Index Funds' Corporate Stewardship Behaviour

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1 Introduction

Over the past few decades, the big three passive investing funds, BlackRock, Vanguard and State Street (Big Three) have increased their share in the equities market significantly. The capital shift to passive investing accelerated following the 2008 financial crisis. Between 2008 and 2015, active funds controlled nearly $\sim$ \$800 billion while passive funds controlled around $\sim$ \$1 trillion. At the end of 2015, passive funds controlled nearly $\sim$ \$4 trillion.

Given the rise in the economic power of the Big Three, their actions are under a spotlight by academics, Wall Street, corporate managers and regulators. Every publicly spoken word by the leaders of these companies is weighed heavily in the industry. Therefore, there is an increasing need to understand what kind of corporate governance decisions the Big Three make as well as the incentives that drive them towards making those decisions.

There have been many opposing opinions about whether index funds and the Big Three, specifically, are fit to wield such decision-making power that is a result of a rise in the trend of passive investing and the natural advantages that they have developed. This essay hopes to shed some light on this question. In Section 2, there is a brief literature review of various essays that have gained traction in this sector. Following this is an in-depth analysis of Bebchuk and Hirst (2019a) in Section 3. The theoretical framework proposed is discussed followed by the discussion of the empirical analysis and finally the policy suggestions proposed by the authors. However, given that Bebchuk and Hirst (2019a) is 10 times longer than this essay, some aspects that were discussed in it have been left out in the interest of preserving quality as well as brevity of this essay. Section 4 will follow with a brief account of what might be the case when a company with significant ownership of the Big Three faces financial distress and designing research into how to study the tradeoffs. Section 5 concludes the essay.

2 Literature Review

Given the rise of the popularity of the Big Three firms as well as their increasing share ownership, there has been a rise in the literature around the rise of the Big Three, the concentration of corporate ownership, passive voting by these firms as well as the incentive

trade-off that these firms face between lending their shares to short sellers and exercising their votes.

Fichtner, Heemskerk, and Garcia-Bernardo (2017) analyze proxy voting records of the Big Three and find a coherent centralized corporate governance strategy that the three firms follow which involves voting with management on most occasions (except for Board of Directors elections). Their major argument is that the Big Three prefer private engagements over open disagreement with management to push their objectives.

Lund (2018) supports these findings by highlighting that index funds choose to stick to a one-size-fits-all, low-cost corporate governance strategy to overcome the incentive issues that exist in the industry. These incentive issues consist of lack of financial incentives to improve the performance of any company in their portfolio since they are not active stock-pickers. It also includes the "free-rider problem" problem where the gains will be shared by all shareholders while the cost will only be incurred by the fund managers.

All these incentive issues are supported by Bebchuk and Hirst (2019a) who contend that the small share of the increased value that the index fund captures does not justify investment in corporate stewardship at the optimal levels. Bebchuk and Hirst (2019a) further argue that this is due to the competitive nature of the index fund industry as well as the low level of fees charged by each fund manager; any further investment in corporate governance would have to come out of the pocket of the fund manager and dip into their profits.

Azar, Duro, Kadach, and Ormazabal (2020) studies the how the increase in ownership and engagements by the Big Three actually led to a decrease in the carbon emissions of some of their portfolio companies. They empirically analyze a wide variety of firms with controls for any other factors that might affect increase in ownership or decrease in carbon emissions.

This concentration of ownership raises new concerns since BlackRock and State Street Global Advisors are both public companies and owe a duty to their own shareholders to maximize their profits. Hu, Mitts, and Sylvester (2020) studies the tradeoffs that the Big Three face between lending their shares which earns extra revenue that helps them lower fees as well as increase profits and exercising their fiduciary duties and voting.

All of this literature is relevant to studying how index funds' managers behave under normal times. Section 3 of the paper will discuss Bebchuk and Hirst (2019a) in more detail.

3 Research and Findings

Bebchuk and Hirst (2019a) (henceforth known as "the paper") discuss how the rise of the popularity and concentration of ownership by the Big Three firms affects corporate governance. The paper discusses the decisions made by the Big Three to exercise their voting rights as shareholders and is divided into three major sections: Theory, Evidence and Policy.

The theory section proposes "An Agency-Costs Theory of Index Fund Stewardship" and discusses why index funds have the incentive to underinvest in corporate governance based on the minute amount of increased value that they capture. Following this, the authors discuss how their theoretical framework supports the empirical evidence observed in the governance activities of the Big Three. Finally, the authors discuss current and proposed policy considerations for the regulators that can help address these issues.

Let's discuss the three sections in detail:

3.1 Theory

Index funds attempt to track the performance of benchmark indices such as the S&P 500 or the Russel 2000 index. Bebchuk and Hirst (2019b) analyzes the index fund sector empirically and discovers that the Big Three dominate the heavily concentrated sector. They further go on to explain that due to the structural advantages that the Big Three firms enjoy - economies of scale, funds' branding and liquidity benefits - this trend of domination and concentration will persist in the future.

Bebchuk and Hirst (2019a) focuses mostly on "stewardship" which is defined by three major components:

1. *Monitoring* the operations and practices of the firm and evaluating its performance as well as compensation and governance practices.

2. *Voting* involves exercising the right of the shareholders at the election of directors, bylaw amendments, mergers and other operational decisions.

3. *Engagement* is defined as all other interactions such as the nomination of directors, or submitting new proposals to the shareholders. It also may include communication with the managers directly (public or private) to discuss corporate governance and performance.

Following this, the paper discusses the major characteristics that define decision by the Big Three managers. Firstly, the Big Three firms own huge equity stakes in public companies that are growing as more money flows into these funds. This increasing influence over corporate decisions is leading to increasing responsibility since they have the resources to affect corporate decisions. Secondly, since the Big Three firms are passive investors, they cannot sell their shares on the market when a company is underperforming or diverges from their governance principles. As BlackRock CEO, Larry Fink stated "BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index.. As a result, our responsibility to engage and vote is more important than ever". Finally, this leads to their third characteristic of having a long time-horizon for their investments which offers these companies a highly significant incentive to to deliver on good governance enforcement for all their portfolio companies.

3.1.1 Agency-Costs Framework

The market as well as many investors believe that the Big Three firms operate within a "value-maximization" framework and seek to maximize the value of their portfolios. However, according to Bebchuk and Hirst (2019a) this view fails to consider the significant agency costs that plague their decision-making process. The authors argue that the Big Three have an incentive to underinvest in the stewardship. This "underinvestment" refers to investing less than what would be the value-maximizing level for the investors in the Big Three Exchange-Traded-Funds (ETFs).

The socially desirable investment in stewardship would be when the marginal cost of investing in stewardship is exceeded by the marginal gain to the portfolio value of the Big Three firms. The Index fund manager (or one of the Big Three) only captures a small amount of the increased value because of the small fee that they charge on their assets under management (0.30%, 0.09%, and 0.17% for BlackRock, Vanguard and SSGA, respectively). The authors do highlight that even this smaller value captured by the Big Three, while lower than socially optimal levels, is still a large incentive.

However, the intensely competitive nature of the industry between the three firms and other smaller index fund managers makes any further investment in stewardship unappealing since the gains will be shared with the rival funds. Furthermore, the increased cost cannot be passed on to the investors/consumers in the index funds as it would lead to lower net returns compared to the rival firms and potentially subsequent outflows. Furthermore, the incentive to be "perceived as good stewards" is more attractive than the incentives to be good stewards.

This might explain the results discussed in Azar et al. (2020) which highlight that engagement and increased investment by the Big Three led to a decline in the carbon emissions of many companies in their portfolios. In order to attract more client and maximize their profits (given that BlackRock and SSGA are both public companies themselves with a profit-maximization motive for their respective shareholders), the current level of investment by the Big Three seems to be directed towards the more visible aspects of the three pillars of Environmental, Social and Corporate Governance framework. This argument is further supported by the evidence that the authors discuss.

The authors go on to discuss why the Big Three are excessively deferential to management on corporate decisions. Reasons include the private costs of regulatory processes, business ties with the managers as well as reputational constraints. In the interest of time and page limits, this section will not be discussed in detail.

3.2 Evidence

In the second section of Bebchuk and Hirst (2019a), the authors investigate the behaviour of the Big Three firms empirically to support their theoretical claims that were explained in Section 3.1 of this paper. The authors discuss the stewardship activities that the Big Three firms do undertake and the process they follow. Following this, the authors also highlight activities that the Big Three do not adequately invest in.

From the Investment Stewardship Annual Reports published by the Big Three firms, the authors gather information about the stewardship personnel, number of private engagements and companies that the Big Three privately engaged with and what governance principles these engagements focused on. The authors also used the proxy-voting guidelines released by the Big Three as well as outcome reports to study the voting patterns of the Big Three firms on issues such as say-on-pay votes as well as a comparison with active managers and the recommendations of Institutional Shareholder Services, the leading proxy advisor.

3.2.1 Stewardship Activities Undertaken

The authors discovered that the stewardship spending by the Big Three was economically insignificant when compared to the estimated fess that that each of these firms charged on managing equity assets: 0.2% of the fees. Based on the number of personnel engaged in stewardship activities, the authors estimate that BlackRock spends approximately $13.5 million on stewardship while Vanguard and State Street spend $6.3 million and $3.6 million respectively.

Following this estimation, the authors estimate the amount spent on each company. Even in the most conservative scenarios where the authors estimate the highest the stewardship investment in companies in which the Big Three have at least $1 billion in equity, the investment comes out to be a meager $4.76 thousand per company. However, this must be taken with a grain of salt, since these are estimates of scenarios and it could be

that the Big Three's stewardship investment is actually skewed towards companies where their equity values are higher.

The authors also consider the "most valuable stewardship tool": the private engagements that the Big Three have with corporate managers in an effort to push their governance principles across the tables. According to BlackRock's *2019 Annual Engagement and Voting Statistics* (2019), "The key to effective engagement is constructive and private communication". However, in their empirical investigation the authors found out that the Big Three did not engage with 92.5% of the companies from 2017 through 2019. 5.2% of the companies were engaged only once and only 2.3% of the portfolio companies were engaged multiple times.

3.2.2 Stewardship Activities Not Undertaken

Following the previous discussion, the authors highlight activities that the Big Three do not invest adequately in. These include monitoring the business performance, influencing the identity of the board of directors, eliminating divergences from governance principles, contributing to legal reforms and involvement in litigation against their portfolio companies.

There were no cases where the Big Three engaged with a portfolio company to discuss financial underperformance. Given the huge amount of equity that the Big Three firms hold, it seems obvious that the Big Three could develop in-house expertise to identify company's that are underperforming financially. However, the fact that they are choosing not to supports the theory proposed by the authors of Bebchuk and Hirst (2019a). Similarly, while the Big Three actively express support for introducing annual elections, eliminate super-majority requirement and adopting majority voting. However, majority of the portfolio companies of the Big Three do not have these governance measures in place and neither have there been any proposals by the Big Three to change these.

The above two sections highlight some of the activities mentioned in Bebchuk and Hirst (2019a). It is interesting to see that while Azar et al. (2020) talk about the Big Three's influence in reducing carbon emissions in their portfolio companies, Fichtner et al. (2017) highlight that 77% of the BlackRock's votes are against ESG proposals by activist shareholders while the number is 44% and 43% for Vanguard and State Street, respectively. It seems the case that private engagements are much more influential in changing management's opinions. However, given the agency costs of stewardship we witness an underinvestment compared to the socially desirable level. The empirical evidence supports the theoretical framework proposed by the authors. Following this, the authors will propose a policy framework to combat some of these issues.

3.3 Policy

In the first two sections, the authors have discussed the incentives for the Big Three to underinvest corporate stewardship by proposing a theoretical framework to explain it followed by an empirical analysis in support of their hypothesis. In Section 3 of Bebchuk and Hirst (2019a), the authors discuss regulatory reforms to combat the issues they have pointed out as well as address ongoing debates around common ownership and hedge fund activism.

Firstly the authors highlight how taking the voting rights from the index fund managers would actually lead to a higher cost and would actually be detrimental to corporate governance given the economies of scale that the Big Three enjoy. Their proposal deals

with increasing investment by the Big Three instead of taking away their voting rights. To do so, the authors propose a standard stewardship fees charged by the index funds to their investors. If this is made standard across the industry, then the actual net returns for one product will not be lower than others. This would alleviate the agency costs and ensure that a socially optimal level of investment is made in to corporate stewardship.

Secondly, the authors propose consolidating research resources. Since information about financial information would be useful to all passive investors, outside organizations that organize and present such research would benefit the entire industry immensely. This would pool the resources of multiple index fund managers and help the organization become more efficient at identifying companies that are underperforming financially and suggest the optimal ways at improving performance given the equity shares that each firm owns.

The authors also propose a minimum of stewardship expenses which would be a fraction of the total assets under management of the firm to ensure that all firms are investing proportionally. Even a mandatory 0.1% of AUM fees to be spent on stewardship would lead to the amount being closer to the desirable number.

Following this, the authors propose a variety of measures aimed at improving transparency in the industry starting with limiting the business relationships of the Big Three with the public companies. These include prohibiting the 401(k) plans for companies among other suggestions as the social costs imposed by these conflicts of interest might be larger than the efficiencies arising from the relationships. Another suggestion is to disclose all business relationships with managers of portfolio companies. This would allow the outsiders in the market to assess effective stewardship as well as help regulators decide whether these relationships require any regulation.

As discussed in Section 3.2.1 of this paper, the Big Three consider private engagements to be one of the most valuable tools in their stewardship toolkit. However, there is much ambiguity about how many conversations took place with managers at different levels and which side initiated these talks. Investors (in the portfolio company as well as the Big Three) would also benefit immensely from knowing what each side was negotiating for at the beginning and the end of these talks. All this information is material and if disclosed would help the market become much more efficient and transparent. Not only would this be useful to the general investor in the market, but disclosing these publicly would push the Big Three to actively work towards achieving loftier goals with each engagement.

A potential concern that Bebchuk and Hirst (2019a) dismiss unconvincingly is that disclosure might lead to a drop in the number of private engagements or decrease their effectiveness in getting work done. As I pointed out in Section 3.2.2, the evidence seems to point that the Big Three privately engage with a small number of companies and that they have been successful in reducing the carbon emissions in their portfolio companies. The question that arises then is, whether public disclosure of what was happening make the managers less susceptible to engaging with the Big Three privately? An example of this would be a manager that might be willing to work on some issues privately and resolve them but would not like them to be public given the level of scrutiny and backlash he would face personally over issues in operations.

A final suggestion is imposing size limits to prevent the Big Three from evolving into the "Giant Three". The challenge posed by such consolidation of economic and corporate power would be unprecedented and any potential concerns can be countered with an equally sound answer about increasing access to the market and economies of scale. The regulators across the world would need to keep a constant eye on the stewardship decisions

of the Big Three as they gain more power in the market. Moreover, significant regulatory measures such as the ones highlighted above can be taken to ensure responsible execution of fiduciary duties.

Finally, the authors address a debate on the anti-competitive effects that might be a result of the "common ownership". Given the agency costs framework proposed earlier, its not likely that index funds will be overly active in corporate governance. In fact, the authors support this and argue that we should be concerned about them doing too little than too much. Anti-trust regulators should focus on corporate decisions, instead of looking into the Big Three's consolidation given that the decisions seem to be driven by financial motives only.

The final debate about hedge fund activism is also addressed in the paper. The rise of index funds cannot substitute the role that activist hedge funds play in exposing financial underperformance. This is primarily due to the different incentives as hedge funds' unique compensation structure of 2 and 20 enables them to capture a significant amount of the upside that they generate. Activist hedge funds also often include the Big Three in their support since in this case, the passive investor does not incur any extra cost to generate a upside. This debate has also led to the lending-voting tradeoff that Hu et al. (2020) discuss in their work.

4 Financial Distress

The Bebchuk and Hirst (2019a) essay discusses in detail how the Big Three firms make decisions around corporate stewardship in a general setting. However, effective corporate stewardship become exponentially more important in times of financial distress. The following section aims to provide a theoretical framework about how the Big Three might approach a decision in times of financial distress. We will focus on companies that have filed for Chapter 11 bankruptcy protection under the United States Bankruptcy Code. This is because Chapter 7, an alternative code, usually includes liquidating the assets and paying back the creditors with the equity being worthless.

Under Chapter 11, the company is planning to restructure and the debtor is still in possession of the assets of the company and a potential re-organization plan might lead to the old equity holders to gain some shares in the newly restructured company as well (although the value will be far lower than before). Since, the Big Three own significant equity shares in a lot of public companies in the United States, it is important to consider how they might approach a potential financial distress situation.

4.1 Exit?

Given that the Big Three are passive investors with little incentive to actively meddle in corporate decisions in order to increase value (as shown in Bebchuk and Hirst (2019a)), exiting the position of a company that has announced bankruptcy seems to be the most obvious option. However, given that an index fund is supposed to replicate the performance of a stock market index such as the Russell 3000 index, index fund managers can only sell their position when the portfolio company's value declines enough that it no longer satisfies the criteria to be part of the index.

When a company is de-listed or is not a part of the index that the Big Three are tracking, they can close their position by selling it on the OTC markets. This position could be bought by an activist hedge fund looking to take over the company and revamp

its operations or a potential acquirer. The business relationships that Bebchuk and Hirst (2019a) seek to limit discussed in the previous section might play a crucial role in this transaction. The Big Three might choose to sell their equity stake to a portfolio company whose managers have significant business relationships with the Big Three. This conflict of interest might be harmful for the bankrupt company as well as its other investors.

If the company is still listed on a major exchange and somehow is still in the index (extremely rare, but theoretically possible event), then the Big Three cannot sell off their equity stake and play an extremely crucial role in the re-organization. As we saw in Neyland and St John (2021), the value of the equity of a company when modeled as a call option on the assets of the firm increases with an increase in time to maturity. However, since the equity is still clearly worth a positive amount significant enough to be part of the index, the Big Three might choose to not push for a delay, incurring legal and other costs despite their expertise and vast amount of resources that might be able to achieve a more efficient outcome.

4.2 Fixed-Income Funds

A much more interesting situation presents itself in case of Fixed-Income ETFs. While a smaller and much less concentrated industry than the equity markets, the Big Three have a significant presence in the Bond ETF market space as well. The top 15 Bond ETFs by assets under management all belong to either BlackRock or Vanguard with a total AUM of $527.88 billion.

In times of financial distress, the creditors have a higher claim and can take control of the company as well as enjoy the right to vote to approve the restructuring plan proposed by the management. Assuming a situation with no financial distress, one can argue that the agency-costs framework proposed by Bebchuk and Hirst (2019a) applies to the Bond ETFs as well since they are operated under the same umbrella of company, namely BlackRock and Vanguard.

The question that arises is: Is there an increase or diversion of stewardship resources to the companies that are under financial distress and have a significant amount of debt owned by the Big Three? Given the relatively new rise in the popularity of passive investing, there has been no empirical studies around this. Theoretically, given the financial incentive of preserving their capital as well as attracting goodwill with their own investors, the Big Three can be expected to vote towards proposals that will fulfill the bankrupt company's obligations towards them as quickly as possible. This also follows from Neyland and St John (2021) where it's shown that a delay in settlement can cause decrease in the value of the claim of the creditors.

4.3 Empirical Analysis Design

To empirically analyze decisions under financial distress will not be hard. Data about ownership is easily available on the Bloomberg Terminal as well as Thomson Reuters or Orbis. Bankruptcy data is also easily available for public companies since they need to file it under the 8-K form with the SEC. Data on bankruptcy proceedings is also often available from a wide variety of judicial as well as bankruptcy research databases such as the UCLA-LoPucki Bankruptcy Research Database.

All this data can be used to isolate the instance where the Big Three owned significant equity shares only and their role in the subsequent proceedings (exit, active participation,

passive by-stander). Furthermore, this can be combined with companies where the Big Three also owned significant debt amounts and analyze their role in the following proceedings.

In both cases, time to wrap up the bankruptcy proceedings as well as payout for different creditors (and different liquidation preferences) would be useful to understand whether the Big Three influenced decision to recover the maximum amount possible for their portfolio.

Given the complexity of the questions posed by the situation in financial distress as well as the complex legal structures of the Big Three themselves, this would be an interesting question to explore. While it is very much possible that there might not be a subset of companies that had significant ownership of both debt and equity by one of the Big Three firms, their influence and ownership concentration will persist over the next few decades and we might be able to witness a situation that matches this criteria.

5 Conclusion

As highlighted in the beginning of this essay, it has become increasingly crucial for the Big Three to exercise their fiduciary rights and ensure that all their portfolio companies are abiding by the governance principles that they are supposed to. In this 2018 Letter to CEOs, Larry Fink (2018), the CEO of BlackRock, the largest of the Big Three, stated that "our responsibility to engage and vote is more important than ever".

The purpose of this essay was to study Bebchuk and Hirst (2019a) and understand the incentives of the Big Three firms to underinvest in corporate stewardship. We went through the authors' proposed theoretical framework to underinvest in stewardship which is a result of the competitive nature of the industry as well as the already low costs charged to their investors. Following this, we discussed the empirical analysis of the essay and highlighted key aspects that supported the authors' theoretical framework. Finally, we considered some policy recommendations and analysis put forward by the authors that the regulators can utilize in order to make the public markets more efficient and deal with the unprecedented situation of rising concentration of ownership in the hands of passive investors. Bebchuk and Hirst (2019a) is a very well-written and detailed account of how index funds behave. The level of thought and the input from other scholars that has been addressed in the essay makes it a pleasure to read.

Following the analysis of this essay, we have tried to understand how financial distress might change these incentives or not. This was purely theoretical and put forward by the author of this essay. There is an opportunity here for future research in to the topic and how an empirical analysis can be put together has been described in section 4.3. It would be interesting to explore the dynamic of the companies that have both significant levels of debt and equity owned by one or more of the Big Three companies.

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