cast at annual meetings, and the Big Three collectively controlled 23.5% of votes cast at annual meetings.

³⁴ For a comparison of the coverage of securities under the provisions, see, e.g., Dan Brecher, *Schedule 13D and Form 13F Filings: What's the Big Difference for Investors?* (2014), <https://scarincihollenbeck.com/law-firm-insights/business-law/securities-law/schedule-13d-and-form-13f-filings-whats-the-big-difference-for-investors> (last visited Feb 18, 2021).

³⁵ Bebchuk and Hirst, *Giant Three*, *supra* note 3 at 738–740.

Table 5. Estimated Proportion of Votes Cast at Annual Meetings
Controlled by the Big Three in S&P 500 Companies

	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>	<i>Total</i>
2003	5.4%	2.3%	3.4%	11.0%
2004	5.2%	2.6%	3.5%	11.3%
2005	4.9%	2.7%	3.2%	10.8%
2006	4.9%	3.5%	3.2%	11.6%
2007	5.2%	3.2%	3.3%	11.7%
2008	5.4%	3.6%	3.6%	12.6%
2009	6.0%	4.1%	3.8%	13.9%
2010	6.5%	4.8%	4.1%	15.4%
2011	7.3%	5.8%	4.9%	18.0%
2012	6.5%	5.7%	4.6%	16.9%
2013	6.7%	6.4%	4.8%	17.9%
2014	6.6%	6.8%	4.8%	18.2%
2015	6.9%	7.6%	4.6%	19.1%
2016	7.2%	8.4%	4.6%	20.2%
2017	8.5%	9.9%	5.2%	23.5%
2018	8.0%	9.9%	4.5%	22.5%
2019	8.3%	10.3%	4.7%	23.3%

Both Mallow and Novick argue that, in assessing the power of the Big Three, it is important to take into account that some institutional investors that invest through the Big Three “retain the right to vote themselves.”³⁶ Novick states that “[w]e estimate that 25% of BlackRock’s large separate account mandates are managed for clients who vote their own shares.”³⁷

³⁶ MALLOW, *supra* note 7 at 10 (“Institutional clients with segregated accounts can delegate voting to the asset manager or they can retain the right to vote themselves, as many institutions do.”).

³⁷ Novick Keynote Address, *supra* note 6 at 3.

However, because a large portion of BlackRock's assets under management comes from non-institutional investors, which do not segregate their accounts or retain the right to vote, the proportion of BlackRock's assets under management for which it does not have voting authority is likely much less than the 25% mentioned by Novick. Each of the Big Three has substantial investments from retail investors in mutual funds and in ETFs. For instance, at the end of 2019, 42% of BlackRock's assets under management were from retail investors or were in ETFs.³⁸ The votes of these mutual funds and ETFs are cast by the investment managers.³⁹

Below we attempt to adjust for the effects of this retained voting authority on the voting power of the Big Three. Based on Novick's estimate, we assume that 25% of the assets that BlackRock managed for institutional clients did not give voting authority to BlackRock. Institutional clients represented 58% of BlackRock's assets under management as of the end of 2017.⁴⁰ We therefore estimate that BlackRock did not have voting authority for 15% of its assets under management, and did not cast votes for 15% of the shares that it controlled. We assume that the same 15% proportion for each of the other Big Three investment managers as well.

Table 6 uses these assumptions to recalculate the data in Table 5. It thus presents data for our estimate of the mean proportion of votes at annual meetings of S&P 500 companies for which each of the Big Three held voting authority, assuming that they exercise voting power for 85% of shares under their control. The voting power held by each of the Big Three remains significant, with BlackRock holding voting power for an average of 7.1% of votes at 2019 annual meetings of S&P 500 companies, Vanguard 8.8%, and SSGA 4.0%. In aggregate, the Big Three therefore retained voting power over an average of 19.8% of the shares cast at 2019 annual meetings of S&P 500 companies.

³⁸ BLACKROCK, *Annual Report (Form 10-K) 5* (2020), https://www.sec.gov/ix?doc=/Archives/edgar/data/1364742/000156459020007807/blk-10k_20191231.htm (last visited Jun 19, 2020).

³⁹ Votes cast by these funds are generally recommended by the investment manager, who also implements the votes after they have been approved by the directors or trustees of the mutual fund or ETF.

⁴⁰ BLACKROCK, *supra* note 38 at 5.

Table 6. Estimated Votes Controlled by the Big Three in S&P 500 Companies

	<i>BlackRock</i>	<i>Vanguard</i>	<i>SSGA</i>	<i>Total</i>
2003	4.6%	2.0%	2.9%	9.4%
2004	4.4%	2.2%	3.0%	9.6%
2005	4.2%	2.3%	2.7%	9.2%
2006	4.2%	3.0%	2.7%	9.9%
2007	4.4%	2.7%	2.8%	9.9%
2008	4.6%	3.1%	3.1%	10.7%
2009	5.1%	3.5%	3.2%	11.8%
2010	5.5%	4.1%	3.5%	13.1%
2011	6.2%	4.9%	4.2%	15.3%
2012	5.5%	4.8%	3.9%	14.3%
2013	5.7%	5.4%	4.1%	15.2%
2014	5.6%	5.8%	4.1%	15.5%
2015	5.9%	6.5%	3.9%	16.2%
2016	6.1%	7.1%	3.9%	17.2%
2017	7.2%	8.4%	4.4%	20.1%
2018	6.8%	8.4%	3.8%	19.0%
2019	7.1%	8.8%	4.0%	19.8%

B. In the Future

This Article has so far focused on the current power of the Big Three. In this section we focus on how the power of the Big Three can be expected to change in the future. In our prior work we estimated the mean percentage of S&P 500 shares likely to be controlled by the Big Three over the next two decades, and the proportion that these shares are likely to represent of the total number of shares voted at the meetings of those companies.⁴¹ The

⁴¹ Bebchuk and Hirst, *Giant Three*, *supra* note 3 at 737–741.

average proportion of the equity of S&P 500 companies *not* managed by the Big Three has declined from 86.5% in 2008 to 79.5% in 2017, an annual decline of 0.84%.⁴² Extrapolating this decline into the future, the Big Three can be expected to control 27.6% of the shares of S&P 500 companies in 2028, and 33.5% in 2038.⁴³ Similar increases hold for the Russell 3000—if current trends continue, the Big Three can be expected to control 23.9% of the shares of Russell 3000 companies in 2028 and 30.1% in 2038.⁴⁴

When the fact that many other shareholders do not vote at annual meetings is taken into account, the voting power exercised by the Big Three is likely to be even greater. In our prior work, we calculated that an average of 73% of shares not held by the Big Three were voted in director elections from 2008 to 2017.⁴⁵ Assuming that proportion remains constant, we further estimated that the Big Three will control 34.3% of S&P 500 votes in 2028, and 40.8% of S&P 500 votes in 2038, and we obtained similar results for the Russell 3000: 29.8% of Russell 3000 votes in 2028, and 36.7% of Russell 3000 votes in 2038.⁴⁶

Mallow and Novick cast doubt on our predictions regarding the growth of index funds. In particular, Novick states that

In the *Specter of the Giant Three*, Bebchuk and Hirst assume that these managers will continue to grow at the rate they have for the past few years.⁵ While their projections are arithmetically correct, this assumption ignores multiple external variables that can change what products, asset classes, or managers are in or out of favor at a given time, and that translates into changes in growth rates.⁴⁷

Novick argues that many organizations that were among the largest in 1991 are no longer in existence, and many of the largest asset managers in 2000, including Deutsche Asset Management and PIMCO, are no longer among the largest.⁴⁸ Both Mallow and Novick point to evidence that the growth rate of other asset managers in 2018 surpassed that of the Big

⁴² *Id.* at 737.

⁴³ *Id.* at 737.

⁴⁴ *Id.* at 737.

⁴⁵ *Id.* at 739.

⁴⁶ *Id.* at 739.

⁴⁷ Novick Keynote Address, *supra* note 6 at 3.

⁴⁸ *Id.* at 3 (describing certain top ten asset managers by AUM in 1990 and 2000 that are no longer in the top 10).

Three.⁴⁹ Mallow and Novick thus imply that the proportion of votes cast by the Big Three might not trend upwards as much as we have predicted, or that it might decline.⁵⁰

We agree that the growth rates we use for our predictions are not certain; indeed, we emphasized in our earlier work the old adage that “it is difficult to make predictions, especially about the future.”⁵¹ However, as we discuss below, continued growth of the Big Three is very plausible, even if not completely certain, and that this is a scenario that policymakers should seriously consider. Mallow and Novick highlight the uncertainty of the growth rates we use, but they do not question the plausibility of the scenario we put forward.

There have been two steady and persistent trends over the past 25 years—the growth of institutional investors and the increasing proportion of institutional investment managed through index funds.⁵² Given that both of these trends have been so steady and consistent, there is a substantial chance that they will continue for some time. This is especially the case where the trends can be explained by clear drivers

One such driver is the advantage that index investing holds over other strategies. Mallow himself recognizes these benefits as reasons for investors to invest in index funds, explaining that “[d]iversification, and obtaining it at a low cost, is the fundamental benefit and a primary reason for the popularity of index investing,”⁵³ and that “the use of index funds as a core investment vehicle has significantly increased, in part because they provide diversification and benchmark returns at a low cost.”⁵⁴

We agree with Mallow that these factors are likely to lead to the increase in the amount of investment using an indexing strategy. It is of course possible that the Big Three may lose their dominance of index fund

⁴⁹MALLOW, *supra* note 7 at 13 (explaining that in 2018 the Big Three “were not, however, the fastest growing among well-known top 30 asset managers,” and providing examples of other large asset managers with higher growth rates that year); Novick Keynote Address, *supra* note 6 at 3 (discussing Dimensional Fund Advisors’ 9% growth rate).

⁵⁰ See, e.g. Novick Keynote Address, *supra* note 6 at 3 (discussing the estimates in *The Specter of the Giant Three* and noting that those statistics might change.”).

⁵¹ Bebchuk and Hirst, *Giant Three*, *supra* note 3 at 737.

⁵² See *id.* at 725–727 (discussing the rise of institutional investors since 1950); *id.* at 727–731 (discussing the increasing share of institutional investment managed through index funds, from 1995 to 2015).

⁵³ MALLOW, *supra* note 7 at 9.

⁵⁴ *Id.* at 14.

management, and, as Mallow suggests, that the inflows to indexing may go instead to other index fund managers. However, as we discuss in our prior work, this is unlikely to occur for structural reasons.

To begin, there are significant economies of scale to index fund operation. These not only benefit the Big Three at the expense of potential entrants, but they incentivize the Big Three to continue to grow. A second, related reason is that larger ETFs can be expected to have greater liquidity (shown in their lower bid-ask spreads), and thus lower costs to investors. This further incentivizes investors to invest in ETFs that are already larger, and that are generally controlled by the Big Three. This can also be expected to lead to the continuing growth of those ETFs.⁵⁵ Finally, the nature of index fund offerings means that even if an upstart rival were to offer a new product to compete with the Big Three, the Big Three could swiftly replicate that product, making it difficult for the potential competitor to take market share from them. Mallow and Novick do not address these structural factors which provide a basis for believing that the Big Three's dominance of the growing sector of index investing is likely to persist.

* * *

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

II. INFLUENCE ON CORPORATE OUTCOMES

In seeking to downplay the power of the Big Three, BlackRock's Mallow and Novick and CIO's Lacaille argue that, notwithstanding the significant share of votes cast by the Big Three, our work overstates the

⁵⁵ See Bebhuk and Hirst, *Giant Three*, *supra* note 3 at 729–730

extent to which the Big Three can influence corporate outcomes.⁵⁶ Lacaille argues that the Big three “do not dominate decision making from a proxy voting perspective.”⁵⁷ Mallow and Novick provide a detailed analysis suggesting that the Big Three have a limited effect on the results of corporate votes,⁵⁸ and that corporate outcomes are largely determined by factors other than the results of corporate votes.⁵⁹ We discuss both types of claims in turn. Section A discusses claims that the Big Three have limited power to influence voting results. Section B discusses claims that those voting results have limited effects on corporate outcomes.

A. The Effect of The Big Three on Voting Results

Mallow and Novick make three arguments in an effort to downplay the impact of the Big Three on voting results. They argue that proxy advisors play a significant role in affecting voting results, that investment managers do not coordinate their voting, and that close votes where Big Three votes may be particularly influential are relatively rare. However, with respect to each of these arguments, Mallow and Novick disregard important factors. We discuss each of these three arguments below.

1. Dominated by the Influence of Proxy Advisors?

Mallow and Novick argue that proxy advisors, especially ISS, exert significant control over the outcomes of corporate votes. For instance, Mallow argues that “many other stakeholders play a role in corporate governance, including most prominently, proxy advisors and compensation consultants.”⁶⁰ Novick points to evidence that “negative ISS recommendations drive a 25% decrease in support for say-on-pay

⁵⁶ See, e.g., MALLOW, *supra* note 7 at 5 (“Some academic papers contributing to this debate overstate the level of control that asset managers have over companies they invest in through voting and engagement”); Novick Keynote Address, *supra* note 6 at 1 (“[W]e at Blackrock approach investment stewardship as part of the overall investment process.”).

⁵⁷ See Lacaille, *supra* note 8 at 55:30 (Stating, in reference to the Big Three, that “collectively our clients and minority investors ... we don't dominate, in any stretch of the imagination, decision making from a proxy voting perspective”).

⁵⁸ See, e.g., MALLOW, *supra* note 7 at 19–22 (arguing that “Asset managers are minority shareholders with limited voting power and corporate control”); Novick Keynote Address, *supra* note 6 at 6–7 (playing down the influence of BlackRock on executive compensation votes).

⁵⁹ See, e.g., MALLOW, *supra* note 7 at 29 (“Focusing solely on [index fund managers] omit[s] the pronounced role of company executives in running our nation’s public companies and boards of directors in holding company management accountable.”).

⁶⁰ *Id.* at 13.

proposals”.⁶¹ Mallow suggests that “proxy advisory firms’ recommendations determine between 20-30% of the vote among institutional investors who lack their own investment stewardship teams.”⁶² Other releases by BlackRock echo this view.⁶³

However, there is evidence to suggest that the actual power of proxy advisors is less than Mallow and Novick suggest. Professors Stephen Choi, Jill Fisch, and Marcel Kahan have presented evidence that proxy advisors have substantially less influence than Novick claims.⁶⁴ Of course, if Mallow and Novick argue that influencing 25% of votes cast in elections is “significant” then they should also admit that the collective power of the Big Three, which hold about the same proportion of shares voted in corporate elections, is also “significant.”

2. Undermined by Lack of Big Three Coordination?

Mallow and Novick also argue that investment managers do not coordinate their voting, and that as a result, there is considerable variation in their voting decisions.⁶⁵ They explain that Section 13(d) of the Securities Exchange Act would require investors which collectively held more than 5% of a company’s shares to file a Form 13D if they coordinated their approach to voting that company’s shares.⁶⁶ Because of difficulties that this would entail for the investment fund manager, they “have a strong incentive

⁶¹ Novick Keynote Address, *supra* note 6 at 6.

⁶² MALLOW, *supra* note 7 at 23.

⁶³ See, e.g., BLACKROCK, *Executive Compensation: The Role of Public Company Shareholders* (2019), <https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-executive-compensation-the-role-of-public-company-shareholders-april-2019.pdf> (suggesting that proxy advisors could influence between 15% and 25% of shareholder votes cast on say-on-pay proposals).

⁶⁴ See Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 906 (2010) (concluding that ISS recommendations influence between 6% and 10% of shareholder votes).

⁶⁵ For Mallow’s discussion of variations in asset manager voting, in part because they do not coordinate voting, see MALLOW, *supra* note 7 at 22–25. See also Novick Keynote Address, *supra* note 6 at 5 (explaining that “index fund managers are discouraged, by virtue of the regulatory hurdles they would encounter, from telling management what to do and from coordinating stewardship activities with other managers).

⁶⁶ See MALLOW, *supra* note 7 at 24 (“If two or more holders coordinate their approach to voting specific company shares, they ... need to jointly file disclosures with the Securities and Exchange Commission if they together hold more than 5% of a company”); Novick Keynote Address, *supra* note 6 at 16 (explaining that “[e]ligibility to file Schedule 13G is a key reason why index fund managers do not coordinate voting of proxies, as doing so would require they file Schedule 13D instead.”).

not to coordinate with each other on voting specific company shares.”⁶⁷ Mallow also points to evidence we present to support his claim that “in practice asset managers do not coordinate their voting.”⁶⁸

Both Mallow and Novick argue that there is substantial variation in the voting behavior of asset managers.⁶⁹ Lacaille has also advanced a similar claim, arguing that each of the Big Three vote differently from each other.⁷⁰ The implication of this claim is that observers should not aggregate the voting power of the Big Three. For instance, if BlackRock and Vanguard each controlled about 5% of votes at a particular corporation and voted in different ways on a proposal at that corporation, then their voting decisions would effectively cancel each other out, and not influence the outcome of the vote.

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

Professor Ryan Bubb and Emiliano Catan use investment manager voting data to generate a “spatial map” of the voting behavior of different investment managers.⁷¹ They find that investment manager voting behavior is clustered into three groups of investment managers with similar voting behavior—which they refer to as “parties”—with each party following a distinctive philosophy concerning corporate governance and the role of shareholders.⁷² They find that BlackRock, Vanguard, and SSGA are all

⁶⁷ MALLOW, *supra* note 7 at 25.

⁶⁸ *Id.* at 25, citing Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3, manuscript at 7-8, 73-74, 102-103.

⁶⁹ For instance, Mallow claims that “there is significant variation in voting across asset managers of all types and sizes,” and Novick refers to the “chorus of voices” of different investors. See MALLOW, *supra* note 7 at 23; Novick Keynote Address, *supra* note 6 at 9–10.

⁷⁰ See Lacaille, *supra* note 8 at 0:55:53 (stating that the Big Three “also vote differently from one another, and those who’ve studied this, I think, have observed that the Big Three take different viewpoints on important issues.”).

⁷¹ See, generally, RYAN BUBB & EMILIANO CATAN, *The Party Structure of Mutual Funds* (2019), <https://papers.ssrn.com/abstract=3124039> (last visited Feb 27, 2018).

⁷² For a general description of Bubb and Catan’s findings, see *Id.* at 2..

members of the same party, which they refer to as the “Managerialist Party.”⁷³

In a second study, Professor Patrick Bolton, Professor Tao Li, Enrichetta Ravina, and Howard Rosenthal use investment manager voting records to identify the “ideology” of different investors.⁷⁴ They find that BlackRock and Vanguard not only share the same (center-right) ideology, but that the views of both are similarly “more profit-oriented and more management-disciplinarian.”⁷⁵ Both articles therefore find that the voting behavior of each of the Big Three is closely correlated with the others, and much less correlated with the voting behavior of other investors. As a result, it makes sense to aggregate the voting power of the Big Three in order to properly understanding their power.

In our own prior work, we provide evidence that each of the Big Three is more deferential to corporate managers on votes on executive compensation than are the three largest active managers: Capital Group, Fidelity Investments, Inc., and T. Rowe Price Group, Inc.⁷⁶ That data shows that the frequency of “no” votes by the Big Three in say-on-pay proposals evaluating executive compensation plans is less than half (and closer to one-third) of the frequency of the largest three active managers.⁷⁷ This finding is not just driven by the voting behavior of the three largest active managers; the same result is obtained comparing the Big Three’s voting to the ten largest active managers.⁷⁸

Indeed, Novick herself presents data on the level of support of different investment managers for shareholder proposals.⁷⁹ This data provides further evidence of the substantial correlation in the voting behavior of the Big Three. BlackRock and Vanguard have the lowest level of support for

⁷³ See *id.* at 2.

⁷⁴ See, generally, Patrick Bolton et al., *Investor ideology*, 137 J. FIN. ECON. 320–352 (2020).

⁷⁵ *Id.* at 321–322.. SSGA is not mentioned in these analyses. Bolton et al. also find that BlackRock and Vanguard have similar “ideal points,” which are different from those of proxy advisors ISS and Glass Lewis, and presumably other investors. See *id.* at 333.

⁷⁶ See Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2093.

⁷⁷ See *id.* at 2093, tbl. 6 (showing that, on average, the Big Three voted against an average 3.1% of say-on-pay votes between 2012, compared to 9.0% for the largest three active managers).

⁷⁸ See *id.* at 2093, tbl. 6 (showing that, on average, the ten largest active managers voted against 9.1% of say-on-pay votes between 2012 and 2018).

⁷⁹ Novick Keynote Address, *supra* note 6 at 10 (showing the support for Russell 3000 shareholder proposals for selected investment managers for the period from July 1, 2018 through June 30, 2019).

shareholder proposals, at 15% and 17% respectively. SSGA's level of support is higher, at 29%, but was still 13th out of 19 investment managers listed, and so separated by only four investment managers from BlackRock and Vanguard at 18th and 19th.⁸⁰

3. *Curtailed by the Infrequency of Close Votes?*

A third argument put forward by Mallow and Novick, as well as by Professors Kahan and Rock, downplays the voting power of the Big Three by arguing that the infrequency of close votes in corporate elections means that even a voting bloc of 20% does not give the Big Three much influence over corporate outcomes.⁸¹ Both Novick and Mallow present evidence of the proportion of Russell 3000 direct elections that were won by margins above and below 30% and 10%.⁸² Novick draws the conclusion that “there’s no individual manager that comes even close to a swing vote.”⁸³ Similarly, Professors Kahan and Rock argue that “the number of potentially consequential individual votes” is very small.⁸⁴ However, these arguments regarding close votes suffer from two serious problems.

To begin, there are important situations where the voting decisions of index fund managers *do* have a significant impact on whether the vote passes or not.⁸⁵ For example, in 2015 there was a proxy contest at E. I. du Pont de Nemours and Company (“DuPont”), when Trian Partners, L.P. nominated directors to contest the election against the incumbent directors.⁸⁶ All of the Big Three voted in favor of the incumbent directors, rather than the nominees put forward by Trian Partners, and none of Trian

⁸⁰ *Id.* at 10.

⁸¹ For instance, Novick states that “[i]n reality, very few votes are contentious.” *Id.* at 10.

⁸² See MALLOW, *supra* note 7 at 20–22; Novick Keynote Address, *supra* note 6 at 7–8.

⁸³ Novick Keynote Address, *supra* note 6 at 8.

⁸⁴ See Kahan and Rock, *supra* note 10 at 33 (“How many potentially consequential individual votes are there? It is a little hard to tell because of settlements before a proxy contest comes to a conclusion but the number is most likely a two-digit figure (and likely in the low two-digits). For example, in 2018, 34 proxy contests were launched against Russell 3000 companies.”).

⁸⁵ This is consistent with the observation of Kahan and Rock, who they count such contests within the small number of votes that they refer to as “consequential.” *Id.* at 33.

⁸⁶ See TRIAN FUND MANAGEMENT, L.P., *Proxy Statement (Schedule 14A)* 1 (2015), <https://www.sec.gov/Archives/edgar/data/30554/000104746915002563/a2223861zdefc14a.htm> (last visited Jun 25, 2020).

Partners' nominees were elected.⁸⁷ The margin between the Trian Partners nominee receiving the most votes (Nelson Peltz) and the DuPont nominee receiving the fewest votes (Lois Juliber) was 53.7 million votes.⁸⁸ At the time of the meeting, BlackRock held 57.2 million DuPont shares, and Vanguard held 50.1 million shares.⁸⁹ Had *either* BlackRock or Vanguard voted for Nelson Peltz then he would have been elected.⁹⁰

The voting decisions of the Big Three can also be decisive in shareholder proposals. As BlackRock's own data shows, it regularly votes against many shareholder proposals.⁹¹ BlackRock and Vanguard have among the lowest levels of support for shareholder proposals of any of the largest investors.⁹² BlackRock and Vanguard have rarely supported shareholder proposals requesting changes in the social and environmental policies or disclosures of their portfolio companies.⁹³

Furthermore, even without support from BlackRock or Vanguard, many proposals nonetheless receive substantial support from other investors. For instance, BlackRock and Vanguard generally vote against disclosure of

⁸⁷ See SULLIVAN & CROMWELL LLP, *Shareholder Activism Update: DuPont Announces Victory in Proxy Fight with Trian* 1 (2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Shareholder_Activism_Update.pdf (last visited Jun 25, 2020) (“DuPont announced ... that all 12 of its incumbent directors were reelected ... DuPont’s three largest institutional shareholders, The Vanguard Group, Blackrock, Inc. and State Street Corporation, all voted in favor of DuPont’s slate”).

⁸⁸ See E. I. DU PONT DE NEMOURS AND COMPANY, *Current Report (Form 8-K)* (2015), <https://www.sec.gov/Archives/edgar/data/30554/000003055415000045/dd6915form8-ka.htm> (last visited Jun 25, 2020).

⁸⁹ See E. I. DU PONT DE NEMOURS AND COMPANY, *Proxy Statement (Schedule 14A)* 37 (2015), <https://www.sec.gov/Archives/edgar/data/30554/000104746915002563/a2223861zdefc14a.htm> (last visited Jun 25, 2020).

⁹⁰ Although Vanguard's holding of 50.1 million shares was less than Peltz's margin of defeat, if Vanguard did vote for one or more of the DuPont nominees, then switching from that nominee to Peltz would have created a swing of double its shareholding, or approximately 100.2 million votes.

⁹¹ See Novick Keynote Address, *supra* note 6 at 11, exh. 8 (listing support by various investment managers for shareholder proposals at Russell 3000 companies in 2019 and showing BlackRock as having the lowest level of support of the group).

⁹² See MORNINGSTAR, *Proxy Voting by 50 U.S. Fund Families* 8, exh. 3 (2019), <https://www.morningstar.com/lp/proxy-voting-esg> (last visited Mar 14, 2020). See also Novick Keynote Address, *supra* note 6 at 11, exh. 8 (showing Vanguard as having the second-lowest level of support for shareholder proposals at Russell 3000 companies in 2019, after BlackRock).

⁹³ For evidence of BlackRock and Vanguard's limited support of social and environmental proposals, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217–244, 225–228 (2018); MORNINGSTAR, *supra* note 92 at 12–14.

political spending and lobbying activity, but many of these proposals receive substantial support from shareholders.⁹⁴ At Exxon's annual meeting in 2019, a shareholder proposal in favor of lobbying transparency received the support of 37% of votes cast.⁹⁵ Had BlackRock and Vanguard both voted their sizable stakes in favor of that proposal it would have passed.⁹⁶

A report by Morningstar provides evidence of the potential effect of BlackRock and Vanguard's voting decisions.⁹⁷ The report identified 23 shareholder proposals that failed by 10% or less.⁹⁸ Either BlackRock or Vanguard voted against all of these proposals, and both of them voted against 20 of the 23 proposals. In all these cases, either or both BlackRock and Vanguard held positions of more than 5% of the company's stock, and often more than 10% of the company's stock.⁹⁹ Therefore, had either BlackRock or Vanguard switched their vote to support the proposal it would have passed.

Moreover, in many cases, even proposals that obtain substantial support but are not successful can create significant pressure for directors and managers to respond to shareholder concerns. For instance, advisors often advise companies that they should regard say-on-pay votes where less than 80% of shareholders vote in favor as a strong negative signal, requiring some response by directors.¹⁰⁰ Consistent with this advice, a study by Professors Yonca Ertimur, Fabrizio Ferri, and David Oesch found that "firms generally respond to high voting dissent" on say-on-pay votes, even where firms received majority support.¹⁰¹ Of the companies in that study that received between 70% and 75% support on say-on-pay proposals, 32%

⁹⁴ For data on BlackRock and Vanguard voting behavior on proposals regarding political spending, see Hirst, *supra* note 93 at 226–227; 244.

⁹⁵ See MORNINGSTAR, *supra* note 92 at 22.

⁹⁶ See *id.* at 22.

⁹⁷ See *id.* at 23, exh. 11.

⁹⁸ See *id.* at 23, exh. 11.

⁹⁹ See *id.* at 23, exh. 11.

¹⁰⁰ See, e.g., Edward Hauder, *Bouncing Back from a Low Say-On-Pay Vote*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/11/05/bouncing-back-from-a-low-say-on-pay-vote/> (last visited Jul 4, 2020) ("If your company's say-on-pay ... vote received less than 80% support, you will need to respond appropriately in next year's proxy ...").

¹⁰¹ See Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACC. RES. 951–996, 986 (2013).

responded with changes to their compensation plans.¹⁰² And of the firms receiving between 65% and 70% support, 72% responded with changes.¹⁰³

As discussed in section I.A, the Big Three collectively controlled, on average, 23.5% of the votes cast at annual meetings of S&P 500 companies in 2019. Had all of the Big Three switched from supporting a say-on-pay proposal to withholding, the proposal would be in the range of those described by Professors Ertimur, Ferri & Oesch, where directors are likely to respond with changes. The substantial holdings of the Big Three thus give them the power to exert substantial influence over directors and managers through their voting decisions, irrespective of the decisions of other investors.

B. The Effect of Vote Results on Corporate Outcomes

Mallow and Novick also argue that even if the Big Three were able to exert significant influence on the outcomes of shareholder votes, those vote outcomes have limited effects on how corporations are managed.¹⁰⁴ They give two reasons for this, which we discuss in turn: that many votes are merely advisory; and that directors, executives, and their advisors are the ones who determine how the corporation will be managed.

First, Mallow and Novick argue that say-on-pay proposals are merely advisory, and therefore that even if BlackRock or others were to cause those proposals to fail, directors and managers would not be required to follow the recommendation of the vote.¹⁰⁵ They are correct in pointing out that say-on-pay votes are not binding.¹⁰⁶ However, negative say-on-pay votes can still have a significant impact. Directors and managers prefer to avoid vote

¹⁰² See *id.* at 986.

¹⁰³ See *id.* at 986.

¹⁰⁴ For arguments by Mallow and Novick that shareholder votes are merely advisory, see Novick Keynote Address, *supra* note 6 at 5 (arguing that say-on-pay votes are advisory votes); MALLOW, *supra* note 7 at 28 (pointing out that say-on-pay votes are “non-binding, advisory ... votes”). For arguments that corporations are managed by directors, executives, and advisors, see *Id.* at 28. (arguing that compensation is determined by a board committee, on the advice of advisors, and that 90% of large U.S. public companies hire such advisors); Novick Keynote Address, *supra* note 6 at 5 (highlighting the “role of management,” “the role of the board,” and “how does the board engage with people like compensation consultants”).

¹⁰⁵ See Novick Keynote Address, *supra* note 6 at 5 (arguing that say-on-pay votes are advisory votes); MALLOW, *supra* note 7 at 28 (pointing out that say-on-pay votes are “non-binding, advisory ... votes”).

¹⁰⁶ See 17 C.F.R. § 240.14a-21 (2019) (requiring corporations to include advisory votes on executive compensation).

outcomes that indicate a significant lack of support, even if those proposals nonetheless pass.¹⁰⁷ In deciding which compensation arrangements to approve, directors are therefore likely to have regard for the likely level of support that those compensation arrangements will receive in future say-on-pay votes. That is, directors are likely to avoid compensation arrangements that they expect will attract significant opposition in future say-on-pay votes, or otherwise take steps to avoid such opposition.¹⁰⁸

Second, Mallow and Novick argue that corporate decisions are not made by shareholders, but instead are made by directors, managers, and advisors.¹⁰⁹ As a result, rather than most U.S. corporations being substantially influenced by Big Three through their very large shareholdings, Mallow and Novick argue that there are thousands of individuals who collectively manage these corporations. Novick states that “there are over 28,000 unique individuals involved in running and setting strategy at US companies.”¹¹⁰ Mallow elaborates, explaining that these include “approximately 3,900 CEOs ... and 24,100 board directors.”¹¹¹

However, this overlooks an important fact regarding the power of shareholders in general, and the Big Three in particular. First, shareholders have significant power because they can ultimately remove directors.¹¹² That is, if investors are not happy with the performance of directors, they can nominate competing directors for election. If BlackRock, Vanguard, SSGA, and other investors do not support the incumbent directors, then they will be replaced by these competing directors. As a result, the decisions of the thousands of directors that Mallow and Novick mention are made against the background of investors’ power to replace those directors. Those

¹⁰⁷ See, e.g., Hauder, *supra* note 100.

¹⁰⁸ See, e.g., David Whissel, *Responding to a Negative Say-on-Pay Outcome* (2016), <https://corpgov.law.harvard.edu/2016/10/27/preparing-for-and-responding-to-a-negative-say-on-pay-outcome/> (last visited Jul 4, 2020) (advising corporations to “plan ahead ... to overcome the setback of a negative recommendation and earn the support of their investors” and the importance of “responsive action” following a negative say-on-pay vote).

¹⁰⁹ See MALLOW, *supra* note 7 at 28 (arguing that compensation is determined by a board committee, on the advice of advisors, and that 90% of large U.S. public companies hire such advisors); Novick Keynote Address, *supra* note 6 at 5 (highlighting the “role of management,” “the role of the board,” and “how does the board engage with people like compensation consultants”).

¹¹⁰ Novick Keynote Address, *supra* note 6 at 5.

¹¹¹ MALLOW, *supra* note 7 at 29.

¹¹² See, generally, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

directors are influenced by that possibility, which constrains their ability to make decisions that are likely to undermine investors' support.

III. MARKET PERCEPTIONS OF BIG THREE POWER

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

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

A. Communications by Management Advisors

This section considers how those who advise corporate directors and executives—lawyers, governance advisors, proxy solicitors, investment bankers, and others—consider the power and influence of the Big Three. Statements made by these advisors commonly reflect explicitly or implicitly their recognition of the Big Three's power. This recognition is reflected in the close attention that these advisors pay to the actions and policy statements of the Big Three, and the great frequency and considerable detail with which they bring these actions and statements to the attention of corporate managers.

As this section documents, each time one of the Big Three revises its voting guidelines, issues a policy statement, or sends a letter to a group of

portfolio companies, law firms and other advisors release memos to their clients describing and analyzing such actions, and this focus dwarfs the attention these advisors pay to other investors. This is illustrated, for example, in the particular attention that management advisors have paid to recent changes in the Big Three’s policies to provide greater support for environmental, social, and governance proposals, and in some cases, to engage with directors and executives to promote corporate changes regarding environmental and social objectives.

Lawyers advising corporate managers have spoken clearly on the power and influence of the Big Three. An interview with prominent lawyer Martin Lipton describes his view that “[t]he large stakes held by [the Big Three], along with their long-term investment horizons, make them a centerpiece of good governance.”¹¹³ Other prominent law firms have echoed this view.¹¹⁴

Consistent with this view, law firms pay close attention to changes in the Big Three’s policies, as well as their engagement and voting behavior. In an annex to a client memo concerning changes in voting policies and decisions by investors, law firm Wachtell, Lipton, Rosen & Katz lists 15 different investors’ policies.¹¹⁵ But the body of the memo discusses only

¹¹³ John Jannarone, *Martin Lipton Says Latest Steps by Big Institutions Align Well with “The New Paradigm”*, YAHOO! FINANCE (2019), <https://finance.yahoo.com/news/exclusive-martin-lipton-says-vanguard-202453971.html> (last visited Jun 16, 2020)

¹¹⁴ For example, Sullivan & Cromwell state that “Concentration of equity ownership, particularly among the largest three index fund providers, continues to be a key component in the activism landscape. As of December 2018, one of BlackRock, Vanguard or State Street was the largest shareholder in 438 of the S&P 500 companies, roughly 88%, and collectively the three firms owned 18.7% of all shares in the S&P 500.” H. Rodgin Cohen et al., *Annual Review and Analysis of 2019 U.S. Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/11/20/annual-review-and-analysis-of-2019-u-s-shareholder-activism/> (last visited Aug 10, 2020). And Kirkland & Ellis has also emphasized the “position of strength” of the Big Three, stating that “BlackRock, State Street and Vanguard—the three largest “passive” managers—now control approximately 20 percent of the value of the S&P 500 and collectively constitute the single largest shareholder in almost 90 percent of S&P 500 firms.” David Feirstein, Sarkis Jebejian & Shaun Mathew, *Purpose, Culture and Long-Term Value—Not Just a Headline*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/26/purpose-culture-and-long-term-value-not-just-a-headline/> (last visited Aug 10, 2020).

¹¹⁵ Andrew Brownstein, Justin Nowell & Sabastian Niles, *Institutional Investors Signal: A Mix of Tougher Standards and Heightened Flexibility for the 2020 Proxy Season*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/05/02/institutional-investors-signal-a-mix-of-tougher-standards-and-heightened-flexibility-for-the-2020-proxy-season/> (last visited Aug 10, 2020).

SSGA and Vanguard, and spends a majority of its discussion on an in-depth analysis of their policies.¹¹⁶ Many law firms publish releases describing the annual letters issued by the Big Three.¹¹⁷ Many law firms have also published releases describing changes in the Big Three's policies, engagement, and voting, on topics such as board composition,¹¹⁸ board diversity,¹¹⁹ and environmental matters.¹²⁰

¹¹⁶ *Id.*

¹¹⁷ See, e.g., Ning Chiu, *State Street and Corporate Culture Engagement*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/04/state-street-and-corporate-culture-engagement/> (last visited Jul 18, 2019) (Davis Polk & Wardwell); David Katz & Laura McIntosh, *Sustainability in the Spotlight*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/01/27/sustainability-in-the-spotlight/> (last visited Aug 10, 2020) (Wachtell, Lipton, Rosen & Katz); Holly Gregory, *Looking Ahead: Key Trends in Corporate Governance*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/01/10/looking-ahead-key-trends-in-corporate-governance/> (last visited Aug 10, 2020) (Sidley Austin); Amy Simmerman et al., *A Guidebook to Boardroom Governance Issues*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/11/08/a-guidebook-to-boardroom-governance-issues/> (last visited Aug 10, 2020) (Wilson, Sonsini, Goodrich & Rosati); Brennan Halloran, Elizabeth Bieber & Pamela Marcogliese, *Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/28/synthesizing-the-messages-from-blackrock-state-street-and-t-rowe-price/> (last visited Aug 10, 2020) (Cleary Gottlieb Steen & Hamilton).

¹¹⁸ See, e.g., Sabastian Niles, *Board Development and Director Succession Planning in the Age of Shareholder Activism, Engagement and Stewardship*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/06/07/board-development-and-director-succession-planning-in-the-age-of-shareholder-activism-engagement-and-stewardship/> (last visited Aug 10, 2020) (WLKR); Marc Gerber, *US Corporate Governance: Turning Up the Heat*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/10/us-corporate-governance-turning-up-the-heat/> (last visited Aug 10, 2020) (Skadden).

¹¹⁹ See, e.g., Gail Weinstein, Philip Richter & Warren de Wied, *The Road Ahead for Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/> (last visited Aug 10, 2020) (Fried Frank); Betty Moy Huber & Paula H. Simpkins, *Women Board Seats in Russell 3000 Pass the 20% Mark*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/10/05/women-board-seats-in-russell-3000-pass-the-20-mark/> (last visited Aug 10, 2020) (DPW); Andrew Brownstein, Steven Rosenblum & Victor Goldfeld, *Mergers and Acquisitions—2019*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/01/15/mergers-and-acquisitions-2019/> (last visited Aug 10, 2020) (WLRK); Courtney Mathes et al., *Preparing for the 2020 Reporting Season*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/12/26/preparing-for-the-2020-reporting-season/> (last visited Aug 10, 2020) (WSGR).

¹²⁰ See, e.g., Elizabeth Ising & Gillian McPhee, *Considerations for 2020 Proxy Statement Preparations*, HARV. L. SCH. F. ON CORP. GOV. (2020),

Governance advisors who assist managers in engaging with investors and in preparing disclosures for investors have also called attention to the importance and influence of the Big Three, and closely follow changes in Big Three policies and activities. For instance, leading governance advisor Camberview Partners (now PJT Camberview) stated in 2017 that “passive investors are increasingly important” because “one of the three biggest index funds (BlackRock, Vanguard and State Street) is the largest single shareholder in 88% of companies in [the S&P 500] index.”¹²¹ As a result of this power, Camberview explains, the topics of concern to the Big Three have become “a critical focal point in activist campaigns.”¹²²

Camberview goes on to describe how the voting decisions of the Big Three have also become central to say-on-pay votes, with changes in the Big Three’s voting policies “heighten[ing] the need to engage with investors to bring them along.”¹²³ Camberview and other governance advisors, such as EY, PricewaterhouseCoopers, and Deloitte, have paid close attention to the annual letters released by the Big Three regarding their priorities,¹²⁴ as

<https://corpgov.law.harvard.edu/2020/02/20/considerations-for-2020-proxy-statement-preparations/> (last visited Aug 10, 2020) (Gibson Dunn); William Savitt, *Tectonic Forces to Watch in Corporate Litigation*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/01/30/tectonic-forces-to-watch-in-corporate-litigation/> (last visited Aug 10, 2020) (WLRK); Catherine Clarkin et al., *The Rise of Standardized ESG Disclosure Frameworks in the United States*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/06/22/the-rise-of-standardized-esg-disclosure-frameworks-in-the-united-states/> (last visited Aug 10, 2020) (Sullivan & Cromwell).

¹²¹ Derek Zaba & Peter Michelsen, *The Rise of Investor-Centric Activism Defense Strategy*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/10/25/the-rise-of-investor-centric-activism-defense-strategy/> (last visited Aug 10, 2020).

¹²² *Id.*

¹²³ Christopher Wightman & David Martin, *The Investor View on Executive Compensation in 2018*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/04/18/the-investor-view-on-executive-compensation-in-2018/> (last visited Aug 10, 2020) (discussing the impact of changes in SSGA’s voting policies on executive compensation).

¹²⁴ See, e.g., Abe M. Friedman et al., *BlackRock’s Call for Companies to Deliver Financial & Social Value*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/02/06/blackrocks-call-for-companies-to-deliver-financial-social-value/> (last visited Aug 10, 2020) (release from Camberview regarding BlackRock’s 2018 letter); Amy Brachio, Jennifer Lee & Steve Klemash, *Board Members Preparedness for Major Risk Event Like COVID-19*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/05/06/board-members-preparedness-for-major-risk-event-like-covid-19/> (last visited Aug 10, 2020) (release from EY regarding BlackRock’s 2020 letter).

well as on particular changes in the Big Three's voting policies, engagement, and voting decisions, on topics such as board composition,¹²⁵ board diversity,¹²⁶ and the environment.¹²⁷

In advising their clients, investment banks have also emphasized the power of the Big Three, and, with it, the importance of the Big Three's activities. For instance, in a release describing activism developments in 2018, investment bank Lazard stated that the “[i]nfluence of passive investors continued to strengthen as Vanguard, BlackRock, and State Street now own ~18% of the S&P 500 vs. ~14% in 2012.”¹²⁸ In other releases Lazard emphasized the influence of the Big Three in proxy contests, describing a proxy contest involving Taubman Centers, Inc., in which “[c]ompany engagement with Vanguard and BlackRock reportedly swung

¹²⁵ See, e.g., Paul DeNicola & Paula Loop, *Investors and Board Composition*, HARV. L. SCH. F. ON CORP. GOV. (2016), <https://corpgov.law.harvard.edu/2016/05/26/investors-and-board-composition/> (last visited Aug 10, 2020) (PWC); Ann Yerger & Ruby Sharma, *Three Things Nominating Committees Need to Know*, HARV. L. SCH. F. ON CORP. GOV. (2016), <https://corpgov.law.harvard.edu/2016/02/14/three-things-nominating-committees-need-to-know/> (last visited Aug 10, 2020) (EY).

¹²⁶ See, e.g., Catie Hall et al., *2019 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/10/28/2019-proxy-season-review/> (last visited Aug 10, 2020) (PWC); Cid Wilson et al., *Missing Pieces Report: The 2018 Board Diversity Census of Women and Minorities on Fortune 500 Boards*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/02/05/missing-pieces-report-the-2018-board-diversity-census-of-women-and-minorities-on-fortune-500-boards/> (last visited Aug 10, 2020) (Deloitte); Abe M. Friedman et al., *BlackRock's Call for Companies to Deliver Financial & Social Value*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/02/06/blackrocks-call-for-companies-to-deliver-financial-social-value/> (last visited Aug 10, 2020) (Camberview); Mark Manoff & Steve Klemash, *2017 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/07/09/2017-proxy-season-review/> (last visited Aug 10, 2020) (EY).

¹²⁷ Abe Friedman et al., *BlackRock's 2017-2018 Engagement Priorities*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/03/17/blackrocks-2017-2018-engagement-priorities/> (last visited Aug 10, 2020) (Camberview); Manoff and Klemash, *supra* note 126 (EY); Paula Loop, *Insights from PwC's 2017 Annual Corporate Directors Survey*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/10/31/insights-from-pwcs-2017-annual-corporate-directors-survey/> (last visited Aug 10, 2020) (PWC); Christine Robinson et al., *The Atmosphere for Climate-Change Disclosure*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/04/05/the-atmosphere-for-climate-change-disclosure/> (last visited Aug 10, 2020) (Deloitte).

¹²⁸ See Jim Rossman, *Lazard's IQ 2018 Activism Review*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/04/20/lazards-iq-2018-activism-review/> (last visited Aug 10, 2020).

the ... proxy contest in management's favor."¹²⁹ Lazard has also emphasized the importance of the Big Three's focus on corporate purpose, and their ESG efforts.¹³⁰

Finally, we note that even Proxy advisors ISS and Glass, Lewis & Co., who advise investors but have considerable influence on the corporate governance landscape as a whole, have devoted particular attention to the Big Three's policies, voting, and engagement on environmental and social issues. ISS discussed the importance of BlackRock's focus on sustainable investment and the likely effect that the move would have because of BlackRock's size.¹³¹ Both ISS and Glass Lewis commented on BlackRock's engagement with firearms manufacturers and retailers.¹³² Both proxy advisors have also commented on SSGA's engagements with issuers regarding board diversity, and the voting policies and practices of

¹²⁹ See Jim Rossman, *Review of Shareholder Activism—IH 2017*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/07/25/review-of-shareholder-activism-1h-2017/> (last visited Aug 10, 2020).

¹³⁰ For Lazard releases discussing the Big Three's focus on corporate purpose, see Jim Rossman, *Lazard's 1Q 2019 Activism Review*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/04/22/lazards-1q-2019-activism-review/> (last visited Aug 10, 2020) (discussing how “[p]assive managers are using their increasing influence to discuss how corporate culture and purpose can affect long-term performance”); Jim Rossman, *2018 Review of Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/01/28/2018-review-of-shareholder-activism/> (last visited Aug 10, 2020) (“BlackRock's Larry Fink set the tone for the year, calling on companies to identify and follow through on their social purpose”); Rossman, *supra* note 128 (“ESG issues have attracted significant attention by passive investors, who are pushing companies to serve a broader social purpose in their communities”). For a Lazard release focusing on the Big Three's ESG efforts, see (“Increasing importance has driven these firms to materially expand their ESG efforts, with BlackRock pledging to double its stewardship team's headcount and Vanguard establishing a European stewardship presence”).

¹³¹ ISS, *BlackRock Announces New Strategy of Sustainable Investing*, ISS GOVERNANCE (2020), <https://insights.issgovernance.com/posts/blackrock-announces-new-strategy-of-sustainable-investing/> (last visited Jul 6, 2020).

¹³² See, e.g., Damien Fruchart, Michael Jenks & Verena Simmel, *Firearms—Investor Responses amid Political Inaction*, HARV. L. SCH. F. ON CORP. GOV. (2019), <https://corpgov.law.harvard.edu/2019/09/09/firearms-investor-responses-amid-political-inaction/> (last visited Aug 10, 2020) (ISS release commenting on BlackRock's announcement of its engagement with firearms manufacturers and retailers); Courtney Keatinge, *Investor Pressure on Firearms Manufacturers*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/03/18/investor-pressure-on-firearms-manufacturers/> (last visited Aug 10, 2020) (Glass, Lewis & Co. release commenting on BlackRock's announcement of its engagement with firearms manufacturers and distributors).

BlackRock, and Vanguard, and SSGA in supporting increased board diversity.¹³³

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

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

This attention is reserved for the Big Three; advisors do not pay such attention to changes in the voting guidelines or policies of other institutional investors. For instance, as section II.B describes, the California State Teachers' Retirement System ("CalSTRS") has been advocating for greater gender diversity on corporate boards since 2009, and has received limited attention from advisors and the media.¹³⁴ But the announcement by SSGA and BlackRock that gender diversity on boards would become one of their primary focal points generated considerable media coverage, and garnered close attention and analysis from corporate advisors, both far beyond what the positions of CalSTRS ever attracted.¹³⁵ The focus of advisors and the

¹³³ See Brianna Castro & Starlar Burns, *Raising the Stakes on Board Gender Diversity*, HARV. L. SCH. F. ON CORP. GOV. (2018), <https://corpgov.law.harvard.edu/2018/01/08/raising-the-stakes-on-board-gender-diversity/> (last visited Aug 10, 2020) (Glass, Lewis & Co. release commenting on SSGA's engagement campaign and voting regarding board diversity, BlackRock's support for board diversity proposals, and Vanguard's letter advocating for greater board diversity); Kosmas Papadopoulos & Subodh Mishra, *Governance Improvements in 2017*, HARV. L. SCH. F. ON CORP. GOV. (2017), <https://corpgov.law.harvard.edu/2017/11/29/governance-improvements-in-2017/> (last visited Aug 10, 2020) (ISS release describing SSGA, BlackRock, and Vanguard's actions and policies supporting board diversity).

¹³⁴ See *infra* notes 149-150 and accompanying text.

¹³⁵ See *supra* notes 119, 126 and accompanying text.

media on the Big Three, far more than on any other investors, is not because they are the first to address these issues, but because of the considerable power and influence they wield.

B. The Big Three's Own Communications

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

Each of the Big Three claims that their engagements have had significant impact. For instance, about one-third of BlackRock's 2019 Investor Stewardship Report is devoted to "Engagement and voting case studies," which describe various ways in which BlackRock has engaged with corporations, and the impact that its engagements have had.¹³⁶ SSGA devotes an entire section of its Stewardship Report for 2018-2019 to the "Impact of [its] Stewardship: Voting and Engagement Stories."¹³⁷ And Vanguard's 2019 Stewardship Report is interspersed with many anecdotes about how Vanguard's engagements influenced the directors and executives of its portfolio corporations to address Vanguard's concerns.¹³⁸

Three examples from BlackRock's own descriptions of its engagements serve to demonstrate its influence. First BlackRock states that "[i]n the US, director board commitments have been a longstanding engagement topic," and then explains that "[w]e believe the focus on this topic has contributed to the reduction in the average number of boards on which directors sit."¹³⁹ BlackRock provides evidence to support this claim: "[T]oday, the

¹³⁶ See BLACKROCK, *2019 Investment Stewardship Annual Report* 10–22 (2019), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf> (constituting 12 pages of the report, which is 38 pages in total, of which 8 pages are appendices).

¹³⁷ See STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019* 80–87 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>.

¹³⁸ See, e.g., VANGUARD, *Investment Stewardship 2019 Annual Report* 15 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf (regarding engagements on board composition); *Id.* at 21. (regarding engagements on strategy and risk); *Id.* at 25 (regarding engagements on executive compensation); *Id.* at 27 (regarding engagements on governance structures).

¹³⁹ BLACKROCK, *supra* note 136 at 11.

percentage of non-CEO directors sitting on more than four boards has decreased from 8.8% in 2008 to 6.7% in 2019. In addition, more than three-quarters of S&P 500 boards have established some limit on their directors' ability to accept other corporate directorships, an increase from 56% in 2008."¹⁴⁰

Second, BlackRock also describes its "engage[ments] with many companies for multiple years on the relationship between board diversity and board effectiveness."¹⁴¹ It explains that, in 2018, it "sent a letter to the companies within the Russell 1000 (approximately 30%) that had fewer than two women on their board. This year, we began voting against the re-election of directors ... at companies that did not publish a clear policy on board diversity or that hadn't improved diversity in the boardroom."¹⁴² BlackRock then points to improvements in boardroom diversity, and explains that "[i]n our view, the acceleration in the increase in the number of women on public company boards is, in part, attributable to the engagement undertaken by investors, including voting on director elections."¹⁴³

Finally, BlackRock, explains how it engages with management in situations where another shareholder "uses its equity stake in a corporation to pressure management to make changes to the company's governance, operations, or strategy."¹⁴⁴ BlackRock "highlight[s] an example of an engagement that improved the terms offered to shareholders during an unusual reverse merger transaction," which involved "multiple engagements and involved a number of conversations with management of the private company, various external advisors of the private company, and the two public companies party to the transaction."¹⁴⁵ Following these engagements, BlackRock explains, the companies put forward a "revised deal [which] provided a US \$5 billion overall value-add when compared to the original valuation. Additionally, the company agreed to appoint a new independent board member. Our engagements and the resulting value-add

¹⁴⁰ *Id.* at 11 (footnotes omitted).

¹⁴¹ *Id.* at 12.

¹⁴² *Id.* at 12.

¹⁴³ *Id.* at 12.

¹⁴⁴ *Id.* at 23.

¹⁴⁵ *Id.* at 23.

to this contested situation underscores [BlackRock's] role as an investment function focused on delivering value for our clients."¹⁴⁶

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

Consider the example of gender diversity on corporate boards, mentioned among BlackRock's success stories above. SSGA has also devoted significant attention and engagement to its "Fearless Girl Campaign" for positive change on gender diversity, which it refers to as a "Core Campaign Focus."¹⁴⁷ In describing "The Impact of Fearless Girl in 2018/19," SSGA explains that "[a]fter two years of productive engagements and voting, we are delighted to report that since the introduction of Fearless Girl in March 2017, 577 companies or approximately 43% of the companies we identified have responded to our call by adding a female director, with another six having committed to do so."¹⁴⁸

SSGA thus suggests that their campaign has had a significant impact on the representation of women on boards. Assuming that this is correct, how were they able to have such an effect? A number of other institutional investors before them have attempted to advance the representation of women on corporate boards. For instance, starting in 2009, CalSTRS put forward a number of shareholder proposals seeking greater board diversity.¹⁴⁹ In 2014 CalSTRS wrote letters to the 131 companies in its portfolio that had no women on their boards, offering to help improve board diversity.¹⁵⁰ However, at least according to BlackRock and SSGA, their engagement on the issue of board diversity had a much greater effect. This is consistent with the power and influence that comes from the Big Three's substantial stakes.

¹⁴⁶ *Id.* at 23.

¹⁴⁷ STATE STREET GLOBAL ADVISORS, *supra* note 137 at 34.

¹⁴⁸ *Id.* at 36.

¹⁴⁹ See California State Teachers' Retirement System, *Firms Answer CalSTRS Call for Increased Diversity on Boards*, CALSTRS.COM (2009), <https://www.calstrs.com/news-release/firms-answer-calstrs-call-increased-diversity-boards> (last visited Aug 10, 2020).

¹⁵⁰ See California State Teachers' Retirement System, *CalSTRS Gets Rapid Response to Board Diversity Effort*, CALSTRS.COM (2014), <https://www.calstrs.com/news-release/calstrs-gets-rapid-response-board-diversity-effort> (last visited Aug 10, 2020).

Just as the Big Three's decisions to push for reforms like increased board diversity can have a substantial impact on their portfolio companies, the Big Three must recognize that their decisions *not* to push for improvements on other matters also have an effect on their portfolio companies and the corporate governance of those companies. Many of those changes are more likely to take place if the Big Three actively exercise their power and influence to support those changes. To take just one example, the voting policies of the Big Three currently support annual elections, and the Big Three generally vote to support shareholder proposals pushing for annual elections when they are put forward at companies.¹⁵¹ However, 1,157 companies in the Russell 3000 (39% of such companies) had staggered boards rather than annual elections in 2019.¹⁵²

Had the Big Three taken a more active stance in favor of annual elections, rather than simply supporting proposals put forward by others, there may have been greater moves towards annual elections. For instance, the Big Three could have threatened to withhold support from certain directors on any boards that did not have annual elections, as BlackRock and SSGA did for boards with no women directors.¹⁵³ Such a move is likely to have led to more corporations moving to annual elections. That more companies have not moved to annual elections cannot therefore be due to a lack of power on the part of the Big Three, but is rather due to the Big Three's choice not to use the substantial power they have.

IV. DISTORTED INCENTIVES

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

¹⁵¹ For the Big Three's voting guidelines expressing broad support for proposals to introduce annual elections see Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2103 n. 193. For the Big Three's voting support for annual elections, see *Id.* at 2103–2014. (finding that BlackRock, SSGA, and Vanguard voted in favor of a majority of proposals on, among other things, board declassification from 2014 to 2018).

¹⁵² Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2014 (citing data as of June 30, 2019).

¹⁵³ See *supra* notes 141-143 and accompanying text (regarding BlackRock's engagements on board diversity) and *supra* notes 147-148 and accompanying text (regarding SSGA's engagements on board diversity).

lack thereof) presented by academic commentators and the Big Three themselves.

We begin in Section A with the Big Three's incentive to under-invest in stewardship. We consider the responses of academic commentators and the Big Three themselves to the claim that the Big Three have incentives to under-invest. Section B then considers the incentive of the Big Three to be excessively deferential to corporate managers, and explains that those challenging the agency-cost account of index fund stewardship have thus far failed to address the

A. Under-Investment in Stewardship

1. The Under-Investment Problem

One type of undesirable incentive that we already discussed in our prior work concerns the incentive of each of the Big Three managers to under-invest in stewardship compared with the level of investment that would serve the interests of their beneficial investors.¹⁵⁴ Investment in stewardship will be desirable if, and only if, the marginal gain to that portfolio of the index fund exceeds the marginal cost of the investment. Even though this level will be optimal for the fund's investors, it is likely to be less than the optimal level for the corporation as a whole, because the investors in the fund will only capture a small portion of gains to the company as a whole. However, even taking this into account, the substantial size of the index fund managers' stake may justify a similarly substantial investment in stewardship. But our analysis shows that the Big Three are likely to invest substantially less than this amount in stewardship activities.

This is because the investment manager's sole return from investing in stewardship comes from a potential increase in their fee income from the assets they manage. And the percentage of the assets under management charged by the Big Three in fees is very small. The average fees charged by BlackRock, Vanguard, and SSGA in 2018 were 0.3%, 0.09%, and 0.17%, respectively.¹⁵⁵ Therefore, if BlackRock were to undertake stewardship activities that brought about an increase in the value of its portfolio by \$1 million, BlackRock would earn an extra \$3,000 in fees. If the increase could

¹⁵⁴ For a discussion of index fund incentives to under-invest in stewardship, see Bebhuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2050–59.

¹⁵⁵ See MORNINGSTAR, INC., *U.S. Fund Fee Study* 12 (2019), <https://www.morningstar.com/blog/2019/04/30/us-fund-fee-study.html>.

be sustained for some time, BlackRock could earn this additional amount for several years. But even if that is the case, the amount that BlackRock earns from undertaking stewardship is a tiny fraction of the \$1 million benefit that its stewardship would bring to its portfolio. It would be optimal from the perspective of investors in the portfolio to spend up to \$1 million to bring about the \$1 million increase in the portfolio. But BlackRock itself will only be willing to invest up to \$3,000 in stewardship.

A number of academic commentators have contested the under-investment claim, or put forward arguments that are inconsistent with it. In this section we consider and respond to four types of objections: arguments that index fund managers do indeed have incentives to undertake stewardship, (i) because it may allow them to compete more effectively with active managers; (ii) because of the *size* of their portfolios; and (iii) because of the *breadth* of their portfolios; and (iv) that index funds *do not* have incentives to undertake stewardship, but that their lack of incentive is natural or appropriate.

2. *Objections Based on Incentives to Attract Additional Funds*

The first type of argument against under-investment that has been raised by academics critical of our approach is that stewardship might allow index fund managers to attract additional investments. This is the case because the index fund managers compete with other investment fund managers, based on returns.¹⁵⁶ There is evidence that investors “chase” past returns, and may be willing to move their investments to investment fund managers that have recently outperformed their competitors.¹⁵⁷ Implicit in this claim is that, were the Big Three to undertake investor stewardship that increased their returns above that of their competitors, then they could attract additional funds from investors, which would bring with them greater fee revenue for the index fund manager.

However, investment stewardship by one index fund manager is unlikely to create any such competitive advantage, because funds managed by other index fund managers will capture exactly the same returns from

¹⁵⁶ See, e.g., Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 37 (arguing that index fund managers compete against active managers through investor stewardship).

¹⁵⁷ For evidence that investors “disproportionately flock to high performing funds,” see Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 THE JOURNAL OF FINANCE 1589, 1598–1601, 1619 (1998).

the stewardship activity.¹⁵⁸ This is implicit in the nature of index fund investing; each index fund holds the same stocks, in the same proportion. So, a gain created by one manager will be shared by the funds of all managers tracking that index. If the costs of stewardship were taken into account, the index fund undertaking the stewardship would perform *worse* than its competitors.

Thus far our analysis has focused on competition among different index fund managers. But the same argument will apply to the many actively managed funds that hold the same stock in the same proportions as index funds, known as “shadow indexing” or “closet indexing.”¹⁵⁹ An index fund undertaking value-increasing stewardship at a company would also perform *worse* than active managers who held a greater proportion of that company’s stock than the index.¹⁶⁰

Professors Fisch, Hamdani, and Solomon argue that index fund managers have incentives to invest in stewardship activities because they compete for investors’ funds, not only with other index fund managers, but also with actively managed funds.¹⁶¹ They argue that investing in stewardship activities will eliminate potential advantages of such actively managed funds, that might otherwise allow them to outperform index fund managers.¹⁶²

However, even if index fund managers were to invest substantially in stewardship activities, this would not allow them to compete effectively with active managers, because those same stewardship activities will cause some active managers to outperform the index fund managers. Active managers who disproportionately hold positions in companies that increase in value as a result of the stewardship activities will outperform the index fund managers undertaking the stewardship. The investment stewardship activities will therefore not allow the index fund managers to capture any

¹⁵⁸ See Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2057–2058.

¹⁵⁹ For evidence that a substantial number of active funds have a high degree of shadow indexing, see K. J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FINANC. STUD. 3329–3365 (2009).

¹⁶⁰ See Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2059.

¹⁶¹ See Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 32 (arguing that index fund managers compete for funds “not only with each other but also with . . . active funds”).

¹⁶² See *id.* at 37 (“[Passive funds] lack the active funds’ ability to generate alpha through investment choices. Passive investors also do not have the firm-specific information or expertise necessary to address operational issues. Instead, passive investors compete by using their voice and seeking to improve corporate governance.”).

additional investment assets, and they may actually lose investment assets to the actively managed funds that disproportionately hold the companies in which they undertake stewardship.¹⁶³

3. *Objections Based on the Size of Big Three Stakes*

The second set of arguments against under-investment in stewardship claim that index funds do have incentives to undertake stewardship because of the significant size of their holdings. Critics of under-investment have argued that the large stakes that index fund managers hold in many companies is sufficient to incentivize them to undertake stewardship.¹⁶⁴ However, this argument is incorrect, because it fails to recognize the very small fraction of the benefits produced by stewardship that index fund managers capture, because of the very low fees that they charge.¹⁶⁵ Our analysis shows that the small fraction of the benefits that index fund managers would capture from stewardship would be insufficient to lead them to invest in stewardship to the level that would best serve the interests of their own beneficial investors.

4. *Objections Based on the Breadth of Index Fund Holdings*

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

¹⁶³ For another criticism of the argument that competition with active funds might lead index fund managers to undertake stewardship, see generally J. B. HEATON, *All You Need is Passive: A Response to Professors Fisch, Hamdani, and Davidoff Solomon* (2018), <https://papers.ssrn.com/abstract=3209614> (last visited Aug 2, 2018).

¹⁶⁴ See, e.g., Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 35–36 ("The size of the Big Three enables them to capture outsize benefits from [investments in corporate governance]."); Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 *BUSINESS AND POLITICS* 327, 338 (2019) ("[T]he Big Three asset managers have such large asset bases . . . that the cost of engagement is minimal when compared to the profits they generate." (footnote omitted)); Kahan and Rock, *supra* note 10 at 15 (noting that "even these low fees [of index fund managers] generate incentives in the context of voting that compare favorably to those of most other shareholders because the principal advisors to equity index funds are very large . . .").

¹⁶⁵ For a discussion of index fund fee levels, see Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2056.

companies.¹⁶⁶ These authors implicitly argue that index fund managers will be *more* likely to undertake investment stewardship than other investment managers. For example, Professors Fisch, Hamdani, and Solomon suggest that these economies of scale lead index fund managers to be involved in rulemaking by the Securities and Exchange Commission (SEC).¹⁶⁷

Another version of the breadth argument made by academic commentators is that, because index funds hold stakes in so many corporations, they benefit the most from “spillover effects” that their stewardship activities at particular companies may have for other companies in their portfolio. As an example of an activity that has demonstrated economies of scale, SSGA has cited the effects of its “thought leadership work” on corporate behavior.¹⁶⁸ These arguments suggest that index fund managers are both well placed to contribute to corporate governance improvements in many companies, and that they are likely to make such improvements.¹⁶⁹

A third breadth argument, made by Professor Jeff Gordon, is that investment managers have incentives to undertake “systematic stewardship,” by which Professor Gordon refers to stewardship to reduce the systematic risk across companies in their portfolios, and thereby

¹⁶⁶ See, e.g., Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 26 (arguing that passive funds “are able to aggregate the size of their substantial holdings as well as the information provided by all their investments and to spread the cost of obtaining information across their entire portfolio”); Kahan and Rock, *supra* note 10 at 34–35 (arguing that “[i]nvestment advisers whose assets under management include shares in a large number of companies benefit the most from the economies of scope related to issue-specific information.”); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507, 515–516 (2019) (arguing that substantial aggregate ownership by investment managers is “likely to improve institutional investors’ incentives and ability to monitor companies in which they invest when dealing with macro legal risks”).

¹⁶⁷ See Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 54 (“Passive investors regularly comment upon and call for change to the rules adopted by the SEC under federal securities laws.”).

¹⁶⁸ See, e.g., Constable, *supra* note 9 (citing a SSGA officer stressing the “extensive thought leadership work that [SSGA] believes influences corporate behavior”).

¹⁶⁹ See, e.g., Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 39 (“Passive investors are well-placed to evaluate such provisions and to determine whether these provisions are likely, as a general matter, to increase or decrease firm value at the majority of portfolio companies. They are also more likely to internalize any spillover effects that may arise from governance provisions.” [Citations omitted]).

increase risk-adjusted portfolio returns.¹⁷⁰ Candidates for such stewardship would include climate change risk, financial stability risk, and social stability risk.¹⁷¹

These breadth-based objections fail for two reasons. First, there are many matters in which company-specific information is valuable, such as those relating to the corporation's specific business circumstances.¹⁷² On these matters, investors must devote considerable time and attention to the company's specific circumstances, and economies of scale are less likely to be relevant. Similarly, there are some issues that cannot be expected to have significant spillover effects to other firms, where broad portfolio holdings will not provide greater incentives to undertake stewardship. Professors Kahan and Rock, in particular, acknowledge these points.¹⁷³

Second, our empirical evidence also provides a response regarding those types of activities for which there are economies of scale, and those activities that might provide spillover benefits to other portfolio companies. We agree that undertaking stewardship on these matters would be beneficial for the beneficial investors in index funds. However, the empirical evidence that we present in prior work shows that index fund managers do not undertake some of these activities at all, and undertake other activities only in a very small proportion of their portfolio companies. That evidence shows that index fund managers do not, for instance, put forward shareholder proposals, and do not contribute substantially to corporate governance legal reforms.¹⁷⁴ This is despite the fact that other organizations have achieved significant economies of scale through submitting

¹⁷⁰ See JEFFREY N. GORDON, *Systematic Stewardship* 14 (2020) (describing systematic stewardship as focusing on reducing systematic risk to increase risk-adjusted portfolio returns).

¹⁷¹ See *id.* at 18–22 (describing candidates for systematic stewardship).

¹⁷² See, e.g., Bebchuk and Hirst, *supra* note 3, *Index Fund Incentives*, at 2090 (describing company-specific information required for stewardship decisions).

¹⁷³ See, e.g., Kahan and Rock, *supra* note 10 at 36 ("The information that is material to a vote on any particular issue consists of some mix of issue-specific information [and] company-specific information . . .").

¹⁷⁴ See Bebchuk and Hirst, *supra* note 3, *Index Fund Incentives*, at 2101–2105 (describing evidence that the Big Three did not submit any shareholder proposals on corporate governance matters between 2014 and 2018); *id.* at 2105–2112 (describing evidence that the Big Three submitted many fewer comment letters on SEC rulemaking proposals than pension funds with much smaller amounts of assets under management, and did not submit any amicus briefs in important cases regarding corporate governance).

shareholder proposals, and regularly contribute to corporate governance reforms.¹⁷⁵

Those economies of scale also mean that these tools could be very effective in reducing climate risk, financial stability risk, or social stability risk across the portfolios of index fund managers. Other work has shown that the Big Three, despite having portfolios that are the most diversified of all portfolios, and, presumably the greatest incentive to reduce systematic risk, actually vote in favor of shareholder proposals addressing climate change risk much less often than many managers of less-diversified, actively-managed portfolios.¹⁷⁶ The only activity that index fund managers do undertake at any scale is private engagement, and the evidence that we present suggests that the scale is much more limited than commentators would suggest.¹⁷⁷ This supports, rather than contests, our argument that index fund managers have incentives to under-invest in stewardship.

5. *Objections Based on Lack of Skills and Expertise*

A fourth and different argument made by some of those taking issue with our conclusions is that index fund managers lack the skills and expertise necessary to consider the specific business circumstances of the portfolio companies they invest in.¹⁷⁸ For instance, Professors Fisch,

¹⁷⁵ For a description of economies of scale achieved by some organizations in submitting shareholder proposals, see Yaron Nili & Kobi Kastiel, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. (2021) (forthcoming; manuscript at 15-17) (describing the substantial number of shareholder proposals submitted by the Shareholder Rights Project, the New York City Comptroller, and the United Brotherhood of Carpenters). For evidence of the contribution of other organizations to corporate governance reforms, see Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2107–2011.

¹⁷⁶ Jackie Cook & Tom Lauricella, *How Big Fund Families Voted on Climate Change: 2020 Edition*, MORNINGSTAR (2020), <https://www.morningstar.com/articles/1002749/how-big-fund-families-voted-on-climate-change-2020-edition> (last visited Nov 19, 2020) (presenting evidence that BlackRock, Vanguard, and SSGA supported 12%, 15%, and 32% of votes, respectively, on key 2020 climate resolutions, compared to 30% and 19% by active managers American Funds, respectively).

¹⁷⁷ For empirical evidence of the Big Three’s private engagements, see Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2084–2088.

¹⁷⁸ See, e.g., Charles M. Nathan, *Institutional Investor Engagement: One Size Does Not Fit All*, THE CONFERENCE BOARD (2018), <https://www.conference-board.org/blog/postdetail.cfm?post=6826> (last visited Jul 23, 2018) (explaining that the Big Three’s stewardship teams “are principally focused on big picture environmental, social, and governance (ESG) issues . . . [and] lack the skill-sets and manpower necessary to deal in depth with company specific issues of strategy design and implementation, capital allocation, M&A opportunities, and operational and financial performance”).

Hamdani, and Solomon consider “passive investors will seek to identify and address firm-specific operational deficiencies,” concluding that they “lack the expertise and the resources to do so effectively.”¹⁷⁹ Professor Gordon similarly argues that the “cost constraints of [their] business model] ... limit [their] capacity to do “deep dive” analysis for many firms in the portfolio.”¹⁸⁰

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

B. Incentives to be Excessively Deferential

Many of the stewardship decisions of index fund managers involve choices whether or not to defer to the views and preferences of the managers of their portfolio companies. These include whether to vote on director elections, compensation matters, and shareholder proposals in the way that the managers of the corporation would prefer; whether to submit shareholder proposals to the company; and the index fund manager’s choice of principles, practices, and policies, such as their voting guidelines. In many cases, where the preferences of managers are likely to be value-enhancing for the company, it would be best for the index fund manager to defer to those preferences. However, there may be some circumstances where deference to corporate managers may not be value-enhancing for the company, and where it would thus be better for the beneficial investors of

¹⁷⁹ Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 43.

¹⁸⁰ GORDON, *supra* note 170 at 23.

the index fund that the index fund manager not defer to the preferences of corporate managers.

In our prior work, we argued that Big Three managers (as well as some other investment fund managers) have strong incentives to be excessively deferential to the preferences of corporate managers.¹⁸¹ The reason is that index fund managers bear particular private costs from nondeference. Where these costs are greater than the fraction of the increase in the value of the corporation that the index fund manager is likely to capture, then the index fund manager will have an incentive to be deferential, even though this is not in the interests of their own investors.

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

The Big Three senior officers challenging the agency-costs account of their stewardship denied the significance of the above concerns but did not provide an adequate basis for this position. For example, in one response to our arguments regarding non-deference reported by the Financial Times, Rakhi Kumar, the head of environmental, social and governance investments and asset stewardship at SSGA, expressed doubt with respect to our excessive deference concerns, stating that “I doubt that you would be able to obtain a company that says that State Street is a pushover.”¹⁸² Kumar’s argument was echoed by SSGA’s Chief Investment Officer

¹⁸¹ For a discussion of index fund incentives to be excessively deferential, see Bebchuk and Hirst, *supra* note 3 at 2059–2066.

¹⁸² Walker, *supra* note 9.

Richard Lacaille, who denied that SSGA is in any way reluctant to vote against management.¹⁸³

However, Kumar's above response fails to recognize that, even if corporate managers were to consider SSGA to be a "pushover," those managers would be better served by not stating that belief or questioning the effectiveness of the investor oversight to which they are subject. Similarly, Lacaille's response does not engage with the empirical evidence that SSGA—as well as other Big Three managers—generally display substantial deference in their voting decisions on executive compensation as well as other matters.¹⁸⁴

BlackRock's Mallow also dismisses the influence of potential conflicts of interest on stewardship decisions. He argues that BlackRock recognizes the potential for these conflicts and manages them, including both by maintaining the independence of its engagement group and by implementing policies to identify and mitigate potential conflicts.¹⁸⁵ In support of this claim Mallow cites not only BlackRock's own conflict policies, but also those of SSGA, both of which seek to implement internal "walls" to manage conflicts.¹⁸⁶

Mallow's arguments also fail to engage with the evidence on the voting decisions of Big Three managers and the substantial deference they display. Furthermore, and importantly, Mallow's focus on the Big Three procedures aimed at addressing conflicts fail to recognize that these procedures are designed to address the problem client favoritism but cannot address the more important problem of general management favoritism. Because

¹⁸³ See Lacaille, *supra* note 8 at 1:00:20 ("We're quite comfortable with voting against management ... I think that there's a perception that if we vote against management it somehow makes life difficult for us. We've done it. I've done it. ... We've voted against the board in a disagreement with them on some issue. And it hasn't damaged the relationship. ... The idea that that would somehow be an incentive for an excessive deference ... doesn't stack up.").

¹⁸⁴ The evidence we present in *Index Funds and the Theory of Corporate Governance* of index fund manager engagement can generally be understood as consistent with the excessive deference hypothesis. See Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2075–2116.

¹⁸⁵ See MALLOW, *supra* note 7 at 30.

¹⁸⁶ *Id.* at 30., n. 139, citing BlackRock, "How BlackRock Investment Stewardship manages conflicts of interest," (2019), <https://www.blackrock.com/corporate/literature/publication/blk-statement-conflicts-of-interest.pdf>; see also State Street Global Advisors, "2019 State Street Global Advisors Conflict Mitigation Guidelines," (2019), <https://www.ssga.com/na/us/financial-advisors/en/our-insights/view-points/2019-ssga-conflict-mitigation-guidelines.html>.

general management favoritism does not involve favoritism towards particular clients, it cannot be addressed by ethical walls and other mechanisms intended to address client favoritism.

Professors Kahan and Rock, and Professors Fisch, Hamdani, and Davidoff Solomon acknowledge our concern regarding conflicts of interest. Professors Kahan and Rock recognize the incentives that the business operations of investment managers create for them not “to antagonize present or future banking or insurance clients with their voting activities.”¹⁸⁷ Similarly, Professors Fisch, Hamdani, and Solomon also acknowledge the possibility of potential conflicts arising from the business ties of investment managers, stating that “potential business ties between sponsors and companies’ management may affect passive funds’ voting behavior ... [which] create the risk that [they] will vote the shares of their funds in favor of management rather than in the best interests of the fund shareholders.”¹⁸⁸ However, these academic critics do not provide a basis for believing that this problem is not substantial, and do not engage with evidence on voting behavior that suggests this problem is consequential.

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

One such factor is the interest of Big Three managers in avoiding activities that could require them to file Schedule 13D disclosures, which would impose considerable private costs. Where an investor obtains more than 5% of a public company, Section 13(d) of the Securities Exchange Act requires that it file either Schedule 13D or Schedule 13G.¹⁸⁹ Nondeferential actions that may be construed as having “the purpose [or] the effect of changing or influencing control” of the company require filing on Schedule 13D.¹⁹⁰ However, filing on Schedule 13D must be done much more frequently, and requires much greater detail, than filing on Schedule 13G.¹⁹¹

¹⁸⁷ Kahan and Rock, *supra* note 10 at 47–48.

¹⁸⁸ Fisch, Hamdani, and Davidoff Solomon, *supra* note 11 at 65.

¹⁸⁹ See 15 U.S.C. § 78m(d), (g) (2012); 17 C.F.R. § 240.13d-1(b) (2019).

¹⁹⁰ See 17 C.F.R. § 240.13d-1(b)(1)(i).

¹⁹¹ Compare 17 C.F.R. § 240.13d-101 (Schedule 13D), with 17 C.F.R. § 240.13d-102 (Schedule 13G).

Because of the size and breadth of investment managers' holdings, all of which are subject to this disclosure, nondeference that requires filing on Schedule 13D would impose substantial costs on them.

In addition, possibly the most important factor that induces Big Three managers to be deferential to corporate managers, and one which is not addressed by the critics of our agency-costs account, is the private interest that the Big Three have in reducing the risk of public and political backlash against them. The Big Three's dominant role in the growing index fund market gives them a lot to lose.¹⁹² Similar concentrations of financial power have led to public and political backlash in the past.¹⁹³ The considerable power of corporate managers means that they could help provoke such a backlash against the Big Three if the Big Three's investor stewardship appeared likely to constrain the power, authority, compensation, or other private interests of corporate managers. The Big Three could limit these risks by being deferential to corporate managers. This factor is likely to contribute substantially to the pro-management voting patterns of the Big Three that have been documented.¹⁹⁴

Finally, we would like to discuss the implications of the above discussion of excessive deference to Professor Gordon's analysis of the "systematic stewardship" of the Big Three.¹⁹⁵ Recall that Professor Gordon presents a favorable view of Big Three stewardship on the grounds that the Big Three are able to produce (and do in fact produce) substantial benefits by focusing on general, systematic issues that are relevant to companies at large, such as environmental and social issues. Professor Gordon correctly argues that the system-wide nature of these issues enable the Big Three to produce benefits without expending substantial costs per company and that Big Three stewardship with respect to such issues is thus not undermined by the incentives to under-invest that we identified.

However, Professor Gordon fails to recognize that, even though the environmental and social stewardship of the Big Three is not undermined

¹⁹² For a discussion of the Big Three's current dominant market position and its likely durability, see *supra* Part I.

¹⁹³ For a history of backlashes against concentrated financial power, see generally Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

¹⁹⁴ For evidence of the pro-management voting patterns of the Big Three, see the studies cited in *supra* notes 71-80.

¹⁹⁵ See GORDON, *supra* note 12 at 15-21 (advocating for certain kinds of systematic stewardship by investment managers, but not discussing their incentives to be excessively deferential to corporate managers).

by incentives not to spend considerable resources on stewardship, such stewardship *is* undermined by the Big Three's incentives to be deferential to corporate managers. Because of these incentives, the Big Three should not be expected to push companies to make changes in their operations that corporate leaders strongly prefer to avoid.

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

The above analysis indicates that the environmental and social stewardship of the Big Three is likely to be long on rhetoric and puffery but short on producing actual and meaningful changes. Our analysis of Big Three activities in this area in recent years indicates that Big Three stewardship in this area has substantially focused on inducing companies to make more expansive disclosures in this area.¹⁹⁶ Such expanded disclosure are not strongly resisted by corporate managers and do not necessarily lead corporate managers to make any changes in how they actually operate the company. Thus, although the systematic stewardship advocated and supported by Professor Gordon is not undermined by Big Three incentives to limit stewardship expenditures, Big Three incentives to be deferential and accommodating to corporate managers cast substantial doubt on the potential benefits of such stewardship.

* * *

This Part has explained the two different sets of incentives that are likely to distort the investment stewardship activities of the Big Three. Part V turns to explain how the combination of these incentives and the substantial

¹⁹⁶ This analysis was based on our review of both the voting record of the Big Three with respect to social and environmental shareholder proposals (available on FactSet), and the annual engagement reports of each of the Big Three managers. See BLACKROCK, *supra* note 136; STATE STREET GLOBAL ADVISORS, *supra* note 137; VANGUARD, *supra* note 138.

power of the Big Three substantially raises the stakes in the debate over the agency-costs account of Big Three stewardship.

V. THE STAKES

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

A. The Unfulfilled Promise of Reconcentrated Ownership

The main problem with the Big Three's investor stewardship is that it leaves unfulfilled the promise of reconcentrated ownership. In *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means described how the ownership of most large U.S. corporations was heavily dispersed among many small investors.¹⁹⁷ The small stakes held by investors meant that they had limited ability to influence the outcome of corporate elections, and also that their share of any gains from increasing the value of the corporation would be similarly small.¹⁹⁸ As a result, dispersed investors did not have incentives to invest in improving the value of the corporation. And to the extent that managers suffer from agency problems, these would be unconstrained by investors.

We do not claim that index fund stewardship is worse than stewardship by others, or than the level of stewardship in a world of dispersed owners, such as that described by Berle and Means. In earlier work with Professor

¹⁹⁷ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 107–109 (1932).

¹⁹⁸ See *id.* at 87.

Alma Cohen, we suggested that the increasing concentration of ownership by institutional investors offers promise that the structural problems of dispersed ownership could be overcome, and that the agency problems of corporate managers could be constrained.¹⁹⁹ As investors' stakes grow, those investors will have a greater ability to undertake stewardship and influence managers to make value-increasing changes. And as their stakes grow, the returns to investors from undertaking such stewardship will also be greater, giving them greater incentive to undertake such stewardship.

The growing stakes of institutional investors therefore offer the promise of investors that will have both the ability and the incentive to constrain the agency problems of corporate managers. The large stakes in most large U.S. corporations that are held by the Big Three represent the apotheosis of this promise. As we have explained, the Big Three now hold the power to constrain the agency problems of corporate managers, and to influence those managers to maximize the value of the corporations they manage.²⁰⁰

The analysis of the incentives of index fund managers in Part IV shows that the Big Three have incentives not to deliver on the promise. While index fund managers have the power to influence corporate directors, they have incentives not to use this power to maximize the value of the corporations they invest in, but rather to defer excessively to corporate managers, and to underinvest in stewardship.²⁰¹ The problem with the incentives of the Big Three is that they leave the promise of their concentrated ownership unfulfilled.

B. Lack of Corrective Mechanisms

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

¹⁹⁹ For a description of this evidence, see Bebchuk, Cohen, and Hirst, *Agency Problems*, *supra* note 3 at 91–93

²⁰⁰ See *supra* section I.A.

²⁰¹ See *supra* Part IV.

A fundamental principle of neoclassical economics is that well-functioning markets contain corrective mechanisms that lead underperforming market participants to either improve or be eliminated.²⁰² In competitive product markets, firms that produce goods and services that are less desirable to consumers than those of their competitors will lose their share of the market to those competitors. If they do not improve their offerings then the underperforming firms will eventually be driven out of business. Similarly, companies that have returns worse than those of their competitors will have a higher cost of capital, and their managers will face pressure from their investors to improve their performance. If they do not improve, there is a threat that the managers may be replaced, or the company may be acquired.

However, there is little or no such market mechanism that would reward the Big Three for good stewardship decisions, and would therefore lead them to improve their stewardship performance. The financial success of the Big Three depends on their ability to attract assets from investors who are looking for a manager. For index funds this success comes from offering a portfolio of investments that track a specified index, with the lowest possible cost. Success in this competition is unrelated to the level or quality of the investment stewardship activities of the index fund manager. Engaging more effectively with corporate managers will not result in any greater financial success; if that activity is costly, it may actually *reduce* the financial success of the index fund manager.²⁰³ There is therefore no market check on the investor stewardship decisions of the Big Three.

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

²⁰² For early work discussing corrective mechanisms in markets, see ALFRED MARSHALL, *PRINCIPLES OF ECONOMICS; AN INTRODUCTORY VOLUME*, (8th ed. ed. 1920).

²⁰³ See *supra* section IV.A.

C. Insulating Corporate Managers

The importance of the Big Three's power lies in how it is used with respect to corporate managers, and in particular, whether it is used to push corporate managers too much, or too little. As we explained in section V.A, the Big Three's power offers significant promise; it could be used to maximize the value of the corporations in which they invest. But as our earlier work has documented, the Big Three are likely to under-invest in stewardship, and to be excessively deferential to corporate managers.²⁰⁴ This means that the power of the Big Three is therefore more significant in its absence.

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

Mallow dismisses these arguments by pointing out that the Big Three promote their goals through engagement rather than by proxy contests.²⁰⁵ Our focus here is not only on their lack of proxy contests, but rather on the many ways in which the Big Three could take actions to increase the value of the corporations in which they invest, but do not. However, there is clear evidence of a number of ways in which the Big Three fail to take such actions.

In our earlier work we provided evidence that the Big Three's engagements do not relate to the business performance of the companies that they invest in, and that their engagements do not address the causes of managers' underperformance.²⁰⁶ Although the identity of the directors of

²⁰⁴ See *supra* section IV.

²⁰⁵ See MALLOW, *supra* note 7 at 30 (“[Vanguard, BlackRock, and State Street] promote [their] goals through engagement rather than hostile proxy contests.”).

²⁰⁶ See Bebchuk and Hirst, *Index Fund Incentives*, *supra* note 3 at 2095–2097.

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

Indeed, in our prior work we estimate that as of 2019, BlackRock spent fewer than 4 person-days per year, and less than \$5,000 in stewardship costs, and that Vanguard and SSGA spent considerably less.²⁰⁷ The limited amount of time and resources devoted to each company means they cannot undertake detailed reviews of those companies in ways that could allow them to apply pressure to increase the value of those companies.

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

D. The Downplaying of Power

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

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

²⁰⁷ See *id.* at 2079.

group.²⁰⁸ Novick’s keynote address starts by focusing on how even the Big Three control a minority of each company’s shares.²⁰⁹ Later, she explains that very few corporate votes are close enough that any individual manager—including any of the Big Three—would have a “swing vote.”²¹⁰

BlackRock has also attempted to downplay its substantial power, and that of the Big Three in general. In an April 2019 release, BlackRock argues that that “[s]hareholders are [d]ispersed and [d]iverse.”²¹¹ The release explains that “[Vanguard, BlackRock, and State Street] represent a minority position in the \$83 trillion global equity market . . . the combined AUM of these three managers represents just over 10% of global equity assets.”²¹² The release goes on to describe how, even at BlackRock, there are many different individuals involved in managing these assets, and variations in the way that they vote BlackRock’s shares.²¹³

In another release that same month, BlackRock responds to claims that “that the growth of index investing will lead to a small handful of individuals effectively controlling all corporations in the near future”²¹⁴ The release focuses on how many individuals oversee public companies in the U.S. It restates claims made in the earlier release, including that “[i]t is generally not possible for even the largest shareholders to determine the outcomes of proxy decisions,” and that “voting records demonstrate

²⁰⁸ For the section of Mallow’s paper arguing that “[a]sset managers are minority shareholders with limited voting power and corporate control,” see MALLOW, *supra* note 7 at 19–22. For the sections arguing that asset managers do not coordinate their voting, and that there is substantial variation in their voting records, see *Id.* at 24–25. and *Id.* at 22–24., respectively.

²⁰⁹ See Novick Keynote Address, *supra* note 6 at 2 (pointing out that “Examining the majority of US public companies – and certainly ‘large cap’ public companies – the largest shareholder holds only a single digit percentage of shares outstanding.”); *Id.* at 2. (“[T]he Top 10 asset managers represent only 17% of equity ownership . . .”).

²¹⁰ Novick Keynote Address, *supra* note 6 at 8 (“However, the charts show that there’s no individual manager that comes even close to a swing vote . . .”).

²¹¹ See BLACKROCK, *Policy Spotlight: Shareholders Are Dispersed And Diverse* (2019), <https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-shareholders-are-dispersed-and-diverse-april-2019.pdf>.

²¹² See *id.*

²¹³ See *id.* at 1 (“For any individual asset manager, AUM represents a variety of investment strategies, each with different investment objectives, constraints, and time horizons . . . there is often some variation in the way shares are voted across portfolios, even among those managed by a single asset manager.”).

²¹⁴ See BLACKROCK, *The Role of Shareholders in Public Companies 1* (2019), <https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-the-role-of-shareholders-in-public-companies-april-2019.pdf> (citing COATES, *supra* note 13).

significant variation in voting patterns amongst the largest fund managers.”²¹⁵

In yet another release, focused on executive compensation, BlackRock disputes the “claim that index fund managers may wield outsized influence over corporations through their proxy voting and engagement.”²¹⁶ The release argues that “index fund managers are rarely the determining factor in say-on-pay votes,” and that “the focus on say-on-pay is misplaced, since executive compensation is neither structured nor decided by shareholders,” but rather by boards of directors, compensation committees, and compensation consultants.²¹⁷

We have addressed many of these claims elsewhere in this Article, but we raise them again here to demonstrate that BlackRock has consistently sought to downplay its own power and influence over corporations. That BlackRock seeks to challenge recognition of their power is consistent with the incentives of the Big Three described in Part IV. In particular, recognition of the Big Three’s substantial power puts them at risk of a public and political backlash that could constrain that power, and that could impose substantial costs on the Big Three. History provides a number of examples of substantial concentrations of financial power being met with such regulatory backlash.²¹⁸ The Big Three therefore have incentives to downplay and reduce the salience of their power as much as possible. These incentives explain the recent arguments made by BlackRock attempting to downplay its power, and the power of the Big Three in general.

Because of the importance of the Big Three’s power, it is also important that this power be recognized, and that attempts of the Big Three to downplay this power be treated with appropriate caution. If the power of the Big Three can be successfully obscured, then there will be less pressure on them to exercise that power in the best interests of their own investors. Conversely, broader public recognition of the power of the Big Three, and recognition of that power by investors, policymakers, and researchers, will also increase scrutiny of how the Big Three exercise—or fail to exercise—

²¹⁵ BLACKROCK, *supra* note 215 at 2.

²¹⁶ BLACKROCK, *supra* note 63 at 1.

²¹⁷ *Id.* at 1.

²¹⁸ For a historical account of the backlashes against concentrated financial interests, see Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10–67, 32–53 (1991).

that power, and thereby give the Big Three incentives to improve how they do so. We hope that this Article may contribute to such recognition.

CONCLUSION

The Big Three collectively control more than 20% of the shares of S&P 500 companies, and almost 30% of the votes cast at the annual meetings of those companies. These substantial stakes give them correspondingly significant voting power, and with it, influence over the managers of the corporations in which they invest. Their stakes and influence are likely to continue to grow. The Big Three have attempted to downplay their own power, including in the recent works of Mallow and Novick. However, the close attention that market participants pay to the engagements, voting policies, and actual voting behavior of the Big Three show that they consider the Big Three to have substantial influence. And the Big Three's own claims regarding the effectiveness of their engagements are also inconsistent with their own attempts to downplay their influence.

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

One mechanism that is important for improvements in stewardship by the Big Three is awareness and recognition of their power, and the problems caused by their distorted incentives. Because the Big Three have incentives to downplay their power, we should treat with caution their attempts to do so. This Article has shown the problems with recent arguments made by the Big Three in their attempts to downplay their power, and reemphasized the substantial power and influence that they do have. We hope that by doing so this Article will help contribute to the recognition of the Big Three's power, and the potential problems it may cause if not exercised properly.