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100 WASHINGTON UNIVERSITY LAW REVIEW (*forthcoming* 2022)

STEWARDSHIP THEATER

JEFF SCHWARTZ*

Large asset managers like BlackRock and Vanguard have amassed staggering equity holdings. The voting rights that accompany these holdings give them enormous power over many of the world's largest companies. This unprecedented concentration of influence in a small group of financial intermediaries is a pressing policy concern. While law and finance literature on the topic has recently exploded, no one has offered a satisfying theory to explain their voting behavior. Existing work tries to understand their approach to voting in conventional terms—as an attempt to improve the performance of portfolio firms—but this is not why large asset managers vote the way they do.

In contrast, this Article offers a political theory of asset-manager voting. Because of the power they wield, and the high stakes involved, large asset managers risk severe political blowback from looking like reluctant participants in corporate governance and from voting counter to the views of powerful politicians. As a result, politics rather than finance drives their decisions.

Politically motivated asset-manager voting is problematic. It leads to market uncertainty and threatens the core division between business and government. It is also an illegitimate use of the voting power that asset managers are duty-bound to exercise on behalf of the shareholders in the funds that they oversee. But voting authority is a privilege not a right. To draw politics out of corporate governance, regulators should require that asset managers seek input from fund shareholders and reflect that input in their votes.

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INTRODUCTION

A small group of asset managers have accumulated unrivaled wealth and power.¹ Industry leaders, like BlackRock, Vanguard, and State Street (the Big 3²), have compiled massive equity holdings in public companies through the mutual funds and exchange traded funds (“ETFs”) that they oversee.²

¹ See John C. Coates, *The Future of Corporate Governance Part I: The Problem of The Twelve* 13-14 (Harvard Pub. Law Working Paper No. 19-07, 2018), <https://corpgov.law.harvard.edu/wp-content/uploads/2019/11/John-Coates.pdf> (BlackRock, Vanguard, and State Street collectively control “a much greater share of U.S. public companies than any three single investors have ever previously done.”); Robert J. Jackson, Jr., Commissioner, Sec. & Exch. Comm., Testimony Before the Federal Trade Commission Hearing on Competition and Consumer Protection, Common Ownership: The Investor Protection Challenge of the 21st Century 7 (Dec. 6, 2018), <https://www.sec.gov/news/testimony/jackson-testimony-ftc-120618> (referring to the concentration of power in the biggest asset managers as “unprecedented”).

² See Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017) (finding that the

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The voting rights that come with these holdings give them enormous clout.³ For example, in May 2021, the Big 3 supported an improbable challenge to the oil giant Exxon from a little-known hedge fund, Engine Company Number 1.⁴ They backed three directors for Exxon’s board, all of whom were nominated because they planned, if elected, to press the company to change its focus to renewable energy.⁵ Thanks to the Big 3’s support, the provocateurs won.⁶ Their election illustrates that leading asset managers have power over the biggest and most fundamental questions of firm strategy and mission at the biggest companies in the world. There is perhaps no greater change than shifting Exxon from its focus on *oil*. A few months after the electoral rebuke, Exxon, once “unrepentant in its defense of crude,”⁷ announced that it was considering the previously unthinkable—a carbon-neutral pledge.⁸

Because the large asset managers wield such tremendous power, understanding why they vote the way they do is the most important question in corporate governance. Why did the Big 3 choose to shake up Exxon rather than support the *status quo*? A wave of recent scholarship has studied asset-manager voting through a conventional law-and-economics lens. These scholars have focused on whether industry leaders are using their voting power to improve the performance of portfolio firms.⁹ The literature

Big 3 are, collectively, the largest shareholder in 88% of S&P 500 companies, and that the remaining firms are typically dominated by founders, family members, or other insiders); Dawn Lim & Justin Baer, *BlackRock, Other Investors Target Climate Issues, Covid-19 Response and Board Seats in Shareholder Votes*, WALL ST. J. (Aug. 12, 2021), <https://www.wsj.com/articles/blackrock-other-investors-wield-growing-board-shareholder-vote-clout-11628766001> (reporting that the Big 3 collectively own nearly 20% of equity in S&P 500 companies).

³ See *infra* Part I.B.

⁴ See Matt Phillips, *Exxon Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021), <https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html>.

⁵ See *id.*

⁶ See *id.*

⁷ *ExxonMobil Loses a Proxy Fight with Green Investors*, ECONOMIST (May 29, 2021), <https://www.economist.com/business/2021/05/23/what-a-proxy-fight-at-exxonmobil-says-about-big-oil-and-climate-change>.

⁸ Christopher M. Matthews & Emily Glazer, *Exxon Considers Pledging ‘Net Zero’ Carbon by 2050*, WALL ST. J. (Aug. 25, 2021), https://www.wsj.com/articles/exxon-considers-pledging-net-zero-carbon-by-2050-11628161201?mod=hp_lead_pos1.

⁹ Professor Bebchuk and Hirst have authored a trio of articles (along with Professor Cohen, who coauthored the first article) arguing that the Big 3 fail to adequately police management of portfolio companies. See generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 95 (2017); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019) [hereinafter Bebchuk & Hirst, *Future of Corporate Governance*]; Lucian Bebchuk & Scott Hirst, *The Power of the Big Three and Why it Matters* (2021)

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reveals that the large asset managers have little economic incentive to do so, but it fails to provide a plausible alternative account of their motives. In this Article, I look beyond the conventional economic incentives. Instead, I show that politics largely motivates voting at the largest managers—and that this is problematic.

The concentration of equity ownership in a small group of financial institutions has transformed U.S. equity markets. Historically, individual investors drove U.S. markets. Millions of individuals held stock directly in public companies, and none had anything approaching a controlling interest.¹⁰ The assumption of dispersed ownership formed the basis of the Berle-Means thesis.¹¹ In its modern incarnation, this theory posits that dispersed ownership causes a collective-action problem: shareholders bear all of the costs of overseeing corporate managers, but enjoy only a sliver of the gains if their oversight leads to performance improvements.¹² As a result, shareholders ignore oversight and leave corporate leaders with a great deal of discretion over how they run their firms, discretion that allows for mismanagement and abuse.¹³ Overcoming the problems that stem from this separation of ownership from control, so-called “agency costs,” has long been considered the principal problem in corporate governance.¹⁴

(unpublished manuscript) (on file with author) [hereinafter Bebchuk & Hirst, *The Power of the Big 3*]. Others challenge this analysis. See Jill Fisch et al., *The New Titans of Wall Street, A Theoretical Framework for Passive Investors*, 168 PENN. L. REV. 17, 31-37 (2019) (arguing that the Big 3 have competitive incentives to police corporate management); Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1796-97 (2020) (arguing that the Big 3 have sufficient economic incentives to police corporate managers); Jeff Schwartz, *‘Public’ Mutual Funds in THE HANDBOOK ON INVESTOR PROTECTION* 57-64 (Arthur Laby ed., 2021) (critiquing Bebchuk and Hirst’s analysis); see also Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (arguing that index funds act as efficient intermediaries between activists and corporate management). BlackRock executives have also defended their voting practices. See generally Barbara Novick, *“The Goldilocks Dilemma” A Response to Lucian Bebchuk and Scott Hirst*, 120 COLUM. L. REV. 80 (2020); Matthew Mallow, *Asset Management, Index Funds, and Theories of Corporate Control* (Working Paper, Nov. 15, 2019), <https://papers.ssrn.com/abstract=3483573>.

¹⁰ See Kristian Rydqvist et al., *The Evolution of Aggregate Stock Ownership: A Unified Explanation* 8 at tbl. 1 (CEPR Discussion Paper No. DP7356, 2009), https://www.ifk-cfs.de/fileadmin/downloads/events/conferences/2011-07-01-Rydqvist_et_al.pdf (showing that, in 1945, individuals directly owned 93% of public-company shares).

¹¹ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 86-87 (1932).

¹² See *id.*

¹³ See *id.*

¹⁴ Professors Jensen and Meckling first used “agency costs” to describe the losses that result from the separation of ownership from control. See Michael C. Jensen & William H.

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The existing scholarship on asset-manager influence seeks to understand their voting from within this tradition. At first blush, it seems that replacing dispersed individual investors with a small group of sophisticated institutions should greatly ameliorate agency-cost concerns. The literature shows, however, that the large asset managers face a complex mix of financial incentives. And scholars are divided on how this affects agency costs. One camp argues that these financial institutions adequately police corporate managers;¹⁵ others argue that they fall far short.¹⁶ The disagreement centers on whether asset managers earn enough money from improving their portfolio firms to invest in careful oversight.¹⁷

This debate is useful and important, but not in the way the participating authors imagine. Those who argue that asset managers have little financial incentive to improve firms in their portfolios have the better argument, but this insight begins the analysis rather than completes it. Stepping outside the agency-cost framework reveals a profound implication: Since engaged voting is unprofitable, something else is dictating how asset managers vote. This is unprecedented. A group of hugely powerful financial institutions control corporate America, but they are not using their power to improve the firms they own.

The lack of a purely financial motivation creates the vacuum that politics fills. Since voting offers little prospect of direct profits, it makes sense for asset managers to use their influence to serve their political interests. It is well-known and understood that companies try to influence regulators and politicians through lobbying and other forms of direct political engagement, like financially backing certain candidates.¹⁸ Underexplored is how they influence politics through their actions. Acting in a way that regulators and politicians have signaled that they prefer reduces the risk of regulatory action and increases the chances of regulatory forbearance. And large asset managers have much to fear.

The Big 3 and others face more regulatory and political uncertainty now than at any time since the New Deal.¹⁹ An array of journalists,

Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

¹⁵ See Fisch et al., *supra* note 9, at 55-56; Kahan & Rock, *supra* note 9, at 1814-15.

¹⁶ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2035; Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 496-97 (2018) (“[P]assive fund managers are not doing enough to push management to maximize shareholder welfare”).

¹⁷ Compare Bebchuk & Scott Hirst, *Future of Corporate Governance*, *supra* note 9, at 2033-2075 (presenting a theory for why stewardship is unprofitable) with Fisch et al., *supra* note 9, at 27-43 (presenting a theory for why stewardship is profitable).

¹⁸ See *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 365 (2010) (holding that corporations may make unlimited independent political expenditures).

¹⁹ See *infra* Part III.A.2.

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politicians, and academics worry that they are destabilizing equity markets,²⁰ suppressing competition in major industries,²¹ and failing to act as responsible stewards on behalf of their funds' shareholders.²² NPR asked, *Is Your Retirement Fund Ruining Our Economy?*²³ The *Atlantic* echoed, *Could Index Funds Be Worse than Marxism?*²⁴

A bit hyperbolic, but this agita has generated a slew of reform proposals. Influential scholars even suggest breaking up the Big 3.²⁵ All of this makes it likely that the large asset managers view voting as a way to reduce the political heat. Their institutional history further supports this conclusion. They are an industry born of regulation, one which views itself as a partner with regulators, and carefully cultivates an image as the lone part of the finance industry that has its investors' interests at heart.²⁶ Voting in a manner that politicians and regulators like seems like an obvious way for them to build on this reputation.

Recent voting on environmental issues illustrates what is happening. Prior to 2021, the Big 3 had consistently voted against shareholder proposals focused on environmental accountability.²⁷ That year, they not only supported the fundamental change at Exxon, but also vastly increased their support for environmental proposals.²⁸ BlackRock's support for such

²⁰ See generally STEVEN D. BLEIBERG ET AL., EPOCH INV. PARTNERS, THE IMPACT OF PASSIVE INVESTING ON MARKET EFFICIENCY (2017); Annie Lowrey, *Could Index Funds Be Worse Than Marxism?*, ATLANTIC (April 5, 2021), <https://www.theatlantic.com/ideas/archive/2021/04/the-autopilot-economy/618497/>; Greg Rosalsky, *Is Your Retirement Fund Ruining Our Economy?*, NPR (Oct. 18, 2019), <https://www.npr.org/sections/money/2019/10/08/767884839/is-your-retirement-fund-ruining-oureconomy?t=1637247577028>.

²¹ See Jackson, *supra* note 1, at 1 ("Today's [Federal Trade Commission] hearing focuses on a pressing question in modern markets: whether institutional investors, and especially passive index funds—the preferred savings vehicle for millions of retail investors—can decrease competition, resulting in higher prices for American consumers."); see generally Jose Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (this seminal work in the field first identified suppressed competition in the airline industry); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 83 ANTITRUST L.J. 669 (2017).

²² See, e.g., Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2037; Lund, *supra* note 16, at 496-97.

²³ Rosalsky, *supra* note 20.

²⁴ Lowrey, *supra* note 20.

²⁵ See Zohar Goshen & Doron Levit, *Common Ownership and the Decline of the American Worker* 5 (Colum. L. & Econ. Working Paper No. 653, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3832069.

²⁶ See *infra* Part III.A.2.

²⁷ See *infra* Part II.C.3.b.

²⁸ See *infra* Part II.C.3.c.

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proposals was ten times higher than the previous year.²⁹ This shift lines up with the change from the Trump administration, which was hostile to institutional-investor involvement in environmental issues, to the Biden administration, which has pressed for it.³⁰ It also accords with a policy reversal at the Securities & Exchange Commission (the “SEC”), the industry’s primary regulator. In 2021, the agency abandoned its long history of focusing almost solely on mandating disclosure of financial information to make environmental accountability a top priority.³¹ This abrupt change in political winds seems to be the only thing that can explain the equally abrupt change in asset-manager voting.

While the Big 3 may have gotten things right with Exxon, politically motivated voting is nonetheless problematic. Stewardship theater—where large asset managers exercise their voting rights to perform for politicians and regulators—has procedural and substantive aspects, both of which are problematic. The rigmarole in which asset managers take part to demonstrate their commitment to engaged voting, or “stewardship,” is an inefficient use of resources that could forestall beneficial regulations. But the substantive aspect—where asset managers vote in the way politicians want—is more worrisome. There is no reason to think politicians know how to steer public companies, and politically motivated voting will shift with political power, which makes companies difficult to manage.³²

More problematic still, when asset managers vote to please politicians, it is as if the politicians themselves are voting. Pandering through stewardship, therefore, represents an indirect form of government intervention in corporate affairs. The separation between business and government has traditionally been sacrosanct because of the risk of

²⁹ See Attracta Mooney, *BlackRock Criticised Over Drop in Climate Votes*, FIN. TIMES (Oct. 4, 2020), <https://www.ft.com/content/7a80f33b-a0ed-4dea-b2d3-ce56381f4084> (reporting that BlackRock supported 6% of environmental proposals in 2020); Lim & Baer, *supra* note 2 (reporting that BlackRock supported 64% of environmental proposals in 2021).

³⁰ See *infra* text accompanying notes 320-324.

³¹ See *infra* text accompanying notes 326-328.

³² See *infra* Part IV.A.

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corruption and waste it creates.³³ Government acting implicitly and indirectly through asset managers is not state capitalism, but it poses similar risks.³⁴

Finally, it is illegitimate for asset managers to use their voting power to serve political ends. They vote corporate shares as trustees for the investors in the funds they manage and are duty-bound to serve their interests.³⁵ When asset managers vote instead to further their own political goals, they inappropriately leverage their fiduciary role. The conduct is particularly egregious because the asset managers are using the voting power that they are supposed to exercise on behalf of mutual-fund shareholders to avert regulations intended to help them.

This fix is to give power to fund investors. Practically speaking, asset managers currently have complete discretion over how they vote the shares held by the funds they oversee. If asset managers were forced to tie their votes to the preferences of fund investors, they would not be able to use voting to their political advantage. Asset managers could theoretically seek investor input on each matter under consideration. But the number of votes—thousands per year³⁶—makes this infeasible. Such a system would be costly to administer, and many investors have little interest in this level of involvement. Instead, asset managers should be required to poll investors on principles and to reflect these principles in their voting. For instance, investors could be asked if they support efforts to bring transparency to diversity at public companies. Asset managers would then be required to vote in proportion to their investors' views. Because asset managers would be deprived of voting discretion, they would be unable to use voting as a political instrument.

Beyond its policy implications, this analysis contributes to corporate-governance theory. The Berle-Means thesis is unidimensional: its sole focus

³³ Kateryna Holland, *Government Investment in Publicly Traded Firms*, 56 J. CORP. FIN. 319, 321 (2019) (“A general explanation [for the poor performance of government-owned entities] is that governments pursue political goals—including employment maximization, domestic investment, and even the personal financial goals of public officials—which conflict with wealth-maximization.” (internal citations omitted)); Simon C.Y. Wong, *Government Ownership: Why This Time it Should Work*, MCKINSEY & CO. (June 2009), <https://www.mckinsey.com/industries/public-and-social-sector/our-insights/government-ownership-why-this-time-it-should-work#> (“historically, government ownership of private companies has been notorious for lowering productivity, wasting resources, and distorting competition—often as a result of unclear objectives, political interference, lack of discipline, and poor transparency”).

³⁴ See *infra* text accompanying notes 345-349.

³⁵ See Proxy Voting by Investment Advisors, 68 Fed. Reg. 6585, 6586 (March 10, 2003).

³⁶ Vanguard voted on over 100,000 shareholder proposals in 2021. VANGUARD, INVESTMENT STEWARDSHIP SEMI-ANNUAL REPORT 8 (2021), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/inv_stew_2021_semiannual_report.pdf.

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is on shareholder incentives to monitor managers and how weak incentives translate to management slack. This Article shows the inadequacy of this narrow view. The large asset managers are not ignoring their funds' portfolio companies, so slack is not the issue. Instead, they are using their voting power to pursue other objectives. The policy concern is the social-welfare impact of voting for reasons that are unrelated to firm performance. In this era of institutional ownership, scholars must consider this additional dimension of shareholder democracy. They must think beyond slack to the myriad other incentives institutional investors may pursue through their voting, and the myriad ways acting pursuant thereto can impact corporations and society.³⁷

Part I of this Article describes the asset-management industry and how a few firms came to dominate it. It also discusses the potential for the large asset managers to use the voting power that they accumulated to resolve the agency-cost problem central to the Berle-Means thesis. Part II undertakes a conventional law-and-economics analysis of whether their voting practices deliver on this promise. The analysis dashes such hopes. It shows that asset managers do not use their votes to police corporate executives. Part III builds on this insight to advance a political theory of asset-manager voting. It shows that large asset managers have a strong incentive to use their power for political purposes and that politics explains their voting record. Part IV explores the theoretical and normative implications of this analysis. Politically motivated voting is unwelcome, but there is a direct way to counter it—require asset managers to represent investor preferences rather than their own.

I. ASSET MANAGERS AND CORPORATE CONTROL

The incredible growth of the asset-management industry has transformed the way that investors engage with markets and the way companies engage with investors. These changes substantially weaken the

³⁷ In this respect, this Article intersects with two broader lines of corporate-governance literature. The first is “principal costs,” which explores the downsides of shareholder power and expresses skepticism regarding institutional voting. These works, however, focus on the problems with institutional oversight from within the agency-cost framework. *See, e.g.,* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017). The other literature involves “empty voting.” Empty voting is where voting power is decoupled from financial risk. *See, e.g.,* Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms* 61 BUS. LAWYER 1011 (2006); Jill Fisch, *Mutual Fund Stewardship and the Empty Voting Problem* (European Corp. Gov. Inst. Working Paper No. 612/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3939112.

effectiveness of conventional tools for understanding the relationship between equity markets and corporate governance.

A. The Structure of the Asset-Management Industry

Asset managers form and run pooled investment vehicles on behalf of individual and institutional investors. Their core product is mutual funds. These funds own a portfolio of securities, typically stocks or bonds.³⁸ Investors own shares in the fund, which is usually organized as a corporation, and are entitled to their *pro rata* share of the asset pool and the related appreciation.³⁹ The principal appeal of mutual-fund investing is diversification. It would be too costly for most retail investors to purchase a widely diversified stock portfolio. But a single share in an equity mutual fund gives investors exactly that.

The portfolio of securities is the mutual fund's only asset, and it typically employs no one. Rather, the fund's portfolio is managed by its asset manager, a company like BlackRock, which has its own shareholders and manages a number of funds.⁴⁰ The top managers oversee hundreds of funds. BlackRock, for example, manages over 600.⁴¹ Each mutual fund has an "expense ratio."⁴² This is an annual percentage-based fee that investors pay the asset manager. A one percent expense ratio means that investors pay 1% of their holdings in the fund to the asset manager each year. For example, in a given year, if an investor owns \$10,000 worth of shares in a fund with a 1% expense ratio, that person would owe \$100 that year. The average mutual

³⁸ See, e.g., Vanguard, Vanguard Mutual Funds, <https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns> (last visited Feb. 7, 2022).

³⁹ See TAMAR FRANKEL & ARTHUR B. LABY, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISORS* 5-29 (3rd ed. 2016).

⁴⁰ Vanguard is an important exception. The vast majority of its funds are internally managed, which means Vanguard has no external shareholders. See Jeff Schwartz, *Mutual Fund Conflicts of Interest in the Wake of the Short-term Trading Scandals: Structural Change Through Shareholder Choice*, 2 N.Y.U. J. L. & BUS. 91, 133-35 (2005). But they do have some externally managed funds. See Dawn Lim & Cara Lombardo, *Vanguard Is Handing Over Some of Its Voting Power*, Wall St. J. (Apr. 25, 2019) https://www.wsj.com/articles/vanguard-is-handing-over-some-of-its-voting-power-11556190120?mod=article_inline (reporting that 9% of Vanguard's funds are externally managed). This structure should not materially impact Vanguard's voting incentives.

⁴¹ See BlackRock, Investment Funds, <https://www.blackrock.com/us/individual/products/investmentfunds#!type=mutualFunds&style=All&view=perfNa> (last visited, Dec. 11, 2021) (listing 611 funds).

⁴² For an overview of mutual-fund fees, see SEC, Investor.gov., Mutual Fund Fees and Expenses, <https://www.investor.gov/introduction-investing/investing-basics/glossary/mutual-fund-fees-and-expenses> (last visited Jan 14, 2022).

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fund fee was .41% in 2020.⁴³ The profits derived from fees charged to mutual-fund shareholders generate returns for the asset manager's shareholders.

Managing mutual funds is a lucrative business. Returns to shareholders in asset managers are almost 3-times that of the portfolio companies in which their affiliated funds invest. In 2018, the industry operating margin was 31.1%,⁴⁴ while the profit margin for the S&P 500 (a list of 500 of the largest companies) was around 13%.⁴⁵

A key distinction in equity mutual funds is between actively and passively managed funds. In actively managed equity funds, the asset manager attempts to pick undervalued stocks for the fund's portfolio in the hopes of earning returns above the market average. In passively managed funds, also called index funds, there is no active stock-picking. The fund simply invests in an index of securities like the S&P 500. Whereas the returns in an actively managed fund are, at least in part, determined by the skill of the manager. In an index fund, the investors solely earn the market return, minus fees. Index funds typically charge much lower fees than actively managed funds.⁴⁶ Some even charge no fee.⁴⁷ There is a near consensus that when fees are considered, index funds outperform funds that are actively managed.⁴⁸

The asset-management industry is enormous. At the end of 2020, there were over 9,000 mutual funds and 2,000 ETFs,⁴⁹ with total assets of \$29.3 trillion.⁵⁰ For comparison, the U.S. GDP for 2020 was about \$21

⁴³ See 2020 U.S. Fund Fee Study 1, MORNINGSTAR (Aug. 2021).

⁴⁴ Stewart L. Brown & Steven Pomerantz, *Mutual Fund Advisory Fees: Sponsors Game the System as Watchdogs Slumber*, 15 OHIO ST. BUS. L. J. 29, 39 (2021).

⁴⁵ CSI Market, Total Market Profitability, https://csimarket.com/Industry/industry_Profitability_Ratios.php?&hist=12 (last visited Jan. 14, 2022).

⁴⁶ See 2020 U.S. Fund Fee Study, *supra* note 43, at 2 (reporting average index fund fees of .11% and actively managed fund fees of .62%).

⁴⁷ See Jeff Sommer, *A Price War Has Driven Fund Fees to Zero. They May Be Set to Drop Further.*, N.Y. TIMES (Apr. 5, 2019), <https://www.nytimes.com/2019/04/05/business/price-war-fund-fees-zero-negative.html>.

⁴⁸ See, e.g., *Active/Passive Barometer*, MORNINGSTAR (Oct. 2021) ("In general, actively managed funds have failed to survive and beat their passive peers, especially over longer time horizons."). There is some evidence to the contrary. See generally Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. 1 (2015) (discussing conflicting evidence and finding that active management adds value).

⁴⁹ INV. CO. INST., 2021 INVESTMENT COMPANY FACT BOOK 40 fig. 2.1 (61st ed.) (2021). ETFs are basically the same as mutual funds, except mutual-fund shares are bought and sold directly from the fund, whereas ETFs are publicly traded. See *id.* at 94. The distinction is irrelevant for this Article as voting is handled identically.

⁵⁰ *Id.* at 42 fig. 2.3.

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trillion.⁵¹ There are over 804 asset managers,⁵² but almost 50% of industry assets are overseen by three companies (the Big 3, plus Fidelity and the Capital Group) with the remaining 799 managing the rest.⁵³ The Big 3 specialize in index funds, which have grown tremendously in the last decade. Index fund assets now total almost \$10 trillion, up from under \$2 trillion 10 years ago.⁵⁴ Vanguard alone manages around 76% of index-fund assets.⁵⁵

A significant part of the success of mutual funds comes from a transformation in the way Americans fund retirement. In the last 40 years, there has been a major shift from defined benefit plans, where employers provide employees with guaranteed income after retirement, to defined contribution plans, like 401(k)s, where employees self-fund their retirements in tax-favored accounts.⁵⁶ Asset managers run these accounts. Vanguard, for example, manages corporate 401(k) plans and channels company employees to its funds to house their 401(k) savings.⁵⁷ Mutual funds hold \$11.1 trillion in 401(k) and related assets,⁵⁸ and Vanguard and BlackRock are the leaders in the space.⁵⁹ Before the introduction of 401(k)s in 1982,⁶⁰ asset managers were minor players in equity markets. In 1981, their affiliated mutual funds

⁵¹ See The World Bank, Data, <https://data.worldbank.org/indicator/ny.gdp.mktp.cd?locations=US> (last visited Jan. 14, 2022).

⁵² INV. CO. INST., *supra* note 49, at 54 fig. 2.12.

⁵³ Jeff Tjornehoj, *Exploring Fund Industry Concentration: The Good, The Bad, and The Unknown*, BROADRIDGE 3-4 & tbl. 2 (2018); see also Bob Eccles, *Concentration in the Asset Management Industry: Implications for Corporate Engagement*, FORBES (April 17, 2019), <https://www.forbes.com/sites/bobeccles/2019/04/17/concentration-in-the-asset-management-industry-implications-for-corporate-engagement/#bf13c44402f5> (discussing implications of concentration in the asset-management industry).

⁵⁴ INV. CO. INST., *supra* note 49, at 49 fig. 2.8 (figure includes ETFs).

⁵⁵ See Tjornehoj, *supra* note 53, at 5 tbl. 7.

⁵⁶ The tax subsidy on which 401(k)s are based, which allows employees to fund their retirement accounts with pre-tax dollars, is valued at around \$90 billion. See OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2020 199 tbl.16-4 (2020). This subsidy not only benefits savers, but also mutual funds, whose assets have swelled because of it and who collect fees based on the pre-tax asset base. For a discussion of the origins of the 401(k), see Timothy W. Martin, *The Champions of the 401(k) Lament the Revolution They Started*, WALL ST. J. (Jan. 2, 2017) <https://www.wsj.com/articles/the-champions-of-the-401-k-lament-the-revolution-they-started-1483382348>. For a critique of 401(k)s on policy grounds, see Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. LEG. 53 (2012).

⁵⁷ See Veronika K. Pool, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, 71 J. FIN. 1779, 1780 (2016) (finding “significant favoritism” toward funds affiliated with the 401(k) administrator).

⁵⁸ INV. CO. INST., *supra* note 49, at 197.

⁵⁹ See Robert Steyer, *Overall Assets Jump Nearly 22% for Top 25 Firms*, PENSION & INVESTMENTS (June 1, 2020), <https://www.pionline.com/largest-money-managers/overall-assets-jump-nearly-22-top-25-firms>.

⁶⁰ Rydqvist et al., *supra* note 10, at 1-2.

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held under 3%⁶¹ of the stock of public companies compared with 30% at the end of 2020.⁶²

B. Voting Power and Stewardship

The voting power of asset managers has swelled with mutual-fund assets. With rare exception, each additional share a fund accumulates comes with voting rights.⁶³ Even though it is the fund shareholders who benefit directly from appreciation in those shares, mutual funds technically own the shares on the shareholders' behalf, and the asset managers that oversee the funds control how the funds vote. As corporate shareholders, mutual funds vote on shareholder proposals and the annual election of directors, as well as other fundamental matters, like whether to amend corporate governing documents, dissolve, or merge.⁶⁴ The Dodd-Frank Act also gave public-company shareholders a nonbinding vote on executive compensation, frequently referred to as a “say on pay.”⁶⁵

While none of the above give shareholders direct power over how businesses are run, all are important. Shareholder proposals are non-binding, but boards nevertheless take them seriously. They tend to address environmental, social, and corporate governance (“ESG”) matters. Corporate governance proposals typically call for removing barriers to shareholder voting power.⁶⁶ Social and environmental proposals often call for transparency about employee diversity and environmental risks and impacts.⁶⁷

⁶¹ *Id.* at 2.

⁶² INV. CO. INST., *supra* note 49, at i.

⁶³ See Hu & Black, *supra* note 37, at 1013 (2006) (discussing the one-share one-vote structure of public companies); Jeff Schwartz, *De Facto Shareholder Primacy*, 79 U. MD. L. REV. 652, 686 (2020) (discussing rarity of reduced shareholder voting rights among public companies).

⁶⁴ See Del. Gen. Corp. L. 242, 251 (2020).

⁶⁵ See 17 C.F.R. § 240.14a-21 (2020).

⁶⁶ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2101-02 (discussing changes to corporate governance arising from shareholder-proposal process); Roberta Karmel, *Voting Power Without Responsibility or Risk—How Should Proxy Reform Address the Decoupling of Economic and Voting Rights?*, 55 VILL. L. REV. 93, 106-08 (2010) (same).

⁶⁷ See Marc Treviño et al., 2021 Proxy Season Review: Shareholder Proposals on Environmental Matters, HARV. LAW SCH. F. ON CORP. GOV. & FIN. REG. (Aug. 11, 2021), <https://corpgov.law.harvard.edu/2021/08/11/2021-proxy-season-review-shareholder-proposals-on-environmental-matters/> (“[M]ost environmental proposals focused more generally on companies’ commitment to adopting sustainability disclosure and policies.”); Shirley Westcott et al., 2021 Proxy Season Review, HARV. LAW SCH. F. ON CORP. GOV. & FIN. REG. (Aug. 5, 2021), https://corpgov.law.harvard.edu/2021/08/05/2021-proxy-season-review/?utm_source=pocket_mylist (listing different types of environmental and social proposals).

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Although social and environmental proposals enjoyed little success until very recently, governance proposals have done well for years.⁶⁸ As a result, they have led to significant changes. Among them, a large majority of S&P 500 companies now require annual election of directors rather than allow directors to serve staggered multiyear terms and require that directors in uncontested elections receive a majority of votes cast for reelection.⁶⁹ Annual elections empower shareholders because it means an entire board can be replaced at once. Majority-voting requirements allow shareholders to express disapproval of board members by casting ballots to “withhold” votes for their reelection. This empowers shareholders because if a majority withholds their votes for particular board members, they are removed even if their seats are uncontested.

These corporate-governance changes have triggered increased shareholder engagement. In particular, hedge-fund activists purchase small ownership stakes in target firms, demand changes, and then sell once their changes are adopted.⁷⁰ If companies refuse, funds appeal to shareholders to vote out intransigent directors at the next annual election and support the funds’ slate of directors instead.⁷¹ These so-called proxy contests often succeed.⁷²

Because of their vast holdings, the Big 3 largely dictate the outcome of shareholder proposals and activist campaigns. They are not majority shareholders, but their ownership stakes are substantial: Vanguard owns 9.8% of the shares of S&P 500 firms, BlackRock 7.6%, and State Street 5.6%,⁷³ for a total of 23%.⁷⁴ This is enough to make them, collectively, the largest shareholder in 88% of S&P 500 companies.⁷⁵ In addition, asset managers vote essentially all of their share while retail investors vote under one-third.⁷⁶ This means that the above figures understate the Big 3’s influence. Scholars estimate that their ownership is more like 30% when

⁶⁸ See sources cited *supra* note 66.

⁶⁹ MARK S. GERBER, U.S. CORPORATE GOVERNANCE: FROM THE FRYING PAN INTO THE FIRE? 1-2 (2020), <https://www.skadden.com/insights/publications/2020/01/2020-insight-s/us-corporate-governance>.

⁷⁰ See Schwartz, *supra* note 63, at 679.

⁷¹ See *id.*

⁷² See INSIGHTIA, THE PROXY VOTING ANNUAL REVIEW 2021, at 20 (showing activists winning at least one board seat or settling almost half the time).

⁷³ Bebchuk & Hirst, Power of the Big Three, *supra* note 9, at 9 tbl. 2 (reporting ownership percentages from 2020).

⁷⁴ *Id.*

⁷⁵ Fichtner et al., *supra* note 2, at 313.

⁷⁶ See PROXY PULSE, 2019 PROXY SEASON REVIEW 5 (2019), https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2019-review.pdf.

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their higher voting rate is considered.⁷⁷ When a few other giant asset managers are added into the mix, these numbers swell even further.

It might seem unfair to group the asset managers with the funds they oversee. The Big 3 manage hundreds of funds, but the funds technically own and vote the shares. In theory, these funds could vote their own shares and do so in opposite directions. Their asset-manager affiliation would be irrelevant. In practice, however, independent voting is rare. A centralized stewardship team at the asset manager makes voting recommendations and individual funds rarely depart from them.⁷⁸

In addition, the large asset managers vote alike. A recent empirical study tracked asset-manager voting on shareholder proposals from 2010 – 2015.⁷⁹ It found a high correlation across the industry. Asset managers voted the same way on shareholder proposals 79% of the time.⁸⁰ The study also grouped asset managers into different “parties” based on their voting patterns.⁸¹ The Big 3, along with the other largest managers, belong to the Traditional Governance Party.⁸² This party backs proposals like those mentioned above, which support the shareholder franchise.⁸³ Members of the Traditional Governance Party hold 66% of mutual-fund assets⁸⁴ and vote together approximately 88% of the time.⁸⁵ It makes sense, therefore, to treat the Big 3, and other large asset managers, as a voting block.

This block dictates the outcomes of controversial shareholder proposals and proxy contests.⁸⁶ Conservatively assume that the Big 3 control 25% of the vote. For them to be on the losing side of a matter, the owners

⁷⁷ See Bebchuk & Hirst, *Power of the Big Three*, *supra* note 9, at 59.

⁷⁸ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2050; Fichtner et al., *supra* note 2, at 317 (discussing rarity of internally conflicting votes); Lim & Baer, *supra* note 2 (“Although different BlackRock funds’ voting decisions can diverge from the BlackRock stewardship team, that doesn’t happen often.”); Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 15 (Eur. Corp. Gov. Inst., Finance Working Paper No. 601/2019 2019), http://ssrn.com/abstract_id=3101473 (finding that a fund diverges from its family in 5.5% of proxy contests).

⁷⁹ Ryan Bubb & Emiliano Katan, *The Party Structure of Mutual Funds* 8 (Eur. Corp. Gov. Inst. Law Working Paper 560/2020, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039.

⁸⁰ *Id.* at 22.

⁸¹ *Id.* at 3.

⁸² This party also includes other significant fund managers, like Fidelity and JP Morgan. *Id.* at 42 tbl 4.

⁸³ *Id.* at 24.

⁸⁴ Bubb & Catan, *supra* note 79, at 22.

⁸⁵ More precisely, for shareholder proposals, 12% of votes were cast against the majority position. *Id.*; see also Bebchuk & Hirst, *Power of the Big Three*, *supra* note 9, at 21 (“[W]hile the votes of the Big Three are generally not identical, they are significantly correlated.”)

⁸⁶ See Coates, *supra* note 1, at 14 (describing the Big 3’s votes as “pivotal”); Fisch et al., *supra* note 9, at 26 (same).

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of 68% of the remaining shares would have to disagree with them.⁸⁷ This is an extremely high bar, particularly given that asset managers tend to vote similarly, and that the remaining shareholders are dispersed and less likely to vote.

It is sometimes argued that, because controversial matters are uncommon, the top asset managers are not actually that powerful.⁸⁸ But this is unconvincing. Power matters when votes are contested. The Big 3 cast the decisive votes to change the makeup of Exxon's board.⁸⁹ In the much-publicized proxy contest at Dupont in 2015, the Big 3 sided with management. Again, their votes were determinative. Trian Partners, the hedge-fund activist, lost even though it won a majority of the other investors.⁹⁰

Moreover, even if there is little dissent as to a particular vote, it does not mean the top managers are less powerful. A majority shareholder is no less powerful on matters where the minority shareholder agrees. The reality is that the majority shareholder is in control. While the biggest asset managers are not majority owners, they are extremely powerful blockholders. The concentration of power in their hands is unprecedented, and potentially upends the Berle-Means thesis, which has dominated corporate-governance thinking for 100 years.

C. The Twilight of The Berle-Means Thesis

The Berle-Means thesis frames the separation of ownership from control as the central dilemma of corporate law.⁹¹ According to this theory, the professional managers who control public companies are duty-bound to

⁸⁷ For simplicity, assume there are 100 shares and the Big 3 hold 25 of them (25%). Out of the 75 remaining, 51 would have to disagree, which is 68%.

⁸⁸ See, e.g., Kahan & Rock, *supra* note 9, at 1778 (arguing that there is a "limited" number of "consequential" proxy contests).

⁸⁹ The Big 3 held more than 20% of Exxon's shares. Steven Mufson, *A Bad Day for Big Oil*, WASH. POST. (May 26, 2021), <https://www.washingtonpost.com/climate-environment/2021/05/26/exxonmobil-rebel-shareholders-win-board-seats/>. The three dissident candidates would not have survived a 20% shift to the three incumbents. See Exxon 8-K, June 2, 2021 (calculations on file with author).

⁹⁰ Fichtner et al., *supra* note 2, at 309 ("The outcome of this high profile proxy contest was determined when the Big Three disclosed that they were voting all their shares in favor of the incumbent."); Tom Hals, *DuPont Wins Board Proxy Fight Against Activist Investor Peltz*, REUTERS (May 13, 2015), <https://www.reuters.com/article/us-dupont-trian-idUSKBN0NY1JI20150513> (reporting that "Trian won the majority of non-index institutions and would have prevailed had one of those three index funds voted differently").

⁹¹ See BERLE & MEANS, *supra* note 11, at 112-16.

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represent the owners of the corporation, its shareholders.⁹² But they may shirk or self-deal if shareholders do not actively oversee them. Shareholders, however, suffer from a collective-action problem, which disincentivizes this very thing. Although faithful management would benefit all shareholders, challenging inept, lazy, or corrupt managers is expensive and uncertain while any increased profits from a successful intervention are shared *pro rata* with other shareholders.⁹³

The incentive problem is most acute when share ownership is dispersed among many investors with small interests, as it was for most of the stock market's history. If shareholders with small stakes intervene, they internalize all the costs, but only a sliver of the gains, making it much better to sell and invest elsewhere when displeased with management. The theory predicts that shareholders will abide by these incentives, leaving management to do as they please at shareholders' expense.⁹⁴ The lost shareholder value has come to be known as agency costs.⁹⁵

Though the collective-action logic of Berle-Means is timeless, the agency-cost concern it highlights is much less salient today. Because of exchange rules requiring majority independent boards,⁹⁶ because of structural changes to corporate governance initiated through the shareholder-proposal process,⁹⁷ and because of a shift to stock-based compensation,⁹⁸ management is much more responsive to shareholders than in the past.⁹⁹

Against this backdrop, socially minded shareholders pressure corporate management to change diversity and environmental practices,¹⁰⁰ while hedge-fund activists lean on them to increase stock prices.¹⁰¹ Each

⁹² Shareholders are conventionally conceptualized as the owners of corporations, but this view is contested. See Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2013 n.45 (2013).

⁹³ See BERLE & MEANS, *supra* note 11, at 8-9, 86-87.

⁹⁴ See *id.*

⁹⁵ See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1913 (2013).

⁹⁶ See NASDAQ STOCK MARKET RULES 5605 (2021), <http://nasdaq.cchwallstreet.com/NASDAQ/Main/>; NYSE LISTED COMPANY MANUAL § 303A.01 (2021), <https://nyseguide.srorules.com/listed-company-manual>.

⁹⁷ See *supra* note 68 and accompanying text.

⁹⁸ See Theo Francis & Inti Pacheco, *From Tesla to GE, See How Much CEOs Made in 2020*, WALL ST. J. (June 1, 2021), <https://www.wsj.com/articles/from-tesla-to-ge-see-how-much-ceos-made-in-2020-11622539802>; Rock, *supra* note 95, at 1917-18, 2024.

⁹⁹ See Rock, *supra* note 95, at 1917-1926 (reviewing evidence of reduced agency costs).

¹⁰⁰ See Paul Kiernan, *SEC Raises Bar for Shareholder Resolution*, WALL ST. J. (Sept. 23, 2020), <https://www.wsj.com/articles/sec-raises-bar-for-shareholder-resolutions-11600877050>.

¹⁰¹ See Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870,

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year, activists launch hundreds of challenges,¹⁰² and other shareholders make hundreds of social and environmental proposals.¹⁰³ Satisfying these groups is now a fundamental part of public-company management.

Because large asset managers decide whether activist challenges and shareholder proposals succeed, they are the most important players in corporate governance. In the twilight of Berle-Means, the central question—what drives their voting—remains unresolved. If they are careful stewards of their clients' money, committed to maximizing the long-term value of the companies held in the funds they oversee, then the agency-cost problem has been largely solved. It is also possible, however, that they are just as apathetic as retail investors and squander their power, leaving behind stubborn agency costs, or that other incentives determine how they vote, leading to a different set of concerns.

II. THE LAW AND ECONOMICS OF ASSET-MANAGER STEWARDSHIP

Recent scholarship has sought to understand whether asset managers' participation in corporate governance finally resolves, or at least substantially ameliorates, the agency-cost problem that stems from the separation of ownership from control. To provide an answer, scholars have focused on whether it is profitable for asset managers to actively engage in voting as a strategy to improve the performance of portfolio firms.¹⁰⁴ The logic being that if active engagement is profitable, then the asset managers will act accordingly, and agency costs will shrink.

In this section, I synthesize and build on the competing threads of literature to offer my own analysis. I conclude that it is unprofitable for asset managers to try to improve portfolio firms through participation in corporate governance, which means that other considerations must drive how they vote.

A. Asset-Manager Incentives to Engage in Stewardship

To begin, there is some reason to believe that large asset managers may be more involved with corporate governance than retail investors. Their

1892 (2017) (“[A]ctivist hedge funds identify companies and take an equity position in them only when they have identified a way to change the corporation’s operations in a manner that the hedge fund believes will cause its stock price to rise.”).

¹⁰² See Schwartz, *supra* note 63, at 685.

¹⁰³ See GIBSON DUNN, SHAREHOLDER PROPOSAL DEVELOPMENTS DURING THE 2021 PROXY SEASON 4-5 (2021), <https://www.gibsondunn.com/wp-content/uploads/2021/08/shareholder-proposal-developments-during-the-2021-proxy-season.pdf>.

¹⁰⁴ See *supra* note 17 and accompanying text.

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size means that the collective-action problem that condemns retail investors to apathy is less problematic. Since large asset managers own significant percentages of portfolio companies, gains from intervention may be big enough to justify the associated expense even if the profits must be shared with other shareholders.¹⁰⁵

And expenses should not be a problem for the Big 3 and other large asset managers. They manage trillions of dollars and can spread diligence costs across the funds they manage.¹⁰⁶ There is also a good chance that the money will be well spent. Since they control so many votes, it is likely their positions will prevail.¹⁰⁷ They also benefit from spillover effects. Stock research for asset-allocation decisions should generate much of the knowledge necessary for informed voting.¹⁰⁸ All of this provides hope that the large asset managers might provide the management oversight that was lacking when retail investors dominated the market.

The hope slowly fades, however, when one focuses on the institutional details of asset management. The link between engaged voting, improved portfolio-firm performance, and asset-manager profits is much more attenuated than in the case of the idealized blockholder. To see this, think of asset managers as profit-maximizing actors. They maximize profits by maximizing fee income (minus associated expenses). They maximize fee income by maximizing assets under management (“AUM”) and expense ratios across their family of funds.

Engaged voting has the potential to increase asset managers’ AUM. Careful oversight, and the threat thereof, should cause corporate managers to perform their jobs more carefully, which should improve firm performance, which should increase the value of portfolio companies. More valuable companies means higher AUM. Increased performance also may attract new investors, which would further increase AUM,¹⁰⁹ and may give asset managers a justification for raising fees. Thus, asset managers have the incentive to invest in corporate oversight to the extent that increases in AUM and fees justify the associated costs.

In theory, managers of index funds have the most to gain from stewardship. Active managers primarily try to improve performance through their stock picking. But index-fund managers cannot choose their

¹⁰⁵ Fisch et al., *supra* note 9, at 38.

¹⁰⁶ *Id.* at 39.

¹⁰⁷ *See id.* at 38.

¹⁰⁸ *See* Kahan & Rock, *supra* note 9, at 1800.

¹⁰⁹ *See, e.g.,* Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged 2* (Tuck Sch. of Bus., Working Paper No. 3265761, 2018), <https://ssrn.com/abstract=3265761> (finding that “a one percentage point increase in an institution’s benchmark-adjusted quarterly return predicts a 1.29 percentage point ... increase in net inflow over the subsequent ten quarters”).

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investments. Thus, the only way to improve performance and generate the increased profits that come with it is through monitoring their portfolio companies.¹¹⁰ Since the Big 3 specialize in managing index funds, this might suggest an inclination towards stewardship.

It turns out, however, that even for the Big 3, the gains from stewardship are minimal. The increase in AUM from actively participating in corporate governance at portfolio firms is speculative and small, and offset by numerous potential losses, and there is little hope that such engagement would allow managers to increase fees.

B. The Illusory Promise of Stewardship Profits

Neither active engagement, where asset managers initiate management challenges, nor passive engagement, where they choose whether to support these challenges, offers the prospect of profits. First consider active engagement. In this type, shareholders identify underperforming companies in their portfolio, insist on operational or personnel changes, and launch proxy contests if management resists. Professors Bebchuk and Hirst argue that the Big 3 should engage with their portfolio companies at this level.¹¹¹

Profitability dictates otherwise, however. It is hard to identify performance-enhancing improvements. Because their compensation depends on it, executives at public companies already have great incentive to keep stock prices high. There is also an expertise gap. Although the Big 3 are sophisticated investors, they are still outsiders and, as such, are inherently less informed about company operations.¹¹² Plus, it is hard to imagine that they, or other large asset managers, are in the best position to engage in this sort of activism. Identifying and resolving underperformance issues is not their area of expertise. For these reasons, active engagement is unlikely to generate a positive return.

It makes more sense for large asset managers to let hedge-fund activists fight these battles. Active engagement is exactly what they are designed for.¹¹³ Instead of getting their hands dirty, the large asset managers

¹¹⁰ See Fisch et al., *supra* note 9, at 32, 35.

¹¹¹ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2095.

¹¹² See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PENN. L. REV. 1469, 1502 (1991) (“Financial institutions would not generally be better informed than incumbent managers who have spent a lifetime in their business.”).

¹¹³ See Jill Fisch, *The Uncertain Stewardship Potential of Mutual Funds*, in GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 112-13 (Dionysia Katelouzou & Dan W. Puchniak eds., forthcoming) (discussing why hedge funds are well-suited for activism).

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can limit their involvement to deciding which activist challenges to support. Letting the activists take the lead allows them to get the benefit of any performance improvements without incurring the significant costs involved with identifying underperformers, figuring out what is wrong, and lobbying for change.¹¹⁴

There are problems, however, with even this more modest form of engagement. For it to prove profitable, the gains from hedge-fund activism must outweigh the costs involved in deciding which challenges to back. Even this is doubtful.

Asset managers internalize only a small portion of the gains from activism. Because the mutual funds that asset managers oversee are diversified and asset managers are further diversified across funds, even the biggest managers hold less than 10% of any portfolio company's stock.¹¹⁵ The asset managers' gains are the fees associated with the activist-driven increase on this holding. In 2020, Vanguard's average fee was .09%, State Street's was .16%, and BlackRock's was .25%.¹¹⁶

Say an activist increases the value of a firm by \$100 million in the first year, Vanguard's share, assuming a 10% holding and its average fee, would be \$9,000.¹¹⁷ Vanguard would earn this additional fee each year for as long as the increase in value remained. A \$100 million improvement may be worth it for an activist hedge fund with a concentrated ownership position, but the resulting gain is a pittance for a large asset manager. And the above calculation is an overstatement.

Typically, hedge-fund activists call for actions that create short-term price boosts, like cuts to research and development or stock buybacks.¹¹⁸ There is significant debate about whether such actions come at the expense of long-term gains.¹¹⁹ One recent study found, for example, that "long-term returns [from activism] insignificantly differ from zero."¹²⁰ Thus, the asset managers' bump today may reverse in the future.

¹¹⁴ Professors Gilson and Gordon celebrate the symbiotic relationship between asset managers and hedge-fund activists—where activists target underperformers and asset managers give or withhold their support—as an efficient allocation of corporate governance. See Gilson & Gordon, *supra* note 9, at 867.

¹¹⁵ See Bebchuk & Hirst, *The Power of the Big Three*, *supra* note 9, at 9 tbl. 2 (reporting median ownership percentages of the Big 3 for the S&P 500).

¹¹⁶ See *2020 U.S. Fund Fee Study*, *supra* note 43, at 15.

¹¹⁷ The math is $\$100,000,000 \times .1 \times .0009$. Estimates of the dollar value of hedge-fund activism vary, but the above example may be generous. See Ed deHaan et al., *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 40 tbl 3. (Stanford Rock Center for Corporate Governance Working Paper No. 236, 2018) (finding an immediate change to market value of \$22 million that declines to \$3.4 million one year later).

¹¹⁸ See Schwartz, *supra* note 63, at 680.

¹¹⁹ See deHaan, *supra* note 117, at 8-13 (reviewing empirical findings).

¹²⁰ *Id.* at 4.

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Large asset managers like the Big 3 also have their bond funds to consider. Stock buybacks and other moves that activists push increase leverage, which hurts bondholders. Thus, increased asset-management fees from improved stock performance are offset by decreases in bond performance.¹²¹ Whether activism is a net positive depends on the asset manager's mix between stock and bond funds.

Activists also often push for a sale of the target company.¹²² A sale increases the stock price of the target, but the asset manager may have holdings in the acquiring firm, which typically drops in value.¹²³ This tradeoff illustrates a broader market reality, which is that gains at one firm may come at the expense of others. If an activist-inspired change makes one company better than its competitors, then that does nothing for an asset manager that also owns stock in the competitors.¹²⁴ It could even hurt. If an asset manager owns more stock in the competitor firms, an improvement in one of its portfolio holdings might reduce overall profits.

Finally, supporting activists might hurt important relationships with portfolio companies. Taking the opposite side of management in a proxy contest could, for instance, threaten the prospects of administering that firm's 401(k) plan.¹²⁵ Not only would the asset manager lose the administrative fees, but its AUM would also suffer because it would no longer be able to channel that company's employees to its funds.¹²⁶ Managers of active funds might also profit by receiving quasi-inside information from corporate executives that aids in their stock picking.¹²⁷ Supporting activists could cause this well to run dry.

In sum, while some hedge-fund activism may increase short-term returns, the bump potentially comes, at least in part, at the cost of long-term returns, bondholders, other companies in the asset managers' funds, and from the asset manager's 401(k) business. By the time all of this is considered, any profits evaporate. The \$9,000 gain from the example above is more likely close to \$0. With nothing to gain, it is not worth investing much in assessing the relative merits of activist proposals.

¹²¹ See John D. Morley, *Too Big To Be Activist*, 92 U.S.C. L. REV. 1407, 1439-40 (2019).

¹²² See Schwartz, *supra* note 63, at 680.

¹²³ See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1424-25 (2007).

¹²⁴ According to modern portfolio theory, diversification—the *sin qua non* of mutual funds—cancels out activist gains because they are largely offset by losses at competitor firms in a fully diversified portfolio. See Jeffrey N. Gordon, *Systemic Stewardship 2* (Working Paper, Feb. 2021) (on file with author).

¹²⁵ See Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1157 (2019).

¹²⁶ See Pool, *supra* note 57, at 1788.

¹²⁷ See Kahan & Rock, *supra* note 9, at 1810.

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The other interventions that asset managers are asked to consider are ESG shareholder proposals. None yield obvious gains to asset managers. As noted above, governance proposals, like destaggering boards, typically disempower corporate executives in favor of shareholders.¹²⁸ Increasing management's accountability to shareholders may reduce agency costs, but it does not necessarily increase firm value.

Corporate executives are experts in the businesses they run. They know more than even the most sophisticated shareholders, and there is no reason to assume *ex ante* that they are doing a poor job. The correct balance between directorial and shareholder power is endogenous, in that it is firm-specific, and dynamic, in that it varies with who is in charge.¹²⁹ Good managers will relish the flexibility that comes with insulation from shareholder oversight; bad managers will use the flexibility to slack off or tunnel firm assets for personal gain. This variability is likely the reason that empirical evidence fails to show that increased shareholder power improves firm performance.¹³⁰

Since management quality varies across firms and across time, there is no one-size-fits-all approach to corporate governance.¹³¹ As such, simply supporting corporate-governance proposals is not a profitable voting strategy for asset managers. While it is possible that there are some companies where corporate-governance changes could lead to improved performance, determining which they are is difficult, if not impossible.¹³²

And, as above, any firm-level performance improvements would not necessarily translate to asset-manager profits. Asset managers would only receive the increase in fees generated from slightly higher AUM. Moreover, any profits from higher fees would be offset by other losses. Because shareholders prefer risk and bondholders prefer safety, bondholders suffer when shareholders gain power.¹³³ Moreover, if the governance changes succeed in making targets more competitive, then this hurts competitor

¹²⁸ See Goshen & Levit, *supra* note 25 at 5.

¹²⁹ See Goshen & Squire, *supra* note 37, at 774; See, e.g., Yakov Amihud et al., *Settling the Staggered Board Debate*, 166 U. PENN. L. REV. 1475, 1480 (2018) (finding that the value of staggered boards is endogenous).

¹³⁰ See Goshen & Squire, *supra* note 37, at 810-25 (surveying mixed empirical evidence on the value of varied corporate-governance structures).

¹³¹ See *id.* at 773 (“[B]ecause the impact of a given governance structure on control costs is firm-specific, there is no particular governance structure that can be described as intrinsically good, bad, welfare enhancing, or inefficient.”).

¹³² See Ronald Gilson, *Legal and Political Challenges to Corporate Purpose*, 31 J. APP. CORP. FIN. 1, 9 (2019) (“[F]or investors, distinguishing between shortsighted and well-disciplined managements—and between farsighted companies and those for whom the payoff will never materialize—is often impossible.”).

¹³³ See Rock, *supra* note 95, at 1926-30 (discussing shareholder-creditor agency costs).

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firms in the asset manager's funds. Finally, supporting measures that take power away from management strains relationships with them at the expense of potential 401(k) business.

The prospects of asset-manager profits from supporting "social" shareholder proposals is even more tenuous. Take initiatives that aim to increase diversity, for instance. It can be argued that diversity improves returns because it brings a broader range of voices to bear on management decisions.¹³⁴ This is a plausible theory, but it lacks empirical support.¹³⁵ As with corporate-governance changes, the value proposition is unclear.

Environmental proposals typically seek more disclosure regarding a company's environmental footprint or exposure to climate-change risk.¹³⁶ Some argue that these measures increase the value of target firms.¹³⁷ But this claim is dubious. Environmental harms are the archetypical negative externality, meaning firms gain by ignoring their environmental impact. A better argument for these proposals is that they encourage companies to act more sustainably. Because more sustainable corporate conduct reduces the climate-change risk that overhangs the stock market, the additional environmental transparency would increase the value of *all* firms.¹³⁸

This theory—that voting to reduce climate-change risk is profitable for asset managers—is attractive because the increased AUM from the reduced risk would not be offset by losses in bond funds or by losses at other portfolio companies. Nevertheless, the case for profitability is highly theoretical. It assumes that the proposals lead to changes in corporate

¹³⁴ See Peter Eavis, *Board Diversity Increased in 2021. Some Ask What Took So Long*, N.Y. TIMES (Jan. 3, 2022), <https://www.nytimes.com/2022/01/03/business/corporate-board-diversity.html> ("Proponents of greater diversity argue that female and nonwhite board members bring different experience and knowledge, especially about markets and customers that existing directors might not know well. That should, over time, lead to greater profits, higher sales and better morale among employees.").

¹³⁵ See Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?* 2 (European Corp. Gov. Inst. Working Paper No. 579/2021, 2021) (reviewing empirical evidence and finding that "increasing board diversity may well reduce investors' return"). The SEC noted when blessing Nasdaq's board diversity rule that studies on the "effects of board diversity are generally inconclusive." Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, To Adopt Listing Rules Related to Board Diversity and To Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service, 86 Fed. Reg. 44424, 44432 (Aug. 6, 2021) [hereinafter *Nasdaq Diversity-Rule Approval*].

¹³⁶ See Treviño et al., *supra* note 67.

¹³⁷ Witold Henisz et al., *Five Ways that ESG Creates Value*, MCKINSEY QUARTERLY (Nov. 2019), <https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.ashx>.

¹³⁸ See Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 5-6 (2020); Gordon, *supra* note 124, at 29.

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behavior, that climate-change risk is priced into the market, and that any loss to a company from the disclosure of questionable practices, or from adopting more sustainable practices, is made up by the market-wide gain and the gain to other firms. There is no empirical evidence suggesting that these assumptions hold true.

Finally, the economic analysis of environmental and social (“ES”) proposals does not capture the true impetus behind them. Social proposals are more about advancing inclusion as a social good than about increasing shareholder returns; environmental proposals are more about concerns over pollution and climate change.¹³⁹ Because of the significant societal overtones, it is doubtful that the profit potential of these proposals drives asset managers’ positions on them.

C. The Illusory Promise of Additional Fund Flows and Higher Fees

It could be argued that the above analysis ignores the potential for asset managers to profit from increased cash flows into their funds and higher fees. In theory, smart voting should improve the performance of asset managers’ funds; investors should notice and direct their money accordingly.¹⁴⁰ The theoretical results are more assets and perhaps even higher fees justified by improved performance.

Such hopes, however, are fanciful. While some studies have shown that mutual-fund investors chase performance,¹⁴¹ there is a lot of friction in the market. Most importantly, many invest in the Big 3 and other large asset managers through 401(k) plans,¹⁴² and these investors are stuck. 401(k) plans typically offer many different types of funds, but do not offer competing funds of the same type.¹⁴³ Therefore, it is not feasible for 401(k) investors to simply move to a similar fund with a better return.

More problematic, even successful stewardship that leads to improved firm performance may not generate a competitive advantage for the asset manager’s funds. Funds are only at a competitive advantage when their return exceeds their competitors’ returns after fees. The problem with

¹³⁹ Elad L. Roisman, Commissioner, Sec. & Exch. Comm., Keynote Address at the Society for Corporate Governance National Conf. (July 7, 2020) https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020#_ftnref13 (“‘E’ and ‘S’ matters tend to be more society, or stakeholder, focused.”).

¹⁴⁰ See Kahan & Rock, *supra* note 9, at 1793.

¹⁴¹ See *id.* at 1793-94.

¹⁴² See Steyer, *supra* note 59.

¹⁴³ See Pool, *supra* note 57, at 1788 (“[A]ffiliated funds are more likely to be more basic investment options (such as standard domestic equity funds or passively managed index funds), whereas unaffiliated funds are more likely to be specialized funds (such as international or sector funds)”).

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stewardship as a competitive tool is that competing mutual funds own many of the same firms. If an asset manager engineers an increase at one of the firms in one of its funds, it shares the gains *pro rata* with competing funds. Because of this overlapping ownership, there is only a competitive advantage for stewardship when funds own proportionally more shares in the target firm than its competitors.¹⁴⁴ If it owns proportionally fewer, then the intervention actually worsens the fund's competitive position. For index funds, there is no hope for competitive advantage through stewardship. Since index funds own the same firms in the same proportions as other index funds, they cannot outcompete other index funds by improving the performance of their portfolio firms.¹⁴⁵

Beyond that, there is no reliable way to know exactly what competitor funds own. Mutual funds must publicly disclose their holdings every quarter,¹⁴⁶ but they file these reports up to 60 days from quarter end.¹⁴⁷ The holdings information is, therefore, out of date. And even if this information were obtainable, it would not be useful. The competitive landscape at the asset-manager level is enormously complex. The different funds that they oversee have different portfolio mixes and different competitors. Stewardship would inevitably advance the competitive interests of some of their funds and hurt others. Thus, any competitive gains at one fund would be offset by diminished competitiveness at others.

Finally, all of this assumes that engaged voting is cost-free, or at least can be accomplished without increasing investor fees. But, of course, informed engagement in corporate governance is not free. It is either paid for out of the asset manager's profits or out of increased fees. Asset managers will be loath to give up profits to fund stewardship. Given the competitive incentives outlined above, it would also be wary of increasing fees. Funds could raise fees if their performance warranted. But since stewardship benefits competitors too, raising fees would potentially only undermine their competitive position.

The calculus outlined above is true for all types of potential engagements, including votes regarding environmental transparency. As noted above, these potentially improve market returns by decreasing climate-change risk. This risk affects all firms differently because each has a different degree of exposure to it. It is only competitively advantageous to decrease this risk if an asset managers' funds are more exposed to climate-change risk than its competitors. If their funds are less exposed, then making

¹⁴⁴ See Kahan & Rock, *supra* note 9, at 1796-97.

¹⁴⁵ See Lund, *supra* note 16, at 511.

¹⁴⁶ See U.S. SEC. & EXCH. COMM'N, OMB. NO. 3235-0578, FORM N-Q.

¹⁴⁷ See *id.* at 1.

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portfolio firms more environmentally conscious may actually hurt their competitive position.

The bottom line is that because stewardship does not consistently improve relative fund performance, and because investors are unable to easily transfer their money to funds that improve their performance, judicious participation in corporate governance is unlikely to lead to fund inflows or higher fees.

Large asset managers have little, if any, financial incentive to engage in stewardship. Careful voting is unlikely to boost profits or improve their competitive position. It also risks important relationships with corporate managers. The counterintuitive implication is that it a waste of their time and money to try to use their voting power to increase the value of portfolio firms. The empirical evidence suggests that the Big 3 and others have reached this same conclusion.

D. Empirical Evidence of Asset-Manager Voting

Asset manager voting behavior suggests that stewardship is not something they view as profitable. Neither their approach to voting nor how they vote aligns with what firms would do if they were using stewardship to reduce agency costs and thereby improve the performance of portfolio firms.

1. The Stewardship Process

As noted previously, asset managers centralize the process for voting their funds' shares. A stewardship team makes voting recommendations to the managers of each fund. Though usually not binding, it is rare for the fund managers to vote otherwise.¹⁴⁸ This is inconsistent with a profit motive. If fund managers viewed stewardship as a way to increase returns, they would want to handle it themselves rather than hand-off responsibility to a team of bureaucrats.¹⁴⁹ Moreover, if stewardship were profitable, asset managers would want to capitalize on the knowledge spillover effects to voting from stock research. Since it is the fund managers who have this knowledge, centralizing voting negates this advantage. This again suggests

¹⁴⁸ See note 78 and accompanying text.

¹⁴⁹ In a move toward partial decentralization, Vanguard recently gave voting power to external managers of its actively managed equity funds, which affects 9% of Vanguard's assets. See Lim & Lombardo, *supra* note 40.

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that asset managers are not using stewardship to generate profits. Similarly, as noted above, because index funds cannot rearrange their portfolios to improve performance, they may have the most to gain from stewardship. If they viewed stewardship in this way, index-fund managers would be actively involved with the stewardship process. Instead, they are absent.¹⁵⁰

The size of the stewardship teams is also telling. For example, Vanguard's team is 35,¹⁵¹ BlackRock's is 60.¹⁵² This is far too few people for the vast number of votes these asset managers tally.¹⁵³ BlackRock voted on more than 165,000 management and shareholder proposals in the 2021 proxy season.¹⁵⁴ There is no way this team is carefully weighing the merits of each proposal. Vanguard reports that in 2021, its "Investment Stewardship team engaged with 734 companies in 29 countries and voted on 137,826 proposals at 10,796 companies in the six months ended June 30, 2021."¹⁵⁵ Not a bad year for 35 people.

In addition, investment-management experience is not a prerequisite to head the stewardship departments. The head of stewardship at Vanguard was a staffer in President Obama's administration.¹⁵⁶ BlackRock's is run by a former senior official from the Bank of England.¹⁵⁷ Moreover, the stewardship teams do not report to the investment side of the asset manager. They are part of the legal and compliance departments.¹⁵⁸ This internal structure suggests the teams are not there to vet proposals based on their impact of portfolio value.

¹⁵⁰ HORTENSE BIOY ET AL., *PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP* 14 (2017), <https://www-prd.morningstar.com/content/dam/marketing/shared/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf> ("Index portfolio managers ... have no say in the voting of their portfolio holdings.").

¹⁵¹ *Vanguard Publishes 2020 Annual Investment Stewardship Report*, VANGUARD (Sept. 15, 2020) <https://pressroom.vanguard.com/news/Press-Release-VG-2020-Investment-Stewardship-Annual-Report-Appointment-091520.html>.

¹⁵² Dawn Lim, *BlackRock Starts to Use Voting Power More Aggressively*, WALL ST. J. (Apr. 30, 2021) https://www.wsj.com/articles/blackrock-takes-aggressive-posture-on-esg-proxy-votes-11619775002?mod=article_inline.

¹⁵³ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2076-77 (discussing the small size of the Big 3's stewardship teams in relation to their holdings).

¹⁵⁴ BLACKROCK, *PURSuing LONG-TERM VALUE FOR OUR CLIENTS: BLACKROCK INVESTMENT* 15 (2021), <https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf>.

¹⁵⁵ VANGUARD, *INVESTMENT STEWARDSHIP: 2021 SEMIANNUAL REPORT* 3 (2021).

¹⁵⁶ Lim & Baer, *supra* note 2.

¹⁵⁷ BlackRock, Sandra Boss, <https://www.blackrock.com/corporate/biographies/sandy-boss> (last visited Nov. 29, 2021).

¹⁵⁸ LATHAM & WATKINS, *THE PARALLEL UNIVERSE OF INSTITUTIONAL INVESTING AND INSTITUTIONAL VOTING* 3 (2010) ("The internal 'corporate governance' staff typically is entirely separate from the portfolio managers and reports either to the general counsel or senior compliance officer of the investment manager, not to the investing function.").

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The way that the large asset managers approach voting reveals that they see it as something separate and distinct from investing. It is an orthogonal consideration—something they must do, but not something that improves returns.¹⁵⁹

2. The Three Eras of Asset-Manager Voting

The history of asset-manager voting also suggests that they do not view it as a profitable undertaking. Their voting record can be divided into three periods: the Governance Apathy Era; the Shareholder Rights Era; and the Stakeholder Rights Era.

a. Governance Apathy Era (1929 – 2003)

The asset-management industry has a long history of sleepy stewardship. For the first 75 years of their existence, their votes were not publicly disclosed, so it is difficult to definitively know the extent to which they participated in corporate governance. But the consensus is that they did not take it seriously during this period.¹⁶⁰ In a 1980 report to Congress, the SEC wrote that asset managers do not historically seek change through stewardship but instead sell when displeased with management.¹⁶¹ Despite a few exceptions, the same proved true through the 1990s.¹⁶² Notably, Vanguard did not establish a stewardship team until 2001.¹⁶³ In advancing voting regulations two years later, the SEC cited the industry's history of

¹⁵⁹ See *id.* at 4 (“The voting decision makers—the corporate governance officers at institutional investors and their counterparts at proxy advisory firms—function in the universe of corporate governance, a universe that may be analogized to a separate, parallel universe from that of the investment decision makers.”)

¹⁶⁰ See, e.g., James Cotter et al., *ISS Recommendations and Mutual Fund Voting*, 55 VILL. L. REV. 1, 2 (2010) (“[M]utual funds historically followed the ‘Wall Street rule,’ selling their shares in underperforming portfolio companies rather than engaging in shareholder activism.”); Roe, *supra* note 112, at 1469 (“despite their size, mutual funds rarely participate in corporate governance”); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 & n.14 (Feb. 7, 2003) (“Traditionally, mutual funds have been viewed as largely passive investors, reluctant to challenge corporate management on issues such as corporate governance.”).

¹⁶¹ DIV. OF CORP. FIN., SEC. & EXCH. COMM., STAFF REPORT ON CORPORATE ACCOUNTABILITY 339 (Sept. 4, 1980).

¹⁶² Roe, *supra* note 112, at 1469.

¹⁶³ Vanguard Publishes 2020 Annual Investment Stewardship Report, *supra* note 151.

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corporate-governance complacency as a rationale for intervention.¹⁶⁴ For 75 years, neither asset managers nor regulators paid much attention to voting.

b. Shareholder Rights Era (2003 – 2020)

In the early 2000s, Enron's collapse, along with a series of other financial scandals, led to a federal regulatory focus on corporate governance, which culminated in the Sarbanes-Oxley Act of 2002.¹⁶⁵ Although asset managers escaped direct regulation under Sarbanes-Oxley, mutual-fund voting entered the regulatory gaze. In 2003, the SEC finalized rules that required asset managers to “adopt and implement policies and procedures for voting proxies in the best interest of clients, to describe the procedures to clients, and to tell clients how they may obtain information about how the [asset manager] has actually voted their proxies.”¹⁶⁶ The agency also affirmed that asset managers had a fiduciary duty to vote shares in the “best interest” of fund shareholders and required, as an implication thereof, that they vote the shares under their control.¹⁶⁷ Related rulemaking required that mutual funds report annually how they vote on a new form, Form N-PX.¹⁶⁸

The impetus for these rules was two-fold. First, as just noted, asset managers were not taking their stewardship obligations seriously. The SEC blamed it on conflicts of interest with their 401(k) administration businesses and other connections with portfolio companies.¹⁶⁹ Second, the SEC reasoned that transparency and other regulatory measures would encourage asset managers to become better stewards, which to the SEC meant that they would police management at portfolio firms to maximize shareholder value.¹⁷⁰ Corporate-governance failures were the chief policy concerns of the era, and pushing asset managers to more actively oversee portfolio companies was viewed as one more way to address these concerns.

The reforms worked, in part. Asset managers reacted by engaging proxy advisory firms to assist in their voting. In the beginning, they heavily relied on their advice,¹⁷¹ and these firms were largely antagonistic toward

¹⁶⁴ See 68 Fed. Reg. at 6566 (“[R]equiring greater transparency of proxy voting by funds may encourage funds to become more engaged in corporate governance of issuers held in their portfolios...”).

¹⁶⁵ Pub. L. No. 107-204, 116 Stat. 745 (2002).

¹⁶⁶ See Proxy Voting by Investment Advisors, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003).

¹⁶⁷ *Id.*

¹⁶⁸ See 17 C.F.R. § 274.129 (2020); 68 Fed. Reg. at 6569.

¹⁶⁹ See 68 Fed. Reg. at 6586.

¹⁷⁰ 68 Fed. Reg. at 6566 (“Proxy voting decisions by funds can play an important role in maximizing the value of the funds’ investments, thereby having an enormous impact on the financial livelihood of millions of Americans.”).

¹⁷¹ See Cotter et al., *supra* note 160, at 55.

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management. They encouraged asset managers to support things like destaggered boards and majority voting in director elections, and they abided.¹⁷² As the influence and power of proxy advisors drew regulatory scrutiny,¹⁷³ asset managers began to grow their in-house stewardship departments,¹⁷⁴ which continued to support measures that empowered shareholders and limited the discretion of managers and board members.¹⁷⁵

During this time, however, asset managers never became activists. They never launched proxy contests or nominated directors.¹⁷⁶ Their role was, and has remained, reactive. In addition, during this period, they mostly only supported measures related to the rules of corporate governance. They almost never voted against executive compensation packages or for political-spending disclosures.¹⁷⁷ They also rarely supported environmental or social proposals during this period.¹⁷⁸ BlackRock has drawn the most scrutiny for its voting record. Its CEO, Larry Fink, has been outspoken about his view that companies should be run for the benefit of all stakeholders, not just shareholders.¹⁷⁹ But BlackRock infrequently supported measures consistent with this view.¹⁸⁰

¹⁷² See *id.*

¹⁷³ See generally Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42989, 43011 (July 22, 2010); Sec. & Exch. Comm., Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (IM/CF), June 30, 2014; Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55082 (Sept. 3, 2020).

¹⁷⁴ See BIOY ET AL., *supra* note 150, at 19.

¹⁷⁵ See Bubb & Catan, *supra* note 79, at 68 fig. 15 (showing fund support for a range of shareholder and management proposals).

¹⁷⁶ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2095-2101.

¹⁷⁷ See Gretchen Morgensen, *Your Mutual Fund Has Your Proxy, Like It or Not*, N.Y. TIMES (Sept. 26, 2016), <https://www.nytimes.com/2016/09/25/business/your-mutual-fund-has-your-proxy-like-it-or-not.html>.

¹⁷⁸ See Bubb & Catan, *supra* note 79, at 68 fig. 15 (showing low support for social proposals among members of the Traditional Governance Party); Caleb Griffin, *Environmental & Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167, 211-12 (2021) (finding Big 3 support for such proposals at between 7.1% and 22.7% during the 2018-2019 proxy year).

¹⁷⁹ See Letter from Larry Fink, CEO of BlackRock, Inc., to CEOs (Jan. 18, 2022), <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

¹⁸⁰ See, e.g., Brian Schatz, U.S. Senator for Hawaii, Schatz, Senators Demand That BlackRock Live Up to Its Public Commitment to Climate Action (Oct. 8, 2020), <https://www.schatz.senate.gov/press-releases/schatz-senators-demand-that-blackrock-live-up-to-its-public-commitment-to-climate-action>.

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c. Stakeholder Rights Era (Beginning in 2021)

In the 2021 proxy season, the large asset managers dramatically changed their stance on environmental and social matters.¹⁸¹ The reversal is stunning. In 2020, BlackRock voted for 6% of environmental proposals.¹⁸² This was a drop from 8% the previous year.¹⁸³ In 2021, the firm supported 64%.¹⁸⁴ Vanguard voted for 22% of environmental proposals in 2020 and 46% in 2021.¹⁸⁵

Voting on social matters follows the same trend. BlackRock's support rose from 11.5% in 2020 to 44.3% in 2021 and Vanguard's from 15% to 29.6% over that same period.¹⁸⁶ BlackRock's support for diversity-related proposals shot from 13.6% to 68.2%.¹⁸⁷ Even State Street, which emphasizes its commitment to environmental and social matters, increased its support: from 48.6% in 2020 to 56.8% in 2021 for environmental proposals and 25% to 35.6% for social proposals.¹⁸⁸

Leading voting analytics firms noticed the change. Surveying the evidence, Morningstar noted "a discernible shift in the voting stance of the largest institutional holders of U.S. public equities."¹⁸⁹ Because of the increased support for environmental and social issues, Insightia called the 2021 proxy season "revolutionary."¹⁹⁰

¹⁸¹ See Lim, *supra* note 152.

¹⁸² See Mooney, *supra* note 29.

¹⁸³ *Id.* In 2019, Vanguard and BlackRock voted against all of the shareholder proposals supported by an influential climate organization, Climate Action 100+. See Eric Rosenbaum, *Activists Thought BlackRock, Vanguard Found Religion on Climate Change. Not Anymore*, CNBC (Oct. 16, 2019), <https://www.cnbc.com/2019/10/13/blackrock-vanguard-found-religion-on-climate-doubts-are-growing.html>. In 2020, they voted against 10 out of 12 that Climate Action considered key votes. See Schatz, *supra* note 180.

¹⁸⁴ Lim & Baer, *supra* note 2.

¹⁸⁵ INSIGHTIA, PROXY VOTING SEASON SNAPSHOT 2021, at 12.

¹⁸⁶ *Id.* at 17.

¹⁸⁷ *Largest Asset Manager Support for Shareholder Votes on Climate and Diversity Rise Sharply*, INST. ASSET MANAGER (Sept. 22, 2021), <https://www.institutionalassetmanager.co.uk/2021/09/22/306563/largest-asset-managers-support-shareholder-votes-climate-and-diversity-rises>.

¹⁸⁸ INSIGHTIA, *supra* note 185, at 12, 17.

¹⁸⁹ Jackie Cooke & Lauren Solberg, *The 2021 Voting Season in 7 Charts*, MORNINGSTAR (Aug. 5, 2021), <https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts>.

¹⁹⁰ INSIGHTIA, *supra* note 72, at 1.

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d. The Three Eras and the Profitability of Stewardship

This history is inconsistent with a profit motivation. If asset managers found stewardship profitable, they would have participated in it since the industry's inception. Instead, they avoided it until regulators prodded them to take voting more seriously.

The regulatory intervention triggered the shareholder rights era, where asset managers mostly supported proposals that increased shareholder power. As noted above, these measures may help in circumstances where management is underperforming, but are detrimental if management is competent and creative.¹⁹¹ That being the case, if asset managers were looking to these measures to improve performance at portfolio firms, they would be selective about which ones they support. Instead, they supported measures that matched their “governance principles” regardless of the firm.¹⁹²

In addition, profits cannot explain the sudden support for social and environmental matters. As noted above, their tie to firm profits is speculative.¹⁹³ And even if these measures are profitable, why the sudden embrace?

Finally, a *Reuters* study that looked at the extent to which the Big 3 voted with management showed that there was little difference in their level of support at poorly performing companies.¹⁹⁴ This again suggests they are not policing their firms for performance improvements.

Theory and evidence line up behind the conclusion that stewardship is not profitable for large asset managers. If the Big 3 and others believed engaged voting was profitable, they would vote enthusiastically, there would be a pattern of targeting underperformers, and finance professionals would be heavily involved in the process. In contrast, the asset-management industry had to be forced to engage in stewardship and asset managers have delegated the task to centralized compliance-oriented teams.

¹⁹¹ See *supra* text accompanying note 129.

¹⁹² See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2089-90.

¹⁹³ See *supra* note 135 and accompanying text.

¹⁹⁴ Tim McLaughlin & Ross Kerber, *Index Funds Invest Trillions But Rarely Challenge Management*, REUTERS (Oct. 8, 2019) <https://www.reuters.com/article/us-usa-funds-index-specialreports-idUSKBN1WN107> (The Big 3 “supported management at the worst-performing Russell 3000 firms only slightly less often than they did for all companies in the index, regardless of performance.”).

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Others troubled by asset-manager stewardship jump directly to reform proposals.¹⁹⁵ But doing so bypasses the most important implication of the foregoing analysis. Hugely influential financial institutions are casting millions of votes every year, votes that chart the trajectory of the world's most important companies, but they are not using their power to increase the value of the firms they own. Their motivation is unknown.

This ignorance of what motivates voting at the large asset managers is a significant gap in corporate- and securities-law scholarship. It is impossible to evaluate whether their stewardship practices pose societal risk or to assess reform proposals without an understanding of what drives their engagement in corporate governance.

III. STEWARDSHIP THEATER

Since stewardship is unprofitable, something else must drive asset-manager voting. While no one thing can fully explain how the large asset managers vote, there is good reason to believe that political considerations are front of mind.

A. A Political Theory of Asset-Manager Voting

All large companies are political actors. Their direct engagement in politics is much discussed. They back candidates with political contributions.¹⁹⁶ Industries employ thousands of lobbyists to argue for their interests on specific bills.¹⁹⁷ The legitimacy of these activities has long been a source of concern.¹⁹⁸

But companies might also conduct their business in ways to advantage themselves politically. This aspect of political engagement has gone almost unrecognized. Doing so, can provide two types of benefits. First, politically motivated actions might forestall regulations. If regulators are signaling that a business may face new forms of regulation, it might change its behavior to cool down the chatter. Just to give a few likely examples: when faced with controversy over its treatment of drivers, Uber

¹⁹⁵ See, e.g., Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2116-2131; Lund, *supra* note 16, at 523-33.

¹⁹⁶ See *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 365 (2010); see generally Ciara Torres-Spelliscy, *Corporate Campaign Spending: Giving Shareholders a Voice*, BRENNAN CENTER FOR JUSTICE (2010), https://www.brennancenter.org/sites/default/files/2019-08/Report_Corporate-Campaign-Spending-Giving-Shareholders-Voice.pdf. The total amount of political spending is unknown. *Id.* at 10.

¹⁹⁷ See Lee Fang, *Where Have All the Lobbyists Gone*, NATION (Feb. 19, 2014), <https://www.thenation.com/article/archive/shadow-lobbying-complex/>.

¹⁹⁸ See generally, e.g., Torres-Spelliscy, *supra* note 196.

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began subsidizing employee health-care coverage;¹⁹⁹ when faced with increasing scrutiny about environmental risks and impacts, companies began producing sustainability reports;²⁰⁰ when faced with a backlash over its role in spreading misinformation, Facebook set up an oversight board.²⁰¹ While there may be plausible business cases for these efforts, it is hard to deny that avoiding regulation was likely a key driver.

Second, conducting business in a manner that pleases government officials provides reputational benefits. It is a way for a company, or even an entire industry, to develop good standing with regulators. This paves the way for more lenient oversight over existing or new lines of business. It can also reduce the likelihood of regulatory enforcement actions.

This understanding of business motives is different from—even the opposite of—the typical view. The default is to assume that companies push legal boundaries and dare regulators to respond. And this is often the case. Uber ignored taxicab regulations and AirBnB ignored hotel laws—to great success.²⁰² The extent to which companies engage in politically motivated behavior depends on the industry and activity in question. Companies in more highly regulated industries would be more attuned to the political consequences of their actions. They would be more reliant on good relations with regulators, and political sensitivity would steep into their culture. Companies would also be more likely to mollify rather than push regulators when there is a credible threat of new rules, those rules would impose significant costs, and where satisfying regulators would not significantly hurt their business.

All of these considerations suggest that the large asset managers use stewardship to advance political goals. As discussed above, since there is no profit incentive to vote a certain way, it is cost-free for asset managers to use their power for political ends. As discussed below, there is a credible threat of costly voting regulations that asset managers undoubtedly wish to avert. They are also one of the most highly regulated and highly political industries

¹⁹⁹ See Anna Cooban, *Uber Said it Would Help Pay Drivers' Healthcare—Then Withdrew the Offer 2 Weeks Later, Calling it a Mistake*, BUSINESS INSIDER (June 11, 2021), <https://www.businessinsider.com/uber-driver-health-insurance-offer-mistake-california-2021-6>.

²⁰⁰ See *90% of S&P 500 Index Companies Publish Sustainability Reports in 2019*, GOVERNANCE & ACCOUNTABILITY INST. (July 16, 2020), <https://www.globenewswire.com/news-release/2020/07/16/2063434/0/en/90-of-S-P-500-Index-Companies-Publish-Sustainability-Reports-in-2019-G-A-Announces-in-its-Latest-Annual-2020-Flash-Report.html> (detailing the rise in sustainability reporting).

²⁰¹ See Kate Klonick, *The Facebook Oversight Board: Creating an Independent Institution to Adjudicate Online Free Expression*, 129 YALE L.J. 2418, 2488 (2020).

²⁰² See Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 U.S.C. L. REV. 383, 386, 389 (2017).

in the U.S. The evidence of both how they vote and how they approach voting also suggests a political motivation.

1. The Threat of Regulation

The Big 3 face greater political and regulatory uncertainty now than they have in decades. A chorus of commentators view them as a threat to financial-market stability, competition, and shareholder democracy.

Many worry that the increasing role of indexing is undermining share-price accuracy, considered the core of financial markets.²⁰³ As noted earlier, an article in the *Atlantic* asked whether indexing is worse than Marxism.²⁰⁴ The substance of the analogy was that, at least in a centrally planned economy, apparatchiks try to efficiently allocate resources, but index funds do so without any regard to quality.²⁰⁵ The concern is that, since indexing does not involve stock-picking, stock prices are unmoored from fundamental value.²⁰⁶

Antitrust scholars have focused on “horizontal shareholdings.”²⁰⁷ The concern here is that because large asset managers own shares in competing firms (i.e., horizontal shareholdings), they will not push the firms to fiercely compete, which would only serve to hurt the industry’s profitability.²⁰⁸ The result is reduced competition and increased prices. Emerging empirical evidence tends to support this fear.²⁰⁹ For example, a controversial study showed that horizontal shareholdings in airlines raised ticket prices three to seven percent.²¹⁰ No one specifically alleges anticompetitive behavior,²¹¹ but the effect can materialize without any

²⁰³ See *supra* note 20 and accompanying text.

²⁰⁴ See Lowrey, *supra* note 20.

²⁰⁵ *Id.*

²⁰⁶ See *id.*; Coates, *supra* note 1, at 19-20 (“Indexation may have blunted price signals.”).

²⁰⁷ See *supra* note 21 and accompanying text.

²⁰⁸ For a useful further explanation of the problem, see Jacob Greenspon, *How Big a Problem Is It That a Few Shareholders Own Stock in So Many Competing Companies?*, HARV. BUS. REV. (Feb. 19, 2019), <https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies>.

²⁰⁹ See Azar et al., *supra* note 21, at 54 (showing higher prices in the airline industry); Melissa Newham et al., *Common Ownership and Market Entry: Evidence from Pharmaceutical Industry* 38 (DIW Berlin Discussion Paper No. 1738, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194394 (showing higher prices in the pharmaceutical industry); Jose Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019) <https://ssrn.com/abstract=2710252> (showing higher banking fees).

²¹⁰ See Azar et al., *supra* note 21, at 54.

²¹¹ See Morley, *supra* note 121, at 1410 n.17.

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coordination. Understanding these incentives, executives might simply fail to compete on price.²¹²

The final concerns relate directly to stewardship. They fall into roughly three categories. The first stems from a general unease about the concentration of wealth and power in the hands of the large asset managers. Government has always been wary of financial institutions exerting outsized control over the firms they own. As discussed further below, this was a key impetus for the New-Deal-Era regulations that still govern the asset-management industry today.²¹³ Professor John Coates gives voice to the modern-day version of this worry. He argues that soon about 12 people (the heads of the large asset managers) will likely have “practical power over the majority of U.S. companies.”²¹⁴ This prospect, he argues, “poses a legitimacy and accountability issue of the first order.”²¹⁵ In a similar vein, the recently deceased founder of Vanguard, John Bogle, argued that the concentration of voting is “not in the national interest.”²¹⁶

A more tangible concern is that asset managers are not representing the interests of the mutual-fund shareholders. As noted above, asset managers only internalize a small percentage of any gain from stewardship. Their investors gain the rest. Because the manager gains only a small share, scholars are concerned that they are not as vigilant as their investors would like.²¹⁷ Investors also have a range of views on ES proposals. Whichever way the large asset managers vote offends the views of a large portion of its investors.

The final concern is substantive—that large asset managers are not voting the way that commentators and regulators would like. The Big 3 have received a great deal of reproach for their failure to back environmental shareholder proposals.²¹⁸ Before BlackRock began broadly supporting environmental proposals in 2021, it had attracted condemnation from Democrat Senators and Congresspersons for its voting record.²¹⁹ Five

²¹² See Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, 82 OHIO S. L.J. 1, 22-23 (2021).

²¹³ See Roe, *supra* note 112, at 1471.

²¹⁴ See Coates, *supra* note 1, at 1.

²¹⁵ *Id.* at 2, 19.

²¹⁶ See John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018), <https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551>.

²¹⁷ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2037.

²¹⁸ See, e.g., Patrick Greenwell, *World's Top Three Asset Managers Oversee \$300bn Fossil Fuel Investments*, GUARDIAN (Oct. 12, 2019), <https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments> (“The two largest asset managers, BlackRock and Vanguard, have also routinely opposed motions at fossil fuel companies that would have forced directors to take more action on climate change.”).

²¹⁹ See Schatz, *supra* note 180; Letter from Elizabeth Warren, U.S. Senator, to Larry Fink, BlackRock Co. CEO (Feb. 25, 2020), <https://www.warren.senate.gov/imo/media/doc>

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Democratic Senators wrote a letter chiding BlackRock: “You lag all of your peers in exercising your fiduciary responsibility to make companies account for their contributions—and exposure—to climate risks. Considering your goal of incorporating climate risks into BlackRock’s investment stewardship, this proxy voting record is troubling and inconsistent.”²²⁰ Senator Warren signed the letter and penned her own expressing similar sentiments with four other Democrat Senators.²²¹ Pressure on climate-related issues is also coming directly from the Biden administration.²²²

Now that the Big 3 have reversed their position, a different group of politicians are upset.²²³ A group of Republicans sent a letter expressing their concern that BlackRock and State Street are “increasingly incorporating left-leaning environmental, social and corporate governance” priorities into their proxy voting.²²⁴ They argue that this shift reflects their personal views rather than those of their shareholders.²²⁵ As ES issues have come to the forefront of corporate governance, politics and corporate governance have converged. Concerns about how the Big 3 vote come not only from nonprofits, journalists, and academics, but also from politicians who wish to push asset managers to support their party’s policy agenda and ideology.

This array of concerns has generated a blizzard of reform proposals. There are calls to break up the Big 3,²²⁶ limit the extent to which they can invest in multiple companies in the same industry,²²⁷ take away or cap their voting rights,²²⁸ require shareholder input for voting,²²⁹ mandate stewardship

/2.25.2020%20-%20Letter%20from%20Sens.%20Warren%20Whitehouse%20Booker%20%20Van%20Hollen%20to%20Larry%20Fink%20BlackRock.pdf.

²²⁰ Schatz, *supra* note 180.

²²¹ See Warren, *supra* note 219.

²²² See Dawn Lim, *Republicans Ask Federal Retirement Plan for Details on BlackRock, StateStreet’s Votes*, WALL ST. J. (July 1, 2021), <https://www.wsj.com/articles/republicansask-federal-retirement-planfor-details-on-blackrock-state-streets-votes-11625139430> (“The Biden administration is ... pressing money managers to be more attentive to climate risks”); Climate-Related Financial Risk, Proclamation No. 14030, 86 Fed. Reg. 27,967 (May 25, 2021) (addressing “the failure of financial institutions to appropriately and adequately account for” climate risk).

²²³ See Lim, *supra* note 222.

²²⁴ *Id.*

²²⁵ See *id.*

²²⁶ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2129; Goshen & Levit, *supra* note 25, at 11; Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It*, AMERICAN ECONOMIC LIBERTIES PROJECT (Nov. 23, 2020), <https://www.economicliberties.us/our-work/new-money-trust/>.

²²⁷ See Posner et al., *supra* note 21, at 670.

²²⁸ See Caleb Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954, 983 (2020); Lund, *supra* note 16, at 528.

²²⁹ See Griffin, *supra* note 228, at 992-94.

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expenditures,²³⁰ force divestiture of their 401(k) businesses,²³¹ impose stewardship codes,²³² and mandate procedures for decentralized fund-level voting.²³³ The Big 3 are constantly defending themselves against these proposals and the related critiques.²³⁴

As the direct attacks from politicians illustrate, concerns about the asset-management industry stretch beyond academic handwringing. In late 2020, the Federal Trade Commission (the “FTC”) proposed rules that would increase reporting obligations in connection with horizontal shareholdings.²³⁵ And regulators have signaled out the finance industry and asset managers for special antitrust scrutiny.²³⁶

The SEC is also highly attuned to the issue. At an FTC hearing on horizontal shareholdings, former SEC Commissioner Jackson referred to the set of challenges posed by horizontal shareholdings as “the investor protection challenge of the 21st century.”²³⁷ In March 2021, SEC Commissioner Lee gave a speech on problems with asset-manager voting to the Investment Company Institute (the “ICI”), the industry’s lobbying association, at its annual conference.²³⁸ The ICI did not hold the conference in 2020, but in 2019, Commissioner Roisman made similar comments.²³⁹

²³⁰ See Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 9, at 2121.

²³¹ See *id.* at 2122-23.

²³² See Coates, *supra* note 1, 20-21.

²³³ See Ann Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligations*, 19 *TRANSACTIONS: TENN. J. BUS. L.* 176, 200 (2017).

²³⁴ See Matt Egan, *BlackRock and the \$15 Trillion Fund Industry Should be Broken Up*, *Antimonopoly Group Says*, CNN (Nov. 24, 2020), <https://edition.cnn.com/2020/11/24/business/black-rock-vanguard-state-street-biden/index.html> (“We fundamentally disagree with the conclusions in this paper and its recommendations, which we believe would do harm to investors,” quoting State Street responding to a critic); Paul Schott Stevens, *SEC Should Reject Complex, Costly “Pass-Through” Proxy Voting*, *INVEST. CO. INST.* (Oct. 2, 2018), https://www.ici.org/viewpoints/view_18_passthrough_voting; Dawn Lim, *supra* note 222; Novick, *supra* note 9 (response to Bebchuk and Hirst’s critique); Mallow, *supra* note 9 (same).

²³⁵ See generally *Premier Notification; Reporting and Waiting Period Requirements*, 85 Fed. Reg. 77042 (Dec. 1, 2020).

²³⁶ See David McLaughlin & Annie Massa, *Antitrust Regulators Ask Whether Index Funds Deserve More Scrutiny*, *BLOOMBERG* (Dec. 20, 2020), <https://www.bloomberg.com/news/articles/2020-12-17/index-funds-antitrust-regulators-weigh-whether-they-deserve-more-scrutiny>; see generally *Executive Order on Promoting Competition in the American Economy*, 86 Fed. Reg. 36987 (July 14, 2021).

²³⁷ See Jackson, *supra* note 1, at, at 1.

²³⁸ See Allison Herren Lee, Acting Chair, Sec. & Exch. Comm., 2021 ICI Mutual Funds and Investment Management Conference: Every Vote Counts: The Importance of Fund Voting and Disclosure (Mar. 17, 2021), https://www.sec.gov/news/speech/lee-every-vote-counts#_ftnref12.

²³⁹ See Elad L. Roisman, Commissioner, Sec. & Exch. Comm., Keynote Remarks: ICI Mutual Funds and Investment Management Conference (Mar. 18, 2019), <https://www.sec.gov/news/speech/speech-roisman-031819>.

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Two years earlier, then-SEC-Chairman Clayton remarked, “Often voting power rests in the hands of [asset managers] who owe a duty to vote proxies in a manner consistent with the best interests of the fund and its shareholders. A question I have is: are voting decisions maximizing the funds’ value for those shareholders?”²⁴⁰

The SEC is also making regulatory moves. In 2019, the agency revised guidance to asset managers on the proper exercise of their proxy obligations;²⁴¹ then supplemented them just two years later.²⁴² The new guidelines focus on clarifying asset managers’ fiduciary duties with respect to proxy voting and how they relate to the use of proxy advisors.²⁴³ In 2021, the SEC Division of Examinations issued a “Risk Alert” in which it expressed concern about “inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices.”²⁴⁴ Months later, the agency issued proposed rules to amend Form NP-X to render disclosures of proxy voting more accessible.²⁴⁵ In the proposing release, the agency expressed concerns that asset managers were not diligent enough, not voting in their investors’ best interests, and influenced by conflicts of interest.²⁴⁶

The regulatory proposals so far chip at the edges of asset-manager stewardship, but illustrate that proxy voting is top of mind at both the FTC and the SEC. Congressional involvement also threatens. All of this means that voting, and the associated influence over corporate affairs, is *the* issue confronting the asset-management industry.

The calculation for large asset managers is clear, even inevitable. There is no financial gain from stewardship. But there are tremendous political stakes. They should exercise their voting power to please politicians and regulators rather than police underperforming companies. While some

²⁴⁰ See Jay Clayton, Chairman, Sec. & Exch. Comm., Remarks at the PLI 49th Ann. Inst. on Securities Regulation—New York, N.Y.: Governance and Transparency at the Commission and in Our Markets (Nov. 8, 2017), <https://www.sec.gov/news/speech/speech-clayton-2017-11-08>.

²⁴¹ See generally Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 84 Fed. Reg. 47420 (Sept. 10, 2019).

²⁴² Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 85 Fed. Reg. 55155 (Sept. 3, 2020), <https://www.govinfo.gov/content/pkg/FR-2020-09-03/pdf/2020-16338.pdf>.

²⁴³ See *id.* at 55155. On the same day as the supplement, the SEC released new rules for proxy advisors. See Exemption from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082 (Sept. 3, 2020).

²⁴⁴ Sec. & Exch. Comm., ESG Risk Alert, SEC Div. of Examinations 4 (Apr. 9, 2021), <https://www.sec.gov/files/esg-risk-alert.pdf>.

²⁴⁵ See generally Enhanced Reporting of Proxy Votes by Management Investment Companies, 86 Fed. Reg. 57,478 (Oct. 15, 2021).

²⁴⁶ See *id.* at 57503.

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industries or firms might resist the political pull, the unique history of asset management makes politically motivated stewardship an easy choice.

2. The Political History of the Asset-Management Industry

An institutional and historical understanding of the asset-management industry buttresses the theoretical case for why they are likely to view stewardship through a political lens. While economic incentives are key drivers of institutional behavior, history and culture also guide corporate decisions.²⁴⁷ Thus, a deeper institutional understanding of asset managers allows for a far more complete picture of how they are likely to approach stewardship.

Since its inception, the industry has been highly political. Regulations launched the industry and inform almost every aspect of its operations. Throughout its history, asset managers have shaped these regulations, and worked hard to cultivate a close relationship with regulators and a clean image. This high sensitivity to politics suggests they will naturally view stewardship as a way to advance political goals.

Today's asset-management industry is a product of two New-Deal-era regulations: The Revenue Act of 1936 and the Investment Company Act of 1940. Before these statutes, asset managers and the mutual funds they oversaw were small players on the periphery of financial markets.²⁴⁸

a. The Revenue Act of 1936

Asset managers launched the first U.S. mutual funds in 1924.²⁴⁹ And only a decade later, it was unclear if mutual funds would survive. At their inception, they benefited from pass-through tax treatment. Fund shareholders paid taxes on dividends, but funds themselves did not.²⁵⁰ In 1935, however, President Roosevelt proposed taxing “intercorporate” dividends.²⁵¹ This would have meant that mutual funds would be subject to their own level of tax. It would have been triple taxation—at the corporate level, the fund level, and the shareholder level. This would have killed the

²⁴⁷ See Roe, *supra* note 112, at 1508 (“[C]orporate culture and history cannot be so easily reversed.”).

²⁴⁸ See *id.* at 1490; MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER’S VIEW 53 (2nd ed. 2011) (“[M]utual funds at this time were still viewed as the stepchild of the investment company industry”).

²⁴⁹ FINK, *supra* note 248, at 10.

²⁵⁰ See *id.* at 26.

²⁵¹ *Id.*

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mutual-fund business.²⁵² In announcing the plan, though, Roosevelt left the door open to leave mutual funds untaxed if they submitted to “public regulation.”²⁵³

The public regulation came in the Revenue Act of 1936 (the “36 Act”).²⁵⁴ The Act permitted mutual funds to maintain pass-through taxation so long as they invested no more than 5% of their assets in any company and held no more than 10% of a single portfolio company’s outstanding stock.²⁵⁵ Even though this is tax legislation, there appears to be no tie between these portfolio-fragmentation requirements and tax policy.

The rationale seems to be to ensure that mutual funds are diversified, which regulators at the time saw as their only legitimate function.²⁵⁶ But this policy justification is also likely incomplete. Only the former limitation—the 5% cap—can be defended on diversification grounds. The rule that limits ownership to 10% of any firm is only loosely tied to this goal. A large fund can own far more than 10% of a single small firm and still be diversified.²⁵⁷

Instead, Professor Mark Roe argues persuasively that these limitations were not primarily about diversification; rather they were about preventing managers of mutual funds from exerting control over portfolio firms.²⁵⁸ Concentrated large holdings make intervention profitable, but the former limitation means that a fund cannot concentrate its holdings in any one company, and the latter means that a fund cannot own anything approaching a controlling interest.

Preventing financial institutions from having a large influence over their portfolio companies was part of the period’s zeitgeist. Policymakers at the time blamed the stock market crash on the outsized role that the banking industry played in the governance of public companies.²⁵⁹ Though mutual-fund holdings were small, and only a few managers had started to take any interest in corporate governance, legislators saw regulation as a way to prevent future interference and send a signal that such control was not to be tolerated.²⁶⁰

²⁵² See FINK, *supra* note 248, at 29 (“[W]ithout such tax treatment, it is doubtful that mutual funds would have continued to exist, much less flourish.”); Roe, *supra* note 112, at 1510 (“Without tax exemption, the funds could not survive.”).

²⁵³ FINK, *supra* note 248, at 26.

²⁵⁴ Pub. L. No. 74-740, 49 Stat. 1648 (1936).

²⁵⁵ See Pub. L. No. 74-740, 49 Stat. 1648, 1669, 26 U.S.C. § 851 (2020).

²⁵⁶ Roe, *supra* note 112, at 1488 (“The SEC testified that a mutual fund’s *only* positive function was to provide diversification; any extension risked thievery.”).

²⁵⁷ See Roe, *supra* note 112, at 1475.

²⁵⁸ *Id.* at 1501.

²⁵⁹ See *id.* at 1486.

²⁶⁰ See *id.* at 1490.

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The chief concern was that asset managers would use their concentrated power to advance their own interests. A senate report went so far as to allege that asset-manager control over portfolio firms was improper.²⁶¹ According to Professor Roe, regulators were worried that they “might pump money into the portfolio company to protect a large position, unwisely change the portfolio company's financial policy or capital structure, force dividends out from the portfolio company at too high a rate, or force a merger on terms disadvantageous to the outside shareholders of the controlled company.”²⁶² Similar suspicions about competence and impropriety echo today.

This historical perspective offers important insights into this Article's argument. It supports the conclusion reached above—that asset managers have little reason to care about stewardship—and suggests that their indifference is the product of politics and regulatory design. Today some worry that asset managers are not involved enough in corporate governance. But when mutual funds were first regulated, Congress's most important concern was keeping fund managers out of corporate affairs.

Also telling is that the asset-management industry was untroubled by limitations on corporate control. As has become a pattern in mutual-fund regulation, the 36 Act resulted from cooperation with industry. The so-called “conduit” theory—the idea that mutual funds are just a conduit for investors to invest in public companies and therefore entitled to pass-through tax treatment—was proposed by the industry in a meeting with President Roosevelt.²⁶³ They also strongly lobbied for the 36 Act.²⁶⁴ Thus, asset managers were voluntarily subjected to this limitation on their ability to impact portfolio companies, suggesting that, even from the beginning, they saw stewardship as unprofitable.

b. Investment Company Act of 1940

The Investment Company Act (the “ICA”) followed four years later. From a public policy perspective, the ICA is a puzzle. It is a lengthy and detailed statute, which sets out exactly how mutual funds must be run.²⁶⁵ This is a departure from other aspects of securities regulation, which typically mandate disclosure but do not interfere with operations. The scope

²⁶¹ See *id.* at 1472.

²⁶² *Id.* at 1473.

²⁶³ See FINK, *supra* note 248, at 27-28.

²⁶⁴ See Roe, *supra* note 112, at 1499.

²⁶⁵ See FINK, *supra* note 248, at 46 (describing the ICA as an “extremely detailed statute that laid down a series of very specific do's and don'ts”); Coates, *supra* note 1, at 8 (describing ICA as “the most stringent set of controls on any financial subsector”).

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of the ICA also cannot be explained as a comprehensive response to widespread abuse. Mutual-fund managers had not been accused of serious impropriety.²⁶⁶ Mutual funds were thought to be overleveraged,²⁶⁷ which was addressed through a provision that significantly limited their ability to borrow,²⁶⁸ but there were no allegations of egregious misconduct.

Like the 36 Act, the ICA addressed prospective concerns about asset-manager involvement in corporate governance. The ICA rules require that for funds to call themselves “diversified,” they must meet the same requirements specified in the 36 Act for pass-through taxation. Namely, they cannot own more than 10% of a company’s stock and they cannot have more than 5% of the fund’s portfolio in any one security.²⁶⁹ To reinforce these rules, the ICA also prohibits mutual funds from banding together to influence management.²⁷⁰

As with the 36 Act, the industry was heavily involved in the legislative process. They opposed, and in response the SEC removed, significant limitations. For instance, the SEC wanted a fund cap of \$150 million²⁷¹ and a limitation on the number of funds overseen by a single asset manager.²⁷² Both died in the face of industry opposition.²⁷³

Industry also introduced, and the SEC accepted, highly unusual price controls. Under the ICA, mutual-fund shares can only be sold at the price in the fund’s federally mandated offering document, the prospectus.²⁷⁴ This sort of resale price maintenance is typically seen as anticompetitive.

Once asset managers got what they wanted, they strongly supported the legislation and worked aggressively for its enactment.²⁷⁵ Despite its length and complexity, the final legislation did little to alter industry practices. In fact, the new rules essentially mandated that all firms operate how the largest asset manager, Massachusetts Investment Trust, already functioned.²⁷⁶

The weak grounds for extensive regulation, along with the industry’s strong support, suggests that an interest-group lens provides a compelling

²⁶⁶ See FINK, *supra* note 248, at 44 (Industry “problems were fund shares trading at substantial premiums over actual portfolio values, excessive use of leverage through borrowing, and securities firms dumping securities into funds they managed.”).

²⁶⁷ See *id.*

²⁶⁸ See 15 U.S.C. § 80a-18(a) (2020).

²⁶⁹ See *id.* at § 80a-5(b)(1).

²⁷⁰ See *id.* at § 80a-17(d).

²⁷¹ Roe, *supra* note 112, at 1473.

²⁷² See FINK, *supra* note 248, at 40.

²⁷³ See *id.* at 40-42; Roe, *supra* note 112, at 1473-74.

²⁷⁴ See 15 U.S.C. § 80a-22(d); FINK, *supra* note 248, at 43; Roe, *supra* note 112, at 1489.

²⁷⁵ See FINK, 33-34, 36 (discussing “strong industry support” for the ICA).

²⁷⁶ See *id.* at 34.

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explanation for the ICA.²⁷⁷ The asset-management industry pushed through a statute that provided credibility to mutual funds at little expense to insiders but at great expense to possible new entrants. As a 1941 *Georgetown Law Review* article observed, “The existing big companies have legal departments quite capable of handling the situation; but on careful consideration one wonders if new men would take one look at the voluminous statute, teeming with hundred-word sentences, and then call the whole thing off.”²⁷⁸

Perhaps because of the additional credibility that accompanied the new regulatory tome, mutual funds expanded greatly after the ICA.²⁷⁹ In 1959, *Time* magazine referred to them as “the fastest-growing...phenomenon of the U.S. financial world.”²⁸⁰ Mutual-fund assets in 1965 were 38-times their size in 1940.²⁸¹

Unlike other businesses, which exist within a regulatory framework that sets outside boundaries on behavior, mutual funds survive because of favorable tax treatment and operate wholly pursuant to detailed regulatory instructions, which the asset managers that oversee them were actively involved in drafting. Regulation, along with participation in the regulatory process, is a central part of the history of mutual funds and asset management.

c. The Ongoing Political Nature of the Industry

The asset-management industry has continued to work closely with regulators. The ICI, which was founded in 1940 to “assist ... SEC officials in the effective regulation” of mutual funds,²⁸² is an aggressive and powerful lobbyist.²⁸³ The industry’s political savvy has helped mutual funds avoid important regulatory initiatives and major financial reforms. For example, the Mutual Fund Fee and Transparency Act of 2003 would have called upon mutual funds to, among other things, report the fees they charge investors in shareholder account statements²⁸⁴—a simple and direct way to protect

²⁷⁷ See generally Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 550 (2009).

²⁷⁸ Timothy Peter Ansberry, *The Investment Company Act of 1940*, 29 GEORGETOWN L. J. 614, 621 (1941).

²⁷⁹ See FINK, *supra* note 248, at 56.

²⁸⁰ *The Prudent Man*, TIME (June 1, 1959), <http://content.time.com/time/subscriber/article/0,33009,811169,00.html>.

²⁸¹ FINK, *supra* note 248, at 58.

²⁸² *Id.* at 50.

²⁸³ See Paula Dwyer et al., *Breach of Trust: The Mutual-Fund Scandal Was a Disaster Waiting to Happen*, BUS. WEEK (Dec. 15, 2003), at 98, available at http://www.businessweek.com/magazine/content/03_50/b3862015.htm?chan=search.

²⁸⁴ See Mutual Funds Integrity and Fee Transparency Act, H.R. 2420, 108th Cong. (2003).

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investors from otherwise invisible fees. It died amid fierce industry opposition.²⁸⁵ The SEC has also tried to require that funds disclose fees directly to investors, but it too failed in the face of ICI resistance.²⁸⁶

Mutual funds were also notably absent from the two most impactful financial reforms of the 21st century—the Sarbanes-Oxley Act and the Dodd-Frank Act. One of the most important parts of Sarbanes-Oxley imposed an internal-controls mandate on public companies;²⁸⁷ asset managers fought the requirements off.²⁸⁸ One of the most important parts of Dodd-Frank increased oversight over systemically important financial institutions.²⁸⁹ Despite their trillions of dollars in holdings, large asset managers won an exemption after extensive lobbying.²⁹⁰ The close call led the industry to further increase its lobbying efforts after 2008.²⁹¹

Despite their winning record, asset managers have not always succeeded. One of their key failures is the reason they are currently under scrutiny. Despite heavy lobbying, they failed to stop the SEC from requiring disclosure of their proxy votes.²⁹² For the most part, however, the ICI gets its way. According to one SEC employee, “Sometimes it seems the SEC and the ICI work so closely together that they forget where one’s job begins and the other’s ends.”²⁹³

The political success of the asset-management industry stems not only from its lobbying efforts, but also from its carefully crafted image. The image-consciousness of the industry is well-known. According to *BusinessWeek*, “For decades, mutual funds were left alone because they convinced enough people that they were squeaky clean and had shareholders’ interests at heart.”²⁹⁴

²⁸⁵ See Neil Wienberg & Emily Lambert, *Your Money at Work Against You*, FORBES (Sept. 15, 2003), at 78.

²⁸⁶ See Dwyer et al., *supra* note 283.

²⁸⁷ Pub. L. No. 107-204, 116 Stat. 745, 789 (2002).

²⁸⁸ See Dwyer et al., *supra* note 283.

²⁸⁹ Dodd-Frank Pub L. 111-203, 124 Stat. 1376, 1387 § 111 (establishing the Federal Stability Oversight Council (“FSOC”)); Steele, *supra* note 226 (describing FSOC’s role).

²⁹⁰ See Egan, *supra* note 234; Steele, *supra* note 226. The issue is still alive. See David Goldman, *Elizabeth Warren Grills Janet Yellen: Why isn’t BlackRock ‘Too Big to Fail?’* CNN (March 24, 2021), <https://edition.cnn.com/2021/03/24/investing/elizabeth-warren-janet-yellen-blackrock/index.html>.

²⁹¹ See Goshen & Levit, *supra* note 25, at 49-50.

²⁹² See K.J. Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rule*, 13 AM. L. & ECON. REV. 220, 221-22 (2011) (describing “considerable industry resistance” to the voting-disclosure rules); Dwyer et al., *supra* note 283 (describing “fierce” industry opposition to the rules).

²⁹³ Dwyer et al., *supra* note 283.

²⁹⁴ *Id.*

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d. BlackRock's Deep Political Ties

BlackRock, the industry leader with \$9.5 trillion in assets under management, is a special case.²⁹⁵ It hires from, and places people with, the highest levels of government. It is also deeply involved in government affairs²⁹⁶ and lobbies extensively.²⁹⁷ BlackRock efforts are self-serving, but they undoubtedly generate positive externalities for other industry members, particularly the other members of the Big 3.

The revolving door between BlackRock and the federal government in recent years is startling. Three prominent members of the Biden administration were high-ranking employees at BlackRock: Mike Pyle is chief economic adviser for Vice President Kamala Harris (formerly BlackRock's chief investment strategist and before that, a member of President Barack Obama's economic staff); Brian Deese is the head of the National Economic Council (formerly global head of sustainable investing at BlackRock and a senior advisor to President Obama),²⁹⁸ and Adewale Adeyemo is deputy treasury secretary (formerly senior advisor at the Center for Strategic and International Studies at Blackrock and president of the Obama Fund).²⁹⁹ Though BlackRock's ties tilt liberal, it also supplied a senior Treasury Department official to the Trump administration.³⁰⁰

BlackRock also hires people from similarly lofty government ranks. The head of BlackRock's research arm, Thomas Donilon, was President Obama's national security advisor.³⁰¹ BlackRock recently hired Dalia Blass

²⁹⁵ Saqib Iqbal Ahmed & Sohini Podder, *BlackRock Profit Beats as Assets Grow to a Record \$9.5 Trillion*, REUTERS (July 15, 2021), <https://www.reuters.com/business/blackrock-quarterly-profit-jumps-28-2021-07-14/>.

²⁹⁶ See, e.g., Jenna Smialek, *Top U.S. Officials Consulted with BlackRock as Markets Melted Down*, N.Y. TIMES (June 24, 2021), <https://www.nytimes.com/2021/06/24/business/economy/fed-blackrock-pandemic-crisis.html>.

²⁹⁷ See Yeganeh Torbati, *Two Biden Aides Will Recuse on BlackRock Issues as Past Ties Pose Questions*, WASH. POST (Jan. 2, 2021), <https://www.washingtonpost.com/business/2021/01/02/blackrock-biden/> (“There are some companies or trade associations who will wait until a particular issue gathers momentum before intervening, but BlackRock seems pretty determined to quash anything,” one former Democratic congressional aide said. “They don’t miss anything, and they intervene early and often.”).

²⁹⁸ See Rebecca Ungarino, *Here are 9 Fascinating Facts to Know about BlackRock, the World's Largest Asset Manager*, INSIDER (June 10, 2021), <https://www.businessinsider.com/what-to-know-about-blackrock-larry-fink-biden-cabinet-facts-2020-12>.

²⁹⁹ U.S. Dep't of the Treasury, Wally Adeyemo, <https://home.treasury.gov/about/general-information/officials/Wally-Adeyemo> (last visited Dec. 5, 2021).

³⁰⁰ See Ryan Tracy, *Meet Craig Phillips the Man in Charge of Trump's Review of Wall Street Rules*, WALL ST. J. (Apr. 24, 2017), <https://www.wsj.com/articles/meet-craig-phillips-the-man-in-charge-of-trumps-review-of-wall-street-rules-1493026201>.

³⁰¹ See Ungarino, *supra* note 298.

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from the SEC's investment management division (the group that regulates asset managers) to oversee groups related to sustainability and stakeholder capitalism.³⁰² Coryann Stefansson, formerly at the Federal Reserve Bank of New York, worked in BlackRock's financial markets advisory unit from 2016 – 2019.³⁰³

Finally, Larry Fink is talked about as a potential treasury secretary,³⁰⁴ and he and BlackRock are routinely consulted on the most important matters of economic policy. Most recently, former Federal Reserve Chairman Mnuchin called Mr. Fink 5 times over one weekend to consult on the government's response to the COVID pandemic.³⁰⁵ Because of all this, BlackRock has been referred to as the "fourth branch of government."³⁰⁶

Stewardship offers large asset managers the opportunity to enhance their political standing without compromising profits. The political history of the asset-management industry suggests that this is an opportunity it would eagerly embrace. The industry has long cultivated its relationship with regulators. It pushed for and drafted the foundational mutual-fund regulations, and it has had close ties with regulators ever since. Over the years, the industry's lobbying activities and carefully constructed image have allowed it to avoid major reforms and earned it a reputation as a savvy political actor. Its history of politically minded action makes it more likely that the industry will view stewardship in this light.

B. Review of the Empirical Evidence of Asset-Management Voting

The empirical evidence discussed above did not align with the theory that asset managers use their voting power to increase the value of portfolio firms. The evidence does, however, largely line up with the theory that they use it to serve political interests.

How asset managers historically approached voting shows that they had little interest in stewardship until their apathy attracted regulatory

³⁰² *Id.*

³⁰³ *Id.*

³⁰⁴ Ed., *Larry Fink's Political Purgatory*, WALL ST. J. (May 22, 2020), https://www.wsj.com/articles/larry-finks-political-purgatory-11590189627?cx_testId=3&cx_testVariant=cx_4&cx_artPos=1&mod=WTRN#cxrecs_.

³⁰⁵ See Smialek, *supra* note 296.

³⁰⁶ Annie Massa & Caleb Melby, *In Fink We Trust: BlackRock is Now 'Fourth Branch of Government'*, BLOOMBERG (May 5, 2021) <https://www.bloomberg.com/news/articles/2020-05-21/how-larry-fink-s-blackrock-is-helping-the-fed-with-bond-buying> (quoting Professor Birdthisle).

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attention. The industry's early response was to outsource voting to proxy advisory firms.³⁰⁷ As scrutiny of this practice built, they formed modest in-house stewardship departments.³⁰⁸ Interest that escalates at the same rate as regulatory pressure suggests that any enthusiasm is feigned. Rather than generate profits, the increasing engagement seems designed to demonstrate legal compliance and blunt the case for future reforms.

The substance of asset-manager stewardship—that is, what they vote for and against—also looks politically motivated. After the SEC mandated disclosure of their votes and explicitly tied fiduciary duties to voting, funds began to back proposals increasing shareholder power at their portfolio firms; then, in 2021, they began to support environmental and social proposals.³⁰⁹

Supporting measures that empower shareholders is ever popular with regulators.³¹⁰ Congress and the SEC have imposed rules that require independent audit committees³¹¹ and give shareholders a “say on pay.”³¹² The SEC also recently proposed rules that would require companies to use a “universal ballot,” which would make it easier for shareholders to elect insurgent directors.³¹³ In addition, the SEC's motivation for requiring public disclosure of fund proxy votes was to improve shareholder oversight of public companies.³¹⁴ The SEC is therefore thrilled when asset managers further its efforts by voting for measures that give shareholders more influence.

The principles-based approach to corporate governance that asset managers follow also implies a political motivation. As discussed above, they vote for things like de-staggering boards across all firms in their portfolios. While this approach does nothing to improve returns, it allows the large asset managers to demonstrate their support for shareholder power much better than through a case-by-case approach.

Similarly, it has long been puzzling why the large asset managers frequently back hedge-fund activists despite significant questions about their

³⁰⁷ See Cotter, *supra* note 160, at 55.

³⁰⁸ See BIOY ET AL., *supra* note 150, at 19.

³⁰⁹ See *supra* Part II.C.2.

³¹⁰ See, e.g., Mary Jo White, Chair, Sec. & Exchange Comm., Keynote Address at the International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity (Jun. 27, 2016), <https://www.sec.gov/news/speech/chair-white-icgn-speech.html> (referring to measures such as de-staggered boards as “success stories”).

³¹¹ See 15 U.S.C. 78j-1(m)(1) (2020).

³¹² See 17 C.F.R. § 240.14a-21 (2020).

³¹³ See *generally* Universal Proxy, 86 Fed. Reg. 68330 (Dec. 1, 2021).

³¹⁴ See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6566 (Feb. 7, 2003).

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contribution to long-term value. They may do so to demonstrate ideological alignment with the SEC. Though the agency has generally been quiet on the matter, activism is consistent with the agency's skeptical view of management. The SEC also proposed a rule in 2020, which was dropped amid wide opposition, that would have greatly aided activism.³¹⁵ This more than anything else signals that it views the practice positively.

The sudden support for environmental and social matters looks the most political of all. After consistently voting down ES proposals, the large asset managers pivoted to supporting such measures in the same year the U.S. presidency switched parties from the Trump to the Biden administration. The former was hostile to such proposals. Most notably, the Department of Labor (the "DOL") during Trump's administration adopted rules that forbid consideration of ES issues when companies select investment alternatives for 401(k) participants,³¹⁶ and forbid companies from considering such issues when exercising voting authority over 401(k) assets.³¹⁷ The SEC also enacted rules that made it more difficult to make ES proposals,³¹⁸ and issued guidance making it easier for companies to challenge them.³¹⁹

The Biden administration is just the opposite. Environmental and social issues are central to its agenda, and agency actions reflect that. The

³¹⁵ See Reporting Threshold for Institutional Investment Managers, 85 Fed. Reg. 46016 (July 31, 2020); Ortenca Aliaj, *SEC Disclosure Change Would Allow Activists to 'Go Dark'*, *Lanterns Warn*, FIN. TIMES (July 23, 2020), <https://www.ft.com/content/1968c32d-5ac0-4502-8af8-7d45ec39791a>; Alicia McElhane, *Why the SEC May Have Scrapped Its Controversial 13F Proposal*, INSTITUTIONAL INV. (Oct 30, 2020), <https://www.institutionalinvestor.com/article/b1p176msszqf3p/Why-the-SEC-May-Have-Scrapped-Its-Controversial-13F-Proposal>.

³¹⁶ See Employee Benefits Security Administration, Financial Factors in Selecting Plan Investments, 88 Fed. Reg. 72846, 72864 (Nov. 13, 2020).

³¹⁷ See generally Employee Benefits Security Administration, Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81658 (Dec. 16, 2020).

³¹⁸ The rules did not single out ES proposals, but because they increased the ownership requirements for making proposals, they have a disproportionate impact on the smaller shareholders that typically raise these issues. See generally Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, 85 Fed. Reg. 70240 (Nov. 4, 2020); Douglas MacMillan, *Small Investors Have Pushed Big Companies Toward Social Change. A New Rule Will Limit Their Influence*, WASH. POST (Sept. 25, 2020), <https://www.washingtonpost.com/business/2020/09/25/sec-shareholder-rule/>.

³¹⁹ See Sec. & Exch. Comm., Staff Legal Bulletin No. 14I, SEC Div. of Corp. Fin. (Nov. 1 2017), <https://www.sec.gov/corpfin/staff-legal-bulletin-14i-shareholder-proposals>; Sec. & Exch. Comm., Shareholder Proposals: Staff Legal Bulletin No. 14J, SEC Div. of Corp. Fin. (Oct. 23, 2018), <https://www.sec.gov/corpfin/staff-legal-bulletin-14j-shareholder-proposals>; Sec. & Exch. Comm., Shareholder Proposals: Staff Legal Bulletin No. 14K, SEC Div. of Corp. Fin. (Oct. 26, 2019), <https://www.sec.gov/corpfin/staff-legal-bulletin-14k-shareholder-proposals>.

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DOL indicated that it will not enforce the aforementioned Trump-era rules,³²⁰ and the SEC has reversed its Trump-era guidance and eased the path for shareholder proposals.³²¹ The SEC has also prioritized rulemaking that would require sustainability reporting,³²² set up an enforcement task force focused on climate and ESG issues,³²³ created a new position, Senior Policy Advisor for Climate and ESG,³²⁴ and approved a Nasdaq rule requiring that companies either have at least two board members of diverse backgrounds or explain why they do not.³²⁵

The abrupt shift in the large asset managers' voting parallels the abrupt shift in government policy. Politics is the only plausible explanation. Environmental and social issues are fundamental to the Biden administration and to the current SEC. That being the case, continuing to thwart ES proposals would have carried extreme political risk.³²⁶

Both theory and evidence suggest that the large asset managers use their voting power to advance political goals rather than to improve fund returns. Trying to make their holdings more valuable through the shareholder franchise is unlikely to yield any benefits, but voting in a way that aligns with the views of regulators and powerful politicians makes it less

³²⁰ See Statement Regarding Enforcement of Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021) <https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf>; Ross Kerber, *Investors Sue U.S. Regulator over Trump-era AGM Resolution Rules*, REUTERS (June 15, 2021), <https://www.reuters.com/world/us/investors-sue-us-regulator-over-trump-era-agm-resolution-rules-2021-06-15/>.

³²¹ See Sec. & Exch. Comm., Staff Legal Bulletin No. 14L, SEC Div. of Corp. Fin. (Nov. 3, 2021) <https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals>; Katanga Johnson & Ross Kerber, *Top U.S. Financial Regulator Reverses Stance on Social Issues*, REUTERS (Nov. 3, 2021), <https://www.reuters.com/business/us-sec-staff-outlines-how-companies-might-exclude-shareholder-proposal-corporate-2021-11-03/>.

³²² See Dave Michaels, *SEC Wants More Climate Disclosures. Businesses are Preparing for a Fight*, WALL ST. J. (June 21, 2021), https://www.wsj.com/articles/climate-fight-breeds-as-sec-moves-toward-mandate-for-risk-disclosure-11624267803?mod=article_inline.

³²³ SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, <https://www.sec.gov/news/press-release/2021-42> (March 4, 2021).

³²⁴ Satyam Khanna Named Senior Policy Advisor for Climate and ESG (Feb 1, 2021), <https://www.sec.gov/news/press-release/2021-20>.

³²⁵ See Nasdaq Diversity-Rule Approval, 86 Fed. Reg. at 44425.

³²⁶ The voting reversal caused a backlash from Congressional Republicans. See Lim, *supra* note 222. But this response was inevitable. Corporate governance has become political, and in politics one must choose a side. Those whom the asset managers crossed may gain power in future years. But asset managers vote annually, so they can adjust their positions if it becomes necessary.

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likely that the unprecedented power of the large asset managers becomes a regulatory target.

C. Other Influences on Asset-Manager Voting

Politics is the only tenable explanation for the sudden support for environmental and social issues. It also aligns with the asset managers' support for hedge-fund activism and for shareholder friendly governance proposals. But it is overly reductionist to suggest that nothing else influences how asset managers vote.

There are a couple of potential counterweights. If an activist campaign or shareholder proposal would clearly and materially harm one of an asset manager's portfolio companies, they are likely to vote against it even if the result is politically disadvantageous. The ultimate vote would be the outcome of weighing the political risk against the risk of damaging the firm they own. Further, asset managers likely have some concern about the views of their mutual-fund investors. Because investors might leave, asset managers are unlikely to vote in a way that alienates a significant proportion of them. As above, their final vote would depend on weighing the risk of losing investors against the political impact. Because few investors likely pay close attention to voting records, however, investor sentiment is likely a small counterweight to politics.

Others have pointed to the role of ideology, culture, and marketing in asset-manager voting. While these considerations likely color their decisions, none appear to be key drivers.

Ideology and Culture. As noted above, Congressional Republicans have recently suggested that the personal views and values of the CEOs of the large asset managers are driving stewardship decisions.³²⁷ Professors Bubb and Catan similarly argue that different asset managers have different governance philosophies and that this explains how they vote.³²⁸ One could combine and expand these views into a theory that leadership ideology and firm culture, in particular the culture of their stewardship departments, influence asset-manager voting.

There is probably some truth to this. Leaders likely have different views on the issues that come before their firms. Some may view hedge-fund activists with skepticism; others may cheer them. The same goes for environmental and social issues. For instance, Larry Fink was likely eager to support ES measures, but BlackRock pragmatically voted against them until it was politically expedient. Leadership ideology also may seep into the firm's

³²⁷ *See id.*

³²⁸ *See* Bubb & Catan, *supra* note 79, at 24.

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culture with respect to stewardship and the values it reflects through its voting.

This theory, however, is limited. It does not explain the sudden shift to supporting environmental and social matters. CEOs did not change at the same time as the U.S. presidency. Asset-management cultures did not suddenly evolve. This theory also does not explain the relative homogeneity in voting across the large asset managers and the asset-management industry.³²⁹ While varied leadership and culture likely play some role, the voting story is more one of similarity than spread.

Marketing. Marketing also likely influences voting. All asset managers would rather be viewed as good stewards than as laggards. Perhaps this is why they prepare stewardship reports, which have the feel of promotional materials.³³⁰ Stewardship may be a show not only for regulators, but also for the investing public.

Like ideology and culture, however, marketing also probably plays a peripheral role. It seems improbable that a material number of investors allocate their money based on their perception of which asset manager is the most diligent participant in corporate governance. It is also unlikely many investors download the stewardship glossies, let alone make investing decisions based on them. Though nominally for investors, these materials are probably aimed at regulators and social activists.

Another possibility is that because ESG funds are a growth area, large asset managers are using their votes to market to investors concerned about such issues.³³¹ Again, though, marketing is likely a secondary rationale. Marketing cannot explain why the large asset managers voted against ES

³²⁹ See *supra* notes 80-85 and accompanying text.

³³⁰ See, e.g., BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT (2020), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf>.

³³¹ See Dawn Lim, *Wall Street Lobbies to Bring More ESG Funds into 401(k)s*, WALL ST. J. (Mar. 3, 2021) <https://www.wsj.com/articles/wall-street-lobbies-to-bring-more-esg-funds-into-401-k-s-11614767400> (showing growth of ESG funds). An influential article argues that the Big 3 are thought leaders on ES issues to market to Millennial investors. See Michal Barzuza et al., *Shareholder Value(s): Index Fund ESG Activism*, 93 U.S.C. L. REV. 1243, 1248-49 (2020). The argument does not match Vanguard's and BlackRock's long history of voting against such issues. See *supra* Part II.D.2.c. Millennials are also a small part of the investor pool, and while their share will inevitably grow, it will happen slowly as they accumulate assets through small payroll deductions that feed their 401(k) accounts. See *Characteristics of Mutual Fund Investors 2020*, at 18 fig 18, INV. CO. INST. (Nov. 2020), <https://www.ici.org/system/files/attachments/pdf/per26-09.pdf>. (showing Millennials owing 16% of mutual-fund assets); Rydqvist et al., *supra* note 10, at 2 (noting that "retirement wealth is built through payroll deductions").

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proposals for so long.³³² ESG funds did not spring up in 2021. And before then, the frequency with which ESG funds voted against ES proposals drew significant criticism.³³³

Finally, voting all of the asset manager's shares for ES proposals—as they have begun to do—is not the best way to target socially conscious investors. A sizable share of an asset manager's potential investors likely comes out differently on such matters.³³⁴ Rather than risk alienating them, asset managers could vote the shares of its ESG funds separately. Failure to divide voting in this simple manner suggests that marketing is not their primary motivation.³³⁵

The actions of a single person, let alone an institution with layers of management and rife with competing interests, cannot be understood solely through reference to one factor. Accordingly, culture, ideology, and marketing likely come into play as large asset managers decide how to vote. None, however, appear nearly as important as politics.

IV. IMPLICATIONS

The fundamental claim outlined above is that politics rather than profits—or any other consideration—principally drives voting at the large

³³² See Jacki Cook & Jon Hale, *Sustainable Fund Proxy Votes Show a Range of Support for ESG Measures* 5, MORNINGSTAR (Dec. 2020) (“Vanguard’s and BlackRock’s ESG funds voted for fewer than 20% of key ESG proposals”), 8-9 (“[A]cross their funds, BlackRock and Vanguard rank amongst the least supportive of ESG key resolutions.”); Jon Hale, *All Sustainable Funds are Not the Same When it Comes to Proxy Voting*, THE ESG ADVISOR (Dec. 18, 2020), <https://medium.com/the-esg-advisor/all-sustainable-funds-are-not-the-same-when-it-comes-to-proxy-voting-c1ae39f6e040>; Betsy Verecky *ESG Funds Often Fail to Vote their Values, Research Shows*, MIT MANAGEMENT SLOAN SCHOOL (June 21, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/esg-funds-often-fail-to-vote-their-values-research-shows> (“the Vanguard Social Index Fund voted against almost all environmental and social resolutions over the time examined”).

³³³ See, e.g., Mooney, *supra* note 29; Schatz, *supra* note 180.

³³⁴ See Ed., *Larry Fink’s Political Purgatory*, WALL ST. J. (May 22, 2020), <https://www.wsj.com/articles/larry-finks-political-purgatory> (“A resolution ... that asked BlackRock’s Board to prepare a report on how to implement a stakeholder corporate purpose drew only 3.85% shareholder support.”); Fisch, *supra* note 37, at 17 n. 115.

³³⁵ See Cook & Hale, *supra* note 332, at 8-9 (“BlackRock and Vanguard’s ‘house’ view on ESG proxy votes is almost exactly replicated across their largest ESG funds.”); *But see* Quinn Curtis et al., *Do ESG Mutual Funds Deliver on Their Promises* 42-43 (ECGI Working Paper No 586/2021, 20210) (finding that ESG funds vote against management more often than non-ESG funds).

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asset managers. This understanding of asset-manager behavior has implications for social welfare, policy, and theory.

A. Social-Welfare Implications

It is worth first considering whether politically driven voting is concerning. Large asset managers are engaged in corporate governance like never before and have supported ESG proposals and hedge-fund activists. Backing these efforts has changed the shape of corporate America. If all of this is for political reasons, those in support of this voting record might welcome the role of politics. If asset managers are engaged and supporting the right things, what does it matter if they are doing so for the right reasons?

But this perspective misses a great deal of nuance. The political aspect of asset-manager stewardship has two dimensions. The first is procedural. Asset managers seek to demonstrate that they are sufficiently diligent when exercising their voting rights. That is why they are growing their internal stewardship teams and tout their engagements. The other is substantive. Asset managers seek to show ideological alignment with regulators and politicians through the proposals and activists they support. The substantive aspect is more worrisome, but both are problematic.

First, consider the procedural component. In a sense, asset managers have invented and are complying with their own quasi-regulatory standard of care for stewardship decisions—a standard they consider high enough to keep regulators at bay. One problem is that the performance may work and thereby ward off more costly, but more effective, regulations. The performance may also be wasteful. Regulations aimed at improving stewardship are an indirect effort to improve the performance of public companies. The hope is that a regulatory push will cause asset managers to scrutinize the corporate executives of the companies they own. If, as this Article argues, funds are not doing this, then stewardship expenditures are an inefficient use of resources.

It is one thing to feign diligence; it is another to determine what to support based on reading political tea leaves. One issue with letting politics guide substance is that the things asset managers end up supporting, although politically advantageous, may not actually be in the best interests of their portfolio companies. As noted above, asset managers generally support measures that shift the locus of power from management and the board to the shareholders.³³⁶ Yet it is not always appropriate to shift this balance. It may impede management and lead to short-termism. Nor are environmental and social proposals good for all companies. Nevertheless,

³³⁶ See Goshen & Levit, *supra* note 25, at 5.

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asset managers apply one-size-fits-all principles to these questions. This voting pattern likely helps the performance of some companies but hurts others.

The social-welfare implications of these votes are also ambiguous. Advancing the power of shareholders comes at the expense of other stakeholders.³³⁷ Environmental proposals may result in greenwashing, social proposals in “social washing.”³³⁸ Also, as above, the private ordering approach to regulatory issues may supplant effective regulation.

In addition to ESG proposals, asset managers frequently support hedge-fund activists. Supporting activists shows an interest in holding management accountable, which appeals to the SEC. Like increased shareholder power, though, activism is not necessarily good for portfolio firms or society. While activism often improves short-term returns, much of the gains come at the expense of long-term investors and other stakeholders.³³⁹ There is also little assurance that funds are picking the right activists to support,³⁴⁰ particularly if their decision-making is driven by political considerations.

More important than asset managers’ voting records is what politically motivated stewardship portends. Even those who applaud the short-term results—shareholder empowerment, hedge-fund activism, more environmental and social transparency—should worry about the long-term. Since voting follows politics, and politics is constantly changing, in the long run, voting is likely to be capricious. Asset managers can be expected to flip flop on issues as the political calculation changes. This is particularly true because of how political shareholder proposals and activism have become. Each year, asset managers will likely face great pressure to align their voting with the politics of the governing party. The sudden support of environmental and social issues that manifested as the federal government changed parties is likely only the first instance of political whipsawing.

Uncertainty as to how their key shareholders will vote from year to year makes managing public companies more difficult. Generally, uncertainty in business is associated with reduced wages, investment, and production, as well as higher risk premiums.³⁴¹ Unpredictable stewardship

³³⁷ See *id.* at 17.

³³⁸ Etica Funds, Social Washing: What is It and Why Could COVID-19 Be Making It Worse?, <https://www.eticasgr.com/en/storie/insights/social-washing> (last visited Jul. 3, 2021).

³³⁹ See deHaan et al., *supra* note 117, at 8-13.

³⁴⁰ See Goshen & Levit, *supra* note 25, at 772 (“[A]ctivist hedge funds sometimes mistakenly target firms whose managers are in fact effective activist”).

³⁴¹ See *How Does Uncertainty Impact Economic Activity?* PWC GLOBAL ECONOMY WATCH (June 2017), <https://www.pwc.com/gx/en/news-room/docs/how-does-uncertainty-impact-economic-activity.pdf>.

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poses all of these risks, particularly with the increasing politicization of corporate governance. In years where progressive policies are more politically advantageous, corporate managers will be pushed to be more stakeholder friendly; in other years, they will be pushed to abandon such efforts and maximize shareholder value. Without a clear and stable mission, managers will be forced to be more cautious and middling, afraid to take on big projects lest they need the resources for a strategy shift.

Politically driven stewardship also hints of state capitalism—where the state runs the economy. If large asset managers are voting to please regulators and politicians, then regulators and politicians indirectly control these votes. This gives government officials an extraordinary say over the operations of public companies, which threatens the sacred, and somewhat imprecise, line between government and business.

Government rules typically provide transparency or set boundaries on firm operations. In the securities area, the rules are primarily designed to protect investors and primarily do so by mandating disclosures,³⁴² a soft form of intervention. Corporate law is similar in that fiduciary duties protect against mismanagement and self-dealing, but corporate codes do not dictate what companies do.³⁴³

When government influence over asset-manager voting gives it shareholder-like power, it takes on a far more substantial role. If the major asset managers voted to oust Exxon's board for political reasons, then politicians are indirectly charting Exxon's course. And this is problematic.

There are questions about motivations and competence.³⁴⁴ Politicians may push asset managers to favor policies for political reasons rather than financial ones. For instance, congresspersons may encourage asset managers to vote against hedge-fund activist challenges at companies that are important financial backers or headquartered in their districts. Politicians might also look to asset managers to further their policy agenda. For instance, they may lean on asset managers to vote against environmental shareholder proposals because their party resists climate activism. Finally, politicians are not financial professionals. Even if they use their power to push asset managers to vote for policies that they think are in portfolio companies' best interest, there is little reason to think they are right.

³⁴² See Jeff Schwartz, *Fairness, Utility, and Market Risk* 89 OR. L. REV. 175, 181 (2010).

³⁴³ See Aronson v. Lewis, 473 A.2d 805, 812 (1984) (describing the deferential standard used to review business decisions).

³⁴⁴ See Holland, *supra* note 33, at 321 (“[G]overnments are motivated by two sets of objectives: economic objectives, such as maximizing investors’ welfare, and noneconomic objectives, such as maximizing political benefits. Noneconomic objectives are likely to reduce profitability...”).

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The overlap with politics is also problematic from a legitimacy perspective. Asset managers are only financial intermediaries. They vote on behalf of the shareholders in the funds they oversee. As such, they owe a fiduciary duty to vote in fund shareholders' best interests. Instead, the large asset managers are voting to serve their own political interests. Not only is this a violation of their fiduciary duty, it is also an illegitimate use of the power entrusted to them, which harms the very people asset managers are supposed to serve. Politically driven voting compromises the long-term value of the companies in which fund shareholders are invested and, if successful, forestalls regulations intended to help them.

This analysis casts the relationship of financial institutions, government, and public companies in a new light. The concentration of ownership and control in the hands of financial institutions typically triggers concerns about self-dealing and conflicts of interest.³⁴⁵ But in this case, the key concern with financial influence is that it hands too much control to government. Another common concern is that business has too much say over politics.³⁴⁶ This Article argues the opposite.

B. Policy Implications

Because of the downsides of politically motivated voting, the policy response is to reduce its role in asset-manager stewardship. There are two conceptual approaches for doing so. One is to alter the incentive calculation of asset managers so that politics is no longer their paramount concern. The other is to tie the discretion of asset managers to the wishes of mutual-fund shareholders. I recommend the latter.

Altering asset-manager incentives is difficult. Politics plays such an important role because the financial incentives for stewardship are so meager. If engagement was profitable, however, politics would shrink in relative importance. As noted above, regulations are largely responsible for stripping asset managers of the financial incentive to participate in corporate governance.³⁴⁷ Concentrated holdings motivate careful voting, but the rules prohibit mutual funds from allocating more than 5% of their portfolio to any company or holding more than 10% of a company's stock.³⁴⁸ These rules could be rescinded.

This change, however, would likely do little to solve the problem. It would theoretically allow asset managers to operate hedge-fund like

³⁴⁵ See Roe, *supra* note 112, at 1502.

³⁴⁶ See Ciara Torres-Spelliscy, *supra* note 196, at 8 (expressing concern over corporate political influence).

³⁴⁷ See *supra* Part III.A.2.

³⁴⁸ See 26 U.S.C. § 851 (2020).

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instruments with concentrated positions in certain firms.³⁴⁹ While this would give asset managers a large financial incentive to carefully vote their shares in these firms, it would do nothing for the hundreds of other companies with respect to which asset managers vote. Politics would thus still drive voting in the vast majority of cases.

The better way to eliminate politics from stewardship is to constrain the voting authority of asset managers. While asset managers today are technically supposed to vote in the “best interests” of mutual-fund shareholders, practically speaking they have complete discretion. Instead, asset managers should be required to vote based on input from mutual-fund investors. As a result, they would no longer be able to use voting to further their political interests.

There are several ways to give investors input. The purest form would be pass-through voting, where investors would instruct asset managers how they would like their votes cast with respect to each matter. But pure pass-through voting would be overkill. It would eliminate the politics problem, but retail investors would be rationally apathetic about voting.³⁵⁰ As a result, few votes would actually be cast.

A middle ground would be to require that asset managers poll fund investors about preferences with respect to voting principles and that asset managers reflect these preferences in their voting across the investors’ portfolios.³⁵¹ For instance, investors could be asked about whether they support diversity efforts and climate transparency efforts at portfolio firms. The asset manager would then be required to proportionally reflect investor preferences at each company where activism or shareholder proposals implicating these issues arise.

Many investors would likely fail to respond to this outreach, but since the costs of participation are far lower, more would participate in governance this way than with pure pass-through voting. A question arises as to what to do with the votes for those investors who do not respond. If asset managers were permitted to vote these shares in their discretion, then they would retain a great deal of power to use voting for political ends. That

³⁴⁹ See Morley, *supra* note 121, at 1412 (discussing hurdles to the Big 3 operating activist hedge funds).

³⁵⁰ See Schwartz, *supra* note 277, at 558. Pass-through voting might be a viable option for institutional clients, however. BlackRock, in fact, will provide its largest institutional clients with such voting rights beginning in 2022. See Dawn Lim, *BlackRock Gives Big Investors Ability to Vote on Shareholder Proposals*, WALL ST. J. (Oct. 7, 2021), <https://www.wsj.com/articles/blackrock-gives-big-investors-ability-to-vote-on-shareholder-proposals-11633617321>.

³⁵¹ Professors Griffin and Hirst have also proposed increased input for mutual-fund shareholders. See Griffin, *supra* note 228 at 992-94; Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 238 (2018).

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being the case, if investors do not respond, asset managers should be required to abstain.

This approach not only sidelines politics, it also makes proxy voting fairer and is a better match to fiduciary duties. As the economic owners (even if not the certificate holders) of portfolio firms, it seems axiomatic that mutual-fund investors should have a say over how their stakes are voted. This is especially the case today, where to an ever-increasing degree, corporate-governance issues are political and controversial. Financial intermediaries seem particularly unsuited to decide these matters.

Asking for investor input also aligns with the asset managers' fiduciary duties. Asset managers today make no effort to gauge whether their votes are in the "best interests" of fund shareholders. This is defensible assuming that asset managers vote to increase the value of portfolio firms. Voting in this manner is plausibly in the best interests of shareholders and likely explains why asset managers always defend votes for ES matters on shareholder-value grounds.³⁵² Appeals to shareholder value ring hollow, however, when the issues and votes are political. For these matters, some effort to understand investor preferences seems appropriate—if not, necessary—to meet the "best interest" standard.

Finally, while this proposal does require some investment, the costs are not large and should be offset by related savings. Asset managers would have to design their questionnaires, reach out to investors, tally results, and reflect those results in their voting.³⁵³ While all of this requires time and resources, this approach is likely cheaper than the stewardship theater funds engage in today. It is also a far more justifiable expense in that it is incurred to empower investors rather than serve the asset managers' political interests.

A common defense of the *status quo* is that, while asset managers may not be perfect, leaving power with them is better than handing the reins to retail investors.³⁵⁴ This claim is unpersuasive.

First, let us not idealize what is being given up. Empowering individuals does not replace sophisticated stewardship with apathy; it replaces politically minded stewardship with good-faith stewardship.

³⁵² See Barzuzza, *supra* note 331 at 1276; Lim, *supra* note 222.

³⁵³ Nuanced issues arise about how best to engage shareholders and reflect their varied preferences across the wide range of topics involved. I plan to address these issues in future work.

³⁵⁴ See, e.g., Kahan & Rock, *supra* note 9, at 1814.

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Moreover, individual investors are better situated to participate in corporate governance than at any time before. Environmental and social proposals were the two most common in 2021, up 37% and 13% over 2020.³⁵⁵ These forms of intervention, which aim to improve social welfare rather than merely firm welfare, appear to be the future of corporate governance. And it is with respect to these issues where voting by individual shareholders makes the most sense. These votes are based on values rather than financial sophistication. Individuals can represent their values just as easily as institutions. Further, the collective-action problem that so troubled Berle and Means is not nearly as problematic when it comes to value-driven voting. While there is a disincentive to engage in corporate governance when financial gains are shared, people are unlikely to be concerned about spreading their values. Given the shift to values-based stewardship, the usual concerns about retail-investor voting are not as salient.

Finally, the change recommended here is not as abrupt as it first appears. Individuals are not the only ones who invest in mutual funds. Fifty-seven percent of the money BlackRock manages, for instance, belongs to institutional investors.³⁵⁶ Thus, while allowing mutual-fund investors to participate in corporate governance does empower individuals, it also shifts power to other institutions.

Similarly, while asset managers hold 30% of the stock market,³⁵⁷ other financial institutions hold an additional 50%.³⁵⁸ Thus, even if asset-manager influence is stymied, banks, pension plans, hedge funds, and other sophisticated investors would still dominate corporate governance and the public market. Instead of the large asset managers driving corporate governance based on political concerns, control would be dispersed among institutional investors and individuals. This mix of voices may not yield perfect corporate governance, if such a thing exists, but it would be fairer to mutual-fund shareholders and provide greater stability for corporate managers. It would also lead to better results because hedge-fund activists and advocates of shareholder proposals would have to convince a range of voters with different views rather than a few large asset managers with compromised incentives.

³⁵⁵ GIBSON DUNN, *supra* note 103, at 4-5.

³⁵⁶ BlackRock, Q2 2021 Earnings Exhibit 99.2 (July 14, 2021), https://www.sec.gov/Archives/edgar/data/0001364742/000156459021036497/blk-ex992_7.htm.

³⁵⁷ *See* INV. CO. INST., *supra* note 49, at i.

³⁵⁸ *See* Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSION & INVESTMENTS (Apr. 25, 2017), <https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions>.

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C. Implications for Corporate-Governance Theory

A motivating question for much scholarship in this area is whether the rise of large asset managers finally resolves the agency-cost problem at the heart of the Berle-Means thesis. This Article shows that, instead of sunseting this concern, the rise of the Big 3 and others shows the inadequacy of the Berle-Means approach. While agency costs are an important part of the corporate-governance story, it is much more useful to think more broadly about the motivations that guide large asset managers' voting. Recognition of the political motivations behind their voting uncovers a host of concerns about the relationship between business and government that Berle-Means cannot envision. The policy prescription to transfer voting discretion to individuals also runs counter to Berle-Means and its concern about the collective-action problems of dispersed ownership. The broader takeaway for corporate-governance theory is that when analyzing core questions—like what is the optimal allocation of power among shareholders and between the board and shareholders—policymakers, judges, and scholars should focus on what motivates different shareholders, and different types of shareholders, rather than on their potential to police agency costs.

CONCLUSION

The Big 3 and other large asset managers have significant power over corporate America, but how they use this power is little understood. The extant literature has sought to understand asset-manager stewardship solely in terms of their incentive to increase the value of portfolio firms. What this perspective reveals is that the incentive for asset managers to use stewardship as a tool to better the companies they own is weak. This insight invites a hugely important and little acknowledged question: if funds have little at stake financially, then what drives their engagement and voting?

I argue that politics drives voting at the large asset managers. While stewardship offers little in the way of conventional profits, if used wisely, it can hedge the significant political risk that large asset managers face because of their tremendous success. Politics offers the only explanation for the Big 3's sudden embrace of environmental and social issues. It also explains their support for hedge-fund activism and shareholder-empowering proposals, as well as the process by which they engage in stewardship.

Politically driven voting is problematic: it is an illegitimate use of the voting power asset managers exercise on behalf of their investors; it makes public companies harder to run; and it provides politicians with too much say over industry. To remove politics from corporate governance, asset

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managers should be required to seek input from their investors and reflect that input in their voting. So constrained, funds would no longer be able to advance their own political agenda without regard to the interests of those whose capital they manage.