

REFORMING U.S. CAPITAL MARKETS TO PROMOTE ECONOMIC GROWTH



MAY 2020

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Reforming U.S. Capital Markets to Promote Economic Growth

This report was prepared by Committee staff, including John Gulliver, Executive Director, Megan Vasios, Deputy Director, and Jonathan Ondrejko, Senior Research Fellow, as well as Hillel Nadler, Senior Research Fellow at the Program on International Financial Systems. In addition, the Committee drew on the expertise of its members, who provided commentary and insight to our team. The members of the Committee are listed on the next page.

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Executive Summary

Vibrant and well-functioning U.S. capital markets create jobs, bolster investment, promote innovation, and enhance retirement savings. Capital markets function best when regulations allow for the efficient allocation of capital while protecting investors. In this report, we evaluate major trends and developments in U.S. capital markets and assess whether existing regulations are continuing to serve U.S. companies and investors. We then set forth regulatory reforms to further enhance the performance of U.S. capital markets.

The report consists of four chapters: (1) The Rise of Dual Class Shares: Regulations and Implications, (2) Short-termism, Shareholder Activism and Stock Buybacks; (3) The Rise of Index Investing: Price Efficiency and Financial Stability; and (4) An Analysis of Investment Stewardship: Mutual Funds and ETFs. An executive summary of each chapter appears below.

Chapter 1: The Rise of Dual Class Shares: Regulations and Implications

Shares of common stock in corporations represent a bundle of rights: economic rights, such as the rights to receive dividends declared by the corporation and to the residual assets of a corporation after all of its creditors have been paid, and governance rights, including the right to vote on certain corporate decisions. These rights are typically allocated proportionally, with each share of common stock entitled to the same economic and voting rights as every other share. However, many jurisdictions allow corporations to offer classes of common stock with unequal voting rights.

In recent years, several prominent companies, such as Google, Facebook, and Alibaba, have gone public with dual class structures in which a minority of the shares, held by the company's founders and executives, have special voting rights that provide their holders with effective control, while a majority of the company's stock, which has regular voting rights, is held by outside investors. The increase in companies going public with dual class share structures, and the corresponding desire by stock exchanges to attract public offerings, have drawn renewed attention to these structures.

This chapter surveys the prevalence of dual class structures in several jurisdictions and the laws in those jurisdictions governing their use. It also considers the approach taken by stock exchanges, providers of stock indexes, and institutional investors with respect to dual class equity structures. That discussion is followed by consideration of the empirical evidence in favor of and against restricting the use of dual class equity structures. This chapter then evaluates specific proposals to regulate dual class equity structures.

We recommend that the Securities and Exchange Commission encourage dual class issuers to provide more robust disclosures regarding material risks associated with the dual class structure, through the SEC's review of and comment on public filings by these issuers. For example, where appropriate, the SEC should direct a dual class issuer to disclose the risk that shares will be excluded

from major indexes. We also recommend that the SEC encourage each dual class issuer to disclose data showing the divergence between economic ownership and control, such as the numerical gap between a shareholder's ownership interest and voting rights.

Chapter 2: Short-termism, Shareholder Activism and Stock Buybacks

According to the short-termism thesis, public companies in the United States are excessively focused on increasing short-term stock prices and are therefore foregoing valuable long-term investment. We evaluate the evidence to support the short-termism thesis including the role of shareholder activism and stock buybacks by public companies.

The first section of this chapter focuses on the empirical literature addressing whether short-termism exists, the potential causes of short-termism, and the economic effects of short-termism, if any. We find that U.S. public companies engage in similar amounts of long-term investment as private companies and public companies' long-term investment has increased substantially in recent years. We therefore do not find support for the contention that short-termism is a problem in U.S. markets.

We then consider the rise of shareholder activism, which refers to tactics employed by shareholders of a company that are aimed at increasing the value of their stake in the company. Shareholder activism is often identified as a *cause* of short-termism as presumably these shareholders are focused on short-term returns. Overall, activism confers positive benefits on firms in the short run and the evidence regarding activism's long-term effects is mixed.

The third section of this chapter considers the rise in stock buybacks by public companies. Critics of stock buybacks argue that the recent rise in stock buybacks is a *symptom* of short-termism—an attempt by companies to boost their stock prices in the near term, while foregoing long-term investment. However, we describe a number of motivating factors for stock buybacks that are not short-term. We also review empirical literature finding that stock buybacks often do not increase short-term stock prices and that long-term investment is particularly strong at companies engaged in share buybacks.

The final section of this chapter sets forth our policy recommendations to enhance long-term investment in U.S. public markets. First, we recommend that U.S. public companies weigh carefully the costs and benefits of issuing quarterly earnings guidance and consider ending the practice if they determine that such guidance is discouraging long-term investment. Second, the SEC should issue guidance clarifying that, when a company's Board of Directors authorizes a stock repurchase program, the company should disclose on a timely basis certain material elements of the program, including its approximate intended duration and the maximum approved repurchase amount (for example, as a total number of shares or a total dollar value). Public companies should disclose these material elements within five business days of the authorization of the repurchase

plan, through a press release or other Reg FD-compliant method that ensures broad public dissemination.

Chapter 3: The Rise of Index Investing: Price Efficiency and Financial Stability

Index investing is based upon a set of predefined, mechanical rules for choosing a publicly known set of stocks. The strategy of index investors is to gain exposure to the performance of the market as a whole or a particular segment of the market. Given its mechanical, rules-based nature, index investing does not require investment in fundamental research about security prices and typically entails significantly less trading activity than active investment. As a result, index investing tends to provide low-cost access to diversified portfolios.

In this chapter, we begin by tracking the growth of index investing in U.S. equity markets from a small niche strategy in the 1970s into an investment style comparable in scale to the active management of mutual funds. We then consider whether the rise of index investing has reduced the extent to which prices of individual stocks reflect their underlying value (price efficiency). We then examine whether the rise of index investing has increased risks to financial stability through three channels: (a) stock market bubbles and crashes; (b) concentration of asset managers; and (c) liquidity and redemption concerns. In conclusion, we find that the empirical evidence, while mixed, indicates that the rise of index investing has not had negative effects on price efficiency or financial stability. We recommend continued study of index investing in the years to come.

Chapter 4: An Analysis of Investment Stewardship: Mutual Funds and ETFs

Investment stewardship refers to shareholder engagement with public companies, including voting and other direct communications between investors and public companies. This chapter focuses on investment stewardship by investment advisers on behalf of index mutual funds and ETFs.

This chapter is divided into five sections.

Section 1 of this chapter provides a very brief introduction to mutual funds and exchange-traded funds and presents data showing their importance as shareholders of public companies. It also summarizes the regulatory framework governing mutual funds and ETFs (regulated as “investment companies” under the Investment Company Act of 1940) and the firms that manage these funds (regulated as “investment advisers” under the Investment Advisers Act of 1940).

Section 2 describes the existing legal and regulatory requirements regarding investment adviser and investment company voting and engagement. Investment advisers have fiduciary duties of care and loyalty to clients, including the investment companies that they manage, that require investment advisers to exercise reasonable care to ensure that votes are cast in the best interest of their clients. In connection with these duties, investment advisers must develop voting policies, describe these policies to clients, and make voting policies and voting records available to clients.

Investment companies are required to publicly disclose voting policies and voting records. We then compare U.S. requirements with rules in the European Union, Hong Kong and Japan.

Section 3 describes the voluntary investment stewardship practices of BlackRock, Vanguard and State Street, whose mutual funds and ETFs are the three largest holders of many U.S. public companies. With respect to voting, we find that these investment advisers voluntarily disclose highly detailed voting guidelines and consolidated voting statistics. With respect to non-voting engagement, including meetings with public companies, we find that these investment advisers disclose their engagement priorities and efforts undertaken to advance them. Such disclosures allow investors to evaluate whether investment advisers' investment stewardship policies are consistent with investor priorities.

Section 4 reviews the empirical literature as it relates to investment stewardship by investment companies. First, we consider studies that evaluate the frequency with which investment companies oppose management proposals and support shareholder proposals. Second, we consider studies that evaluate whether holdings by investment companies are positively correlated with improved performance of public companies. Third, we review studies that assess whether holdings by investment companies are correlated with positive measures of corporate governance at public companies. In doing so, we also consider empirical studies that are focused exclusively on index funds as a subset of investment companies.

In Section 5, we evaluate proposals to reform voting by index funds. We begin by evaluating proposals that would require index funds to allow for "pass through voting," whereby the millions of individual shareholders in index funds would provide instructions on how to vote. Second, we consider proposals that would require that index funds "poll" their shareholders to determine their voting decisions. Third, we evaluate proposals that would effectively eliminate index funds' authority to vote their shares. We conclude by recommending enhanced transparency of non-voting engagement practices by investment advisers.

Chapter 1: The Rise of Dual Class Shares: Regulation and Implications

Summary

Shares of common stock in corporations represent a bundle of rights: economic rights, such as the rights to receive dividends declared by the corporation, and governance rights, including the right to vote on certain corporate decisions. These rights are typically allocated proportionally, with each share of common stock entitled to the same economic and voting rights as every other share. However, many jurisdictions allow corporations to offer classes of common stock with unequal voting rights (a “**dual class**” share structure).¹

In recent years, several prominent companies, such as Google, Facebook, and Alibaba, have gone public with dual class structures in which a minority of the shares, held by the company’s founders and executives, have special voting rights that provide their holders with effective control, while a majority of the company’s stock, which has regular voting rights, is held by outside investors. The increase in companies going public with dual class share structures, and the corresponding desire by stock exchanges to attract public offerings, have drawn renewed attention to these structures. However, public debate regarding the use of dual class shares has existed for almost a century—at least since 1925, when Dodge Brothers listed on the New York Stock Exchange with a structure that gave the automaker’s founders total voting control with only 1.7 percent of equity.²

This chapter surveys the prevalence of dual class shares in several jurisdictions and the laws in those jurisdictions governing their use. It also considers the approach taken by private actors, including stock exchanges, providers of stock indexes, and institutional investors, with respect to dual class shares. That discussion is followed by consideration of the empirical evidence in favor of and against restricting the use of dual class shares. The then evaluates specific proposals to regulate dual class shares by requiring that they “sunset” after a predetermined period of time, as well as additional disclosure requirements for dual class shares.

We recommend that the Securities and Exchange Commission (the “**SEC**”) encourage dual class issuers to provide more robust disclosures regarding material risks associated with the dual class structure, through the SEC’s review of and comment on public filings by these issuers. For example, where appropriate, the SEC should direct a dual class issuer to disclose the risk that shares will be excluded from major indexes. We also recommend that the SEC encourage dual class issuers to disclose data showing the divergence between economic ownership and control, such as the numerical gap between a shareholder’s ownership interest and voting rights.

¹ Although corporations can offer more than two classes of stock with unequal voting rights, for simplicity we refer to this kind of structure as a “dual class” share structure. The scope of this chapter is limited to dual class structures; it does not address other means of separating corporate ownership and control.

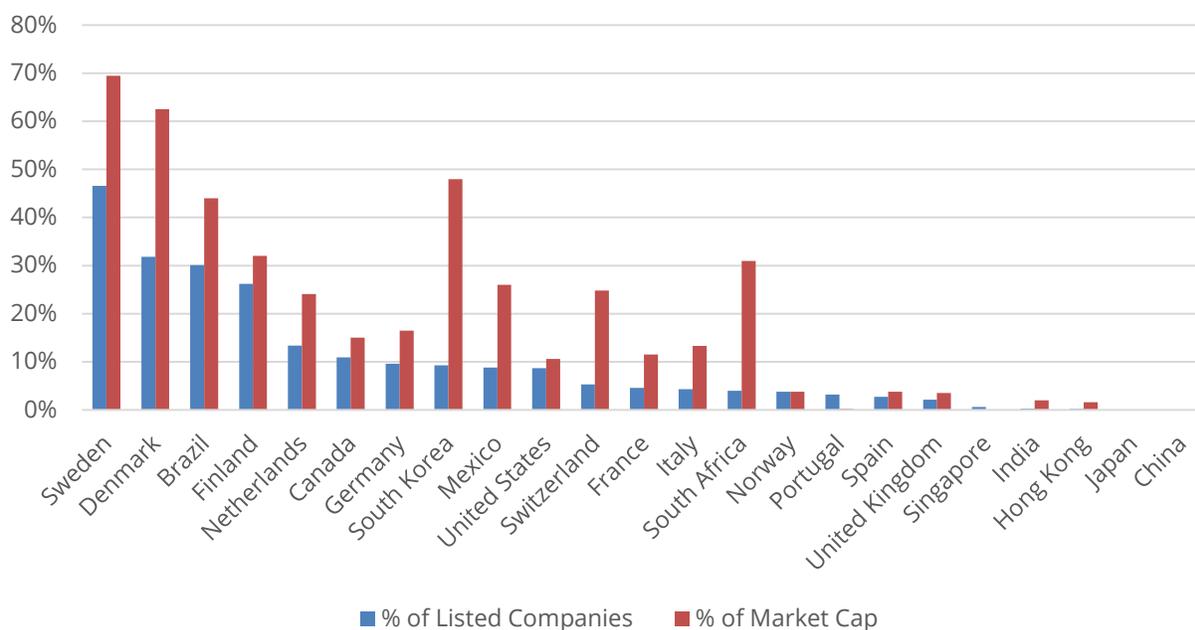
² See Joel Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 *Geo. Wash. L. Rev.* 687, 694–97 (1986).

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1. Prevalence and regulation of dual class shares

The prevalence of dual class share structures varies widely across jurisdictions (see **Figure 1.1**). Differences between jurisdictions are in part explained by regulation. Many countries allow the use of dual class shares with few or no restrictions, while others either prohibit outright or strongly restrict the ability of corporations to offer shares to the public that have unequal voting rights. But regulation is not the only explanation for differences between countries: even among countries that allow departures from a “one share, one vote” structure, there are significant disparities with respect to the prevalence of dual class equity structures. This section surveys the prevalence of dual class structures in several major jurisdictions as well as applicable regulations in those jurisdictions.

Figure 1.1. Prevalence of listed companies with multi-class structures (2016).¹



a. United States

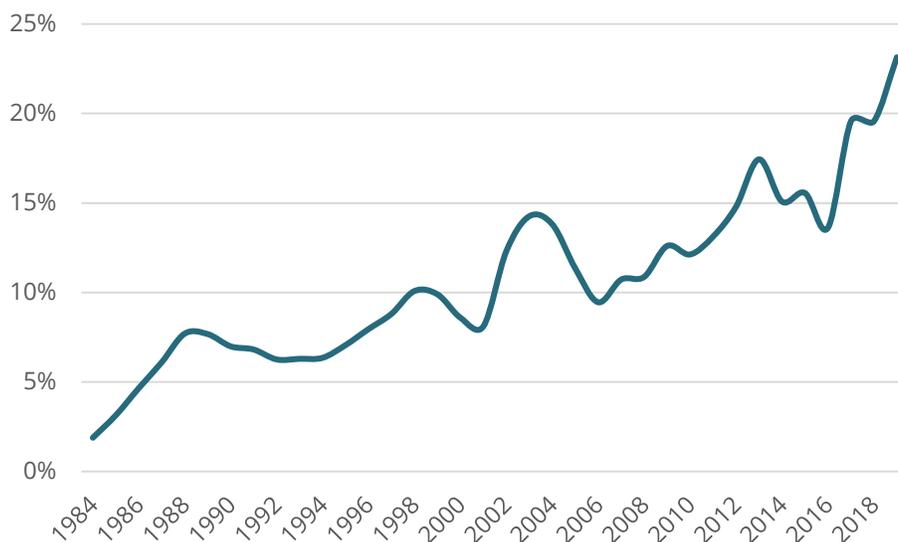
Between 2005 and 2015, the number of U.S. companies with dual class share structures increased by 44 percent.² By July 2016, 6.4 percent of the companies included in the S&P 500 and 8.2 percent

¹ See Jinhee Kim, Pedro Matos and Ting Xu, *Multi-Class Shares Around the World: The Role of Institutional Investors* 39 (Nov. 2018).

² See *Recommendation of the Investor as Owner Subcommittee: Dual Class and Other Entrenching Governance Structures in Public Companies*, Investor Advisory Committee, Securities and Exchange Commission 1 (Feb. 27, 2018), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iaco30818-investor-as-owner-subcommittee-recommendation.pdf>. The index provider MSCI reports that as of September 1, 2017, 10.9% (by market cap) of the U.S. issuers included in the MSCI ACWI Index, its global flagship index, had multi-class share

of those included in the Russell 3000 had dual class share structures.³ The prevalence of dual class share structures has further increased since then: according to one measure, more than 20 percent of the companies listing shares on U.S. exchanges between 2017 and 2019 had a dual class structure (see **Figure 1.2**).⁴

Figure 1.2. Dual class IPOs as a share of all U.S. IPOs, 1984-2019 (three-year moving average).⁵



Institutional Shareholders Services (ISS), the proxy advisory firm, reports different numbers, because they only include dual class share companies that are in the Russell 3000 and dual class share structures in which the class of shares with superior voting rights represents more than 5 percent of voting rights.⁶ Still, their numbers are consistent with an increase in the prevalence of dual class share structures in the United States. According to data from ISS, as of early 2019, 7 percent of companies in the Russell 3000 had a dual class share structure, an increase of one percentage point over the previous decade.⁷

structures. See *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?*, MSCI 22 (January 2018), available at https://www.msci.com/documents/1296102/8328554/Discussion+Pa-per_Voting+rights.pdf.

³ See Lucian A. Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 *Virginia L. Rev.* 585, 594 (2017).

⁴ See Jay R. Ritter, *Initial Public Offerings: Dual Class IPOs* (Jan. 14, 2020), available at <https://site.warrington.ufl.edu/ritter/files/2020/02/IPOs2019DualClass.pdf>.

⁵ See *id.*

⁶ See *Dual Class Shares: Governance Risks and Company Performance*, ISS Analytics: Governance Insights (June 14, 2019).

⁷ See *id.*

Dual class equity structures in the U.S. are more prevalent among small capitalization companies than larger companies. ISS reports 9 percent of non-S&P 1500 companies in the Russell 3000 have multi-class share structures, compared to less than 5 percent for S&P 1500 companies.⁸ Dual class equity structures are also more prevalent in certain industries than others. These industries include the tech industry, where notable companies like Google and Facebook maintain such structures.⁹ It also includes the media industry, where dual class share structures—such as the structure adopted by The New York Times Company—are widely considered necessary to insulate the editorial independence of media companies from shareholder pressure.¹⁰

Public companies in the United States are subject to a two-tier system of federal and state regulation. Very generally, federal law governs the production and distribution of information about issuers and their securities, the flow of funds in securities markets, and the basic structure of securities markets, while state law addresses corporate governance directly, including the regulation of conflict of interest transactions.

Currently, U.S. federal law does not restrict the ability of companies to publicly offer stock that is part of a dual class equity structure.¹¹ However, under federal securities law as interpreted and enforced by the SEC, the disclosure requirements imposed in connection with public offerings require companies to disclose risk factors associated with nontraditional governance structures such as dual class shares.¹²

A review of recent SEC filings by companies planning a public offering illustrates that companies with dual class share structures disclose risks associated with investors' lack of control. The We Company (WeWork), for example, disclosed that its dual class structure would “limit the ability of other stockholders to influence corporate activities” and, as a result, it could take actions that “stockholders other than [its founder] do not view as beneficial.” The company also emphasized that “[a]s a stockholder, even a controlling stockholder, [its founder] is entitled to vote his shares, and shares over which he has voting control as a result of voting arrangements, in his own interests, which may not be the same as, or may conflict with, the interests of our other stockholders.”

⁸ See *id.* It is not clear whether ISS accounts for the fact that new companies with multi-class share structures have been excluded from the S&P 1500 since 2017. See text accompanying note 62.

⁹ See *Dual Class Shares: Governance Risks and Company Performance* (cited in note 6).

¹⁰ See *id.* See also Joe Nocera, *How Punch Protected The Times*, N.Y. Times (Oct 1, 2012), available at <https://www.nytimes.com/2012/10/02/opinion/nocera-how-punch-protected-the-times.html>.

¹¹ See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (striking down SEC Rule 19c-4, which prohibited (1) covered exchanges from listing or continuing to list the equity securities of an issuer with a dual class share structure and (2) covered securities associations from authorizing the equity securities of such an issuer for quotation and/or transaction reporting on an automated quotation system). See also Stephen M. Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights*, UCLA School of Law Research Paper No. 07-16 (May 2007), available at <https://ssrn.com/abstract=985707>.

¹² See *Recommendation of the Investor as Owner Subcommittee* at 3-4 (cited in note 2).

In addition, the We Company disclosed that its dual class structure could diminish the value, liquidity and trading price of its low-vote common stock.¹³

Virtually all state corporate codes adopt one vote per common share as the default rule but allow corporations to depart from the norm by adopting appropriate provisions in their constitutive documents.¹⁴ Dual class capital structures are routinely upheld by state courts.¹⁵ However, courts in certain states review proposed transactions involving dual class (and other controlled) corporations more carefully than transactions involving noncontrolled corporations.

For example, Delaware, the favored state of incorporation for U.S. businesses, allows a corporation's certificate of incorporation to provide that one or more classes or series of stock will have limited or no voting rights.¹⁶ But when a controlling shareholder (including a shareholder that controls a corporation using dual class shares) has an interest in a transaction that differs from that of other shareholders, Delaware law treats the board as incapable of exercising truly independent judgment as to whether the transaction is in the best interests of the company and the other shareholders, due to the ability of the controlling shareholder to remove directors and elect new ones. Accordingly, Delaware courts reviewing transactions involving controlling shareholders apply the onerous "entire fairness" standard of judicial review—requiring the board to show that both the price and process are fair—instead of the more deferential "business judgment" standard.¹⁷

For example, in *In re Ezc Corp. Inc. Consulting Agreement Derivative Litigation*,¹⁸ corporate management, which controlled 100 percent of voting power while owning just 5.5 percent of the outstanding stock, entered into a series of allegedly "rubber-stamped" related-party transactions that purportedly undermined the company's financial health. Public shareholders sued in the Delaware

¹³ See *The We Company*, S-1A (Sep. 13, 2019), available at <https://www.sec.gov/Archives/edgar/data/1533523/000119312519244329/d804478ds1a.htm>. WeWork's public offering ultimately failed. See Maureen Farrell, *WeWork Parent Postpones IPO*, Wall Street Journal (Sep. 17, 2019), available at <https://www.wsj.com/articles/wework-parent-expected-to-postpone-ipo-11568671322>; Maureen Farrell and Corrie Driebusch, *WeWork to List Shares on Nasdaq, Make Governance Changes*, Wall Street Journal (Sep. 13, 2019), available at <https://www.wsj.com/articles/wework-to-list-shares-on-nasdaq-make-governance-changes-11568348421>.

¹⁴ See Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights* at 7 (cited in note 11).

¹⁵ See *id.*

¹⁶ See 8 Del. C. § 151(a) ("Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, ... which classes or series may have such voting powers, full or limited, or no voting powers, ... as shall be stated and expressed in the certificate of incorporation....").

¹⁷ See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face*, 30 Del. J. Corp. L. 673, 678 (2005) ("Delaware is more suspicious when the fiduciary who is interested is a controlling stockholder ... there is an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders.").

¹⁸ C.A. No.9962-VCL (Del. Ch. Jan. 25, 2016).

Court of Chancery, alleging breach of fiduciary duty and waste of corporate assets, and successfully defended the suit against a motion to dismiss (the suit was ultimately settled).¹⁹ In the process, the Chancery Court applied the “entire fairness” standard of judicial review because the transaction expressly provided a benefit to an affiliate of the controlling shareholder.²⁰

That said, Delaware courts have identified certain circumstances in which transactions involving controlling shareholders will not be subject to “entire fairness” review. In *IRA Trust FBO Bobbie Ahmed v. Crane*,²¹ the Delaware Court of Chancery held that the “entire fairness” standard would otherwise apply to the recapitalization undertaken by a dual class share corporation to stop the erosion of the controlling stockholder’s voting power and extend the time the controller held majority voting control of the corporation. However, the court held that since the corporation’s board of directors conditioned the recapitalization on approval by (i) a fully empowered independent committee of the board of directors and (ii) a fully informed, uncoerced majority of the minority vote, the more deferential “business judgment” standard was appropriate. In doing so, the court applied the rule of *Kahn v. M & F Worldwide Corp.*,²² which held that if a conflicted controller transaction is subject from the outset to the conditions of approval by both a special committee of independent directors and a majority of the unaffiliated stockholders, then the business judgment standard would apply instead of the entire fairness standard.²³ The *IRA Trust* holding suggests that the Delaware courts will emphasize procedural safeguards in protecting the interests of noncontrolling shareholders of corporations with dual class equity structures.²⁴

b. Europe

The prevalence of dual class equity structures varies considerably between European jurisdictions. In a 2006 study of more than 4,000 publicly traded European corporations, Bennedsen and Nielsen found that—for countries that permitted dual class share structure at the time of the survey—the use of dual class shares ranged from highs in Sweden (62 percent of sample corporations) and Switzerland (52 percent) to lows in France (3 percent), Portugal and Spain (both 0 percent).²⁵ A

¹⁹ See *id.*

²⁰ See *id.*

²¹ C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017).

²² Del. Supr., No. 334, 2013 (March 14, 2014).

²³ For more on the emphasis on procedural safeguards for control shareholder transactions, see Itai Fiegenbaum, *The Controlling Shareholder Enforcement Gap* (April 4, 2019), available at <https://ssrn.com/abstract=3227828>.

²⁴ For another case in which a Delaware court emphasized the requirement for controlling shareholders of dual class companies to abide by corporate formalities, see *Espinoza v. Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015) (holding that informal approval by controlling shareholder of dual class company was insufficient to authorize an increase in non-management director compensation and formal consent was required).

²⁵ See Morten Bennedsen and Kasper Meisner Nielsen, *The Principle of Proportional Ownership, Investor Protection and Firm Value in Western Europe*, ECGI Working Paper Series in Finance, Working Paper No. 134/2006 (May 2008), available at <https://ecgi.global/sites/default/files/The%20Principle%20of%20Proportional%20Ownership%2C%20Investor%20Protection%20and%20Firm%20Value%20in%20Western%20Europe.pdf>.

2007 survey, commissioned by the European Commission and conducted by ISS, reported similar results based on a sample of 464 companies in 16 European countries, though it differed noticeably in some cases. For example, ISS reported that 3 percent of U.K. companies in their sample used dual class shares (compared to 25 percent reported by Bennedsen and Nielsen). These differences could be explained by Bennedsen and Nielsen's much larger sample, which included numerous small companies.²⁶

A more recent academic survey found that, as of 2016, dual class shares continued to be prevalent in Sweden (46.6 percent of companies analyzed; 69.5 percent when weighted by market capitalization) and were less common in France (4.6 percent; 11.5 percent by market cap) and the U.K. (2.1 percent; 3.5 percent by market cap) (see **Figure 1.1**).²⁷ The index provider MSCI reported that as of September 2017, the number of issuers included in the MSCI ACWI Index, its global flagship index, that had dual class share structures ranged from a high of 68.3 percent by market cap in Sweden to a low of 0.4 percent by market cap (representing just two issuers) in the United Kingdom.²⁸

The disparities in prevalence of dual class voting structures in Europe are partly attributable to the different regulatory approaches to dual class equity structures that have been adopted by European jurisdictions. For example, some jurisdictions discourage them or prohibit them outright, while others allow shares with unequal voting rights (in some cases, subject to certain limits on the disproportionality of voting rights).

Some European jurisdictions have adopted a permissive approach to dual class voting structures: France, Italy, Ireland and Finland generally allow unequal voting structures.²⁹ France, in fact, has

²⁶ See Institutional Shareholder Services, *Report on the Proportionality Principle in the European Union*, 38–39 (May 18, 2007), available at https://ecgi.global/sites/default/files/final_report_en.pdf. See also Anete Pajuste, *Determinants and Consequences of the Unification of Dual Class Shares*, European Central Bank Working Paper No. 465 (March 2005), available at <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp465.pdf?2a436e67ce16b853494adab3efb255d7> (documenting a decline in the number of companies using dual class shares in several European countries, including Germany, Sweden and Switzerland, between 1995 and 2001).

²⁷ See Kim, Matos and Xu, *Multi-Class Shares Around the World* at 39 (cited in note 1). See also Kristof Ho Tiu, *Analysis: Differentiated Voting Rights in Europe* (Feb. 17, 2015), available at <https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/> (noting that in the Nordic region, differentiated voting rights implemented through dual class share structures are common). Differentiated voting rights can also be implemented without dual class structures, as in France. See text accompanying note 30.

²⁸ See *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?* at 22 (cited in note 2) (reporting that the number of issuers with unequal voting structures represented 53% of the market cap in Denmark and 38% in Finland, followed by Italy with 30%, Switzerland with 25%, Netherlands with 23%, and Germany—close to the global average—with 12%).

²⁹ See *Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion*, OECD Steering Group on Corporate Governance 16 (Dec. 2007), available at <https://www.oecd.org/daf/ca/40038351.pdf>. Italian law allows listed companies to issue loyalty shares that entitle shareholders to a double vote after a two-year

adopted a favorable approach to unequal voting rights more broadly: in 2014 France changed the default voting structure from one in which each share is entitled to an equal vote to a tenure voting structure, which entitles shareholders to a double vote after holding their shares for a loyalty period (typically, two years). French law allows companies to opt out of the tenure voting default structure through a shareholder resolution and a two-thirds majority binding vote.³⁰

Other European jurisdictions—such as Germany, Belgium, and Spain—differentiate between common and preferred shares, allowing companies to issue non-voting preferred shares, but not common shares with unequal (or no) voting rights.³¹ Still others differentiate between shares with unequal voting rights and shares with no voting rights at all: the Netherlands and Sweden, for example, allow companies to issue shares with unequal voting rights but do not permit the issuance of nonvoting shares (whether common or preferred).³²

In the United Kingdom, company law grants companies considerable discretion in adopting the internal rules, including voting rights, under which the company is governed.³³ However, a company with a dual class share structure is only permitted to publicly offer shares within the “standard listing” regime (which covers financial instruments ranging from equity shares to Global Depositary Receipts, debt and securitized derivatives), but not the “premium listing” regime (which is limited to equity shares of companies and closed- and open-ended investment entities).³⁴ Premium listings are generally considered more attractive to investors because premium listed companies

holding period, and non-listed companies to issue multiple-vote shares with a maximum of three votes per share. See Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat*, ECGI Working Paper Series in Law, Working Paper No. 288/2015 13–17 (March 2015), available at https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2574236.pdf.

³⁰ See Marco Becht, Yuliya Kamisarenka and Anete Pajuste, *Loyalty Shares with Tenure Voting - A Coasian Bargain? Evidence from the Loi Florange Experiment*, ECGI Working Paper Series in Law, Working Paper No. 398/2018 9–11 (April 2018), available at https://ecgi.global/sites/default/files/working_papers/documents/final-bechtkamisarenkapajuste.pdf. French companies with tenure voting are not treated as having dual class equity structures in the studies of dual class prevalence cited earlier.

³¹ See *Lack of Proportionality Between Ownership and Control* at 16 (cited in note 29).

³² See *id.* Swedish law provides that no share may carry voting rights that are ten times greater than the voting rights of any other share. See *Proportionality Between Ownership and Control in EU Listed Companies: External Study Commissioned by the European Union*, Shearman & Sterling LLP, Exhibit C (Part II) 235–236 (November 1, 2016).

³³ See *Bushell v. Faith* (1970) 1 All ER 53 (enforcing unequal voting rights structure).

³⁴ Financial Conduct Authority, *Listing Rules 7.2.1A* (Sep. 2018). As of May 31, 2019, 505 of the stocks (excluding closed- and open-ended investment companies) listed on the London Stock Exchange’s Main Market had a premium listing, compared to 241 that had a standard listing. See *Companies and Securities: Instrument List*, London Stock Exchange, available at <https://www.londonstockexchange.com/statistics/companies-and-issuers/companies-and-issuers.htm>.

must satisfy more restrictive corporate governance and transparency standards (including the one-share, one-vote principle).³⁵

A review commissioned by the Chancellor of the Exchequer and published in 2017 noted that permitting dual class structures within the premium listing regime could help make public offerings more attractive in the United Kingdom, and it urged the Financial Conduct Authority to consider the move, but the FCA has taken no firm action on the proposal.³⁶ Nevertheless, in November 2019, reports emerged that the UK government is considering altering the listing rules to permit the broader use of dual class shares, particularly to attract more listings by technology companies among whom dual class share structures are popular.³⁷

c. Asia

Asian jurisdictions also exhibit variation with respect to the regulation and prevalence of dual class equity structures, though as a general matter such structures are not prevalent in major Asian jurisdictions. Indeed, rates of dual class share structures are low even in Asian jurisdictions that effectively permit such structures; in other jurisdictions, the “one share, one vote” principle has been codified and companies that assign unequal voting rights to their common stock are non-existent.

Japan and Hong Kong are examples of Asian jurisdictions where dual class equity structures are permitted but uncommon. In Japan, such structures are rare: the MSCI report described above indicates that as of September 2017, only one of the Japanese issuers in its global flagship index had a dual class share structure.³⁸ That is the case even though Japan permits the issuance of non-voting preferred or common shares and Japan’s Corporation Act allows companies to adopt a “unit” share system, pursuant to which a company may specify in its articles of incorporation the number of shares that will constitute one voting unit, which effectively allows an unequal voting

³⁵ See Andrew Bailey, *Premium listing will not water down corporate governance*, Financial Times (June 10, 2018), available at <https://www.ft.com/content/5dbf33e0-6b24-11e8-ae1-39f3459514fd>.

³⁶ See *Financing Growth in Innovative Firms: Consultation*, HM Treasury 4.13 (August 2017), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/642456/financing_growth_in_innovative_firms_consultation_web.pdf; *Feedback Statement to DP17/2 Review of the Effectiveness of Primary Markets: the UK Primary Markets Landscape*, Financial Conduct Authority 2.25 (Sep. 2017), available at <https://www.fca.org.uk/publication/feedback/fs17-03.pdf>.

³⁷ See Attracta Mooney, *Big investors fight back over dual class shares*, Financial Times (Nov. 24, 2019), <https://www.ft.com/content/bc220535-5055-47ce-811d-fc4a56d32937>; Daniel Thomas, Philip Stafford and Patrick Jenkins, *UK seeks change in listing rules to lure tech start-ups*, Financial Times (Nov. 4, 2019), <https://www.ft.com/content/d4d2da5a-fee8-11e9-be59-e49b2a136b8d>.

³⁸ See *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?* at 22 (cited in note 2).

structure. A corporation can divide its stock into multiple classes and specify how many shares of each class are needed to count as one unit.³⁹

Dual class equity structures are also not prevalent in Hong Kong, even though Hong Kong law allows companies to incorporate with different voting rights for different classes of stock.⁴⁰ MSCI reports that as of September 2017, only one of the Hong Kong issuers in its global flagship index had a dual class share structure. That may be because, until 2018, the Hong Kong stock exchange did not allow companies with multiple classes of equity with different voting rights to be listed, so local dual-class companies wishing to go public would either have to list in another country or eliminate their dual class share structures.⁴¹ As of year-end 2019, three dual class companies had listed on the Hong Kong stock exchange under the exchange’s new listing regime.⁴²

Unlike Japan and Hong Kong, South Korea has adopted the “one share, one vote” principle, and does not allow corporations to issue common shares with unequal (or no) voting power—they can, however, issue nonvoting preferred shares.⁴³ Likewise, China has incorporated the “one share, one vote” principle into both the Chinese company law and the securities regulator’s listing rules for its major mainland stock exchanges.⁴⁴ As a result, Chinese companies seeking to adopt a dual class equity structure with unequal voting rights have undertaken public offerings in the United States: as of June 2016, approximately 30 percent of the China-headquartered companies listed on U.S. stock exchanges (and more than half of those that had listed since 2011) employed dual class share structures.⁴⁵ These companies have a combined market capitalization of \$561 billion, representing more than 80 percent of the market value of all mainland Chinese companies that are listed in the United States.

China has, however, experimented with allowing listed companies to issue non-voting preferred shares.⁴⁶ In addition, China’s company law anticipates that China’s cabinet may promulgate separate regulations for the issuance of shares with differentiated voting rights,⁴⁷ and recently, Chinese

³⁹ See *Proportionality Between Ownership and Control in EU Listed Companies* at 332-345 (cited in note 32).

⁴⁰ See Companies Ordinance (Hong Kong), Cap. 622, Article 588(4).

⁴¹ See below, Section 2(a).

⁴² See *Market Statistics 2019*, HKEx 2 (2020), available at <https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/2019-Market-Statistics.pdf>;

⁴³ See Commercial Act (Republic of Korea), Articles 369, 370 (2012).

⁴⁴ See Companies Law of People’s Republic of China, Art. 103 (2018); China Securities Regulation Commission, *Guidelines for the Articles of Association of Listed Companies (2019 Revision)*, Art. 78 (2019).

⁴⁵ See Fa Chen and Lijun Zhao, *To Be or Not to Be: An Empirical Study on Dual Class Share Structure of US Listed Chinese Companies*, 16 J. of Int. Bus. Law 215 (2017).

⁴⁶ See *Measures for the Administration of the Pilot Program of Preferred Shares*, China Securities Regulation Commission (March 21, 2014).

⁴⁷ See Companies Law of People’s Republic of China, Art. 131 (2018).

authorities have taken several steps to loosen restrictions on dual class shares.⁴⁸ In 2018, China’s cabinet approved a pilot program to allow large “red-chip” companies—companies whose main business is in mainland China but that are incorporated and listed abroad—to issue depository receipts that trade on China’s main stock exchanges. These red-chip companies include companies that opted out of listing in China in order to skirt various Chinese listing rules, including restrictions on dual class equity structures.⁴⁹ More recently, in early 2019 China’s securities regulator approved the launch of a new science and technology innovation board that would allow companies with dual class share structures to go public.⁵⁰

2. Response of private actors to dual class shares

In addition to government regulation, the prevalence of dual class equity structures is affected by the policies and behavior of private actors. Stock exchanges have liberalized their listing rules to allow public offerings by companies with dual class shares. On the other hand, index providers have considered—and in some cases adopted—policies that exclude companies with dual class share structures from their major indexes. Institutional investors have also weighed in on the debate about unequal voting shares.

a. Exchanges

Though some stock exchanges have historically imposed a “one-share, one-vote” rule on listing issuers, the current trend—driven by competition among stock exchanges for listings—has been in the direction of allowing the listing of stock with unequal voting rights (see **Table 1.1**).

⁴⁸ See *Promising startups to get backing for listing*, State Council of the People’s Republic of China (September 27, 2018) (“[L]egislation and regulations related to the capital market will be improved to allow technological companies to adopt a management structure in which differentiated rights are given to the same amount of shares.”), available at http://english.www.gov.cn/policies/latest_releases/2018/09/27/content_281476320340892.htm.

⁴⁹ See Gabriel Wildau, *China clears path for foreign-listed tech unicorns to return home*, Financial Times (March 30, 2018), available at <https://www.ft.com/content/60859464-342b-11e8-ae84-494103e73f7f>. Depository receipts avoid these restrictions because technically they are certificates issued by a bank that holds shares registered in another country, rather than the underlying shares themselves.

⁵⁰ See *Administrative Measures for the Management of the Pilot Registration System of Initial Public Offering on the Science and Technology Innovation Board (Trial)*, China Securities Regulation Commission (Jan, 30, 2019).

Table 1.1. Stock exchange listing rules.

| | Dual class shares allowed? | | Dual class shares allowed? |
|---------------------------------|----------------------------|--|----------------------------|
| New York Stock Exchange | ✓ | Bombay Stock Exchange | × |
| Nasdaq | ✓ | National Stock Exchange (India) | × |
| Tokyo Stock Exchange | ✓ | Australian Securities Exchange | × |
| Shanghai Stock Exchange | × | Deutsche Börse | ✓ |
| Hong Kong Stock Exchange | ✓ | SIX Swiss Exchange | ✓ |
| Euronext | ✓ | Stockholm Stock Exchange | ✓ |
| London Stock Exchange | × | Johannesburg Stock Exchange | ✓ |
| Shenzhen Stock Exchange | × | Singapore Stock Exchange | ✓ |
| Toronto Stock Exchange | ✓ | | |

In the United States, the New York Stock Exchange (since the mid-1980s) and NASDAQ allow a company’s stock to be listed even if it has unequal voting rights, but both exchanges restrict the ability of listed companies to disparately reduce the voting power of already-issued shares by, for example, issuing shares of a new class of stock with greater voting rights.⁵¹

Other exchanges allow companies to list with dual class equity structures as long as they include substantive protections for non-controlling shareholders. The Toronto Stock Exchange, for example, requires that listed dual class companies provide “coat-tail” protections, which provide that holders of ordinary shares must be allowed to participate in any change of control transaction on the same terms as the holders of high-vote stock.⁵² This kind of provision prevents controlling shareholders from selling their control stake at a premium at the expense of the company’s other shareholders.

Recently, after losing out on initial public offerings to exchanges in the United States, both the Hong Kong and Singapore stock exchanges have liberalized their listing rules to allow for dual class equity structures. Although the Hong Kong stock exchange continues to emphasize that the “one-share, one vote” principle is “the optimum method of empowering shareholders and aligning

⁵¹ See *NYSE Listing Company Manual* Rule 313.00(A) & (B): Voting Rights (2018), available at http://wallstreet.cch.com/LCMTTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Fflcm%2Fsections%2Fflcm-sections%2F; *NASDAQ Stock Market Listing Rules* Rule 5640: Voting Rights (2018), available at http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual=%2Ffnasdaq%2Fmain%2Ffnasdaq-equityrules%2F. Both of these rules are based on SEC Rule 19c-4, and were adopted in response to SEC pressure after Rule 19c-4 was struck down. See note xx.

⁵² See Toronto Stock Exchange, *TSX Company Manual*, Sec. 624(l) (2019).

their interests in a company,” it amended its listing rules in April 2018 to allow for the listing of shares with unequal voting rights.⁵³ The Singapore exchange subsequently adopted similar rules.⁵⁴

Like the Toronto Stock Exchange, the Hong Kong and Singapore exchanges impose certain requirements on dual class issuers that are intended to protect investors in those companies. Both exchanges impose a cap on the voting power of controlling shareholders: high-vote shares of listed dual class companies cannot have more than ten times the voting power of ordinary shares.⁵⁵ The Hong Kong stock exchange also requires additional investor protection safeguards for listed dual class companies: high-vote holders must be directors of the company and must collectively own at least a ten percent economic interest in the company; shares must automatically convert to regular common stock upon transfer or upon the retirement or incapacity of their initial holder; and certain corporate decisions, such as the appointment or removal of an independent director or auditor, must be undertaken on a one-share, one-vote basis.⁵⁶

Notably, stock exchanges in mainland China also appear to be liberalizing their approach regarding dual class share structures. After initial indications to the contrary, China’s mainland stock exchanges agreed to allow Chinese mainland investors to buy dual class companies listed on the Hong Kong stock exchange through the trading platform linking the Hong Kong stock exchange to stock exchanges in mainland China.⁵⁷ And in 2019, the Shanghai Stock Exchange—one of China’s two primary mainland exchanges—launched a science and technology innovation board that allows companies with dual class share structures to list, provided they meet certain financial and regulatory conditions.⁵⁸ The first listing of a dual class company on the board was approved in September 2019.⁵⁹

⁵³ See *Consultation Conclusions: A Listing Regime For Companies From Emerging And Innovative Sectors*, Hong Kong Exchanges and Clearing Limited I-5 (April 2018), available at [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-\(April-2018\)/cp201802cc.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-(April-2018)/cp201802cc.pdf).

⁵⁴ See *Singapore Details Rules For Offering Dual Class Shares, Follows Hong Kong*, Reuters (June 28, 2018), available at <https://www.reuters.com/article/sgx-regulation/singapore-details-rules-for-offering-dual-class-shares-follows-hong-kong-idUSL4NiTS3E3>.

⁵⁵ See Singapore Exchange Limited, *Mainboard Rules*, Chapter 2, Rule 210(10)(d) (2019); Hong Kong Exchanges and Clearing Limited, *Consolidated Main Board Listing Rules*, Chapter 8A.10 (2019).

⁵⁶ See Hong Kong Exchanges and Clearing Limited, *Consolidated Main Board Listing Rules*, Chapter 8A (2019).

⁵⁷ See Emma Dunkley, *China bourses plan reprieve on dual class Hong Kong shares*, Financial Times (July 18, 2018), available at <https://www.ft.com/content/db181dfo-8a39-11e8-bf9e-8771d5404543>.

⁵⁸ See *Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (Revised in 2019)* Art. 2.1.4 (March 2019).

⁵⁹ See Hudson Lockett, *Shanghai’s Star Market fades after initial success*, Financial Times (Sep. 29, 2019), available at <https://www.ft.com/content/f5285292-e112-11e9-9743-db5a370481bc>.

b. Index providers

Index providers have often pushed back on the use of dual class shares. Unlike active investors, passive investors aim to hold the “entire” market or an entire segment of the market—in other words, they have committed to not sell the stock of companies within that segment of the market. Because passive investors cannot “vote with their feet” by selling stock of individual companies, exercising their voting rights is the primary way in which they can affect corporate policy.⁶⁰ However, major index providers such as FTSE, S&P and MSCI have taken different approaches to multiple class equity structures (see Table 1.2).

Table 1.2. Major index treatment of dual class shares.⁶¹

| Inclusion | Weighting | Hurdle | Exclusion |
|---|--|---|---|
| <ul style="list-style-type: none"> • CRSP US Total Market • Nasdaq 100 • MSCI EAFE • FTSE Emerging Markets All Cap China A Inclusion • MSCI Emerging Markets Investable Market • CRSP US Large Cap Value • CRSP US Large Cap Growth • NASDAQ US Dividend Achievers Select • MSCI USA Minimum Volatility • MSCI US Investable Market Real Estate 25/50 | <ul style="list-style-type: none"> • None | <ul style="list-style-type: none"> • Russell 1000 • FTSE Developed All Cap ex US • Russell 1000 Growth • Russell 2000 • Russell 1000 Value | <ul style="list-style-type: none"> • S&P 500 • S&P MidCap 400 • S&P SmallCap 600 |

⁶⁰ See *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?* at 13 (cited in note 2).

⁶¹ The indexes included here represent those tracked by the twenty largest equity ETFs, as measured by assets under management. The list of these ETFs can be found using ETF.com’s ETF Screener & Database, available at <https://www.etf.com/etfanalytics/etf-finder/>. See *S&P U.S. Indices Methodology*, S&P Dow Jones Indices 7 (March 2020), available at <https://us.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf>; *Russell U.S. Equity Indexes v4.3: Construction and Methodology*, FTSE Russell 16 (March 2020), available at <https://research.ftserussell.com/products/downloads/Russell-US-indexes.pdf>; *FTSE Global Equity Index Series v9.3: Ground Rules*, FTSE Russell 12 (March 2020), available at https://research.ftserussell.com/products/downloads/FTSE_Global_Equity_Index_Series.pdf; *CRSP Indexes Methodology Guide*, Center for Research in Security Prices 6 (Jan. 2020), available at http://www.crsp.org/files/Equity-Indexes-Methodology-Guide_o.pdf; *MSCI Will Retain the MSCI Global Investable Market Indexes Unchanged and Launch a New Index Series Reflecting the Preferences of Investors on Unequal Voting Structures*, MSCI (Oct. 30, 2018), available at https://www.msci.com/documents/10199/238444/PR_Voting_Results.pdf/ob548379-fbe7-71c7-b392-7140b2215cc9; *NASDAQ-100 Index Methodology*, Nasdaq (Dec. 2018), available at https://indexes.nasdaqomx.com/docs/Methodology_NDX.pdf; *NASDAQ US Dividend Achievers™ Select Index Methodology*, Nasdaq (Oct. 2019), available at https://indexes.nasdaqomx.com/docs/Methodology_DVG.pdf.

Exclusion approach

Some index providers have adopted an exclusion approach to multi-class equity structures for certain indexes—that is, companies with multi-class structures are left out of the index. In the United Kingdom, only “premium listed” companies are eligible for inclusion in the FTSE UK Index Series, so companies with multiple class share structures (as well as others that fail to qualify for a premium listing) are excluded. And S&P Dow Jones Indices announced in 2017 that companies with multiple share class structures would be excluded from its S&P Composite 1500 indexes, including the S&P 500, though existing members would be grandfathered in.⁶²

Hurdle approach

FTSE Russell has eschewed the strict exclusion approach in favor of a voting rights hurdle in order to ensure that minority investors have some minimum degree of control over companies they hold. Beginning in 2017, to be eligible for inclusion in certain FTSE Russell equity indexes, including the popular Russell 1000, 2000, and 3000 indexes, companies from developed markets must have at least 5% of their voting rights across all securities held by public investors.⁶³ (Existing constituents are grandfathered for five years until 2022.⁶⁴) Because FTSE Russell already imposed voting rights restrictions on UK incorporated companies for inclusion in its UK Index Series, the effects of the new policy will be felt primarily in FTSE’s United States and global indexes.⁶⁵

Weighting approach

One concern with index exclusion is that it reduces the opportunity for passive investors to get comprehensive exposure to the market. An alternative to exclusion is a weighting approach, which reduces the weight of unequal voting shares in an index to better align economic exposure with listed voting power.⁶⁶ Both exclusion and weighting penalize companies for adopting dual class equity structures by reducing the demand for their shares from passive investors. Unlike outright exclusion, however, the weighting approach operates on a sliding scale—as the voting power of outside shareholders increases, the company’s weight in the index increases—giving companies an

⁶² See *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, S&P Dow Jones Indices (July 31, 2017); Andrew Winden and Andrew Baker, *Dual Class Index Exclusion*, Rock Center for Corporate Governance, Working Paper Series No. 233 24–26 (August 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3201578. The S&P Composite 1500 (comprising the S&P 500, S&P MidCap 400 and S&P SmallCap 600) is designed to reflect the U.S. equity market, but follows stricter and, in some cases, more subjective eligibility rules than other, broader equity indexes.

⁶³ See *FTSE Russell Voting Rights Consultation – Next Steps*, FTSE Russell 3 (July 2017), available at https://research.ftserussell.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

⁶⁴ See *id.*

⁶⁵ See Winden and Baker, *Dual Class Index Exclusion* at 27–28 (cited in note 62).

⁶⁶ See *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?* at 14–15 (cited in note 2) (describing how a company’s weight in the index could be adjusted by multiplying the free float of its securities by the ratio of the voting power of listed shares to the total free float of the company).

incentive to reduce the gap between free float and voting power even if they do not eliminate it entirely.

No major index provider has adopted a weighting approach. MSCI considered a weighting approach⁶⁷ but ultimately rejected it on the grounds that indexes should represent the broadest investment opportunities available, regardless of investor preferences regarding corporate governance policy.⁶⁸ Instead, MSCI includes dual class companies in its indexes, but offers an alternative series of benchmarks that specifically include voting rights in their weighting criteria and construction methodology.⁶⁹

c. Institutional investors

Institutional investors have generally opposed dual class equity structures. Like passive investors that seek comprehensive exposure to markets, institutional investors tend to have long-term investment horizons, so voting rather than sale is often their primary tool to align their interests with the interests of corporate management. Accordingly, institutional investors such as CalPERS have expressed support for the “one-share, one-vote” principle.⁷⁰ Likewise, the Council of Institutional Investors (CII) has taken the position that each share of a public company’s common stock should have equal voting rights in order to minimize principal-agent costs. With the endorsement of prominent institutional investors such as BlackRock and T. Rowe Price,⁷¹ CII has called for restrictions on the use of dual class equity structures by listed companies.⁷²

⁶⁷ See id; Winden and Baker, *Dual Class Index Exclusion* at 39-31 (cited in note 62).

⁶⁸ See Rachel Evans, *MSCI Rejects Calls to Ban Dual Class Stocks From its Indexes*, Bloomberg (Oct. 30, 2018), available at <https://www.bloomberg.com/news/articles/2018-10-30/msci-rejects-calls-to-ban-dual-class-stocks-from-its-indexes>.

⁶⁹ See *MSCI Voting Rights-Adjusted Indexes Methodology*, MSCI (May 2019), available at https://www.msci.com/eqb/methodology/meth_docs/MSCI_Voting_Rights_Adjusted_Indexes_Methodology_May2019.pdf.

⁷⁰ See *Dual Class/Non-Voting Shares Update*, CalPERS Investment Committee (April 2018), available at https://www.calpers.ca.gov/docs/board-agendas/201804/invest/item06a-01_a.pdf.

⁷¹ See Benjamin Bain, *BlackRock Backs Limits on Listings With Separate Share Classes*, Bloomberg (Oct. 24, 2018), available at <https://www.bloomberg.com/news/articles/2018-10-24/blackrock-backs-limits-on-listings-with-separate-share-classes>; Lorraine Mirabella, *T. Rowe Price Takes Stand Against Stock Structures That Create Unequal Shareholder Rights*, Baltimore Sun (Mar. 19, 2016), <http://www.baltimoresun.com/business/bs-bz-t-rowe-price-oppose-dual-class-stock-20160319-story.html>.

⁷² See Ash Williams, Ken Bertsch and Jeff Mahoney, *Letter to John Zecca, Senior Vice President, NASDAQ Stock market* (Oct. 24, 2018), available at https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf; Ash Williams, Ken Bertsch and Jeff Mahoney, *Letter to Elizabeth King, Chief Regulatory Officer, Intercontinental Exchange Inc. (NYSE)* (Oct. 24, 2018), available at https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf; Ken Bertsch and

While CII views “one-share, one-vote” as the optimal approach, it has supported the use of dual class shares with sunset provisions, whereby the unequal voting structure is automatically wound down by the seven-year anniversary of a company’s IPO unless it is approved by a majority of each share class on a one-share, one-vote basis.⁷³ BlackRock has proposed that dual class companies obtain shareholder approval for their dual class structures on a periodic basis, giving shareholders the opportunity to keep the current share classes or convert to a one-share, one-vote structure.⁷⁴

Other international investor groups, such as International Corporate Governance Network and the European Shareholders Group, as well as country-specific shareholders’ associations, have also strongly supported the principle that each share of a company’s common stock should have equal voting rights.⁷⁵

3. Evidence for and against dual class shares

“The advantage of a dual class share structure is that it protects entrepreneurial management from the demands of shareholders. The disadvantage of a dual class share structure is that it protects entrepreneurial management from the demands of shareholders.”⁷⁶ That the very same feature of a corporate structure can, depending on the circumstances, be both beneficial and detrimental to companies and investors complicates the policy debate about dual class shares.

That policy debate would be improved by distinguishing between two questions: (1) whether it is better or worse for companies, their shareholders, and the economy as a whole for management to be protected from the demands of shareholders and (2) whether shareholders and entrepreneur-

Jeff Mahoney, *Letter to Delaware State Bar Association: Limiting Multi-Class Voting Structures* (September 13, 2019), available at https://www.cii.org/files/issues_and_advocacy/correspondence/2019/September%2013%202019%20Final%20DGCL%20letter.pdf.

⁷³ See Council of Institutional Investors, *Dual Class Stock* (2019), available at https://www.cii.org/dualclass_stock..

⁷⁴ See also *Key considerations in the debate on differentiated voting rights*, BlackRock, available at <https://www.blackrock.com/corporate/literature/whitepaper/blackrock-the-debate-on-differentiated-voting-rights.pdf>. However, BlackRock has opposed excluding companies from broad market indexes based on unequal voting structures. See *A Potential Solution for Voting Rights and Index Inclusion Issues*, BlackRock (October 2017), available at <https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf>.

⁷⁵ See *Differential rights*, International Corporate Governance Network: ICGN Viewpoint (April 2015), available at <https://www.icgn.org/policy/viewpoints/differential-rights>; *Lack of Proportionality Between Ownership and Control* at 26-27 (cited in note 29).

⁷⁶ See Andrew Hill, *Enrolment open for an MBA in Murdoch*, Financial Times (July 18, 2011), available at <http://www.ft.com/cms/s/0/2fd9e8e-b176-11e0-9444-00144feab49a.html>. See also Paul A. Gompers, Joy Ishii and Andrew Metrick, *Extreme Governance: An Analysis of Dual Class Firms in the United States*, 23 Rev. of Fin. Stud. 1051 (March 2010) (reporting that about 85 percent of companies with dual class shares have at least one class of shares that are held by people who do not want to dispose of them and that company insiders own roughly 60 percent of the votes but only 40 percent of the cash flow rights of dual class companies).

ial management should have the *option* to agree to an arrangement whereby management is protected from the demands of shareholders. This section reviews arguments on both sides of these questions and considers the empirical evidence in support of those arguments.

We find that the empirical evidence regarding the effects of dual class equity structures on company value, capital costs and performance is ultimately inconclusive. The difficulty in establishing a definitive link between dual class shares and company performance may be attributable to confounding factors—such as the relative sophistication of investors and regulators, protections afforded minority investors and restrictions on private benefits—that vary widely across jurisdictions. However, there is suggestive evidence that the use of dual class shares facilitates access to public equity financing for some companies that otherwise would rely on private equity.

The absence of compelling evidence that dual class shares harm companies, their shareholders or the broader economy—especially in countries with sophisticated public markets and strong investor protections like the United States—should caution policymakers against limiting the ability of companies to adopt dual class equity structures.

a. Are dual class structures helpful or harmful?

Opponents of dual class equity structures argue that economic rights should be aligned with voting rights because shareholders, as the owners and residual claimants against company assets, have the incentive to maximize a company’s value.⁷⁷ Accordingly, participation in corporate decisions should be proportionate to the amount of capital shareholders have committed to the company. By separating control from economic incentives, unequal voting structures create opportunities for controlling shareholders to make decisions that benefit themselves at the expense of the company’s value (and the interests of other shareholders). Their control over the company also insulates them from pressure in the market for corporate control.⁷⁸

Several empirical studies, based on analyses of companies in a variety of different jurisdictions, appear to demonstrate that unequal voting structures hurt firm value. Claessens et al. (2002), based on a study of firms in eight East Asian economies, find that separation of cash flow and control decreases firm value.⁷⁹ Likewise, Lins (2003) reports that firm value is lower whenever votes are more concentrated than cash flow in emerging markets;⁸⁰ Cronqvist and Nielsen (2003) show that the presence of controlling minority owners decreases firm value and performance, especially

⁷⁷ See Sanford J. Grossman and Oliver D. Hart, *One Share–One Vote and The Market for Corporate Control*, 20 J. of Fin. Econ. 175 (1988) (discussing the optimality of the one–share, one–vote rule).

⁷⁸ See Milton Harris and Artur Raviv, *Corporate Control Contests and Capital Structure*, 20 J. of Fin Econ. 55 (1988).

⁷⁹ See Stijn Claessens, Simeon Djankov, Joseph P. H. Fan and Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. of Fin. 2741 (2002).

⁸⁰ See Karl V. Lins, *Equity ownership and firm value in emerging markets*, 38 J. of Fin. and Quant. Analysis 159 (2003).

when the controlling shareholders are families (Sweden);⁸¹ and Maury and Pajuste (2004) document that firm value is lower when large owners control firms through disproportionate ownership structures (Finland).⁸²

Focusing on the United States, Smart, Thirumalai and Zutter (2008) report that companies with multiple classes of shares traded at lower prices than single-class firms, both at IPO and over the subsequent five years. They also find statistically and economically significant value gains when dual class companies unify their share classes.⁸³ Gompers, Ishii and Metrick (2010) find that company values decrease when insiders have disproportionate control.⁸⁴ And Masulis Wang and Xie (2009) report that company value decreases as insider control rights and cash flow rights diverge. In particular, as the gap between insider control rights and cash flow rights increases, CEOs receive higher levels of compensation, corporate cash holdings are worth less to outside shareholders, managers are more likely to make shareholder-value destroying acquisitions, and capital expenditures contribute less to shareholder value.⁸⁵ Based on these studies, Adams and Ferreira (2008) conclude in a literature review that there is support for the argument that unequal voting shares negatively affect the value of outside equity.⁸⁶

On the other hand, proponents of allowing dual class equity structures counter that protecting management from the immediate demands of shareholders can be in a company's long-term best interest. They argue that public shareholders tend to be focused on short-term increases in a company's value. This short-term focus induces management to pursue strategies that will increase the immediate value of the company, potentially at the expense of investments by the company that will be more profitable in the long term.⁸⁷ This rationale motivated the French adoption of tenure

⁸¹ See Henrik Cronqvist and Mattias Nilsson, *Agency costs of controlling minority shareholders*, 38 J. of Fin. and Quant. Analysis 695 (2003).

⁸² See Benjamin Maury and Anete Pajuste, *Multiple Controlling Shareholders and Firm Value*, 29 J. of Banking and Fin. 1813 (2004).

⁸³ See Scott B. Smart, Ramabhadran S. Thirumalai and Chad J. Zutter, *What's in a vote? The short- and long-run impact of dual class equity on IPO firm values*, 45 J. of Acc. and Econ. 94 (2008).

⁸⁴ See Gompers et al., *Extreme Governance: An Analysis of Dual Class Firms in the United States* (cited in note 76).

⁸⁵ See Ronald W. Masulis, Cong Wang and Fei Xie, *Agency Problems at Dual Class Companies*, 64 J. of Fin. 1697 (2009).

⁸⁶ See Renee Adams and Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 Rev. of Fin. 51 (2008).

⁸⁷ See Thomas J. Chemmanur and Yawen Jiao, *Dual class IPOs: A theoretical analysis*, 36 J. of Banking and Fin. 305 (2012) (predicting that that multi-class initial public offerings are more likely to be prevalent in: companies operating in industries where value can be created by ignoring short-term trends; family firms and firms run by founders (who tend to build reputations for good management); and firms where large private benefits of control exist). See also Harry DeAngelo and Linda DeAngelo, *Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock*, 14 J. of Fin. Econ. 33 (1985) (suggesting that dual class structures encourage managers to make company-specific investment in their human capital); Jeremy Stein, *Takeover Threats and Managerial Myopia*, 96 J. of Pol. Econ. 61 (1988) (developing a model in which managers undertake costly methods of signaling, including investing in short-term projects, in order to avoid being replaced).

voting as a default rule.⁸⁸

There is some recent empirical evidence to support this argument. Jordan, Kim and Liu (2016) find that dual class companies face less short-term market pressure based on a variety of measures: they have fewer short-term investors, lower analyst coverage, and are less likely to be the target of a takeover. They also find that these companies have higher sales growth and R&D intensity, consistent with a focus on increased growth. Most significantly, they find that dual class share structures tend to increase the market valuation of high growth companies.⁸⁹

Several empirical studies of dual class companies report ambiguous results, suggesting that dual class share structures may not be uniformly harmful or beneficial. Based a sample of Canadian companies, Jog, Zhu and Dutta (2010) find no evidence that companies with unequal voting structures exhibit better or worse company value, stock performance, or operating performance than companies that follow the one-share, one-vote principle.⁹⁰ Similarly, Morey (2017) finds that unequal voting structures do not result in a meaningful increase or reduction in long-term value creation, measured by return on invested capital.⁹¹

Kamonjoh (2016) finds that controlled companies in the S&P 1500 underperformed non-controlled firms over all periods with respect to total shareholder returns, revenue growth, return on equity and dividend payout ratios. However, he also reports that controlled companies generally outperformed non-controlled firms with respect to return on assets, return on invested capital and EBITDA growth.⁹² A study by Bennedsen and Nielsen (2006) reports a negative relationship between unequal voting rights and price-to-book ratios in European companies in their sample. But their evidence is not definitive: they find significant regional variation in the effect of dual class

⁸⁸ See Becht, Kamisarenka and Pajuste, *Loyalty Shares with Tenure Voting - A Coasian Bargain?* at 12 (cited in note 30). See also Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, Wall Street Journal (Aug. 14, 2018), available at <https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687> (arguing that the short-termism of public markets warrants a broader reconsideration of the principle of shareholder control of public companies).

⁸⁹ See Bradford D. Jordan, Soohyung Kim and Mark H. Liu, *Growth opportunities, short-term market pressure, and dual-class share structure*, 41 J. of Corp. Fin. 304 (2016).

⁹⁰ See Vijay Jog, PengCheng Zhu and Shantanu Dutta, *Impact of Restricted Voting Share Structure on Firm Value and Performance*, 18 Corp. Gov. 415 (2010).

⁹¹ See Gabriel Morey, *Multi-Class Stock and Firm Value: Does Multi-Class Stock Enhance Firm Performance? A Regression Analysis*, Council of Institutional Investors (May 2017), available at https://www.cii.org/files/publications/misc/05_10_17_dual-class_value_study.pdf.

⁹² See Edward Kamonjoh, *Investor Responsibility Research Ctr. Inst., Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk* 84 (Mar. 2016), available at <https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-CompaniesIRRCI-2015-FINAL-3-16-16.pdf>.

share structures on company value.⁹³ They also find no impact of unequal voting rights on operating performance, likelihood of bankruptcy, dividend policy, or growth.⁹⁴

Another group of studies offers evidence that the effect of dual class share structures depends on a company's maturity. Cremers, Lauterbach and Pajuste (2018) examine an extensive sample of U.S. dual and single class firms from the time of their IPO, and document that the valuation difference between dual and single class firms varies over their life cycle. They find that, around the time of the IPO, dual class firms tend to have higher valuations than single class firms. Over time, however, this valuation premium tends to dissipate.⁹⁵ Similarly, Kim and Michaely (2019) find that while young dual class companies trade at a premium and perform at least as well as single-class companies, as dual class firms mature, their valuation declines, and they become less efficient in their margins, innovation, and labor productivity compared to similarly situated single-class companies.⁹⁶

b. Should dual class structures be prohibited?

A related question is whether shareholders and management should have the legal ability to contract into an arrangement that gives some shareholders disproportionate voting rights. The argument that such an arrangement should be permitted emphasizes that the decision to acquire non-voting or unequal voting stock represents the voluntary choice of an informed agent in a competitive market—even though, in some cases, the arrangement might harm shareholders. Assuming that shareholders are adequately informed about the potential risks associated with unequal voting stock, competition for funding will facilitate the efficient pricing of different voting structures in public markets. The risks of unequal voting stock will be incorporated into their price and shareholders can decide for themselves whether the stock is appropriately valued.

⁹³ See Bennedsen and Nielsen, *The Principle of Proportional Ownership* at 18–19 (cited in note 25) (finding that the regional differences correlate with investor protection and anti-self-dealing measures and explaining that controlling shareholders with increased voting rights—when they are not also managers—can be effective substitutes for investor protections in jurisdictions with weak investor protection regimes). See also Armando Gomez, *Going Public without Finance: Managerial Reputation Effects*, 55 J. of Fin. 615 (2000) (proposing a reputation-based explanation for why the value discount on unequal voting structures may be affected by investor protection regimes, according to which controlling shareholders build reputation through abstaining from exploiting non-controlling shareholders and lack of investor protection increases the potential gain from reputation building).

⁹⁴ See Bennedsen and Nielsen, *The Principle of Proportional Ownership* at 18–19 (cited in note 25).

⁹⁵ See Martijn Cremers, Beni Lauterbach and Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation*, European Corporate Governance Institute (ECGI) – Finance Working Paper No. 550/2018 (Dec. 2018), available at <https://ssrn.com/abstract=3062895>.

⁹⁶ See Hyunseob Kim and Roni Michaely, *Sticking around Too Long? Dynamics of the Benefits of Dual Class Voting*, European Corporate Governance Institute (ECGI) – Finance Working Paper No. 590/2019; Swiss Finance Institute Research Paper No. 19–09 (January 2, 2019), available at <https://ssrn.com/abstract=3145209>.

Opponents of dual class equity structures might counter that shareholders are not adequately informed about the risks associated with such structures (if disclosure is poor) or that they do not fully assimilate that information into their decision about whether to hold unequal voting stock. For example, a passive investor in an index fund is not likely to exit his or her position based on an underlying issuer's voting rights structure. The presence of underinformed investors, or investors who are insensitive to concerns about corporate governance, could result in a failure to price in the risks associated with unequal voting rights, potentially suggesting that dual class shares should be prohibited or restricted to protect these investors.

Empirical evidence, however, indicates that dual class companies have lower market values than their single-class counterparts.⁹⁷ That suggests, contrary to the critics of dual class shares, that shareholders *do* appreciate the risks associated with the divergence between control rights and economic rights. Further, there is evidence that investors are discerning when it comes to different kinds of dual class companies. Anderson, Ottolenghi and Reeb (2017) report that investors demand a premium for holding dual class companies that are family-controlled, but dual class companies that are not family-controlled possess high stock valuations. Overall, their findings suggest that investors exhibit substantial concerns over *family control* rather than dual class structures.⁹⁸ Likewise, former SEC Commissioner Robert Jackson has offered evidence that firms with perpetual dual class stock trade at a discount to those with sunset provisions.⁹⁹ Both of these studies indicate not only that investors are informed as to the risks associated with dual class stock, but that they exhibit particular concern about certain kinds of dual class structures. Left largely to their own devices—in the absence of any restrictions on dual class structures—it appears that shareholders compensate for their reduced ability to control management by demanding a higher return.

There is another side to that coin. If dual class companies are penalized by shareholders, then they will have a higher cost of capital. That, in turn, increases the hurdle for the type of investments that those companies can pursue. In the case of any individual company, the fact that it foregoes an otherwise profitable project would not seem to warrant legal intervention to restrict dual class shares. But if many similarly-situated companies do the same, then the prevalence of dual class

⁹⁷ See text accompanying notes 85–92.

⁹⁸ See Ronald Craig Anderson, Ezgi Ottolenghi and David M. Reeb, *The Dual Class Premium: A Family Affair*, Fox School of Business Research Paper No. 17-021 (August 14, 2017), available at <https://ssrn.com/abstract=3006669>. See also Chun-Keung Hoi and Ashok Robin, *Agency Conflicts, Controlling Owner Proximity, and Firm Value: An Analysis of Dual-Class Firms in the United States*, 18 Corp. Gov. 124 (2010) (dual-class structure overall is unrelated to firm value; value is correlated with the proximity of the controlling shareholder to the locus of management—whether the controlling shareholder is a top executive, board member or an outside); Belén Villalonga and Raphael Amit, *How Are U.S. Family Firms Controlled?*, 22 Rev. of Fin. Stud. 3047 (2009) (investors penalize the use of dual class shares by family-controlled companies compared to other control mechanisms).

⁹⁹ See Robert J. Jackson, Jr., *Perpetual Dual Class Stock: The Case Against Corporate Royalty* (Feb. 15, 2018), available at <https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty>.

shares might have negative consequences for the economy as a whole by increasing the cost of capital and reducing investment.¹⁰⁰ The fact that individual companies—and their shareholders—might not take into account the broader economic consequences of a dual class structure is an alternative argument for restricting their ability to use them.

Recent experience in the United States, however, suggests that many dual-class companies have successfully raised capital in order to fund long-term investments. Indeed, as demonstrated by **Figure 1.2** above, the prevalence of dual class share structures as a percentage of U.S. IPOs has substantially increased in recent years.¹⁰¹

Moreover, there is evidence that the use of dual class equity structures is associated with low-cost public equity financing by companies that, for one reason or another, would not otherwise raise capital in public markets. If that is the case, then restricting the use of dual class structures would make it more costly for them to undertake potentially profitable investments.

The empirical literature on which companies adopt dual class equity structures and when is not extensive, but it suggests that many of them might not go public, or remain public, if they did not have the option of using unequal voting structures to maintain control rights while transferring economic rights. Amoako-Adu and Smith (2001), for example, find that family control of a large stake before an initial public offering increases the likelihood of going public with a dual class structure.¹⁰² Families that cannot take their companies public without relinquishing control may decide to stay private. Notably, Amoako-Adu and Smith also find that, up to ten years after the IPO, control changes in dual class firms happened in roughly two-thirds of the cases, which is inconsistent with the idea that dual class structures serve to unduly entrench managers.¹⁰³

Another group of studies indicates that dual class recapitalizations are an important tool for public companies seeking to pursue growth opportunities. Lehn, Netter and Poulsen (1990) compare public companies that go private with those that remain public but choose to adopt dual class share structures. They find that companies that choose dual class recapitalizations over going private have better growth prospects, as measured by growth in sales and the number of employees, the ratio of R&D to sales, advertisement expenditure-to-sales ratios, and market-to-book ratios.¹⁰⁴ Lehn et al. offer the following interpretation of their evidence: firms that wish to consolidate

¹⁰⁰ Cf. William D. Nordhaus, *Schumpeterian Profits and the Alchemist Fallacy*, Yale Economic Applications and Policy Discussion Paper No. 6 (2005) (estimating that companies captured only a small fraction of the overall benefits from technological advances over the 1948–2001 period).

¹⁰¹ See Ritter, *Initial Public Offerings: Dual Class IPOs* (cited in note 4).

¹⁰² See Ben Amoako-Adu and Brian F. Smith, *Dual class firms: Capitalization, ownership structure and recapitalization back into single class*, 25 J. of Banking and Fin. 1083 (2001).

¹⁰³ See *id.* at 1098–99.

¹⁰⁴ See Kenneth Lehn, Jeffrey Netter and Annette Poulsen, *Consolidating corporate control: Dual class recapitalizations versus leveraged buyouts*, 27 J. of Fin. Econ. 557 (1990).

control but have strong growth prospects prefer dual class recapitalizations because they allow the companies to pursue long-term projects while at the same time maintaining a public and less costly source of financing.¹⁰⁵ Their findings suggest that if dual class recapitalizations were prohibited, companies that were looking to consolidate control would rely instead on more expensive private financing, which would increase their cost of capital and potentially cause them to forego growth opportunities.

The reliance of these companies on private markets would also make it more difficult for retail investors, who are generally restricted from investing in private companies, to participate in their growth. Dimitrov and Jain (2006) find that the growth associated with the adoption of unequal voting structures is beneficial for shareholders. They report that companies that undertake dual class recapitalizations experience positive abnormal returns in a period of four years following the announcement of the recapitalization. In other words, the change creates value for controlling and non-controlling shareholders alike. They also find that abnormal returns are larger for companies that raise capital by issuing equity after a dual class recapitalization—consistent with the argument that dual class recapitalizations allow controlling shareholders to finance new investment without losing control of their companies.¹⁰⁶

Bauguess, Slovin and Sushka (2007) add more detail to this picture by showing that dual class recapitalizations can benefit companies and shareholders even if they are accompanied by the liquidation of large holdings by the controlling shareholder (that is, even if they are used by the controlling shareholder to cash out of their investment). They find that companies that use dual class structures to facilitate the transfer of economic rights by controlling shareholders exhibit superior industry-adjusted operating performance. They argue that dual class shares solve the problem of risk aversion by dominant shareholders. If the fortunes of controlling shareholders are undiversified, they are unlikely to sign off on risky investment opportunities; once they cash out, they are more willing to pursue those opportunities.¹⁰⁷ The possibility that the use of dual class equity structures is beneficial for both companies and their shareholders suggests that policymakers should proceed with caution when it comes to limiting their use.

¹⁰⁵ See *id.* at 578.

¹⁰⁶ See Valentin Dimitrov and Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual Class: Growth and Long-Run Stock Returns*, 12 J. of Corp. Fin. 342 (2006). See also Stephan Nüesch, *Dual Class Shares, External Financing Needs, and Firm Performance*, 20 J. of Man. and Gov. 525 (2016) (dual class shares increase firm performance if the firm requires external finance and decrease firm performance if the firm does not require external finance).

¹⁰⁷ See Scott W. Bauguess, Myron B. Slovin and Marie E. Sushka, *Large shareholder diversification, corporate risk taking, and the benefits of changing to differential voting rights*, 36 J. of Banking and Fin. 1244 (2012).

4. Evaluating policy responses

The debate about dual class equity structures tends to focus on the consequences of unequal voting rights, and whether those effects justify restrictions on the ability of management and shareholders to allocate voting rights as they see fit. Policymakers wary of banning dual class equity structures outright have sought alternative policy responses. One such alternative is requiring that dual class equity structures include time-based sunset provisions, whereby the unequal voting structure is automatically wound down (or required to be put to a shareholder vote) after a certain amount of time. However, additional disclosure requirements may be sufficient to protect investors while also allowing public companies access to the potential benefits of unequal voting structures. We evaluate both proposals in this section.

a. Sunset provisions

Former SEC Commissioner Jackson has expressed support for mandatory sunset provisions, stating that, unless higher voting rights associated with dual class shares include a sunset provision, they are “antithetical to our values as Americans.”¹⁰⁸ Influential market participants have also expressed support for sunset provisions. As noted earlier, CII has supported time-based sunset provisions, whereby the multi-class equity structure is automatically wound down over time unless approved by shareholders on a one-share, one-vote basis, as a reasonable approach to achieving alignment between investors and management.¹⁰⁹ Likewise, the proxy advisory firm ISS recommends voting against or withholding votes from incumbent directors at companies with unequal voting rights if there are no “reasonable” sunset provisions.¹¹⁰

In addition, the push for sunset provisions has received academic support: Bebchuk and Kastiel (2017) advocate for time-based sunset provisions as a response to the adverse effects of dual class share structures.¹¹¹ Proponents of mandatory sunset provisions point to the empirical studies discussed in the prior section that offer evidence that the advantages associated with dual class share structures, if any, tend to diminish over time as companies mature.

¹⁰⁸ See Jackson, *Perpetual Dual Class Stock: The Case Against Corporate Royalty* (cited in note 99).

¹⁰⁹ See Council of Institutional Investors, *Dual Class Stock* (2018), available at https://www.cii.org/dualclass_stock.

¹¹⁰ The reasonableness of a dual class structure, according to ISS, depends on balancing a number of factors; a sunset period of more than seven years, however, is considered per se unreasonable. See *United States Proxy Voting Guidelines: Benchmark Policy Recommendations*, Institutional Shareholder Services 14 (November 18, 2019), available at <https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf>.

¹¹¹ See Lucian A. Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual Class Stock*, 103 Virginia L. Rev. 558 (2017).

However, mandatory sunset provisions have their critics. Govindirajan et al. (2018) argue that mandatory time-based sunset provisions are ill-advised, for two reasons.¹¹² First, it is not clear when the sunset clause should take effect, and whether one size could fit all public companies: the number of years that it takes after IPO for a growth company to mature has been steadily declining, and differs based on the firm's technology and business model.¹¹³ Second, given the increasing pace of disruption and the need for companies to consistently revise their business models, the assumption that companies actually reach a mature stage where further reinvention (and thus an unequal voting structure to facilitate it) is unnecessary is mistaken.¹¹⁴ Instead of mandatory sunset provisions, Govindirajan et al. argue that companies should be required, after a predetermined period, to gain majority approval from all shareholders to continue a multiple class share structure.¹¹⁵

Fisch and Solomon (2019) criticize proposals based on mandatory time-based sunset provisions or shareholder votes.¹¹⁶ Like Govindirajan et al., and for similar reasons, they argue that a one-size-fits-all approach to unequal voting structures is wrongheaded. In addition, they note that any proposal to predictably and suddenly dilute holders of high-vote stock after a predetermined period creates perverse incentives for them to maximize their personal economic position at the expense of other shareholders in anticipation of dilution.¹¹⁷

Unlike Govindirajan et al., Fisch and Solomon argue that mandatory shareholder approval to extend dual class equity structures past a particular date does not solve the problems of time-based sunset provisions. They question whether the institutional investors who would control such a decision would have the appropriate incentives to vote to retain the dual class structure, even where it enhances the value of the company.¹¹⁸ After all, if these investors are not well positioned to pursue the long-term interests of the company when it initially went public—the reason for the dual class structure in the first place—then why would they be at the end of the sunset term? Especially when they stand to obtain a private benefit from eliminating the unequal voting structure, which will transfer control from the previously controlling shareholders to them.¹¹⁹

Instead, Fisch and Solomon highlight the benefits of sunset provisions that are tied to particular events, such as the dilution or transfer of a founder's interest, though they ultimately stop short of

¹¹² See Vijay Govindarajan, Shivaram Rajgopal, Anup Srivastava and Luminita Enache, *Should Dual Class Shares Be Banned?*, Harvard Business Review (Dec. 3, 2018), available at <https://hbr.org/2018/12/should-dual-class-shares-be-banned>.

¹¹³ See *id.*

¹¹⁴ See *id.*

¹¹⁵ See *id.*

¹¹⁶ See Jill E. Fisch and Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. Rev. 1057 (2019).

¹¹⁷ See *id.* at 1083–84.

¹¹⁸ See *id.* at 1084–86.

¹¹⁹ See *id.*

recommending *any* mandatory sunset provisions.¹²⁰ Even mandatory sunset provisions that are tied to events such as the dilution of a founder’s economic interest may have unintended negative consequences. As discussed earlier, dual class recapitalizations can solve problems associated with the risk aversion of dominant shareholders, by allowing them to diversify their wealth while still maintaining control. Mandatory sunset provisions tied to the dilution of a founder’s interest would foreclose that possibility.

b. Enhanced disclosure

Proponents of the “one-share, one-vote” principle argue that unequal voting rights allow controlling shareholders to extract private benefits. It is not clear, however, that “one-share, one-vote” is the best mechanism for restricting conflicted transactions; the direct regulation of related-party transactions may be more efficient.¹²¹ In jurisdictions where noncontrolling shareholders have fewer means of redress against controlling shareholders, and controlling shareholders can more easily extract private benefits,¹²² it may be necessary to protect noncontrolling shareholders by prohibiting unequal voting structures outright or by introducing significant restrictions on their use. But where robust investor protection regimes exist—such as in the United States, where controlling shareholder transactions involving Delaware corporations (the vast majority of large U.S. corporations) are subject to an exacting fairness review unless they receive the majority approval of the minority shareholders—they can be a more efficient substitute for regulation of conflicts of interest through voting.¹²³

Likewise, the concern that public shareholders are not adequately informed of the risks associated with dual class shares is a better argument for additional disclosure than against dual class share structures. Under existing SEC regulations, companies must disclose and describe—both in their

¹²⁰ See *id.* at 1086–91.

¹²¹ Legal tools for direct regulation of related-party transactions include requiring approval by a majority of noncontrolling shareholders or by disinterested or independent directors, enhanced disclosure, third-party advice or fairness opinions, and ex post judicial review. See Geeyoung Min, *The SEC and the Courts’ Cooperative Policing of Related Party Transactions*, 2014 Colum. Bus. L. Rev. 663 (2014) (describing how the SEC and state courts regulate related-party transactions through a combination of ex ante screening and ex post litigation); Luca Enriques, *Related Party Transactions: Policy Options and Real-world Challenges (with a Critique of the European Commission Proposal)*, 16 European Bus. Org. L. Rev. 1 (2015) (surveying legal tools for direct regulation of related-party transactions).

¹²² See Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. of Fin. 537 (Apr. 2004) (premium paid for control is higher when the buyer comes from a country that protects investors less and thus is more willing or able to extract private benefits).

¹²³ See Aurelio Gurrea-Martínez, *Theory, Evidence, and Policy on Dual Class Shares: A Country-Specific Response to a Global Debate*, Ibero-American Institute for Law and Finance Working Paper Series 3/2019; Singapore Management University School of Law Research Paper No. 32 (June 2, 2019), available at <https://ssrn.com/abstract=3397880> (arguing that whether dual class shares should be allowed depends on the particular features of a country).

registered offerings and periodic reporting—risk factors relevant to an investment in the company.¹²⁴ According to the SEC, these risk factors include “risks posed by non-traditional governance structures.”¹²⁵ With respect to dual class shares, these increased risks arise from a divergence between economic ownership and control, and they may include: (i) additional barriers to holding management accountable; (ii) disagreements between shareholders and management yielding litigation because voting is no longer a fair dispute resolution mechanism; (iii) shareholders with disproportionate voting rights approving changes to the detriment of other shareholders; and (iv) exchange delisting or removal from major indexes, resulting in lost liquidity.¹²⁶

However, there are gaps in risk factor disclosures as they relate to dual class shares.¹²⁷ As observed by the SEC’s Investor as Owner Subcommittee, while existing rules may require the disclosure of some risks, U.S. companies generally do not disclose specific information that would empower investors to fully understand the consequences of the dual class voting structure in question.¹²⁸ Specifically, companies are not required to, and generally do not, disclose straightforward quantitative information on the “wedge” – or difference – between economic ownership and corporate control that dual class share structures create.¹²⁹ Likewise, companies typically do not disclose how the existing wedge may increase over time, because of provisions that entrench existing controlling interests or permit companies to issue additional equity that increases the wedge.¹³⁰ Finally, companies do not disclose the specific kinds of conflicts of interest related to dual class shares that have arisen in the past, nor do they explain in detail how dual class share structures raise the risk of de-listing or removal from major indexes.¹³¹

The SEC should act to remedy these deficiencies. To the extent the empirical evidence suggests that investors penalize companies for a significant divergence between ownership and control, then the risks of unequal voting structures may be sufficiently managed by well-informed investors. As a result, greater disclosure of this divergence and its associated risks will empower investors to police and discipline the use of dual class share structures. The SEC’s Investor as Owner Subcommittee has released actionable recommendations to this effect, some of which would commendably enhance disclosure without dramatically burdening the public companies concerned.¹³²

¹²⁴ See 17 C.F.R. § 229.105.

¹²⁵ See *Recommendation of the Investor as Owner Subcommittee* at 3 (cited in note 2).

¹²⁶ See *id.* at 5–6.

¹²⁷ See *id.* at 4.

¹²⁸ See *id.*

¹²⁹ See *Recommendation of the Investor as Owner Subcommittee* at 4 (cited in note 2).

¹³⁰ See *id.* at 5.

¹³¹ See *id.*

¹³² See *id.* at 6–8.

Accordingly, we support additional disclosures by companies with dual class share structures. Specifically:

- Through its review of and comment on issuer disclosures, the SEC should encourage each company with a dual class structure to disclose data that illustrates the divergence between economic ownership and control at that company. Such data could include: (i) straightforward quantitative metrics illustrating the numerical gap between a person's beneficial ownership and voting rights arising from the dual class share structure and (ii) the minimum beneficial ownership that persons with special voting shares can hold while still retaining majority control without further approval by other shareholders. To the extent the SEC is unsuccessful in eliciting satisfactory disclosure by scrutinizing public offerings and issuing guidance, then the SEC could require disclosure of this information under Regulation S-K Item 403, which requires companies to disclose the beneficial ownership of management and control persons.¹³³
- Through its review of and comment on issuer disclosures, the SEC should encourage companies with dual class share structures to enhance their risk factor disclosures under Regulation S-K Item 105.¹³⁴ In particular, firms should disclose material risks related to dual class shares with greater specificity. For example, where applicable, such disclosures could identify the risk that the structure may result in delisting from major exchanges and removal from key indexes, reducing liquidity and the value of an investment in the company.

¹³³ See 17 C.F.R. § 229.403.

¹³⁴ See 17 C.F.R. § 229.105.

Chapter 2: Short-termism, Shareholder Activism and Stock Buybacks

Summary

According to the short-termism thesis, public companies in the United States are excessively focused on increasing short-term stock prices and are therefore foregoing valuable long-term investment. We evaluate the evidence to support the short-termism thesis including the role of shareholder activism and stock buybacks by public companies.

The first section of this chapter focuses on the empirical literature addressing whether short-termism exists, the potential causes of short-termism, and the economic effects of short-termism, if any. We find that U.S. public companies engage in similar amounts of long-term investment as private companies and public companies' long-term investment has increased substantially in recent years. We therefore do not find support for the contention that short-termism is a problem in U.S. markets.

We then consider the rise of shareholder activism, which refers to tactics employed by shareholders of a company that are aimed at increasing the value of their stake in the company. Shareholder activism is often identified as a *cause* of short-termism as presumably these shareholders are focused on short-term returns. This section focuses primarily on the empirical literature related to shareholder activism by hedge funds, which typically includes aggressive tactics, such as proxy fights aimed at replacing a company's board of directors. Overall, we find that hedge fund activism confers positive benefits on firms in the short run and the evidence regarding activism's long-term effects is mixed.

The third section of this chapter considers the rise in stock buybacks by public companies. A stock buyback is a firm repurchasing its own previously issued stock from shareholders and is a method, along with dividends, for firms to redistribute excess capital back to shareholders. Critics of stock buybacks argue that the recent rise in stock buybacks is a *symptom* of short-termism—an attempt by companies to boost their stock prices in the near term, while foregoing long-term investment. However, we describe a number of motivating factors for stock buybacks that are not short-term, including increased flexibility of buybacks as compared to dividends and lowering a firm's cost of capital. We also review empirical literature finding that stock buybacks often do not increase short-term stock prices and that long-term investment is particularly strong at companies engaged in share buybacks.

The final section of this chapter sets forth our policy recommendations to enhance long-term investment in U.S. public markets. First, we recommend that U.S. public companies weigh carefully the costs and benefits of issuing quarterly earnings guidance and consider ending the practice if they determine that such guidance is discouraging long-term investment. Second, the SEC should issue guidance clarifying that, when a company's Board of Directors authorizes a stock repurchase program, the company should disclose on a timely basis certain material elements of the program, including its approximate intended duration and the maximum approved repurchase

amount (for example, as a total number of shares or a total dollar value). Public companies should disclose these material elements within five business days of the authorization of the repurchase plan, through a press release or other Regulation FD-compliant method that ensures broad public dissemination.

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1. The short-termism debate

Though the debate on whether short-termism afflicts public companies goes back one hundred years, politicians continue to sound the short-termism alarm. For example, in 2016, then Vice President Joe Biden wrote that “[s]hort-termism...is one of the greatest threats to America’s enduring prosperity.”¹ During her presidential campaign, Hilary Clinton also took aim at the alleged short-term focus of public companies, and called for legislation aimed at countering “hit and run” activist shareholders.² Republican Senator Marco Rubio has similarly criticized corporations’ focus on short-term returns to shareholders, which he argues is “devastating for American workers, and in the long term it’s devastating for America,”³ and stresses that since the 1970s “changes made by American businesses and policymakers began prioritizing high returns to investors in the short term, rather than investment in long-term capabilities.”⁴ In a report titled “American Investment in the 21st Century” he noted that “[w]e need to build an economy that can see past the pressure to understand value-creation in narrow and short-run financial terms, and instead envision a future worth investing in for the long-term.”⁵

Despite this political narrative, prominent legal and economic scholars have often concluded that there is little to no evidence of a short-termism problem in U.S. public markets. Harvard Law School Professor Mark Roe argues that “the proponents of stock-market-driven short-termism

¹ Joe Biden, *How Short-Termism Saps the Economy*, Wall Street Journal (Sep. 27, 2016), available at <https://www.wsj.com/articles/how-short-termism-saps-the-economy-1475018087>.

² See Jonathan Allen and Luciana Lopez, *Clinton proposes tax, buyback changes to encourage long-term growth*, Reuters (July 24, 2015), available at <https://www.reuters.com/article/us-usa-election-clinton/clinton-proposes-tax-buyback-changes-to-encourage-long-term-growth-idUSKCN0PY26N20150724>. Short-termism has also been highlighted as a matter of global concern. The World Economic Forum included short-termism among its five leadership priorities in 2017. Also, in 2017, the United Nations Global Compact issued a report in 2017 providing strategies and recommendations for managing market short-termism. See Klaus Schwab, *Five Leadership Priorities for 2017*, World Economic Forum (Jan. 2017), available at <https://www.weforum.org/agenda/2017/01/five-leadership-priorities-for-2017/>; Principles for Responsible Investment and United Nations Global Compact, *Coping, Shifting, Changing 2.0: Corporate and investor strategies for managing market short-termism* (2017).

³ James Hohmann, *The Daily 202: Marco Rubio slams CEOs for bad China deals, short-term thinking and not investing in U.S. workers*, Washington Post (May 15, 2019), available at <https://www.washingtonpost.com/news/powerpost/paloma/daily-202/2019/05/15/daily-202-marco-rubio-slams-ceos-for-bad-china-deals-short-term-thinking-and-not-investing-in-u-s-workers/5cdf5841ad2e544fo0idd1a/>.

⁴ Marco Rubio, *We need to invest in America again*, Washington Examiner, (May 13, 2019, available at <https://www.washingtonexaminer.com/opinion/op-eds/marco-rubio-we-need-to-invest-in-america-again>.

⁵ Marco Rubio, *American Investment in the 21st Century, Project for Strong Labor Markets and National Development*, (May 15 2019), available at https://www.rubio.senate.gov/public/_cache/files/94fcb79e-eedd-4496-a262-7091647563e6/B68DE3EF858700E482305C9ED26AEC72.5.14.2019.-final-project-report-american-investment.pdf.

have not yet made their case...⁶ and “the stock-market-driven short-termism story is weak.”⁷ Likewise, Steven Kaplan concludes that “there is very little long-term evidence that is consistent with the predictions of the short-term critics.”⁸ And, Larry Summers has noted that “[m]atters are not as clear as is often suggested regarding short-term driven ‘quarterly capitalism,’” and “skepticism is appropriate towards arguments that horizons should be lengthened in all cases.”⁹

We now consider empirical evidence regarding: (1) whether short-termism exists; (2) the causes of short-termism; and (3) the implications of short-termism, if any, for the broader economy.

a. Does short-termism exist?

While the empirical literature on whether, and to what extent, public companies prioritize short-term results at the expense of long-term growth is extensive, the results are inconclusive.¹⁰ Empirical studies on the existence and extent of short-termism take several different approaches. One approach has been to survey public company executives, posing a direct question to management as to whether they would sacrifice long-term growth for short-term gains. Overall, the general consensus among these surveys is that corporate executives do report *feeling* short-term pressures.

Another approach focuses on the behavior of individual firms, specifically comparing public companies with private companies, under a presumption that any differences are attributable to short-term pressures felt by public, but not private, firms. Under this approach, the evidence is mixed, with different empirical studies reaching contrasting conclusions.

The final approach considers aggregate macro level data of U.S. public companies, focusing on metrics including shareholder distributions (e.g. dividends and stock buybacks) and investment spending. The evidence is also mixed under this approach.

Public company surveys

Although surveys of corporate executive and director views on short-termism are not plentiful, there have been two surveys that suggest that most corporate executives and directors feel pressure

⁶ Mark J. Roe, *Stock Market Short-Termism's Impact*, European Corporate Governance Institute (ECGI) - Law Working Paper No. 426/2018, 45 (October 22, 2018), available at <https://ssrn.com/abstract=3171090>.

⁷ Id at 46.

⁸ Steven N. Kaplan, *Are US Companies Too Short-Term Oriented? Some Thoughts*, 18 *Innovation Policy and the Economy* 107, 108 (2018).

⁹ Lawrence Summers, *Taking a Long View on Corporate Reform*, *Washington Post* (Aug. 9, 2015), available at https://www.washingtonpost.com/opinions/taking-a-long-view-on-corporate-reform/2015/08/09/c786cdb8-3doc-11e5-9c2d-ed991d848c48_story.html.

¹⁰ See Scott Latham and Michael Braun, *Does Short-termism Influence Firm Innovation? An Examination of S&P 500 Firms, 1990-2003*, 22 *Journal of Managerial Issues* 368 (Fall 2010) (“In general, the debate on how managers reconcile short-term results and long-term competitive advantage remains equivocal.”); Roe, *Stock Market Short-Termism's Impact* at 14 (cited in note 6) (noting that the empirical literature on short-termism is “extensive but disputed”).

to satisfy the short-term expectations of public markets. The first survey, conducted by Graham, Harvey and Rajgopal (2005), found that 78% of corporate executives and directors would sacrifice long-term investment to meet short-term earnings expectations.¹¹ A more recent McKinsey (2017) survey, updating previous surveys, found similar results, reporting that 87% of executives and directors felt pressure to deliver performance within 2 years or less, and that 65% said that short-term pressure had increased over the five-year period from 2011 to 2016.¹² A comparison of the 2017 McKinsey study with an earlier 2013 McKinsey study shows that short-term pressure on executives may have increased. In the 2017 study, the percentage of respondents reporting feeling pressure to deliver performance within 2 years or less was 7% higher than in the 2013 study.¹³ Similarly, in the 2017 study, the percentage of respondents that were in favor of a planning horizon of 2 years or less was 10% higher than in the 2013 study.^{14,15}

Firm-level comparisons: public versus private companies

The primary challenge for empirical examinations of short-termism is the identification of plausible counterfactuals. That is, to conclude that certain firm behavior is evidence of a short-term focus (e.g. decreased investment spending), it is necessary to identify how that firm would behave without short-term pressures.

An empirical study by Asker, Farre-Mensa and Ljungqvist (2015) attempts to address the counterfactual issue by comparing long-term investment by public companies with that of private companies, assuming that differences between long-term investment by public and private firms are attributable to short-term pressures in public markets.¹⁵ This assumption is generally motivated by the fact that private firms are often owner-managed and even when not, they are illiquid and have highly concentrated ownership, which increases monitoring of management by private owners (versus public owners) to ensure that long-term value is maximized.¹⁶ The study finds that public companies engage in substantially less long-term investment (capital expenditures and mergers

¹¹ See John R. Graham, Campbell Harvey and Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. of Acc. and Econ. 3 (2005).

¹² See McKinsey Global Institute, *Measuring the Economic Impact of Short-Termism*, McKinsey & Company (February 2017), available at <https://www.mckinsey.com/~media/mckinsey/featured%20insights/Long%20term%20Capitalism/Where%20companies%20with%20a%20long%20term%20view%20outperform%20their%20peers/MGI-Measuring-the-economic-impact-of-short-termism.ashx>.

¹³ See Dominic Barton, Jonathan Bailey and Joshua Zoffer, *Rising to the challenge of short-termism*, FCLT Global 5 (Sept. 2016), available at <https://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf>.

¹⁴ See id at 4.

¹⁵ See John Asker, Joan Farre-Mensa and Alexander Ljungqvist, *Corporate Investment and Stock Market Listing: A Puzzle?*, 28 Rev. of Fin. Stud. 342 (Feb. 2015).

¹⁶ See id at 355, 373.

and acquisitions) than private companies, and public companies are less responsive to new investment opportunities.¹⁷ Ultimately, the study argues that its “findings highlight short-termist pressures as a potentially important cost of a stock market listing.”¹⁸

Countering these results, Feldman et al. (2018) note that the Asker, Farre-Mensa and Ljungqvist study only considers capital expenditures and mergers and acquisitions (M&A) activity, while ignoring research and development (R&D) spending that also contributes to long-term growth.¹⁹ When including R&D spending, the Feldman et al. study, finds that public firms invest more in R&D than their private counterparts, which they attribute to the ability of public stock markets to facilitate investment.²⁰ This result runs counter to the argument that public markets are prone to investment-chilling short-term behavior.

In another analysis that highlights the long-term patience of public firm investors for growth companies, Kaplan (2018) notes the prominent examples of public companies, such as Amazon, that have sustained high stock prices despite not earning any profits, all the while making substantial long-run investments that have subsequently paid off.²¹ Moreover, in a 2019 editorial, Larry Summers and Anna Stansbury note that 84% of initial public offerings of technology companies are by companies that are not profitable.²² Summers and Stansbury suggest that this trend illustrates that, at least when it comes to growth companies, “it does not seem that shareholder capitalism has created a systemic bias toward short-termism; on the contrary, shareholders have been willing to pay high prices for companies on the expectation that they will make profits in the distant future.”²³

Aggregate public company data

Other empirical research on short-termism focuses on *aggregate* levels of public company investment. In particular, in an empirical study frequently referenced by short-termism critics, Lazonick (2014) argues that the short-term incentives of corporate executives have led to an overall increase

¹⁷ See id at 355–56.

¹⁸ See id at 384.

¹⁹ See Naomi Feldman, Laura Kawano, Elena Patel, Nirupama Rao, Michael Stevens, and Jesse Edgerton, *The Long and the Short of It: Do Public and Private Firms Invest Differently*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2018-068 (August 2018), available at <https://www.federalreserve.gov/econres/feds/files/2018068pap.pdf>.

²⁰ See id at 19.

²¹ See Kaplan, *Are US Companies Too Short-Term Oriented?* at 122 (cited in note 8).

²² See Anna Stansbury and Lawrence H. Summers, *What Marco Rubio gets right – and wrong – about the decline of American investment*, Washington Post (May 31, 2019), available at <https://www.washingtonpost.com/opinions/2019/05/31/what-marco-rubio-gets-right-wrong-about-decline-american-investment/>.

²³ Id. See also Roe, *Stock Market Short-Termism’s Impact* at 29 (cited in note 6) (“[T]he American companies *most strongly supported* by the stock market – are Amazon, Apple, Alphabet (Google), Facebook, and Microsoft. All are quintessential long-term companies... Their current earnings cannot justify their current stock price; only a belief that they will grow long-term does.”).

of profit distribution to shareholders, through dividends and stock buybacks, at the expense of long-term investment. Specifically, the study shows that from 2003–2012, S&P 500 companies paid out more than 90 percent of net income in the form of stock buybacks and dividends.²⁴ However, the statistics cited by Lazonick are not without dispute. Fried and Wang (2018) illustrate several flaws in Lazonick’s analysis, noting that public firms also raise capital through equity issuances, partially offsetting the capital drain that results from shareholder distributions.²⁵ When considering *net distributions* (i.e. including capital raised over the same time period), S&P 500 companies only paid out 50% of net income in the form of dividends and share buybacks.²⁶ A more complete discussion of the stock buyback debate can be found in the third section of this chapter.

Echoing Lazonick’s concerns, Coffee and Palia (2016) argue that short-termism is evidenced by the fact that a smaller percentage of public companies’ cash flows are being directed towards capital expenditures.²⁷ In addition, Garel (2017) finds reductions in R&D investment.²⁸ However, other empirical studies suggest that the decline in capital expenditures may not be the result of short-term pressures. Roe (2018) notes that much of the decline in capital expenditures occurred during the global financial crisis, as the result of a global recession and not due to otherwise increasing short-term pressures.²⁹ In fact, as illustrated in **Figure 2.1**, capital expenditures as a percentage of GDP have increased since 2009.³⁰ Additionally, Roe finds that capital expenditures have declined globally, with the rate of U.S.-decline being only half of other OECD countries (including non-stock market sectors),³¹ suggesting that other global macroeconomic factors may have caused a decrease in capital expenditures, rather than short-termism in U.S. public markets.³²

²⁴ See William Lazonick, *Profits without Prosperity*, Harvard Business Review (Sep. 2014).

²⁵ See Jesse M. Fried and Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment?*, Harvard Business Review (March–Apr. 2018).

²⁶ See Committee on Capital Markets Regulation, *Nothing But The Facts: Restricting Stock Buybacks Would Harm U.S. Capital Markets* (Feb. 19, 2019), available at <https://www.capmksreg.org/wp-content/uploads/2019/02/02-19-CCMR-NBTF-Proposals-to-Restrict-Stock-Buybacks.pdf>.

²⁷ See John C. Coffee and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 *Annals of Corp. Gov.* 1 (2016).

²⁸ See Alexandre Garel, *Myopic Market Pricing and Managerial Myopia*, 44 *J. of Bus. Fin. & Acc.* 44 (Oct./Nov. 2017).

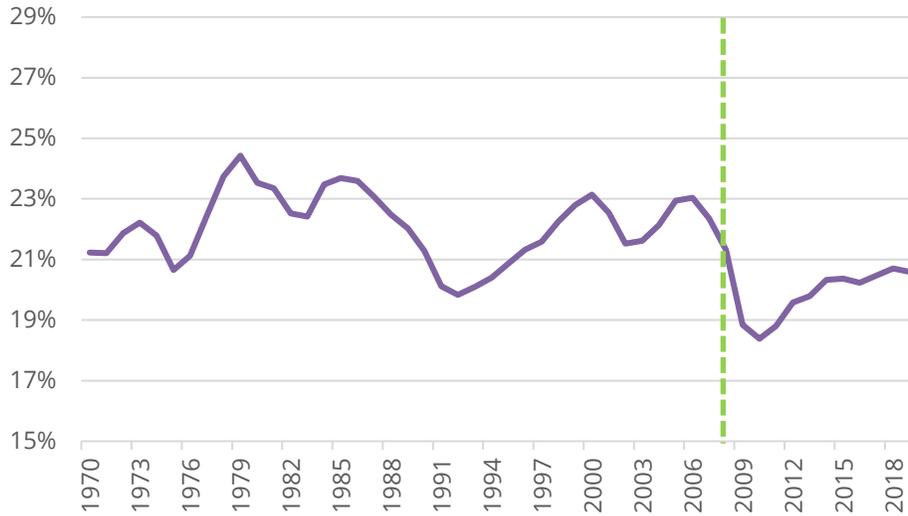
²⁹ See Roe, *Stock Market Short-Termism’s Impact* at 18–19 (cited in note 6).

³⁰ See *id.* at 17.

³¹ See *id.* at 20.

³² See also Salman Arif and Charles M.C. Lee, *Aggregate Investment and Investor Sentiment*, 27 *Rev. of Fin. Stud.* 3241 (November 2014) (finding that corporate investments peak during periods of positive sentiment and that higher aggregate investment precede lower earnings and macroeconomic growth).

Figure 2.I. Capital Expenditures in the United States, 1970–2016, Scaled to GDP.³³



b. Potential causes of short-termism

Proponents of the short-termism thesis have identified several factors that potentially cause the short-term focus of public companies. One potential factor is that certain public company shareholders have relatively short-term holding periods and therefore may be more focused on the short-term appreciation of a stock’s price rather than its long-term prospects.³⁴ A second potential contributing factor is that short-term increases in stock prices typically result in increases in executive compensation for management.³⁵ And a third possible cause of short-termism is the requirement for public companies to disclose quarterly financial performance and the corresponding earnings release guidance issued by certain companies. Presumably, management feels pressure to show improvements in operating performance at these quarterly intervals.³⁶ A fourth potential cause of short-termism is the threat of shareholder activism.³⁷

i. Short-term holding periods

The average holdings period of shares in U.S. public companies has declined in recent decades,

³³ See Organization for Economic Co-operation and Development, *Gross Fixed Capital Formation in United States*, available at <https://fred.stlouisfed.org/series/USAGFCFADSMEI>; U.S. Bureau of Economic Analysis, *Gross Domestic Product*, available at <https://fred.stlouisfed.org/series/GDPA>.

³⁴ See Roe, *Stock Market Short-Termism’s Impact at 19–20* (cited in note 6).

³⁵ See *id.*

³⁶ See, for example, Larry Summers and Ed Balls, *Report of the Commission on Inclusive Prosperity*, Center for American Progress 35 (January 2015) (noting that “[o]ne reason that economists have advanced for [the] transition to corporate short-termism is the overwhelming shift to stock-market-based compensation for CEOs and other highly compensated executives at publicly traded corporations.”).

³⁷ See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports*, 83 Fed. Reg. 65601 (Dec. 18, 2018).

from roughly 2 years in 1990 to less than 1 year in 2017.³⁸ However, whether these statistics actually indicate a growing short-term focus among investors is dubious. Average holding periods are estimated based on share turnover: how much of a company's outstanding stock is traded over a given period. Much of the recent increase in turnover is therefore driven by the rise of high-frequency trading, not changes in behavior by investors. In other words, trading volumes have largely increased due to an increase in the frequency with which liquidity providers such as market makers buy and sell stock. It would therefore be inaccurate to contend that the decrease in the average holding period of U.S. stocks is due to changes in the investment horizon for investors. The stability of holding periods for large institutional investors further suggests that reduced average holding periods do not reflect widespread changes in the investment horizon of investors.³⁹ Recent academic studies confirm this interpretation.⁴⁰

The portion of investors in public companies that are short-term versus long-term is unclear. In one recent study, Harford, Kecskes and Mansi (2017) suggest that, as of 2012, approximately 24% of U.S. public equity was held by long-term institutional investors, with another 36% held by short-term institutional investors and 40% held by non-institutional investors whose investment horizons are unclear.⁴¹ The authors conclude that “[institutional] [i]nvestors as a group have not become more short-term over time; instead, short-term investors have increased the frequency of

³⁸ See Roe, *Stock Market Short-Termism's Impact* at 11–12 (cited in note 6). See also World Federation of Exchanges, Stocks traded, turnover ratio of domestic shares (%) – United States, available at <https://data.worldbank.org/indicator/CM.MKT.TRNR?end=2018&locations=US&start=1984&view=chart> (turnover ratio of U.S. shares increased from 66% in 1990 to 116% in 2017).

³⁹ See Mark J. Roe, *Corporate Short-Termism – In the Boardroom and in the Courtroom*, 68 *The Business Lawyer* 977, 999 (Aug. 2013).

⁴⁰ See Paul H. Edelman, Wei Jiang and Randall S. Thomas, *Will Tenure Give Corporate Managers Lifetime Tenure?*, Vanderbilt Law Research Paper No. 18-04; European Corporate Governance Institute (ECGI) – Law Working Paper No. 384/2018 34 (Feb. 1, 2018) (noting that “[t]he annual turnover rates at the stock level started to trend up in the 1980s and then increased dramatically around mid-2000s, coincided with rise of algorithmic trading. However, it is important to note... that increasing turnover rates at the stock level do not imply that the typical or most institutional investors are churning their portfolio faster, nor does it suggest that companies are increasingly held by short-term investors.”); Charles Nathan and Kal Goldberg, *The Short-Termism Thesis: Dogma vs. Reality*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 18, 2019), available at <https://corpgov.law.harvard.edu/2019/03/18/the-short-termism-thesis-dogma-vs-reality/> (noting that “[s]tockholding duration is commonly measured by aggregating all trades in a given security during a period and dividing by the number of shares outstanding. Thus, trades by program traders count as much as trades by long-term investors. When holdings of long-term investors are viewed separately, the findings are that duration of ownership has remained constant, and in some instances increased, over the past 30 years.”). See also Roe, *Stock Market Short-Termism's Impact* at 33 (cited in note 6).

⁴¹ See Jarrad Harford, Ambrus Kecskes, and Sattar Mansi, *Do Long-Term Investors Improve Corporate Decision Making?*, 50 *J. of Corp. Fin.* 424, 429–30 (2018) (defining “long-term investors” as those with less than 35% three-year portfolio turnover).

their trading.”⁴²

ii. Stock-based compensation

Theory predicts that management should be more prone to short-termism when executive compensation is linked to short-term stock price movements. Empirical studies provide support for this theory. Ladika and Sautner (2020) examine the relationship between executive compensation and long-term investment, finding that when executives are allowed to exercise their stock options sooner than originally scheduled, then long-term investments are reduced and short-term earnings increase, making the vested options more valuable as stock prices rise in the short-term.⁴³ They also find that companies that reduce the vesting period of their executive’s stock options underperform the market in the long run.⁴⁴

Edmans, Fang and Lewellen (2017) find that companies with a significant amount of equity compensation vesting in a given quarter tend to spend less on investments.⁴⁵ A follow-up study by Edmans, Fang and Huang (2018) finds that increased short-term incentives for CEOs (again measured by the amount of equity vesting in a given quarter) is associated with increased probabilities of share buybacks and M&A activity.⁴⁶ While stocks returns for these companies are positive in the quarters immediately following share buybacks and M&A activity, stock returns turn negative two years after buybacks and four years after M&A activity.⁴⁷

iii. Quarterly reporting and earnings guidance

Recently, there has been a public debate about whether mandatory quarterly financial reporting and voluntary quarterly earnings guidance increase pressure on public companies to perform in the short-term. Corporate attorney Martin Lipton has urged the SEC to give public companies the option of discontinuing quarterly reporting.⁴⁸ JPMorgan Chase Chairman and CEO Jamie Dimon and Berkshire Hathaway CEO Warren Buffet have argued that “quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy,

⁴² Id at 429.

⁴³ See Tomislav Ladika and Zacharias Sautner, *Managerial Short-Termism and Investment: Evidence from Accelerated Option Vesting*, 24 Rev. of Fin. 305, 322–27 (March 2020).

⁴⁴ See id.

⁴⁵ See Alex Edmans, Vivian W. Fang and Katharina A. Lewellen, *Equity Vesting and Investment*, 30 Rev. of Fin. Stud. 2229 (July 2017).

⁴⁶ See Alex Edmans, Vivian W. Fang and Allen Huang, *The Long-Term Consequences of Short-Term Incentives*, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 527/2017 (Mar. 13, 2020), available at <https://ssrn.com/abstract=3037354>.

⁴⁷ See id at 13–23.

⁴⁸ See Martin Lipton, *Legal & General Calls for End to Quarterly Reporting*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Aug. 19, 2015), available at <https://corpgov.law.harvard.edu/2015/08/19/legal-general-calls-for-end-to-quarterly-reporting/>.

growth and sustainability.”⁴⁹

Quarterly reporting

In August 2018, President Trump requested via Twitter that the SEC consider moving from a quarterly reporting system to a six-month financial reporting system.⁵⁰ In response, the SEC committed to studying public company financial reporting.⁵¹ In December 2018, the SEC issued a request for comment on quarterly earnings releases and quarterly reports, considering whether the current system “foster[s] an inefficient outlook among registrants and market participants by focusing on short-term results.”⁵² The SEC received over 80 comment letters, including comments from large public companies, national stock exchanges, major accounting and law firms, buy-side entities and other financial institutions.⁵³

The majority of commenters did not support replacing the quarterly system, but instead recommended streamlining and simplifying the reporting process and discouraging quarterly earnings guidance. For example, FedEx Corporation encouraged the SEC to “streamline required disclosures and eliminate duplicative information in quarterly reporting.”⁵⁴ BlackRock noted quarterly reporting may increase management’s focus on short-term results, but they “believe the loss in transparency and timely availability of information would outweigh potential benefits” and

⁴⁹ See Jamie Dimon and Warren E. Buffett, *Short-Termism Is Harming the Economy*, Wall Street Journal (June 6, 2018), available at <https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801>.

⁵⁰ In a tweet President Trump stated: “In speaking with some of the world’s top business leaders I asked what is it that would make business (jobs) even better in the U.S. ‘Stop quarterly reporting & go to a six month system,’ said one. That would allow greater flexibility & save money. I have asked the SEC to study!” See Dave Michaels, Michael Rapoport and Jennifer Maloney, *Trump Asks SEC to Study Six-Month Reporting for Public Companies*, Wall Street Journal (Aug. 17, 2018), available at <https://www.wsj.com/articles/trump-directs-sec-to-study-six-month-reporting-for-public-companies-1534507058>.

⁵¹ See Jay Clayton, *Statement on Investing in America for the Long Term* (Aug. 17, 2018), available at <https://www.sec.gov/news/public-statement/statement-clayton-081718>.

⁵² See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports*, 83 Fed. Reg. 65,601 (Dec. 21, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-12-21/pdf/2018-27663.pdf>. The SEC also held a roundtable in July 2019 that focused on the impact of short-termism on U.S. capital markets. Reactions from panelists were mixed on whether quarterly reporting contributed to short-termism and some called on the SEC to instead focus on reforming or banning quarterly earnings guidance. See Securities and Exchange Commission, *Roundtable on Short-Term / Long-Term Management of Public Companies* (Jul. 18, 2019), available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=roundtable-short-long-term-071819.

⁵³ See Securities and Exchange Commission, *Comments on Earnings Releases and Quarterly Reports*, <https://www.sec.gov/comments/s7-26-18/s72618.htm> (last visited Oct. 29, 2019).

⁵⁴ See John L. Merino and Jennifer L. Johnson, *FedEx Corporation Letter in Response to the Securities and Exchange Commission’s Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at <https://www.sec.gov/comments/s7-26-18/s72618-5167619-183471.pdf>.

pointed to quarterly earnings guidance as a driver of short-termism.⁵⁵ Both Bank of America and State Street Corporation agreed that the quarterly reporting framework should stay in place, with modifications to the content of disclosures.⁵⁶

History of quarterly reporting in the United States

In 1926 the New York Stock Exchange asked NYSE-listed firms to commit to quarterly reporting.⁵⁷ With the passage of the Securities Exchange Act of 1934 (“Exchange Act”), the SEC began requiring annual reporting of financial statements by all public companies.⁵⁸ The SEC itself did not require quarterly reporting until 1945, when the SEC required firms with war contracts exceeding 25% of sales to file quarterly reports due to concerns that investors would be unprepared for a reduction in sales following World War II.⁵⁹ In 1946, the SEC went further and required most exchange-listed companies to report revenues quarterly.⁶⁰

The SEC quarterly revenues reporting rules were rescinded in 1953,⁶¹ and the SEC shifted to semi-annual reporting requirements in 1955.⁶² The SEC again began mandating quarterly financial reports on Form 10-Q in 1970,⁶³ as part of a program to improve disclosures made under the Exchange Act prompted by a report from the legal and accounting profession, securities industry and business community to the SEC entitled “Disclosure to Investors—A Reappraisal of Administrative Policies under the ’33 and ’34 Acts”.⁶⁴ This report issued at the direction of SEC Commissioner Francis Wheat was meant to find ways to, among other items, “clarify the law of disclosure and make its application more certain” and “enhance the utility to investors and to those who

⁵⁵ See Barbara Novick and Thomas Clark, *BlackRock, Inc. Letter in Response to the Securities and Exchange Commission’s Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at <https://www.sec.gov/comments/s7-26-18/s72618-5165791-183444.pdf>.

⁵⁶ See John M. James, *Bank of America Letter in Response to the Securities and Exchange Commission’s Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at <https://www.sec.gov/comments/s7-26-18/s72618-5169917-183472.pdf>; Ian Appleyard, *State Street Corporation Letter in Response to the Securities and Exchange Commission’s Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at <https://www.sec.gov/comments/s7-26-18/s72618-5162557-183436.pdf>.

⁵⁷ For a history of financial reporting in the U.S., see Marty Butler, Arthur Kraft and Ira S. Weiss, *The effect of reporting frequency on the timeliness of earnings: The cases of voluntary and mandatory interim reports*, 43 J. of Acc. and Econ. 181, 184–86 (2007); Arthur Kraft., Rahul Vashishtha and Mohan Venkatachalam, *Frequent Financial Reporting and Managerial Myopia*, 93 Acc. Rev. 249 (2018).

⁵⁸ See Butler et al., *The effect of reporting frequency on the timeliness of earnings* at 185 (cited in note 57).

⁵⁹ See id at 186.

⁶⁰ See id.

⁶¹ See Securities and Exchange Commission, *Twentieth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1954* (Nov. 1954), available at https://www.sec.gov/about/annual_report/1954.pdf.

⁶² See Butler et al., *The effect of reporting frequency on the timeliness of earnings* at 186 (cited in note 57).

⁶³ See id.

⁶⁴ See Securities and Exchange Commission, *Disclosure to Investors—A Reappraisal of Administrative Policies under the ’33 and ’34 Acts*, Staff Report directed by Francis M. Wheat, announced in Securities Act Release, No. 4963 (April 1969).

advise them of the documents generated under the Federal securities statutes.”⁶⁵ The SEC “propos[ed] to adopt regular quarterly reporting which [would] provide detailed information as a back-up to” Form 8-K’s event-driven disclosure requirements, which the SEC was concerned were not widely used at the time by investors or their advisors to receive information pertinent to their investments.⁶⁶ Quarterly reporting has been mandatory in the United States since the 1970s.

In the period between 1950 to 1970, as public firms in the United States began to increase the frequency of financial reporting, Kraft, Vashishtha and Venkatachalam (2018) found that there was a decline in investment after a firm increased their reporting frequency and that firms that reported more frequently were more likely to have a subsequent decline in operating efficiency and sales growth.⁶⁷ They concluded these findings were due to increased capital market pressures to achieve short term performance objectives.⁶⁸ On the other hand, Fu, Kraft and Zhang (2012) found that increased reporting frequency reduced the cost of capital in the period from 1951 through 1973 due to a reduction in information asymmetry between investors and executives at the company.⁶⁹

A European case study

The European Union has also undergone recent changes regarding the mandatory frequency of financial reporting by public companies. In 2007, the EU began requiring firms to publish quarterly “interim management statements” describing each company’s financial position and performance over the relevant period.⁷⁰ This effectively moved the EU onto a mandatory quarterly reporting regime from a semi-annual regime. However, the EU moved to eliminate their new quarterly reporting obligations in 2014, asserting that quarterly reporting “encourage[s] short-term

⁶⁵ Id.

⁶⁶ See Securities and Exchange Commission, *Form 10-Q for Disclosure of Financial Information, Notice of Proposed Rule Making*, 34 Fed. Reg. 14239 (Sept. 10, 1969).

⁶⁷ See Kraft et al., *Frequent Financial Reporting and Managerial Myopia* (cited in note 57).

⁶⁸ See id at 274–75.

⁶⁹ See Renhui Fu, Arthur Kraft and Huai Zhang, *Financial Reporting Frequency, Information Asymmetry and the Cost of Equity*, 54 J. of Acc. and Econ. 139 (2012).

⁷⁰ See *Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC*, OJ L 390/38 (Dec. 15, 2004).

performance and discourage[s] long-term investment.”⁷¹ By November 2015, member states, including the U.K., had returned to mandatory semi-annual reporting regimes.⁷²

Regardless, many public companies in the EU continued to voluntarily report on a quarterly basis immediately after the EU rescinded its quarterly reporting requirement. For example, in 2015, 90% of U.K. public companies voluntarily published quarterly reports.⁷³ Initially, the U.K. companies abandoning quarterly reporting were mostly small domestic companies.⁷⁴ However, a much broader trend away from voluntary quarterly reporting is now evident in the U.K. Between October 2016 and August 2017, (i) the number of FTSE 100 companies voluntarily issuing quarterly reports fell from 70 to 57, and (ii) the number of FTSE 250 companies doing so fell from 111 to 83.⁷⁵ Nevertheless, the trend away from quarterly reporting has varied by jurisdiction. For example, companies listed on the Deutsche Börse under the “prime standard”, a segment of the exchange with the highest transparency standards that exceed the “general standard” required by law, must publish quarterly reports.⁷⁶ As of October 2019, 308 of the 502 companies listed on the Deutsche Börse were voluntarily listed on the prime standard,⁷⁷ meaning that over 60% of companies on the Deutsche Börse still publish quarterly reports.

In examining the shift to and from mandatory quarterly reporting, researchers have reached differing conclusions as to the impact of quarterly reporting on short-termism. Ernstberger, Link, Stich, and Vogler (2015) examine how mandatory quarterly reporting affected R&D.⁷⁸ To do so,

⁷¹ Directive 2013/50/EU of the European Parliament and of the Council amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC, OJ L 294/13 (Oct. 22, 2013).

⁷² See U.K. Financial Conduct Authority, *Policy Statement PS14/15: Removing the Transparency Directive’s requirement to publish interim management statements* (Nov. 2014), available at <https://www.fca.org.uk/publication/policy/ps14-15.pdf> (implementing the directive ahead of schedule).

⁷³ See Robert Pozen, Suresh Nallareddy, and Shivaram Rajgopal, *Impact of Reporting Frequency on UK Public Companies*, CFA Institute Research Foundation Briefs 12 (March 2017), available at <https://www.cfainstitute.org/-/media/documents/article/rf-brief/rfbr-v3-n1-1-pdf.ashx>.

⁷⁴ See id.

⁷⁵ See Owen Walker, *The long and short of the quarterly reports controversy*, Financial Times (July 1, 2018), available at <https://www.ft.com/content/e61046bc-7a2e-11e8-8e67-1e1a0846c475>.

⁷⁶ See Deutsche Börse Group, *Prime Standard* (last accessed Oct. 21, 2019), available at <https://www.deutsche-boerse.com/dbg-en/our-company/know-how/glossary/glossary-article/Prime-Standard-243278>. See also Philipp Melzer, *New financial reporting requirements for listed companies in 2016*, Lexology (July 4, 2016), available at <https://www.lexology.com/library/detail.aspx?g=b72104cc-7dc2-42be-845a-4b75f8e0c3bd>.

⁷⁷ See Deutsche Börse Group, *Listed Companies* (last accessed Oct. 21, 2019), available at <https://www.deutsche-boerse-cash-market.com/dbcm-en/instruments-statistics/statistics/listes-companies>.

⁷⁸ See Jürgen Ernstberger, Benedikt Link, Michael Stich, and Oliver Vogler, *The Real Effects of Mandatory Quarterly Reporting*, 92 Acc. Rev. 33 (2017).

they analyzed EU firms that switched to mandatory quarterly reporting in 2007.⁷⁹ They found that the shift to mandatory quarterly reporting was correlated with increased cuts to R&D to boost short-term performance metrics, and that these cuts weighed on operating performance after the first year.⁸⁰ Conversely, Pozen, Nallareddy and Rajgopal (2017) analyzed the effect of quarterly reporting on capital investment at U.K. companies between 2005 and 2015.⁸¹ They found that when companies were required to report quarterly in 2007, rather than semiannually, the level of investment was generally unchanged.⁸² They also found that the change back from quarterly to semiannual reporting did not create any significant benefit, or harm, to firms that discontinued quarterly reporting.⁸³

Overall, empirical studies are mixed as to the impact on investment by public companies from regulatory changes regarding the frequency of mandatory reporting, with some finding investment decreased after mandatory quarterly reporting was implemented and others finding that there was not a significant effect on investment.

Quarterly earnings guidance

Short-termism critics have also argued that the *voluntary* issuance of forward-looking quarterly earnings guidance⁸⁴ can encourage companies to manage around quarterly targets at the expense of long-term investment, and attract investors with “a short-term orientation who intensify the attention to short-term results and eschew strategies with long-term payoffs.”⁸⁵

Issuance of quarterly earnings guidance increased after the turn of the millennium, increasing from less than 10% of U.S. public companies in the mid-1990s to a peak of nearly 50% of large cap companies in 2004.⁸⁶ Many market participants assume that quarterly earnings guidance continues

⁷⁹ See id at 34.

⁸⁰ See id at 56.

⁸¹ See Pozen et al., *Impact of Reporting Frequency on UK Public Companies* at 5 (cited in note 73).

⁸² See id at 6–7.

⁸³ See Suresh Nallareddy, Robert Pozen and Shivaram Rajgopal, *Consequences of Mandatory Quarterly Reporting: The U.K. Experience*, Columbia Business School Research Paper No. 17-33 (Mar. 15, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2817120. Similarly, a study of firms in Singapore found no evidence of myopic investment by firms that are required to publish quarterly financial statements compared to those that are not required to publish quarterly financial statements. See Peter Kajüter, Florian Klausmann and Martin Nienhaus, *The Effect of Mandatory Quarterly Reporting on Firm Value*, 94 *Acc. Rev.* 251 (2019).

⁸⁴ See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports* at 65604 (cited in note 52).

⁸⁵ FCLT Global, *Comment Letter Regarding Earnings Releases and Quarterly Reports* (March 21, 2019), available at <https://www.sec.gov/comments/s7-26-18/s72618-5167609-183488.pdf>. See also Ariel Fromer Babcock and Sarah Keohane Williamson, *Moving Beyond Quarterly Guidance: A Relic of the Past*, FCLT Global 5 (Oct. 2017) (“Companies that choose to offer shareholders a long-term vision and strategy benefit not only from a reduced focus on short-term metrics but also by attracting and building a long-term investor base.”).

⁸⁶ See id at 8.

to be a widespread practice, but U.S. public companies have been shifting away from quarterly earnings guidance.⁸⁷ As of 2016, only 28% of the S&P 500 issued quarterly earnings guidance, down from 36% in 2010.⁸⁸

Certain studies have found links between quarterly earnings guidance and short-termism concerns. Cheng, Subramanyam and Zhang (2005) found that firms that issue quarterly earnings guidance invested less in R&D and had lower long-term growth rates compared to companies that did not issue guidance.⁸⁹ A survey by FCLT Global found that earnings guidance policy from 2010 through 2016 had no effect on price-to-earnings ratios and that companies that offer annual range guidance had lower volatility around earnings reporting periods compared to those that issued quarterly guidance,⁹⁰ suggesting that companies would not be harmed by discontinuing the practice of issuing quarterly earnings guidance.⁹¹

If quarterly earnings guidance were to exacerbate short-termism concerns, then decisions to cease such guidance should result in benefits for long-term investors. However, the empirical evidence relating to this proposition is mixed. Finding positive benefits, Kim, Su and Zhu (2017) report that companies that stopped issuing quarterly earnings guidance attracted a greater number of long-term investors, placed more weight on long-term earnings and had a lower sensitivity to short-term analyst forecasts compared to firms that issued quarterly earnings guidance.⁹² Other studies, however, have found contrasting results. Houston, Lev and Tucker (2010) find that firms that cease quarterly earnings guidance do not subsequently increase capital investments or research and development expenditures.⁹³ They report that firms stop quarterly guidance primarily because of poor performance—not because they are focused on the long-term. In addition, they find that nearly one-third of firms that ceased quarterly guidance—particularly firms that experience fewer loss quarters and better earnings performance after they stop providing guidance—chose to resume guidance after six quarters.⁹⁴

Empirical studies also confirm benefits that accrue to firms through the issuance of earnings guidance. By disclosing and meeting earnings forecasts, management provides investors with valuable

⁸⁷ See id at 8–11.

⁸⁸ See id at 6.

⁸⁹ See Mei Cheng, K. R. Subrahmanyam, and Yuan Zhang, *Earnings Guidance and Managerial Myopia* (Nov. 2005), available at <https://ssrn.com/abstract=851545>.

⁹⁰ See Babcock and Williamson, *Moving Beyond Quarterly Guidance* at 11–12 (cited in note 85).

⁹¹ When comparing volatility and price-to-book ratios for U.S. firms that decreased the frequency of their earnings-per-share guidance, no effect on volatility or P/B ratios were found from the guidance change. See id at 12.

⁹² See Yongtae Kim, Lixin (Nancy) Su and Xindong (Kevin) Zhu, *Does the Cessation of Quarterly Earnings Guidance Reduce Investors' Short-Termism?*, 22 Rev. of Acc. Stud. 715 (2017).

⁹³ See Joel F. Houston, Baruch Lev and Jennifer Wu Tucker, *To Guide or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance*, 27 Cont. Acc. Research 143 (2010).

⁹⁴ See id.

information that lowers uncertainty and, as a result, lowers a firm’s cost of equity capital. In studying this effect, Chen, Matsumoto and Rajgopal (2011) find evidence that ceasing quarterly earnings guidance can lead to an increase in a firm’s cost of capital, driven by the theory that investors typically reward firms that provide guidance with lower equity capital costs.⁹⁵ This result is consistent with other empirical studies finding more generally that earnings guidance reduces a firm’s cost of capital. For example, Baginski and Rakow (2012) find that firms with more frequent earnings forecasts tend to have lower costs of equity capital.⁹⁶ Additionally, in looking at firms globally (i.e. U.S. and non-U.S.), Cao et al. (2017) determine that equity capital costs are 30 to 60 basis points lower for firms issuing earnings guidance.⁹⁷

The issue of the impact of earnings guidance on long-term investment and growth can also be evaluated by the types of firms that issue such guidance. Boone et al. (2019) show that mature firms with fewer growth options, and thus less uncertainty about future prospects, are more likely to provide earnings guidance.⁹⁸ Conversely, firms that spend heavily on research and development (e.g. biotechnology firms) are less likely to provide earnings guidance.⁹⁹ Larger firms and those with higher levels of institutional ownership and analyst coverage are also more likely to provide earnings guidance.¹⁰⁰ In fact, as Chen et al. found, the firms that choose to cease providing quarterly guidance are those with low institutional ownership and low analyst coverage.¹⁰¹ These results suggest that firms do not abandon quarterly guidance in an effort to relieve short-term pressures, but rather do so simply when demand for such guidance is relatively low.¹⁰²

iv. Shareholder activism

Shareholder activism has increased over the past two decades. BlackRock’s Larry Fink has noted

⁹⁵ See Shuping Chen, Dawn Matsumoto and Shivaram Rajgopal, *Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance*, 51 J. of Acc. and Econ. 134 (2011). However, the findings of Chen et al. only find a relatively weak link between quarterly earnings guidance and cost of capital, arguably due to the relatively high variance in cost of capital measures across firms.

⁹⁶ See Stephen P. Baginski and Kenneth C. Rakow Jr., *Management earnings forecast disclosure policy and the cost of equity capital*, 17 Rev. of Acc. Stud. 279 (2012).

⁹⁷ See Ying Cao, Linda A. Myers, Albert Tsang and Yong George Yang, *Management forecasts and the cost of equity capital: international evidence*, 22 Rev. of Acc. Stud. 791 (2017).

⁹⁸ See Audra Boone, Craig Lewis, Austin Starkweather, and Joshua T. White, *Is the bottom line the top priority? Revenue versus earnings guidance* (Oct. 27, 2019), available at http://faculty.bus.olemiss.edu/rvanness/Speakers/Presentations%202019-2020/Disaggregated_Guidancepdf.pdf.

⁹⁹ See *id.* at 14–15. However, these firms are more likely to provide *revenue* guidance. See *id.*

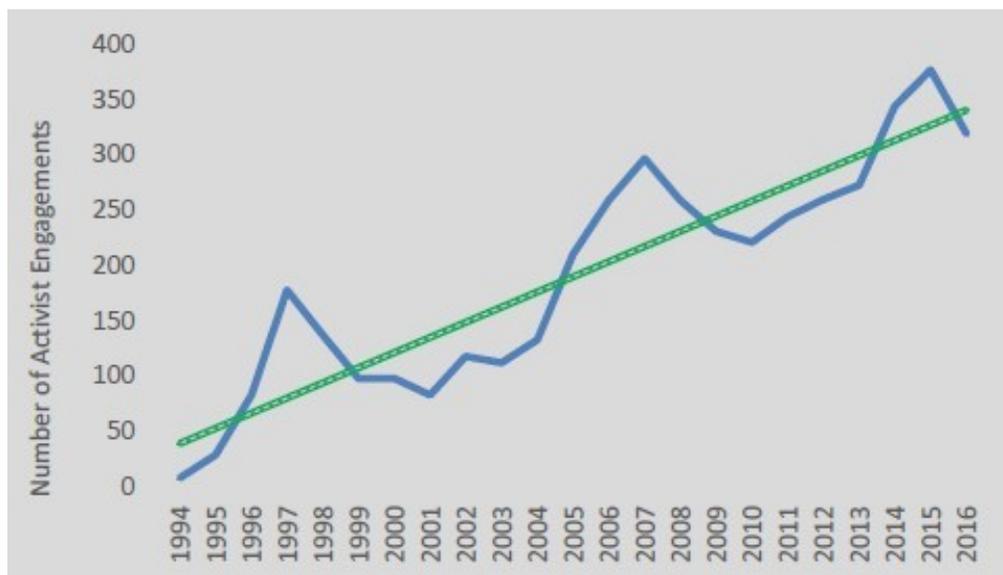
¹⁰⁰ See *id.*

¹⁰¹ See Chen et al., *Is Silence Golden?* at 140–42.

¹⁰² See *id.* at 140. (“Because analysts are the primary beneficiaries of earnings guidance, firms with increases in analyst following also likely feel greater pressure to continue providing guidance.”) However, Chen et al. suggest that firms may cease providing guidance—stopping a practice associated with a short-term focus—in an attempt to attract more long-term institutional investors. See *id.*

that “[t]he role of activists is getting larger.”¹⁰³ Figure 2.2 below, adapted from Roe (2018), illustrates the rise in shareholder activism. Roe (2018) also notes that nearly 10 percent of all U.S. public companies can expect to face activist campaigns in a given year.¹⁰⁴ We address the impact of activism on firm value and long-term investment in the next section of this chapter.

Figure 2.2. Rising incidence of high-impact shareholder activism, 1994-2016.



c. Effects of short-termism

If public companies tend to forgo long-term investments for short-term gains, then the consequences of short-termism should be reflected in the broader economy. But, similar to the empirical literature on the existence of short-termism, the literature on the effects of short-termism on the broader economy is inconclusive.

One way that short-termism could lead to negative economic effects is by reducing the growth of companies that are focused on the short term, therefore resulting in lower job creation and profits for shareholders that can be reinvested in the economy. A study conducted by McKinsey, for example, found that between the years 2001 and 2014, the revenue of companies that were

¹⁰³ Svea Herbst-Bayliss and Ross Kerber, *BlackRock’s Fink Learns to Live with Activist Investors*, Reuters (Nov. 13, 2017), available at <https://www.reuters.com/article/us-investment-summit-fink-shareholders/blackrocks-fink-learns-to-live-with-activist-investors-idUSKBN1DD2B6>.

¹⁰⁴ Roe, *Stock Market Short-Termism’s Impact* at 12 (cited in note 6).

focused on the long term (calculated based on a five-factor Corporate Horizon Index¹⁰⁵) cumulatively grew on average 47% more than the revenue of other companies. In addition, the earnings of those long-term focused companies grew 36% more than other companies. They also added more jobs (12,000 on average from 2001-2015) and invested more in R&D (50% more on average) than other companies.¹⁰⁶ McKinsey also found that long-term firms delivered greater total returns to shareholders than other companies.¹⁰⁷ Similarly, Brochet, Loumioti and Serafeim (2015) found a correlation between companies that they identified as short-term oriented and lower return on equity and lower future profitability.¹⁰⁸

On the other hand, a certain amount of short-termism may be beneficial for the long-term value of companies.¹⁰⁹ Thakor (2016) argues that short-termism can benefit firms by preventing investments in bad projects and enabling faster learning about managerial ability.¹¹⁰ Similarly, Kaplan (2018) argues that “some of the...short-term pressures can actually prompt companies to become more efficient.”¹¹¹ Barzuza and Talley (2019) argue that corporate managers can be overly optimistic on the likelihood of the success of projects, costing investors in the long term, and that short-termism can be an appropriate check for management.¹¹²

¹⁰⁵ The five factors in the Corporate Horizon Index are (i) investment (measuring ratio of capital expenditures to depreciation), (ii) earnings quality (measuring accruals as a share of revenue), (iii) margin growth (measuring the difference between earnings growth and revenue growth), (iv) quarterly management (measuring incidence of beating EPS targets by less than two cents and incidence of missing EPS targets by less than two cents), and (v) earnings-per-share growth (measuring difference between EPS growth and true earnings growth). The hypothesis behind these factors is that long-term firms will invest more, generate earnings that are reflected in cash flow, are less likely to over-index on EPS and are more willing to miss short-term targets if needed, and short-term firms are more likely to grow margins unsustainably in order to hit near-term targets and will do whatever they can to hit short-term targets. See McKinsey Global Institute, *Measuring the Economic Impact of Short-Termism* at 3 (cited in note 12).

¹⁰⁶ See *id.* at 4-7.

¹⁰⁷ See *id.* at 6.

¹⁰⁸ See Francois Brochet, Maria Loumioti and George Serafeim, *Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia*, 20 Rev. of Acc. Stud. 1122 (2015).

¹⁰⁹ See David Marginson and Laurie McAulay, *Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis*, 29 Strat. Mgmt. J. 273, 274 (March 2008) (“Balancing the needs of both the long term and the short term is thus important and gives rise to two possibilities. The first is that managers’ short-term actions extrapolate into optimal long-term consequences.”).

¹¹⁰ See Richard Thakor, *A Theory of Efficient Short-termism* (Aug. 2016), available at <https://ssrn.com/abstract=2821162>.

¹¹¹ Kaplan, *Are US Companies Too Short-Term Oriented?* at 121 (cited in note 8); see also Stansbury and Summers, *What Marco Rubio gets right – and wrong – about the decline of American investment* (cited in note 22) (“[W]e are not altogether sure that a more long-term, institution building approach, without shareholder pressure, always results in more efficient allocation of investment.”).

¹¹² See Michal Barzuza and Eric Talley, *Long-Term Bias*, Virginia Law and Economics Research Paper No. 2019-05; European Corporate Governance Institute (ECGI) – Law Working Paper No. 449/2019 (May 2019), available at <https://ssrn.com/abstract=3338631>.

The short-termism debate has persisted for decades: critics have been warning about the excessive short-term focus of U.S. companies since at least the late 1970s and early 1980s. Accordingly, the recent history of corporate performance can shed light on whether their predictions about the long-term consequences of managerial myopia have materialized. Kaplan notes that if those early critics of short-termism had been correct, then the long-run consequences of underinvestment would be playing out today, forty years later.¹¹³ But corporate profits are now at near-record highs, which suggests that the concerns voiced by earlier critics of short-termism—that excessive focus on short-term results deterred companies from investing in profitable, long-term projects—were overblown.¹¹⁴

2. Shareholder activism

Shareholder activism refers to tactics employed by shareholders of a company that are aimed at increasing, in the short term (often one year), the value of their stake in the company.¹¹⁵ The tactics used by activist shareholders range from shareholder proposals seeking corporate policy changes or disclosures related to a particular issue, to proxy fights aimed at replacing boards of directors, in whole or in part.¹¹⁶ As former Chief Justice of the Delaware Supreme Court Leo Strine has noted, “whether the corporations that activists leave behind are better or worse positioned to generate sustainable profits in the future is debatable.”¹¹⁷

This section begins by surveying the prevalence of shareholder activism in the U.S., including its recent increase. It then provides an overview of empirical studies that attempt to measure the short-term and long-term effects of activism. Much of the current debate surrounding the value of activism, and its relationship to short-termism in particular, focuses on the aggressive tactics used by certain activist hedge funds.¹¹⁸ Accordingly, this section will focus primarily on the empirical literature related to hedge fund activism. Overall, the majority of studies find that hedge fund activism confers positive short-term benefits on public companies, while the evidence of long-term benefits is mixed.¹¹⁹ This section concludes by discussing the link between the rise of shareholder activism and the rise of passive investing.

¹¹³ See Kaplan, *Are US Companies Too Short-Term Oriented?* at 109–11 (cited in note 8).

¹¹⁴ See *id.*

¹¹⁵ See, for example, Paula Loop, Catherine Bromilow and Leah Malone, *The Changing Face of Shareholder Activism*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 1, 2018), available at <https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/>.

¹¹⁶ See *id.*

¹¹⁷ 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, 1909 (2017).

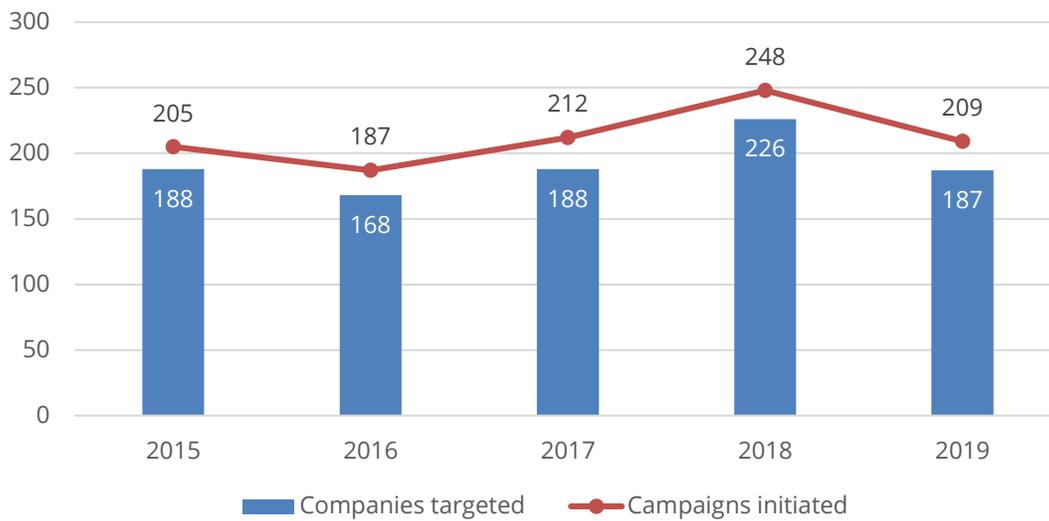
¹¹⁸ See, for example, Lucian Bebchuk, Alon Brav and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 Colum. L. Rev. 1085 (June 2015); Coffee and Palia, *The Wolf at the Door* (cited in note 27).

¹¹⁹ See *id.* at 7 (noting that “[a]ll studies have found that activist campaigns result *on average* in short-term gains for shareholders, but the evidence...is decidedly more mixed with respect to long-term gains.”).

a. Prevalence of activism

Lazard’s annual review of shareholder activism reports that 2018 was a record-breaking year for shareholder activism; 2019 saw a decrease in activist campaigns, but the number of campaigns remained in line with multi-year average levels. **Figure 2.3** shows annual activist campaign activity since 2013. In 2019, 187 companies were targeted in 209 campaigns, down from the record 226 companies that were targets of 247 activist campaigns in 2018, but consistent with the 188 companies targeted by 212 campaigns in 2017. These numbers were significantly higher than just five years prior, which saw 139 companies targeted in 166 campaigns.

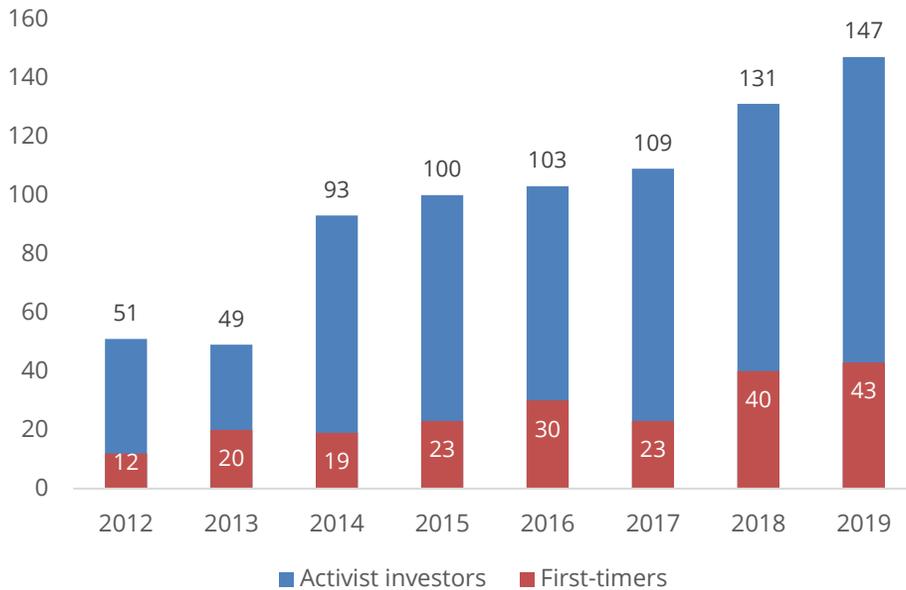
Figure 2.3. Annual campaign activity.¹²⁰



The number of investors employing activist tactics reached record highs in 2019, as 147 investors—43 of whom were first-time activists—engaged in activist campaigns. **Figure 2.4** shows the annual number of investors involved in activism since 2012, including the number of first-time activists.

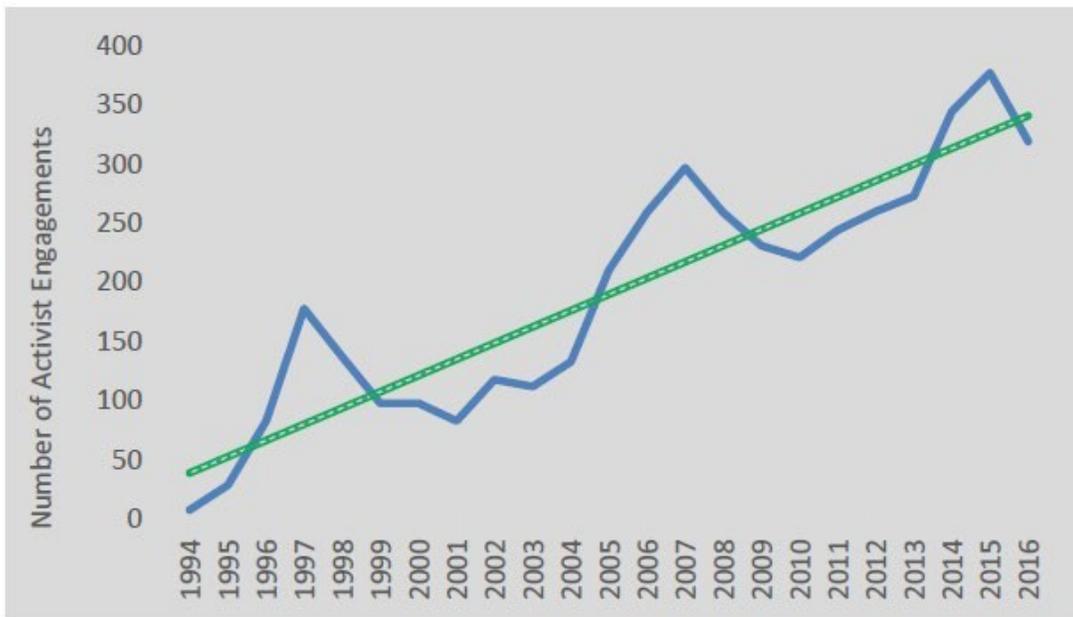
¹²⁰ See Shareholder Advisory Group, *2019 Review of Shareholder Activism*, Lazard 2 (Jan. 2020), available at <https://www.lazard.com/media/451141/lazards-2019-review-of-shareholder-activism-vf.pdf>.

Figure 2.4. Investors launching activist campaigns.¹²¹



Roe (2018) also documents the prevalence of activist engagements over time, and finds a similar trend (though he shows slightly higher figures than the Lazard report, as Roe includes target companies with a lower market capitalization than Lazard).¹²² Figure 2.5 shows the annual number of

Figure 2.5. Number of activist engagements.



¹²¹ See id at 6.

¹²² See Roe, *Stock Market Short-Termism's Impact* at 12 (cited in note 6). Lazard limits its figures to campaigns against companies with a market capitalization of \$500 million or greater, while it is unclear whether the Roe data is limited by market cap. This may explain the higher Roe numbers.

activist engagements from 1994 through 2016 according to Roe. While there were almost no activist campaigns in the mid-1990s, the number of campaigns rose to over 300 more recently.

b. Effects of activism

Critics of shareholder activism argue that activist intervention leads to short-term stock market gains at the expense of long-term value, whereas proponents argue that activist campaigns can revive moribund companies, improving both their short- and long-term prospects. This subsection reviews the empirical evidence of both the short-term and long-term effects of shareholder activism.

Short-term effects

While the precise magnitude of the stock price impact of activist campaigns varies by study, most studies find that stock prices experience average positive abnormal returns of six to eight percent following the announcement of an activist intervention.¹²³ The range of abnormal returns largely depends on the study's definition of the short-term window (the time frame over which stock returns are calculated) and the time period studied. For example, Bebchuk, Brav and Jiang (2015) find abnormal returns of six percent measured over a 40-day period, from 20 days prior to the announcement of an activist campaign to 20 days after the announcement, during the period of 1994 to 2007.¹²⁴ Klein and Zur (2009) find average abnormal returns of more than seven percent in activist campaigns that occurred primarily from 2003 to 2005, measured from 30 days prior to 30 days after the announcement.¹²⁵ And Boyson and Mooradian (2011) find, in the study period of 1994 through 2005, average abnormal returns of more than eight percent, measured from 25 days prior to 25 days after the announcement of an activist campaign.¹²⁶

Importantly, these short-term returns are *average* abnormal returns for targeted firms. Not every firm that is the target of activism experiences positive returns, even in the short run. For example, Brav et al. (2008) found that 38 percent of firms targeted by activists in the study period of 2001 through 2006 did not experience *positive* abnormal returns in the short run.¹²⁷ Likewise, Clifford

¹²³ "Abnormal" return is the portion of the stock return in excess of the return that would be expected based on traditional factors (e.g. overall stock market factors).

¹²⁴ See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* (cited in note 118).

¹²⁵ See April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. of Fin. 187 (Feb. 2009).

¹²⁶ See Nicole M. Boyson and Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism* 14 Rev. of Deriv. Res. 169 (2011).

¹²⁷ See Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. of Fin. 1729 (Aug. 2008).

(2008) reported that 37 percent of targeted firms from 1998 through 2005 experienced negative abnormal returns.¹²⁸

While these studies focus on the U.S. stock market, the short-term benefits of activist campaigns have also been documented in non-U.S. stock markets. Becht et al. (2015), for example, show that activist interventions lead to positive abnormal stock returns in more than 20 stock markets globally.¹²⁹

Long-term effects

Critics of activism argue that activist tactics merely provide a short-term boost to stock prices, benefiting the activists but sacrificing long-term firm value. Judge Strine, for example, has warned of the “danger that activist shareholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation.”¹³⁰ Similarly, Coffee and Palia (2016) argue that “the increasing rate of hedge fund activism is beginning to compel corporate boards and managements to forego long-term investments (particularly in R&D) in favor of a short-term policy of maximizing shareholder payout.”¹³¹

A longstanding critic of shareholder activism, corporate attorney Martin Lipton, has argued that “the short-term influence of activist hedge funds has been, and continues to be, profoundly destructive to the long-term health of companies and the American economy.”¹³² His evidence is primarily anecdotal, based on “the decades of [his] and [his] firm’s experience in advising corporations.”¹³³ The empirical literature, however, paints a different picture.¹³⁴

¹²⁸ See Christopher P. Clifford, *Value Creation or Value Destruction? Hedge Funds as Shareholder Activists*, 14 J. of Corp. Fin. 323 (Sep. 2008).

¹²⁹ See Marco Becht, Julian Franks, Jeremy Grant and Hannes Wagner, *Returns to Hedge Fund Activism: An International Study*, 30 Rev. of Fin. Stud. 2933 (Sep. 2017).

¹³⁰ Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Manage for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 Bus. Lawyer 1 (Nov. 2010).

¹³¹ Coffee and Palia, *The Wolf at the Door* at 9 (cited in note 27).

¹³² Martin Lipton, *Do Activist Hedge Funds Really Create Long Term Value?*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jul. 22, 2014), available at <https://corpgov.law.harvard.edu/2014/07/22/do-activist-hedge-funds-really-create-long-term-value/>.

¹³³ Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 26, 2013), available at <http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/>.

¹³⁴ Lipton acknowledges that econometric evidence that appear to undermine his claims, but cites Allaire and Dauphin (2014) to call into question the value of empirical studies relative to observations based on real-world experience. According to them, “[e]conometrics provides a crude tool kit, a weak lens through which the researcher can, at best, view the blurred contours of complex phenomena.” See Yvan Allaire and Francois Dauphin, “*Activist Hedge Funds: Creators of Lasting Wealth?*,” Institute for the Governance of Private and Public Organizations 2 (July 2014).

Several studies examine the long-term stock returns of companies targeted by activists, testing whether the short-term gains in stock price are subsequently reversed. Bebchuk, Brav and Jiang show that, during the period of 1994 to 2007, targets of activism experience average abnormal returns of 2.6 percent over the three years following activist intervention and 5.8 percent over the five years following activist intervention.¹³⁵ Klein and Zur find that target companies earned abnormal returns of 11.4 percent over the year following an activist intervention from 2003 to 2005.¹³⁶ And Greenwood and Schor (2009) find abnormal returns of 10.4 percent over the following 18 months following an activist intervention in the study period of 1993 through 2006.¹³⁷

On the other hand, deHaan, Larcker and McClure (2019) found that on a value-weighted basis pre- and post-activism long-term returns (from one month before intervention through one to two years following intervention) insignificantly differ from zero during the study period of 1994 through 2011.¹³⁸ They found that positive gains following activist intervention were primarily driven by the smallest 20% of target firms, and that nearly all the positive long-term returns following activist interventions were concentrated among firms that were later acquired.¹³⁹

In addition to measuring the long-term effects on stock returns, Bebchuk, Brav and Jiang also observe the long-term effects of activism on the target firm's operating performance. Their study finds that both Tobin's Q (a commonly used measure of a firm's operating performance)¹⁴⁰ and the return on assets of a target company increase on average over the five years following an activist campaign.¹⁴¹

Brav, Jiang and Kim (2015) examine the impact of hedge fund activism on target company productivity in the study period of 2001 through 2006.¹⁴² They find that productivity at manufacturing plants improves over the three years following an activist intervention. In the same vein, they find that investment in information technology increases at target companies, which is also positively associated with productivity improvements. Brav et al. argue that their empirical find-

¹³⁵ Based on a value-weighted buy-and-hold strategy. See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* (cited in note 118).

¹³⁶ See Klein and Zur, *Entrepreneurial Shareholder Activism* (cited in note 125).

¹³⁷ See Robin Greenwood and Michael Schor, *Investor Activism and Takeovers*, 92 J. of Fin. Econ. 362 (Jun. 2009).

¹³⁸ See Ed deHaan, David Larcker and Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 Rev. of Acc. Stud. 436 (2019).

¹³⁹ See *id.* at 540.

¹⁴⁰ See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* at 1101 (cited in note 118): "Tobin's Q is the metric most commonly used by financial economists for studying the effectiveness with which firms operate and serve their shareholders...[and] is designed to reflect a company's success in turning a given book value of assets into market value accrued to investors."

¹⁴¹ See *id.* at 1103-06.

¹⁴² See Alon Brav, Wei Jiang and Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 Rev. of Fin. Stud. 2723 (Oct. 2015).

ings refute “the assertion that the effects of hedge fund activism are purely financial (such as extracting payouts to shareholders through leverage), as argued by some policy makers and the popular press.”¹⁴³

By contrast, Allaire and Dauphin (2015) find that companies targeted in activist campaigns in the period of 1994 through 2007 reduced average R&D spending (measured as a percentage of sales) from 17.34 percent to 8.12 percent over four years following an activist campaign.¹⁴⁴ Brav et al. (2018) report similar results, finding that R&D spending declines by an average of \$21 million in the five years after an activist intervention between 1994 and 2007. However, they also find that the productivity of R&D, measured by patent counts and citations, improves significantly despite the reduction in spending.¹⁴⁵ They attribute this apparent improvement in innovation to the more efficient allocation of resources, more efficient use of labor, and changes to board-level expertise that follow activist interventions.¹⁴⁶

c. Passive investors and activist strategies

The recent increase in shareholder activism has occurred against the backdrop of the rise of passive indexing as a popular investment strategy. Between 2005 and 2018, the aggregate assets held by index mutual funds and ETFs that invest primarily in U.S. equities grew more than fourfold, from \$721 billion to more than \$4 trillion.¹⁴⁷ Over the same period, the fraction of U.S. equity market capitalization held by index funds grew from 4 to 13 percent.¹⁴⁸ And according to estimates from Morningstar Inc., as of August 2019, assets managed by passive index funds exceed those held by active funds.¹⁴⁹ The growth of passive investing has been heavily concentrated at the top: since 2010, index funds controlled by the three largest asset managers have received 70 percent of cumulative inflows to index funds.¹⁵⁰

Appel, Gormley and Keim (2019) study the relationship between passive ownership and activists,

¹⁴³ See *id.* at 2726.

¹⁴⁴ See Yvon Allaire and Francois Dauphin, *Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence*, Institute for the Governance of Public and Private Organizations 24 (April 2015).

¹⁴⁵ See Alon Brav, Wei Jiang, Song Ma and Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?* 130 *J. of Fin. Econ.* 237 (2018).

¹⁴⁶ See *id.* at 247–56.

¹⁴⁷ See 2019 *Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, Investment Company Institute 201, 233 (2019).

¹⁴⁸ See *id.* at 41.

¹⁴⁹ See John Gittelsohn, *End of Era: Passive Equity Funds Surpass Active in Epic Shift*, Bloomberg News (September 11, 2019), available at <https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift>.

¹⁵⁰ See Vladyslav Sushko and Grant Turner, *The implications of passive investing for securities markets*, BIS Quarterly Review 113, 118 (March 2018).

specifically analyzing whether the “increasingly large and concentrated ownership stakes of passive institutional investors influence the types of campaigns undertaken by activists, the tactics they employ, and their eventual outcomes.”¹⁵¹ They predict that the increased presence of passive institutional investors—in particular, the increased concentration of public company ownership—may facilitate activist campaigns, so long as the campaigns are focused on improving long-term value, as opposed to temporary short-term gains: “[t]he large and concentrated ownership stakes of passive institutions might help...facilitat[e] activist investors’ ability to rally support for their demands...and decreas[e] the coordination costs of activism.”¹⁵²

Their prediction is borne out by their results. While they do not find a correlation between higher passive ownership and increases in the likelihood of an activist campaign,¹⁵³ they report that passive ownership does influence the strategies and outcomes of activist campaigns, as activists launch more aggressive campaigns against companies with higher passive ownership. Higher passive ownership correlates with: (i) increased likelihood of activists seeking board representation (a relatively ambitious and more costly campaign as compared to other types of campaigns);¹⁵⁴ (ii) increased use of hostile tactics versus more friendly approaches;¹⁵⁵ (iii) an increase in “both the likelihood and favorability of proxy settlements with management;”¹⁵⁶ and (iv) an increase in the likelihood for success related to campaigns advocating for a sale of the company to a third party (i.e. not to the activist) and removal of takeover defenses.¹⁵⁷ Their results also suggest that the rise of passive investors facilitates activist campaigns focused on long-term changes, while having no effect on the success of activist campaigns focused on short-term objectives such as capital payouts

¹⁵¹ See Ian R. Appel, Todd A. Gormley and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 Rev. of Fin Stud. 2720, 2721 (July 2019).

¹⁵² Id at 2721–22. See also Jill E. Fisch, Asaf Hamdani and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. Pa. L. Rev. 17, 42 (2020) (“Passive funds also play a complementary role in the more focused engagement provided by hedge funds by serving as gatekeepers for activism... [H]edge funds typically purchase less than 10% of an issuer’s shares and, as a result, cannot wage a successful campaign unless they have the support of institutional investors (and thus passive funds).”).

¹⁵³ An earlier study by Appel, Gormley and Keim found “evidence that a larger ownership stake by passive funds is associated with a decline in hedge fund activism; a one standard deviation increase in ownership by passive mutual funds is associated with a 1.6 percentage decline in the likelihood of a hedge fund activism event (statistically significant at the 10% level).” This decline is attributed to “the engagement of passive investors reducing the need for activism by other investors.” Ian R. Appel, Todd A Gormley and Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. of Fin. Econ. 111, 114 (2016).

¹⁵⁴ Less ambitious campaigns include shareholder proposals and exempt solicitations. See Appel, Gormley and Keim, *Standing on the Shoulders of Giants* at 2724–26 (cited in note 151).

¹⁵⁵ Hostile tactics include proxy battles against incumbent directors. See id.

¹⁵⁶ See id.

¹⁵⁷ See id.

(dividends and share repurchases) or other changes to the capital structure.¹⁵⁸

3. Stock buybacks

Stock buybacks are firm repurchases of stock from shareholders and, along with dividends, are a method for firms to redistribute excess capital back to shareholders. Lawmakers have recently recommended curtailing public companies' use of stock buybacks, arguing that the practice has constrained long-term investment while enriching wealthy shareholders and executives.¹⁵⁹

This section begins with a discussion of the current regulatory scheme governing buybacks and a discussion of recent trends in stock buybacks and dividends by U.S. firms. It then discusses the several reasons that a firm may conduct stock buybacks, followed by an analysis of the potential long-term impact of stock buybacks on public companies. This section concludes with an analysis of the various proposals that are aimed at curtailing stock buybacks and total shareholder payouts more generally, and sets forth a recommendation to enhance the transparency of stock buyback plans.

a. Regulation of stock buybacks in the United States

Stock buybacks were not a common practice until the 1980s, as they were generally perceived to be prohibited by the Exchange Act.¹⁶⁰ A company purchasing its own shares could be considered manipulative and therefore liable under the Exchange Act.¹⁶¹ In 1982, the SEC promulgated Rule 10b-18, which provided for a safe harbor from liability for manipulation for engaging in stock

¹⁵⁸ Notably, their earlier study, mentioned above, found that public companies with higher shares of ownership by passive funds demonstrated improved corporate governance measures, such as a higher number of independent directors, fewer takeover defenses and fewer dual class share structures. See Appel, Gormley and Keim, *Passive Investors, Not Passive Owners* at 114 (cited in note 153).

¹⁵⁹ See, for example, Chuck Schumer and Bernie Sanders, *Schumer and Sanders: Limit Corporate Stock Buybacks*, NY Times (Feb. 3, 2019); Senators Baldwin, Schumer, Van Hollen, Schatz, and Wyden proposed amendment SA 2124 to S. 2155 (Mar. 7, 2018), available at <https://www.congress.gov/amendment/115th-congress/senate-amendment/2124>; Letter to SEC Commissioner Jay Clayton signed by Senators Tammy Baldwin, Richard Blumenthal, Sherrod Brown, Cory A. Booker, Kirsten Gillibrand, Edward J. Markey, Jack Reed, Charles E. Schumer, Chris Van Hollen, Mark Warner, Elizabeth Warren, Sheldon Whitehouse, and Ron Wyden (Jun. 28, 2018); U.S. Senate Committee on Small Business & Entrepreneurship, *Made in China 2025 and the Future of American Industry*, available at https://www.rubio.senate.gov/public/_cache/files/d1c6db46-1a68-481a-b96e-356c8100fib7/3EDECA923DB439A8E884C6229A4C6003.02.12.19-final-sbc-project-mic2025-report.pdf.

¹⁶⁰ See Financial Services Committee Majority Staff, *Memorandum - October 17, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing Entitled: "Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment"*, United States House of Representatives Committee on Financial Services (Oct. 11, 2019), available at <https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-20191017-sd002-u1.pdf>.

¹⁶¹ See Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 Calif. Law Review 1323 (2005).

buybacks.¹⁶²

In 2003, Rule 10b-18 was updated to “simplify and update [its provisions] ... in light of market developments.”¹⁶³ To make use of this safe harbor, a firm must abide by the manner (limiting the issuer to a single broker or dealer per day to bid for or purchase stock), timing (restricting purchases during the opening and closing 30 minutes of trading), price (specifying the highest price an issuer may bid or purchase stock) and volume conditions (limiting purchases in an amount up to 25% of average daily trading volume),¹⁶⁴ which are intended “to minimize the market impact of the issuer’s repurchases, thereby allowing the market to establish a security’s price based on independent market forces without undue influence by the issuer.”¹⁶⁵

As a general matter, companies are required to disclose certain material events on Form 8-K within four days of their occurrence, but only if they fall into a specific item listed on the form.¹⁶⁶ Stock repurchase programs are not a specific item on Form 8-K, so their disclosure is not required.¹⁶⁷ However, companies may *elect* to disclose other material events on Form 8-Ks not otherwise required to be immediately disclosed.¹⁶⁸ Therefore, some companies promptly disclose the approval of stock repurchase programs, including their size and occasionally their intended duration, on Form 8-Ks under Item 8.01.¹⁶⁹

Separately, NASDAQ and NYSE require the immediate disclosure of certain material information.¹⁷⁰ Under NASDAQ Rule 5250(b)(1), a listed company must “make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors’ decisions.”¹⁷¹ Likewise, under NYSE rules, “a listed company is ex-

¹⁶² See *id.*

¹⁶³ Securities and Exchange Commission, *Purchases of Certain Equity Securities by the Issuer and Others*, 68 Fed. Reg. 64952 (Nov. 17, 2003).

¹⁶⁴ See *id.*

¹⁶⁵ See *id.*

¹⁶⁶ See Form 8-K, Item 8.01.

¹⁶⁷ See *id.*, Item 1.01.

¹⁶⁸ See *id.*, Item 8.01 (“The registrant may, at its option, disclose under this Item 8.01 any events, with respect to which information is not otherwise called for by this form, that the registrant deems of importance to security holders.”).

¹⁶⁹ See, for example, Vaalco Energy, Inc., *Current Report on Form 8-K* (June 20, 2019) <https://www.sec.gov/Archives/edgar/data/894627/000089462719000038/egy-20190620x8k.htm>; Eagle Pharmaceuticals, Inc., *Current Report on Form 8-K* (Oct. 30, 2018), https://www.sec.gov/Archives/edgar/data/827871/000110465918064476/a18-38166_18k.htm.

¹⁷⁰ See NASDAQ Rule 5250(b)(1); NYSE Listed Company Manual, Rule 202.05.

¹⁷¹ NASDAQ Rule 5250(b)(1).

pected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities.”¹⁷² These obligations are generally understood to capture the adoption of repurchase programs, but they do not require the disclosure of specific program details like intended duration and authorized amount.¹⁷³ Moreover, they can be satisfied by any disclosure “reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”¹⁷⁴ In addition to Form 8-Ks, this can include press releases, conference calls, webcasts, and posts to the company’s website.¹⁷⁵

Periodic SEC reporting requirements oblige companies to disclose certain material details of repurchase programs. Quarterly reports must include a description of stock repurchase programs to the extent that they are material.¹⁷⁶ Public companies are also required to disclose certain repurchase activity in their quarterly and annual reports for any publicly announced share repurchase programs.¹⁷⁷ These details include, by month:

- (a) the total shares repurchased,
- (b) the average price paid,
- (c) the total number of shares to be repurchased; and
- (d) the maximum number (or dollar value) of shares that may be purchased.¹⁷⁸

Public companies must also disclose:

- (1) the date of announcement,
- (2) the expiration date of such program or plan, if any,
- (3) each program or plan that has expired during the applicable quarter, and
- (4) each program or plan the firm has decided to terminate prior to expiration or which the firm does not intend to make any further purchases under.¹⁷⁹

¹⁷² NYSE Listed Company Manual, Rule 202.05.

¹⁷³ See Jesse M. Fried, *Insider Trading Via The Corporation*, U. Penn. L. Rev. 801 (2014).

¹⁷⁴ 17 C.F.R. § 243.101(e)(2) (“An issuer shall be exempt from the requirement to furnish or file a Form 8-K if it instead disseminates the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”).

¹⁷⁵ See, for example, NYSE Listed Company Manual, Rules 202.05, 204.00.

¹⁷⁶ See 17 C.F.R. § 229.703.

¹⁷⁷ See Fried, *Informed Trading and False Signaling with Open Market Repurchases* at 1340–1341 (cited in note 161).

¹⁷⁸ See 17 CFR § 229.703.

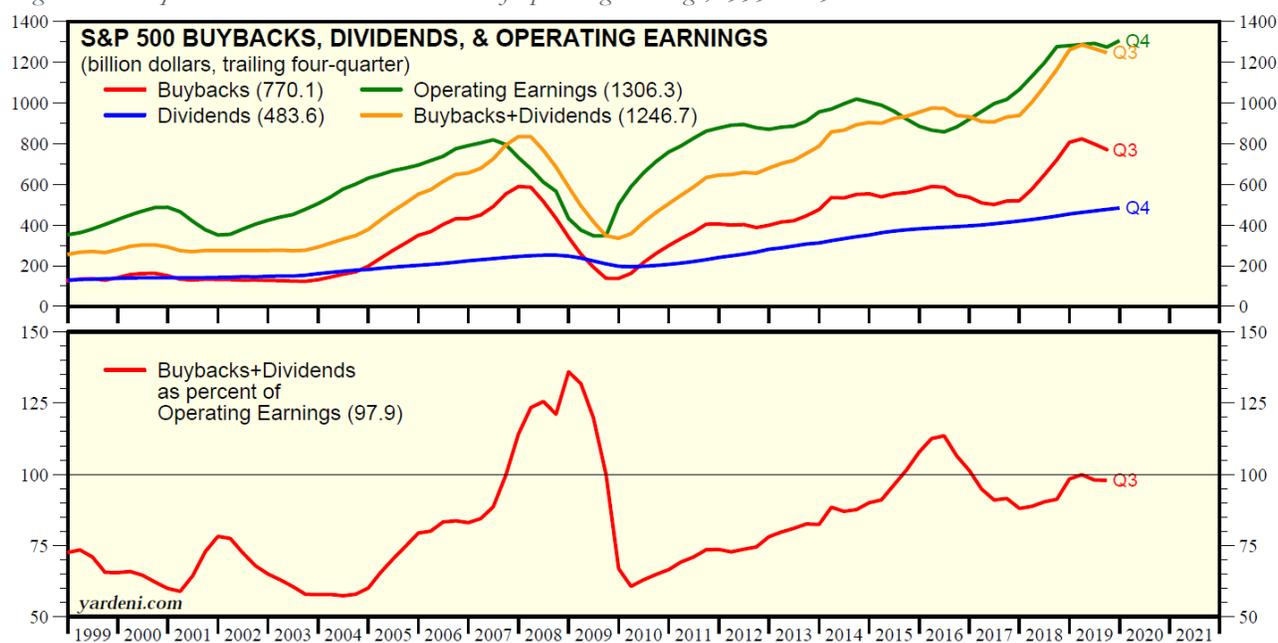
¹⁷⁹ See *id.*

b. Data on total payouts

Stock buybacks and dividends are near all-time highs. **Figure 2.6** (top panel) illustrates quarterly stock buyback and dividend data for S&P 500 companies since 1999.¹⁸⁰ As of the third quarter of 2019, total payouts from S&P 500 companies reached \$1.18 trillion over the previous four quarters, consisting of \$770 billion in stock buybacks and \$478 billion in dividends. From 1999 to 2019, the operating earnings of these companies more than tripled to roughly \$1.3 trillion annually. This rise largely traces the corresponding increase in dividends and buybacks over the same period. As a result, the increase in distributions is largely consistent with growing profits and cannot be *primarily* attributed to an increased preference by public companies to distribute capital to shareholders.

However, as shown in **Figure 2.6** (bottom panel), stock buybacks and dividends have also risen as a percentage of operating earnings in recent decades, from about 75% in 1999 to 98% in the third quarter of 2019.¹⁸¹ Thus, those who assert that public companies are paying out a greater share of their earnings to shareholders in Q3 2019 as compared to two decades ago are in fact correct. However, the percentage of net income paid out to shareholders today is lower than it was from 2007–2009 (see **Figure 2.6**, bottom panel).

Figure 2.6. Buybacks and dividends as a share of operating earnings, 1999–2019.



¹⁸⁰ See Edward Yardeni, Joe Abbott, and Mali Quintana, *Corporate Finance Briefing: S&P 500 Buybacks, & Dividends*, Yardeni Research, Inc., 10 (April 2, 2020), <https://www.yardeni.com/pub/buybackdiv.pdf>.

¹⁸¹ See *id.*

Several studies have more comprehensively examined the relationship between payouts and earnings, reaching divergent conclusions. Lazonick (2014) calculates total payouts, including stock buybacks and dividends, as a percentage of net income for S&P 500 firms between 2003–2012, finding that 91% of aggregate net income was distributed to shareholders, 54% through buybacks and 37% through dividends.¹⁸² Advocates of restricting stock buybacks cite this figure as evidence that firms are “restrain[ing] their capacity to reinvest profits more meaningfully in the company” since such a high percentage (nearly all) of profits are distributed to shareholders.¹⁸³ However, subsequent empirical research has identified significant flaws in this oft-cited statistic.

Fried and Wang (2018) study S&P 500 firms between 2007–2016 and also find a relatively high percentage of net income distributed as shareholder payouts at 96%.¹⁸⁴ However, that finding, like those of Lazonick (2014), considers *gross* payouts (i.e. total capital that flows *out* of the corporation through dividends and buybacks), while ignoring capital inflows that replace distributed capital. Therefore, it excludes the capital that managers obtain from new investors for investment. The more appropriate measure is *net* payouts, which also accounts for the significant amount of new capital flowing into corporations through new equity issuances and invested in the business. Fried and Wang (2018) find that, between 2007–2016, net payouts among S&P 500 firms constituted only 50% of net income, far less than the 91% statistic frequently cited.¹⁸⁵ Moreover, because smaller firms outside the S&P 500 are more often capital importers compared to larger peers, net payouts at *all* public companies constituted a lesser 41% of net income over the period.¹⁸⁶

Taken together, these findings indicate that although managers choose to distribute a substantial proportion of earnings, they also raise large sums of new capital, lowering their net payout ratio and equipping them with significant sums of capital for investment.

c. Motivations for stock buybacks

Critics of current stock buyback practices argue that buybacks are motivated by management’s short-term goals, such as increasing earnings per share (EPS) and stock price, at the expense of investment in innovation and long-term growth.¹⁸⁷ It is therefore important to understand the various motivating factors for stock buyback programs, as many are unrelated to short-termism.

¹⁸² See Lazonick, *Profits without Prosperity* (cited in note 24).

¹⁸³ Schumer and Sanders, *Limit Corporate Stock Buybacks* (cited in note 159).

¹⁸⁴ See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25). A more detailed analysis of the data can be found in Jesse M. Fried and Charles Y. Wang, *Short-Termism and Capital Flows*, 8 Rev. of Corp. Fin. Stud. 207 (March 2019).

¹⁸⁵ See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

¹⁸⁶ See *id.*

¹⁸⁷ See, for example, Lazonick, *Profits without Prosperity* (cited in note 24); Schumer and Sanders, *Limit Corporate Stock Buybacks* (cited in note 159).

Most importantly, stock buybacks are an alternative method for distributing cash to shareholders that would otherwise be paid as dividends.¹⁸⁸ Management may prefer stock buybacks over dividends for several reasons. First, stock buybacks offer tax advantages for shareholders, since dividends are immediately taxable at ordinary income rates, while stock buybacks allow shareholders to defer tax—they can choose to hold onto their shares, rather than sell—and pay capital gains rates.¹⁸⁹ Second, stock buyback programs offer more flexibility than dividends, allowing management to appropriately time repurchases and adjust payouts in response to investment opportunities and accommodate impacts on earnings-per-share or stock valuation.¹⁹⁰ Stock buybacks are also preferable for employees since they do not entail stock price declines as occurs with dividends and therefore do not devalue employee stock options.¹⁹¹ Stock buybacks may also signal firm value to the market, since firms typically repurchase shares that management views as undervalued.¹⁹² In a survey of CFOs, Brav et al. (2005) note that 85% believe that stock buybacks do indeed convey positive information to shareholders.¹⁹³

Finally, another motivating factor for stock buybacks is to lower overall costs of capital by replacing equity with debt.¹⁹⁴ A new issuance of debt is preferable from a tax perspective, as the interest payments are tax deductible and result in a lower tax burden.¹⁹⁵ Roe (2018) notes that stock buy-

¹⁸⁸ See generally Michael J. Brennan and Anjan V. Thakor, *Shareholder Preferences and Dividend Policy*, 45 J. of Fin. 993 (Sep. 1990); Utpal Bhattacharya and Stacey E. Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence*, 20 Rev. of Fin. 725, 725–29 (March 2016).

¹⁸⁹ Under current federal tax law, ordinary income tax rates on dividends generally are equivalent to capital gains rates, so the deferral of taxes is the greater advantage for buybacks over dividends. See 26 USC § 1(h)(11).

¹⁹⁰ See Alon Brav, John R. Graham, Campbell R. Harvey and Roni Michaely, *Payout Policy in the 21st Century*, 77 J. of Fin. Econ. 483, 501–03 (Sep. 2005).

¹⁹¹ See Kathleen M. Kahle, *When a buyback isn't a buyback: Open market repurchases and employee options*, 63 J. of Fin. Econ. 235 (2002).

¹⁹² See Bhattacharya and Jacobsen, *The Share Repurchase Announcement Puzzle* (cited in note 188); Richard G. Sloan and Haifeng You, *Wealth Transfers via Equity Transactions*, 118 J. of Fin. Econ. 93 (Oct. 2015) (quantifying the magnitude of wealth transfers from selling shareholders to ongoing shareholders).

¹⁹³ See Brav et al., *Payout Policy in the 21st Century* at 511–13 (cited in note 190).

¹⁹⁴ See Clifford Asness, Todd Hazelkorn and Scott Richardson, *Buyback Derangement Syndrome*, 44 J. of Port. Mgmt. 50, 52 (Spring 2018) (“A considerable portion of the recent share repurchase activity has simply been a recapitalization, shifting from equity to debt. Given low real and nominal rates, it is quite possible that corporate treasurers view debt financing as cheaper than equity financing and thus engaged in this swap.”); Roe, *Stock Market Short-Termism's Impact* at 24 (cited in note 6) (“Substituting debt for equity... is not the *short-term* destruction of the firms' cash for investment. It is a recapitalization from equity to debt when long-term debt is cheap.”).

¹⁹⁵ See Asness et al., *Buyback Derangement Syndrome* at 53 (cited in note 194) (“[B]ecause interest payments are tax deductible, debt-financed repurchases can be viewed as good news because of the resulting lower tax burden.”).

backs have increased when interest rates are low and have declined when interest rates have increased, which is consistent with the argument that firms engage in buybacks to recapitalize their balance sheet with relatively cheaper debt.¹⁹⁶

None of the above motivating factors are short term in nature. In contrast, the use of stock buybacks solely to boost the firm's EPS or price would entail a short-term focus on the part of management. Two questions arise in analyzing these possible short-term motivations for stock buybacks. What is the effect of stock buybacks on EPS and stock price? And what is the evidence that management uses buybacks for these short-term purposes?

Effect of stock buybacks on EPS and stock price

Hribar, Jenkins and Johnson (2006) note that the effect of stock buybacks on EPS is “determined by three factors: the timing of the repurchase, the proportion of shares bought back, and the financial return forfeited on the funds used to buy back shares.”¹⁹⁷ EPS may increase or decrease depending on the overall weight of the first two factors versus the third factor. In their study, Hribar et al. report that reductions in EPS of one cent or more (21.1% of cases) are more likely than increases of one cent or more (only 9.34% of cases). In the remaining 70% of cases, buybacks result in no meaningful impact on EPS.¹⁹⁸ On the other hand, Almeida, Fos and Kronlund (2016) find that firms that are at risk of missing EPS forecasts in a given quarter are 5-10% more likely to engage in stock buybacks that *increase* EPS.¹⁹⁹ Therefore, while any given stock buyback may increase or decrease EPS, buybacks motivated by short-term EPS goals have been found to increase EPS.

Evidence that management engages in buybacks for short-term goals

In their survey of CFOs, Brav et al. (2005) find that 75% of CFOs claim that increasing EPS is an “important” or “very important” factor in stock buyback decisions.²⁰⁰ In addition, Cheng, Harford and Zhang (2015) analyze CEO bonus structures, finding that “when a CEO’s bonus is directly tied to EPS, his company is more likely to conduct a repurchase and the magnitude of the repurchase tends to be larger.”²⁰¹ The study further determines that when CEO bonuses are tied to EPS, share buybacks increase CEO bonuses by approximately 34%.²⁰² Similarly, Kim and Ng (2018) find that management is more likely to conduct a stock buyback if their stock’s EPS is slightly

¹⁹⁶ See Roe, *Stock Market Short-Termism’s Impact* at 22 (cited in note 6).

¹⁹⁷ Paul Hribar, Nicole Thorne Jenkins and W. Bruce Johnson, *Stock Repurchases as an Earnings Management Device*, 41 J. of Acc. and Econ. 3, 6 (2006).

¹⁹⁸ See *id* at 12.

¹⁹⁹ See Heitor Almeida, Vyacheslav Fos and Mathias Kronlund, *The Real Effects of Share Repurchases*, 119 J. of Fin. Econ. 168, 174 (Jan. 2016).

²⁰⁰ See Brav et al., *Payout Policy in the 21st Century* at 515 (cited in note 190).

²⁰¹ Yingmei Cheng, Jarrad Harford, and Tianming Zhang, *50 Bonus-driven Repurchases*, 50 J. of Fin. and Quant. Analysis 447, 448 (June 2015).

²⁰² See *id* at 468.

below the bonus threshold in their compensation agreement.²⁰³ SEC research also found that executives are twice as likely to sell shares in the eight days following a buyback program announcement compared to an ordinary trading day.²⁰⁴ We therefore find evidence that stock buybacks may be used to support certain short-term goals, such as increases in executive compensation.

d. Stock buybacks and long-term investment

Regardless of the motivations for stock buybacks, whether short term in nature or not, empirical research shows that companies' aggregate investment in long-term projects remains strong. In fact, Fried and Wang (2018) show that as of the end of 2016, when total stock buybacks had hit record highs, research and development (R&D) spending as a percentage of total revenue by S&P 500 firms was also at record highs.²⁰⁵ Moreover, total investment spending, measured as R&D plus capital expenditures (CAPEX) as a percentage of revenue, was also at its highest level in two decades.²⁰⁶ More recently, despite stock buybacks hitting another record high in 2018, S&P 500 firms increased CAPEX and R&D spending by 13%.²⁰⁷ The concern, however, is that R&D spending would have increased even more if capital had not been allocated to stock buybacks, but the record cash balances at S&P 500 firms suggest otherwise. Even after accounting for the \$800 billion in stock buybacks in 2018, S&P 500 firms still held an aggregate of \$1.4 trillion in cash at the end of the year.²⁰⁸ This data indicates that stock buybacks have not depleted public companies of their resources available for investment in long-term growth, but rather public companies simply have "more capital than they need for the investment opportunities available."²⁰⁹

While aggregate levels of investment have not appeared to suffer with the rise in total stock buybacks, another relevant question is whether stock buybacks affect investment spending at the individual firm level, rather than in aggregate. A recent MSCI study looks at the link between stock buybacks and investment spending at the firm level, finding that contrary to the concerns of stock-buyback critics, companies that are the most actively engaged in stock buybacks are also the

²⁰³ See Sunyoung Kim and Jeff Ng, *Executive Bonus Contract Characteristics and Share Repurchases*, 93 *Acc. Rev.* 289 (Jan. 2018).

²⁰⁴ See Commissioner Robert J. Jackson, Jr., *Stock Buybacks and Corporate Cashouts*, Speech at the Center for American Progress (June 11, 2018), available at <https://www.sec.gov/news/speech/speech-jackson-061118>.

²⁰⁵ See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

²⁰⁶ See *id.*

²⁰⁷ See David Kostin and Cole Hunter, *Buyback Realities: Debunking buybacks myths*, 77 *Top of Mind: Goldman Sachs Global Investment Research* 4 (April 11, 2019), available at <https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf>.

²⁰⁸ See Peter Brennan, *S&P 500 share buybacks could reach \$1 trillion in 2019 on swollen cash piles*, *S&P Global Market Intelligence* (Mar. 26, 2019), available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/50751184>.

²⁰⁹ Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

strongest in terms of R&D and CAPEX spending.²¹⁰ The study concludes there is “[no] evidence that companies might be diverting resources to buybacks instead of reinvesting in their companies.”²¹¹ Similarly, Kay and Martin (2019) found that companies that participate in larger share buybacks had higher CAPEX spending over the four years after the buyback.²¹² Yet another link at the individual firm level is the fact that the ten S&P 500 firms that accounted for two-thirds of the increase in buybacks in 2018 also increased total investment in R&D and CAPEX by 26% that year.²¹³

Finally, even if individual firms were to divert cash from investment spending for use in buybacks, that cash is not necessarily withdrawn from the capital markets. The capital that shareholders receive from buybacks can be invested in other companies that can use the funding in more productive ways. In this case, instead of stock buybacks draining investment capital from the economy, buybacks free up capital to be deployed more productively. For example, while the largest public companies have experienced net outflows of capital over the past decade, smaller public growth companies have experienced net inflows of over \$400 billion from 2007–2016.²¹⁴ Roe (2018) argues that recent data shows that cash is flowing from larger firms, including those participating in largescale buybacks, to smaller firms that may be better suited to drive innovation.²¹⁵ In addition, Steil and Rocca (2019) show that it is the companies with the least productive use for excess cash, as measured by average return on capital, that constitute a majority of buyback activity.²¹⁶ Because of this, buybacks may actually mitigate *overinvestment* problems by returning capital to shareholders in cases where productive uses of capital are scarce,²¹⁷ and avoiding so-called empire building, whereby managers deploy excess cash in projects simply to increase the size of the firm that they manage, even if the projects are poor investments.²¹⁸

²¹⁰ See Ric Marshall, Panos Seretis and Agnes Grunfeld, *Taking Stock: Share Buybacks and Shareholder Value*, MSCI 17 (Aug. 2018), available at <https://www.msci.com/documents/10199/ba01b4c4-683c-74ca-339e-f422df5d879e>.

²¹¹ *Id.*

²¹² See Ira Kay and Blaine Martin, *Are Share Buy Backs a Symptom of Managerial Short-Termism?*, Harvard Law School Forum on Corporate Governance (May 18, 2019), available at <https://corpgov.law.harvard.edu/2019/05/18/are-share-buybacks-a-symptom-of-managerial-short-termism/>.

²¹³ See Kostin and Hunter, *Buyback Realities* at 4 (cited in note 207).

²¹⁴ See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

²¹⁵ See *id.*

²¹⁶ See Benn Steil and Benjamin Della Rocca, *Why Schumer and Sanders Are Wrong on Buybacks*, Council on Foreign Relations Blog (Feb. 15, 2019) (finding that “the three sectors experiencing the largest decline in return on capital – IT, Health Care, and Energy – account for nearly 80 percent of the rise in buyback activity in the first half of last year.”), available at <https://www.cfr.org/blog/why-schumer-and-sanders-are-wrong-buybacks>.

²¹⁷ See Dennis Oswald and Steven Young, *Share reacquisitions, surplus cash, and agency problems*, 32 J. of Bank. and Fin. 795 (May 2008).

²¹⁸ See, for example, Asness et al., *Buyback Derangement Syndrome* at 53 (cited in note 194) (noting that “[t]his kind of agency cost is often characterized as empire building, and avoiding it has long been viewed as one of the benefits of returning cash to shareholders.”).

4. Recommendations

Advocates of the short-termism thesis have argued that public companies take actions to increase their short-term stock price at the expense of long-term investment, which, in turn, will negatively impact economic growth and job creation economy-wide. While surveys of public company executives have shown an increase in short-term pressure, there is limited empirical evidence showing that executives are acting on these pressures or that short-termism is harming the economy. Empirical studies have not shown an economy-wide decline in long-term investment by public companies.

An important consideration for public companies is the potential consequences of issuing quarterly earnings guidance. Our research shows mixed results on the link between such guidance and short-term pressures, suggesting that any mandatory restrictions on quarterly earnings guidance would be inappropriate. On the one hand, there is some empirical evidence that firms issuing quarterly earnings guidance are more likely to attract short-term investors and, thus, invest less in long-term growth. On the other hand, contrasting studies find that ceasing quarterly earnings guidance not only fails to increase long-term investment spending, but can also lead to higher costs of equity capital for firms. As a result, the decision to issue quarterly earnings guidance is best left to individual firms who should give consideration to the costs and benefits of such guidance.

The rise of shareholder activism and the increase in stock buybacks by public companies have been criticized as exacerbating short-termism, by either causing companies to focus on short-term stock prices at the expense of long-term value to appease activists or as a method to boost stock prices in the short-term by engaging in stock buybacks. We find that the majority of empirical literature regarding the short-term impact of activism on public companies is positive and the evidence regarding long-run effects of shareholder activism is ambiguous. We therefore do not recommend any regulatory changes to reduce the role of shareholder activism in U.S. capital markets. As to stock buybacks, we find that although stock buybacks have been increasing, long-term investment remains strong. However, firms are subject to limited disclosure requirements with respect to stock buyback programs. The SEC could facilitate additional transparency by enhancing their existing disclosure regime for share repurchase programs.

In light of these findings, we recommend the following reforms:

- U.S. public companies should weigh carefully the costs and benefits of quarterly earnings guidance and consider ending the practice if it discourages them from committing to long-term investments.
- The SEC should issue precatory guidance clarifying that companies should publicly disclose certain material elements of a stock buyback program after authorization by a com-

pany's Board of Directors. Such material elements should include the maximum repurchase amount of shares (number of shares and total dollar value) and the approximate intended duration of the plan. Public companies should publicly disclose such elements within five business days of the authorization of a stock buyback plan. Public companies should be permitted to provide public disclosure through press releases or other Regulation FD-compliant methods that ensure broad public dissemination.

Chapter 3: The Rise of Index Investing: Price Efficiency and Financial Stability

Summary

Index investing is based upon a set of predefined, mechanical rules for choosing a publicly known set of stocks.¹ The strategy of index investors is to gain exposure to the performance of the market as a whole or a particular segment of the market.² Given its mechanical, rules-based nature, index investing does not require investment in fundamental research about security prices and typically entails significantly less trading activity than active investment.³ As a result, index investing tends to provide low-cost access to diversified portfolios.⁴

In this chapter, we begin by tracking the growth of index investing in U.S. equity markets from a small niche strategy in the 1970s into an investment style comparable in scale to the active management of mutual funds.⁵ We then consider whether the rise of index investing has reduced the extent to which prices of individual stocks reflect their underlying value (price efficiency).⁶ We then examine whether the rise of index investing has increased risks to financial stability through three channels: (a) stock market bubbles and crashes; (b) concentration of asset managers; and (c) liquidity and redemption concerns. In conclusion, we find that the empirical evidence, while mixed, indicates that the rise of index investing has not had negative effects on price efficiency or financial stability. We recommend continued study of index investing in the years to come.

¹ See Clifford Asness, *The Value of Fundamental Indexing*, INSTITUTIONAL INVESTOR (Oct. 15, 2006), <https://www.institutionalinvestor.com/article/b15onsjcm4ph3y/the-value-of-fundamental-indexing> (“What is an index? ... [A]ny rule-based method of constructing a portfolio. The method can be completely mechanical — this is how we usually think of it — but it can also be the result of a committee decision, such as that undertaken to construct the Standard & Poor’s 500 index. What is important is that it is defined ex ante, so we know the components before we see the results.”); Jeffrey Wurgler, *On the Economic Consequences of Index-Linked Investing*, in Gerald Rosenfeld, Jay W. Lorsch, and Rakesh Khurana, *Challenges to Business in the Twenty-First Century* 20 (2010).

² See Wurgler, *On the Economic Consequences of Index-Linked Investing*, supra note 1, at 31-33.

³ See Wurgler, *On the Economic Consequences of Index-Linked Investing*, supra note 1, at 31-33.

⁴ See Asness, *The Value of Fundamental Indexing*, supra note 1 (“Traditional indices and the funds based on them are market-capitalization-weighted and provide the investor with exposure to markets, usually at a very low, all-in cost.”).

⁵ See Wurgler, *On the Economic Consequences of Index-Linked Investing*, supra note 1, at 21. Indexing has also grown dramatically in bond and commodity markets. See Vladyslav Sushko and Grant Turner, *The implications of passive investing for securities markets*, BIS QUARTERLY REVIEW 113, 114-15 (March 2018), https://www.bis.org/publ/qtrpdf/r_qtr1803j.pdf.

⁶ See, e.g., Inigo Fraser-Jenkins, *The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism*, BERNSTEIN RESEARCH (Aug. 23, 2016).

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1. Index investing in U.S. equity markets

In this section we examine the rate of growth and share of public stock ownership by index mutual funds and ETFs. We follow with an explanation of certain drivers of that growth and conclude this section with a discussion of the nuances of measuring the absolute size of index investing in U.S. equity markets.

a. Mutual funds and ETFs

The growth of indexing in U.S. equity markets has been largely driven by increases in stock ownership by index mutual funds and index ETFs. Mutual funds are investment funds that issue common shares directly to investors, which can be redeemed with the fund on a daily basis for cash equal to a pro rata share of the fund's net asset value.¹ ETFs are similar to mutual funds with respect to the pooling of investor money and offering of shares that represent a pro-rata share of the fund's net asset value, but unlike traditional mutual funds, ETF shares trade on stock exchanges.² Index ETFs comprise roughly 99% of all ETFs.³

A unique feature of ETFs is their creation and redemption process, which is managed by financial institutions known as "authorized participants."⁴ ETFs depend on these authorized participants to ensure that the price of an ETF is adjusted to reflect the underlying value of its securities.⁵ When the price of an ETF temporarily exceeds the value of its underlying securities, authorized participants bring prices into line by purchasing the underlying securities and delivering the securities to the ETF issuer in exchange for newly created ETF shares that the authorized participant then sells into the market.⁶ Authorized participants do the opposite when the price of an ETF is lower than the price of its underlying securities.⁷

¹ The Investment Company Act of 1940 requires open-end mutual funds to redeem shares within seven days of an investor's redemption demand. See 15 U.S.C. § 80a-22(e).

² See U.S. SEC. & EXCH. COMM'N, *Investor Bulletin: Exchange-Traded Funds (ETFs)* (Aug. 10, 2012), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-24>.

³ See Sushko & Turner (2018), *supra* note 5, at 114 (noting that only approximately 1% of ETF assets are active ETFs).

⁴ See *Investor Bulletin: Exchange-Traded Funds (ETFs)*, *supra* note 2.

⁵ See *id.* See also BLACKROCK, *iShares Investigates: The ETF Ecosystem* (2019), <https://www.blackrock.com/corporate/literature/investor-education/ishares-investigates-authorized-participants-market-makers-part-1-en-us.pdf>.

⁶ *iShares Investigates: The ETF Ecosystem*, *supra* note 5, at 2.

⁷ *iShares Investigates: The ETF Ecosystem*, *supra* note 5, at 2.

b. The rise of index investing in U.S. equity markets

Equity indexing experienced an early period of rapid growth during the late 1970s and early 1980s, with assets invested in index mutual funds swelling from 0.5 percent of S&P 500 market capitalization in 1975 to 3.1 percent in 1983.⁸ In 1993, the first index ETF was introduced in the United States.⁹ However, index investment languished through the end of the dot-com boom: in 2001, index mutual funds and ETFs still held just 3 percent of U.S. equity market capitalization.¹⁰ Once the tech bubble burst, indexing began to grow again. As **Figure 3.1** demonstrates, the fraction of U.S. equity market capitalization held by index mutual funds and ETFs grew from 4 percent in 2005 to 15 percent as of year-end 2019.¹¹ Over the same period of time, the fraction of market capitalization held by actively managed funds declined from 20 percent to 15 percent.¹² In other words, the ratio of actively managed funds to index funds declined from 5-to-1 in 2005 to 1-to-1 in 2019.¹³ As of January 31, 2020, according to Morningstar, equity index funds that invest primarily in U.S. companies had \$4.7 trillion in assets under management, compared to \$4.5 trillion for similarly-focused active equity funds.¹⁴

⁸ See Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*, 41 J. OF FIN. 579, 584 (July 1986).

⁹ See Asjylyn Loder, *As First ETF Turns 25, Exchange-Traded Funds Dominate Investing World*, WALL STREET JOURNAL (Jan. 22, 2018) <https://www.wsj.com/articles/as-first-etf-turns-25-exchange-traded-funds-dominate-investing-world-1516626000>.

¹⁰ See INVESTMENT COMPANY INSTITUTE, *2018 Investment Company Fact Book*, at 43 (2018), https://www.ici.org/pdf/2018_factbook.pdf.

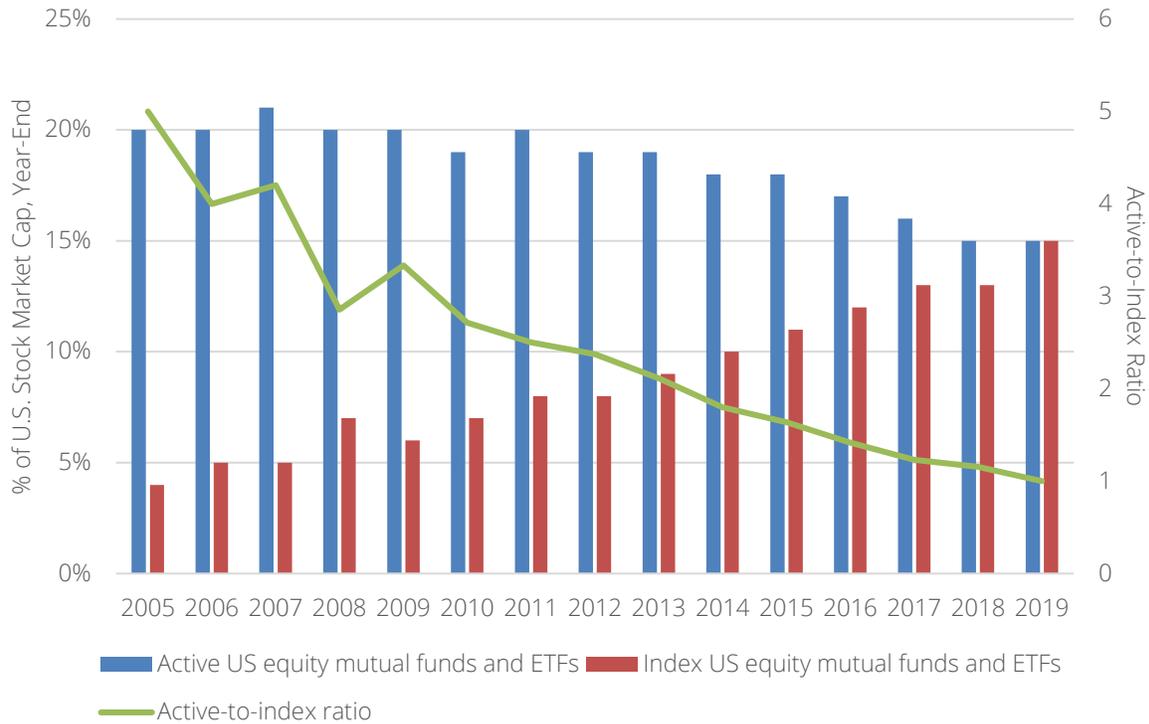
¹¹ INVESTMENT COMPANY INSTITUTE, *2020 Investment Company Fact Book* at “Facts at a Glance” (60th Ed. 2020), https://www.ici.org/pdf/2020_factbook.pdf. See also INVESTMENT COMPANY INSTITUTE, *2019 Investment Company Fact Book*, at 41 (2019), https://www.ici.org/pdf/2019_factbook.pdf; INVESTMENT COMPANY INSTITUTE, *2018 Investment Company Fact Book*, at 43 (2018), https://www.ici.org/pdf/2018_factbook.pdf. Compare Sushko and Turner (2018), *supra* note 5, at 116.

¹² *2020 Investment Company Fact Book*, *supra* note 11, at 40.

¹³ *2020 Investment Company Fact Book*, *supra* note 11, at 40.

¹⁴ See Tony Thomas and Nick Watson, *Morningstar U.S. Fund Flows Commentary*, MORNINGSTAR RESEARCH 3 (Jan. 2020).

Figure 3.1. Percent of U.S. stock market held by active and passive mutual funds and ETFs.



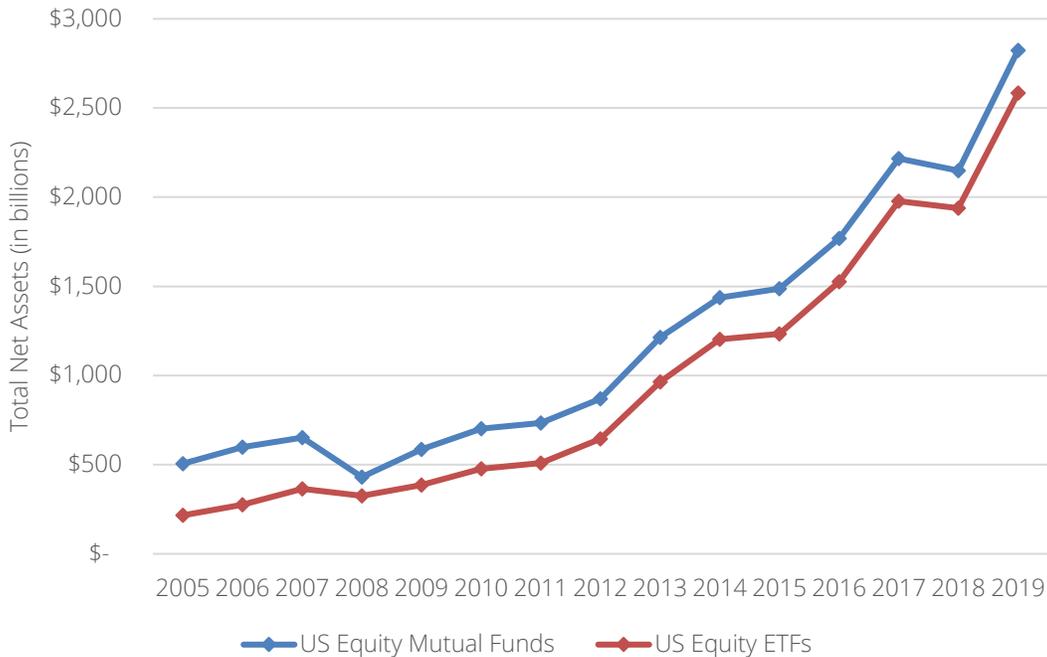
Between 2005 and 2019, the total net assets held by U.S. domestic equity index mutual funds grew from \$505 billion to more than \$2.8 trillion (see **Figure 3.2**).¹⁵ The rise of index ETFs has been equally dramatic. The total net assets held by U.S. domestic equity ETFs, the overwhelming majority of which are indexed,¹⁶ increased from \$216 million in 2005 to more than \$2.58 trillion by year-end 2019 (see **Figure 3.2**).¹⁷

¹⁵ 2020 Investment Company Fact Book, supra note 11, at 237.

¹⁶ Approximately 1% of assets held by equity ETFs are held by actively-managed equity ETFs, which do not seek to track an index, but instead offer investors an active investment strategy designed to deliver absolute returns or high returns relative to a benchmark. Because active equity ETFs account for just a small share of ETFs overall, these figures treat all equity ETFs as passive. See Sushko and Turner (2018), supra note 5, at 114; 2020 Investment Company Fact Book, supra note 11, at 206 (showing that 97.7% of all 1940 Act ETFs are indexed).

¹⁷ 2020 Investment Company Fact Book, supra note 11, at 206. See also FEDERAL RESERVE SYSTEM: FEDERAL RESERVE BANK OF ST. LOUIS, Exchange-Traded Funds; Total Financial Assets in Domestic Equity Funds, Level, (last accessed 2019), <https://fred.stlouisfed.org/series/BOGZIFL564091600Q>.

Figure 3.2. US index mutual funds and ETFs, total net assets (billions of dollars).



The rise of index funds in the U.S. has been paralleled globally. According to Sushko & Turner (2018), index funds and ETFs managed about \$8 trillion globally as of June 2017, which represented 20% of aggregate fund assets, up from 8% in 2007.¹⁸ And according to one analysis by the Investment Company Institute, index-tracking funds managed over \$10 trillion world-wide as of year-end 2019, compared to approximately \$2 trillion in 2007.¹⁹

c. Cost of index investing as a driver of growth

One factor driving the growth of index equity funds relative to active equity funds is the relatively low cost of index investing. As noted earlier, index investing does not typically involve significant fundamental research about security prices or high levels of trading activity, which helps to keep index fund fees low.²⁰ Nobel Laureate William Sharpe has argued that due to the higher costs of active management, “the average actively managed dollar must underperform the average passively managed dollar, net of fees.”²¹ Indeed over the past decade, the majority of active equity

¹⁸ Sushko & Turner (2018), supra note 5, at 114.

¹⁹ Robin Wigglesworth and Alex Janiaud, *Index funds break through \$10tn-in-assets mark amid active exodus*, THE FINANCIAL TIMES (Jan. 7, 2020), <https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3fode>.

²⁰ See text accompanying notes 2–4.

²¹ William F. Sharpe, *The Arithmetic of Active Management*, <https://web.stanford.edu/~wfsarpe/art/active/active.htm>.

funds have failed to outperform their benchmark index net of fees,²² and funds that have outperformed their benchmark have often failed to do so consistently.²³ Historically, empirical research has also found that over long horizons, the average active equity fund underperforms its benchmark due in part to the higher costs associated with active investing.²⁴ And more recent research shows that “the majority of active U.S. mutual funds underperformed their benchmarks over [a] 10-year period, even before accounting for fees.”²⁵

Index mutual funds are also larger, on average, than active funds: in 2018, the size of the average index equity mutual fund (\$6.3 billion) was four times the size of the average actively managed equity mutual fund (\$1.5 billion).²⁶ The relatively large size of index funds helps reduce fund expense ratios through economies of scale --the fixed costs associated with managing the fund becomes a lower percentage of the total assets under management, further reducing the expense ratios.²⁷ A large asset base also allows asset managers to invest in cost reductions and gives them more leverage to negotiate with brokers for more favorable trading fees.²⁸ As fees drop, even more investment dollars are attracted to these larger funds, and the cost-lowering cycle continues.

The net result from 2000 to 2019 was a lowering of the average expense ratio of index equity mutual funds from 0.27 percent to 0.07 percent.²⁹ Index ETFs also offer low expenses and diversification, with an average expense ratio of 0.18 percent in 2019.³⁰ However, it is important to note that average expense ratio for active mutual funds also declined between 2000 and 2019, from 1.06 percent to 0.74 percent.³¹

²² See Berlinda Liu, *SPIVA U.S. Scorecard: Year-End 2019*, S&P DOW JONES INDICES RESEARCH (April 2, 2020).

²³ See Berlinda Liu and Philip Brzenk, *Does Past Performance Matter? The Persistence Scorecard: December 2019*, S&P DOW JONES INDICES RESEARCH (December 4, 2019).

²⁴ See e.g., Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. OF FIN. 57 (1997) (the best past-performance active mutual funds earn back their expenses and transaction costs; the majority of active funds underperform by approximately their investment costs).

²⁵ Berlinda Liu and Hamish Preston, *SPIVA Institutional Scorecard: How Much Do Fees Affect the Active versus Passive Debate?*, S&P Dow Jones Indices Research (December 2018).

²⁶ INVESTMENT COMPANY INSTITUTE, *2019 Investment Company Fact Book*, at 122 (2019), https://www.ici.org/pdf/2019_factbook.pdf.

²⁷ See *id.*

²⁸ See Joseph Chen, Harrison Hong, Ming Huang, and Jeffrey Kubik, *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94(5) THE AMERICAN ECONOMIC REVIEW 1276, 1293 (2004), <http://www.columbia.edu/~hh2679/AER-SIZE.pdf> (“It is well known that there are tremendous economies of scale associated with trading commissions and lending fees at the family level. Bigger families like Fidelity are able to get better concessions on trading commissions and earn higher lending fees for the stocks held by their funds.”); Gjergji Cici, Laura Dahm, and Alexander Kempf, *Trading efficiency of fund families: Impact on fund performance and investment behavior*, 88(C) JOURNAL OF BANKING & FINANCE 1-12 (2018).

²⁹ *2020 Investment Company Fact Book*, supra note 11, at 127.

³⁰ *2020 Investment Company Fact Book*, supra note 11, at 129.

³¹ *2020 Investment Company Fact Book*, supra note 11, at 127.

d. Ambiguity regarding the “true” size of the indexed market

It is important to note that index mutual funds and index ETFs do not represent the entire universe of index investment. Indeed, in a 2017 review of global investment, BlackRock estimated that \$6.8 trillion, representing 10 percent of the market cap of global equity stocks, is indexed outside of mutual funds and ETFs.³²

One reason for this is that many institutional investors manage their investments internally, without investing in mutual funds or ETFs or otherwise delegating investment decisions to an asset manager. For example, of the \$181 trillion in global financial assets owned by pension funds (\$33.9tn), insurance companies (\$24.1tn), sovereign wealth funds (\$5.2tn), endowments (\$1.4tn), and other asset owners in 2012, only 23.9% were externally managed by asset managers.³³ Many of these large sophisticated investors that manage their own assets have implemented index investment strategies.³⁴ Anecdotal evidence also suggests that internal indexing is growing in the United States: California Public Employees' Retirement System (CalPERS)—the largest public pension fund in the United States—recently shifted its public equity investment strategy to focus largely on internal, index-tracking strategies.³⁵

Another reason is that when investors do rely on asset managers to manage their investments, they may invest through vehicles other than mutual funds and ETFs. For example, they may invest via separately managed accounts, whereby an asset manager advises with respect to a portfolio of securities that is owned entirely by the investor.³⁶ According to Pensions & Investments data on U.S. asset managers, of the \$64 trillion in total worldwide assets under management as of December 2018, 38.2% was in separately managed accounts.³⁷ Indexing strategies may be adopted with

³² BLACKROCK, *Index Investing Supports Vibrant Capital Markets*, 6(2017), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf>.

³³ BLACKROCK, *Who Owns the Assets, Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation* (May 14, 2012), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf>.

³⁴ Robin Wigglesworth and Alex Janiaud, *Index funds break through \$10tn-in-assets mark amid active exodus*, FINANCIAL TIMES (Jan. 7, 2020), <https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3f0de>; Kate Smith, *After Shift to Passive Investing, Endowments Now Are Staying Put*, Bloomberg (June 8, 2017), <https://www.bloomberg.com/news/articles/2017-06-08/after-shift-to-passive-investing-endowments-now-are-staying-put>.

³⁵ CHIEF INVESTMENT OFFICER, *Exclusive: CalPERS Fires Most of Its Equity Managers* (Dec. 4, 2019) <https://www.ai-cio.com/news/exclusive-calpers-fires-equity-managers/>. See also CALPERS, *California Public Employees' Retirement System Total Fund Investment Policy* (June 17, 2019) (“CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management.”).

³⁶ *Id.*

³⁷ PENSIONS & INVESTMENTS, *The Largest Money Managers*, 18, 25 (May 27, 2019), <https://www.pionline.com/assets/docs/CO119854528.PDF>.

respect to separately managed accounts and other investment vehicles outside of mutual funds and ETFs.

Managers of active funds may also pursue investment strategies that are similar to index tracking. Wurgler (2010) notes that, given the choice between a stock that is a member of the benchmark index and a stock that is not a member, an active manager will prefer the index member stock, as long as both stocks are expected to perform equally well.³⁸ Choosing the index member stock over the nonmember stock reduces the likelihood that the active portfolio will deviate from the benchmark index, thereby minimizing the probability of underperformance.

To account for such investment behavior by active funds, Cremers and Petajisto (2009) propose a measure called “active share” that quantifies the fraction of a fund’s holdings that differs from its benchmark index.³⁹ They find that funds with an active share of less than 50% grew from less than one percent of active equity mutual fund assets in the 1980s to nearly 35 percent of active equity mutual fund assets in 2003. In other words, as of 2003, nearly 35% of active equity mutual funds were primarily tracking an index.⁴⁰ However, Cremers (2016) finds that, by the end of 2015, the percentage of assets in active funds that are primarily tracking an index had declined from 35 to 12 percent of assets in active equity mutual funds.⁴¹ Gottesman and Morey (2017) find a similar decline, with active funds primarily tracking an index dropping from 30% in 2009 to 11% in 2014.⁴²

Similarly, some index funds may implement investment strategies that seek to mimic investment strategies that involve investment discretion. Smart-beta or factor index funds, for example, track indices that are constructed using alternative rules (such as weighting for value, volatility or dividend yield) that are meant to provide investors with patterns of returns differing from those of a capitalization-weighted market index. Though these funds track an underlying index, the underlying index in question is often built specifically by the very fund that tracks it.⁴³ In fact, more than 75 percent of published indices are tracked by only a single fund (albeit representing an average of only \$1.4 billion in assets under management per fund).⁴⁴ Accordingly, while these funds

³⁸ See Wurgler, *On the Economic Consequences of Index-Linked Investing*, supra note 1.

³⁹ K. J. Martijn Cremers and Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22(9) REVIEW OF FINANCIAL STUDIES 3329 (2009).

⁴⁰ See *id.*

⁴¹ Martijn Cremers, *Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity* (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860356 (based on a sample of active equity mutual funds that primarily invest in U.S. equity stocks).

⁴² Aron A. Gottesman and Matthew R. Morey, *Active Share and Emerging Market Equity Funds* (Feb. 27, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2761660.

⁴³ Adriana Robertson, *Passive in Name Only: Delegated Management and 'Index' Investing* (June 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244991.

⁴⁴ See Adriana Robertson, *Passive in Name Only: Delegated Management and 'Index' Investing* (June 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244991.

are index funds in the sense that they track indices constructed using mechanical rules, the construction of these indices involves varying degrees of discretion by the index providers, based on the stated objective of the particular index.⁴⁵ In turn, the fund manager ultimately has discretion in selecting which index to use and deciding how closely to track the index.

These examples illustrate the challenge in measuring the aggregate size of index investing in U.S. and global equity markets. Rather than simply summing the value of the shares held by index mutual funds and index ETFs, a more nuanced approach would recognize that investment strategies can be measured along different axes, including the degree of investment discretion involved, and that certain investors may execute index investing strategies without investing in a fund.

2. Effects of indexing on stock market efficiency

Efficient stock markets are important for economic growth, as they ensure that capital is allocated to the most promising companies so they can grow and innovate. The rise of index investing has sparked concern about its potential effects on stock market efficiency.

Under standard finance theory, an efficient stock price should incorporate only fundamental information, which includes both stock-specific information that is relevant to the future cash flows of the individual firm as well as market-wide information that is relevant to the overall risk faced by all firms (so-called systematic risk).⁴⁶ A stock's price is said to be perfectly efficient when it is *solely* determined by all available fundamental information.⁴⁷ Conversely, stock prices become less efficient when they incorporate non-fundamental information, such as the mere effects of index inclusion.⁴⁸

Active investors seek fundamental information, and their trading incorporates that information into public stock prices.⁴⁹ If stock prices deviate from their fundamental underlying value, active investors exploit the mispricings until prices realign.⁵⁰ Without such trading by active investors, mis-pricings would perpetuate. In this way, the presence of active investors promotes market efficiency.⁵¹ Index investors, by contrast, do not trade based upon stock-specific fundamental information. As index investing grows and replaces active investing, the concern arises that markets

⁴⁵ BLACKROCK, *Index Investing Supports Vibrant Capital Markets*, 6(2017), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf>.

⁴⁶ See Lawrence Summers, *Does the Stock Market Rationally Reflect Fundamental Values*, JOURNAL OF FINANCE (July 1986).

⁴⁷ See Joseph Stiglitz and Sanford Grossman, *On the Impossibility of Informationally Efficient Markets*, AMERICAN ECONOMIC REVIEW (June 1980), <http://www.dklevine.com/archive/refs41908.pdf>.

⁴⁸ See Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, THE JOURNAL OF FINANCE (1986).

⁴⁹ See Stiglitz and Grossman (1980), *supra* note 47.

⁵⁰ See *id.*

⁵¹ See *id.* Sushko and Turner (2018), *supra* note 5.

become less efficient.⁵² However, an important counter is that when assets move from active funds to index funds, the least skilled (i.e., worst-performing) active managers are likely to experience the largest withdrawals. In addition, it is active *trading* that promotes market efficiency, not merely active assets under management.⁵³ While the total assets under management of index funds have increased significantly, the share of trading by index funds versus active funds has been less so. For example, an analysis by S&P Dow Jones illustrates that even if index funds constituted more than 90% of assets under management, they would only account for less than 50% of trading.⁵⁴ Furthermore, the substantial trading of index-linked products, which often exceeds the trading volumes in the individual stocks,⁵⁵ itself contributes to market efficiency at a macro level, i.e. reflecting investors' views of the appropriate value of the market as a whole.⁵⁶

The potential price efficiency impact of index investing would manifest itself as an “index premium” associated with inclusion in an index and co-movement (or correlation) of stock prices within an index. We now evaluate empirical research related to the index premium and co-movement of stock prices. We then consider the effect of the rise of index ETFs on pricing efficiency.

a. Index premium

Numerous empirical studies have examined whether the inclusion of a stock in an index causes a price increase for the added stock (an “index premium”), with early studies finding significant evidence of such a premium, while more recent studies suggest it has disappeared.⁵⁷ The index premium is arguably indicative of inefficient pricing, since the price changes are not driven by fundamental information, either firm-specific or economy-wide.⁵⁸ Moreover, persistent index premiums are much more problematic for market efficiency than temporary price changes that are relatively short-lived surrounding the inclusion date.

⁵² See Wurgler, *On the Economic Consequences of Index-Linked Investing*, supra note 1, at 8; Martijn Cremers, Miguel Ferreira, Pedro Matos and Laura Starks, *Indexing and active fund management: International evidence*, 120(3) JOURNAL OF FINANCIAL ECONOMICS 539 (2016).

⁵³ See Craig Lazzara, *Too Much Indexing?*, INDEXOLOGY BLOG (Feb. 12, 2015), <https://www.indexology-blog.com/2015/02/12/too-much-indexing/>.

⁵⁴ Craig Lazzara, *Too Much Indexing?*, INDEXOLOGY BLOG (Feb. 12, 2015), <https://www.indexology-blog.com/2015/02/12/too-much-indexing/>.

⁵⁵ See Chris Bennett, Tim Edwards, Sherifa Issifu, and Craig J. Lazzara, *A Window on Index Liquidity: Volumes Linked to S&P DJI Indices*, S&P DOW JONES INDICES (Aug. 2019), <https://us.spindices.com/documents/research/research-a-window-on-index-liquidity.pdf>.

⁵⁶ See Craig Lazzara, *The Gift of a Benevolent Providence*, INDEXOLOGY BLOG (Oct. 15, 2019), <https://www.indexologyblog.com/2019/10/15/the-gift-of-a-benevolent-providence/>.

⁵⁷ Antti Petajisto, *The index premium and its hidden cost for index funds*, 18(2) JOURNAL OF EMPIRICAL FINANCE 271 (2011); Scott Hirst and Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 BOSTON UNIVERSITY LAW REVIEW 1229 (2019).

⁵⁸ See Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, THE JOURNAL OF FINANCE (1986).

A prominent example of the index premium occurred in July 2002 when seven foreign companies were removed from the S&P 500 and replaced with comparable U.S. companies.⁵⁹ On the day of the announcement the newly added stocks returned 5.9 percent more than the market, while excluded stocks returned 3.7 percent less than the market.⁶⁰ Over the next two weeks, the additions posted 12.3 percent in market-adjusted returns, while the excluded companies declined 6.6 percent relative to the market.⁶¹

The existence of a historical index premium has been supported by several empirical studies over the past three decades. Lynch and Mendenhall (1997) examined changes in the S&P 500 index from 1990 to 1995, finding that stocks added to the index received a 3.2% market-adjusted gain and stocks removed from the index suffered a 6.3% market-adjusted loss on the day the change was announced.⁶² Similarly, Elliot et al. (2006) examined changes to the S&P 500 index from 1993 to 2001, finding a market-adjusted announcement-day gain of 5.67% for stocks added to the index.⁶³ Finally, Petajisto (2011) examined changes to the S&P 500 index from 1990 to 2005, finding that newly added stocks received a 8.8% market-adjusted gain and removed stocks experienced a 15.1% loss over a 5-day period after inclusion.⁶⁴ However, each of these studies only measure price impacts immediately after index inclusion. They do not consider the more important question of whether the index premium persists over the long-term or whether the index premium has effects on capital allocation. Kasch and Sarkar (2012) study the issue of persistence and find that index inclusion does not have a permanent effect on price.⁶⁵

Kaptein (2016) analyze the price impact of index inclusion in the major large, mid and small cap stock indices of the Dutch stock market.⁶⁶ They find that: (i) for stocks included in the large cap index, the initial positive return from index inclusion fully reverses within 50 days; but (ii) for stocks included in the mid cap index, the initial positive abnormal returns persist

⁵⁹ Antti Petajisto, *Why Do Demand Curves for Stocks Slope Down?*, 44(5) JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 1013 (2009), <https://www.petajisto.net/papers/petajisto%202009%20jfq%20-%20demand%20curves.pdf>.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² Anthony Lynch & Richard Mendenhall, *New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index*, 70(3) THE JOURNAL OF BUSINESS 351 (July 1997), <http://people.stern.nyu.edu/alynch/pdfs/jb97lm.pdf>.

⁶³ William Elliot, Bonnie Van Ness, Mark Walker and Richard Warr, *What Drives the S&P 500 Inclusion Effect? An Analytical Survey*, 35(4) FINANCIAL MANAGEMENT 31 (Dec. 2006).

⁶⁴ Antti Petajisto, *The Index Premium and Its Hidden Cost for Index Funds*, J. OF EMPIRICAL FINANCE (March 2011).

⁶⁵ See Maria Kasch and Asani Sarkar, *Is There an S&P 500 Index Effect?*, NY FED STAFF REPORT (Nov. 2012).

⁶⁶ Robert Kaptein, *The effect of index inclusion*, ERASMUS UNIVERSITEIT ROTTERDAM, ERASMUS SCHOOL OF ECONOMICS (May 2016), <https://thesis.eur.nl/pub/33763/MA-Thesis-Robert-Kaptein.pdf>.

– suggesting that index inclusion makes previously less-known, less-liquid stocks more valuable by increasing the supply of public information about them.⁶⁷ For index exclusion, they find no significant price patterns, and suggest this may be attributable to short-sale constraints.⁶⁸

Massa et al. (2005) examined S&P 500 index changes from 1981 to 1997, finding that companies added to the index experienced a reduction in the cost of capital of 1.2% on average, as reflected in their stock price.⁶⁹ The study further finds that firms responded to the positive impact on their stock price and cost of capital by issuing new equity and investing in mergers and acquisitions.⁷⁰ However, these investments proved largely counterproductive, as firms that issued equity and increased investment after index inclusion tended to underperform both the overall market and other comparable firms.⁷¹ These findings suggest that the index premium can translate into suboptimal capital allocation.⁷²

However, more recent studies find that the index premium has decreased or even disappeared in recent years, suggesting that such suboptimal capital allocation may not be an issue. Petajisto (2011) finds that the index premium *declined* from 10.3% in 1990–2000 to 4.6% in 2001–2005.⁷³ Scari (2016) finds that the index premium declined starting in the late 1990s and disappeared entirely by 2010.⁷⁴ Schitzler (2016) and Patel and Welch (2017) also find that the index premium has effectively disappeared.⁷⁵ Therefore, while the presence of an index premium has been established historically to varying degrees, its continued existence has been challenged by recent empirical studies, most of which find a decline in or disappearance of the index premium over the time period that coincides with the greatest growth of index investing.

⁶⁷ Kaptein (2016), *supra* note 66, at 30.

⁶⁸ Kaptein (2016), *supra* note 66, at 30.

⁶⁹ Massimo Massa, Urs Peyer and Zhenxu Tong, *Limits of Arbitrage and Corporate Financial Policy*, CEPR DISCUSSION PAPER 4829 (2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=702981.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² Massa et al. (2005), *supra* 69.

⁷³ Antti Petajisto, *The Index Premium and Its Hidden Cost for Index Funds*, J. OF EMPIRICAL FINANCE (March 2011).

⁷⁴ Cameron Scari, *On the Changes to the Index Inclusion Effect with Increasing Passive Investment Management* (2016), https://repository.upenn.edu/cgi/viewcontent.cgi?article=1020&context=joseph_wharton_scholars.

⁷⁵ Jan Schitzler, *S&P 500 Inclusions and Stock Supply*, J. OF EMPIRICAL FIN. (2016), <http://janschnitzler.com/wp-content/uploads/2016/12/sp500.pdf>; Nimesh Patel & Ivo Welch, *Extended Stock Returns in Response to S&P 500 Index Changes*, Review of Asset Pricing Studies, 7(2) THE REVIEW OF ASSET PRICING STUDIES 172 (2017). See also Konstantina Kappou, *The diminished effect of index rebalances*, UNIVERSITY OF READING (2018), http://centaur.reading.ac.uk/76714/1/Diminished%20effect%20of%20index%20rebalances_kkappou.pdf.

b. Co-movement

Another potential issue of concern regarding index investing is that it can increase the co-movement of stock prices within an index. Co-movement can be caused by the trading patterns of index funds: when money flows into (out of) index funds, the index constituents are bought and sold in unison, causing the stock prices of the index components to move together.⁷⁶ It is important to note, however, that increased co-movement resulting from fund flows will only materialize while the funds are flowing into (out of) the index fund, reverting to normal co-movement after the fund flows stabilize. While co-movement of stock prices based on *market-wide* fundamental information is consistent with efficient prices, co-movement resulting from non-fundamental factors is not.⁷⁷ Co-movement may also exacerbate market shocks⁷⁸ and decrease the benefits of diversification, which relies on a relative lack of co-movement.⁷⁹

Barberis et al. (2005) examine changes to the S&P 500 index from 1976 to 2000, finding that after a stock is added to the S&P 500, the co-movement of its price with other S&P 500 stocks increases, while co-movement with non-index stocks decreases.⁸⁰ Specifically, a stock that is added to the S&P 500 index experiences an increase in beta (i.e. an approximate measure of correlation) with the S&P 500 of 0.357 and a decrease in beta with non-S&P 500 stocks of 0.373.⁸¹ Coles et al. (2017) find a similar effect with respect to the Russell 2000 index, finding an increase in correlation of 0.055 between the included stock and the Russell 2000 index.⁸² Finally, Da & Shive (2018) show that ETFs contribute to co-movement of index-component stocks, finding that a one-standard-deviation increase in ETF turnover (i.e. a change in the ETF's underlying portfolio, which is

⁷⁶ See Robert Pindyck and Julio Rotemberg, *The Co-movement of Stock Prices*, 108(4) THE QUARTERLY JOURNAL OF ECONOMICS 1073 (1993), <https://pdfs.semanticscholar.org/2607/0aadd1e6ec859b06ab4fd434bob22c726e9f.pdf>; Rodney Sullivan and James Xiong, *How Index Trading Increases Market Vulnerability*, 68(2) FINANCIAL ANALYSTS JOURNAL (2012).

⁷⁷ See Robert Pindyck and Julio Rotemberg, *The Co-movement of Stock Prices*, 108(4) THE QUARTERLY JOURNAL OF ECONOMICS 1073 (1993), <https://pdfs.semanticscholar.org/2607/0aadd1e6ec859b06ab4fd434bob22c726e9f.pdf>.

⁷⁸ See Kenechukwu Anadu, Mathias Kruttli, Patrick McCabe, Emilio Osambela, Chae Hee Shin, *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?*, FEDERAL RESERVE BANK OF BOSTON (Aug. 27, 2018), <https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/2018/rpai1804.pdf>.

⁷⁹ See Sushko & Turner (2018), *supra* note 5.

⁸⁰ Nicholas Barberis, Andrei Shleifer, Jeffrey Wurgler, *Comovement*, 75(2) JOURNAL OF FINANCIAL ECONOMICS 283 (2005) (specifically, a stock that is added to the S&P 500 index experiences an increase in beta with the S&P 500 of 0.357 and a decrease in beta with non-S&P 500 stocks of 0.373).

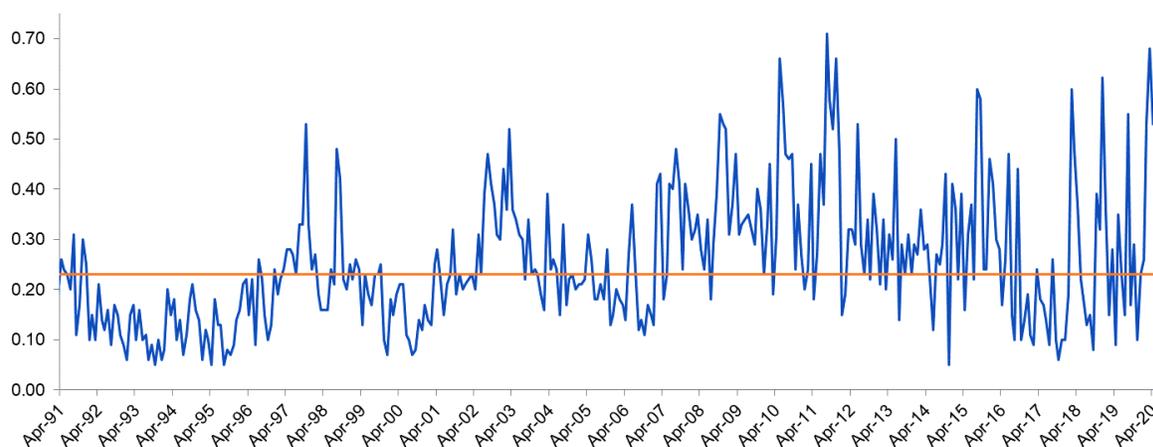
⁸¹ Barberis et al. (2005), *supra* note 80.

⁸² Jeffrey Coles, Davidson Heath, and Matthew Rigggenberg, *On Index Investing*, (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3055324.

driven by index changes) corresponds with “a 1% increase in the average correlation among its component stocks.”⁸³

However, the empirical evidence is mixed as to whether the co-movement effect has increased with the growth of index investing overall. Kamara, Lou, and Sadka (2008, 2010) show that average co-movement of large stocks increased between 1968 and 2008.⁸⁴ Similarly Bolla, Kohler, and Wittig (2017) examine co-movement in the U.S. and Europe, finding that co-movement generally increased from 2002 to 2014, consistent with the growth period of index investing.⁸⁵ However, when Chen, Singal, and Whitelaw (2016) examine index inclusion over differing time periods, they find that co-movement effects were smaller from 2001 to 2012 than in the previous decade, even though index investing had become much more widespread in the latter period.⁸⁶ Most importantly, S&P Global notes that correlations among S&P 500 stocks recently have been at the lowest levels since 1991.⁸⁷

Figure 33. S&P 500 correlation (1991-2020).



On the other hand, increased co-movement may not necessarily be indicative of pricing inefficiencies. Barberis (2005) posits that increased co-movement may actually be reflective of more efficient incorporation of systematic fundamental information into stock prices.⁸⁸ According to

⁸³ Zhi Da & Sophie Shive, *Exchange Traded Funds and Asset Return Correlations*, EUROPEAN FINANCIAL MANAGEMENT (Sept. 2017).

⁸⁴ A. Kamara, X. Lou, and R. Sadka, *The Divergence of Liquidity Commonality in the Cross-section of Stocks*, 89 JOURNAL OF FINANCIAL ECONOMICS, 444 (2008).

⁸⁵ Lidia Bolla, Alexander Kohler, and Hagen Wittig, *Index-linked investing-A curse for the stability of financial markets around the globe?*, 42 JOURNAL OF PORTFOLIO MANAGEMENT 26 (2017).

⁸⁶ Chen Honghua, Vijay Singal, Robert Whitelaw, *Co-movement revisited*, 121(3) JOURNAL OF FINANCIAL ECONOMICS 624 (Sept. 2016).

⁸⁷ S&P INDICES, *The Slings and Arrows of Passive Fortune*, 14 (last accessed May 13, 2020), <https://us.spindices.com/indexology/core/the-slings-and-arrows-of-passive-fortune>.

⁸⁸ Nicholas Barberis, Andrei Shleifer, Jeffrey Wurgler, *Comovement*, 75(2) JOURNAL OF FINANCIAL ECONOMICS 283 (2005)

Barberis (2015), systematic fundamental information can be incorporated more efficiently into the prices of index stocks, because stocks included in indices have higher liquidity and lower trading costs than non-index stocks.⁸⁹ These benefits may also be found in indices of smaller companies if index funds make their component stocks *relatively* more liquid, even if not as liquid as stocks in major indices. Similarly, Madhavan and Morillo (2018) examine volume changes in ETFs and their underlying securities, attributing cross-stock correlations to the macro environment rather than ETF growth.⁹⁰

Overall, the empirical evidence is mixed as to whether index inclusion leads to greater co-movement of index stocks. In addition, it may be that increased co-movement actually reflects an improvement in—rather than a deterioration of—price efficiency.

c. Price efficiency impact of ETFs

As a first order matter, it is worth considering the price efficiency of ETFs themselves. In other words, do ETFs reflect the value of their underlying constituents? The answer is yes. Typically, ETF prices are aligned with the price of their underlying securities, as arbitrageurs, including authorized participants, trade on any disparities, quickly aligning these prices. However, the imposition of single stock circuit breakers due to excessive volatility in specific stocks (or ETFs) can cause a delay in the alignment of equity ETF share prices with the price of underlying stocks.⁹¹ That is because when there is a trading halt in individual underlying securities (or ETF shares), authorized participants responsible for creating and redeeming ETF shares can no longer accurately price shares of the fund.⁹² In 2016, the three major U.S. exchanges—the New York Stock Exchange, NASDAQ and CBOE Global Markets—adopted uniform rules for reopening trading after circuit breakers for individual stocks are tripped, in order to avoid prolonged price dislocations and significant market swings.⁹³ As a result, although these circuit breakers have caused brief price dislocations, trading generally resumes normally after they are tripped without any significant negative effects on ETF investors.⁹⁴

⁸⁹ *Id.*

⁹⁰ Ananth Madhavan and Daniel Morillo, *The Impact of Flows into Exchange-Traded Funds: Volumes and Correlations*, 44(7) THE JOURNAL OF PORTFOLIO MANAGEMENT 96 (Summer 2018), <https://jpm.pm-research.com/content/44/7/96.abstract>.

⁹¹ See Lara Crigger, *How Trading Halts Impact ETFs*, ETF.COM (March 9, 2020), <https://www.etf.com/sections/features-and-news/how-trading-halts-impact-etfs>.

⁹² See *id.*; Dave Nadig, *Understanding ETF 'Flash Crashes'*, ETF.COM (Aug. 24, 2016), <https://www.etf.com/sections/blog/understanding-etf-flash-crashes>.

⁹³ See Drew Voros, *Exchanges Propose New Unified Trading Rules*, ETF.COM (Aug. 11, 2016), <https://www.etf.com/sections/features-and-news/exchanges-propose-new-unified-trading-rules>.

⁹⁴ See Lara Crigger, *How Trading Halts Impact ETFs*, ETF.COM (March 9, 2020), <https://www.etf.com/sections/features-and-news/how-trading-halts-impact-etfs>. In bond ETFs, however, price dislocations can persist

As to the impact of ETFs on the price efficiency of their underlying constituents, Israeli, Lee and Sridharan (2017) find that an increase in a stock's ownership by ETFs reduces the pricing efficiency of the stock,⁹⁵ arguing that ETFs –like other comingled investment vehicles such as mutual funds– remove the underlying shares of stock from the supply available to investors looking to trade on company-specific information.⁹⁶ In addition, demand for the underlying stock decreases since traders who would otherwise trade the underlying stocks instead trade the ETF (of course, in that case the traders were *not* looking to trade on company-specific information).⁹⁷ These supply and demand effects combine to lower liquidity in stocks owned by ETFs, thereby increasing transaction costs through higher bid-ask spreads – a 1% increase in ETF ownership leads to a 1.6% increase in average bid-ask spread over the next year.⁹⁸ In turn, the increase in the cost of trading reduces the profitability of acquiring and trading on new information, which in turn drives a reduction in information gathering in underlying stocks. As a result, the informational efficiency of the ETF's underlying stocks observed in the study decreased.⁹⁹

By contrast, Glosten et al. (2017) find that an increase in ETF ownership improves the price efficiency of underlying stocks.¹⁰⁰ Glosten et al. attribute the increase in price efficiency to improved incorporation of systematic fundamental information (information that relates to a broader market segment, rather than a specific company): since ETFs allow investors to trade a basket of stocks, ETF trading allows systematic information to be reflected more quickly in a broader cross-section of stock prices. Notably, this effect is concentrated in small-cap stocks.¹⁰¹ Small-cap stocks are less likely than large-cap stocks to be well-followed by analysts and sophisticated investors that cause new information to be quickly incorporated into stock prices. As a result, increased ETF trading is more likely to noticeably improve small cap stocks' information environment.¹⁰²

for much longer, as the underlying bonds are less liquid than stocks and authorized participants can have difficulty finding a buyer or seller. Dawn Lim, *Bond ETFs Flash Warning Signs of Growing Mismatch*, WALL STREET JOURNAL (March 23, 2020), <https://www.wsj.com/articles/bond-etfs-flash-warning-signs-of-growing-mismatch-11584964801>; Peter Chatwell, *The liquidity 'doom loop' in bond funds is a threat to the system*, FINANCIAL TIMES: MARKETS INSIGHT (March 25, 2020), <https://www.ft.com/content/b7c15426-6e1b-11ea-89df-41bea055720b>.

⁹⁵ Doron Israeli, Charles Lee & Suhas Sridharan, *Is There a Dark Side to Exchange Traded Funds? An Information Perspective*, REVIEW OF ACCOUNTING STUDIES (Sep. 2017).

⁹⁶ Israeli et al. (2017), *supra* note 95.

⁹⁷ Israeli et al. (2017), *supra* note 95.

⁹⁸ Israeli et al. (2017), *supra* note 95.

⁹⁹ Israeli et al. (2017), *supra* note 95.

¹⁰⁰ Lawrence Glosten, Suresh Nallareddy & Yuan Zou, *ETF Activity and Informational Efficiency of Underlying Securities* (April 27, 2017). See also Thomas Ernst, *Online Appendix to Stock-Specific Price Discovery From ETFs* (Feb. 8, 2020), http://www.mit.edu/~ternst/docs/online_appendix.pdf.

¹⁰¹ Glosten et al. (2017), *supra* note 100 (noting also the absence of a similar increase in informational efficiency for large-cap stocks and stocks that trade in competitive markets).

¹⁰² Glosten et al. (2017), *supra* note 100.

Overall, these contrasting studies demonstrate that the empirical evidence on the impact of ETFs on price efficiency is mixed.

3. Index investing and financial stability

The rise of index investing raises three distinct sources of potential financial instability: (1) contribution to stock market bubbles and crashes; (2) the increased concentration of asset management companies; and (3) the potential inability of index funds to meet redemption demands.

a. Potential contribution to stock market bubbles

To the extent that the rise of index investing boosts the price of index constituents, as discussed in the prior section, it is possible that their rising prices can lead to even more index investing, creating an “index bubble.”¹⁰³ An index bubble may arise due to the price increases associated with any index premium. However, as discussed in the previous section, the evidence shows that the index premium, and possible index bubble that would result, has either declined or disappeared entirely.¹⁰⁴

Some commentators have argued that index bubbles may also arise as a result of market-cap weightings as index funds are contributing to the over-valuation of the largest U.S. companies, since indices are typically weighted by market capitalization and fund inflows are primarily directed to the largest companies, regardless of performance.¹⁰⁵ Meanwhile, the decreasing number of dollars being invested on an active basis could weaken countervailing forces to push the valuations of the largest companies down based on fundamentals.¹⁰⁶ However, this line of criticism is fundamentally flawed, as index fund inflows do not increase the size of largest U.S. companies by

¹⁰³ See James Ledbetter, *Is Passive Investment Actively Hurting the Economy*, THE NEW YORKER (Mar. 9, 2016), <https://www.newyorker.com/business/currency/is-passive-investment-actively-hurting-the-economy>.

¹⁰⁴ See text accompanying notes 69–75.

¹⁰⁵ See generally Joe Rennison and John Authers, ‘Momentum’ investing bubble worries fanned by focus on market cap, FINANCIAL TIMES (Oct. 9, 2017), <https://www.ft.com/content/d16ba076-ac98-11e7-aab9-abaa44b1e130>; Heejin Kim and Myungshin Cho, *The Big Short’s Michael Burry Sees a Bubble in Passive Investing*, BLOOMBERG NEWS (Aug. 28, 2019), <https://www.bloomberg.com/news/articles/2019-08-28/the-big-short-s-michael-burry-sees-a-bubble-in-passive-investing?sref=2lCQoMoA>.

¹⁰⁶ See William A. Ackman, *Letter to Shareholders of Pershing Square Holdings Ltd.*, PERSHING SQUARE CAPITAL MANAGEMENT, LP (Jan. 26, 2016); Matt Levine, *Bill Ackman Runs an Anti-Index Fund*, BLOOMBERG OPINION (Jan. 27, 2016), <https://www.bloomberg.com/opinion/articles/2016-01-27/bill-ackman-runs-an-anti-index-fund>. On the other hand, some studies have found that an increase in index ownership of individual stocks makes it easier to bet against those stocks, and thus increases the efficiency of their prices, by increasing the supply of the stock available for short-selling. See Darius Palia and Stanislav Sokolinski, *Does Passive Ownership Help Relax Ownership Constraints?* (2019), https://sites.rutgers.edu/darius-palia/wp-content/uploads/sites/218/2019/07/Paper_July_2019.pdf; Melissa Porras Prado, Pedro A. Saffi, Jason Sturgess, *Ownership Structure, Limits to Arbitrage, and Stock Returns: Evidence from Equity Lending Markets*, 29(12) THE REVIEW OF FINANCIAL STUDIES, 3211 (Dec. 2016).

market capitalization relative to other index constituents. For example, assume an institutional investor is seeking to invest \$10 billion in the S&P 500 and Microsoft is the largest stock in the index at a 4% weighting, so \$400 million will go into MSFT. Microsoft is 4% of the S&P 500 prior to the investment, Microsoft is 4% of what the institutional investor buys, and Microsoft remains at 4% of the S&P500 after the investment. Whether the largest U.S. companies are over-valued relative to other index constituents is therefore not a function of index investment, rather it is determined by investment decisions made by active investors.

b. Concentration of asset managers

The growth of index investing has been associated with an increase in the concentration of the asset management industry, with the largest asset managers accounting for an increasing share of index fund assets. For example, since 2010 the three largest asset managers—Vanguard, BlackRock and State Street—have received 70 percent of cumulative index fund inflows¹⁰⁷ and, the share of all mutual fund and ETF assets at the five largest fund families increased from 35 to 51 percent over 2005 to 2018.¹⁰⁸

The increased concentration of funds and asset managers gives rise to the possibility that an idiosyncratic risk affecting a single asset manager could have spillover effects on the industry. However, there is no empirical evidence to support that idiosyncratic problems at an asset manager would have an effect on other managers and their funds; rather than resulting in redemptions from the fund industry as a whole, an event that affects one asset manager may just cause investors to shift their money from funds at one manager to another.¹⁰⁹

¹⁰⁷ Anadu et al. (2018), *supra* note 78; Kaptein (2016), *supra* note 66.

¹⁰⁸ Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, and John Sedunov, *The Granular Nature of Large Institutional Investors*, CEPR DISCUSSION PAPER (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2620271.

¹⁰⁹ In 2014, for example, the departure of Bill Gross from PIMCO triggered outflows of nearly €200 billion, which were largely shifted to other asset managers. See ALLIANZ, *Allianz – A Strong Community* (Feb. 26, 2015), https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/investor-relations/en/results/2014_fy/fy14_analyst_presentation.pdf; Kirsten Grind, *Rivals Outdo Gross in Race for Bond Cash*, WALL STREET JOURNAL (Nov. 10, 2014), <https://www.wsj.com/articles/bill-gross-new-janus-fund-took-in-364-million-in-his-first-month-1415636219>. See also FINANCIAL STABILITY OVERSIGHT COUNCIL, *Notice Seeking Comment on Asset Management Products and Activities*, 79 FED. REG. 77488, 77493 (2014), <https://www.federalregister.gov/documents/2014/12/24/2014-30255/notice-seeking-comment-on-asset-management-products-and-activities> (“[C]lients have routinely replaced asset managers without significant impact in non-stressed situations.”). See FINANCIAL STABILITY BOARD AND OICU-IOSCO, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Globally Systemically Important Financial Institutions*, 30 (2014), https://www.fsb.org/wp-content/uploads/r_140108.pdf (“[F]unds close (and are launched) on a regular basis with negligible or no market impact. In other words, the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable). A fund may close

Furthermore, although concentration in the registered fund industry has increased, it remains a competitive market. According to Anadu (2017), between 2005 and 2018, the Herfindahl-Hirschman Index (“HHI”)—a commonly-used measure of industry concentration—of registered funds (including mutual funds and ETFs) has increased from approximately 500 to more than 800.¹¹⁰ The increase has largely been driven by the growth of index funds, which tend to be more concentrated than active funds.¹¹¹ However, the concentration of registered funds is still relatively low—a market is not considered concentrated for antitrust purposes unless its HHI is above 1,500 and the HHI of registered funds is approximately half of that at 800.¹¹²

c. Liquidity and redemption risk

The redemption process for index funds can potentially lead to liquidity concerns in the underlying stocks. If index funds face unusually high redemption requests by investors in a period of market stress, for example, the selling of the underlying stocks may trigger destabilizing fire sales.¹¹³ Moreover, if the redemptions themselves are already the result of a negative shock to stock

for a variety of reasons, for example not attracting sufficient investor interest or performing poorly over a given period, leading investors to gradually withdraw their money.”).

¹¹⁰ Kenechukwu Anadu, Mathias Kruttli, Patrick McCabe, Emilio, Osambela, and Chae Hee Shin, *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?*, FEDERAL RESERVE BOARD: FINANCE AND ECONOMICS DISCUSSION SERIES 15-16 (2018), <https://www.federalreserve.gov/econres/feds/files/2018060pap.pdf>

¹¹¹ The average HHI for index funds over that period was about 2,800, compared to 450 for active funds. *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?*, *supra* note 110, at 109. HHI is calculated by squaring the market share of each company competing in the market and then summing the resulting numbers. For example, for a market consisting of four companies with shares of 30, 30, 20, and 20 percent, the HHI is 2,600 ($30^2 + 30^2 + 20^2 + 20^2 = 2,600$). For purposes of antitrust enforcement, the department of Justice and Federal Trade Commission generally consider markets in which the HHI is between 1,500 and 2,500 points to be moderately concentrated, and markets in which the HHI is in excess of 2,500 points to be highly concentrated. See U.S. DEPARTMENT OF JUSTICE & FED. TRADE COMM’N, *Horizontal Merger Guidelines* § 5.3 (2010), <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>.

¹¹² Jeff Tjornehoj, *Exploring Fund Industry Concentration: The Good, The Bad, and The Unknown*, BROADRIDGE 3-4 (2018), https://www.broadridge.com/_assets/pdf/broadridge-exploring-fund-industry-concentration.pdf.

¹¹³ See, e.g., Michael Feroli, Anil Kashyap, Kermit Schoenholtz, and Hyun Song Shin, *Market Tantrums and Monetary Policy*, CHICAGO BOOTH RESEARCH PAPER NO. 14-09 (2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2409092&rec=1&srcabs=2382839&alg=1&pos=10; Itay Goldstein, Hao Jiang, and David Ng, *Investor flows and fragility in corporate bond funds*, 126 JOURNAL OF FINANCIAL ECONOMICS 592 (2017), <http://finance.wharton.upenn.edu/~itayg/Files/bondfunds-published.pdf>; FINANCIAL STABILITY OVERSIGHT COUNCIL, *2016 Annual Report*, 9 (2016), <https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf>; Sergey Chernenko and Adi Sunderam, *Liquidity Transformation in Asset Management: Evidence from the Cash Holdings of Mutual Funds* (Jan. 2016); FINANCIAL STABILITY BOARD, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (Jan. 12, 2017), <https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>; Chris Giles and Owen Walker, *BoE governor Mark Carney calls for change to investment regulation*, THE FINANCIAL TIMES (June 26, 2019), <https://www.ft.com/content/e6d5bfo4-980b-11e9-8cfb-30c211dcd229>.

prices, redemptions by index funds could amplify stock market losses. However, such concerns have not materialized during the COVID-19-related market stress as of May 2020.¹¹⁴

Kamara, Lou, and Sadka (2008, 2010) and Bolla, Kohler, and Wittig (2017) find increases in correlated liquidity shocks among stocks in the U.S. equity market, which they attribute to the spread of index investing.¹¹⁵ Their findings suggest that the growth of index investing might make stocks more likely to become illiquid simultaneously, which would magnify the effect of a “run” on index funds.

On the other hand, Anadu et al. (2018) provide evidence that the sensitivity of investor inflows and outflows to performance for index funds is weaker than for active funds: while a one percent decrease in monthly net return is associated with a 2.5 percent outflow from active stock funds, the same decrease correlates with only a 0.7 percent outflow from index funds.¹¹⁶ Recent prominent liquidity crises at mutual funds (such as those at H2O, Woodford and GAM) have all occurred at active funds that held illiquid assets, including stock of private companies and illiquid debt securities, that are typically not held by index equity funds.¹¹⁷

Sushko and Turner (2018) analyze several recent stress episodes and compare the stability of fund flows across index mutual funds, index ETFs and active mutual funds.¹¹⁸ They find that index mutual fund flows were the least volatile; index ETFs exhibited the largest fund inflows and outflows relative to asset size (active mutual fund flows were the largest in absolute terms); and active mutual funds experienced the most persistent outflows.¹¹⁹ Their findings are consistent with evidence from Ben-David, Franzoni and Moussawi (2017) that ETFs attract short-term investors.¹²⁰ Their findings also suggest that while index mutual funds are a stabilizing influence in times of market stress, index ETFs (and their investors) tend to be more sensitive to market conditions.¹²¹

¹¹⁴ For example, in 2020 U.S. ETFs have seen year-to-date net inflows of \$115.8 billion, up from the net inflows of \$70.9 billion over the same time frame in 2018. See Sumit Roy, *First Weekly ETF Outflow Since March*, ETF.COM (May 8, 2020), <https://www.etf.com/sections/weekly-etf-flows/weekly-etf-flows-2020-05-07-2020-05-01>.

¹¹⁵ See A. Kamara, X. Lou, and R. Sadka, *The Divergence of Liquidity Commonality in the Cross-section of Stocks*, 89 JOURNAL OF FINANCIAL ECONOMICS, 444 (2008); Lidia Bolla, Alexander Kohler, and Hagen Wittig, *Index-linked investing-A curse for the stability of financial markets around the globe?*, 42 JOURNAL OF PORTFOLIO MANAGEMENT 26 (2017).

¹¹⁶ Anadu et al. (2018), *supra* note 78.

¹¹⁷ Anadu et al. (2018), *supra* note 78.

¹¹⁸ Sushko & Turner (2018), *supra* note 5.

¹¹⁹ Sushko & Turner (2018), *supra* note 5.

¹²⁰ Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, and John Sedunov, *The Granular Nature of Large Institutional Investors*, CEPR DISCUSSION PAPER (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2620271.

¹²¹ Ben-David et al. (2019), *supra* note 120.

4. Conclusion

The first section of this chapter measured the rise of index investing, finding that approximately 15% of U.S. equities were owned by index mutual funds and ETFs as of year-end 2019.¹²² We also considered the drivers of index fund growth and challenges in measuring the rise of index investing.

The second section of this chapter considered whether there is evidence that the rise of index investing has had an effect on price efficiency. We found evidence to support a temporary “index premium” after a company is included in an index. However, the magnitude of the index premium and its long-term effects have decreased in recent years and appear to be nonexistent today. We also found mixed evidence surrounding the link between index inclusion and an increase in the co-movement of stocks in an index.

In the third section of this chapter we considered the impact of index investing on financial stability. The evidence that index investing negatively impacts financial stability is weak. First, since the long-term effects of index inclusion are minimal, it appears unlikely that index inclusion could cause a stock market bubble. Second, although the rise of index investing has been concentrated at the largest asset managers, there is no evidence to suggest that the idiosyncratic failure of an asset manager would cause widespread problems across financial markets. Third, empirical studies generally find that investors in index funds do not engage in correlated selling during periods of market stress.

In conclusion, while the rise of index investing in recent years has been significant, the empirical evidence, while mixed, indicates that the rise of index investing has not had negative effects on price efficiency or financial stability. We recommend continued study of the effects of the rise of index investing in the years to come.

¹²² 2020 *Investment Company Fact Book*, supra note 11, at 40.

Chapter 4: An Analysis of Investment Stewardship: Mutual Funds and ETFs

Summary

Investment stewardship refers to shareholder engagement with public companies, including voting and other direct communications between investors and public companies. This chapter focuses on investment stewardship by investment advisers on behalf of mutual funds and ETFs with a focus on index funds. We begin by reviewing the existing regulatory requirements and the voluntary investment stewardship practices by certain investment advisers. We then review the empirical literature that relates to the effects of investment stewardship on firm performance and corporate governance. Finally, we review proposals to reform voting by index funds and conclude by setting forth reforms that would enhance the transparency of non-voting engagement by investment advisers.

This chapter is divided into five sections:

Section 1 provides a very brief introduction to mutual funds and exchange-traded funds (“ETFs”) and presents data showing their importance as shareholders of public companies. It also summarizes the regulatory framework governing mutual funds and ETFs (regulated as “investment companies” under the Investment Company Act of 1940 (the “**Company Act**”)) and the firms that manage these funds (regulated as “investment advisers” under the Investment Advisers Act of 1940 (“**Advisers Act**”)).

Section 2 describes the existing legal and regulatory requirements regarding investment adviser and investment company voting and engagement. Investment advisers have fiduciary duties of care and loyalty to clients, including the investment companies that they manage, that require investment advisers to exercise reasonable care to ensure that votes are cast in the best interest of their clients. In connection with these duties, investment advisers must develop voting policies, describe these policies to clients, and make voting policies and voting records available to clients. Investment companies are required to publicly disclose voting policies and voting records. We then compare U.S. requirements with rules in the European Union, Hong Kong and Japan.

Section 3 describes the voluntary investment stewardship practices of BlackRock, Vanguard and State Street, whose mutual funds and ETFs are the three largest holders of many U.S. public companies. With respect to voting, we find that these investment advisers voluntarily disclose highly detailed voting guidelines and consolidated voting statistics. With respect to non-voting engagement, including meetings with public companies, we find that these investment advisers disclose their engagement priorities and efforts undertaken to advance them. Such disclosures allow investors to evaluate whether investment advisers’ investment stewardship policies are consistent with investor priorities.

Section 4 reviews the empirical literature as it relates to investment stewardship by investment companies. First, we consider studies that evaluate the frequency with which investment companies oppose management proposals and support shareholder proposals. Second, we consider studies that evaluate whether holdings by investment companies are positively correlated with improved performance of public companies. Third, we review studies that assess whether holdings by investment companies are correlated with positive measures of corporate governance at public companies. In doing so, we also consider empirical studies that are focused exclusively on index funds as a subset of investment companies.

In **Section 5**, we evaluate proposals to reform voting by index funds. We begin by evaluating proposals that would require index funds to allow for “pass through voting,” whereby the millions of individual shareholders in index funds would provide instructions on how to vote. Second, we consider proposals that would require that index funds “poll” their shareholders to determine their voting decisions. Third, we evaluate proposals that would effectively eliminate index funds’ authority to vote their shares. We conclude by recommending enhanced transparency of non-voting engagement practices by investment advisers.

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1. Introduction to mutual funds, ETFs, and fund managers

a. Mutual funds and ETFs

Mutual funds are pooled investment vehicles wherein investors purchase redeemable shares in order to invest in the funds' underlying diversified portfolio of assets.¹ ETFs are similar to mutual funds and issue redeemable shares, but ETF shares trade on exchanges so investors obtain liquidity from secondary markets.² Fund managers sponsor these funds, sell shares in them to investors, contract to manage their investments for a fee under the supervision of each fund's board of directors, and have no ownership of the fund's underlying assets.³

At the direction of their fund managers, mutual funds and ETFs invest in the securities of public companies (their "**portfolio companies**"). Together, they collectively hold approximately 32% of U.S. public equity at year-end 2019.⁴ **Table 4.1** sets forth mutual fund and ETF ownership of the ten largest public companies by market capitalization as of December 31, 2019. Mutual funds and ETFs can therefore exert significant influence on portfolio companies through investment stewardship.⁵

¹ H. Anne Nicholson, *Securities Law: Proxies Pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 OKLA. L. REV. 687, 692-693 (2004).

² INVESTMENT COMPANY INSTITUTE, *ICI Research Perspective: Understanding Exchange-Traded Funds: How ETFs Work*, at 1 (Sept. 2014), https://am.jpmorgan.com/blob-gim/1383262775476/83456/1323398305717_ICI-RESEARCH-PERSPECTIVE.pdf; Bryan Chegwiddden, James Thomas and Sarah Davidoff, *Investment Funds in United States: Regulatory Overview*, PRACTICAL LAW COMPANY, 1 (2013).

³ INVESTMENT COMPANY INSTITUTE, *2019 Investment Company Fact Book*, 102 (59th Ed. 2019), https://www.ici.org/pdf/2019_factbook.pdf. See also H. Anne Nicholson, *Securities Law: Proxies Pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 OKLA. L. REV. 687, 694 (2004).

⁴ INVESTMENT COMPANY INSTITUTE, *2020 Investment Company Fact Book* at "Facts at a Glance" (60th Ed. 2020), https://www.ici.org/pdf/2020_factbook.pdf. See also *2019 Investment Company Fact Book*, supra note 3, at 10.

⁵ See, e.g., MORNINGSTAR, *Proxy Voting by 50 U.S. Fund Families: Growing support for ESG Resolutions, but the largest lag behind*, 13 (Feb. 6, 2020), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Proxy_Voting_020620_jc-KG-Final_.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=20694&mod=article_inline.

Table 4.I. Mutual fund and ETF ownership of the largest U.S. public companies (December 2019).

| Largest U.S. Public Companies ⁶ | Mutual Fund & ETF Ownership ⁷ |
|--|--|
| Apple Inc. | 28.80% |
| Microsoft Corp. | 42.14% |
| Alphabet Inc. | 39.58% |
| Amazon.com Inc. | 32.14% |
| Facebook Inc. | 45.93% |
| Berkshire Hathaway Inc | 32.56% |
| JPMorgan Chase & Co. | 39.20% |
| Visa Inc. | 50.19% |
| Johnson & Johnson | 33.89% |
| Wal-Mart Stores Inc | 14.77% |
| Bank of America Corp. | 34.82% |

b. Regulatory framework

The two key statutes that govern U.S. fund managers, mutual funds, and ETFs are the Investment Advisers Act of 1940 (the “**Advisers Act**”), and the Investment Company Act of 1940 (the “**Company Act**”).

i. Investment Advisers Act of 1940

Fund managers are regulated as “investment advisers” under the Advisers Act, which defines an “**investment adviser**” as “any person who, for compensation, engages in the business of advising others... as to the value of securities or as to the advisability of investing in... securities[.]”⁸ Because fund managers have mutual fund and ETF clients, they must register as investment advisers with the SEC.⁹

⁶ SIBLIS RESEARCH, *Historical Market Caps of Largest U.S. Companies* (last accessed April 15, 2020), <https://siblisresearch.com/data/market-caps-us-companies/>.

⁷ Mutual fund ownership data is sourced from company-specific data available at CNN Business, money.cnn.com.

⁸ 15 U.S.C. § 80b-2(a)(11). See generally U.S. SEC. & EXCH. COMM’N, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, 2 (March 2013), https://www.sec.gov/about/offices/oia/oia_invest-man/rplaze-042012.pdf.

⁹ Investment Advisers Act of 1940, as amended, Sections 203A(a)(1)(B); 203A(a)(2)(A).

Under the Advisers Act, investment advisers owe their clients a fiduciary duty that is “broad and applies to the entire adviser–client relationship.”¹⁰ The investment adviser’s fiduciary duty “means the adviser must, at all times, serve the best interest of its client and not subordinate its client’s interest to its own.”¹¹ The “obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty.”¹² In connection with their general fiduciary duty, investment advisers are also required to seek to obtain best execution for client transactions,¹³ adopt certain written compliance policies and procedures, and file specified periodic reports with the SEC.¹⁴

ii. Investment Company Act of 1940

Under the Company Act, an “**investment company**” is “any issuer which... is or holds itself out as being engaged primarily... in the business of investing, reinvesting, or trading in securities[.]”¹⁵ Mutual funds and ETFs that primarily invest in securities (including the equity of U.S. public companies) constitute “investment companies” under the Company Act.¹⁶ Under the Company Act, investment companies are generally required to file a registration statement with the SEC that discloses, among other things, the fund’s investment objectives and strategies, its fees and operating expenses, performance information and the fund’s investment adviser.¹⁷

¹⁰ U.S. SEC. & EXCH. COMM’N, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 FED. REG. 33669, 33670 (July 12, 2019), <https://www.federalregister.gov/documents/2019/07/12/2019-12208/commission-interpretation-regarding-standard-of-conduct-for-investment-advisers> [“**Standard of Conduct**”].

¹¹ *Standard of Conduct*, *supra* note 10, at 33671.

¹² *Standard of Conduct*, *supra* note 10, at 33671.

¹³ *Standard of Conduct*, *supra* note 10, at 33674 (“An investment adviser’s duty of care includes a duty to seek best execution of a client’s transactions where the adviser has the responsibility to select broker–dealers to execute client trades”).

¹⁴ See generally U.S. SEC. & EXCH. COMM’N, *Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients*, Investment Advisers Act Release No. 1406 (Mar. 16, 1994); U.S. SEC. & EXCH. COMM’N, *Securities; Brokerage and Research Services*, Exchange Act Release No. 23170 (Apr. 23, 1986); 15 U.S.C. § 80b–4.

¹⁵ 15 U.S.C. § 80a–3(a).

¹⁶ U.S. SEC. & EXCH. COMM’N, *Investment Companies* (July 9, 2013), <https://www.sec.gov/fast-answers/answersm-finvc.htm>; INVESTMENT COMPANY INSTITUTE, *ICI Research Perspective: Understanding Exchange-Traded Funds: How ETFs Work*, at 9 (September 2014), available at https://am.jpmorgan.com/blob-gim/1383262775476/83456/1323398305717_ICI-RESEARCH-PERSPECTIVE.pdf.

¹⁷ See 15 U.S.C. § 80a–8(b).

The Company Act also requires investment companies to have a board of directors elected by investors.¹⁸ The board of directors is responsible for overseeing an investment company’s compliance with certain legal requirements,¹⁹ and is subject to fiduciary duties of care and loyalty that arise under federal and state law.²⁰ The duty of care requires that directors act in good faith and in a manner they reasonably believe to be in the best interest of the investment company and its investors.²¹ The duty of loyalty requires directors to place the best interests of investors over their own interests and avoid self-dealing.²²

2. Regulation of investment stewardship: U.S. requirements and an international perspective

This section sets forth the U.S. requirements applicable to investment stewardship by investment advisers with respect to: (a) voting authority for portfolio company shares on behalf of their clients; (b) developing voting policies, managing conflicts of interest and the role of proxy advisors; (c) making votes and voting policies accessible to clients, including the additional public disclosure requirements applicable to investment companies; and (d) non-voting engagements with the management of portfolio companies. In addition, we compare U.S. regulations with rules in the European Union, Hong Kong, and Japan.

a. Investment adviser voting authority

According to the SEC, “in the context of voting, the specific obligations that flow from the investment adviser’s fiduciary duty depend upon the scope of voting authority assumed by the adviser.”²³ For mutual funds and ETFs, investment advisers’ voting authority is determined by the

¹⁸ See 15 U.S.C. § 80a-10(a). *But see* 15 U.S.C. § 80a-16(a)-(b).

¹⁹ The Company Act requires that a fund’s board, among other things: approve the fund’s contracts with its investment adviser and principal underwriter (15 U.S.C. § 80a-15(a), (b)); select the independent public accountant of the fund (15 U.S.C. § 80a-31(a)); and select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract (15 U.S.C. §§ 80a-16(b), 15(f)(1)(A)). In addition, rules promulgated under the Company Act require independent directors to: approve distribution fees paid under rule 12b-1 under the Act (17 CFR 270.12b-1); approve and oversee affiliated securities transactions (17 CFR 270.10f-3, 270.17a-7, 270.17a-8, and 270.17e-1); set the amount of the fund’s fidelity bond (17 CFR 270.17g-1); and determine if participation in joint insurance contracts is in the best interest of the fund (17 CFR 270.17d-1(d)(7)).

²⁰ 3A William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Corporations*, § 1032 (perm. ed., rev. vol. 2011). *See also* Robert A. Robertson, *Fund Governance: Legal Duties of Investment Company Directors* § 2.04 (2017).

²¹ Edward Brodsky & M. Patricia Adamski, *Law of Corporate Officers and Directors*, § 2:1 (2017).

²² Edward Brodsky & M. Patricia Adamski, *Law of Corporate Officers and Directors*, § 2:1 (2017).

²³ U.S. SEC. & EXCH. COMM’N, *Commission Guidance Regarding the Proxy Voting Responsibilities of Investment Advisers* 3, Investment Adviser Act Release No. 5325, Investment Company Act Release No. 33605 (Aug. 21, 2019), <https://www.sec.gov/rules/interp/2019/ia-5325.pdf> [“2019 Voting Guidance”].

advisory agreement governing their relationship.²⁴ Under this agreement, the fund board typically delegates voting authority to the investment adviser.²⁵

When an investment adviser assumes voting authority on behalf of clients, it must: (i) have a “reasonable understanding” of the client’s objectives; (ii) make voting determinations that are in the best interest of their client based on the client’s objectives;²⁶ and (iii) conduct an investigation “reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information.”²⁷ In connection with these requirements, investment advisers are generally expected to “monitor” portfolio company affairs in order to form a reasonable basis for voting decisions.²⁸

However, investment advisers that have assumed voting authority on behalf of their clients may refrain from voting if the investment adviser determines that “the cost of voting the proxy exceeds the expected benefit” to the client,²⁹ because refraining from voting in these circumstances would be in the best interest of the client.³⁰ For example, voting foreign securities may not be in the client’s best interest if the cost of translation, travel, and research are not worth the benefits of voting.³¹ In its August 2019 Guidance on the Proxy Voting Responsibilities of Investment Advisers (the “**2019 Voting Guidance**”), the SEC clarified that an investment adviser’s duty to vote shares can be determined by an agreement with the client taking into account specific parameters designed to serve the client’s best interest.³²

Although investment advisers currently tend to vote all or most of the proxies that they hold in clients’ shares,³³ SEC Commissioner Elad Roisman recently noted that voting may entail greater costs than initially acknowledged, including “opportunity costs... such as foregone income from shares on loan that have to be recalled to be voted or shares that are restricted from being lent out

²⁴ 2019 *Voting Guidance*, *supra* note 23, at 2 fn. 7.

²⁵ 2019 *Voting Guidance*, *supra* note 23, at 2 fn. 7.

²⁶ *Standard of Conduct*, *supra* note 10, at 33671.

²⁷ 2019 *Voting Guidance*, *supra* note 23, at 3-4.

²⁸ U.S. SEC. & EXCH. COMM’N, *Proxy Voting by Investment Advisers*, 68 FED. REG. 6585, 6586 (Feb. 7, 2003), <https://www.federalregister.gov/documents/2003/02/07/03-2952/proxy-voting-by-investment-advisers> [**“Proxy Voting by Investment Advisers”**].

²⁹ *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587.

³⁰ 2019 *Voting Guidance*, *supra* note 23, at 24.

³¹ *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587 (“For example, casting a vote on a foreign security may involve additional costs such as hiring a translator or traveling to the foreign country to vote the security in person.”).

³² 2019 *Voting Guidance*, *supra* note 23, at 10.

³³ SEC Commissioner Elad Roisman, *Keynote Remarks: ICI Mutual Funds and Investment Management Conference* (Mar. 18, 2019) <https://www.sec.gov/news/speech/speech-roisman-031819> (“For example, it appears to be the default position of many advisers that they vote every proxy, for every company, in every fund’s portfolio.”).

for this same reason.”³⁴ The 2019 Voting Guidance clarifies that clients can agree that investment advisers need not vote proxies in such instances.³⁵

b. Voting policies, conflicts of interest & proxy advisors

The SEC requires investment advisers to “adopt and implement written policies and procedures that are reasonably designed to ensure that [investment advisers] vote client securities in the best interest of clients,” including how to “address material conflicts that may arise between [investment advisers] interests and ... clients.”³⁶ The SEC does not prescribe specific content for these policies, rejecting a “one-size-fits-all” approach, instead “leav[ing] advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face.”³⁷

With respect to conflicts of interest, “an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest.”³⁸ In its 2003 release on proxy voting by investment advisers, the SEC provided that “an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party.”³⁹ Investment advisers often retain independent proxy advisors to act as an independent third party and inform the investment adviser’s voting decisions. According to Institutional Shareholder Services, the largest proxy advisor, “[p]roxy advice is the data, analysis and vote recommendations that investors use to help them fulfil their fiduciary responsibilities and corporate governance oversight of their public stock investments when they vote the shares they own at shareholder meetings.”⁴⁰

In 2014, an SEC staff bulletin confirmed that investment advisers have a duty to select and oversee proxy advisors diligently when relying on their advice to vote client shares.⁴¹ Even prior to this SEC guidance, most investment advisers reported conducting independent due diligence of proxy

³⁴ SEC Commissioner Elad Roisman, *Keynote Remarks: ICI Mutual Funds and Investment Management Conference* (Mar. 18, 2019) <https://www.sec.gov/news/speech/speech-roisman-031819> (“I imagine these costs could add up quickly, considering the differing matters of the many companies whose proxies fund advisers are often asked to vote.”).

³⁵ 2019 *Voting Guidance*, *supra* note 23, at 11.

³⁶ 17 C.F.R. 275-206(4)-6(a) (2003); *Proxy Voting by Investment Advisers*, *supra* note 28, at 6592.

³⁷ *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587.

³⁸ 2019 *Voting Guidance*, *supra* note 23, at 8.

³⁹ *Proxy Voting by Investment Advisers*, *supra* note 28, at 6588.

⁴⁰ Gary Retelny, Chief Executive Officer of Institutional Shareholder Services, *Why we are suing the SEC*, FINANCIAL TIMES (Nov. 5, 2019), <https://www.ft.com/content/cdcb6ed7-18f4-4729-8dc4-6a577ac44f15?share-type=nongift>.

⁴¹ SECURITIES AND EXCHANGE COMMISSION, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) <https://www.sec.gov/interps/legal/cfs1b20.htm>.

advisors to obtain reasonable assurances regarding conflicts of interest.⁴² Subsequently, in its 2019 Voting Guidance, the SEC elaborated on the ways in which investment advisers should monitor proxy advisors to ensure that shares are voted in the best interest of clients.⁴³ The 2019 Voting Guidance recommends that investment advisers, among other things: (i) periodically sample and examine sets of recommended votes to ensure they would, if cast, meet the investment advisers fiduciary duties; (ii) consider outside information other than the proxy advisor’s recommendation, including filings and supplemental input from issuers and shareholder proposal proponents; (iii) engage in greater in-house analysis on important or controversial proposals; and (iv) conduct a periodic review of their proxy advisors’ voting policies and practices.⁴⁴

c. Disclosure of voting policies and votes

The SEC requires investment advisers to: (i) describe their proxy voting policies to clients and provide copies on request; and (ii) disclose to clients how they may obtain information on how the investment adviser voted their proxies.⁴⁵ The SEC further requires that each registered investment company:⁴⁶ (i) “disclose in its registration statement... the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities;”⁴⁷ and (ii) “file with the [SEC] and... make available to its shareholders, either on its website or upon request, its record of how it voted proxies relating to portfolio securities” (the latter, its “**voting record**”).⁴⁸ The voting record must include, with respect to *each vote cast*: (i) the name, ticker and CUSIP of the portfolio company; (ii) the meeting date; (iii) the matter voted upon; (iv) whether the proposal originated with the company or a stockholder; (v) whether and how the fund voted; and (vi) whether the fund voted against management’s recommendation.⁴⁹ If an investment company casts votes in a manner inconsistent with its own policy, then it must explain the reason for the deviation.⁵⁰

⁴² GAO Report, *supra* note 32, at II.

⁴³ See generally 2019 Voting Guidance, *supra* note 23.

⁴⁴ 2019 Voting Guidance, *supra* note 23, at 15-18.

⁴⁵ 17 C.F.R. 275-206(4)-6 (2003). See also *Proxy Voting by Investment Advisers*, *supra* note 28, at 6588.

⁴⁶ U.S. SEC. & EXCH. COMM’N, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 67 FED. REG. 60827 (2003), <https://www.federalregister.gov/documents/2002/09/26/02-24409/disclosure-of-proxy-voting-policies-and-proxy-voting-records-by-registered-management-investment> [“**Investment Company Adopting Release**”].

⁴⁷ The policies are reported on Forms N-1A, N-2, N-3, and N-CSR.

⁴⁸ *Investment Company Adopting Release*, *supra* note 46.

⁴⁹ *Proxy Voting by Investment Advisers*, *supra* note 28, at 6585. See also Form N-PX, <https://www.sec.gov/about/forms/formn-px.pdf>.

⁵⁰ *Investment Company Adopting Release*, *supra* note 46, at 60832.

d. Non-voting engagement with portfolio company management

Non-voting types of engagement consist of direct oral or written dialogue between an investment adviser and portfolio company management regarding investor concerns.⁵¹ An investment adviser may use such engagement to better understand portfolio company governance, to develop an informed position on specific votes or issues, and to advocate certain governance priorities.

The Advisers Act, the Company Act, and the regulations promulgated thereunder do not explicitly require investment advisers to undertake or disclose non-voting engagement activity. However, an investment adviser’s legal obligations, particularly its fiduciary duty to clients, inform its non-voting engagement decisions, including whether and how to engage with portfolio company management. For example, in its voting-related guidance, the SEC states that “the duty of care requires an adviser with proxy voting authority to monitor corporate events”⁵² and to reasonably investigate facts underlying voting determinations.⁵³ In light of these statements, an investment adviser may determine that non-voting engagement with company management is appropriate to fulfill its duty of care.

Certain investment advisers have effectively agreed to voluntarily disclose their non-voting engagement policies, as recommended by the Investment Stewardship Group (“ISG”). The ISG is a non-profit group that includes BlackRock, Vanguard and State Street as members whereby large investment advisers and other institutional investors, such as pension funds, have agreed to six investment stewardship principles.⁵⁴ These principles are typically highly generalized and often

⁵¹ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf> (referring to “engagements conducted in-person or via conference calls and... letter-writing campaigns.”); VANGUARD, *Investment Stewardship 2019 Annual Report*, 5 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf. (“Engagement: We meet with portfolio company executives and directors to share our long-term orientation and principled approach and to learn about companies’ corporate governance practices.”); BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 3 (July 1, 2018 – June 30, 2019), <https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagement-statistics-annual-report-2019.pdf> (“The key to effective engagement is constructive and private communication. Engagement allows us to share our philosophy on and approach to investment and corporate governance with companies. Through dialogue, we make clear our expectations of companies in relation to their governance and business practices, including their management of relevant environmental and social factors.”).

⁵² *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587.

⁵³ *2019 Voting Guidance*, *supra* note 23, at 4.

⁵⁴ INVESTOR STEWARDSHIP GROUP, *Frequently Asked Questions* (last accessed Feb 7, 2020), <https://isgframework.org/faq/>. Members include, among others, BlackRock, Vanguard, State Street Global Advisors, T. Rowe Price, Wellington Management, BNY Mellon, JP Morgan, and Goldman Sachs. INVESTOR STEWARDSHIP GROUP, *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance* (last accessed Feb 7, 2020), <https://isgframework.org/>.

do not go beyond existing regulatory requirements for investment advisers. For example, Principle A states that “institutional investors are accountable to those whose money they invest” and Principle E states that “institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.”⁵⁵ However, as to non-voting engagement, the ISG recommends that member firms, including investment advisers, should periodically disclose their “general engagement activities undertaken to monitor corporate governance,”⁵⁶ and “disclose, in general, what further actions they may take in the event they are dissatisfied with the outcome of their engagement efforts.”⁵⁷ These principles thereby encourage investment advisers that are members of the ISG to disclose non-voting engagement activities and policies.

e. Select international approaches to investment stewardship

Other jurisdictions, including the European Union, Hong Kong, and Japan, have imposed certain voting and non-voting engagement obligations on firms that manage assets on behalf of clients, including pooled investment vehicles analogous to U.S. mutual funds and ETFs.

i. European Union

In the European Union (the “EU”), “investment firms” provide “portfolio management services to investors.”⁵⁸ As a general matter, an investment firm’s voting authority is determined by its agreement with the client.⁵⁹ Whenever investment firms act on behalf of their clients, they are subject to fiduciary duties of loyalty and prudence, and they must act in accordance with the best interest of their clients.⁶⁰

Investment firm voting and non-voting engagement is governed by the Shareholder Rights Directive II (“SRD II”).⁶¹ SRD II requires investment firms to develop a policy that “describes how they integrate shareholder engagement in their investment strategy,” including how they monitor portfolio companies, cast votes, conduct dialogue with management, cooperate with shareholders

⁵⁵ INVESTOR STEWARDSHIP GROUP, *Stewardship Principles* (last accessed May 11, 2020), <https://isgframework.org/stewardship-principles/>.

⁵⁶ INVESTOR STEWARDSHIP GROUP, *Stewardship Principles*, supra note 55, B.1-B.3.

⁵⁷ INVESTOR STEWARDSHIP GROUP, *Stewardship Principles*, supra note 55.

⁵⁸ See *SRD II*, supra note 61, at Article 1(1)(f).

⁵⁹ See generally *SRD II*, supra note 61, at Recital 9 and Article 3c.

⁶⁰ See generally Directive 2014/65 of the European Parliament and of the Council of 15 May 2014, Article 24(1), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>. See also EUROPEAN COMMISSION, *Interim Report: Financing a Sustainable European Economy* 22 (July 2017), https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf (“At the EU level, the duties of loyalty and prudence are partly codified in a number of directives, but standards differ greatly.”).

⁶¹ Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the Encouragement of Long-term Shareholder Engagement, Recital 15 (“SRD II”) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN>.

and stakeholders, and manage conflicts of interest.⁶² With respect to conflicts of interest, investment firms “should provide proper information... on whether... conflicts of interests have arisen in connection with engagement activities and how the [investment firm] has dealt with them.”⁶³ With respect to disclosure, SRD II also requires investment firms to publicly disclose: (i) their engagement policy;⁶⁴ and (ii) how that policy is implemented on an annual basis, including “a general description of voting behavior, an explanation of the most significant votes, and the use of... proxy advisors.”⁶⁵ These requirements allow investors to monitor “whether and how the manager acts in the best long-term interests of the investor and whether the [investment firm] pursues a strategy that provides for efficient shareholder engagement.”⁶⁶

ii. *Hong Kong*

In Hong Kong, the Securities and Futures Commission (“SFC”)⁶⁷ regulates firms that advise on the acquisition and disposition of securities⁶⁸ and firms that manage collective investment schemes (collectively referred to in this section as “investment firms”).⁶⁹ The *Code of Conduct for Persons Licensed by or Registered with the SFC*⁷⁰ and the *Fund Manager Code of Conduct*⁷¹ establish the regulatory requirements for such investment firms. As a general matter, investment firms must enter into written agreements with clients that “set out the precise terms and conditions under which discretion will be exercised,”⁷² including voting authority. In exercising voting authority,

⁶² See *SRD II*, *supra* note 61, at Article 3g(1)(a).

⁶³ See *SRD II*, *supra* note 61, at Recital 23.

⁶⁴ See *SRD II*, *supra* note 61, at Article 3g(1)(a).

⁶⁵ See *SRD II*, *supra* note 61, at Article 3g(1)(b).

⁶⁶ See *SRD II*, *supra* note 61, at Recital 20.

⁶⁷ See generally, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, *International Review of Equity Market Structure Regulation* (October 2019), <https://www.pifsiinternational.org/wp-content/uploads/2019/10/PIFS-International-Review-of-Equity-Market-Structure-Reg-for-website.pdf>

⁶⁸ See generally HONG KONG SECURITIES & FUTURES ORDINANCE, *Schedule 5: Regulated Activities* (2018) <https://www.elegislation.gov.hk/hk/cap571> (defining “advising on securities”).

⁶⁹ HONG KONG SEC. AND FUT. COMM’N, *Fund Manager Code of Conduct* (Nov. 2018) <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/fund-manager-code-of-conduct/fund-manager-code-of-conduct.pdf>.

⁷⁰ HONG KONG SEC. AND FUT. COMM’N, *Code of Conduct for Persons Licensed by or Registered with the SFC* (Mar. 2016) <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf>.

⁷¹ *Fund Manager Code of Conduct*, *supra* note 69.

⁷² See, e.g., *Fund Manager Code of Conduct*, *supra* note 69, at 31 (“A Discretionary Client Agreement should set out the precise terms and conditions under which discretion will be exercised and contain at least such information set out in the section ‘Minimum Content of Discretionary Client Agreement’ and be provided in a language understood by the client.”). See also HONG KONG SEC. AND FUT. COMM’N, *Code of Conduct for Persons Licensed*

an investment firm must act “honestly, fairly, and in the best interests of its clients and the integrity of the market.”⁷³

Neither code of conduct requires investment firms to develop voting policies, nor do they require the disclosure of voting policies and actual votes. However, in March 2016, the SFC promulgated non-binding and voluntary *Principles of Responsible Ownership* (the “Principles”)⁷⁴ that apply to investment firms that hold or manage investments on behalf of clients.⁷⁵ Investment firms are “encouraged to adopt the Principles,” and apply the Principles in their entirety.⁷⁶ With respect to voting authority, the Principles provide that adopting investment firms “should seek to vote all shares held” and, if they have not done so, “disclose the reasons to their stakeholders.”⁷⁷ Investment firms should also have clear policies on voting and managing conflicts of interests.⁷⁸ The Principles clarify that “ownership responsibilities extend beyond voting,” and include “monitoring and engaging on matters such as strategy, performance, risk, capital structure and corporate governance.”⁷⁹ With respect to disclosure of voting and non-voting engagement, the Principles provide that investment firms should: (i) report to their stakeholders their policies for discharging their ownership responsibilities; and (ii) at least annually, report to stakeholders on how they have discharged their ownership responsibilities.⁸⁰

iii. Japan

In Japan, the Financial Services Authority (the “FSA”) regulates “investment management businesses,” or “investment managers,” pursuant to the Financial Instruments and Exchange Act (the

by or Registered with the SFC 14 (Mar. 2016) <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf>.

⁷³ HONG KONG SEC. AND FUT. COMM’N, *Code of Conduct for Persons Licensed by or Registered with the SFC 14* (Mar. 2016) <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf>.

⁷⁴ HONG KONG SEC. AND FUT. COMM’N, *Principles of Responsible Ownership* (Mar. 7, 2016) <https://www.sfc.hk/web/EN/rules-and-standards/principles-of-responsible-ownership.html> [“SFC Principles”].

⁷⁵ Paul Westover and Karen Lau, *Corporate Governance and Directors’ Duties in Hong Kong: Overview*, THOMPSON REUTERS: PRACTICAL LAW (June 1, 2019) [https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&comp=pluk&bhcp=1](https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1).

⁷⁶ SFC Principles, *supra* note 74, at 1.

⁷⁷ SFC Principles, *supra* note 74, at 5.

⁷⁸ SFC Principles, *supra* note 74.

⁷⁹ SFC Principles, *supra* note 74, at 3.

⁸⁰ SFC Principles, *supra* note 74.

“FIEA”).⁸¹ Investment managers are firms that contract to invest and manage assets on behalf of clients, including through discretionary accounts, investment corporations, investment trusts, and collective investment schemes.⁸² The relationship between the investment manager and its client is set forth in the relevant agreement, which typically addresses voting authority.⁸³ Like other financial business operators, investment managers must “operate their businesses in an honest and fair manner for the best interest of their clients” and “appropriately manage conflicts of interest.”⁸⁴

The FIEA does not impose specific requirements with respect to voting, voting policies, and related disclosure. However, in 2017, the FSA promulgated the *Principles for Responsible Institutional Investors* (the “**Stewardship Code**”) in order to “enhance the medium- to long-term investment return” at Japanese companies.⁸⁵ The Stewardship Code was motivated by concern that “institutional investors” (including “asset managers” that “are entrusted to manage funds and invest in companies”⁸⁶) were not using voting or engagement to hold portfolio company management accountable for underperformance.⁸⁷ The Stewardship Code is voluntary,⁸⁸ but those that adopt it are expected to comply with it in full or explain any deviations.⁸⁹

⁸¹ FINANCIAL SERVICES AGENCY OF JAPAN, *Financial Instruments and Exchange Act*, Article 28(4) (Act No. 25 of 1948 up to the revisions of Act No. 99 of 2007, effective April 1, 2008), <https://www.fsa.go.jp/common/law/fieo1.pdf>.

⁸² FINANCIAL SERVICES AGENCY OF JAPAN, *FAQ on Financial Instruments and Exchange Act: Section 6 Financial Instruments Business Operator*, Q5 (last accessed Feb. 12, 2020), https://www.fsa.go.jp/en/laws_regulations/faq_on_fiea/section06.html#06-06.

⁸³ See generally, Kiyomi Kikuchi and Kazuyuki Wakasa of TMI Associates, *Fund Management*, LAW BUSINESS RESEARCH (July 2019), <https://gettingthedealthrough.com/area/76/jurisdiction/36/fund-management-japan/>.

⁸⁴ FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Customer-Oriented Business Operations* (Feb. 2017), <https://www.fsa.go.jp/news/28/sonota/20170119-1/01.pdf>. See also Christopher P. Wells and Tomoko Fuminaga, *Japan Releases Draft Principles for Consumer-Oriented Business Conduct*, MORGAN LEWIS (Feb. 2017), <https://www.morganlewis.com/pubs/japan-releases-draft-principles-for-customer-oriented-business-conduct>.

⁸⁵ PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS (May 29, 2017) Introduction, para. 4, available at <https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/02.pdf> [hereinafter, the “**Stewardship Code**”]; see also CORPORATE GOVERNANCE CODE (June 1, 2018), available at https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxxr-att/20180602_en.pdf. Updated in 2017 and 2018, respectively. See also HONG KONG SECURITIES & FUTURES COMMISSION, *Consultation Paper on the Principles of Responsible Ownership: Appendix B: Summary of the United Kingdom, Australia and Japan shareholder engagement models* (Mar. 2, 2015), <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=I5CP2>.

⁸⁶ Stewardship Code, *supra* note 85, at Background, para. 7.

⁸⁷ See generally Madison Marriage, *Foreign investors fear holding Japan Inc to account*, FINANCIAL TIMES (Jan. 9 2016), <https://www.ft.com/content/080fd530-a7fe-11e5-9700-2b669a5aeb83>; Attracta Mooney, *Japanese asset managers will reveal AGM votes*, FINANCIAL TIMES (June 4, 2017), <https://www.ft.com/content/478ad316-4782-11e7-8d27-59b4dd6296b8>.

⁸⁸ *Stewardship Code*, *supra* note 85, at Background, para. 7.

⁸⁹ *Stewardship Code*, *supra* note 85, at “Principles-Based Approach: and “Comply or Explain”, para. 7.

According to the Stewardship Code, with respect to voting, asset managers “should seek to vote on all shares held.”⁹⁰ In addition, asset managers should: (i) have a clear policy on how they fulfill their stewardship responsibilities generally; (ii) have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities; and (iii) develop a clear policy on voting “designed to contribute to sustainable growth of investee companies.”⁹¹ With respect to other non-voting engagement activities, the Stewardship Code states that asset managers should: (i) “monitor investee companies... with an orientation towards the sustainable growth of the companies;” (ii) “seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies;” and (iii) “have in-depth knowledge of the investee companies and their business environment.”⁹² With respect to disclosure, the Stewardship Code provides that asset managers should: (i) publicly disclose their stewardship, voting, and conflict-of-interest policies; and (ii) “report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.”⁹³ At a minimum, asset managers should disclose “aggregate voting records” broken down by proposal type and “voting records for each investee company on an individual agenda item basis.”⁹⁴

iv. Comparative Analysis

In each jurisdiction,⁹⁵ an investment adviser’s voting authority in respect of client assets is defined by an agreement between the adviser and its client (the investment fund). In exercising that authority, each jurisdiction also subjects the investment adviser to a fiduciary duty to act in the best interest of its client, which requires it to avoid conflicts of interest.⁹⁶

⁹⁰ *Stewardship Code*, *supra* note 85, at Art. 5, para. 1.

⁹¹ *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

⁹² *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

⁹³ *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

⁹⁴ *Stewardship Code*, *supra* note 85, at Art. 5, page 15.

⁹⁵ Each jurisdiction regulates firms that manage assets on behalf of clients, which include the foreign equivalents of U.S. investment advisers. Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 1(i)(f); HONG KONG SEC. AND FUT. COMM’N, *Fund Manager Code of Conduct* (Nov. 2018); HONG KONG SEC. AND FUT. COMM’N, *Code of Conduct for Persons Licensed by or Registered with the SFC* (Mar. 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Financial Instruments and Exchange Act*, Article 28(4) (Act No. 25 of 1948 up to the revisions of Act No. 99 of 2007, effective April 1, 2008); FINANCIAL SERVICES AGENCY OF JAPAN, *FAQ on Financial Instruments and Exchange Act: Section 6 Financial Instruments Business Operator*, Q5 (last accessed Feb. 12, 2020); 15 U.S.C. § 80b-2(a)(11).

⁹⁶ Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Recital 9 and Article 3c; HONG KONG SEC. AND FUT. COMM’N, *Code of Conduct for Persons Licensed by or Registered with the SFC 1* (Mar. 2016); FINANCIAL SERVICES AGENCY

In the US and EU, investment advisers are required by regulation to develop written policies that govern how they cast votes on behalf of clients and manage related conflicts of interest.⁹⁷ However, in Hong Kong and Japan, investment advisers are only subject to non-binding regulatory guidance that encourages voluntary adoption of voting policies.⁹⁸ As to non-voting engagements, the EU requires the adoption and disclosure of such policies, whereas the US does not.⁹⁹ The guidance in Hong Kong and Japan recommends the adoption of non-voting engagement policies.¹⁰⁰

Both the US and EU require the disclosure of voting policies, but the US requirements go further by requiring public disclosure of every vote cast.¹⁰¹ In Hong Kong, the guidance also states that investment advisers should disclose voting policies but does not recommend the disclosure of each vote cast.¹⁰² Japan's voluntary guidance goes further than Hong Kong by recommending that investment advisers disclose voting policies and each vote cast.¹⁰³

Therefore, investment advisers in all four jurisdictions are required to act in the best interests of their clients when voting their shares. However, only the EU and US apply binding regulations on the development and disclosure of voting policies and the US goes further than the EU in requiring the public disclosure of every vote cast. On the other hand, the EU requires the adoption and public disclosure of non-voting engagement policies, such as meetings between an investment adviser and portfolio company, whereas the US does not. In **Section 5**, we consider whether the SEC should mandate additional disclosure of non-voting engagement policies.

OF JAPAN, *Principles for Customer-Oriented Business Operations* (Feb. 2017); U.S. SEC. & EXCH. COMM'N, *Commission Guidance Regarding the Proxy Voting Responsibilities of Investment Advisers* 3, Investment Adviser Act Release No. 5325, Investment Company Act Release No. 33605 (Aug. 21, 2019).

⁹⁷ Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 3g(1)(a); 17 C.F.R. 275-206(4)-6(a).

⁹⁸ HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership* (Mar. 7, 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, page 8 (May 29, 2017).

⁹⁹ Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 3g(1)(a).

¹⁰⁰ HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership*, 30 (Mar. 7, 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, page 8 (May 29, 2017).

¹⁰¹ 17 C.F.R. 275-206(4)-6; U.S. SEC. & EXCH. COMM'N, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 67 FED. REG. 60827 (2003).

¹⁰² HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership* (Mar. 7, 2016).

¹⁰³ FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, pages 8 and 15 (May 29, 2017).

3. Investment stewardship practices of certain investment advisers

Section 3 describes the voluntary investment stewardship practices of BlackRock, Vanguard, and State Street Global Advisors,¹⁰⁴ as mutual funds and ETFs managed by these three firms are the three largest shareholders in many U.S. public companies.¹⁰⁵ **Section 3** refers to each firm as an “investment adviser.”¹⁰⁶

a. Voting

As described in **Section 2(c)**, under the Advisers Act, the Company Act, and the rules thereunder, investment advisers and investment companies have certain disclosure obligations with respect to voting policies and actual votes cast. As further described below, BlackRock, Vanguard and State Street have elected to exceed these requirements by voluntarily: (i) disclosing detailed proxy voting guidelines; and (ii) disclosing consolidated voting statistics, although their practices differ.

¹⁰⁴ PENSION & INVESTMENTS, *Money Managers* (Last accessed Feb.19, 2020), <https://researchcenter.pionline.com/v3/rankings/money-manager/datatable> (listing these firms as the three largest money managers by world-wide assets under management, both total and equity).

¹⁰⁵ See, e.g., Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo, *Hidden power of the Big Three?*, 19(2) BUSINESS AND POLITICS 298, 314 (2017), <https://pdfs.semanticscholar.org/eof4/1af67167d2c7911393eccc33f47do35cb59.pdf>; See also MORNINGSTAR, *Proxy Voting by 50 U.S. Fund Families: Growing support for ESG Resolutions, but the largest lag behind*, 11 (Feb. 6, 2020), [https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Proxy_Voting_020620_jc-KG-Final_.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=20694&mod=article_inline](https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Proxy_Voting_020620_jc-KG-Final_.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=20694&mod=article_inline;);

¹⁰⁶ Each firm’s public proxy voting guidelines apply when voting shares on behalf of clients, sponsored funds, or both. See, e.g., BLACKROCK, *Proxy voting guidelines for U.S. securities* 3 (January 2020) <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; VANGUARD FUNDS, *Proxy Voting Guidelines for U.S. Portfolio Companies* 2 (April 1, 2019) https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf; FIDELITY INVESTMENTS, *Proxy Voting Guidelines*, 1 (Jan. 2020) https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Full-Proxy-Voting-Guidelines-for-Fidelity-Funds-Advised-by-FMRCo-and-SelectCo.pdf; BNY MELLON, *Summaries of Selected Proxy Voting Guidelines – Proxy Contests* (last accessed Feb. 5, 2020), <https://im.bnymellon.com/us/en/individual/policies/proxy-voting-and-governance/summaries.jsp>; CAPITAL GROUP AMERICAN FUNDS, *Proxy Voting Guidelines* 1 (2020) https://americanfundsretirement.retire.americanfunds.com/content/dam/rpassets/pdf/proxy_voting_guidelines.pdf.

i. Detailed voting policies

As noted earlier, the SEC has not prescribed specific content or procedures for the disclosure of voting policies.¹⁰⁷ Nevertheless, BlackRock, Vanguard and State Street set forth detailed voting policies and engagement practices on their public websites.¹⁰⁸ These websites represent a resource that investors can use to understand the investment adviser’s general approach to voting and engagement.

BlackRock maintains “Proxy Voting Guidelines” setting out its general voting positions on governance matters, including board composition, governance structure and rules, shareholder rights, compensation, capital structure, M&A, anti-takeover devices, environmental and social issues, and corporate political activities.¹⁰⁹ Moreover, BlackRock, and Vanguard each specify enumerated factors to consider for contested director elections (State Street does not enumerate such factors). **Table 4.2** sets forth the specific self-reported factors considered by BlackRock and Vanguard when voting in a contested director election. Investors can use variations in approaches to contested director elections to help select an investment adviser with priorities that align with the investor.

¹⁰⁷ See, e.g., *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587 (“We did not propose, and are not adopting, specific policies or procedures for advisers. Nor are we, as some commenters requested, providing a list of approved procedures. Investment advisers registered with us are so varied that a ‘one-size-fits-all’ approach is unworkable. By not mandating specific policies and procedures, we leave advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face.”).

¹⁰⁸ See BLACKROCK, *Investment Stewardship* (2020) <https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us>; VANGUARD, *Investment Stewardship* (2020) <https://about.vanguard.com/investment-stewardship/>; STATE STREET GLOBAL ADVISERS, *Asset Stewardship* (2020) <https://www.ssga.com/us/en/individual/etfs/about-us/asset-stewardship>. See also FIDELITY INVESTMENTS, *Proxy Voting* (2020) https://www.fidelity.ca/fidca/en/proxy#ipl_guidelines; BNY MELLON, *Proxy Voting and Governance* (2020) <https://im.bnymellon.com/us/en/policies/proxy-voting-and-governance/all.jsp>; CAPITAL GROUP AMERICAN FUNDS, *Proxy voting and American Funds* (2020) <https://americanfundsretirement.retire.americanfunds.com/about/proxy-voting.html>.

¹⁰⁹ BLACKROCK, *Proxy voting guidelines for U.S. securities* (January 2020) <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf> [the “**BlackRock Voting Guidelines**”].

Table 4.2. Self-reported factors considered in contested director elections.

| | |
|---------------------------------------|---|
| <p>BlackRock¹¹⁰</p> | <p>For contested director elections, BlackRock considers:</p> <ul style="list-style-type: none"> • the qualifications of the dissident and management candidates; • the validity of the concerns identified by the dissident; • the viability of both the dissident’s and management’s plans; • the likelihood that the dissident’s solutions will produce the desired change; and • whether the dissident represents the best option for enhancing long-term shareholder value. |
| <p>Vanguard¹¹¹</p> | <p>For contested director elections, Vanguard considers:</p> <ul style="list-style-type: none"> • the case for change at the target company, including performance relative to peers, deficient oversight, and the dissident’s case to improve long-term strategy and returns; • the relative quality of the company and dissident’s board nominees, including independence, engagement, focus on long-term shareholder interests, and the extent to which the nominee slates meet the company’s current management needs; and • the general quality of company governance, including management’s prior engagement with the dissident, the adoption of shareholder friendly governance practices at the company, and management’s past efforts at shareholder engagement. |

¹¹⁰ BLACKROCK, *Proxy Voting Guidelines for U.S. Securities* 6 (Jan. 2020) <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>.

¹¹¹ VANGUARD FUNDS, *Proxy Voting Guidelines for U.S. Portfolio Companies* 5-6 (April 1, 2019) https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf.

ii. Annual consolidated voting statistics

In addition to the required itemized disclosure of each vote cast,¹¹² BlackRock,¹¹³ Vanguard,¹¹⁴ and State Street¹¹⁵ provide consolidated voting statistics reflecting all votes cast. A sample of self-reported consolidated voting statistics for these three investment advisers for the 12-month proxy season ended June 2019 is partially reproduced below in Tables 4.3–4.5. Based on this data, an investor can draw inferences about an investment adviser’s voting priorities.

Table 4.3. BlackRock: Self-reported votes against management, 2018–19 (% of total votes cast).¹¹⁶

| Management Proposals | Global | United States |
|---|--------|---------------|
| Anti-takeover and related proposals | 13% | 7% |
| Capitalization | 11% | 5% |
| Election of directors and related proposals | 8% | 8% |
| Non-salary compensation | 16% | 6% |
| Mergers, acquisitions and reorganizations | 11% | 1% |
| Routine business | 5% | 2% |
| Shareholder Proposals | | |
| Compensation | 9% | 3% |

¹¹² Firms take different approaches to meeting this requirement, from proxy vote search functions to fund-specific lists of votes. See, e.g., BLACKROCK, *Proxy Voting Search* (last accessed April 30, 2020), <http://vds.is-proxy.com/SearchPage.php?CustomerID=10228>; VANGUARD, *How our funds voted* (last accessed April 30, 2020), <https://about.vanguard.com/investment-stewardship/how-our-funds-voted/>.

¹¹³ BLACKROCK, *2019 Investment Stewardship Annual Report*: (Aug. 2019) <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf>; BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 6 (July 1, 2018 – June 30, 2019), <https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagement-statistics-annual-report-2019.pdf>.

In addition to voting statistics, BlackRock publishes “voting bulletins” that explain specific high-profile voting decisions. See generally BLACKROCK, *Investment Stewardship* (2020) <https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us>. In early 2020, BlackRock published twelve such bulletins. See generally BLACKROCK, *Investment Stewardship* (2020) <https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us>. See, e.g., BLACKROCK, *Voting Bulletin: The Boeing Company* (April 2020), <https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-boeing-apr-2020.pdf>.

¹¹⁴ VANGUARD, *Investment Stewardship 2019 Annual Report*, 28 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

¹¹⁵ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018–2019*, 9–10 (2019) <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>.

¹¹⁶ BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 6 (July 1, 2018 – June 30, 2019), <https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagement-statistics-annual-report-2019.pdf>.

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| | | |
|---|-----|-----|
| Corporate Governance | 10% | 48% |
| Election of directors and related proposals | 3% | 12% |
| Miscellaneous business | 5% | 6% |

Table 4.4. State Street: Self-reported votes with management, 2018-19 (% of total votes cast).¹¹⁷

| Management Proposals | Global |
|--|--------|
| Anti-takeover and related proposals | 19% |
| Capitalization | 77% |
| Election of directors and related proposals | 87% |
| Compensation | 77% |
| Reorganization- and merger-related proposals | 76% |
| Routine business | 94% |
| Shareholder Proposals | |
| Compensation | 61% |
| Corporate governance | 71% |
| Election of directors and related proposals | 96% |
| Environmental- and social-related proposals | 72% |
| Routine business | 85% |
| Other miscellaneous | 68% |

Table 4.5. Vanguard: Self-reported votes for proposals, 2018-19 (% of total votes cast).¹¹⁸

| Management Proposals | Global | United States |
|------------------------|--------|---------------|
| Elect directors | 91% | 93% |
| Approve auditors | 98% | 100% |
| Executive compensation | 91% | 94% |
| Governance-related | 87% | 94% |

¹¹⁷ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 9-10 (2019) <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>; STATE STREET GLOBAL ADVISORS, *Asset Stewardship 2018-2019* (Sept. 2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/asset-stewardship-highlights-2018-2019.pdf>.

¹¹⁸ VANGUARD, *Investment Stewardship 2019 Annual Report*, 28 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

| | | |
|------------------------------|-----|-----|
| Capitalization | 98% | 91% |
| Mergers and acquisitions | 97% | 98% |
| Shareholder Proposals | | |
| Board-related | 82% | 22% |
| Environmental/social | 6% | 7% |
| Compensation-related | 60% | 3% |
| Governance-related | 50% | 42% |

b. Disclosure of non-voting engagement activities and priorities

BlackRock, Vanguard, and State Street voluntarily release annual reports that review their past engagement activities and forward-looking engagement priorities.¹¹⁹

BlackRock releases: (i) an annual engagement report that reviews non-voting engagement efforts in a narrative style;¹²⁰ (ii) a global quarterly report on itemized engagements listing each company, the sector, the region, the topics covered by that engagement, and the last engagement date;¹²¹ and (iii) a regional quarterly report on engagement activities for the Americas,¹²² the Asia Pacific,¹²³ and Europe, the Middle East, and Africa.¹²⁴ According to BlackRock's 2019 Investment Stewardship Report, which covered the 12-month period ended June 2019, BlackRock conducted 2,050 engagements with 1,458 portfolio companies representing 50.4% of equity assets under management.¹²⁵ The Report describes BlackRock's engagement priorities, including governance, corporate strategy, capital allocation, compensation that promotes long-termism, environmental risks

¹¹⁹ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>;

VANGUARD, *Investment Stewardship 2019 Annual Report*, 5 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf

BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 3 (July 1, 2018 – June 30, 2019), <https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2019.pdf>.

¹²⁰ BLACKROCK, *2019 Investment Stewardship Annual Report* (Aug. 2019), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf>.

¹²¹ See, e.g., BLACKROCK, *Investment Stewardship Global Engagement Summary Report* (Q1 2020), <https://www.blackrock.com/corporate/literature/press-release/blk-engagement-summary-report-q1-2020.pdf>.

¹²² BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf>.

¹²³ BLACKROCK, *Q4 2019 Investment Stewardship Report: Asia -Pacific* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-apac.pdf>.

¹²⁴ BLACKROCK, *Q4 2019 Investment Stewardship Report: Europe, Middle East, and Africa* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-emea.pdf>.

¹²⁵ BLACKROCK, *2019 Investment Stewardship Annual Report*, 4 (Aug. 2019), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf>.

and opportunities, and human capital management.¹²⁶ In addition, BlackRock’s regional quarterly reports include statistics on (i) the total number of engagements and (ii) the percentage of engagements related to each engagement priority. For Q4 2019, this included 451 total engagements, of which 55% related to board composition and effectiveness, 49% corporate strategy, 42% compensation, 24% environmental impact, and 23% human capital management.¹²⁷ These quarterly reports also include narrative descriptions of specific engagements and their results.¹²⁸

Vanguard and State Street Global Advisors take broadly similar approaches.¹²⁹ Over the same period, Vanguard engaged 868 portfolio companies representing 59% of global assets under management.¹³⁰ According to State Street’s 2018–2019 Annual Stewardship Report, it engaged with 1,533 portfolio companies, including 686 in-person or teleconference engagements and 847 letter-writing campaigns, which together represented 70% of equity assets under management.¹³¹ Table 4.6 provides a brief overview of BlackRock, Vanguard and State Street’s recent self-reported engagement priorities. In each case, engagement priorities are described in more detail in the relevant disclosures.

Table 4.6. Self-reported engagement priorities by investment adviser.

| | |
|---------------------------------|--|
| BlackRock ¹³² | <p><u>Engagement Priorities:</u></p> <ul style="list-style-type: none"> • Governance • Corporate Strategy & Capital Allocation • Compensation that Promotes Long-termism • Environmental Risks & Opportunities • Human Capital Management |
| Vanguard ¹³³ | <p><u>Engagement Priorities:</u></p> <ul style="list-style-type: none"> • Board Composition • Oversight of Strategy and Risk • Executive Compensation |

¹²⁶ BLACKROCK, *2019 Investment Stewardship Annual Report*, 9 (Aug. 2019), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf>.

¹²⁷ BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas*, supra note 122.

¹²⁸ BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas*, supra note 122, at 4–8.

¹²⁹ Investment advisers tend to define engagement as any substantive dialogue with the officers or directors of a portfolio company, from letters to direct meetings and negotiations.

¹³⁰ VANGUARD, *2019 Investment Stewardship Annual Report*, 8 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

¹³¹ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018–2019*, 13 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>.

¹³² BLACKROCK, *2019 Investment Stewardship Annual Report* 9 (Aug. 2019), <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf>.

¹³³ VANGUARD, *Investment Stewardship 2019 Annual Report*, 4 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

| | |
|--|---|
| | <ul style="list-style-type: none"> • Governance Structures |
| State Street Global Advisors ¹³⁴ | <p><u>Core Campaigns:</u></p> <ul style="list-style-type: none"> • Fearless Girl Campaign for Board Gender Diversity • Climate Risk and Reporting <p><u>Sector Focuses for 2018-2019:</u></p> <ul style="list-style-type: none"> • Retail • Pharmaceuticals • Materials <p><u>Thematic Focuses for 2018-2019</u></p> <ul style="list-style-type: none"> • Compliance with Corporate Governance Principles in the US, UK, Australia, and Europe • Pay Strategies • Sustainability and Long-Term Strategy |

Alongside these general engagement priorities, some investment advisers publicize their position on specific engagement issues. For example, Vanguard released a stand-alone document setting forth its expectations with respect to board diversity at U.S. public companies.¹³⁵ State Street’s website includes “Guidelines and Attributes for Effective Independent Board Leadership”¹³⁶ and a “Climate Change Risk Oversight Framework for Directors.”¹³⁷ Likewise, BlackRock has published commentaries covering its position on differential voting rights,¹³⁸ voting rights and index

¹³⁴ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>

¹³⁵ VANGUARD, *Vanguard Investment Stewardship Perspectives: Board Diversity* (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp_board_diversity.pdf.

¹³⁶ STATE STREET GLOBAL ADVISORS, *Guidelines and Attributes for Effective Independent Board Leadership* (March 2019), <https://www.ssga.com/content/dam/ssmp/library-content/products/esg/guidelines-and-attributes-for-effective-independent-board-leadership.pdf>.

¹³⁷ STATE STREET GLOBAL ADVISORS, *Climate Change Risk Oversight Framework For Directors* (June 2019), <https://www.ssga.com/content/dam/ssmp/library-content/products/esg/climate-change-risk-oversight.pdf>

¹³⁸ BLACKROCK, *Key Considerations in the Debate on Differentiated Voting Rights* (last accessed Aug. 12, 2019) <https://www.blackrock.com/corporate/literature/whitepaper/blackrock-the-debate-on-differentiated-voting-rights.pdf>. Letter from BlackRock to the Securities and Exchange Board of India regarding Consultation Paper on the Issuance of Shares with Differential Voting Rights (April 19, 2019) <https://www.blackrock.com/corporate/literature/publication/securities-and-exchange-board-of-india-differential-voting-rights-response.pdf>.

inclusion,¹³⁹ general engagement with agribusiness companies on sustainable business practices,¹⁴⁰ and specific engagement with the palm oil industry on sustainability, among other issues.¹⁴¹ Additional engagement-related materials that BlackRock provides on its website range from comment letters to regulators in different jurisdictions,¹⁴² to an analysis of best practices when using proxy advisors,¹⁴³ to an overview of the intersection of carbon emissions and engagement.¹⁴⁴

The voluntary disclosure of engagement practices enables investors to evaluate whether an investment adviser’s engagement activities and priorities accord with their fiduciary duties as well as the investor’s own priorities. However, such disclosures are inconsistent across investment advisers and such inconsistencies may limit the value of these disclosures for comparing engagement practices across investment advisers. For example, self-reported engagement statistics can vary by investment adviser, including with respect to the types of engagement, their geographic breakdown, and the subject matter to which the engagement relates.

With respect to types of engagement, State Street *uniquely* distinguishes between “active” and “reactive” engagements as well as between “comprehensive” and other engagements.¹⁴⁵ With respect to the geographic breakdown of engagement statistics, Vanguard reports engagement in (1) the United States, (2) Americas ex-U.S., (3) Europe, Middle East & Africa, (4) Asia-Pacific, and (5) Australia & New Zealand; BlackRock reports in (1) the Americas, (2) Asia-Pacific, and (3) Europe, the Middle East, & Africa; and State Street reports in (1) North America, (2) Japan, (3) the U.K.,

¹³⁹ BLACKROCK, *A Potential Solution for Voting Rights and Index Inclusion Issues* (Oct. 2017), <https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf>.

¹⁴⁰ BLACKROCK, *Commentary: Investment Stewardship’s approach to engagement with agribusiness companies on sustainable business practices* (last accessed Feb. 6, 2020), <https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-sustainable-agriculture.pdf>.

¹⁴¹ BLACKROCK, *BlackRock Investment Stewardship’s approach to engagement with the palm oil industry* (May 2019), <https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-palm-oil.pdf>.

¹⁴² BLACKROCK, *Letter to the SEC re: SEC Staff Roundtable on the Proxy Process; File No. 4-725* (Nov. 16, 2018), <https://www.blackrock.com/corporate/literature/publication/sec-roundtable-proxy-process-111618.pdf>;

BLACKROCK, *Letter to Securities and Exchange Board of India re: Working group’s report on issues related to Proxy Advisers* (Aug. 16, 2019), <https://www.blackrock.com/corporate/literature/publication/consultation-to-securities-and-exchange-board-of-india-on-issues-related-to-proxy-advisors.pdf>.

¹⁴³ BLACKROCK, *Best practices when using an independent fiduciary in proxy voting* (March 2020), <https://www.blackrock.com/corporate/literature/publication/blk-best-practices-using-independent-fiduciary-proxy-voting.pdf>.

¹⁴⁴ BLACKROCK, *Emissions, Engagement, and Transition to a Low-Carbon Economy* (March 2020), <https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-emissions.pdf>.

¹⁴⁵ STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 26 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>.

(4) Europe ex-U.K., (5) Australia & New Zealand, and (6) the “Rest of the World”.¹⁴⁶ With respect to subject matter, BlackRock, State Street and Vanguard each have differing approaches for disclosing the subject matter discussed at engagements. For example, BlackRock reports the percentage of engagements related to environmental impact whereas Vanguard does not.¹⁴⁷ We further address the issue of standardization for disclosure of non-voting engagement practices in **Section 5**.

4. Empirical analysis of investment stewardship practices by investment companies

In **Section 4**, we review three bodies of empirical literature that relate to investment stewardship activities by investment companies.

First, we consider studies that evaluate voting by investment companies as compared to other investors. In doing so, we consider the literature regarding voting by index funds. We generally find that investment companies, are willing to challenge management and support shareholders’ proposals thereby demonstrating that they are exercising considered independent judgment when voting.

Second, we review studies that measure the relationship between *holdings* by investment companies and firm performance, such as return on assets. In doing so, we also consider studies that focus on index fund holdings and firm performance. The studies we review generally find that firms that have a high share of holdings by investment companies outperform other firms. These studies

¹⁴⁶ VANGUARD, *Investment Stewardship 2019 Annual Report*, 8 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf>; BLACKROCK, *Q4 2019 Investment Stewardship Report: Asia Pacific* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-apac.pdf>; BLACKROCK, *Q4 2019 Investment Stewardship Report: EMEA* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-emea.pdf>; STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf>.

¹⁴⁷ Vanguard reports the primary topic of each engagements as either board composition, oversight of strategy and risk, executive compensation, and governance structures; BlackRock reports the percentage of engagements (non-exclusively) related to board composition and effectiveness, corporate strategy, compensation, environmental impact, and human capital management; State Street relates engagement to each of its core, sector, and thematic focuses. VANGUARD, *Investment Stewardship 2019 Annual Report*, 36 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas II* (Jan. 2020), <https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf>.

often link such outperformance to effective “monitoring” of firms by investment companies. Investment stewardship is a means by which investment companies monitor firms through voting and non-voting engagements with firms.

Third, we review studies that link holdings by investment companies with corporate governance quality at firms, such as performance-sensitive executive compensation and board independence. In doing so, we also consider empirical research as to the link between holdings by index funds and corporate governance quality. The studies we review generally find that firms that have high shares of holdings by investment companies have improved measures of corporate governance quality. However, the evidence regarding index fund holdings and corporate governance quality at firms is mixed.

a. Voting by investment companies

Cotter, Palmiter and Thomas (2010) find that investment company support for management proposals is lower than shareholders overall and investment company support for shareholder proposals is higher than shareholders overall.¹⁴⁸ Morgan, Poulsen, Wolf and Yang (2010) find that investment companies are more likely than other investors to support shareholder proposals that would enhance corporate governance at portfolio companies, such as board declassification and majority voting for directors.¹⁴⁹ Morgan et. al. note that investment companies “appear better able to discern and more willing to vote for higher quality (i.e., potentially wealth increasing) proposals than other investors types....” and investment company “voting has a significant impact on the success of shareholder proposals; higher support by funds leads to a greater likelihood of passage of a proposal and a greater likelihood of subsequent implementation by management.”¹⁵⁰

Index funds also appear willing to challenge management. For example, Rothberg and Lilien (2006) find that index funds were less supportive of management recommendations than active funds, noting that index funds voted with management 81% of the time versus 95% for active funds.¹⁵¹ Appel et al. (2016) also find that index funds are less supportive than active funds of management and more supportive than active funds of shareholder proposals.¹⁵² More recently,

¹⁴⁸ James Cotter, Alan Palmiter, Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 30 (2010), <https://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1032&context=vlr>.

¹⁴⁹ Angela Morgan, Annette Poulsen, Jack Wolf, Tina Yang, *Mutual funds as monitors: Evidence from mutual fund voting* (March 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572049.

¹⁵⁰ *Id.* at 2-3.

¹⁵¹ Burton Rothberg and Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1(1) UNIVERSITY OF MARYLAND JOURNAL OF BUSINESS & TECHNOLOGY LAW (2006), <https://digitalcommons.law.umaryland.edu/jbtl/vol1/iss1/13/>.

¹⁵² Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), <https://www.nber.org/papers/w22707.pdf>.

Fichter, Heemskerk and Garcia-Bernardo (2017) report that BlackRock, Vanguard, and State Street tend to oppose management at a similar rate to active funds.¹⁵³

However, for certain proposals, index funds may be more deferential to management than active funds. Heath et al. (2019) find that for contentious proposals—defined as those where management and proxy advisor recommendations conflict—index funds are more likely than active funds to vote with management.¹⁵⁴ And Brav et al. (2019) find that index funds are significantly less likely than active funds to vote with activist shareholders that oppose management.¹⁵⁵ Bebchuk and Hirst (2019) find that index funds exhibit voting behavior aligned with management on say-on-pay proposals, siding with management more often than active funds.¹⁵⁶

b. Investment company holdings and firm performance

An extensive body of literature finds that holdings by investment companies are associated with positive measures of firm performance. These studies often link improvements in firm performance to effective “monitoring” of firms by investment companies. As noted earlier, investment stewardship is a means by which investment companies monitor firms through voting and non-voting engagements with firms.

Elyasiani and Jia (2010) find a positive association between a firm’s return on assets and the share of holdings by investment companies.¹⁵⁷ Based on these findings, the authors conclude that investment companies *monitor* portfolio companies more frequently and more effectively than other investors.¹⁵⁸ Cornett et al. (2007) also find a positive correlation between a firm’s operating cash flow and investment company holdings.¹⁵⁹ And Chen, Harford and Li (2007) find a positive association between holdings by independent long-term institutions, which includes investment

¹⁵³ 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, *Business & Politics* (April 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2798653.

¹⁵⁴ Davidson Heath, Daniele Macciocchi, Roni Michaely and Matthew Ringgenberg, *Do Index Funds Monitor?*, SWISS FINANCE INSTITUTE, 4 (July 6, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3259433&download=yes.

¹⁵⁵ Alon Brav, Matthew Cain, and Jonathon Zytneck, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, ECGI Working Paper No. 637 (Nov. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3387659.

¹⁵⁶ Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy* 119(8) COLUMBIA LAW REVIEW 2029, 2039 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

¹⁵⁷ Elyas Elyasiani and Jingyi Jia, *Distribution of institutional ownership and corporate firm performance*, 34 JOURNAL OF BANKING & FINANCE 606 (2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2451145.

¹⁵⁸ *Id.* at 615.

¹⁵⁹ Marcia Millon Cornett, Alan J. Marcus, Anthony Saunders, and Hassan Tehranian, *The impact of institutional ownership on corporate operating performance*, 31 JOURNAL OF BANKING & FINANCE 1771 (2007), https://www2.bc.edu/alan-marcus/papers/JBF_2007.pdf.

companies, and successful mergers and acquisitions, measured by the likelihood of deal completion and a firms' post-merger financial performance.¹⁶⁰ Chen et. al conclude that investment companies are effectively monitoring M&A activity and intervening through voting or non-voting engagements to reverse misguided acquisitions by these firms.¹⁶¹ Aghion, Van Reenen and Zingales (2013) also find a positive association between institutional holdings, including investment companies, and firm spending on R&D, and the productivity of R&D spending.¹⁶²

With respect to index funds, Appel et al. (2016) also find a positive correlation between index fund holdings and firm performance, as measured by a company's return on assets.¹⁶³ On the other hand, Qin and Wang (2018) find that increased index fund holdings correlate with lower company value (measured by Tobin's Q, which compares a company's market value to its book value).¹⁶⁴ And Schmidt and Fahlenbrach (2017) find that as the proportion of index fund holdings increase, management becomes more entrenched and more likely to engage in "empire building" through value destroying M&A activity.¹⁶⁵

c. Investment company holdings and corporate governance

Other empirical studies consider the relationship between investment company holdings and corporate governance quality at portfolio companies. Almazan, Hartzell and Starks (2005), for example, consider the relationship between institutional holdings, including investment companies, on portfolio companies' executive compensation practices.¹⁶⁶ They find that higher holdings by institutional investors are associated with lower total executive compensation at portfolio companies and more performance-sensitive compensation at portfolio companies.¹⁶⁷ The authors conclude "the results imply that investment companies and independent investment advisers play a more

¹⁶⁰ Xia Chen, Jarrad Harford, Kai Li, *Monitoring: Which institutions matter?*, JOURNAL OF FINANCIAL ECONOMICS (2007), https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=1819&context=soa_research.

¹⁶¹ *Id.* at 30.

¹⁶² Philippe Aghion, John Van Reenen, and Luigi Zingales, *Innovation and Institutional Ownership*, 103(1) AMERICAN ECONOMIC REVIEW 277, 278 (2013), <http://mitsloan.mit.edu/shared/ods/documents/?DocumentID=2566>.

¹⁶³ Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), <https://www.nber.org/papers/w22707.pdf>.

¹⁶⁴ Nan Qin and Di Wang, *Are Passive Investors a Challenge to Corporate Governance?*, 5 (March 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3148309.

¹⁶⁵ Cornelius Schmidt and Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?*, JOURNAL OF FINANCIAL ECONOMICS (June 2016), <https://corpgov.law.harvard.edu/2017/05/20/do-exogenous-changes-in-passive-institutional-ownership-affect-corporate-governance-and-firm-value/>

¹⁶⁶ Andres Almazan, Jay C. Hartzell, Laura T. Starks, *Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive Compensation* (2008), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.556.1603&rep=rep1&type=pdf>.

¹⁶⁷ *Id.* at 31.

active monitoring role than do other types of institutions.”¹⁶⁸ Hartzell and Starks (2002) also find that holdings by institutional investors, including investment companies, are negatively related to total executive compensation and positively related to the performance-sensitivity of that compensation.¹⁶⁹ The authors conclude that “institutional investors [including investment companies] influence executive compensation”¹⁷⁰ and “serve as a complementary monitoring device to incentive compensation”.¹⁷¹

With respect to index funds, Appel et al. (2016) find that increased index holdings are associated with greater board independence and reduced takeover defenses.¹⁷² However, focusing on other measures of corporate governance quality, Qin and Wang (2018) report that an increase in index fund holdings is associated with reductions in the sensitivity of manager pay to company performance and reduced probability of “performance-based disciplinary turnover” of senior management.¹⁷³

5. Evaluating proposals to reform investment stewardship by index funds

In **Section 5**, we evaluate proposals to reform voting by index funds. We begin by evaluating proposals that would require index funds to allow for “pass through voting,” whereby the millions of individual shareholders in index funds would instruct index funds on how to vote. Second, we consider proposals that would require that index funds “poll” their shareholders to determine their voting decisions. Third, we consider proposals that would effectively eliminate index funds’ authority to vote their shares. We conclude by evaluating proposals that would enhance the transparency of non-voting engagement practices by index funds.

In general, the proposals to reform voting by index funds are intended to address concerns that index funds lack an incentive to make informed voting decisions. According to Bebchuk, Cohen and Hirst (2017), index funds lack such an incentive, because making informed voting decisions is costly and the associated benefits of improved corporate governance or performance at public companies is widely dispersed.¹⁷⁴ Indeed, index funds primarily attract investors by minimizing

¹⁶⁸ *Id.* at 31.

¹⁶⁹ Jay Hartzell and Laura Starks, *Institutional Investors and Executive Compensation* (2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=236592.

¹⁷⁰ *Id.* at 20.

¹⁷¹ *Id.* at 14.

¹⁷² Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), <https://www.nber.org/papers/w22707.pdf>.

¹⁷³ Nan Qin and Di Wang, *Are Passive Investors a Challenge to Corporate Governance?* (March 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3148309.

¹⁷⁴ Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31(3) JOURNAL OF ECONOMIC PERSPECTIVES 89, 96 (2017), <https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.31.3.89>.

costs and tracking the appropriate index, neither of which incentivize index funds to invest in improving the governance of specific portfolio firms.¹⁷⁵ Bebchuk, Cohen and Hirst (2017) therefore argue that index funds may not be voting in the best interest of their shareholders, and corporate governance outcomes and performance at public companies may be negatively affected.¹⁷⁶ However, a counterargument is made by Fisch, Hamdani and Solomon (2019), noting that index fund managers are indeed motivated to improve the performance of their portfolio companies since fund investors can withdraw their money at any time (even if the fund itself is locked into specific investments), which could be likely if an index were to exhibit poor performance.¹⁷⁷

a. Pass-through voting

Griffin (2019) has proposed a “pass-through voting approach,” whereby investors would have the right to provide instructions to their index fund on how to vote shares in each portfolio company.¹⁷⁸ Griffin contends that pass through voting would better align index fund voting with investor preferences.¹⁷⁹ However, as noted by Bebchuk and Hirst (2019), investors would likely provide such voting instructions on an uninformed basis, as they lack the incentive to acquire relevant information necessary to make informed voting decisions.¹⁸⁰ Furthermore, as noted by Hirst (2016), the administrative costs from collecting voting instructions from shareholders would be costly and difficult to manage.¹⁸¹ Moreover, pass-through voting would likely lead to the effective disenfranchisement of index fund investors, since most fund shareholders would fail to respond to the proxies.

In fact, investment companies already encounter administrative challenges when soliciting votes for their own shareholder meetings. For example, in November 2018, the Investment Company Institute surveyed 52 members representing 71% of U.S. registered fund assets under management.¹⁸² When asked about their two most recent fund proxy campaigns, respondents reported that: (i) 37% were forced to adjourn at least one shareholder meeting for lack of quorum; (ii) 37%

¹⁷⁵ Bebchuk, Cohen, and Hirst, *supra* note 174, at 97–98.

¹⁷⁶ Bebchuk, Cohen, and Hirst, *supra* note 174, at 100–101.

¹⁷⁷ See Jill Fisch, Assaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, Univ. of Penn. L. Rev. 1983 (2019).

¹⁷⁸ Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, MARYLAND LAW REVIEW, 33–35 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365222.

¹⁷⁹ Griffin, *supra* note 178, at 35.

¹⁸⁰ Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119(8) COLUMBIA LAW REVIEW 2029, 2118–2119 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

¹⁸¹ Scott Hirst, *Social Responsibility Resolutions*, HARVARD LAW SCHOOL PROGRAM ON CORPORATE GOVERNANCE, 26 (Aug. 2016), <https://pcg.law.harvard.edu/wp-content/uploads/2015/11/Scott-Hirst-Social-Responsibility-Resolutions.pdf>.

¹⁸² INVESTMENT COMPANY INSTITUTE, *Letter to the SEC re: SEC Roundtable on the Proxy Process (File No. 4-725)*, 4, fn. 13 (June 11, 2019), https://www.ici.org/pdf/19_ltr_fundproxy.pdf.

indicated that the total costs of their proxy campaigns were \$1 million or more; (iii) five individual campaigns exceeded \$10 million; and (iv) the largest cost for a single proxy campaign exceeded \$100 million.¹⁸³ Pass-through voting could magnify these administrative difficulties by extending them to a much larger universe of votes. We therefore do not support proposals to mandate “pass through voting” by index funds.

b. Polling

Alternative proposals put forward by Hirst (2016)¹⁸⁴ and Griffin (2019) would require index funds to “poll” investors as to how they would vote portfolio company shares and then vote their shares accordingly. Hirst (2016) suggests that index funds could randomly sample investors on their general preferences on recurring governance topics, such as executive compensation, board independence and ESG.¹⁸⁵ The managers of index funds would then vote their shares consistent with those preferences.¹⁸⁶ However, it is unlikely that individual investors have the *expertise* necessary to answer generalized polling questions that relate to complex issues such as executive compensation policies or board independence. Such polling could therefore result in index funds making voting decisions that are not in the best interest of investors and produce worse corporate governance outcomes at public companies. We therefore do not support requiring index funds to poll investors to inform their voting decisions.

c. Eliminating index fund voting rights

Lund (2018)¹⁸⁷ and Griffith (2019)¹⁸⁸ have each proposed that index funds should be required to vote in proportion to other shareholders. For example, assume that 86% of non-index fund shareholders support a specific director for re-election. Lund and Griffith’s proposals would require that index funds “mirror” vote 86% of their shares in favor of that director.¹⁸⁹ This would have the same practical effect as eliminating index fund voting rights entirely, since index funds and their shareholders would be effectively prohibited from making independent voting judgments, and

¹⁸³ INVESTMENT COMPANY INSTITUTE, *supra* note 182, at 4.

¹⁸⁴ Hirst, *supra* note 181, at 26–30.

¹⁸⁵ Hirst, *supra* note 181, at 26–28.

¹⁸⁶ Hirst, *supra* note 181, at 27–28.

¹⁸⁷ Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43(3) J. CORP. L. 493 (2018); Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119(8) COLUMBIA LAW REVIEW 2029, 2117 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

¹⁸⁸ Sean Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE, 49–50 (July 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3404298.

¹⁸⁹ Griffith, *supra* note 188, at 49–50. Bebchuk and Hirst, *supra* note 187, at 2117; *see also* M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, THE WALL STREET JOURNAL (June 22, 2017).

thereby increase the proportional voting power of other shareholders.¹⁹⁰ Lund contends that doing so would concentrate voting power with “active investors that have the motive and information to vote intelligently.”¹⁹¹ This position presumes that the interests of active investors align with index investors’ interests, which may not be the case. For example, active investors’ interests may diverge from index investors’ interests due to a shorter-term investment horizon among active investors. Lund’s position also presumes that investment advisers that vote on behalf of index funds do not have the information and expertise necessary to vote effectively.

However, neither Lund nor Griffith provide evidence to support that other shareholders are better motivated or more informed than index funds at making voting decisions. Indeed, as noted by critics, these proposals would effectively increase the voting power of: (i) corporate insiders, which could negatively impact public shareholders; (ii) retail investors, who likely have weaker incentives than index funds to acquire information to cast informed votes;¹⁹² and (iii) short-term oriented investors.¹⁹³ In addition, based on the Fisch et al. (2019) contention that index fund managers are incentivized by the performance of their portfolio companies, it may be that index funds are more concerned with shareholder voting than active managers.¹⁹⁴ Active funds can simply choose to sell a position, rather than engage in a shareholder vote to improve performance, while index funds do not have the option to sell, having no practical alternative to voting. We therefore do not support proposals that would eliminate the voting rights of index fund managers and their investors.

d. Enhancing disclosure of non-voting engagement policies

We now evaluate proposals to enhance disclosure of non-voting engagement by index funds, such as meetings between index fund managers and portfolio companies. Policy proposals generally do not focus on enhanced disclosure of voting by index funds,¹⁹⁵ as index funds must publicly disclose all votes and their voting policies and procedures.¹⁹⁶ And, as described in **Section 3**, BlackRock,

¹⁹⁰ John Bogle, *Bogle Sounds a Warning on Index Funds*, THE WALL STREET JOURNAL (Nov. 29, 2018).

¹⁹¹ M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, THE WALL STREET JOURNAL (June 22, 2017).

¹⁹² Bebchuk and Hirst, *supra* note 187, at 2117.

¹⁹³ John Bogle, *Bogle Sounds a Warning on Index Funds*, THE WALL STREET JOURNAL (Nov. 29, 2018).

¹⁹⁴ See Fisch, Hamdani, and Solomon, *supra* note

¹⁹⁵ James McRitchie (who has called for real-time, machine-readable, user-friendly voting disclosure by investment companies) is a notable exception. CORPORATE GOVERNANCE (A/K/A CORPGOV.NET), *File 4-748: Request to amendment of Title 17, §270.30b1-4, Report of proxy voting record* (July 9, 2019), <https://www.sec.gov/rules/petitions/2019/petn4-748.pdf>; James McRitchie (of Corporate Governance), *Proxy Scorecard and Fund Competition*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Sept. 7, 2019), <https://corpgov.law.harvard.edu/2019/09/07/proxy-scorecard-and-fund-competition/>.

¹⁹⁶ See Section 2(c).

State Street and Vanguard also voluntarily disclose their rationale for voting on certain governance matters, including contested director elections and environmental and social issues.¹⁹⁷

However, there are no disclosure requirements that apply to non-voting engagement. As described in **Section 3**, BlackRock, State Street and Vanguard voluntarily disclose their non-voting engagement policies and certain summary statistics.¹⁹⁸ However, Bebchuk and Hirst (2019)¹⁹⁹ and Coates (2019)²⁰⁰ both support going further and mandating disclosure of the detailed content of meetings between index fund managers and public companies.

Bebchuk and Hirst, and Coates support such mandatory disclosures for different reasons. For instance, Bebchuk and Hirst (2019) argue that index funds lack the incentive to adequately invest in informed voting and non-voting engagement,²⁰¹ and the enhanced disclosure of non-voting engagements would encourage index funds to invest more in non-voting engagement.²⁰² Specifically, with enhanced disclosure of non-voting engagement, index fund investors would better understand the impact of non-voting engagement, and this will motivate index funds to ensure their non-voting engagement achieves demonstrable results.²⁰³ On the other hand, Coates (2019) argues that index funds have become excessively large and powerful, as their stake of ownership in U.S. public companies has increased dramatically over the past decade to approximately 15% today.²⁰⁴ Coates argues that increased transparency of non-voting engagement may be necessary to ensure that investors and the public can be aware of how index funds are wielding their power in private meetings and, if necessary, hold them accountable for their conduct.²⁰⁵

In general, we support SEC rulemaking to require transparency of non-voting engagement policies by investment advisers, as transparency enables investors to determine whether non-voting engagement priorities are consistent with investors' best interests. However, we do not agree with proposals that the SEC should require that index funds provided detailed disclosures as to the content of each meeting between an index fund manager and its portfolio companies. As noted in **Section 3**, the three largest index fund managers—BlackRock, State Street, and Vanguard—held 4,000 such meetings in 2018.²⁰⁶ Requiring such detailed disclosures would be costly and burdensome for index fund managers. Additionally, requiring substantive disclosures of the contents of a

¹⁹⁷ See Section 3(a)

¹⁹⁸ See Section 3.

¹⁹⁹ Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2123–2124.

²⁰⁰ John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, 22–23 (Sept. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337.

²⁰¹ Lucian Bebchuk and Scott Hirst, *supra* note 187.

²⁰² Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2124.

²⁰³ Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2124–2126.

²⁰⁴ Coates, *supra* note 200, at 13.

²⁰⁵ Coates, *supra* note 200, at 22–23.

²⁰⁶ See Section 3(b).

meeting could chill discussion between index fund managers and portfolio companies, thereby limiting the positive effects of non-voting engagement. Furthermore, we believe that such disclosure requirements should apply equally to investment advisers acting on behalf of index funds and active funds. The principle that such disclosures enable investors to determine whether an investment adviser is acting consistent with an investor's best interest and engagement priorities applies equally to investors in index funds and active funds.

Instead, we recommend that the SEC require that investment advisers disclose their non-voting engagement policies, key non-voting engagement priorities, and certain annual summary statistics of those practices, including the total number of non-voting engagements. As described in **Section 3**, BlackRock, Vanguard and State Street already provide similar disclosures on a voluntary basis.²⁰⁷ However, there are differences between such disclosures that limit the ability of investors to compare non-voting engagement activities across investment advisers.²⁰⁸ We recommend that the SEC issue guidance setting forth a standardized method for such disclosures in a manner that is consistent with the formats required in other jurisdictions to the extent possible.

²⁰⁷ See Section 3(b).

²⁰⁸ See Section 3(b).

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