STEWARDSHIP THEATER

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ABSTRACT

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 3")—have compiled massive equity holdings in public companies through the mutual funds and exchange traded funds (ETFs) that they oversee.[2] 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 nothing more momentous than upending Exxon's 135-year emphasis on oil.[7] A few months after the electoral rebuke, Exxon,

1. *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 13–14 (Harvard Pub. Law Working Paper No. 19-07, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 [https://perma.cc/8T7C-5T52] (BlackRock, Vanguard, and State Street collectively control "a much greater share of US public companies than any three single investors have ever previously done."); Robert J. Jackson, Jr., Comm'r, Sec. & Exch. Comm'n, Testimony Before the Federal Trade Commission Hearing on Competition and Consumer Protection: Common Ownership: The Investor Protection Challenge of the 21st Century (Dec. 6, 2018), https://www.sec.gov/news/testimony/jackson-testimony-ftc-120618 [https://perma.cc/RN2L-ZZJN] (referring to the concentration of power in the biggest asset managers as "unprecedented").

2. *See* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017) (finding that the 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, 7:00 AM), https://www.wsj.com/articles/blackrock-other-investors-wield-growing-board-shareholder-vote-clout-11628766001 [https://perma.cc/MM7W-WTMD] (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 [https://perma.cc/43D9-ASR3].

5. *See id.*

6. *See id.*

7. *See Our History*, EXXONMOBIL (July 22, 2021), https://corporate.exxonmobil.com/About-us/Who-we-are/Our-history [https://perma.cc/543W-JD8A].

once "unrepentant in its defense of crude,"[8] announced that it was considering the previously unthinkable—a carbon-neutral pledge.[9]

Because the large asset managers wield such tremendous power, understanding why they vote the way they do is crucially important to law and society. 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.[10] The literature 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.[11] The assumption of dispersed ownership formed the basis of the

8. *ExxonMobil Loses a Proxy Fight with Green Investors*, ECONOMIST (May 27, 2021), https://www.economist.com/business/2021/05/23/what-a-proxy-fight-at-exxonmobil-says-about-big-oil-and-climate-change [https://perma.cc/2XZB-WU2L].

9. Christopher M. Matthews & Emily Glazer, *Exxon Considers Pledging 'Net Zero' Carbon by 2050*, WALL ST. J. (Aug. 5, 2021, 1:00 PM), https://www.wsj.com/articles/exxon-considers-pledging-net-zero-carbon-by-2050-11628161201?mod=hp_lead_pos1 [https://perma.cc/UB5K-DMLU].

10. Professors 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. PERSPS. 89 (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) (unpublished manuscript) (on file with author) [hereinafter Bebchuk & Hirst, The Power of the Big Three]. Others challenge this analysis. *See* Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street*, *A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 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 CAMBRIDGE HANDBOOK ON INVESTOR PROTECTION 46–51 (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 Revaluation 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 J. Mallow, Asset Management, Index Funds, and Theories of Corporate Control (Dec. 22, 2019), https://papers.ssrn.com/abstract=3483573 [https://perma.cc/Z3YW-PQRU].

11. *See* Kristian Rydqvist, Joshua Spizman & Ilya Strebulaev, *The Evolution of Aggregate Stock Ownership: A Unified Explanation* 8 at tbl.1 (CEPR Discussion Paper No. DP7356, 2009),

Berle-Means thesis.[12] 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.[13] 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.[14] 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.[15]

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;[16] others argue that they fall far short.[17] The disagreement centers on whether asset managers earn enough money from improving their portfolio firms to invest in careful oversight.[18]

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 case,[19] 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.

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https://www.ifk-cfs.de/fileadmin/downloads/events/conferences/2011-07-01-Rydqvist_et_al.pdf [https://perma.cc/SFU8-YZ4R] (showing that, in 1945, individuals directly owned 93% of public-company shares).

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

13. *See id.*; Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1013 (2006).

14. *See* BERLE & MEANS, *supra* note 12, at 86–87; Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1916 (2013).

15. *See* Rock, *supra* note 14, at 1911. Professors Jenson 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. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

16. *See* Fisch et al., *supra* note 10, at 55–56; Kahan & Rock, *supra* note 10, at 1814–15.

17. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, 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").

18. *Compare* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2033–2075 (presenting a theory for why stewardship is unprofitable), *with* Fisch et al., *supra* note 10, at 27–43 (presenting a theory for why stewardship is profitable).

19. *See infra* Part II.A–C.

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.[20] 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.[21] An array of journalists, politicians, and academics worry that they are destabilizing equity markets,[22] suppressing competition in major industries,[23] and failing to act as responsible stewards on behalf of their funds' shareholders.[24] *NPR* asked, *Is Your Retirement Fund Ruining Our Economy?*[25] *The Atlantic* echoed, *Could Index Funds Be 'Worse than Marxism'?*[26]

A bit hyperbolic, but this agita has generated a slew of reform proposals. Influential scholars even suggest breaking up the Big 3.[27] All of this makes

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

21. *See infra* Part III.A.2.

22. *See generally* STEVEN D. BLEIBERG, WILLIAM W. PRIEST & DAVID N. PEARL, EPOCH INV. PARTNERS, THE IMPACT OF PASSIVE INVESTING ON MARKET EFFICIENCY (2017); Annie Lowrey, *Could Index Funds Be 'Worse Than Marxism'?*, ATLANTIC (Apr. 5, 2021), https://www.theatlantic.com/ideas/archive/2021/04/the-autopilot-economy/618497/ [https://perma.cc/5TBP-AL35]; Greg Rosalsky, *Is Your Retirement Fund Ruining Our Economy?*, NPR (Oct. 18, 2019, 6:30 AM), https://www.npr.org/sections/money/2019/10/08/767884839/is-your-retirement-fund-ruining-oureconomy? [https://perma.cc/B9M5-8NHK].

23. *See* Jackson, *supra* note 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, Martin C. Schmalz & Isabel Tecu, *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, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017).

24. *See, e.g.*, Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2037; Lund, *supra* note 17, at 496–97.

25. Rosalsky, *supra* note 22.

26. Lowrey, *supra* note 22.

27. *See generally* Zohar Goshen & Doron Levit, *Common Ownership and the Decline of the American Worker* 11 (Colum. L. & Econ. Working Paper, Paper No. 653, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3832069 [https://perma.cc/H63L-CRQ7].

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.[28] Voting in a manner that pleases politicians and regulators 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.[29] That year, they not only supported the fundamental change at Exxon, but also vastly increased their support for environmental proposals.[30] BlackRock's support for such proposals was ten times higher than the previous year.[31] 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.[32] It also accords with a policy reversal at the Securities & Exchange Commission (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.[33] 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.[34]

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28. *See infra* Part III.A.2.
29. *See infra* Part II.D.2.d.
30. *See id.*
31. *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 [https://perma.cc/AYJ2-UPHP] (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).
32. *See infra* text accompanying notes 320–324.
33. *See infra* text accompanying notes 326–328.
34. *See infra* Part IV.A.

Of still greater concern, 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 corruption and waste it creates.[35] Government acting implicitly and indirectly through asset managers is not state capitalism, but it poses similar risks.[36]

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.[37] 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.

The 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 year[38]—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

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35. 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 citation omitted)); Simon C.Y. Wong, *Government Ownership: Why This Time it Should Work*, MCKINSEY & CO. (June 1, 2009), https://www.mckinsey.com/industries/public-and-social-sector/our-insights/government-ownership-why-this-time-it-should-work# [https://perma.cc/NDN8-L4HD] ("[H]istorically, 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.").

36. *See infra* text accompanying notes 345–349.

37. *See* Proxy Voting by Investment Advisors, 68 Fed. Reg. 6585, 6586 (Mar. 10, 2003).

38. Vanguard voted on over 100,000 shareholder proposals in 2021. VANGUARD, INVESTMENT STEWARDSHIP: 2021 SEMIANNUAL REPORT 8 (2021), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/inv_stew_2021_semiannual_report.pdf [https://perma.cc/55QH-P4JN].

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 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.[39]

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.

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39. 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); Jill E. Fisch, *Relationship Investing: Will it Happen and Will it Work?*, 55 OHIO ST. L.J. 1009 (1994); 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.*, Hu & Black, *supra* note 13; Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem* (European Corp. Gov. Inst. L. Working Paper, Paper No. 612/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3939112 [https://perma.cc/8LP2-YUUU] [hereinafter Fisch, *Mutual Fund Stewardship*].

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 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.[40] 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.[41] 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.[42] The top managers oversee hundreds of funds. BlackRock, for example, manages over 600.[43] Each mutual fund has an "expense ratio."[44] This is an annual percentage-based fee that investors pay

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40. *See, e.g.*, *Discover Vanguard Mutual Funds*, VANGUARD, https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns [https://perma.cc/9JD9-D8P3] (last visited Sept. 19, 2022).

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

42. 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: Encouraging 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, 7:02 AM), https://www.wsj.com/articles/vanguard-is-handing-over-some-of-its-voting-power-11556190120?mod=article_inline [https://perma.cc/Y3ZE-H4NN] (reporting that 9% of Vanguard's funds are externally managed). This structure should not materially impact Vanguard's voting incentives.

43. *See Investment Funds*, BLACKROCK, https://www.blackrock.com/us/individual/products/investmentfunds#!type=mutualFunds&style=All&view=perfNa [https://perma.cc/J7W2-MEHA] (last visited Sept. 19, 2022) (listing 620 funds).

44. *See* SEC, *How to Read a Mutual Fund Prospectus (Part 2 of 3: Fee Table and Performance)*, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_mfprospectus2 [https://perma.cc/U2VX-8VMA] (last visited Sept. 19, 2022). For an overview of mutual fund fees, see SEC, *Mutual Fund Fees and Expenses*, https://www.investor.gov/introduction-investing/investing-basics/glossary/mutual-fund-fees-and-expenses [https://perma.cc/357R-PRRS] (last visited Sept. 19, 2022).

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 fund fee was 0.41% in 2020.[45] 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 three times that of the portfolio companies in which their affiliated funds invest. In 2018, the industry operating margin was 31.1%,[46] while the profit margin for the S&P 500 (a list of 500 of the largest companies) was around 13%.[47]

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. The returns in an actively managed fund are, at least in part, determined by the skill of the manager, but investors solely earn the market return, minus fees, in an index fund. Index funds typically charge much lower fees than actively managed funds.[48] Some even charge no fee.[49] There is a near consensus that when fees are considered, index funds outperform funds that are actively managed.[50]

The asset-management industry is enormous. At the end of 2020, there were over 9,000 mutual funds and 2,000 ETFs,[51] with total assets of $29.3

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45. *See* BEN JOHNSON & GABRIELLE DIBENEDETTO, MORNINGSTAR, 2020 U.S. FUND FEE STUDY 1 (2021).

46. 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).

47. *Total Market Profitability*, CSIMARKET.COM, https://csimarket.com/Industry/industry_ProfitAbility_Ratios.php?&hist=12 [https://perma.cc/R7G6-JV2F] (last visited Sept. 19, 2022).

48. *See* JOHNSON & DIBENEDETTO, *supra* note 45, at 2 (reporting average index fund fees of 0.11% and actively managed fund fees of 0.62%).

49. *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 [https://perma.cc/4VW8-HHBW].

50. *See, e.g.*, BEN JOHNSON, MORNINGSTAR, MORNINGSTAR'S ACTIVE/PASSIVE BAROMETER 2 (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).

51. 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

trillion.[52] For comparison, the U.S. GDP for 2020 was about $21 trillion.[53] There are over hundreds of asset managers,[54] but almost 50% of industry assets are overseen by five companies (the Big 3, plus Fidelity and the Capital Group).[55] 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.[56] Vanguard alone manages around 76% of index-fund assets.[57]

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.[58] 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.[59] Mutual funds hold $11.1 trillion in 401(k) and related assets,[60] and Vanguard and BlackRock are the leaders in the space.[61] Before the introduction of 401(k)s

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fund, whereas ETFs are publicly traded. *See id.* at 94. The distinction is irrelevant for this Article as voting is handled identically.

52. *Id.* at 42 fig.2.3.

53. *See GDP (Current US$) – United States*, THE WORLD BANK, https://data.worldbank.org/indicator/ny.gdp.mktp.cd? locations=US [https://perma.cc/C2TP-CETN] (last visited Sept. 19, 2022).

54. INV. CO. INST., *supra* note 51, at 54 fig.2.12.

55. JEFF TJORNEHOJ, EXPLORING FUND INDUSTRY CONCENTRATION: THE GOOD, THE BAD, AND THE UNKNOWN, BROADRIDGE 3–4 tbl.2 (2018); *see also* Robert G. Eccles, *Concentration in the Asset Management Industry: Implications for Corporate Engagement*, FORBES (Apr. 17, 2019, 7:44 AM), https://www.forbes.com/sites/bobeccles/2019/04/17/concentration-in-the-asset-management-industry-implications-for-corporate-engagement/#bf13c44402f5 [https://perma.cc/X6W5-NGQJ] (discussing implications of concentration in the asset-management industry).

56. INV. CO. INST., *supra* note 51, at 49 fig.2.8 (figure includes ETFs).

57. *See* TJORNEHOJ, *supra* note 55, at 5 tbl.7.

58. 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* OFF. 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, 1:39 PM), https://www.wsj.com/articles/the-champions-of-the-401-k-lament-the-revolution-they-started-1483382348 [https://perma.cc/M7DU-TWLA]. For a critique of 401(k)s on policy grounds, see Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. LEGIS. 53 (2012).

59. *See* Veronika K. Pool, Clemens Sialm & Irina Stefanescu, *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).

60. INV. CO. INST., *supra* note 51, at 197.

61. *See* Robert Steyer, *Overall Assets Jump Nearly 22% for Top 25 Firms*, PENSION & INVS. (June 1, 2020, 12:00 AM), https://www.pionline.com/largest-money-managers/overall-assets-jump-nearly-22-top-25-firms [https://perma.cc/MJ6E-33ZG].

in 1982,[62] asset managers were minor players in equity markets. In 1981, their affiliated mutual funds held under 3%[63] of the stock of public companies compared with 30% at the end of 2020.[64]

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.[65] 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.[66] The Dodd-Frank Act also gave public-company shareholders a nonbinding vote on executive compensation, frequently referred to as a "say on pay."[67]

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.[68] Social and environmental proposals often call for transparency about employee diversity and environmental risks and impacts.[69]

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62. Rydqvist et al., *supra* note 11, at 1–2.
63. *Id.* at 2.
64. INV. CO. INST., *supra* note 51, at i.
65. *See* Hu & Black, *supra* note 13, at 1013 (discussing the one-share one-vote structure of public companies); Jeff Schwartz, *De Facto Shareholder Primacy*, 79 MD. L. REV. 652, 686 (2020) (discussing rarity of reduced shareholder voting rights among public companies).
66. *See* DEL. CODE. ANN. tit. 8 §§ 242, 251 (2020).
67. *See* 17 C.F.R. § 240.14a-21 (2020).
68. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2101–02 (discussing changes to corporate governance arising from shareholder-proposal process); Roberta S. 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).
69. *See* Marc Treviño, June M. Hu & Joshua L. Levin, *2021 Proxy Season Review: Shareholder Proposals on Environmental Matters*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 11, 2021), https://corpgov.law.harvard.edu/2021/08/11/2021-proxy-season-review-shareholder-proposals-on-environmental-matters/ [https://perma.cc/5HDE-9PF6] ("[M]ost environmental proposals focused more generally on companies' commitment to adopting sustainability disclosure and policies"); Shirley Westcott, *2021 Proxy Season Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 5, 2021), https:/corpgovlaw.harvard.edu/2021/08/05/2021-proxy-season-review/?utm_source=pocket_mylist [https://perma.cc/RK2H-W95E] (listing different types of environmental and social proposals).

Although social and environmental proposals enjoyed little success until very recently, governance proposals have done well for years.[70] As a result, they have led to significant changes. Among these changes, 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.[71] Annual elections empower shareholders because it means an entire board can be replaced at once. Majority-voting requirements empower shareholders because they can defeat an incumbent even in an uncontested election.[72]

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.[73] 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.[74] These so-called proxy contests often succeed in replacing one or more board members.[75]

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%, for a total of 23%.[76] This is enough to make them, collectively, the largest shareholder in 88% of S&P 500 companies.[77] In addition, asset managers vote essentially all of their share while retail investors vote under one-third.[78] This means that the above figures understate the Big 3's influence. Scholars estimate that their ownership is more like 30% when their higher voting rate is considered.[79] When a few other giant asset managers are added into the mix, these numbers swell even further.

70. *See* sources cited *supra* note 68.

71. Marc S. Gerber, *U.S. Corporate Governance: From the Frying Pan into the Fire*?, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (Jan. 21, 2020), https://www.skadden.com/insights/publications/2020/01/2020-insights/us-corporate-governance [https://perma.cc/7WGT-KUMT].

72. *See* Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U CHI. L. REV. 1119, 1125-26 (2016).

73. *See* Schwartz, *supra* note 65, at 679.

74. *See id.*

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

76. Bebchuk & Hirst, The Power of the Big Three, *supra* note 10, at 9 tbl.2 (reporting ownership percentages from 2020).

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

78. *See* PROXYPULSE, 2019 PROXY SEASON REVIEW 5 (2019), https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2019-review.pdf [https://perma.cc/88K7-H2NW].

79. *See* Bebchuk & Hirst, The Power of the Big Three, *supra* note 10, at 59.

It might seem like overcounting to act as if the asset managers control the votes of the mutual funds that 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.[80]

In addition, the large asset managers vote alike. A recent empirical study tracked asset-manager voting on shareholder proposals from 2010 to 2015.[81] It found a high correlation across the industry. Asset managers voted the same way on shareholder proposals 79% of the time.[82] The study also grouped asset managers into different "parties" based on their voting patterns.[83] The Big 3, along with the other largest managers, belong to the Traditional Governance Party.[84] This party backs proposals like those mentioned above, which support the shareholder franchise.[85] Members of the Traditional Governance Party hold 66% of mutual fund assets[86] and vote together approximately 88% of the time.[87] It makes sense, therefore, to treat the Big 3, and other large asset managers, as a voting bloc.

This bloc dictates the outcomes of controversial shareholder proposals and proxy contests.[88] Conservatively assume that the Big 3 control 25% of the vote. For them to be on the losing side of a matter, the owners of 68% of the remaining shares would have to disagree with them.[89] This is an extremely high bar, particularly given that asset managers tend to vote

80. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, 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.").

81. Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* 9 (Eur. Corp. Governance Inst. L. Working Paper, Paper No. 560/2020, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039 [https://perma.cc/FH5R-RJPH].

82. *Id.* at 28.

83. *Id.* at 3.

84. This party also includes other significant fund managers, like Fidelity and JP Morgan. *Id.* at 54 tbl.9.

85. *Id.* at 30–31.

86. *Id.* at 34.

87. More precisely, for shareholder proposals, 12% of votes were cast against the majority position. *Id.* at 28; *see also* Bebchuk & Hirst, The Power of the Big Three, *supra* note 10, at 21 ("[W]hile the votes of the Big Three are generally not identical, they are significantly correlated.")

88. *See* Coates, *supra* note 1, at 14 (describing the Big 3's votes as "pivotal"); Fisch et al., *supra* note 10, at 26 (same).

89. 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%.

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.[90] 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.[91] 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.[92]

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.[93] According to this theory, the professional managers who control public companies are duty-bound to represent the owners of the corporation—its shareholders.[94] 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

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90. *See, e.g.*, Kahan & Rock, *supra* note 10, at 1778 (arguing that there is a "limited" number of "consequential" proxy contests).

91. The Big 3 held more than 20% of Exxon's shares. Steven Mufson, *A Bad Day for Big Oil*, WASH. POST (May 26, 2021, 10:24 PM), https://www.washingtonpost.com/climate-environment/2021/05/26/exxonmobil-rebel-shareholders-win-board-seats/ [https://perma.cc/BE22-43XR]. The three dissident candidates would not have survived a 20% shift to the three incumbents. *See* Exxon Mobil Corp. Current Report (Form 8-K) (June 2, 2021) (calculations on file with author).

92. 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, 7:57 AM), https:/www.reuters.com/article/us-dupont-trian-idUSKBN0NY1JI20150513 [https://perma.cc/X2EY-2Z2R] (reporting that "Trian won the majority of non-index institutions and would have prevailed had one of those three index funds voted differently").

93. *See* BERLE & MEANS, *supra* note 12, at 112–16.

94. 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) ("[C]orporations are legal entities that own themselves; shareholders merely own a contract with the corporation called a 'share,' just as bondholders own a contract with the firm called 'debt.'").

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.[95]

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.[96] The lost shareholder value has come to be known as "agency costs."[97]

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,[98] structural changes to corporate governance initiated through the shareholder-proposal process,[99] and a shift to stock-based compensation,[100] management is much more responsive to shareholders than in the past.[101]

Against this backdrop, socially minded shareholders pressure corporate management to change diversity and environmental practices,[102] while hedge-fund activists lean on them to increase stock prices.[103] Each year, activists launch hundreds of challenges,[104] and other shareholders make

95. *See* BERLE & MEANS, *supra* note 12, at 8–9, 86–87; Hu & Black, *supra* note 13, at 1013.

96. *See* BERLE & MEANS, *supra* note 12, at 8–9, 86–87; Jensen & Meckling, *supra* note 15, at 312–13.

97. *See* Rock, *supra* note 14, at 1913.

98. *See, e.g.*, NASDAQ STOCK MARKET RULES 5601, 5605 (2021), http://nasdaq.cchwallstreet.com/NASDAQ/Main/ [https://perma.cc/9V7C-JTZS]; NYSE LISTED COMPANY MANUAL § 303A.01 (2021), https://nyseguide.srorules.com/listed-company-manual [https://perma.cc/Q7VA-SSW9].

99. *See supra* note 68 and accompanying text.

100. *See* Theo Francis & Inti Pacheco, *From Tesla to GE, See How Much CEOs Made in 2020*, WALL ST. J. (June 1, 2021, 5:30 AM), https://www.wsj.com/articles/from-tesla-to-ge-see-how-much-ceos-made-in-2020-11622539802 [https://perma.cc/X5QS-P556]; Rock, *supra* note 14, at 1917–18, 1924.

101. *See* Rock, *supra* note 14, at 1917–26 (reviewing evidence of reduced agency costs); *id.* at 1926 ("the core shareholder–manager agency cost problem now seems largely under control").

102. *See* Paul Kiernan, S*EC Raises Bar for Shareholder Resolutions*, WALL ST. J. (Sept. 23, 2020, 5:32 PM), https://www.wsj.com/articles/sec-raises-bar-for-shareholder-resolutions-11600877050 [https://perma.cc/QQ4E-DU38].

103. *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, 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.").

104. *See* Schwartz, *supra* note 65, at 685.

hundreds of social and environmental proposals.[105] 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.[106] 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 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.[107]

105. *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 [https://perma.cc/6P8Z-XAGT].

106. *See supra* note 18 and accompanying text.

107. Fisch et al., *supra* note 10, at 38.

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.[108] 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.[109] They also benefit from spillover effects. Stock research for asset-allocation decisions should generate much of the knowledge necessary for informed voting.[110] 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,[111] 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 investments. Thus, the only way to improve performance and generate the increased profits that come with it is through monitoring their portfolio companies.[112] Since the Big 3 specialize in managing index funds, this might suggest an inclination towards stewardship.

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108. *Id.* at 39.

109. *See id.* at 38.

110. *See* Kahan & Rock, *supra* note 10, at 1800.

111. *See, e.g.*, Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged*, 78 J. FIN. 213, 214–15 (2022) finding that "a 1 percentage point increase in an institution's quarterly return predicts a highly significant 1.39 percentage point increase in net inflow over the subsequent 12 quarters").

112. *See* Fisch et al., *supra* note 10, at 32, 35.

It turns out, however, that even for the Big 3, the gains from stewardship are minimal. The discussion below shows that 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.[113]

Profitability dictates otherwise, however. It is hard to identify performance-enhancing improvements. Because their compensation depends on it, executives at public companies already have a 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.[114] 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.[115] Instead of getting their hands dirty, the large asset managers 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.[116]

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113. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2095.

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

115. *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).

116. 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

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.[117] The asset managers' gains are the fees associated with the activist-driven increase on this holding. In 2020, Vanguard's average fee was 0.09%, State Street's was 0.16%, and BlackRock's was 0.25%.[118]

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.[119] 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.[120] There is significant debate about whether such actions come at the expense of long-term gains.[121] One recent study found, for example, that "long-term returns [from activism] are insignificantly different from zero."[122] Thus, the asset managers' bump today may reverse in the future.

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.[123] Whether activism is a net positive depends on the asset manager's mix between stock and bond funds.

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their support—as an efficient allocation of corporate governance. *See* Gilson & Gordon, *supra* note 10, at 867.

117. *See* Bebchuk & Hirst, The Power of the Big Three, *supra* note 10, at 9 tbl.2 (reporting median ownership percentages of the Big 3 for the S&P 500).

118. *See* JOHNSON & DIBENEDETTO, *supra* note 45, at 15.

119. The math is $100,000,000*.1*.0009. Estimates of the dollar value of hedge-fund activism vary, but the above example may be generous. *See* Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUD. 536, 552, 551 tbl.3 (2019) (finding an immediate change to market value of $18.8 million that declines to $3.4 million one year later).

120. *See* Schwartz, *supra* note 65, at 680.

121. *See* deHaan et al., *supra* note 119, at 542–45 (reviewing empirical findings).

122. *Id.* at 564.

123. *See* John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407, 1439–40 (2019).

Activists also often push for a sale of the target company.[124] 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.[125] 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.[126] 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.[127] 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.[128] Managers of active funds might also profit by receiving quasi-inside information from corporate executives that aids in their stock picking.[129] 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.

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 de-staggering boards, typically disempower corporate executives in favor of shareholders.[130] Increasing management's accountability to shareholders may reduce agency costs, but it does not necessarily increase firm value.

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124. *See* Schwartz, *supra* note 65, at 680.

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

126. 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 (Euro. Corp. Governance Inst. L. Working Paper, Paper No. 566/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814 [https://perma.cc/67VA-K9P7].

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

128. *See* Pool et al., *supra* note 59, at 1780 ("Our results reveal significant favoritism toward affiliated funds.").

129. *See* Kahan & Rock, *supra* note 10, at 1810.

130. *See* Goshen & Levit, *supra* note 27, at 5, 35.

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.[131] 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.[132]

Since management quality varies across firms and across time, there is no one-size-fits-all approach to corporate governance.[133] 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.[134]

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.[135] Moreover, if the governance changes succeed in making targets more competitive, then this hurts competitor 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 are 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

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131. *See* Goshen & Squire, *supra* note 39, at 774; *see, e.g.*, Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475, 1480 (2018) (finding that the value of staggered boards is endogenous).

132. *See* Goshen & Squire, *supra* note 39, at 770 ("[C]areful empirical studies find no consistent relationship between the degree of shareholder empowerment and overall financial performance."); *id.* at 810–25 (surveying mixed empirical evidence on the value of varied corporate-governance structures).

133. *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.").

134. *See* Ronald Gilson, *Legal and Political Challenges to Corporate Purpose*, 31 J. APPLIED CORP. FIN. 18, 20 (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.").

135. *See* Rock, *supra* note 14, at 1926–30 (discussing shareholder-creditor agency costs).

decisions.[136] This is a plausible theory, but it lacks empirical support.[137] 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.[138] Some argue that these measures increase the value of target firms.[139] 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.[140]

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 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

136. *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 [https://perma.cc/RL4L-66M9] ("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.").

137. *See* Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?* 2 (Eur. Corp. Governance Inst. Working Paper No. 579/2021, 2021) (reviewing empirical evidence and finding that "increasing board diversity may well reduce investors' returns"). The SEC noted when blessing Nasdaq's board diversity rule that studies on the "effects of board diversity are generally inconclusive." Order Approving Proposed Rule Changes 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].

138. *See* Treviño et al., *supra* note 69.

139. Witold Henisz, Tim Koller & Robin Nuttall, *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 [https://perma.cc/8TY2-9EKA].

140. *See* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 5–6 (2020); Gordon, *supra* note 126, at 29.

pollution and climate change.[141] 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.[142] 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,[143] 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,[144] 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.[145] 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 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.[146] 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

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141. Elad L. Roisman, Comm'r, Sec. & Exch. Comm'n, Keynote Address at the Society for Corporate Governance National Conference (July 7, 2020), https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020#_ftnref13 [https://perma.cc/G765-WDCS] ("'E' and 'S' . . . matters tend to be more society, or stakeholder, focused.").

142. *See* Kahan & Rock, *supra* note 10, at 1793.

143. *See id.* at 1793–94.

144. *See* Steyer, *supra* note 61.

145. *See* Pool et al., *supra* note 59, 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).").

146. *See* Kahan & Rock, *supra* note 10, at 1796–97.

funds, they cannot outcompete other index funds by improving the performance of their portfolio firms.[147]

Beyond that, there is no reliable way to know exactly what competitor funds own. Mutual funds must publicly disclose their holdings every quarter,[148] but they file these reports up to sixty days from quarter end.[149] 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, they 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 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.

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147. *See* Lund, *supra* note 17, at 511.

148. *See* U.S. SEC. & EXCH. COMM'N, OMB. NO. 3235-0578, FORM N-Q, https://www.sec.gov/files/formn-q.pdf [https://perma.cc/GCJ6-AC38].

149. *See id.* at 1.

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 is 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.[150] 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.[151] 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 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.[152]

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150. *See supra* note 80 and accompanying text.

151. 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 42.

152. HORTENSE BIOY, ALEX BRYAN, JACKIE CHOY, JOSE GARCIA-ZARATE & BEN JOHNSON, MORNINGSTAR, 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 [https://perma.cc/PLW9-52RJ] ("Index portfolio managers . . . have no say in the voting of their portfolio holdings.").

The size of the stewardship teams is also telling. For example, Vanguard's team is 35,[153] BlackRock's is 60.[154] This is far too few people for the vast number of votes these asset managers tally.[155] BlackRock voted on more than 165,000 management and shareholder proposals in the 2021 proxy season.[156] 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."[157] 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.[158] BlackRock's is run by a former senior official from the Bank of England.[159] Moreover, the stewardship teams do not report to the investment side of the asset manager. They are part of the legal and compliance departments.[160] The separation of voting from investing suggests that the stewardship teams are not there to vet proposals based on their impact of portfolio value.

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.[161]

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153. *Vanguard Publishes 2020 Annual Investment Stewardship Report*, VANGUARD (Sept. 15, 2020), https://corporate.vanguard.com/content/corporatesite/us/en/corp/who-we-are/pressroom/Press-Release-VG-2020-Investment-Stewardship-Annual-Report-Appointment-091520.html [https://perma.cc/PDW3-9XTM].

154. Dawn Lim, *BlackRock Starts to Use Voting Power More Aggressively*, WALL ST. J. (Apr. 30, 2021, 5:30 AM), https://www.wsj.com/articles/blackrock-takes-aggressive-posture-on-esg-proxy-votes-11619775002?mod=article_inline [https://perma.cc/455S-9HRN].

155. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2076–77 (discussing the small size of the Big 3's stewardship teams in relation to their holdings).

156. BLACKROCK, PURSUING LONG-TERM VALUE FOR OUR CLIENTS: BLACKROCK INVESTMENT STEWARDSHIP 15 (2021), https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf [https://perma.cc/Q4XF-ZH93].

157. *See* VANGUARD, *supra* note 38, at 3.

158. Lim & Baer, *supra* note 2.

159. *Sandra Boss*, BLACKROCK, https://www.blackrock.com/corporate/biographies/sandy-boss [https://perma.cc/8HX2-U6SM] (last visited Sept. 19, 2022).

160. Charles Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, HARV. L. SCH. F. ON CORP. GOVERNANCE (2010), https://corpgov.law.harvard.edu/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/ [https://perma.cc/EX4V-LFKM] ("The internal 'corporate governance' staff typically is entirely separate from the portfolio managers and reports either on to the general counsel or senior compliance officer of the investment manager, not to the investing function.").

161. *See id.* at 5–6 ("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.").

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 (1924–2003)*

The asset-management industry has a long history of sleepy stewardship. For the first 80 years of its existence,[162] how asset managers voted was 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.[163] Stewardship was apparently such an afterthought that Vanguard did not establish a team devoted to it until 2001.[164] In advancing voting regulations two years later, the SEC cited the industry's history of corporate-governance complacency as a rationale for intervention.[165] For 80 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.[166] 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,

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162. The first U.S. mutual fund was founded in 1924. MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW 7 (2d ed. 2011).

163. *See, e.g.*, James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 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 114, at 1469 ("[D]espite 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) (to be codified) ("Traditionally, mutual funds have been viewed as largely passive investors, reluctant to challenge corporate management on issues such as corporate governance.").

164. *Vanguard Publishes 2020 Annual Investment Stewardship Report*, *supra* note 153.

165. *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 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 . . . .").

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

and to tell clients how they may obtain information about how the [asset manager] has actually voted their proxies."[167] 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.[168] Related rulemaking required that mutual funds report annually how they vote on a new form, Form N-PX.[169]

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.[170] 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.[171] 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, asset managers heavily relied on their advice,[172] and these firms were largely antagonistic toward management. Proxy advisors encouraged asset managers to support things like de-staggered boards and majority voting in director elections, and they abided.[173] As the influence and power of proxy advisors drew regulatory scrutiny,[174] asset managers began to grow their in-house stewardship departments,[175] which continued to support measures that

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

168. *Id.* ("The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.") (citations omitted).

169. *See* 17 C.F.R. § 274.129 (2020); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. at 6569.

170. *See* Proxy Voting by Investment Advisors, 68 Fed. Reg. at 6586.

171. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 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.").

172. *See* Cotter et al., *supra* note 163, at 55.

173. *See id.*

174. *See generally* Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982, 43011 (July 22, 2010); SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/investment/slb20-proxy-voting-responsibilities-investment-advisers [https://perma.cc/LNZ7-ZUMF]; Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55082 (Sept. 3, 2020).

175. *See* BIOY ET AL., *supra* note 152, at 19.

empowered shareholders and limited the discretion of managers and board members.[176]

During this time, however, asset managers never became activists. They never launched proxy contests or nominated directors.[177] 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.[178] They also rarely supported environmental or social proposals during this period.[179] 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.[180] But BlackRock infrequently supported measures consistent with this view. [181]

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.[182] The reversal is stunning. In 2020, BlackRock voted for 6% of environmental proposals.[183] This was a drop from 8% the previous year.[184] In 2021, the firm supported 64%.[185]

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176. *See* Bubb & Catan, *supra* note 81, at 30–31.

177. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2095–2101.

178. *See* Gretchen Morgensen, *Your Mutual Fund Has Your Proxy, Like It or Not*, N.Y. TIMES (Sept. 23, 2016), https://www.nytimes.com/2016/09/25/business/your-mutual-fund-has-your-proxy-like-it-or-not.html [https://perma.cc/YYR2-STSH].

179. *See* Bubb & Catan, *supra* note 81, at 70 fig.9 (showing that members of the Traditional Governance Party usually vote with management on social proposals); Caleb N. Griffin, *Environmental & Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167, 167 (2020) (finding Big 3 support for such proposals at between 7.1% and 22.7% during the 2018–2019 proxy year).

180. *See* Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (Jan. 18, 2022), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/T8UN-S84C] (letter from CEO of BlackRock).

181. *See, e.g.*, Press Release, 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 [https://perma.cc/RLL8-7TB2].

182. *See* Lim, *supra* note 154.

183. *See* Mooney, *supra* note 31. The *Wall Street Journal* calculates that BlackRock supported a similarly paltry 11% of environmental proposals in 2020. *See* Lim & Baer, *supra* note 2.

184. Mooney, *supra* note 31. 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, 8:50 AM), https://www.cnbc.com/2019/10/13/blackrock-vanguard-found-religion-on-climate-doubts-are-growing.html [https://perma.cc/RDR3-Y4LD]. In 2020, they voted against ten out of twelve proposals that Climate Action considered key votes. *See* Schatz, *supra* note 181.

185. Lim & Baer, *supra* note 2.

Vanguard voted for 22% of environmental proposals in 2020 and 46% in 2021.[186]

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 rose from 15% to 29.6% over that same period.[187] BlackRock's support for diversity-related proposals shot from 13.6% to 68.2%.[188] 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.[189]

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."[190] Because of the increased support for environmental and social issues, Insightia called the 2021 proxy season "revolutionary."[191]

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 they are detrimental if management is competent and creative.[192] 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.[193]

In addition, profits cannot explain the sudden support for social and environmental matters. As noted above, their tie to firm profits is

186. INSIGHTIA, PROXY VOTING SEASON SNAPSHOT 2021 12 (2021).

187. *Id.* at 17.

188. *Largest Asset Managers' Support for Shareholder Votes on Climate and Diversity Rises Sharply*, INST. ASSET MANAGER (Sept. 22, 2021, 6:32 PM) (on file with author).

189. INSIGHTIA, *supra* note 186, at 12, 17.

190. 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-chartshttps://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts [https://perma.cc/7WYC-2MML].

191. INSIGHTIA, *supra* note 75, at 3.

192. *See supra* text accompanying note 131.

193. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2089–90.

speculative.[194] 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.[195] This again suggests they are not policing their firms for performance improvements.

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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.

Others troubled by asset-manager stewardship jump directly to reform proposals.[196] 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.

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194. *See supra* note 137 and accompanying text.

195. Tim McLaughlin & Ross Kerber, *Index Funds Invest Trillions but Rarely Challenge Management*, REUTERS (Oct. 8, 2019, 5:20 AM), https://www.reuters.com/article/us-usa-funds-index-specialreports-idUSKBN1WN107 [https://perma.cc/YR4V-4MBZ] (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.").

196. *See, e.g.*, Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2116–2131; Lund, *supra* note 17, at 523–33.

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.[197] Industries employ thousands of lobbyists to argue for their interests on specific bills.[198] The legitimacy of these activities has long been a source of concern.[199]

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 began subsidizing employee health-care coverage;[200] when faced with increasing scrutiny about environmental risks and impacts, companies began producing sustainability reports;[201] and when faced with a backlash over its role in spreading misinformation, Facebook set up an oversight board.[202] 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.

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197. *See* Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 365 (2010) (overruling restrictions on corporate political spending); *see generally* Ciara Torres-Spelliscy, *Corporate Campaign Spending: Giving Shareholders a Voice*, BRENNAN CTR. FOR JUST. (2010), https://www.brennancenter.org/sites/default/files/2019-08/Report_Corporate-Campaign-Spending-Giving-Shareholders-Voice.pdf [https://perma.cc/2SP3-37FV]. The total amount of political spending is unknown. *Id.* at 10.

198. *See* Lee Fang, *Where Have All the Lobbyists Gone?*, NATION (Feb. 19, 2014), https://www.thenation.com/article/archive/shadow-lobbying-complex/ [https://perma.cc/7SQS-UUSM].

199. *See generally, e.g.*, Torres-Spelliscy, *supra* note 197.

200. *See* Anna Cooban, *Uber Said it Would Help Pay Drivers' Healthcare–Then Withdrew the Offer 2 Weeks Later, Calling it a Mistake*, BUS. INSIDER (June 11, 2021, 7:19 AM), https:/www.businessinsider.com/uber-driver-health-insurance-offer-mistake-california-2021-6 [https://perma.cc/M7V2-EHCL].

201. *See 90% of S&P 500 Index Companies Publish Sustainability Reports in 2019. G&A Announces in its Latest Annual 2020 Flash Report*, GLOBAL NEWSWIRE (July 16, 2020, 9:35 AM), 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 [https://perma.cc/XM3M-B55Q] (detailing the rise in sustainability reporting).

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

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.[203] 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 seep 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 in the United States. 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.[204] As noted earlier, an article in *The Atlantic* asked whether indexing is worse than Marxism.[205] 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.[206] The concern is that, since indexing does not involve stock-picking, stock prices are unmoored from fundamental value.[207]

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

204. *See supra* note 22 and accompanying text.

205. *See* Lowrey, *supra* note 22.

206. *Id.*

207. *See id.*; Coates, *supra* note 1, at 19–20 ("Indexation may have blunted price signals.").

Antitrust scholars have focused on "horizontal shareholdings."[208] 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.[209] The result is reduced competition and increased prices. Emerging empirical evidence tends to support this fear.[210] For example, a leading study showed that horizontal shareholdings in airlines raised ticket prices three to seven percent.[211] No one specifically alleges anticompetitive behavior,[212] but the effect can materialize without any coordination. Understanding these incentives, executives might simply fail to compete on price.[213]

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.[214] Professor John Coates gives voice to the modern-day version of this worry. He argues that soon about twelve people (the heads of the large asset managers) will likely have "practical power over the majority of U.S. companies."[215] This prospect, he argues, "poses a legitimacy and accountability issue of the first order."[216] In a similar vein, the recently deceased founder of Vanguard, John Bogle, argued that the concentration of voting is not in "the national interest."[217]

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208. *See supra* note 23 and accompanying text.

209. 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. 22, 2019), https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies [https://perma.cc/5XJF-UDYY].

210. *See* Azar et al., *supra* note 23, at 1559 (showing higher prices in the airline industry); Melissa Newham, Jo Seldeslachts & Albert Banal-Estañol, *Common Ownership and Market Entry: Evidence from the Pharmaceutical Industry* 34–35 (DIW Berlin Discussion Paper, Paper No. 1738, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194394 [https://perma.cc/K6FQ-2YBG] (showing higher prices in the pharmaceutical industry); José Azar, Sahil Raina & Martin Schmalz, Ultimate Ownership and Bank Competition 1 (May 8, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252 [https://perma.cc/4ZGK-9LUD] (showing higher banking fees).

211. *See* Azar et al., *supra* note 23, at 1517.

212. *See* Morley, *supra* note 123, at 1410 n.17.

213. *See* Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, 82 OHIO ST. L.J. 1, 22–23 (2021).

214. *See* Roe, *supra* note 114, at 1471.

215. *See* Coates, *supra* note 1, at 1.

216. *Id.* at 2, 19.

217. *See* John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018, 10:15 AM), https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551 [https://perma.cc/7T56-5ZMC].

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.[218] 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.[219] Before BlackRock began broadly supporting environmental proposals in 2021, it had attracted condemnation from Democratic Senators and Congresspersons for its voting record.[220] Five 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."[221] Senator Warren signed the letter and penned her own expressing similar sentiments with three other Democratic Senators.[222] Pressure on climate-related issues is also coming directly from the Biden administration.[223]

Now that the Big 3 have reversed their position, a different group of politicians are upset.[224] A group of Republican Senators sent a letter

218. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2037.

219. *See, e.g.*, Patrick Greenfield, *World's Top Three Asset Managers Oversee $300bn Fossil Fuel Investments*, GUARDIAN (Oct. 12, 2019, 7:00 AM), https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments [https://perma.cc/J2Z8-8FP2] ("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 . . . .").

220. *See* Schatz, *supra* note 181; Letter from Elizabeth Warren, U.S. Senator, to Larry Fink, Chairman & CEO, BlackRock (Feb. 25, 2020), https://www.warren.senate.gov/imo/media/doc/2.25.2020%20-%20Letter%20from%20Sens.%20Warren%20Whitehouse%20Booker%20%20Van%20Hollen%20to%20Larry%20Fink%20BlackRock.pdf [https://perma.cc/V2TQ-7DYQ].

221. Schatz, *supra* note 181 (quoting Letter from Brian Schatz, Sheldon Whitehouse, Tammy Baldwin, Elizabeth Warren & Martin Heinrich, U.S. Senators, to Larry Fink, Chairman & CEO, BlackRock (Oct. 8, 2020)).

222. *See* Warren, *supra* note 220.

223. *See* Dawn Lim, *Republicans Ask Federal Retirement Plan for Details on BlackRock, StateStreet's Votes*, WALL ST. J. (July 1, 2021, 2:10 PM), https://www.wsj.com/articles/republicansask-federal-retirement-planfor-details-on-blackrock-state-streets-votes-11625139430 [https://perma.cc/MRE9-9EE7] ("The Biden administration is . . . pressing money managers to be more attentive to climate risks"); Climate-Related Financial Risk, Proclamation No. 14030, 86 Fed. Reg. 27967 (May 25, 2021) (addressing "the failure of financial institutions to appropriately and adequately account for" climate risk).

224. *See* Lim, *supra* note 223.

expressing their concern that BlackRock and State Street are "increasingly incorporating left-leaning environmental, social and corporate governance" priorities into their proxy voting.[225] They argue that this shift reflects their personal views rather than the best interests of their investors.[226] 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,[227] limit the extent to which they can invest in multiple companies in the same industry,[228] take away or cap their voting rights,[229] require shareholder input for voting,[230] mandate stewardship expenditures,[231] force divestiture of their 401(k) businesses,[232] impose stewardship codes,[233] and mandate procedures for decentralized fund-level voting.[234] The Big 3 are constantly defending themselves against these proposals and the related critiques.[235]

As the direct attacks from politicians illustrate, concerns about the asset-management industry stretch beyond academic handwringing. In late 2020, the Federal Trade Commission (FTC) proposed rules that would increase reporting obligations in connection with horizontal shareholdings.[236] And

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225. *Id.*

226. *See id.*

227. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2129; Goshen & Levit, *supra* note 27, at 11; Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It*, AM. ECON. LIBERTIES PROJECT (Nov. 2020), https://www.economicliberties.us/our-work/new-money-trust/ [https://perma.cc/H8NR-3SB3].

228. *See* Posner et al., *supra* note 23, at 670.

229. *See* Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954, 983 (2020); Lund, *supra* note 17, at 528.

230. *See* Griffin, *supra* note 229, at 992–94.

231. *See* Bebchuk & Hirst, *Future of Corporate Governance*, *supra* note 10, at 2121.

232. *See id.* at 2122–23.

233. *See* Coates, *supra* note 1, at 20–21.

234. *See* Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: TENN. J. BUS. L. 175, 200 (2017).

235. *See* Matt Egan, *BlackRock and the $15 Trillion Fund Industry Should be Broken Up, Antimonopoly Group Says*, CNN (Nov. 24, 2020, 1:25 PM), https://edition.cnn.com/2020/11/24/business/blackrock-vanguard-state-street-biden/index.html [https://perma.cc/AKR5-UEL5] ("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*, INV. CO. INST. (Oct. 2, 2018), https://www.ici.org/viewpoints/view_18_passthrough_voting [https://perma.cc/FJ4B-8AL9]; Lim, *supra* note 223; Novick, *supra* note 10 (response to Bebchuk and Hirst's critique); Mallow, *supra* note 10 (same).

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

regulators have singled out the finance industry and asset managers for special antitrust scrutiny.[237]

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."[238] In March 2021, SEC Commissioner Lee gave a speech on problems with asset-manager voting to the Investment Company Institute (ICI), the industry's lobbying association, at its annual conference.[239] The ICI did not hold the conference in 2020, but in 2019, Commissioner Roisman made similar comments.[240] Two years earlier, then-SEC-Chairman Clayton remarked, "[o]ften 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?"[241]

The SEC is also making regulatory moves. In 2019, the agency revised guidance to asset managers on the proper exercise of their proxy obligations;[242] then supplemented them just one year later.[243] 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.[244] In 2021, the SEC Division of Examinations issued a "Risk Alert" in which it expressed concern about "inconsistencies between public ESG-related

237. *See* David McLaughlin & Annie Massa, *Antitrust Regulators Ask Whether Index Funds Deserve More Scrutiny*, BLOOMBERG (Dec. 17, 2020, 4:00 AM), https://www.bloomberg.com/news/articles/2020-12-17/index-funds-antitrust-regulators-weigh-whether-they-deserve-more-scrutiny [https://perma.cc/6NRR-RRRJ]; *see generally* Promoting Competition in the American Economy, Exec. Order No. 14,036, 86 Fed. Reg. 36987 (July 14, 2021).

238. *See* Jackson, *supra* note 1.

239. *See* Allison Herren Lee, Acting Chair, Sec. & Exch. Comm'n, 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 [https://perma.cc/RY47-YNZU].

240. *See* Elad L. Roisman, Comm'r, Sec. & Exch. Comm'n, Keynote Remarks: ICI Mutual Funds and Investment Management Conference (Mar. 18, 2019), https://www.sec.gov/news/speech/speech-roisman-031819 [https://perma.cc/L22E-QDFY].

241. *See* Jay Clayton, Chairman, Sec. & Exch. Comm'n, Remarks at the PLI 49th Annual Institute on Securities Regulation - New York, N.Y.: Governance and Transparency at the Commission and in Our Markets (Nov. 8, 2017) (citation omitted), https://www.sec.gov/news/speech/speech-clayton-2017-11-08 [https://perma.cc/V9L6-FJWH].

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

243. Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 85 Fed. Reg. 55155 (Sept. 3, 2020).

244. *See id.* at 55,155. On the same day as the supplement, the SEC released new rules for proxy advisors. *See* Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55082 (Sept. 3, 2020).

proxy voting claims and internal proxy voting policies and practices."[245] Months later, the agency issued proposed rules to amend Form NP-X to render disclosures of proxy voting more accessible.[246] 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.[247]

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. The letter from Republican Senators discussed above suggests that Congressional involvement might also loom.[248] 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 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.[249] 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.

245. SEC Div. of Examinations, *ESG Risk Alert* 4 (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf [https://perma.cc/EXZ8-57JD].

246. *See generally* Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, 86 Fed. Reg. 57478 (Oct. 15, 2021).

247. *See id.* at 57,503.

248. *See infra* text accompanying notes 225–226.

249. *See* Roe, *supra* note 114, at 1508 ("Corporate culture and history cannot be so easily reversed.").

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.[250]

a. The Revenue Act of 1936

Asset managers launched the first U.S. mutual funds in 1924.[251] 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.[252] In 1935, however, President Roosevelt proposed taxing "intercorporate" dividends.[253] 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 mutual fund business.[254] In announcing the plan, though, Roosevelt left the door open to leave mutual funds untaxed if they submitted to "public regulation."[255]

The public regulation came in the Revenue Act of 1936 (the "36 Act").[256] 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.[257] 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.[258] 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

250. *See id.* at 1490; FINK, *supra* note 162, at 53 ("Mutual funds at this time were still viewed as the stepchild of the investment company industry.").

251. FINK, *supra* note 162, at 10.

252. *See id.* at 26.

253. *Id.*

254. *See id.* at 29 ("Without such [tax] treatment, it is doubtful that mutual funds would have continued to exist, much less flourish."); Roe, *supra* note 114, at 1510 ("Without tax exemption, the funds could not survive.").

255. FINK, *supra* note 162, at 26.

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

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

258. Roe, *supra* note 114, at 1488 ("The SEC testified that a mutual fund's *only* positive function was to provide diversification; any extension risked thievery.") (emphasis in original).

fund can own far more than 10% of a single small firm and still be diversified.[259]

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.[260] 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.[261] 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. [262]

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.[263] 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."[264] Similar suspicions about competence and impropriety echo today.

This historical perspective supports this Article's argument. History shows that Congress intentionally stripped asset managers of the incentive to influence corporate affairs. This accords with the theoretical and empirical conclusion reached above—that asset managers have little reason to care about stewardship. It also 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.

259. *See* Roe, *supra* note 114, at 1475.
260. *Id.* at 1501.
261. *See id.* at 1486.
262. *See id.*
263. *See id.* at 1472.
264. *Id.* at 1473.

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.[265] They also strongly lobbied for the 36 Act.[266] 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 (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.[267] This is a departure from other aspects of securities regulation, which typically mandate disclosure but do not interfere with operations. The scope of the ICA also cannot be explained as a comprehensive response to widespread abuse. Mutual fund managers had not been accused of serious impropriety.[268] Mutual funds were thought to be overleveraged,[269] which was addressed through a provision that significantly limited their ability to borrow,[270] 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.[271]

As with the 36 Act, the industry was heavily involved in the legislative process. They opposed, and, in response, the SEC removed, significant

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265. *See* FINK, *supra* note 162, at 27–28.

266. *See* Roe, *supra* note 114, at 1499.

267. *See* FINK, *supra* note 162, at 46 (describing the ICA as an "extremely detailed statue 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").

268. *See* FINK, *supra* note 162, 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.").

269. *See id.*

270. *See* 15 U.S.C. § 80a-18(a) (2020).

271. *See id.* at § 80a-5(b)(1).

limitations. For instance, the SEC wanted a fund cap of $150 million[272] and a limitation on the number of funds overseen by a single asset manager.[273] Both died in the face of industry opposition.[274]

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.[275] 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.[276] 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.[277]

The weak grounds for extensive regulation, along with the industry's strong support, suggests that an interest-group lens provides a compelling explanation for the ICA.[278] 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, "[t]he existing big companies have legal departments quite capable of handling the situation; but on careful consideration one wonders if new men would not take one look at the voluminous statute, teeming with hundred-word sentences, and then call the whole thing off."[279]

Perhaps because of the additional credibility that accompanied the new regulatory tome, mutual funds expanded greatly after the ICA.[280] In 1959, *Time* magazine referred to them as "the fastest-growing . . . phenomenon of the U.S. financial world."[281] Mutual fund assets in 1965 were 38 times greater than in 1940.[282]

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272. Roe, *supra* note 114, at 1473.

273. *See* FINK, *supra* note 162, at 40.

274. *See id.* at 40–42; Roe, *supra* note 114, at 1473–74.

275. *See* 15 U.S.C. § 80a-22(d); FINK, *supra* note 162, at 43; Roe, *supra* note 114, at 1489. What this means in practice is that mutual fund dealers who charge a commission, referred to as a "load," must charge all investors the same load. *See* James V. Heffernan & James F. Jorden, *Section 22(d) of the Investment Company Act of 1940—Its Original Purpose & Present Function*, 1973 DUKE L.J. 975, 976–77.

276. *See* FINK, *supra* note 162, at 33–34, 36 (discussing "strong industry support" for the ICA).

277. *See id.* at 34.

278. *See generally* Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 584 (2009).

279. Timothy Peter Ansberry, *Investment Company Act of 1940*, 29 GEO. L.J. 614, 626 (1941).

280. *See* FINK, *supra* note 162, at 56.

281. *Wall Street: The Prudent Man*, TIME (June 1, 1959), http://content.time.com/time/subscriber/article/0,33009,811169,00.html [https://perma.cc/2Q2T-LFPW].

282. FINK, *supra* note 162, at 58.

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,[283] is an aggressive and powerful lobbyist.[284] 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 statements[285]—a simple and direct way to protect investors from otherwise invisible fees. It died amid fierce industry opposition.[286] The SEC has also tried to require that funds disclose fees directly to investors, but it too failed in the face of ICI resistance.[287]

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.[288] Asset managers fought the requirements off.[289] One of the most important parts of Dodd-Frank increased oversight over systemically important financial institutions.[290] Despite their trillions of dollars in holdings, large asset

283. *Id.* at 50.
284. *See* Paula Dwyer, Amy Borrus & Lauren Young, *Breach of Trust*, BLOOMBERG BUSINESSWEEK (Dec. 14, 2003, 11:00 PM), https://www.bloomberg.com/news/articles/2003-12-14/breach-of-trust [https://perma.cc/CZ89-9XZ4].
285. *See* Mutual Funds Integrity and Fee Transparency Act, H.R. 2420, 108th Cong. (2003).
286. *Your Money at Work—Against You*, FORBES (Sept. 15, 2003, 12:00 AM), https://www.forbes.com/forbes/2003/0915/176sidebar/?sh=3069f3c769c4 [https://perma.cc/6ZCW-GPL5].
287. *See* Dwyer et al., *supra* note 284.
288. Pub. L. No. 107-204, 116 Stat. 745, 789 (2002).
289. *See* Dwyer et al., *supra* note 284.
290. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. 111-203, § 111, 124 Stat. 1376, 1392 (2010) (establishing the Federal Stability Oversight Council (FSOC)); Steele, *supra* note 227, at 25 (describing FSOC's role).

managers won an exemption after extensive lobbying.[291] The close call led the industry to further increase its lobbying efforts after 2008.[292]

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.[293] For the most part, however, the ICI gets its way. According to one SEC employee, "[s]ometimes it seems the SEC and the ICI work so closely together that they forget where one's job begins and the other's ends."[294]

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*, "[f]or decades, mutual funds were left alone because they convinced enough people that they were squeaky clean and had shareholders' interests at heart."[295]

d. BlackRock's Deep Political Ties

BlackRock, the industry leader with $9.5 trillion in assets under management, is a special case.[296] It hires from, and places people with, the highest levels of government. It is also deeply involved in government affairs[297] and lobbies extensively.[298] BlackRock's efforts are self-serving, but they undoubtedly generate positive externalities for other industry members, particularly the other members of the Big 3.

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291. *See* Egan, *supra* note 235; Steele, *supra* note 227, at 25–26. The issue is still alive. *See* David Goldman, *Elizabeth Warren Grills Janet Yellen: Why Isn't BlackRock 'Too Big to Fail?'*, CNN (Mar. 24, 2021, 3:10 PM), https://edition.cnn.com/2021/03/24/investing/elizabeth-warren-janet-yellen-blackrock/ index.html [https://perma.cc/DEE9-JEJM].

292. *See* Goshen & Levit, *supra* note 27, at 49–50.

293. *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 284 (describing "fierce" industry opposition to the rules).

294. Dwyer et al., *supra* note 284.

295. *Id.*

296. Saqib Iqbal Ahmed & Sohini Podder, *BlackRock Profit Beats as Assets Grow to a Record $9.5 Trillion*, REUTERS (July 14, 2021, 7:03 PM), https://www.reuters.com/business/blackrock-quarterly-profit-jumps-28-2021-07-14/ [https://perma.cc/JT5G-XAKU].

297. *See, e.g.*, Jeanna 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 [https://perma.cc/3JWN-N5WP].

298. *See* Yeganeh Torbati, *Two Biden Aides Will Recuse on BlackRock Issues as Past Ties Pose Questions*, WASH. POST (Jan. 2, 2021, 4:35 PM), https://www.washingtonpost.com/business/2021/01/02/blackrock-biden/ [https://perma.cc/FG5W-3UQ5] ("'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.'").

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);[299] 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).[300] Though BlackRock's personnel ties tilt liberal, it also supplied a senior Treasury Department official to the Trump administration.[301]

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.[302] BlackRock recently hired Dalia Blass from the SEC's investment management division (the group that regulates asset managers) to oversee groups related to sustainability and stakeholder capitalism.[303] Coryann Stefansson, formerly at the Federal Reserve Bank of New York, worked in BlackRock's financial markets advisory unit from 2016 to 2019.[304]

Finally, Larry Fink is talked about as a potential treasury secretary,[305] and he and BlackRock are routinely consulted on the most important matters of economic policy.[306] Most recently, former Federal Reserve Chairman Mnuchin called Mr. Fink five times over one weekend to consult on the

299. *See* Rebecca Ungarino, *Here Are 9 Fascinating Facts to Know About BlackRock, the World's Largest Asset Manager*, INSIDER (Mar. 10, 2021 3:39 PM), https://www.businessinsider.com/what-to-know-about-blackrock-larry-fink-biden-cabinet-facts-2020-12 [https://perma.cc/8B4Z-RJGN].

300. *Wally Adeyemo*, U.S. DEP'T TREASURY, https://home.treasury.gov/about/general-information/officials/Wally-Adeyemo [https://perma.cc/HMD4-RCTP].

301. *See* Ryan Tracy, *Meet Craig Phillips, the Man in Charge of Trump's Review of Wall Street Rules*, WALL ST. J. (Apr. 24, 2017. 3:30 PM), https://www.wsj.com/articles/meet-craig-phillips-the-man-in-charge-of-trumps-review-of-wall-street-rules-1493026201 [https://perma.cc/7UNE-S6FR].

302. *See* Ungarino, *supra* note 299.

303. *Id.*

304. *Id.*

305. Ed. Bd., Opinion, *Larry Fink's Political Purgatory*, WALL ST. J. (May 22, 2020, 7:20 PM), https://www.wsj.com/articles/larry-finks-political-purgatory-11590189627 [https://perma.cc/AR3T-LPG8].

306. *See* Annie Massa & Caleb Melby, *In Fink We Trust: BlackRock is Now 'Fourth Branch of Government'*, BLOOMBERG (May 21, 2020, 4:00 AM), https://www.bloomberg.com/news/articles/2020-05-21/how-larry-fink-s-blackrock-is-helping-the-fed-with-bond-buying [https://perma.cc/UF4A-JSYL].

government's response to the COVID pandemic.[307] Because of all this, BlackRock has been referred to as the "fourth branch of government."[308]

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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 attention. The industry's early response was to outsource voting to proxy advisory firms.[309] As scrutiny of this practice built, they formed modest in-house stewardship departments.[310] 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

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307. *See* Smialek, *supra* note 297. At the beginning of the pandemic, BlackRock managed a large bond-buying program on behalf of the Federal Reserve. *See* Dawn Lim, *Federal Reserve Taps BlackRock to Purchase Bonds for the Government*, WALL ST. J. (Mar. 24, 2020, 5:37 PM), https://www.wsj.com/articles/federal-reserve-taps-blackrock-to-purchase-bonds-for-the-government-11585085843 [https://perma.cc/Y3LZ-7UTF].

308. Massa & Melby, *supra* note 306 (quoting Professor Birdthisle). BlackRock's influence extends to Europe as well. *See* Jordan Pouille*, Blackrock: The Financial Leviathan that Bears Down on Europe's Decisions*, INVESTIGATE EUR. (Apr. 17, 2019), https://www.investigate-europe.eu/en/2019/blackrock-the-financial-leviathan-that-bears-down-on-europes-decisions [https://perma.cc/ZW7D-2KCC].

309. *See* Cotter, *supra* note 163, at 55.

310. *See* BIOY ET AL., *supra* note 152, at 19.

began to back proposals increasing shareholder power at their portfolio firms. Then, in 2021, they began to support environmental and social proposals.[311]

Supporting measures that empower shareholders is ever popular with regulators.[312] Congress and the SEC have imposed rules that require independent audit committees[313] and allow shareholders to cast non-binding votes on executive compensation.[314] The SEC also recently proposed rules that would require companies to use a "universal proxy," which would make it easier for shareholders to elect insurgent directors.[315] In addition, the SEC's motivation for requiring public disclosure of fund proxy votes was to improve shareholder oversight of public companies.[316] The SEC is therefore thrilled when asset managers further its efforts by voting for measures that give shareholders more influence.[317]

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,[318] 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 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.[319] This more than anything else signals that it views the practice positively.

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311. *See supra* Part II.D.2.

312. *See, e.g.*, Mary Jo White, Chair, Sec. & Exch. Comm'n, Keynote Address at the International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability (June 27, 2016), https://www.sec.gov/news/speech/chair-white-icgn-speech.html [https://perma.cc/TZB3-FAVD] (referring to measures such as de-staggered boards as "success stories").

313. *See* 15 U.S.C. § 78j-1(m)(1) (2020).

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

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

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

317. *See, e.g.*, Mary Jo White, *supra* note 312 (lauding the role of institutional investors in supporting shareholder rights).

318. *See supra* note 133 and accompanying text.

319. *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', Lawyers Warn*, FIN. TIMES (July 23, 2020, 4:00 AM), https://www.ft.com/content/1968c32d-5ac0-4502-8af8-7d45ec39791a [https://perma.cc/3YQZ-YV57]; Alicia McElhaney, *Why the SEC May Have Scrapped*

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 (DOL) during Trump's administration adopted rules that forbid consideration of ES issues when companies select investment alternatives for 401(k) participants,[320] and forbid companies from considering such issues when exercising voting authority over 401(k) assets.[321] The SEC also enacted rules that made it more difficult to make ES proposals,[322] and issued guidance making it easier for companies to challenge them.[323]

The Biden administration is just the opposite. Environmental and social issues are central to its agenda, and agency actions reflect that. The DOL indicated that it will not enforce the aforementioned Trump-era rules,[324] and the SEC has reversed its Trump-era guidance and eased the path for shareholder proposals.[325] The SEC has also prioritized rulemaking that

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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 [https://perma.cc/GK2R-2V73].

320. *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72864 (Nov. 13, 2020).

321. *See generally* Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81658 (Dec. 16, 2020).

322. 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 SEC Rule Will Limit Their Influence*, WASH. POST (Sept. 25, 2020, 11:17 AM), https://www.washingtonpost.com/business/2020/09/25/sec-shareholder-rule/ [https://perma.cc/A9UN-V8L2].

323. *See* SEC Staff Legal Bulletin No. 14I, SEC Div. of Corp. Fin. (Nov. 1, 2017), https://www.sec.gov/corpfin/staff-legal-bulletin-14i-shareholder-proposals [https://perma.cc/ 9X5R-NJYX]; Shareholder Proposals: SEC Staff Legal Bulletin No. 14J, SEC Div. of Corp. Fin. (Oct. 23, 2018), https://www.sec.gov/corpfin/staff-legal-bulletin-14j-shareholder-proposals [https://perma.cc/P2YP-ZTUY]; Shareholder Proposals: SEC Staff Legal Bulletin No. 14K, SEC Div. of Corp. Fin. (Oct. 16, 2019), https://www.sec.gov/corpfin/staff-legal-bulletin-14k-shareholder-proposals [https://perma.cc/RF98-VED3].

324. *See* Emp. Benefits Sec. Admin., *U.S. Department of Labor Statement Regarding Enforcement of Its 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 [https://perma.cc/P8U8-DNJ3]; Ross Kerber, *Investors Sue U.S. Regulator over Trump-era AGM Resolution Rules*, REUTERS (June 15, 2021, 5:03 PM), https://www.reuters.com/world/us/investors-sue-us-regulator-over-trump-era-agm-resolution-rules-2021-06-15/ [https://perma.cc/XV2K-MH9V].

325. *See* Shareholder Proposals: SEC Staff Legal Bulletin No. 14L, SEC Div. of Corp. Fin. (Nov. 3, 2021), https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals [https://perma.cc/ NG8H-JCRX]; Katanga Johnson & Ross Kerber, *Top U.S. Financial Regulator Reverses Stance on Social Issues*, REUTERS (Nov. 3, 2021, 2:39 PM), https://www.reuters.com/business/us-sec-staff-outlines-how-companies-might-exclude-shareholder-proposal-corporate-2021-11-03/ [https://perma.cc/USE6-7A7Z].

would require sustainability reporting,[326] set up an enforcement task force focused on climate and ESG issues,[327] created a new position, Senior Policy Advisor for Climate and ESG,[328] and approved a Nasdaq rule requiring that companies either have at least two board members of diverse backgrounds or explain why they do not.[329]

The abrupt shift in 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.[330]

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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 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

326. *See* Dave Michaels, *SEC Wants More Climate Disclosures. Businesses are Preparing for a Fight.*, WALL ST. J. (June 21, 2021, 5:53 PM), https://www.wsj.com/articles/climate-fight-brews-as-sec-moves-toward-mandate-for-risk-disclosure-11624267803?mod=article_inline [https://perma.cc/3J6M-32MG].

327. Press Release, Sec. & Exch. Comm'n, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42 [https://perma.cc/9RAT-X2MC].

328. Press Release, Sec. & Exch. Comm'n, Satyam Khanna Named Senior Policy Advisor for Climate and ESG (Feb. 1, 2021), https://www.sec.gov/news/press-release/2021-20 [https://perma.cc/7G4V-BLW3].

329. *See* 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, 44425 (approving Nasdaq board diversity rule).

330. The voting reversal caused a backlash from Congressional Republicans. *See* Lim, *supra* note 223. 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.

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.[331] Professors Bubb and Catan similarly argue that different asset managers have different governance philosophies and that this explains how they vote.[332] 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 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

331. *See id.*
332. *See* Bubb & Catan, *supra* note 81, at 24.

industry.[333] 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.[334] 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. Mutual fund investors are notoriously apathetic and parsing voting records is tough.[335] 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.[336] Again, though, marketing is likely a secondary rationale. Marketing cannot explain why the large asset managers voted against ES proposals for so long.[337] ESG funds did not spring up in 2021. And before

333. *See supra* notes 82–87 and accompanying text.

334. *See, e.g.*, BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT (2020), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf [https://perma.cc/GN9W-65XP].

335. *See* Schwartz, *supra* note 42, at 130.

336. *See* Dawn Lim, *Wall Street Lobbies to Bring More ESG Funds into 401(k)s*, WALL ST. J. (Mar. 3, 2021, 5:30 AM) https://www.wsj.com/articles/wall-street-lobbies-to-bring-more-esg-funds-into-401-k-s-11614767400 [https://perma.cc/MW8M-HA2Y] (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, Quinn Curtis, & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. 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* Inv. Co Inst., *Characteristics of Mutual Fund Investors, 2020*, ICI RSCH. PERSP., Nov. 2020, 18 fig.18, https://www.ici.org/system/files/attachments/pdf/per26-09.pdf [https://perma.cc/WMU4-URHU] (showing Millennials owing 16% of mutual fund assets); Rydqvist et al., *supra* note 11, at 2 (noting that "retirement wealth is built through payroll deductions"). Millennials will also inherit a great deal of money, but that shift is still years away. *See* Barzuza et al., *supra*, at 1287 (noting that "baby boomers will retain the largest percentage of disposable capital for some years to come").

337. *See* JACKIE COOK & JON HALE, MORNINGSTAR, SUSTAINABLE FUND PROXY VOTES SHOW A RANGE OF SUPPORT FOR ESG MEASURES 9 (2020), https://www.corpgov.net/wp-content/uploads/2021/03/Sustainable-Fund-Proxy-Votes-Show-a-Range-of-Support-for-ESG-Measures-copy.pdf [https://perma.cc/7PM6-X2SS] ("[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*, ESG ADVISOR (Dec. 18, 2020), https://medium.com/the-esg-

then, the frequency with which ESG funds voted against ES proposals drew significant criticism.[338]

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.[339] 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.[340]

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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 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

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advisor/all-sustainable-funds-are-not-the-same-when-it-comes-to-proxy-voting-c1ae39f6e040 [https://perma.cc/2TVZ-AMUR]; Betsy Verecky, *ESG Funds Often Fail to Vote Their Values, Research Shows*, MIT MGMT. SLOAN SCH. (June 21, 2021), https://mitsloan.mit.edu/ideas-made-to-matter/esg-funds-often-fail-to-vote-their-values-research-shows [https://perma.cc/J93Q-4VK6] ("[T]he Vanguard Social Index Fund voted against almost all environmental and social resolutions over the time examined.").

338. *See, e.g.*, Mooney, *supra* note 31; Schatz, *supra* note 181.

339. *See* Ed. Bd., *Larry Fink's Political Purgatory*, *supra* note 305 ("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, *Mutual Fund Stewardship*, *supra* note 39, at 17 n.115.

340. *See* COOK & HALE, *supra* note 337, at 9 ("BlackRock and Vanguard's 'house' view on ESG proxy votes is almost exactly replicated across their largest ESG funds."); *but see* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 435 (2021) (finding that ESG funds vote against management more often than non-ESG funds).

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 touting 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.[341] 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, 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.[342] Environmental proposals may result in greenwashing,

341. *See* Goshen & Levit, *supra* note 27, at 5.
342. *See id.* at 17.

social proposals in "social washing."[343] 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.[344] There is also little assurance that funds are picking the right activists to support,[345] 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 ramifications. 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.[346] Unpredictable stewardship 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

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343. *Social Washing: What Is It and Why Could COVID-19 Be Making It Worse?*, ETICA FUNDS (July 3, 2020), https://www.eticasgr.com/en/storie/insights/social-washing [https://perma.cc/EE2W-PB64].

344. *See* deHaan et al., *supra* note 119, at 8–13.

345. *See* Goshen & Squire, *supra* note 39, at 772 ("[A]ctivist hedge funds sometimes mistakenly target firms whose managers are in fact effective").

346. *See* Barret Kupelian & James Loughridge, *Global Economy Watch: How Does Uncertainty Impact Economic Activity?*, PWC (June 2017), https://www.pwc.com/gx/en/news-room/docs/how-does-uncertainty-impact-economic-activity.pdf [https://perma.cc/NB8K-T7RL].

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,[347] 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.[348]

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.[349] 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.

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

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

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

349. *See* Holland, *supra* note 35, 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 . . . .").

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.[350] 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.[351] 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.[352] 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.[353] 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 instruments with concentrated positions in certain firms.[354] 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.

350. *See* Roe, *supra* note 114, at 1502.

351. *See* Torres-Spelliscy, *supra* note 197, at 8 (expressing concern over corporate political influence).

352. *See supra* Part III.A.2.

353. *See* 26 U.S.C. § 851 (2020).

354. *See* Morley, *supra* note 123, at 1412 (discussing hurdles to the Big 3 operating activist hedge funds).

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. While it would eliminate the politics problem, retail investors would be rationally apathetic about voting.[355] 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.[356] 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 that implicate 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 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.

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355. *See* Schwartz, *supra* note 278, 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, 1:21 PM), https://www.wsj.com/articles/blackrock-gives-big-investors-ability-to-vote-on-shareholder-proposals-11633617321 [https://perma.cc/9PAG-DUW7].

356. Professors Griffin and Hirst have also proposed increased input for mutual fund shareholders. *See* Griffin, *supra* note 229, at 992–94; Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 238 (2018).

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.[357] 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.[358] While all of this requires time and resources, this approach is likely cheaper than the stewardship theater in which funds engage 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.

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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.[359] 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.

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.[360] 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

357. *See* Barzuza, *supra* note 336, at 1276; Lim, *supra* note 223.

358. 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.

359. *See, e.g.*, Kahan & Rock, *supra* note 10, at 1814–15.

360. GIBSON DUNN, *supra* note 105, at 4–5.

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.[361] 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,[362] other institutional investors also own a significant share.[363] 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.

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 sunsetting this concern, the rise of the Big 3 and others shows the

361. BlackRock, Q2 2021 Earnings: Earnings Release (July 14, 2021), https://www.sec.gov/Archives/edgar/data/0001364742/000156459021036497/blk-ex992_7.htm [https://perma.cc/NJT4-QXNA].

362. *See* INV. CO. INST., *supra* note 51, at i.

363. *See 80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017, 1:00 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/JFH2-A34J] ("Institutions own about 78% of the market value of the U.S. broad-market Russell 3000 index, and 80% of the large-cap S&P 500 index."); Greenspon, *supra* note 209 ("Overall, institutional investors . . . own 80% of all stock in the S&P 500").

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 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 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.