If Not The Index Funds, Then Who?

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Abstract

Large asset managers manage trillions of dollars of assets on behalf of tens of millions of clients. In this article, I take a close look at the underlying interests of those clients. Because asset managers' clients are affected by corporate actions as customers, employees, creditors, taxpayers, and the general public, they are interested in more than the financial performance of the corporations in their portfolios. Instead of maximizing the profits of individual firms, an asset manager acting in their clients' best interests should focus on improving the alignment between corporations and society more broadly. First, I show that asset managers can induce significant changes at portfolio companies. I then put forward a set of actions that asset managers could implement that would significantly increase clients' collective welfare. Finally, I show that there is little legal risk from a reorientation towards client welfare by asset managers.

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INTRODUCTION

In recent years, large asset managers have reached incredible sizes, managing trillions of dollars of assets on behalf of tens of millions of clients. The largest three, BlackRock, Vanguard, and State Street, taken together (the "Big Three"), vote about 20% of shares in most large companies, with the majority of these shares held in passive index funds.[1] This concentration of financial power has ignited debates over the role of large asset managers and the effects of index fund portfolios in corporate governance. The size and composition of the large asset managers has significant implications, both normative and positive, for the economy and society more broadly.

Recent research on large asset managers' index fund holdings has focused on two primary questions. The first has considered whether common concentrated owners may have anticompetitive effects on portfolio firms. The most well-known study argues that shareholders who own multiple firms in the same industry will prefer that those firms limit competition.[2] In particular, the authors find that concentrated ownership of airline companies by institutional investors has led to significant increases in airline fares. There is an active academic debate over these empirical findings and a growing literature on the legal and policy ramifications of common ownership.[3]

The second area of focus explores whether asset managers with large index fund holdings have adequate incentives to improve governance, and thereby financial performance, at portfolio firms. On the one hand, asset managers' substantial holdings give them the potential to influence portfolio firms. On the other hand, because asset managers are not the beneficial owners of the securities that they manage, agency problems may limit their involvement. Scholars are divided on whether asset managers will take actions to improve the financial value of portfolio firms, and whether the government should intervene to increase or limit the role of asset managers in corporate decision making.[4]

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1. Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298 (2017).

2. José Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

3. *See generally* José Azar, Sahil Raina & Martin Schmalz, Ultimate Ownership and Bank Competition (July 23, 2016) (unpublished manuscript); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017); Edward Rock & Daniel Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221 (2018).

4. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* (ECGI, Law Working Paper, No. 433/2018, 2018); Marcel Kahan & Edward Rock,

Each of the issues mentioned above is defined by particular characteristics of the large asset managers. The literature on anticompetitive effects focuses on the fact that large asset managers hold positions in competing companies. The literature on agency conflicts between asset managers and their clients focuses on the size and financial incentives of large asset managers. Yet, these literatures overlook the single most important feature of large asset managers: the enormous size and diversity of the individuals they serve, who are the ultimate end investors in portfolio companies.

The large asset managers have tens of millions of clients.[5] These clients increasingly invest in low-cost index funds that passively track the entire market, meaning that an individual client may hold stakes in thousands of publicly traded firms.[6] These clients are affected by the financial returns of the individual companies in their portfolios, but they are also affected by portfolio firms in many other ways. No shareholder is only a shareholder. Shareholders might also be customers, employees, or creditors, and they are invariably taxpayers and members of the general public. Shareholders therefore have interests in corporations that extend far beyond share prices. There are often conflicts between what is best for corporations' profits or share prices and what is best for the broad constituencies affected by corporations' actions. And because shareholders and other corporate constituencies overlap, maximizing profits may not maximize shareholders' overall welfare. Solving the problems that have dominated corporate governance research—getting managers to maximize profits or increase the share price—may in fact be bad for shareholders if they are harmed by such actions.

There is no shortage of examples of corporations that have increased their share price while harming society. Companies may profit as they release harmful toxins,[7] expose employees to dangerous working conditions,[8] lie to consumers about hazardous products,[9] imperil the financial system,[10] and regularly break the law.[11] In principle, governments could take steps to minimize the harms corporations impose. However, officials are often unable or unwilling to intervene. Revolving doors, corporate lobbying, and political economy issues limit the government's oversight, giving corporations extensive latitude to profit at the expense of others. Under the standard manager-shareholder agency problem that defines the corporate governance literature, managers of companies that increase profits by harming society are performing splendidly. But despite higher-value portfolios, many investors are made worse off by profit-maximizing actions taken by corporations.

Index Funds and Corporate Governance: Let Shareholders Be Shareholders (NYU L. & Econ. Research Paper, No. 18-39, 2018.

5. *See, e.g.*, *Fast Facts About Vanguard,* VANGUARD, https://about.vanguard.com/who-we-are/fast-facts/ (last visited Jan. 19, 2019) (showing that Vanguard alone has more than 20 million investors).

6. Madison Marriage, *Passive to overtake active in US by 2024, says Moody's*, FIN. TIMES (Feb. 2, 2017), https://www.ft.com/content/856a0372-e897-11e6-893c-082c54a7f539.

7. Roy Shapira & Luigi Zingales, Is Pollution Value-Maximizing? The DuPont Case (Sept. 1, 2017) (unpublished manuscript) (showing that DuPont made a rational decision to release harmful pollution).

8. David Barstow, *U.S. Rarely Seeks Charges for Deaths in Workplace*, N.Y. TIMES (Dec. 22, 2003), https://www.nytimes.com/2003/12/22/us/us-rarely-seeks-charges-for-deaths-in-workplace.html (explaining deaths from willful safety violations).

9. Howard Damstadter, *The Times and General Motors: What Went Wrong?* 3 COGENT ARTS & HUMAN. 1 (2016), https://www.tandfonline.com/doi/full/10.1080/23311983.2015.1134030.

10. Anat Admati, *It Takes a Village to Maintain a Dangerous Financial System*, *in* JUST FINANCIAL MARKETS? FINANCE IN A JUST SOCIETY 293 (Lisa Herzog ed., 2017).

11. BRANDON L. GARRETT, TOO BIG TO JAIL (2014).

This article considers the role that large asset managers can take in acting in their clients' best interests rather than focusing on just the value of clients' portfolios. I argue that asset managers should focus on improving the alignment between corporations and society more broadly instead of aiming to increase profits at corporations. Through their broad clientele and enormous index fund portfolios, asset managers can, in principle, represent the public interest better than most other actors. This argument is not based on charity or altruism, but instead is founded on what clients would actually prefer as individuals. I explore this issue by discussing two overarching questions.

First, what should the objective function of a large asset manager be? Scholars and commentators have emphasized important characteristics of the holdings of asset managers: their size, the inability to exit because of index positions, common ownership of competing firms, and their long-term focus.[12] However, this focus overlooks the sheer number and diversity of clients, which implies that many or most actions that affect a firm's financial value will also affect clients in at least one of their roles as consumers, employees, creditors, taxpayers, neighbors, or just the general public. For example, a corporation that cuts costs by releasing a harmful toxin will benefit clients' financial portfolios, but its clients will likely be among those harmed by the toxin. Therefore, what is best for clients entails considering both the profits and the harms related to the toxin. This article will show that, in many cases, by narrowly maximizing the profits of individual portfolio companies, asset managers do not act in their clients' best interests. Instead, an asset manager that is taking clients' interests into account should consider both profits *and* the social welfare implications of firms' actions.

With the asset manager's objective function in place, this paper considers a second question: what can, and should, asset managers do to further their clients' interests? I show that there are many actions that asset managers could take that would both improve clients' welfare and the value of their portfolios. Most fundamentally, asset managers can improve clients' utilities by inducing corporate managers to consider the effects of their actions beyond profit.

The ability of asset managers to influence portfolio companies is predicated on both their size and their index fund portfolios. I discuss how asset managers can use their public voice coupled with private engagements and proxy voting to effect change at portfolio companies. There are three broad classes of actions that asset managers can take, and I make specific recommendations in each area, while considering agency costs and the structure of asset managers. First, asset managers can take actions that improve the values of individual firms. While this area has received much attention in the corporate governance literature, I suggest underexplored strategies. Second, asset managers can take actions that increase the financial value of clients' portfolios, potentially at the expense of the profitability of the target firm. And finally, asset managers can move past financial metrics alone to consider the types of actions that improve clients' overall welfare. There are close, and often unexplored, links between firm value, portfolio value, and client welfare. Asset managers will best serve clients when they take these relationships into account.

The remainder of the article is structured as follows. The next section reviews the origins of the corporate form and the state's interests in corporations.

12. See all publications cited *supra* in notes 1-5.

Corporations are chartered by the government. Historically, the government offered the privilege of charters to business corporations to further public interests. Today, corporations can form for any legal purpose and, in practice, often take actions that are not in the public interest, even if those actions are unlawful. In light of governments' failure to ensure corporations always further public interests, asset managers can play an important and beneficial role, which I explore in Section II. I begin by developing the underlying objective function of asset managers. I show that it is in the interests of asset managers' clients for portfolio companies to consider their effects on society beyond simply maximizing particular financial metrics.

After considering what asset managers' interests should be, I consider what actions they presently take in Section III. First, I explore how asset managers currently interact with portfolio firms. Interactions are generally couched in terms of "shareholder value" as measured through a given firm's share price, which limits asset managers' effectiveness. I then move on to consider what asset managers can and should do to further their clients' interests in Section IV. Asset managers' most effective tools are their abilities to shape norms and standards that govern corporations' behavior. The breadth and depth of asset managers' holdings means that their comparative advantage relative to other actors is their ability to engage with many firms on a particular issue rather than their ability to identify and interact with firm-specific issues. Through influencing norms, asset managers can change what behavior is normal. Further, by setting standards for portfolio companies to follow, asset managers can affect behavior on a macro scale. However, because it is not enough for asset managers to publicly espouse norms and standards, direct engagements and voting can be used to effectuate changes.

In Section V, I make specific recommendations for where asset managers should focus their efforts. I argue that asset managers can take actions that focus on firm value, portfolio value, or clients' broader interests. In some cases, these three goals overlap. But when there is conflict, asset managers should prioritize client welfare over portfolio value, and prioritize portfolio value over firm value. In Section VI, I explore legal issues related to these recommendations.

I. THE SOCIAL PURPOSE OF THE CORPORATION

For the majority of the corporation's history, it was taken for granted that corporations were chartered by the government to undertake actions that advanced the common good.[13] Corporate charters were initially given for activities such as building and running canals or roads, where the benefits were meant to extend to the community at large. From their origin in Europe and through their continuation in the early United States, corporate charters for enterprises such as the Dutch East India Company were created only on a case-by-case basis through an act of the government. Charters required regular renewal and the government reserved the right to revise or rescind charters of corporations that failed to meet public purposes.[14]

13. *See generally* David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation*, 107 AM. POL. SCI. REV. 139 (2013). The two most well-known early corporations, the Dutch East India Company and the British East India Company, were both trading companies that pursued commercial profits. But both companies received corporate charters because they served public purposes by contributing to the advancement of their countries' military interests overseas. Giuseppe Dari-Mattiacci et al., *The Emergence of the Corporate Form*, 33 J.L. ECON. & ORG. 193, 211 (2017).

14. Ciepley, *supra* note 13, at 139.

Governments justified shareholder profits as a means of providing incentives for the corporation to pursue social ends. As a former president of the American Economics Association put it, "A corporation . . . may be defined in the light of history as a body created by law for the purpose of attaining public ends through an appeal to private interests."[15]

The 19th century saw a stark shift as lawyers, scholars, and the public at large began to view corporations as a creation of private contract rather than governmental decree.[16] As more businesses sought the corporate form, it became unwieldy to require each to seek a legislative charter. General incorporation statutes allowed corporations to be chartered to serve any legal purpose, exempting corporations from any duties to the public at large. Of course, many corporations often serve the public interest by providing products for consumers, jobs for employees, and returns for shareholders, but managers became free to focus on the private benefits to shareholders. Over the decades, shareholders became the focus of both managers and academics who saw the corporation as a "nexus of contracts" effectively "owned" by shareholders rather than as a creation of the state.[17] This view of the corporation sees shareholders as the most vulnerable corporate stakeholders, unprotected by the contracts and laws that protect the interests of other constituencies.

While the shareholder-focused view is dominant today, corporations remain creations of the state. The government has granted corporations and their shareholders special privileges including asset lock-in, entity shielding, tradable shares, and limited liability.[18] While these privileges create clear benefits for some, they can create costs for others. Ideally, the government would ensure that the social benefits of corporations outweigh the social costs they may impose. If corporations harm the public in a preventable way, the government's role is to intervene and try to prevent the harm. The prevailing view of the corporation is of a manager making decisions on behalf of, and for the benefit of, shareholders, but from society's perspective, the question must be whether this governance arrangement is beneficial for society as a whole.

The focus on shareholders is appealing in its simplicity—let managers focus on what is best for the share price, and let markets and the government sort out everything else. In a frictionless world, competitive labor markets would ensure that managers treat employees fairly, that well-functioning contracts allow creditors to protect themselves through covenants, and that effective public enforcement of fair laws would exist. Without frictions, a focus on the share price allows corporations to efficiently internalize their externalities. The chief problem that then arises is the conflict between managers and shareholders—the familiar agency problem that has dominated research in finance and economics. But in a world that is far from frictionless, the primary solution to the managerial agency problem—tying managerial compensation to financial measures—may in fact exacerbate other conflicts, limiting the ability of corporations to make beneficial commitments.[19]

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15. Henry Carter Adams, *Economics and Jurisprudence*, 8 SCIENCE 15, 16 (1886).

16. Ciepley, *supra* note 13, at 139.

17. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

18. *See* Ciepley, *supra* note 13; Dari-Mattiacci et al., *supra* note 13.

19. Anat R. Admati, *A Skeptical View of Financialized Corporate Governance*, 31 J. ECON. PERSP. 131 (2017) (discussing the many pathologies that arise from this "financialization" of the corporation).

The harms arising from this narrow shareholder focus can be seen throughout society.[20] Companies may lie and defraud investors and customers;[21] corporate lobbying can lead to laws and regulations that favor corporations over other members of society;[22] corporate managers will favor excessive leverage that leads to collateral harms for counterparties;[23] and companies may knowingly flout laws given ineffective public enforcement.[24] These examples illustrate some of the ways in which corporations may take actions that are not in the public interest.

The government plays a crucial role in determining the place of corporations in society. As the Chief Justice of the Delaware Supreme Court puts it: "policy makers should not delude themselves about the corporation's ability to police itself; government still has a critical role in setting the rules of the game."[25] Through setting rules, the government affects the allocation of costs and benefits to various constituencies. At its best, the government balances the interests of various parties to ensure that the benefits of the corporate form are widely shared among members of society. To best support the social purpose of corporations, the government should correct market failures, ensure competitive markets, and efficiently and fairly enforce contracts and laws. Because an individual corporation is generally focused on its own narrow interests—even when the pursuit of those interests harms others in society—the role of the government is to make sure that society does not suffer from the narrow interests of managers, directors, or particular shareholders. But while the government's role is to help provide the conditions for corporations to make beneficial commitments, it often fails to do so.

The government's ability to intervene effectively in the corporate sector was greatly limited by the Supreme Court's 2010 holding in *Citizens United v. Federal Elections Commission*,[26] which restricted Congress' ability to regulate the political speech of corporations. The Nobel Prize-winning economist and advocate of the free market, Milton Friedman, famously wrote that "[t]here is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits." Less often quoted is the second half of the sentence: ". . .so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[27] Effective rules are key to any justification of the shareholder primacy norm, but *Citizens United* calls into question whether "the rules of the game" will curtail the socially undesirable behavior of corporations. When corporations have influence over the rules themselves, the balance between corporations and other members of society begins to break down. Corporations employ consultants, lawyers, lobbyists, and well-connected individuals to shape laws

20. *Id*.

21. Emily Glazer, *Wells Fargo to Pay $185 Million Fine Over Account Openings*, WALL STREET J. (Feb. 13, 2019) (characterizing Wells Fargo's practice of incentivizing employees to create false accounts for customers).

22. Karthik Ramanna, *Thin Political Markets: The Soft Underbelly of Capitalism*, 57 CAL. MGMT. REV., Feb. 2015, at 5, https://journals.sagepub.com/doi/abs/10.1525/cmr.2015.57.2.5.

23. Anat R. Admati, Peter M. Demarzo, Martin F. Hellwig & Paul Pfleiderer, *The Leverage Ratchet Effect*, 73 J. FIN. 145 (2018).

24. *See* Shapira & Zingales, *supra* note 7.

25. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Firms Seek Profit*, 47 WAKE FOREST L. REV. 135, 135–36 (2012).

26. Citizens United vs. F.E.C., 130 S. Ct. 876, 880 (2010).

27. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970.

and regulations. In 2017, there were 11,545 unique, registered lobbyists who actively lobbied in the United States, spending over $3 billion.[28] The public has an interest in fair rules and effective governance of corporations, but the government is increasingly failing in this role. Powerful corporations are able to shape laws in their favor at the expense of others in society.

Even when regulations are in place, the government may fail to effectively enforce those laws. When corporate wrongdoings come to the surface, prosecutors often avoid large fines because of fear of collateral consequences to employees and the community.[29] This under-prosecution limits the ability of the government to deter bad behavior. And because corporate crimes may go undetected or underenforced, corporations will rationally make decisions that are harmful from a societal perspective, but profitable for the firm.[30]

While in some cases the government fails to correct market distortions, in other cases inefficiencies arise from government interventions themselves. Tax laws favor debt over equity, which rewards dangerous leverage by financial institutions.[31] The risks associated from leverage are exacerbated by explicit and implicit guarantees on debts by the government. The belief that the government will support distressed financial institutions to avoid contagion or "systemic risk" further incentivizes those firms to take risky actions.[32] In other cases, the government allows distressed and potentially-insolvent "zombie banks" to persist for years, which further distorts the economy.[33] The government's policies subsidize borrowing and excessive risk, which ultimately harms the public.

Most other actors are even more limited than the state in aligning the interests of corporations with society. Managers of firms can be expected to pursue profits and their own self-interests if they are not monitored by others. In general, individual shareholders have little incentive to monitor corporations. Activist hedge funds are powerful institutional investors who are able to induce changes at companies they target. But while these changes may improve the value of target firms, the business model of activist hedge funds is to focus on changes that result in the most profit rather than on social welfare concerns.[34] Further, while auditors can help improve disclosures and allow investors to gauge risk, conflicts of interests limit their effectiveness. The proliferation of individual and institutional actors pursuing their own—or their clients'—best interests coupled with failures of the government to create and enforce effective laws and regulations raises the question of who is representing the interests of society.

28. *Lobbying Database*, CENTER FOR RESPONSIBLE POLITICS, https://www.opensecrets.org/lobby/, (last visited Jan. 19, 2019).

29. GARRETT, *supra* note 11; JESSE EISINGER, THE CHICKENSHIT CLUB (2018).

30. *See* Shapira & Zingales, *supra* note 7.

31. *See* Admati, *supra* note 10.

32. *Id*.

33. ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES, chaps. 3, 11 (2013).

34. However, recent research calls into question the ability of activist hedge funds to improve firms' values. Ed deHaan, David F. Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activism* (Rock Center for Corp. Governance at Stan. Univ.), Working Paper No. 236; Stanford Univ. Graduate Sch. of Bus., Research Paper No. 18-47 (2018); European Corp. Governance Inst. (ECGI) – Finance, Working Paper No. 577/2018, 2018).

II. THE PUBLIC INTERESTS OF ASSET MANAGERS

The government often fails to ensure that corporations are serving public purposes. Given the failure of the government, this section explores why large asset managers have, or should have, an interest in the public purposes of corporations.

Just as governments gain their authority from the consent of citizens, asset managers gain their authority from their clients. Each one of an asset manager's portfolios is governed by an "investment management agreement" contract.[35] These contracts generally specify broad goals and constraints of the portfolio, such as tracking the S&P 500 index. While managing clients' investments, asset managers are tasked with taking actions that are in the best interests of their clients.[36] This is generally interpreted to mean that asset managers should take actions to maximize the value of individual portfolio corporations. However, what is best for the asset manager's clients extends beyond the share price of any given firm and depends on both the asset manager's investments and its clientele.

Consider an asset manager representing a single client holding shares in a single corporation. This client's financial wellbeing is closely tied to the firm's performance, and actions taken by the asset manager that increase the firm's share price will help its client's portfolio. However, the client is affected by more than just the share price. If the client is an employee of the company, she also wants a fair wage, job security, and safe working conditions. Similarly, if the client is both a shareholder and a consumer of the firm's product, she has personal interests that extend beyond the share price (e.g. safety standards on a car). Likewise, a shareholder that lives next to a factory is likely interested in clean air and water, factors that may be external to the share price.

When an asset manager represents a single shareholder in a single corporation, determining what is best for the client entails weighing the client's interests in the share price against her other interests related to that company. If the company affects the client in ways other than the share price (e.g. she is a customer or employee), she will likely want the asset manager to take those interests into account. If the asset manager can take an action that increases the value of the firm but harms the client in some other way, the client's preferences will be influenced by the size of her investment in the firm. For a client with a small stake, the non-financial aspects of the firm's decisions will likely be more important, whereas financial gains may outweigh the harm imposed on the client with a larger stake in the firm. All else equal, the larger the client's financial interest in the firm, the more she will favor actions that increase the share price at the expense of other aspects of her well-being.

Consider the decision of General Motors (GM) in 2005 not to fix a faulty ignition switch.[37] A faulty switch was built into around 30 million cars and caused at least 124 deaths.[38] The Department of Transportation puts the value of a human life at

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35. Barbara Novick, *Remarks at OECD Discussion on Common Ownership by Institutional Investors* (Dec. 6, 2017), https://www.blackrock.com/corporate/literature/publication/barbara-novick-remarks-oecd-common-ownership-120617.pdf.

36. Section VI explores the fiduciary duties of asset managers.

37. Sonari Glinton, *The Long Road to GM's Ignition Switch Recall*, NPR (Mar. 31, 2014), https://www.npr.org/2014/03/31/297312252/the-long-road-to-gms-ignition-switch-recall.

38. Anton R. Valukas, *Report to Board of Directors of General Motors Company Regarding Ignition Switch Recalls*, N.Y. TIMES (June 5, 2014), https://www.nytimes.com/interactive/2014/06/05/business/06gm-report-doc.html?_r=0.

approximately $9.5 million.[39] Using these values, the expected cost to a customer from the faulty ignition switch was approximately $40.[40] GM's cost to repair the switch was $1 per car.[41] Thus, assuming the price of a car is fixed, repairing the faulty switch in 30 million cars would decrease GM's profits by $30 million. Because the problem was hidden, customers could not factor the cost into their purchasing decisions. Consider the preferences of an investor in GM who assumes that GM will face no litigation risk and also buys a car. Suppose that the investor has a portfolio of $10,000, all of which is invested in GM. She therefore holds approximately 0.00002% of outstanding GM shares, and gains $6 from GM not repairing the faulty switch on its cars.[42] However, if the investor is also a GM customer, the expected consumption cost of $40 outweighs the $6 stock gains, so she would prefer GM to fix the ignition switch. Now consider a wealthier investor with $1 million invested in GM. This customer holds approximately 0.002% of outstanding GM shares, and therefore gains $600 in profits from the faulty switch.[43] And because this outweighs the $40 cost, she prefers that GM leaves the faulty switch in its cars. This illustrates that wealthier investors have more to gain financially from a firm taking actions that increase its share price. However, because wealthier individuals tend to be more willing to spend to avoid risk, they may need even larger financial rewards to compensate them for bearing non-financial risk.[44] Furthermore, because individuals increasingly hold diversified portfolios, even wealthy individuals have relatively small exposures to the share price of any given firm.[45]

Modern portfolio theory implies that investors minimize risk by holding portfolios of the entire market.[46] Investors increasingly place their savings in passive index funds that mimic the performance of the entire market. When an asset manager represents a single client holding a portfolio of the entire market, the client is largely ambivalent about the financial returns of any given firm. Instead, her financial interests depend on the returns of the market as a whole. To see this, consider again the GM ignition switch example. An investor with $1,000,000 invested in GM preferred GM to install faulty ignition switches, but an investor with $1,000,000

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39. U.S. Dep't of Transp., Memorandum (June 13, 2014), https://www.transportation.gov/sites/dot.gov/files/docs/VSL_Guidance_2014.pdf.

40. At least 124 deaths resulted from the faulty switches, and approximately 30 million cars were at risk of failure. Therefore, the average cost per vehicle is approximately $40: ($9.5 million)(124)/(30,000,000)=39.3. This estimate understates the cost imposed by the faulty ignition switch, as it does not take into account damage to property or injuries from accidents that did not cause deaths.

41. Paul Lienert & Marilyn Thompson, *GM Ignition Switch Linked to 13 Deaths Wasn't Changed Since It Would've Added $1 to Car Cost*, BUS. INSIDER (Apr. 1, 2014), https://www.businessinsider.com/gm-recall-ignition-switch-2014-4.

42. GM's market cap on November 2, 2018 was approximately $50 billion, so the client's stake is $10,000/$50 billion = 0.00002%. Her share of the profits from the faulty ignition switch are therefore (0.0002%)($30 million)=$6.

43. The client's stake is $1,000,000/$50 billion = 0.002%. Her share of the profits from the faulty ignition switch are therefore (0.002%)($30 million)=$600.

44. It is standard in models of economics to assume that individuals have utility functions that are concave in their wealth. Therefore the marginal value of a dollar is less for a relatively wealthy person than for a relatively poor person. If the disutility of personal harm (e.g. developing cancer) is the same for all people, then a wealthy individual is more willing to spend to avoid that risk because they sacrifice less utility than a poor person does. See, for example, Harry Markowitz, *The Utility of Wealth*, 60 J. POL. ECON. 151 (1952) (discussing the relationship between wealth and utility).

45. See Fichtner et al, *supra* note 1.

46. Markowitz, *supra* note 44.

invested in the S&P 500 index fund will not. GM's weighting in the S&P 500 is approximately 0.2%,[47] so the investor effectively holds $2,000 in GM shares. She only gains $1.20 from the faulty switch,[48] and therefore has a clear preference for GM to fix the switch, despite her considerable wealth. In this example, an investor would need to have more than $33 million invested in the S&P 500 to prefer GM not to fix the faulty ignition switch.[49]

Portfolio diversification diminishes an investor's financial stake in any given firm, but it does not diminish how an investor is affected by portfolio firms outside of their share prices. As a holder of the entire market, she interacts with and is affected by the firms in her portfolio in many ways—she is likely a customer, employee, creditor, and neighbor of the very firms she holds shares in. But while all diversified shareholders are affected by a multitude of companies, each shareholder is affected in her own way. Investors in GM who purchase GM cars will generally prefer that GM adhere to safety standards, while an investor in GM who purchases a car from a different automaker gains financially from the faulty ignition switch but does not bear the expected accident costs.[50] As the majority of GM's investors are likely not consumers of GM cars, the majority of shareholders may find it rational to keep the faulty switch. Doing so is socially inefficient, but provides a general benefit to all shareholders and a localized cost only borne by a minority of shareholders. Thus, while a shareholder holding the market portfolio has some interests beyond the share price of individual portfolio companies, her interests are predominantly financial in others. In some cases, this may lead shareholders to prefer socially inefficient actions that yield financial benefits.

However, the focus on financial metrics breaks down when we consider that, in reality, asset managers indefinitely hold the market portfolio on behalf of millions of households. These clients are shareholders in every publicly traded company, but they are also representative of the employees, creditors, customers, and the general public affected by these corporations' actions. The large number of clients means that it is virtually certain that any corporate decision will affect its clients in both financial and non-financial ways. When there was only one investor, it was conceivable that she was only affected by GM's faulty switch through GM's share price. Once there are millions of investors, it is certain that many of them will face the expected costs associated with the faulty switch.

When an asset manager has millions of clients and invests in the entire market, it is not enough to look at only financial returns. Profit-maximizing corporate actions are not necessarily welfare-maximizing actions from clients' perspectives. The asset manager's holdings make it artificial to talk about distinctions between the classes of shareholders, employees, creditors, and even the community at large. It no longer

47. As of November 6, 2018 (weightings are updated quarterly). S&P 500 COMPANIES BY WEIGHT, SLICKCHARTS, https://www.slickcharts.com/sp500.

48. The client's stake is $2,000/$50 billion = 0.000004%. Her share of the profits from the faulty ignition switch are therefore (0.000004%)($30 million)=$1.20.

49. With $33.4 million invested in the S&P 500, the client's stake in GM is ($33.4 million)(0.2%)/($50 billion)=0.00013%. Therefore, her share of the profits are (0.00013%)($30 million)=$40.08.

50. In fact, a purchaser of a different car brand still faces some cost from GM's faulty ignition switch. They may be a passenger in a family member's GM car at some point. And even if they never drive in a GM vehicle, the presence of malfunctioning vehicles increases the probability of an accident for all drivers.

makes sense to speak of the interests of "the shareholder" or "the public" when the asset manager subsumes these diffuse interests. Through its many multifaceted clients, the asset manager represents all stakeholders, raising the fundamental issue of what should be the objective function of an asset manager that holds a diversified portfolio and represents a broad cross-section of society.[51]

The simplest solution for the asset manager is to ignore the question entirely and to remain a passive investor: investing in companies on behalf of clients but taking no actions to affect firms' behavior. However, remaining passive means that the asset managers' clients forgo any of the potential gains that could be created by the asset manager. Instead of remaining passive, the asset manager may choose to view its clients solely as shareholders. The asset manager could therefore maximize the value of assets under management and ignore the effects of portfolio companies' actions on its clients in their non-shareholder roles. This would have the effect of limiting interactions with portfolio firms to those that improve the value of the portfolio. For example, asset managers may induce portfolio firms to consider their respective externalities on one another. Recent research suggests that asset managers support anticompetitive behavior in portfolio companies, particularly within the airline and banking industries.[52] Other research suggests that anticompetitive behavior in the airline industry might increase the value of airline stocks, but has an uncertain effect on the market portfolio, as other firms must bear the increased costs and inefficiencies associated with anticompetitive behavior.[53]

But an asset manager that views clients only as shareholders may support actions that harm clients in other ways. Even if anticompetitive airline pricing maximizes the value of a client's portfolio, any client that regularly flies will be harmed by anticompetitive behavior. As a fiduciary, the asset manager should do what is in the best interest of its clients. Further, a proper examination requires looking at clients in all of their complexity—not just as shareholders, but also as creditors, customers, employees, and the public at large. The large number of diversified shareholders makes the traditional distinctions between corporate constituencies artificial.

An asset manager that is doing what is best for its clients must consider clients' total welfare, not just the financial returns from their portfolios. This complicates the asset manager's objective function. Not only must the asset manager think about individual clients in all their complexity, but they also must aggregate the interests of millions of individual clients. Many corporate actions will have both winners and losers, and the asset manager needs to balance clients' interests. The following example helps illustrate the decisions facing an asset manager acting in the best interest of its clients.

In 2017, DuPont paid $670 million to settle litigation related to its emissions of a toxic chemical in West Virginia.[54] The toxin was extremely harmful from a social perspective, causing extensive health problems to those living in the vicinity of the

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51. The complexity of this question was alluded to in Anat R. Admati, Paul Pfleiderer & Josef Zechner, *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097 (1994).

52. See all the publications cited in notes 1 and 2, *supra*.

53. Menesh Patel, *Common Ownership, Institutional Investors, and Antitrust*, ANTITRUST L.J. (forthcoming); C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership* (NYU L. & Econ. Research Paper No. 18-29; European Corp. Governance Inst. (ECGI) - Law Working Paper No. 423/2018, Dec. 1, 2018).

54. Shapira & Zingales, *supra* note 7.

DuPont factory. DuPont was aware of the harms as early as 1984, yet continued to emit the toxin for decades. An examination of internal DuPont documents reveals that the harmful pollution was not the result of a mistake or poor governance. Instead, managers believed the probability of being fined coupled with the expected magnitude of the fine favored emitting the toxin, as doing so was the profit-maximizing decision that was viewed to be in the best interest of shareholders.[55]

Profit-maximizing firms have many opportunities to create private benefits while imposing social costs. When shareholders are thought of only as shareholders, doing so is rational, if amoral, as DuPont's shareholders were expected to benefit from releasing the toxin. But suppose that an asset manager was in the meeting where DuPont made the decision to knowingly emit the toxin. Like other financially-motivated shareholders, the financial portfolios of the asset manager's clients favor pollution. However, some of these clients will be among those harmed by the toxin; accordingly, the welfare-maximizing decision for these clients is to refrain from polluting. Increasing your portfolio by a few dollars is not worth the risk of developing cancer, but because the harm stemmed from a single factory in West Virginia, only about 70,000 individuals were exposed to the contamination. Since a large asset manager may have tens of millions of clients, even if all 70,000 who were exposed were clients, this would still only be a small percentage of the asset managers' clientele. Furthermore, the clients that were not affected by the toxin benefited not just from DuPont's share price, but also from the lower costs of DuPont's products.

In cases such as this, the asset manager faces a tradeoff between the portfolio gains of millions of clients and the health externalities to a subset of clients. If the asset manager follows the purely financial interests of the vast majority of its clients, it would endorse emitting the toxin. On a case-by-case basis, an asset manager that seeks to emulate the majoritarian preferences of its clients would tend to favor inefficient actions that increase a firm's share price while imposing localized costs on other constituencies.

However, this short-sightedness may have negative implications for the asset manager's clients. On a case-by-case basis the majority of clients can profit at the expense of a minority, but this might eventually lead to parties being worse off than they would otherwise be. The DuPont case harmed a community in West Virginia, but other cases harm other constituencies. Tobacco companies misled the public about the harm from cigarettes, automakers hid defects leading to deaths, and banks have assumed socially-damaging levels of leverage.[56] Furthermore, corporations can mistreat employees, and place creditors and the public at unnecessary risk to increase profits. In other cases, corporations lobby against, or avoid paying, taxes. In these examples and others, the effect is to create private profits at the expense of other members of society. In each individual case, the majority of an asset manager's clients profit at the expense of a specific constituency's harm. But taken together, most of the asset manager's clients suffer, as each is eventually affected negatively by some corporate actions, outweighing minor financial gains.

The asset manager will benefit its clients by looking beyond clients' narrow case-by-case preferences to their broader interests. Instead of deciding what clients would prefer in each case, the asset manager should commit to the decision function

55. *Id*.
56. Admati, *supra* note 19.

that would be best in aggregate. This avoids a multitude of short-sighted decisions that make all parties worse off. To see this more clearly, consider an example of an asset manager with four clients: A, B, C, and D, each with equal wealth. The asset manager is the sole investor in three companies: 1, 2, and 3. Each company can take an action that will increase the value of the company by $20. However, these actions impose costs on others in society: company 1's action creates a harm of $25 to A, company 2's action creates a harm of $25 to B, and company C's action creates harm of $25 to C.[57] In each case, the companies' actions create private financial gains for the company's shareholders but have net effects of decreasing social welfare. Yet, in each case, three of the four shareholders prefer that the company at hand take the harmful action. Shareholders B, C, and D gain from company 1 taking an action that harms only shareholder A. Similarly, only B prefers company 2 to not take the action and only C prefers company 3 not to take the action. If corporate managers take the actions preferred by shareholders on a case-by-case basis, the net effect is that shareholders A, B, and C are worse off by $10.[58] This illustrates an important point: it is not enough for company managers to think about the case-by-case preferences of its shareholders. Doing so can still make shareholders worse off than they would otherwise be.

In each decision, the asset manager faces a tradeoff between financial gains to its clients and costs unrelated to the share price. The above example illustrates that a case-by-case majoritarian approach can make clients worse off. But there are many possible decision functions that an asset manager could commit to, and each will have winners and losers. For example, if the asset manager allowed company 1 to harm shareholder A, but did not allow companies 2 and 3 to harm shareholders B and C, then shareholder A would be $20 worse off, while shareholders B, C, and D would each be better off by $5. There are many ways that the asset manager could decide to act, further complicating the analysis.

But the analysis is simplified by the anonymity of the asset manager's clients. In reality, the asset manager cannot observe precisely which clients are affected by the corporations' decisions. The asset manager may learn that company 1's action causes $25 of harm, but it is unlikely to be able to identify shareholder A as the harmed party. Rather than complicating the asset manager's problem, the anonymity of who precisely the company harms simplifies the problem. If the asset manager only knows that a corporation's action will create $20 of gain and $25 of harm for its clients, the optimal solution is to not take the harmful action, because it makes all of the asset manager's clients worse off in expectation. Instead of deciding which clients to favor, the asset manager maximizes their total welfare by committing to only endorse actions that improve social welfare.

While shareholders A, B, and C are better off because of the asset manager's focus on social welfare, shareholder D is not. Because D is not adversely affected by any of the harmful actions, she may prefer for the companies to maximize profits, despite the harm to others in society. Similarly, if a corporation could take an action that harmed non-shareholders, all four shareholders—and the asset manager—may

57. There are many justifications for these decisions. For example, company 1 may be able to increase profits by decreasing safety standards at a plant where A works, company 2 may be a monopolist and may be able to increase the cost of a medication that B has inelastic demand over, and company 3 may be able to take a risky business decision where C is a creditor that will bear the company's losses.

58. Each shareholder captures 25% of the financial gain from the three companies' decisions but bears the entire cost of one of the decisions: 0.25*(20+20+20)-25= -10.

endorse taking the action. The asset manager's interests are aligned with social welfare, but they are not perfectly aligned.

Even this misalignment is reduced when we consider the anonymity of the asset manager's clients. The asset manager has an idea about the magnitude of harms, but it knows much less about the distribution of harms in society. In the DuPont case, the asset manager does not know whether those harmed by actions are clients or not. This anonymity means that the asset manager's decisions must be made behind a veil of ignorance.[59] The asset manager is deprived of knowledge of the precise effects of a corporation's actions, and instead must make decisions based on expectations. This gives its decisions a degree of impartiality. It must weigh the financial benefits that accrue to clients against the costs to the rest of society, recognizing that its clients may be among those harmed by the actions. In other words, by representing their clients' interests, asset managers should have preferences for portfolio companies to act in the public interest. Social welfare should enter into an asset manager's objective function alongside the financial performance of portfolio firms.

In this sense, asset managers share some of the state's interests in social welfare. The state's ultimate interest should be social welfare, and it should charter corporations for that purpose. For the state, corporations' profits are not an end in and of themselves, but instead are a means of improving social welfare. Similarly, the asset manager's clients are interested in their financial portfolios not in and of themselves, but as a means of improving their utilities. The number and diversity of the asset manager's clients means that the best proxy for its clients' utilities is not simply the financial value of the portfolio, but also social welfare. The distinction between clients' interests and the public interest becomes blurry.

The analogy is not perfect. The large asset managers have tens of millions of clients. And while these clients represent the interests of a large portion of society, the clients are not a representative sample. Half of Americans have no money invested in the stock market, and asset manager's clients can be expected to be older, wealthier, and whiter than society as a whole.[60] An asset manager that takes its clients' interests into account will consider social welfare, but the alignment between clients and the general public is not perfect. However, an asset manager that represents its clients' interests is more aligned with the public interest than any other actors that have the ability to meaningfully influence corporate decision making. In most cases, actions that create a public benefit will create a benefit for the asset manager's clients. An asset manager that is considering what is best for its clients should be interested both in the financial returns of portfolio companies and their effects on social welfare.

Given the interests of asset managers' clients, asset managers should commit to take actions influencing portfolio companies to consider the social welfare effects of their actions. Asset managers are not the only actors that should take actions to further the public interest, but they are the best positioned. Many other institutional investors also represent a wide range of individuals, but none can match the public interest and ability to effect change of the large asset managers. In principle, sovereign wealth funds should represent the public, but most of the large sovereign

59. J. RAWLS, A THEORY OF JUSTICE (1971).

60. Helaine Olen, Opinion, *A Record-Breaking Market Doesn't Matter to Most Americans*, WASH. POST, https://www.washingtonpost.com/blogs/post-partisan/wp/2018/08/22/a-record-breaking-market-doesnt-matter-to-most-americans/?utm_term=.8a5610dc0179.

wealth funds are controlled by non-democratic governments, undermining their ability to commit to public purposes.[61] Pension funds share asset managers' time horizons and broad clientele, but even the largest funds have tiny assets compared to the large asset managers.[62] Actively traded funds may be large, but because they are not committed to holding all companies indefinitely, they lack the incentives and ability to make beneficial commitments. Activist hedge funds regularly agitate for change at companies, but they are not well positioned to influence more than a handful of firms.[63] Accordingly, asset managers are best positioned to represent the public interest and to take actions to further that interest.

III. Focusing on "Shareholder Value": What Asset Managers Do

The large asset managers should internalize their clients' interests in social welfare in addition to financial returns. But for asset managers to further social welfare, they must have the ability to influence the firms in their portfolios. This section discusses the abilities of asset managers to influence decision making at portfolio companies.

The asset managers' ability to effect change comes from their extraordinary size. At the end of 2017, BlackRock, the world's largest asset manager, had $6.2 trillion of assets under management. Vanguard managed a further $5.2 trillion, while State Street managed $2.8 trillion. The holdings of the large asset managers are both broad and deep, consisting of significant shares in most publicly traded companies. Globally, BlackRock manages blocks of at least 3% in 3,648 publicly traded companies, blocks of at least 5% in 2,632 publicly traded companies, and blocks of at least 10% in 375 publicly traded companies. To put this in perspective, there are approximately 3,900 publicly listed companies in the United States, and BlackRock manages blocks of at least 5% in over half of them. While smaller, Vanguard and State Street share a similar pattern. If they were to pool their assets, BlackRock, Vanguard, and State Street would comprise the largest shareholder in 88% of the S&P 500 companies.[64]

Index funds comprise the majority of the large asset managers' equity holdings. Passive funds are far less expensive than actively traded funds, but because they track a particular set of stocks, asset managers cannot effectively use the threat of exit to induce change at portfolio companies.[65] As former Vanguard Chairman and CEO William McNabb put it: "We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is

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61. Sovereign-wealth funds, The Economist (Feb. 25, 2017), https://www.economist.com/economic-and-financial-indicators/2017/02/25/sovereign-wealth-funds.

62. Catherine Austin Fitts, The State of America's Pension Funds, Global Research (Jan. 22, 2018) https://www.globalresearch.ca/the-state-of-americas-pension-funds/5630374 (showing that the largest plan in the United States, CalPERS has only about $300 billion of assets under management).

63. Section III, *infra*, discusses activist hedge funds in more depth.

64. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 1.

65. The ability of a large shareholder to sell its position in a company can help align managerial behavior with shareholder preferences. Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 Rev. Fin. Studies 2645 (2009).

piling in. And when everyone else is running for the exits."[66] The large asset managers' holdings are both large and long-term.[67] Contrast this with actively managed funds or activist hedge funds that have significantly more leeway to buy and sell shares in companies. While this flexibility allows activist hedge funds to quickly build up large stakes in firms, the likelihood that they will not be holding the stock in several years' time lessens their ability to make credible commitments to their portfolio companies.

Asset managers focus on "shareholder value" as measured through financial metrics: State Street's stewardship philosophy is "protecting and promoting the long-term economic value of client investments;"[68] BlackRock's mission is "to create a better financial future for our clients;"[69] and Vanguard's approach entails an "unwavering commitment to the long-term economic value of your funds' investments."[70]

In recent years, asset managers' focus on clients' finances has moved away from only proxy voting and towards direct engagements with portfolio companies. In the three years from July 2014 through June 2017, BlackRock, Vanguard, and State Street collectively performed 8,553 private engagements with corporations on everything from climate disclosure to board composition to long-term strategy. Collectively, smaller asset managers also performed thousands of engagements. In this essay, I use the term engagement to mean conversations between asset managers and target companies. This is a broad definition that captures many activities ranging from short phone calls concerning minor questions to multi-year interactions on a company's long-term strategy. Here, it is important to emphasize the distinction between engagement by asset managers and engagement by activist hedge funds.

The business model of an activist hedge fund is to identify an underperforming firm, acquire a significant stake in that firm, agitate for value-improving change, and then to sell the stake at a significant premium. Activism by activist hedge funds is the most salient form of shareholder engagement—it is generally public, often contentious, and is meant to make substantial changes to firms' operational details that result in significant increases in firms' share prices. Activists frequently push for changes in board representation, strategy, executive structure, and financial management.[71] To achieve these goals, activist hedge funds invest the equivalent of one to three years, or more, in due diligence with a target firm before initiating

66. F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 24, 2015), https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/.

67. For example, the Vanguard 500 has an annual turnover rate of only 3%. VANGUARD, VANGUARD 500 INDEX FUND PROSPECTUS (Apr. 25, 2018), https://personal.vanguard.com/pub/Pdf/p040.pdf.

68. STATE STREET GLOBAL ADVISORS, 2016 YEAR END ANNUAL STEWARDSHIP REPORT (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf.

69. BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP (January 2019), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.

70. VANGUARD, 2018 INVESTMENT STEWARDSHIP REPORT (Aug. 15, 2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf [hereinafter "Vanguard 2018"].

71. April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188, 226 (2009).

negotiations with management and launching proxy contests.[72]

Asset managers are not well-positioned to perform engagements in the style of activist hedge funds. While activist hedge funds can target a small number of firms, asset managers hold the entire market. Though it is possible for asset managers to perform activist-style interventions at a number of firms, doing this for every portfolio company would require millions of hours of effort.[73] Finally, because activist-style interventions are so costly and time-consuming, agency costs are more likely to bind and to limit the incentives of asset managers.

For these reasons, the investment stewardship departments at asset management companies have focused their engagements on high-level governance issues. Most fundamentally, asset managers focus on board composition. Boards are responsible for setting a company's strategic aims and establishing a framework for risk management. Without an effective board of directors, executives will be ill-positioned to manage threats and opportunities for their company. Assessing a Board's quality is not simple or formulaic. For any element of corporate governance, it is possible to find a fraud or mismanagement that occurred under "ideal" governance practices. Quality may be assessed on several factors, including: the fit between directors and the firm's strategy, the tenure of board members, the responsiveness of the board to investors, and the comprehensiveness of succession planning. Engagements on board composition can take many forms. In some cases, a formulaic approach may be applied—for example, how many outside directors are on the board? In other cases, engagement may be more qualitative—for example, does this board have a coherent long-term strategy? Engagements that focus on board composition are not focused on operational details. Instead, these engagements seek to create a team that will be able to identify and address these concerns without further oversight by the asset manager.[74]

The degree to which asset managers can improve board quality is unclear. Asset managers do not provide sufficiently granular data to judge their effectiveness. All we have is the anecdotal evidence that the asset managers publicize. For example, a pharmaceutical company that faced financial distress populated its board with directors that had distressed-debt experience and successfully turned the company around. However, after the turn-around, this board was ill-suited to run a pharmaceutical company and consistently reported disappointing results. Over two years, an asset manager engaged with the company to appoint different directors with skills better equipped for the company's current challenges.[75] In other cases, asset managers have engaged with companies to improve CEO succession planning.[76] While many scholars have called for large institutional investors to play an increased role in improving board quality, doing so is difficult,[77] and asset managers' efforts

72. Cas Sydorowitz, *Successful Activism—What Does It Mean?* ETHICAL BOARDROOM (last visited Jan. 19, 2019), https://ethicalboardroom.com/successful-activism-what-does-it-mean/.

73. Section VI, *infra*, discusses the perception that disclosure requirements prevent asset managers from engaging with portfolio firms.

74. STATE STREET GLOBAL ADVISORS, *supra* note 68, at 12.

75. BLACKROCK, 21ST CENTURY ENGAGEMENT (2015), https://www.blackrock.com/corporate/literature/publication/blk-ceres-engagementguide2015.pdf.

76. *Id*. at 42.

77. For example, Enron's board was compliant with most of the best practices of time, including having an independent director and fully independent audit and compensation committees. DAVID LARCKER & BRIAN TAYAN, CORPORATE GOVERNANCE MATTERS (2nd ed., 2016).

could fruitfully be applied elsewhere.

Improving a company's disclosure is one such area that asset managers can be more effective. Investors have an interest in ensuring that they can understand what the company is doing. While more disclosure is not necessarily better, investors engage companies to improve disclosure across a few areas. In recent years, engagements have sought to better understand companies' risk factors. In particular, climate risk has become a focus of investors, not simply for ideological reasons, but for financial reasons as well. Engagements on disclosure may also seek to learn about companies' long-term strategies. By engaging to improve disclosure, investors accomplish two things. First, investors help ensure that the market price of a company's stock better reflects its underlying value. And second, it becomes easier for investors to identify poor management.

At times, there are issues that face an entire industry, sector, or location. Or there may be issues that permeate across the entire economy. The large asset managers have both the incentive and ability to engage across an entire industry because of the breadth, depth, and time-horizon of their holdings. At first blush, it may seem too costly to engage across an entire industry. However, the large asset managers can realize economies of scale because of the similarity of these engagements, and thereby lower the average cost of engagements.

The flexibility of direct engagements allows asset managers to interact with companies in a more nuanced way than through voting by focusing on issues that are not directly voted on. Furthermore, direct engagements are a two-way street. Not only do asset managers express their concerns to companies, but managers and directors seek the input of asset managers. An analyst at an asset manager reported that, during proxy season, about 75% of engagements are initiated by corporations, which frequently contact asset managers because they are concerned about the voting recommendations given by proxy advisory firms such as ISS or Glass Lewis.[78] At other times of the year corporate managers and directors contact asset managers with the intention of preemptively garnering support by actively soliciting their views on governance matters. In 2010, only 6% of S&P 500 companies disclosed engagements with investors.[79] By 2017, 72% of companies disclosed engagement with investors, where a full 29% of companies disclosed that directors were involved in engagements with investors.[80]

The prevalence of direct engagements has important voting implications. An analysis of proxy voting shows that institutional investors with a high share of passive funds almost always vote with management.[81] Among contentious votes, passive funds vote with management 53% of the time, compared to active funds that

78. Conversation between the author and analyst.

79. EY, *Four Takeaways from Proxy Season 2015*, EY CENTER FOR BOARD MATTERS (June 2015), https://www.ey.com/Publication/vwLUAssets/EY-four-takeaways-from-proxy-season-2015/$File/EY-four-takeaways-from-proxy-season-2015.pdf.

80. Mark Manoff & Steve Klemash, *2017 Proxy Review Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 9, 2017), https://corpgov.law.harvard.edu/2017/07/09/2017-proxy-season-review/.

81. R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016); Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds (Feb. 14, 2018) (unpublished manuscript).

only support management 47% of the time.[82] Some have argued that this is evidence that passive managers pursue a "low-cost, unthinking approach to governance."[83] However, making such a conclusion based on voting behavior is premature, because asset managers claim that they often use voting only when engagements have failed.[84] For example, in 2017, two US energy companies faced shareholder resolutions on climate risk.[85] Vanguard engaged with these two firms, and secured commitments from the management teams to increase disclosure of climate risk. Given this responsiveness, Vanguard did not support either proposal, and instead committed to following up to ensure that the companies follow through on their commitments. In another case, Vanguard engaged with another energy company for years, and only voted against management in a shareholder proposal and withheld votes for independent directors after persistent resistance from the company.[86]

Without knowing Vanguard engaged with these firms, it may appear that it is either overly-supportive of management or that it is utilizing an "unthinking approach to governance." But any examination that attempts to gauge the sophistication of an asset manager's governance based solely on voting behavior will have biased results if asset managers use engagement at a significant scale. In this case, it would appear that Vanguard opposed increased climate risk disclosure because of its support of management. Only upon learning about the content of Vanguard's engagements is its position clear. Vanguard can learn about management's perspective and can express its views in a more nuanced manner by directly engaging than through a proxy vote. While passive funds support management at a higher rate than active funds, this number alone cannot tell us that passive funds are more compliant than active funds. Judging asset managers' behavior would entail examining behind-the scenes actions in addition to voting behavior.[87] As expressed by Chair of the Securities and Exchange Commission Mary Jo White, "Direct engagement with a company is likely to be more meaningful than a precatory vote on a 500-word proposal."[88] However, in those cases that public appeals and direct engagements are unsuccessful, voting is a powerful tool at asset managers' disposal.

The asset managers' annual reports give anecdotes of engagements and statistics on voting, but quantifying the effect of asset managers on firms is tricky. A change in operational details, such as selling a division or changing capital structure may have an immediate and measurable impact on firm's profitability and share price. Yet, governance improvements are much subtler. A "good" board of directors is better than a "bad" board of directors, but this can be hard to measure. The difference between good governance and bad governance may only emerge in certain cases. Recent papers on the governance effects of index funds have been able to get around

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82. Davidson Heath et al., Passive Investors Are Passive Monitors (last rev'd Jan. 8, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3259433.

83. Dorothy Lund, *The Case Against Passive Shareholder Voting*, J. CORP. L. (forthcoming) (Univ. of Chic. Coase-Sandor Inst. for L. & Econ., Research Paper No. 829, Mar. 21, 2018)).

84. STATE STREET GLOBAL ADVISORS, *supra* note 68.

85. Vanguard 2018, *supra* note 70.

86. *Id*.

87. Asset managers should take step to share this data with researchers.

88. Mary Jo White, *Building Meaningful Communication and Engagement with Shareholders*, U.S. SEC. & EXCH. COMM'N (June 25, 2015), https://www.sec.gov/news/speech/building-meaningful-communication-and-engagement-with-shareholde.html.

this problem by exploiting institutional details of the composition and ownership of index funds. Popular indexes such as the S&P 500, the Russell 1000, and the Russell 2000 track various segments of the stock market. Whether a company is included in an index depends primarily on its market capitalization—the S&P 500 tracks 500 large companies with stock listed on the NYSE or NASDAQ; the Russell 1000 comprises the largest 1,000 U.S. stocks in terms of market capitalization; the Russell 2000 tracks the next 2,000 largest stocks. Index funds provided by asset managers track a given index, so inclusion of a company in an index results in increased ownership by the asset manager. Furthermore, index funds are asset weighted, so a large company will comprise a larger share of an index than a small company does.[89] These institutional details allow researchers to compare two types of firms—those that are barely included in an index, and those that are not. These firms are very similar to one another, but inclusion in the index significantly increases ownership by asset managers.[90]

Utilizing this strategy, researchers have found generally positive effects of index funds and ownership by asset managers on firms' governance. Inclusion of a company in an index is associated with increases in the probability of management turnover,[91] increases in the sensitivity of CEO pay,[92] increases in the number of independent directors,[93] decreases in turnover among independent directors,[94] reductions in takeover defenses, more equalized voting rights,[95] and decreases in the likelihood that management proposals will pass. The changes to governance associated with index fund inclusion are also associated with changes to operational details. Firms increase spending on R&D,[96] file more patents,[97] make fewer cash and diversifying acquisitions,[98] have lower cash expenditures,[99] and make significant improvements to firms' long-term performance.[100]

However, the effects are not uniformly positive. Using this identification strategy and others, others have found that index funds vote with management more

89. For example, Apple, the largest firm in the S&P 500, has a weight of nearly 4%, and the smallest weighting in the S&P 500 belongs to News Corporation Class B shares, which have a weighting of only 0.007%.

90. Appel, Gormley & Keim, *supra* note 81, find that the largest firms in the Russell 2000 index have passive ownership that is 66% higher than the smallest firms in the Russell 1000 index. This specification and the corresponding results are controversial. Wei Wei and Alex Young challenge the use of a regression discontinuity design because preexisting trends. Wei Wei & Alex Young, *Selection Bias or Treatment Effect? A Re-Examination of Russell 1000/2000 Index Reconstitution* (Nov. 17, 2017) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2780660. Heath et al., *supra* note 82, develop a new regression discontinuity design that is meant to get around the failings of the other studies and find that index funds are more likely to vote with management than other funds.

91. William Mullins, The Governance Impact of Index Funds: Evidence from Regression Discontinuity (Jan. 7, 2014) (unpublished manuscript).

92. *Id*.

93. Appel, Gormley & Keim, *supra* note 81.

94. Cornelius Schmidt & Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?* 124 J. FIN. ECON. 285 (2017).

95. *Id*.

96. Philippa Aghion, John Van Reene & Luigi Zingales, *Innovation and Institutional Ownership*, 103 AM. ECON. REV. 277 (2013), https://www.aeaweb.org/articles?id=10.1257/aer.103.1.277.

97. *Id*.

98. Mullins, *supra* note 91.

99. *Id*.

100. Appel, Gormley & Keim, *supra* note 81.

than actively traded funds,[101] that there is a negative market reaction following an index fund's support of a passing agenda item,[102] and that increased passive ownership is associated with increases in CEO power. Furthermore, all of the studies leave open questions about the mechanisms through which passive funds influence portfolio firms. While we need more research on what effects asset managers *do* have on portfolio companies, the next sections speak to the effects that asset managers *could* and *should* have on portfolio firms.

IV. THE ABILITY OF ASSET MANAGERS TO EFFECT CHANGE

As things stand, the large asset managers see investment stewardship through a particularly narrow focus on clients' financial portfolios. However, this narrow perception of clients' interests can harm clients' welfare. Asset managers that focus only on clients' portfolios implicitly endorse corporate actions that are good for clients' finances, but bad for clients' welfare and society more broadly. Large asset managers that truly act in the best interests of their clients would have quasi-governmental interests in social welfare. However, asset managers lack states' police powers and the ability to make and enforce binding rules. While they manage significant portions of companies, their holdings are minority blocs, so there are constraints on their ability to force companies to change. However, asset managers do have the tools to have a significant impact on individual firms and the economy at large. This section shows that the asset managers' tools can give them the power to exercise quasi-governmental oversight over portfolio companies.

Asset managers' most powerful tool is the development of norms around the social purpose of corporations. By framing corporate discourse, asset managers can have a large and beneficial impact on clients and society as a whole. However, it is not enough for asset managers to espouse the importance of socially-beneficial behavior; they must also take actions to ensure that firms respond. In order to enforce the adoption of socially-desirable corporate norms, asset managers can use public speech, direct engagements, and voting.

State Street's campaign to improve gender diversity on corporate boards is an example of an asset manager using these tools to achieve social purposes. Regardless of the financial ramifications of gender diversity on boards of directors, there are non-financial benefits to society if female representation on corporate boards increases. In 2015, State Street started to address the gender gap in corporations. The first step was to address norms of gender equality: it publicly committed to "achieve gender equality and empower all women and girls."[103] It then publicly asked portfolio companies to "take intentional steps to increase the number of women on their corporate boards."[104] After espousing the norm of increased gender diversity, State Street turned to engagements to establish and reinforce the norm. In 2017, following its public appeals, State Street directly engaged with over 700 companies

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101. Heath et al., *supra* note 82.

102. *Id*.

103. STATE STREET CORP., STATE STREET CORPORATE RESPONSIBILITY REPORT 2016, at 63, http://www.statestreet.com/content/dam/statestreet/documents/values/StateStreet_2016_CorporateResponsiblityReport.pdf.

104. BUSINESS WIRE, *State Street Global Advisors Calls on 3,500 Companies Representing More Than $30 Trillion in Market Capitalization to Increase Number of Women on Corporate Boards* (Mar. 7, 2017), https://www.businesswire.com/news/home/20170307005817/en/.

that had no women on their boards of directors. These engagements were successful at getting 152 companies to add at least one woman to their board.[105] However, because engagements alone were insufficient to induce change at many firms, State Street exercised its voting power and voted against directors on nominating committees at over 500 companies that failed to address its concerns over gender diversity.[106] Following these votes, an additional 149 companies have added at least one woman to their boards.[107] As fewer firms retain all-male boards, and as State Street continues to withhold votes from non-compliant boards, the gender-diversity norm will grow stronger.

This example illustrates some of the advantages of asset managers inculcating norms rather than relying on laws. Political economy concerns make it difficult to pass laws. Even if laws are passed, they can be challenged and rescinded.[108] In some cases, laws have the counterproductive effect of crowding out norms and prosocial behavior.[109] Asset managers can use the above-mentioned tools to further a wide set of policies that are in their clients' interests. In the following section, I will discuss the tools at asset managers' disposal, and then the agency costs and the internal structures of the large asset managers.

A. Norms

There are thousands of publicly traded companies in the United States and many more throughout the world. While asset managers can directly engage with some firms, it is infeasible for them to meaningfully engage with all firms. Accordingly, asset managers' most powerful tool is their ability to shape broad norms governing the behavior of corporations. To be successful, they must be able to shape norms of many firms with relatively little individualized attention to any given company.

While scholarship in finance, economics, and corporate law primarily focuses on the self-interested actions of managers, shareholders, and other actors, their behaviors are also dictated by norms. Individual incentives guide behaviors with the prospect of future awards, while social norms "push" individuals to act as if by inertial forces.[110] A norm is sustained in society when it is broadly shared by others

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105. STATE STREET GLOBAL ADVISORS, STEWARDSHIP ACTIVITY REPORT: Q1 2018 (May 29, 2018), https://www.ssga.com/our-insights/publications/stewardship-activity-report-q1-20180.html.

106. State Street's campaign was coupled with the addition of the "Fearless Girl" statue facing the Charging Bull statue in New York's financial district, resulting in a publicity coup. The statue garnered billions of social media impressions in the span of a few weeks. State Street Global Advisors, *Fearless Girl* (last visited Jan. 19, 2019), https://www.ssga.com/global/en/about-us/who-we-are/fearless-girl.html. Apex Marketing Group estimated that State Street garnered $13 million in publicity from the campaign. Jeff Green, *Fearless Girl Has Been a Publicity Coup for State Street*, BLOOMBERG (Mar. 7, 2018), https://www.bloomberg.com/news/articles/2018-03-07/fearless-girl-has-been-publicity-coup-for-state-street-chart.

107. STATE STREET GLOBAL ADVISORS, *supra* note 103.

108. California's recent law requiring gender diversity may not hold up to judicial scrutiny. *See* Theodore N. Mirvis & Kevin S. Schwartz, *California Law Awaiting Governor's Signature Exceeds State's Jurisdiction*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 24, 2018), https://corpgov.law.harvard.edu/2018/09/24/california-law-awaiting-governors-signature-exceeds-states-jurisdiction/.

109. Roland Benabou & Jean Tirole, *Laws and Norms* (Nat'l Bureau of Econ. Research, Working Paper No. 17579, 2011), https://www.nber.org/papers/w17579.

110. More formally, Jon Elster explains that rational behavior is outcome-oriented and dictates an optimal strategy—to achieve Y, do X. Norms are generally perceived to be non-outcome-oriented—do X.

who help to sustain it through their own actions, approval, or disapproval. Norms can arise organically or may be intentionally shaped by governments or other actors.

There are many norms that influence corporate decision making, but the overarching "shareholder value" norm is the most important. The consensus view is that managers should manage the corporation in the interest of shareholders, where the share price is the primary means of measuring shareholders' interests.[111] This is a relatively new norm—throughout most of the history of the corporate form, no such norm had existed. Despite the many pathologies that arise from the shareholder value norm, it has remained persistent and if anything, has grown stronger. The shareholder value norm is very impactful on corporate governance. A survey of directors of Fortune 200 companies found that almost all would condone the release of a harmful toxin in order to increase their firm's share price.[112] When justifying their decisions, the directors indicated that they had duties to shareholders and that there were legal ramifications if they violated these duties (however, their decision would have been clearly protected by the Business Judgment Rule, so there were no legal duties in this case). While some directors acknowledged that they owed duties to other stakeholders, they believed that "the primary stakeholder is the shareholder." Furthermore, directors that did not want to emit the toxin yet nonetheless chose to do so made statements such as "I cannot violate my responsibility to owners because I have personal feelings about the decision." This survey evidence comports with near-daily evidence of corporate management taking actions that increase the share price at the expense of social welfare. While the shareholder value norm can decrease social welfare, it is self-reinforcing. A CEO that takes an action with general welfare benefits while failing to maximize the share price risks the possibility of facing a hostile activist. The threat of a proxy contest may be sufficient to induce most managers to maximize the share price even when doing so harms others in society.

The pathologies that arise from the shareholder value norm do not imply that corporations should not pursue policies that increase the share price. Instead, it would be socially optimal if corporations considered the social welfare effects of their actions in addition to considerations of share price. Asset managers should inculcate norms to these ends and have the tools to do so. In January 2018, BlackRock CEO Larry Fink released his annual letter to CEOs. The letter called for "a new model of corporate governance," where "companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate." Fink's letter drew wide attention and resonated with many people because of his emphasis that long-term shareholder value is inexorably linked to the success and empowerment of other stakeholders:

> "Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures

Jon Elster, *Social Norms and Economic Theory*, 3 J. ECON. PERSP. 99 (1980), https://www.aeaweb.org/articles?id=10.1257/jep.3.4.99).

111. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* (Yale L. Sch. Working Paper No. 235; NYU Working Paper No. 013; Harv. L. Sch. Discussion Paper No. 280; Yale SOM Working Paper No. ICF - 00-09, Jan. 2000) https://ssrn.com/abstract=204528 or http://dx.doi.org/10.2139/ssrn.204528.

112. Jacob M. Rose, *Corporate Directors and Social Responsibility: Ethics Versus Shareholder Value*, 73 J. BUS. ETHICS 319 (2007).

> that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education."

Appeals to good citizenship sometimes work well. But appeals are much more effective when coupled with social comparisons.[113] When the observability of an individual's (or corporation's) behavior is more salient, individuals feel a stronger desire to appear to be good. Furthermore, appeals are more successful when they are able to change reference norms. Currently "shareholder value" is the reference norm of corporations, and managers can easily use it as a justification. However, as norms move towards taking social welfare into account, perceptions of what a "normal" behavior is will change.

In order to positively impact norms, asset managers can make appeals to broader social welfare while simultaneously increasing the salience of those companies that do and do not adhere to these norms. Some progress has been made. In past letters to CEOs, BlackRock requested that CEOs communicate their "strategic frameworks for long-term value creation."[114] As part of this strategic framework, BlackRock looked "to see that a company is attuned to the key factors that contribute to long-term growth: sustainability of the business model and its operations, attention to external and environmental factors that could impact the company, and recognition of the company's role as a member of the communities in which it operates." By increasing disclosures, corporations' actions can be more easily observed and norms that promote social welfare can be better inculcated.

However, if asset managers truly intend to further the social purpose of corporations, it is not enough just to make calls for action and to increase the salience of those actions. Norms are important, but so is the self-interested behavior of those who run corporations. To be effective, the asset managers need to demonstrate commitment to ensuring that corporations serve social purposes. Corporate managers will be reticent to support broader notions of social welfare at the expense of share price when they are worried about the voracity of asset managers' support. If asset managers support a rival slate of candidates or a shareholder proposal because the manager is pursuing a strategy that does not maximize the share price, there is no reason that corporate managers and directors will embrace the norms espoused by asset managers. For this reason, it is essential that the large asset managers help corporations create beneficial commitments by supporting norms through direct engagements with corporations.

B. Direct Engagement

The large asset managers collectively perform thousands of direct engagements with portfolio companies every year. While these engagements generally focus on improving the financial performance of portfolio firms, direct engagements can also be used to help establish and reinforce the norms of social welfare discussed in the previous section.

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113. Robert B. Cialdini et al., *Managing Social Norms for Persuasive Impact*, 1 SOC. INFLUENCE 3 (2006).

114. Larry Fink, *Larry Fink's 2017 Letter to CEOs*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2017-larry-fink-ceo-letter.

At their most basic level, direct engagements can be used to clarify the asset manager's interests and wishes. An asset manager's interests extend beyond the financial performance of any given company, while firms have a much narrower focus on their own financial metrics. This focus by corporate insiders is understandable—shareholders typically judge them by financial metrics. Direct engagements are a means through which asset managers can extend a corporation's focus beyond financial metrics to encompass social welfare. Public appeals alone are insufficient—before State Street directly engaged with corporations, many investors had made public appeals for increased gender diversity but failed. The asset manager's direct engagements, and subsequent voting actualized these appeals.

To be effective, asset managers must demand that companies be proactive in disclosing their effects on social welfare. It is easy to see the number of women on a company's board but much harder to determine how the company is treating its employees or whether it is harming communities. The first step for asset managers should therefore be asking companies to explicitly enumerate how they are affecting not just shareholders, but also employees, customers, communities, the environment, and the public at large. Indices that measure corporations' non-financial impacts are a useful starting point, but they do not go far enough. In order for asset managers to best serve clients' interests, it is essential that companies provide meaningful disclosures on the ways in which they affect society. Only when asset managers understand how corporations are affecting society more broadly can they ensure that companies are acting in society's (and their clients') interests.

Increased disclosure allows asset managers to better understand the trade-offs between financial performance and social welfare. If the company can "do well by doing good," the manager can easily pursue both profit and social welfare without conflicts. However, even in these cases, corporate managers and directors may need a nudge from asset managers.[115] Asset managers should focus on cases involving a conflict between corporate profits and social welfare. The DuPont case is an example where managers and directors were faced with such a trade-off. Under the circumstances, the asset manager would like the corporation to take social welfare into account while managers and directors may be reluctant to do so. This reluctance may arise because those in charge of a corporation may fear for their jobs if they pursue a policy that fails to maximize financial returns.

Managers that do not maximize shareholder value as measured by stock price may be disciplined by the market for corporate control.[116] A poorly managed firm will be the target of a hostile takeover that will replace the underperforming manager. In the case of a manager pursuing social welfare at the expense of profits, the acquirer can profit by restoring the focus to purely financial metrics. Today this threat takes the form of activist hedge funds that initiate proxy contests at firms that are underperforming as measured by stock price. In recent years, boards of directors have seen the threat of activism become mainstream, and most boards have at least one member who has been targeted by an activist hedge funds.[117] Corporate decisions

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115. Gender diversity again provides an example. It is hard to imagine that adding a woman to a company's board would harm the company's performance. Yet despite the social benefits, hundreds of companies needed a nudge to appoint their first female director.

116. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

117. Lindsay Fortado, *Investing: Activism Enters the Mainstream*, FIN. TIMES (Feb. 13, 2018), https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2.

are increasingly made in the shadow of activists' threat as boards preemptively make decisions to forestall activists' aggressive engagements.

Corporate managers and directors cannot be expected to sacrifice financial profits if doing so results in an activist campaign. Therefore, asset managers need to use engagements to support companies that take social welfare into account. Proxy contests are hard-fought and expensive endeavors. Activist hedge funds will only initiate a proxy contest if there is a reasonable chance of success. Given the substantial holdings of the large asset managers, any activist that attempts a proxy contest without their support would face an uphill battle. Corporate managers and directors recognize the importance of maintaining relationships with the large asset managers and other large investors. Companies report that actively engaging with institutional shareholders is an integral part of winning contests against activists.[118] The large asset managers can be strong allies for management—or for the activist—during an activist campaign. Asset managers should use this power to commit to supporting managers and directors that respond to the asset managers' concerns. In his 2017 letter to directors, Vanguard's CEO summarized his position: "You can't wait to build a relationship until you need it."[119] Asset managers should not unthinkingly support incumbents. Engagements should be used to commit to supporting companies that are taking social interests into account. The stronger the threat of activists, the more influence asset managers can exert over portfolio companies.

While engagements can be an effective tool, they may not always be enough to induce companies to make beneficial commitments to other constituencies. In these cases, asset managers can use (or threaten to use) their voting power to induce change at portfolio companies.

C. Voting

When public appeals and direct engagements are insufficient to induce companies to take social welfare into account, the large asset managers can use voting to effect change. Unfortunately, voting is a blunt tool, because shareholders ultimately vote on so few things. While shareholder resolutions may make specific requests, these are generally non-binding. For the most part, the only meaningful votes that asset managers could regularly effect are votes on director elections. In some cases, there may be a close relationship between the issue at hand and a vote for a particular director. For example, in the case of State Street's campaign to elect more women to boards, a natural response to non-compliant companies was to withhold votes for directors who sit on nomination committees. Similarly, an issue of poor oversight may be dealt with by targeting members of the audit committee. But in many cases, there is no such nexus between the issue and a director vote. In these cases, the asset manager may vote against the board chairman, a subset of directors, or even the entire board. A strategy of "just vote no" can be an effective means of inducing change.[120]

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118. EY, *supra* note 79.

119. F. William McNabb III, *An Open Letter to Directors of Public Companies Worldwide*, VANGAURD (Aug. 31, 2017), https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf.

120. Joseph A. Grundfest advocated for "just vote no" campaigns in the context of antitakeover provisions. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside*

At first, it may appear unclear why the threat from an asset manager to vote against incumbent directors should carry any weight. Even a large asset manager is unlikely to control the votes of more than 10% of outstanding shares. While there are occasionally votes in which the asset manager would be pivotal, this is a minority of cases. Given that directors are generally re-elected with overwhelming support, withholding votes will not always have an immediate impact. Initially, the effect will be symbolic. All but the most vulnerable of directors would initially be able to keep their positions, even in the face of a large asset manager withholding the vote.

However, the size of the large asset managers coupled with their long time horizons make voting an effective tool for inducing change at companies. The large and long-term positions in index funds make asset managers credible long-term holders of their portfolio companies. This allows the asset manager to commit to voting against directors until the company complies. This decreases the probability that the director will be reelected in a future contest. Furthermore, the size and time horizons of the large asset managers allow them to gain support for their position from other investors. In principle, the large asset managers should share the same preferences, so votes against management by one asset manager will be noticed by other asset managers and investors. While the asset manager's voting preference may spread directly to other investors, there is a possibility that proxy advisory firms will adopt the asset manager's position. While the process of formulating recommendations is opaque, proxy advisors explicitly solicit feedback from investors when developing voting recommendations.[121] And because a negative recommendation by Institutional Shareholder Services is estimated to sway up to 20% of all votes cast,[122] losing the support of a proxy advisor significantly reduces a director's probability of reelection. Furthermore, votes against incumbent directors will make the company more appealing to activist hedge funds that can expect relatively more support from the asset manager.

The impact of voting depends on the relative costs that corporate managers and directors face from complying with the asset manager's wishes or not. In most cases, asset managers will find it preferable to restrict their attention to cases where compliance is relatively low-cost, so that corporate insiders will respond favorably. However, voting remains a powerful tool that could be used to enforce more

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the Gates, 45 STAN. L. REV. 857 (1990). Grundfest argued that "just vote no" campaigns should be used where "management's operational or strategic shortcomings are so fundamental that they cannot be adequately addressed through shareholder resolutions," but other methods such as Rule 14a-8 inititatives could be better used when there is a specific concern but where "management's basic operational or strategic competence is not an issue." However, with the growth of the large asset managers since the time of Grundfest's writings, the vote of no confidence can now be used as a much finer tool. In 1990, the relatively small size of even the largest institutional investors meant that there would be difficult coordination problems for a "just vote no" campaign where management's basic competence was not at issue. But the size of the large asset managers makes it considerably easier to induce change.

121. James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967 (2012). There is considerable discretion employed by the proxy advisors in developing recommendations. David F. Larcker, Allan L. McCall & Brian Tayan, *And Then a Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?* ROCK CENTER FOR CORP. GOVERNANCE AT STAN. UNIV. CLOSER LOOK SERIES: TOPICS, ISSUES AND CONTROVERSIES IN CORP. GOVERNANCE & LEADERSHIP, NO. CGRP- 31 (Feb. 25, 2013), https://ssrn.com/abstract=2224329.

122. Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29 (2002), and Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389 (2009), estimate that a negative recommendation on a management proposal from ISS can sway 13.6%–20.6% of votes and 19% of votes, respectively.

substantial changes when the asset manager is committed to doing so.

D. Agency Costs

This broad conception of asset manager's interests has so far largely ignored the interests of those who run the asset managers. Just as corporate decisions involve conflicts between constituencies, asset managers' actions do as well. In particular, what is best for the asset managers' clients may not be best for the asset managers' investors or management teams. To make this clearer, consider the case of the largest asset manager, BlackRock. BlackRock manages investments on behalf of millions of individuals and institutions—its clients. But BlackRock is also a publicly traded company, with its own investors,[123] and management team. BlackRock is as an agent for its clients, but its management team is also working on behalf of shareholders—and themselves. This agency conflict means that asset managers may not act in the best interests of their clients.

To begin, asset managers are not the economic beneficiaries of the assets that they manage (despite the fact that they are considered "beneficial owners" by Section 13 of the Securities and Exchange Act for reporting purposes). For this reason, the incentives of an asset manager that manages 7% of a corporation differ from the incentives of the set of clients who collectively own 7% of a corporation. In fact, value-increasing engagements by an asset manager—even very large increases—have only a small effect on the asset manager's financial position.[124] However, others have shown that even asset managers who manage the bulk of their assets in index funds have financial incentives to increase portfolio value.[125]

The agency critique leveled at asset managers is often coupled with a comparison to activist hedge funds. While activist hedge funds have more ability to spend heavily on interventions, there are also engagement tools where asset managers have a considerable advantage over activist hedge funds. Activists use aggressive engagements—or the threat of aggressive engagements—to overcome management resistance. These tools are expensive—a campaign ending in a proxy fight has an estimated total cost of $10.7 million,[126] with recent proxy contests

123. In fact, there is considerable overlap between BlackRock's customers and its investors. Because BlackRock manages shares in all large, publicly traded companies, it manages a significant portion of itself, making BlackRock's customers indirect investors in BlackRock.

124. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Lund, *supra* note 83; Hemphill & Kahan, *supra* note 53.

125. *See* Kahan & Rock, *supra* note 4. Also note that Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged* (Tuck Sch. of Bus., Working Paper No. 326576, Nov. 4, 2018) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3265761, find that "However, in dollar terms, a 1% increase in firm value leads to an extra $255,600 of annual management fees for the largest institutions," suggesting that asset managers have financial incentives to improve the value of portfolio firms. However, it must be noted that the authors assume an expense ratio of 0.5%. While this is considerably less than the industry average (1.01%), some of the large asset managers charge lower fees. For example, Vanguard's average expense ratio is 0.18%, which means that its financial incentives to take value improving actions are lessened relative to a manager with a 0.5% expense ratio.

126. Nickolay Gantchev, *The Costs of Shareholder Activism, Evidence from a Sequential Decision Model*, 107 J. FIN ECON. 610 (2013).

costing more than $60 million.[127] Asset managers, on the other hand, can use their indefinite time horizon to induce change at portfolio companies at much lower costs. If an asset manager credibly commits to vote against a firm's management for the long term, it may induce change without resorting to the costs of a proxy contest. So, while agency costs may lessen asset managers' incentives, their size and structure also reduce the cost of inducing changes.

In addition to the agency critique levied at asset managers, many have argued that free-riding on behalf of investors will undermine asset managers' pursuit of social welfare.[128] The argument is that investors will choose the least-expensive fund, resulting in a race to the bottom among asset managers to cut costs related with influencing portfolio companies. A rational asset manager, the story goes, will not appreciate the benefits it creates and will therefore refrain from meaningful interventions. While this is a legitimate concern, it is unlikely to be dispositive. Research in finance shows that large shareholders will still create benefits in the presence of free-riding.[129] Furthermore, investors are notoriously bad at choosing the best-performing investment vehicles. For decades, millions of investors have invested in actively managed funds that charge high fees and consistently underperform the market.[130] This misallocation of investment indicates that increasing expenses to provide stewardship is not a death knell for asset managers.

However, there may still be substantial slack for asset managers to spend on governance teams even if costs are the driving choice in investors' choice of asset managers. Asset managers make money by charging annual expense ratios on clients' portfolios. An expense ratio of 1% means that the asset manager takes 1% of the value of the client's portfolio as compensation for managing the portfolio. Asset managers publish expense ratios to two digits, such as 0.10% or 1.13%. With the size of the large asset managers, it would be possible to add thousands of employees to governance and stewardship teams without affecting the published expense ratio. Consider Vanguard, which has the lowest average expense ratio in the industry at 0.11%. With Vanguard's $5.1 trillion in assets under management, expenses could increase over $500 million before increasing the expense ratio to 0.12%. This illustrates that the large asset managers have extensive latitude to increase spending even while competing on cost.

Furthermore, the empirical reality belies the claims that agency costs will prevent asset managers from investing in investment stewardship. The stewardship departments at the large asset managers have grown in recent years and the major asset managers have announced substantial plans for future growth. So, while agency costs should not be ignored when thinking about investment stewardship by the large asset managers, agency concerns should not be taken as dispositive. While the direct benefits of engagement and stewardship to asset managers may be minor, there are real potential benefits for clients. Few investors are price-sensitive enough to abandon an asset manager that increases expense ratios by a fraction of a basis point to spend on stewardship activities for clients' wellbeing.

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127. Julie Creswell, *An Epic, and Costly, Boardroom Battle at Proctor & Gamble*, N.Y. TIMES (Oct. 8, 2017), https://www.nytimes.com/2017/10/08/business/economy/an-epic-and-costly-boardroom-battle-at-procter-gamble.html.

128. Bebchuk, Cohen & Hirst, *supra* note 124.

129. Admati, Pfleiderer & Zechner, *supra* note 23.

130. JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM (2005).

There are two primary drivers of why asset managers do (and should) engage with portfolio companies with the aim of improving social welfare. The first is marketing. Large stewardship departments may make a given asset manager more desirable in the eyes of many investors. State Street's campaign to increase women on boards of directors was highly effective. Furthermore, it was a great marketing success, generating millions of dollars' worth of free press.[131] Marketing extends beyond the asset manager to management teams at asset management companies. BlackRock CEO Larry Fink has been lauded for his effort to improve corporations' social purposes in the press with headlines such as "I Hate Business, But I Love Larry Fink."[132] Doing good makes you look good.

More importantly, taking actions that benefit clients is the right thing to do, and asset managers can do so at little cost to themselves. Behavioral research shows that people have prosocial preferences,[133] and companies with more market power spend more on charity.[134] Asset managers are fiduciaries on behalf of their clients, and doing their job means taking actions to increase clients' welfare. They should do their job, and policy makers and academics should encourage their involvement.

Finally, the agency cost critique leveled at asset managers by other scholars is always couched in terms of "shareholder value" as measured through the share price. It is difficult to make further gains by using traditional tools such as voting on shareholder resolutions or supporting or opposing declassifying a board of directors. Instead, I advocate for a slate of actions in Section V where asset managers can make large impacts with minor expenses.

E. The Internal Structure of Asset Managers

Thus far, this paper has considered asset managers as if they were homogenous entities. However, the large asset managers are an aggregation of hundreds of different funds and therefore are often referred to as "fund families." For example, Vanguard is composed of 129 mutual funds and 56 ETFs,[135] while BlackRock has 608 mutual funds, 71 closed-end funds, and 359 different ETFs.[136] These funds range from equity to debt to real estate; some focus on a particular state or sector while others invest globally and broadly; and some funds attempt to mimic the market while others bet against the market. For example, in November 2017, BlackRock portfolios managed over 46 million shares of Delta Airlines. The shares were spread across 345 separate portfolios. Of these, 67 were actively managed, and 278 were

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131. Jeff Green, *"Fearless Girl" Earns $7.4 Million in Free Media for State Street*, SFGATE (Apr. 28, 2017), https://www.sfgate.com/business/article/Fearless-Girl-earns-7-4-million-in-free-media-11106492.php.

132. Kevin O'Marah, *I Hate Business, but I Love Larry Fink*, FORBES (Jan. 22, 2018), https://www.forbes.com/sites/kevinomarah/2018/01/22/i-hate-business-but-i-love-larry-fink/#3d1cf3b07833.

133. Roland Bénabou & Jean Tirole, *Incentives and Prosocial Behavior*, 96 AM. ECON. REV. 1652 (2006).

134. William O. Brown, Eric Helland & Janet Kilholm Smith, *Corporate Philanthropic Practices*, 12 J. CORP. FIN. 855 (2006).

135. VANGUARD MUTUAL FUNDS, VANGUARD (last visited July 10, 2018), https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns.

136. INVESTMENT FUNDS, BLACKROCK (last visited July 10, 2018), https://www.blackrock.com/investing/products/product-list-fund#!type=mutualFunds&tab=performance&view=list&subtab=atNav.

index trackers that tracked 142 separate indexes.[137]

Despite the large number of constituent funds, the large asset managers have centralized governance and stewardship departments. These are the departments tasked with voting shares and engaging with companies on behalf of the constituent funds. These departments engage and vote the shares of all of the constituent funds unless an active manager has different preferences. Stewardship departments reach out internally to the active funds to gauge their preferences and to discuss disagreement.[138] However, there is a remarkable degree of internal agreement among the large asset managers' funds. At State Street, there is internal disagreement in 195 out of every 100,000 votes. At Blackrock, the number is 18 out of every 100,000 votes. Vanguard has the highest amount of internal agreement, with internal disagreement in only 6 per 100,000 votes. Contrast this with a more active manager such as Fidelity, which has internal disagreement in 3,144 per 100,000 votes.[139]

Furthermore, in cases where there is internal disagreement between funds, this disagreement is between actively and passively managed funds. The decisions of the centralized stewardship departments generally apply to all funds, but they always apply to the index funds. At each of the Big Three, index funds make up the plurality of investments, giving the stewardship departments direct control over most engagement decisions. BlackRock and Vanguard each have 81% of total equity invested in index funds while State Street has a full 97% of equity in index funds.[140] So even in cases of internal disagreement, the index funds carry much more weight than active funds. And this dominance of passive funds is only expected to increase. Index funds are growing relentlessly—from 2005 to 2015, the market share of index funds doubled to 34%.[141] Passively managed funds are expected to overtake actively managed funds in aggregate by 2024.[142] As index funds make up an increasingly large proportion of investments at the large asset managers, internal disagreement will be expected to further decrease. This essay focuses primarily on the three largest asset managers: BlackRock, Vanguard, and State Street. These three asset managers dominate the market for index funds—they collectively manage 71% of the entire ETF market, and Vanguard alone is thought to hold at least 75% of the entire index mutual fund market.[143]

V. WHERE ASSET MANAGERS SHOULD FOCUS

Section II shows that asset managers, in principle, should internalize clients'

137. Novick, *supra* note 35.

138. Author's conversations with stewardship teams at large asset managers.

139. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 1. And while this is indicative that the big three apply centralized voting strategies, Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL. ST. J., Oct. 24, 2016, https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101, show that the active managers can persuade the stewardship team. Bubb & Catan, *supra* note 81, map the voting behavior of institutional investors onto a two-dimensional issue space and show that institutional investors can be broadly classified into three "parties"—those that vote closely with management (including the Big Three), those that vote closely with Institutional Shareholder Services (the "Shareholder Intervention Party," and those who vote closely with Glass Lewis (the "Shareholder Veto Party").

140. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 1.

141. *Id*. at 302.

142. Marriage, *supra* note 6. '

143. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 1.

welfare. However, Section III shows that asset managers only take minor actions to further clients' welfare, despite having substantial tools to influence portfolio companies. In this section, I explore specific policies that could be adopted by asset managers for the benefit of their clients.

This section is separated into three parts. The first part explores actions that improve the values of individual firms. While this area is the focus of the vast majority of the corporate governance literature, I suggest underexplored ways that asset managers can improve the value of individual firms. The second area of focus are actions that increase the value of clients' portfolios, possibly at the expense of the profitability of the target firm. Finally, the third section moves past financial metrics alone to consider the types of actions that improve clients' overall welfare. The distinction between these three sections can be blurry at times, because many actions have ancillary effects—for example, combating corporate crime benefits shareholders at the given firm who will not see share price drop following litigation. However, doing so also removes an unfair competitive advantage for the firm, thereby improving the value of the portfolio as a whole. Further, because individuals are the victims of corporate crimes, limiting those crimes will improve client welfare outside of their financial portfolios.

A. *Actions that Increase Firm Value*

There is wide agreement that asset managers should take actions that increase the value of particular portfolio firms. For this reason, the large asset managers have policies on issues like staggered boards, cumulative voting, director independence, executive pay, activist campaigns, and unequal voting rights that may have effects on firm value. While some of these are important issues, there are many more actions that asset managers could take that would improve the value of portfolio firms. Agency costs and the structure of asset managers forecloses particular value-improving interventions. However, this section illustrates that there are inexpensive firm-value improving actions that asset managers could effectively take.

Asset managers can create large gains for clients through improving auditing and targeting fraud. In principle, auditors should provide meaningful independent oversight. However, the structure of the industry gives auditors few incentives to discover fraud. Auditors often look more like lapdogs than watchdogs because they compete with one another and are paid by their clients.[144] Since auditing firms are partnerships, asset managers can only influence their behavior through the public corporations that they audit. However, asset managers could insist that portfolio companies only employ auditing firms that comply with a particular set of standards, such as the recommendations put forth in the Advisory Committee on the Auditing Profession's 2008 report including: a requirement that the large auditing firms file a public annual report that includes indicators of quality and effectiveness; to file confidential audit statements with the Public Accounting Oversight Board; and to require the engagements partner's signature on the auditor's report.[145] Furthermore, asset managers could engage with the government in support of better regulations of the auditing industry.

Asset managers also create firm-level value by improving corporate boards.

144. Joshua Ronen, *Corporate Audits and How to Fix Them*, 24 J. ECON. PERSP. 189 (2010).
145. *Id*.

Much of the discussion on corporate governance deals with board-level questions, such as whether boards should be classified or whether the CEO and chairman roles should be separated. However, these discussions distract from more substantial changes that address the fundamental problems of corporate boards. Corporate board members often serve on several boards while also holding their own full-time executive positions. Boards are often controlled by chief executives who may prefer over-stretched board members. Furthermore, the flow of information to board members is generally controlled by management, limiting the ability of well-intentioned board members to effectively monitor the firm. Those who could make changes to the board structure often have no incentives to do so.

There are many possible ways that boards could be structured. Some have argued that boards should make use of independent professional directors, who would be able to develop firm-level expertise and would improve monitoring.[146] Others have argued that boards suffer from the inability to effectively commit to other parties, and that changes in structure could remedy this.[147] There are many possibilities, but what must be recognized is that there is little hope of changing board structures for the benefit of shareholders in the absence of outsider intervention. Leaving board structure up to the market is a sure way to ensure that nothing changes.

B. Actions that Increase Portfolio Value

The recent literature on common ownership has focused on a particular aspect of common ownership—the possibility that asset managers could increase the value of their portfolios by facilitating collusion among portfolio firms. The paradigmatic case is a study that purports to show that common ownership within the airline industry has led to significant price increases.[148] There are active debates over the empirical findings and the legal and policy ramifications of common ownership and antitrust.[149] This section focuses on potential benefits to common ownership outside of the antitrust context. I examine areas where asset managers can influence the value of the portfolio by targeting a small number of portfolio firms. Unlike increasing the value of the portfolio through monopolization, the policies I recommend in this section have positive collateral consequences on shareholders and society as a whole.

As discussed in section IV, asset managers have made positive progress by asking companies to increase disclosures related to climate change risks. However, the steps required to limit the adverse financial effects of climate change are far too large to be taken on by asset managers alone. For this reason, the most important thing that asset managers can do is to combat lobbying by portfolio firms against climate regulation. Corporations, and energy firms in particular, have extensively lobbied against regulations and taxes meant to combat climate change.[150] If asset managers took actions to limit lobbying and denialism by portfolio companies, it would pave the way for better regulation.

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146. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

147. COLIN MAYER, FIRM COMMITMENT (2013).

148. Azar, Schmalz, and Tecu, *supra* note 2.

149. See all the publications cited in notes 1 and 2, *supra*.

150. Nathaniel Rich, Losing Earth: *The Decade We Almost Stopped Climate Change*, N.Y. TIMES MAG., (Aug. 1, 2018), https://www.nytimes.com/interactive/2018/08/01/magazine/climate-change-losing-earth.html.

The potential benefit of asset managers goes beyond climate change lobbying to corporate speech more broadly. Following *Citizens United*, corporations can spend an unlimited amount of money in support of candidates that are favorable to their regulatory needs. Putting the constitutional question aside, there are clearly issues that arise from corporations exerting their influence.[151] While corporate speech may be good for managers and the financial returns of shareholders, it is often bad for shareholders' overall welfare. A shareholder's portfolio may increase a few dollars from the gains resulting from lobbying by energy firms, but for many shareholders the impacts on pollution and climate change outweigh those gains. *Citizens United* shifts the balance of power away from the public interest as embodied in the state and towards corporations. The push for the SEC to adopt political disclosure rules has stalled. Even following a financial crisis that had its roots in poor financial regulation, US Senator Richard Durbin noted in 2009 that "banks are still the most powerful lobby on Capitol Hill and they frankly own the place." Given the state's limited powers, asset managers can take actions to reign in socially-undesirable corporate influence on the political process. The first step is for asset managers to call for detailed disclosures of portfolio companies' political spending, which would allow investors to better identify undesirable political spending. Asset managers and other investors could then take steps against corporations that are pursuing welfare-decreasing political speech.[152]

Perhaps the single most important action that asset managers could take would be to address systemic financial risk. The 2007-2008 financial crisis resulted in a roughly 50% decrease in the stock market, along with massive losses to home values, employment, and retirement savings. A recent report by the San Francisco Federal Reserve Bank estimates the lifetime costs of the financial crisis to be $70,000 for every American.[153] The financial crisis illustrates the dangers of systemic risk in financial institutions. When banks have little equity, small decreases in asset values can lead to insolvency. In an interconnected financial system, this can lead to dire consequences for the economy as a whole.[154] While, in principle, regulators and politicians should take actions to avoid systemic risk, failure to do so means that there is still substantial risk that the 2007-2008 crisis will be repeated.

151. In his dissent, Justice Stevens noted, "All of the majority's theoretical arguments turn on a proposition with undeniable surface appeal but little grounding in evidence or experience, 'that there is no such thing as too much speech.'" Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 472 (2010) (Stevens, J., concurring and dissenting) (quoting Austin v. Mich. State Chamber of Commerce, 494 U.S. 652, 695 (1989) (Scalia, J., dissenting)); *see* David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After Citizens United*, 89 N.C. L. REV. 1197 (2011), for a discussion.

152. The issue of the role of asset managers in combating corporate speech is discussed in Leo E. Strine, *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending* (U. of Penn., Inst. for Law & Econ., Research Paper No. 19-03, last rev'd Jan. 6, 2019), https://ssrn.com/abstract=3304611 or http://dx.doi.org/10.2139/ssrn.3304611.

153. Regis Barnichon, Christian Matthes & Alexander Ziegenbein, *The Financial Crisis at 10: Will We Ever Recover?*, FED. RESERVE BANK OF S.F. (Aug. 13, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/.

154. Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expensive* (Max Planck Inst. for Res. on Collective Goods 2013/23; Rock Center for Corp. Governance at Stan. Univ. Working Paper No. 161; Stanford University Graduate School of Business Research Paper No. 13-7, Oct. 22, 2013), https://ssrn.com/abstract=2349739 or http://dx.doi.org/10.2139/ssrn.2349739.

This is despite the existence of a clear tool that can be used to combat financial instability: increased equity requirements. By increasing equity as a source of funding, financial institutions can absorb losses, and thereby stabilize highly interconnected financial systems. Some progress has been made since the financial crisis, with Basel III requiring that common equity make up at least 4.5% of risk-weighted assets.[155] However, many leading experts have argued that this is not nearly enough,[156] and a group of prominent academics have argued that there would be substantial social benefits if equity were to make up at least 15% of banks' non-risk-weighted assets.[157] Bankers, however, have resisted calls for increased equity requirements by making many false and misleading claims about the consequences of increased regulation.[158]

The failure of politicians and regulators to combat systemic risk means that asset managers' clients can expect significant losses in their portfolios from a future financial crisis. Asset managers could combat this by requiring portfolio financial institutions to maintain minimum equity ratios in excess of those required by law. Doing so would be straightforward. The asset manager could stipulate that it will vote against all directors if dividends are paid out when equity makes up less than 15% of total assets. The small losses in dividends from financial firms would be swamped by the gains across all firms (financial firms included) from increased financial stability. Given the failure of regulators and politicians, asset managers are the best hope for preventing the next financial crisis.

C. Actions that Increase Client Welfare

The previous two sections illustrated just a few of the actions that asset managers could take to increase the value of individual companies in clients' portfolios, and the value of those portfolios as a whole. Importantly, many of those recommendations would have significant positive effects on clients *beyond* their financial portfolios. For example, while combating systemic risk would increase the expected value of clients' portfolios, doing so would also decrease the chances that clients would lose their jobs or homes in a financial crisis. This section focuses on areas where asset managers could take actions that improve client welfare outside of their financial portfolios. As discussed in Section IV, asset managers have substantial powers to help companies make beneficial commitments to non-shareholder constituencies. It is in their clients' interests if companies regularly consider the welfare effects of corporate policies. Among these cases, there are particular areas in which asset managers can best serve their clients.

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155. *Basel 3, an International Capital-Adequacy Standard, Is Unloved But Much Needed*, THE ECONOMIST (May 4, 2017), https://www.economist.com/special-report/2017/05/04/basel-3-an-international-capital-adequacy-standard-is-unloved-but-much-needed.

156. Admati et al., *supra* note 154. Admati, *supra* note 10, makes the analogy that the increase in capital requirements is akin to reducing the speed limit in a residential neighborhood from 100 miles per hour to 95 miles per hour—the reduction is good, but it is not nearly enough. Martin Wolf argues in response to banks' claims that they have tripled capital reserves that "tripling almost nothing does not give one very much." Martin Wolf, *Basel: Tthe Mouse That Did Not Roar*, FIN. TIMES, Sept. 14, 2010.

157. Anat Admati et al., *Healthy Banking System Is the Goal, Not Profitable Banks*, FIN. TIMES (Nov. 9, 2010), https://www.ft.com/content/966b5e88-c034-11df-b77d-00144feab49a.

158. *Id.*; Admati et al., *supra* note 154; *see also* Anat Admati, *The Great Bank Escape*, PROJECT SYNDICATE (Dec. 31, 2012), https://www.project-syndicate.org/commentary/enhancing-shareholder-value-through-financial-reform-by-anat-admati.

Asset managers' engagements are still couched in terms of "shareholder value." Larry Fink's 2018 letter to CEOs made progress by stating that "Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate." But the letter constantly reiterated that the end goal was "long-term value" for shareholders. And following Fink's remarks, other asset managers were quick to note that they pursued "value, not values."[159]

If the asset managers can help companies do well by doing good, that is progress. Those are the easy cases—if managers can do well by doing good, then they should do so in the absence of any external prodding. The interest of the asset managers' clients goes beyond corporations doing well by doing good to corporations simply doing good. Clients are not just interested in their financial returns, but also their welfare more broadly. Asset managers can help their clients by pushing back against the "shareholder value" norm as currently conceived, and as propagated by the large asset managers. This entails emphasizing that companies should serve social purposes beyond maximizing profits.

Most fundamentally, it is in clients' best interests if companies obey the law despite the fact that clients might gain financially from corporate crimes. There is no shortage of scandals in which corporations and their employees have been found to be flouting laws at the expense of investors, consumers, and the general public. However, slap-on-the-wrist penalties are far too common and undermine the legitimacy of corporations and the law.[160] Many companies break the law repeatedly, but suffer very minor consequences.[161] Asset managers can help by not only encouraging the norms of good corporate citizenship, but by taking actions when companies fall afoul of the law. Too often managers and directors retain their positions after corporate crimes; the company is able to obfuscate the scope of crimes through non-disclosure agreements and plea bargains. Asset managers should work to replace directors and managers after corporate crimes and ensure that pay packages allow the company to claw back earnings. Asset managers can also be a voice for more reasonable and transparent corporate prosecutions, because even though large fines will harm clients' financial portfolios in the short run, combating corporate crime will ultimately be in clients' best interests.

The above examples are only a sampling of areas in which asset managers could use their powers to improve the role of corporations in society. In principle, asset managers' interests and powers are quasi-governmental. They should therefore have the same interests in effective regulation as the state. However, asset managers have fewer political barriers for action than governments and should therefore leverage this advantage. Asset managers should look to areas where companies are taking actions that are not in the public interest, but where the state fails to act. In these cases, there is an opening for asset managers to fill a void that is left by the state and to improve its clients'—and the public's—welfare.

159. Cyrus Taraporevala, *Index Funds Must Be Activists to Serve Investors*, FIN. TIMES (July 24, 2018), https://www.ft.com/content/4e4c119a-8c25-11e8-affd-da9960227309 ("We are creating long-term value; not imposing values.").

160. GARRETT, *supra* note 11.

161. Nathan Atkinson, Capital Structure and Corporate Crime (2019) (unpublished manuscript) (on file with the author).

VI. LEGAL CONCERNS

This paper has reframed the question of what asset managers' objective function should be and has argued that asset managers should take actions that maximize clients' welfare. This section considers some of the legal issues raised by asset managers and shows that these are not barriers to the type of actions I advocate in Section V. In particular, I consider securities law, laws around corporate purpose, and the fiduciary duties of asset managers to show that none of them prevent asset managers from taking a larger role in pursuing clients' welfare.[162]

A. *Securities Law*

Shareholder engagement with corporations is governed by a number of laws. These laws generally act as a barrier on the ability of investors to acquire and exercise "control" over a company. In particular, a number of scholars have identified the ways in which laws constrain the ability of asset managers to engage, and have argued that asset managers will refrain from engaging because of these laws.[163]

However, discussions around laws that regulate engagement by institutional investors fail to distinguish between the types of engagement. It is correct that legal restrictions make it difficult for asset managers to engage in the style of activist hedge funds, but the tools at asset managers' disposal are quite different from those employed by activist hedge funds. This section details some of the laws governing engagement by asset managers and shows how they are not a restriction on the ability of asset managers to improve the social purposes of portfolio companies.

The primary barrier to asset managers taking a more active role in influencing portfolio companies are regulations promulgated under Section 13(d) of the Securities Exchange Act of 1934.[164] This section is a means to inform other shareholders that a blockholder is acquiring a large stake in the company. These rules require an investor who acquires more than 5% of a company's voting class shares to file a "beneficial owner report" within 10 days of the acquisition. The Schedule 13D report requires the owner to disclose the extent of the investment and the owner's intentions with regards to voting and control. Ownership is construed broadly to include the power to direct the sale or voting of securities.[165] Additionally, the regulations require that the Schedule 13D be promptly updated if there is any material change to the disclosures including, but not limited to, a change in one percentage or more of the amount of stock held. Whenever 13D is updated, the owner must disclose all trades made in the past 60 days. Activist hedge funds structure their purchases of stock with filing requirements in mind. In a creeping acquisition, the

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162. I do not take on the concerns related to common ownership and antitrust that have been raised following the empirical findings of Azar, Schmalz & Tecu, *supra* note 2. This is because their findings, coupled with subsequent legal analyses—Elhauge, *supra* note 3; Posner, Morton & Weylku, *supra* note 3; Rock & Rubinfeld, *supra* note 3; and others—are premised on the idea that asset managers take actions to improve the value of a portfolio by decreasing competition. This paper shows that asset managers should pursue clients' broader welfare, meaning that asset managers should generally oppose anticompetitive behavior among portfolio firms.

163. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); John Morley, *Too Big to Be Activist*, S. CAL. L. REV. (forthcoming) (Yale L. & Econ. Res. Paper, No. 596, Aug. 1, 2018), https://ssrn.com/abstract=3225555.

164. 15 U.S.C. § 78m(d) (2016).

165. Exchange Act Rule, 17 C.F.R. § 240.13d-3 (2016).

activist slowly accumulates a 5% stake in the company and then quickly buys more shares over the next ten days before filing a 13D.[166]

However, asset managers do not generally file the onerous 13D report, and instead file under Section 13(g). An investor acquiring a 5% stake is eligible to file a schedule 13G if the owner certifies that the owner "has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer."[167] Filing Schedule 13G requires no disclosure of trades, no disclosure of intentions, and only needs to be updated once per year.

The ability to file a 13G instead of a 13D hinges on the concept of "influencing control," which is not well-defined. The SEC has offered some guidance, stating that engagement on corporate governance topics does not disqualify an investor from filing a 13G: "[e]ngagement on corporate governance topics, such as removal of staggered boards, majority voting standards in director elections, and elimination of poison pill plans, without more, generally would not disqualify an otherwise eligible shareholder from filing on Schedule 13G if the discussion is being undertaken by the shareholder as part of a broad effort to promote its view of good corporate governance practices for all of its portfolio companies, rather than to facilitate a specific change in control in a particular company."[168] On the other hand, the investor would need to file a 13D if it "engages with the issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors."[169] Therefore, as long as the asset manager is pursuing "a broad effort to promote its view of good corporate governance practices for all of its portfolio companies," it would still be allowed to file a 13G.

The reporting requirements associated with filing a 13D instead of a 13G are perceived to be extremely costly for large asset managers, who would have to disclose every trade made by every constituent fund.[170] While this would entail reporting many of trades, it is unclear whether this would act as more than a minor nuisance to the large asset managers. For example, in 2017, BlackRock filed a 13D relating to its investment in Calpine Corporation. At the time, BlackRock managed over 15 million shares with a value of roughly $1.2 billion.[171] Over the 60-day reporting window, BlackRock reported 525 trades, or about 12 trades per day. Reporting trades for a large asset manager is much less onerous than it would have been in the past. Electronic trading makes it easy for computers to catalog trades and to print a report of each trade made by a large asset manager.[172] If an asset manager

166. Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS® IN FIN. 185 (2010), http://dx.doi.org/10.1561/0500000026 (finding that the median initial stake that an activist takes in a company is 6.3%, whereas the median maximum stake that the activist holds is 9.5%).

167. SEC Rule 13d-l(b)(l)(i), 17 C.F.R. 240.13d-1(b)(1)(i).

168. EXCHANGE ACT SECTIONS 13(D) AND 13(G) AND REGULATION 13D-G BENEFICIAL OWNERSHIP REPORTING, QUESTION 103.11 (July 14, 2016), SEC, https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

169. *Id*.

170. Morley, *supra* note 163, argues that this is a sufficient deterrent to the large asset managers.

171. BlackRock, Schedule 13D Filing (Aug. 25, 2017).

172. To put this in perspective, asset managers have millions of clients who are regularly making trades, and asset managers accurately report these trades. In the author's (very small) passive retirement portfolio in Vanguard, there were 26 actions during the month of January 2019, which Vanguard

wanted to exert more control at a firm, 13D requirements are not a significant barrier.

Another potential obstacle to engagement by large shareholders is regulations governing insider trading. Section 10(b)-5 of the Securities and Exchange Act prohibits trading on material, nonpublic information. "A person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating § 10(b) and Rule 10b–5."[173]

Insider trading concerns are mitigated by the independence of the investment stewardship teams at the large asset managers. Due to the separation of the investment stewardship team from investment managers, there is low risk of an inadvertent disclosure of nonpublic material to the investment managers. More importantly, the nature of engagements by investment stewardship teams does not entail the accumulation of nonpublic information. The ability of asset managers to influence portfolio companies discussed in Section IV is predicated on public disclosures and exercising economies of scale. However, if a stewardship team were to inadvertently receive insider information, it would promptly issue a public disclosure in accordance with Regulation FD.[174] While insider trading concerns could be an issue for an institutional investor pursuing activist-style strategies, it is not a meaningful barrier for the types of engagements that asset managers would pursue.

B. Corporate Purpose

The debate over the shareholder value norm is persistent legal discourse. Stephen Bainbridge argues that "the shareholder wealth maximization norm. . . indisputably is the law in the United States,"[175] while Lynn Stout argues that "The notion that corporate law requires directors. . . to maximize shareholder wealth simply isn't true."[176] The Delaware General Corporation Law has nothing to say about corporate purpose other than that corporations "can be formed to conduct or promote any lawful business or purposes."[177] While a corporation's charter could contain a specific purpose, the vast majority of corporate charters say that the purpose is to do "anything lawful."[178] Furthermore, while the code vests managerial power in a board of directors,[179] it does not specify what actions the board should pursue or on whose behalf. The only mention of the fiduciary obligations of directors in the code is part of the statute that allows corporations to eliminate the liability of directors for breaches of that duty. Given the lack of a shareholder wealth mandate in state statutes or companies' charters, the only other law that could govern is case law.

The canonical case in support of the shareholder value norm is *Dodge v. Ford*.[180]

automatically categorized and made available. The idea that the asset managers could not accurately report these same trades to the SEC is a stretch.

173. United States v. O'Hagan, 521 U.S. 642 (1997).

174. SEC Rule 10b5, 17 C.F.R. 240.

175. STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE THEORY AND PRACTICE (2008).

176. LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH (2012).

177. 8 DEL. C. § 101(B) (1953).

178. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163 (2008).

179. 8 Del. C. § 141(a) (1953).

180. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

By 1913, the Ford Motor Company had become incredibly successful and paid out large dividends to shareholders. Among those shareholders were the Dodge brothers who owned a 10% minority stake in the firm and also manufactured cars on behalf of Ford. In 1914, the Dodge brothers began making their own cars, financing their endeavors with dividends from Ford. In an effort to disrupt his competitors, Ford stopped paying dividends, and instead said the profits would be used to increase wages and decrease prices. The Michigan Supreme Court issued one of the few decisions that explicitly enforces shareholder wealth maximization as a rule of law, stating that "A business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed for that end."[181] While not Delaware law, *Dodge* is the paradigmatic case supporting the shareholder value norm.

In contrast to *Dodge*, supporters of a broader view of corporate purpose point to *Unocal v. Mesa*.[182] The Unocal board believed that a tender offer from Mesa was too low and employed defensive tactics to prevent the bid. The Delaware Supreme Court determined that permissibility of defensive actions would be judged by whether they were "reasonable in relation to the threat posed."[183] The court went on to say that the concerns that could be included in anti-takeover plan could include "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."

However, while *Unocal* suggests that corporations can consider the interests of non-shareholders, the relevant portion of the opinion is dicta that is clarified to an extent in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc*.[184]Revlon was targeted by the hostile raider Ronald Perelman. To avoid being acquired, the Revlon board employed a variety of defensive measures, and eventually decided to sell the company to a private equity firm rather than allowing Perelman to take over the firm. The board claimed that the sale would protect constituencies other than shareholders and justified its actions under *Unocal.* The Delaware Supreme Court recognized that "[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." But the court went on to say that "such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder." Taken together, *Unocal* and *Revlon* stand for the idea that, so long as a business is a going concern, the courts will not question the directors' decisions about how to best maximize shareholder value. The famous *Unocal* quote makes it clear that maximizing shareholder value may entail being good to other constituencies. However, *Revlon* makes it clear that when shareholders no longer have an interest in the firm, other constituencies cannot come before shareholders.

However, these cases consider conflicts *between* constituencies. The key idea of this paper is not that asset managers should take actions that favor certain other constituencies over shareholders. Instead, asset managers should think about

181. Stout, *supra* note 178, argues that "Dodge v. Ford was not really a case about a public corporation at all. It was a case about the duty a controlling majority shareholder (Henry Ford) owed to minority shareholders (Horace and John Dodge) in what was functionally a closely held company" (Shareholder Value Myth).

182. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

183. *Id*. at 949.

184. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

shareholders in all of their complexity, and should look to other constituencies as a proxy for this. Regardless of the holdings of *Unocal* and *Revlon*, the business judgment rule gives corporate directors expansive discretion to decide what business decisions are in the best interests of the corporation. The business judgement rule provides protection so long as directors are informed and deliberate. In other words, directors' legal obligations are primarily procedural rather than substantive.[185] This allows managers to sidestep the problem of corporate purpose in most circumstances—so long as directors do not act in a self-interested manner, they can spend corporate assets as they see fit.[186]

Furthermore, recent years have seen an increase in the number of firms that explicitly pursue goals other than pure profit maximization. While the "B Corporation" certification mark by B Labs is the most well-known, many states have created new corporate forms to allow for goals beyond profit maximization.[187] These forms allow (or require) the corporations to specify environmental or social goals in their corporate charters, where the board has a fiduciary duty to the specified mission. By allowing corporations to make beneficial commitments to constituencies other than shareholders, these corporate forms can also help improve shareholder welfare.[188]

C. *Fiduciary Duties of Asset Managers*

Asset managers owe fiduciary duties to clients. These duties arise both through the common law and through statutory laws, most notably the Investment Advisers Act of 1940.[189] The fiduciary relationship includes both duties of loyalty and duties of care.[190] This paper has argued that it is in the interest of asset managers' clients to take the public interest into account. The section shows that taking actions that further the welfare of clients beyond a narrow focus on the financial performance of clients' portfolios is consistent with asset managers' fiduciary duties to clients. It also shows that a few small changes could further insulate asset managers from legal risk related to fiduciary obligations. Throughout this section I will discuss fiduciary duties as they interact with the three types of actions advocated in Section V: actions that increase firm value, actions that increase portfolio value, and actions that increase client welfare.

The duty of loyalty is primarily negative—asset managers must refrain from self-interested behavior and avoid conflicts of interest. Taking clients' welfare into account beyond the portfolio performance does not in itself introduce a loyalty conflict.[191] The duty of care is largely positive—asset managers must take reasonable efforts to pursue clients' interests. What is required from the duty of loyalty is less

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185. *See* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985).

186. Stout, *supra* note 176, at 25.

187. For an excellent overview of the varieties of corporate forms, see Suz Mac Cormac, *To "B" or Not to "B": The Power of Corporate Form*, CORNERSTONE CAP. GRP. (Sept. 28, 2016), https://cornerstonecapinc.com/to-b-or-not-to-b-the-power-of-corporate-form/.

188. MAYER, *supra* note 147; Admati, *supra* note 19.

189. Investment Advisers Act of 1940, 15 U.S.C. § 80b.

190. Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS 79 (William A. Birdthistle and John Merley, eds., 2018).

191. However, this could be used as a smoke screen for self-dealing.

certain than what is required from the duty of loyalty, because the scope of clients' interests may be uncertain—pursuing clients' financial interests in a given portfolio may differ from pursuing their interests more broadly.

Each of an asset manager's portfolios is governed by a contract called an "investment management agreement."[192] In this regard, every fund files two things: a prospectus and a statement of additional information. The prospectus specifies particular behaviors that the asset manager must follow. For example, the iShares Core S&P 500 ETF by BlackRock tracks the S&P 500 index through a representative sampling method, and commits to approximate the underlying index.[193] The statement of additional information specifies a variety of other information about how the fund is run, including its voting policies and procedures. For example, the iShares Core S&P 500 ETF by BlackRock Prospectus states that "[t]he Board of Directors of the Funds has delegated the voting of proxies for the Funds' securities to the Manager pursuant to the Manager's proxy voting guidelines and procedures (the "BlackRock Proxy Voting Guidelines"). The Statement of Additional Information states that "the Manager will vote proxies related to Fund securities in the best interests of the Fund and its stockholders."[194] Therefore, the behavior of the asset manager must be consistent with the procedures specified in the manager's voting guidelines. BlackRock's guidelines specify a broad set of policies, but the overarching goal is that "BlackRock, Inc. and its subsidiaries (collectively, "BlackRock") seek to make proxy voting decisions in the manner most likely to protect and enhance the economic value of the securities held in client accounts."[195] Under these guidelines, BlackRock can clearly take actions that increase firm value, and even actions that increase portfolio value.[196] However, only small changes to the voting guidelines are required to protect those actions that increase client welfare. Since most of the client-welfare increasing actions outlined in Section V also increased portfolio value, asset managers would face little legal risk even if no changes were made.

The SEC has explained that "[the fiduciary principle applies to all aspects of investment management."[197] But asset managers have considerable discretion on how to employ their fiduciary duties. Both voting and direct engagements that take into account clients' interests beyond their portfolios are consistent with asset managers' fiduciary duties. When it comes to proxy voting, SEC rule 206(4)-6 requires that those who "exercise voting authority with respect to client securities must adopt proxy voting policies and procedures. . . [t]hey must be reasonably

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192. Novick, *supra* note 35.

193. 2018 SUMMARY PROSPECTUS: ISHARES BY BLACKROCK (Aug. 1, 2018), https://www.ishares.com/us/literature/summary-prospectus/sp-ishares-core-s-and-p-500-etf-3-31.pdf.

194. STATEMENT OF ADDITIONAL INFORMATION: ISHARES S&P 500 INDEX FUND BY BLACKROCK (April 30, 2018) https://www.blackrock.com/investing/resources/regulatory-documents/stream-document?stream=reg&product=FF-WFSPX&shareClass=CLASS+A&documentId=1246032~1246028~1246027~920569~1586902&iframeUrlOverride=%2Finvesting%2Fliterature%2Fsai%2Fsai-sandp500fund-us.pdf.

195. PROXY VOTING GUIDELINES FOR U.S. SECURITIES, BLACKROCK (Jan. 2019), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

196. If there is a conflict between firm and portfolio value, the asset manager may need to vote its securities in different manners depending on the funds' compositions.

197. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1461–62 (2002) (quoting an SEC Staff Report).

designed to ensure that the adviser votes in the best interest of clients."[198] The SEC did not propose nor adopt specific policies, but instead allowed flexibility for advisers to craft their own policies. This included "matters involving social issues or corporate social responsibility." The SEC rule compels each investment manager to determine and disclose how it will fulfill its fiduciary duties towards clients.[199] This gives asset managers flexibility to pursue client welfare, so long as it properly disclosed to clients.

Regulators also give asset managers considerable discretion in the use of engagements with portfolio companies. A 2016 interpretive bulletin from the Department of Labor endorses engagements that are meant to influence corporations, so long as doing so is in the interest of clients.[200] Acceptable engagement with corporations is construed broadly:

> Active monitoring and communication activitiesFalsemay include such matters as governance structures and practices, particularly those involving board composition, executive compensation, transparency and accountability in corporate decision-making, responsiveness to shareholders, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, *the nature of long-term business plans including plans on climate change preparedness and sustainability, governance and compliance policies and practices for avoiding criminal liability and ensuring employees comply with applicable laws and regulations, the corporation's workforce practices (e.g., investment in training to develop its work force, diversity, equal employment opportunity), policies and practices to address environmental or social factors that have an impact on shareholder value, and other financial and nonfinancial measures of corporate performance*. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder.[201]

This directive allows for investment managers to engage with corporations far beyond actions that are expected to have direct and immediate impacts on the firm's share price. If asset managers seek to influence corporations through engagements and voting, they mostly do so while fulfilling their fiduciary obligations. The actions advocated in Section V are consistent with those fiduciary obligations. The fiduciary rules governing actions by asset managers are based on deliberation and disclosure.[202] So long as asset managers disclose how they intend to act in their clients' interests (and how they have acted), they fulfil their fiduciary obligations to their clients. As is, asset managers can clearly take actions that increase firm value and portfolio value. To further insulate themselves from legal risk, asset managers can clarify their intentions to take actions that benefit clients' welfare more broadly. Such a conception places asset managers precisely where they should be—as fiduciary stewards of their clients' investments and welfare.

CONCLUSION

Large asset managers represent millions of clients, giving them an interest in

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198. SEC, FINAL RULE: PROXY VOTING BY INVESTMENT ADVISORS, https://www.sec.gov/rules/final/ia-2106.htm#P70_13795.

199. Laby, *supra* note 190.

200. 29 CFR 2509.2016-01.

201. *Id*. (emphasis added).

202. *See* Laby, *supra* note 190.

social welfare. Their large size gives them the power to influence portfolio companies. It is not enough for asset managers to focus on improving the financial portfolios of their clients. As fiduciaries with the power to effect change, asset managers should take actions that improve clients' welfare more broadly. In other words, asset managers should also take public interest into account.

Some scholars have made proposals that index funds should be prohibited from voting or that institutional investors should be prohibited from holding significant positions in competing firms.[203] While these proposals could help mitigate the antitrust concerns associated with common ownership, it would effectively destroy the ability of the large asset managers to perform any sort of beneficial engagements with portfolio firms. Because the empirical research on the antitrust effects of common ownership are still new and hotly contested, it would be rash to embrace any such proposal at this point.

However, there are clear benefits to diversification,[204] and there is evidence for the positive effects of index funds. Restricting the vote of passive funds would concentrate power in the hands of corporate insiders, activist hedge funds, and active fund managers—none of whom have the same incentives as asset managers to pursue social welfare. There would be substantial negative effects from implementing this policy and few—if any—benefits. Commentators and regulators should exercise restraint on calls to restrict the ability of asset managers to influence portfolio companies. The large asset managers are growing by the day and manage staggeringly large amounts of money. This makes them a natural target for those that are concerned about concentrated financial power. There are legitimate concerns about the size and influence of these asset managers, but those concerns must be backed by empirical data and sound theory that captures reality. Any benefits from a particular proposal must be weighed against the potential costs.

The rise of large asset managers has already resulted in gains to society. The growth of asset managers has been propelled by a massive shift towards passive investing. This overdue change will save the investing public billions of dollars of management fees. Furthermore, recent empirical evidence is largely supportive of positive governance effects of passive ownership. However, stewardship by asset managers did not materialize overnight, and followed sustained requests by academics and regulators that asset managers engage with firms. Those that advocate imposing liability or breaking up asset managers risk reversing years of progress towards engagement. This does not mean that scholars and policy makers should leave the question of asset managers' influence alone. Scholars should study the effects of engagements by asset managers, and to the extent that the evidence continues to support their positive effects, policy makers and academics should continue to encourage the increased uptake of engagement.

While some have advocated for a reduced role for asset managers, others have

203. Posner, Morton & Weyl, *supra* note 3 (advocating that "[n]o institutional investor or individual holding shares of more than a single effective firm in an oligopoly may ultimately own more than 1% of the market share unless the entity holding shares is a free-standing index fund that commits to being purely passive."); Lund, *supra* note 83 (arguing that passive shareholding is bad for governance and that passive funds should be restricted from voting).

204. Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. FIN. ECON. 440 (2018). (showing that the top 90 stocks have created *half* of the US stock market's $35 trillion gain since 1926, and just five firms (Exxon Mobile, Apple, Microsoft, General Electric, and International Business Machines) make up a full 10% of the entire stock market gains since 1926).

advocated for an increased role for the state and other constituencies. In August 2018, Senator Elizabeth Warren introduced the Accountable Capitalism Act. The proposed law would require directors of large corporations to consider the "general public benefit" resulting from its business operations, limit political spending, and limit the ability of executives to sell shares received through stock-based compensation. Most notably, the law would require that at least 40% of companies' boards of directors be elected by the corporation's employees.[205] However, it is unlikely that including employees will be a panacea.[206] Like shareholders, employees can profit at the expense of others in society—Volkswagen cheated emissions testing and caused massive harm despite a supervisory board where half of the members were employees,[207] and where numerous employees knew about the cheating.[208]

Senator Warren's proposal is similar to the arguments of this paper which recognize that the government has a fundamental interest in the social purposes of corporations that goes beyond profit maximization. However, it is predicated on the idea that there is a fundamental conflict between shareholders and employees. Senator Warren wants to shift the balance of power towards employees. This paper has argued that the idea of a conflict between constituencies is artificial given the structure of modern investing and the large asset managers. Instead of having a board where 60% of directors advance the interests of shareholders and 40% advance the interests of employees, society would be better served by a board that recognizes the interdependence of shareholders with employees, customers, and the public at large. Thinking in terms of conflicts between constituencies can lead to policies that make all parties worse off. Everyone shares in the public interest, and boards should recognize the breadth of their shareholders' interests.

More importantly, asset managers must recognize that their clients' underlying interests extend beyond profits. Progress is beginning to be made as more business leaders speak out about the importance of non-financial considerations. While supporting increases in corporate taxes to combat San Francisco's homelessness problem in 2018, Salesforce's CEO Mark Benioff stated that "[t]he business of business is no longer merely business. Our obligation is not just to increase profits for shareholders. We must also hold ourselves accountable to a broader set of stakeholders: to our customers, our employees, the environment and the communities

205. The model for employee codetermination is Germany, where workers elect representatives (who are usually trade union representatives) for almost half of the seats on the supervisory board. However, while Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EUROPEAN ECON. ASS'N 863 (2004) (explaining that large German companies have a two-tiered board structure. The supervisory board is elected by shareholders and workers, which in turn appoints and oversees an executive board made up of the CEO and other executives.).

206. Gorton and Schmid, *id.*, exploit a discontinuity in the German law that mandates that for firms with between 500 and 2,000 employees, one third of board seats be filled by employees, but for firms with more than 2,000 employees, one half. The authors find that companies with half of their representatives coming from employees trade at a 31% discount relative to firms with only one third of their representatives coming from employees.

207. Rik Oldenkamp, Rosalie van Zelm & Mark A. J. Huijbregts, *Valuing the Human Health Damage Caused by the Fraud of Volkswagen*, 212 ENVIRONMENTAL POLLUTION 121 (2015), estimate that the fraudulent pollution emitted over the legal threshold from 2009 to 2015 is associated with forty-five thousand disability-adjusted life years and a value of loss of life of at least $39 billion.

208. Dietmar Hawranek, *Volkswagen: Dutzende Manager in VW-Skandal verwickelt*, DER SPIEGEL (2015), http://www.spiegel.de/wirtschaft/unternehmen/volkswagen-dutzende-manager-in-vw-skandal-verwickelt-a-1057741.html..

in which we work and live."[209] Benioff's actions are laudable; however, in this paper, I do not ask asset managers to go that far. This paper does not tell asset managers that they owe duties to employees, the environment, and communities. My argument is much simpler—asset managers are fiduciaries on behalf of their clients, and doing their job means taking into account their clients' underlying interests. It is in their clients' interests that asset managers should pursue the public interest.

In principle, asset managers have unique incentives and tools to ensure corporations improve social welfare. But asset managers are not the panacea. In some cases, their ownership stakes will be insufficient to induce companies to comply with their wishes. And while asset managers wield considerable influence, there is no democratic process directing their actions. As their influence is felt more strongly, society must critically examine their actions to ensure that asset managers too are serving public purposes. In their public statements and direct engagements, asset managers have been strong advocates of increased diversity, increased disclosure of climate impacts, and curtailing management misdeeds. But these engagements are still couched in terms of share price. This essay has argued that it is in the best interest of asset managers' clients if they take social welfare into account. This does not mean that they are already doing so. Asset managers can be a powerful force for good, but it is up to scholars, regulators, and policy makers to help them to pursue social ends.

But in the end, the market alone cannot be relied on to ensure that firms are well-functioning and serving social purposes. Asset managers have stronger incentives and tools than many other investors, but they are still private actors. In the end, only half of Americans have any assets invested in the stock market, yet corporate actions affect everyone. If asset managers internalize their clients' welfare, there will still be cases where clients can profit at the expense of non-clients. In the end, the state must be the ultimate referee of corporate behavior. Only the state has the power to charter corporations, and only the state has the power to rescind those charters. Corporations should serve social purposes, and while asset managers can aid in this pursuit, the state too must take actions to ensure that corporations are serving society.

209. Marc Benioff, *The Social Responsibility of Business*, N.Y. TIMES (Oct. 24, 2018), https://www.nytimes.com/2018/10/24/opinion/business-social-responsibility-proposition-c.html.