THE BIG THREE AND SOVEREIGN WEALTH FUNDS: FROM BERLE AND MEANS TO THE NEW BLOCKHOLDERS

Umberto Piano

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Supervised by *Prof. Pierluigi Matera*

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*This is dedicated to my **parents** and **brother**, who have always encouraged me and never urged me to settle for less,*

*to **Enza**, who has always been by my side at my darkest times,*

*and to my dear friend **Edo**, who has been a wonderful and true travel companion.*

This accomplishment would not have been possible without your help.

Sincerely,

Umberto

Abstract

In latest years, the Berle and Means definition of the global equities market structure – particularly in the United States – has proven to be no longer accurate. Sure enough, ownership has faced a re-concentration process, prompted by increasing growth of index funds or tracker funds. Passive funds do not attract investors on the ground of their ability to analyse the market in order to find the investments that will yield the higher return, instead they try to replicate the overall performance of the market. They follow a certain index, such as the S&P 500, to eliminate the idiosyncratic risk associated with each individual company. In this fashion, they can have lower cost ratios and a competitive advantage against active funds that charge higher fees. The latter, along with other reasons, made the phenomenon of "indexing" always more popular among investors. The rise of index funds coincides with the clustering of ownership in the hands of a handful of index fund providers: Vanguard, State Street and BlackRock. The "Big Three" hold the largest amount of public share that any previous three single shareholders have ever had. Analogously, In the last decades, another major category of institutional investors experienced an exponential growth: Sovereign Wealth Funds. Sovereign wealth funds' finances stem from the sale of commodities such as oil, or from international trade surpluses. Things tends to heat up when we start to analyse the implications arising over corporate governance. Some commentators argue that the Big Three are beneficial to the financial market since they might actively engage in governance concern, nonetheless there are several studies that suggest their lack of incentives to have an active involvement in such matters. Besides their impossibility to have a key role in corporate governance, their huge power is source of several conflict of interests. I deem that the remedy that needs to be implemented to address the issue is to exclude institutional investors from voting, but without entirely removing the voting privileges linked to those securities.

Although the advent of such large players undoubtedly brought some advantages, it also brought a slew of negative consequences that must be addressed lawfully.

Keywords: rise of indexed funds, re-concentration of ownership, blockholders, institutional investors, corporate governance, conflicts of interest, cross-ownership, sovereign wealth funds, legal strategies.

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I. INTRODUCTION

During the Berle and Means era, corporate governance was more concerned with the potential agency issues that might have arose as a result of ownership and control separation. This is no longer a challenge with the emergence of new Blockholders, including the Big Three and Sovereign Wealth Funds. Indeed, the situation has shifted in the opposite direction. The three most prominent index funds now possess more than 15% of the U.S. stock market and in U.K. Blackrock alone holds more than 6% of the FTSE 100. Similarly, Sovereign Wealth Funds' market capitalization – as of 2021 – exceeded 3 trillion dollars and is expected to grow at a bewildering rate.

These numbers become much more important as one considers that index funds have no incentives to participate directly in governance practices. In truth, index providers have little option but to take a hands-off approach. They just don't have the resources to monitor or comprehend what their portfolio firms are up to on a quarterly, much alone daily, basis. Furthermore, index fund managers have a fundamental collective action challenge., because an index fund's manager improving the stewardship would translate in: higher costs, higher fees charged to beneficiaries, and consequently a lower competitiveness against other index funds offering the same indexed portfolio, but at a lower cost. Not only index funds don't participate actively to the stewardship of their portfolio company, but their clout give rise to several conflict of interest. One being the "cross-ownership" conflict, arising from those huge funds being on both sides of an issue (M&A). A further conflict is the one between index funds and portfolio companies' shareholders: since one of the biggest sources of assets for the Big Three are the 401(k) plans, they might be more inclined to favour the Board instead of the shareholders in a given proxy contest. Additionally, index funds, through their clout, can pressure their portfolio companies to participate in environmentally friendly activities in

order to strengthen their own brand and attract new clients, despite the fact that this activity is detrimental to the portfolio company. Another form of conflict arises as an aftermath of the ties that fund managers maintain with the management of the portfolio companies to get some non-material insider information, in that, to keep those connections, they are most likely going to be pro management in the majority of the proxies. Conflicts among different funds belonging to the same advisor may arise as well. Conflicts of interest often exist for Sovereign Wealth Funds as well: they can pursue goals that are not only profitable in terms of return on investment, but also in the interest of their sovereign government. Some states might impinge upon their funds an enormous clout, and those funds might be well willing to extract some value from overseas companies to promote national interests.

The aforementioned governance issues must be addressed. This research paper will first root through the origins of passive investing and the magnitude of their clout over the largest publicly traded companies both in US and UK. Then I will delve into the origins of sovereign wealth funds and their rise to prominence during the last few decades. In Section III, I will discuss some of the consequences of the re-concentration of control, such as the diminished position of courts in corporate governance, the emerging conflicts of interest that arise as a result of the new equity asset, and the enormous danger to national security posed by sovereign wealth funds' exponential development. In Section IV, I will address possible solutions to specific issues, such as eliminating passive voting by establishing a law that prohibits index funds from voting, however that ban can be lifted if funds show significant portfolio company analysis. Another option would be to implement a pass-through voting scheme, which would enable index fund investors to vote directly in portfolio companies on non-routine matters. Finally, index funds could be required to send along votes to their clients, albeit with the ability for investors to reassign their proxy to the fund. The

final proposal includes Sovereign Wealth Funds: they would be barred from voting, but the valuation of their stock would not decrease because those shares would reacquire the privilege to vote once sold to other owners.

I would refute those who argue that institutional investors can play an active role in corporate governance, diminishing the role of courts and thereby bringing about the "death of corporate law"[1].

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[1] Goshen Zohar & Hannes Sharon, *The Death of Corporate Law* (April 30, 2017). 94 N. Y. U. L. REV., 263 (2019).

I. FROM DISPERSED OWNERSHIP TO "INSTITUTIONAL OWNERSHIP"

A. From Berle and Means to the "Re-Concentration"

In 1930s, Berle and Means, through "The Modern Corporation and Private Property" masterpiece, depicted the issue of the "dispersed ownership" that the United States were facing with retail investors and the separation between ownership and control arising from that concern[2]. Even in 1950, their portrayal remained quite accurate, since equities were still held predominately by households and, institutional investors held merely 6.1% of US equities[3].

Concerted investing was established in the late eighteenth century, initially in Belgium and the Netherlands, in response to the fact that persons with small sums to spend could not easily exercise their investment privileges. The "Foreign and Colonial Government Investment Trust" was booming in Scotland and the United Kingdom in the late 1800s, thanks to the development of the middle class and poor rates on domestic investments. Though at this stage there was no option for truly passive investing, since "index" not existed yet[4]. In US (1960s) there was a public spotlight

[2] Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (6th ed. 1932). *See also* Brian R. Cheffins, *The Rise and Fall (?) of the Berle--Means Corporation,* 42 SEATTLE U. L. REV. 445, (2019); Thomas K. McCraw, *Berle and Means*, 18 REV. AM. HIST. 578, 584 (1990); William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 148 (2008); Kenneth Lipartito & Yumiko Morii, *Rethinking the Separation of Ownership from Management in American History*, 33 SEATTLE U. L. REV. 1025, 1027 (2010)*;* James P. Hawley & Andrew T. Williams, *The Rise Of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic,* 42 (2000); Ronald J. Gilson and Jeffrey N. Gordon*, The Agency Costs Of Agency Capitalism: Activist Investors And The Revaluation Of Governance Rights*, 113 COLUM. L. REV. 863, 874 (2013), ; Matteo Tonello, Harvard Law School Forum on Corporate Governance and Financial Regulation, *The Separation of Ownership from Ownership* (2013), available at https://corpgov.law.harvard.edu/2013/11/25/the-separation-of-ownership-from-ownership/.

[3] Matteo Tonello & Stephan Rabimov, The Conference Bd., Inc., *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* 22 tbl.10 (2010), available at http://ssrn.com/abstract=1707512. *See also* Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective* (August 2003). Weinberg Center for Corporate Governance Working Paper No. 2003-01, at 3. Available at SSRN: http://dx.doi.org/10.2139/ssrn.439500.

[4] Coates, John C., *The Future of Corporate Governance Part I: The Problem of Twelve*, 7-8 (September 20, 2018). Harvard Public Law Working Paper No. 19-07. Available at SSRN: https://ssrn.com/abstract=3247337.

on fund's fees, so the Congress amended the ICA in 1970[5] that required fund advisors to act as fiduciaries in regard to their fund's shareholders and, created a right for fund investors to challenge "excessive" fees.[6]

Second, and most importantly, the emphasis inspired scholars and then entrepreneurs to establish and encourage the concept of fully passive investment – passive not just at the level of the top beneficiary, but even at the level of the agent portfolio manager, and not only in terms of monitoring and utilization of rights, but even in terms of portfolio selection.[7]

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[5] *See* Gerard H. Manges, *The Investment Company Amendments Act of 1970--An Analysis and Appraisal After Two Years*, 14 B. C. L. REV., 388-390 (1973): "The Securities and Exchange Commission's Study ofInvestmentCompaniesandInvestment Trusts […] brought into public focus a variety of abuses and unregulated practices present in the investment company industry in 1938. The study led to lengthy congressional hearings, substantial debate over adetailed regulatory framework and, ultimately, to enactment of a measure imposing controls on investment company operations, transactions and management—the Investment Company Act of 1940. The section 1 preamble declares the policy and purpose of the Act to be the mitigation and elimination of certain conditions found by the SEC to affect adversely the national public interest and the interest of investors,including: (1) the failure of investment companies to provide investors with adequate, accurate and explicit information, fairlypresented, concerning the character of their securities and the circumstances, policies, and financial responsibility of their companies and management; (2) the organization, operation and management of investment companies in the interest of their directors, officers, investment advisers, underwriters or otheraffiliated persons rather than in the interest of all the company's shareholders; and (3) the use, by investmentcompanies, of unsound methods of keeping accounts, maintaining reserves, and computing earnings and asset values. […] In the next thirty years, the investment company industry evolved from a $1 billion industry to a $50 billion industry, and the regulated investment company emerged as one of the major financial institutions in the United States. […] The Investment Company Act of 1940 has substantially eliminated the serious abuses at which it was aimed, but the tremendous growth of the industry and the accompanying changes have created a need for additional protections for mutual fund shareholders in areas which were either unanticipated or of secondary importance in 1940. […] The House Committee on Interstate and Foreign Commerce held extensive hearings of its own and reported out a new bill, H.R. 17333,16 which was passed by the House in September, 1970.11 A joint conference committee was formed to settle the differences between the Senate- and House-passed bills, and on December 14, 1970, the Senate bill, incorporating major House amendments, was enacted as the Investment Company Amendments Act of 1970 (1970 Amendments)".

[6] John C. Coates & Robert G. Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy* (August 2007). 592, Harvard Law and Economics Discussion Paper Available at SSRN: https://ssrn.com/abstract=1005426 or http://dx.doi.org/10.2139/ssrn.1005426. *See also* John C. Coates, *The Downside of Judicial Restraint: The (Non-) Effect of Jones v. Harris*, 6 DUKE J. CONST. L. & PUB. POL. 58 (2010), *available at* https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1018&context=djclpp.

[7] *See* Ananth N. Madhavan, *Exchange-Traded Funds and the New Dynamics of Investing* 4-7 (2016). *See also* Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?,* 66 BUS. LAW. 1 (2010); Eugene F. Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYST J. 55, 59 (1965); Caleb N. Griffin, *We Three Kings: Disintermediating Voting at The Index Fund Giants*, MD. L. REV., 79, 954 (2020), *available at* Https://Advance.Lexis.Com/Api/Document?Collection=Analytical-Materials&Id=Urn:Contentitem:60nm-Jbj1-Jp4g-62kc-00000-00&Context=1516831.

B. *The Rise of Index Funds in the US Equity Market*

Nowadays with Passive index funds[8] we intend index mutual funds and exchange traded funds (ETFs). Although index mutual funds and ETFs[9] are technically different— index funds are exchanged just once a day after markets close, while ETFs may be purchased and sold at any time during the trading day[10]— both strive to duplicate stock indexes and reduce cost ratios.[11]

Since passive funds attract investors based on their ability to follow an index and because they do not seek to surpass active funds, their choices to acquire new shares do not need a detailed examination, therefore they charge significantly lower fees. Over the last decades active managed funds succumbed over the low-cost structure of the index funds, thus leading to an exponential growth in passive investing across US.[12] In late 2015, US passive index funds had around $4 trillion in assets under management, which was more than the entire hedge fund sector.[13] Portfolio diversification permits to investors to reduce firm-specific risk not giving up on expected return. If an investor decides to buy some shares of an index fund tracking the S&P 500, he's exposed to

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[8] *Id*.

[9] For a review of the different structure of ETFs, *see* Martin Lettau & Ananth Madhavan, *Exchange-Traded Funds 101 for Economists*, 32 J. ECON. PERSP. 135, 135-36 (2018).

[10] *See* Benjamin Braun, *From Performativity to Political Economy: Index Investing, ETFs and Asset Manager Capitalism*, 21 NEW POL. ECON. 257, 266 (2016). *See also* Anna Agapova, *Conventional Mutual Index Funds Versus Exchange Traded Funds*, 14 J. FIN. MKT. 323, 224 (2011); Edwin J. Elton Et Al., *Passive Mutual Funds And Etfs: Performance And Comparison* 3–6 (2018).

[11] *See* Jan Fitchtner, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 299 (2017).

[12] *See* Itzhak Ben-David et al., *Exchange-Traded Funds*, 9 ANN. REV. FIN. ECON. 169, 175 (2017). *See also* Alec J. Burnside, Adam Kidane, *Common ownership: an EU perspective,* J Antitrust Enforcement 4 (2020), *available at* https://advance.lexis.com/api/document?collection=analytical-materials&id=urn:contentItem:629W-BT11-JWR6-S417-00000-00&context=1516831.

[13] *See* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, San Diego L. Rev. 803, 809-813 (2018). Available at SSRN: https://ssrn.com/abstract=3187159 or http://dx.doi.org/10.2139/ssrn.3187159. *See also* Carolyn K. Brancato and Stephan Rabimov, "*The 2008 Institutonal Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations"* (The Conference Board, 2008); Azar, José and Schmalz, Martin C. and Tecu, Isabel, *Anticompetitive Effects of Common Ownership* (May 10, 2018). Journal of Finance, 73(4), 2018. Available at SSRN: https://ssrn.com/abstract=2427345.

market performance, thus avoiding the idiosyncratic risks associated with any individual firm.[14] Passive funds incur in lower operating costs, furthermore they reduce taxable events, because they buy and hold securities. Those, along with others, are some of the reasons behind the exponential growth of global fund in indexed funds, started from almost zero in 1980, to about 30% in 2017.[15] Index funds are allowed to engage in governance activities, such as voting and monitoring the portfolio company. Indeed, index funds are required to fulfil some legal obligation that encourage minimal governance efforts. Since index funds can "only" hold a slight percentage of each public company, like other retail investors, they have no rational motivation to engage in much governance activity because, doing so, they will incur in some costs, making other investors benefit of their efforts. A more recent increase in indexing is due to several changes in institutional settings:

- An ever growing propensity of employers to feature indexed funds as a default choice in 401(k) plans;[16]
- Discount brokers outclassed traditional brokers.[17]

The rise of indexing concurs with the increased concentration of ownership in the hands of a handful of indexed fund providers.[18] The "Big Three", Vanguard, State Street, and BlackRock,

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[14] *See* Richard A. Booth, *Index Funds and Securities Fraud Litigation*, 64 S.C. L. REV. 265, 281 (2012).

[15] *See* Alexander I. Platt., *Index Fund Enforcement*, 53 UC DAVIS 1466 (2020). *See also* James J. Rowley, *Setting the Record Straight: Trust About Indexing* 2 (2018). John C. Bogle, *The Index Mutual Fund: 40 Years of Growth, Change, and Challenge*, 72 FIN. ANALYSTS J. 9 (2016).

[16] *See* Edwin J. Elton, Martin J. Gruber, and Christopher R. Blake, *The Adequacy of Investment Choices Offered by 401k Plans*, 90 J. PUB. ECON. 1299, 1314 (2006). *See* Inv. Co. Inst., 2019 Investment Company Fact Book 43 (59th ed. 2019). *See* Investopedia, Section on Education, *What is a 401(k) Plan?*, *available at* https://www.investopedia.com/terms/1/401kplan.asp (last visited Apr 21, 2021): "A 401(k) plan is a tax-advantaged, defined-contribution retirement account offered by many employers to their employees. It is named after a section of the U.S. Internal Revenue Code. Workers can make contributions to their 401(k) accounts through automatic payroll withholding, and their employers can match some or all of those contributions. The investment earnings in a traditional 401(k) plan are not taxed until the employee withdraws that money, typically after retirement. In a Roth 401(k) plan, withdrawals can be tax-free".

[17] *See* Coates, *supra note* 4 at 809-811.

[18] *See* James Hawley & Andrew Williams, "*Universal Owners: Challenges and Opportunities"* (2007) 15 CORP. GOV. INT. REV. 415 (2007).

in 2017, owned over 15% of the S&P 500, the largest percentage of US public businesses held by any prior three single investors. When it comes to portfolio firms, more than 30% of the S&P 500 has four or fewer owners owning more than 20% of the company's stock. Investment company act and Internal Revenue Code require a strict diversification constraint at fund level, but not to all funds sponsored or advised by the single advisor. Funds are separate legal entities from their own board of directors, that have the role of retaining and monitoring the management, which is provided externally by an investment adviser that owes fiduciary duties to the advised fund.[19] For instance, Vanguard holds in total 6.3% of the shares of Apple, Inc., but considering the "single" funds, none of them has more than 2% of the shares. We should also note that there is no legal barrier on an advising firm voting on behalf of all of its funds with a certain portfolio company. Also, BlackRock and State Street own a considerable stake in Apple, Inc. thus making those "big three" hold a more than significant part of the most valuable company in the world.[20] The situation outlined by Berle and Means is no longer a reality, even for the biggest publicly listed firms, thanks to the growth of institutional investors. In 2017, the top 20 institutional investors owned a combined 33.4 percent of the top 20 firms.

Ownership Structure in the UK Equity Market

The fact that in UK institutional investors are the major owners of publicly-traded company it is not itself a recent phenomenon.[21] This is the aftermath of a global shift from direct ownership by individuals, toward ownership through financial intermediaries: banks, insurance companies,

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[19] *See* Edward B. Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B. U. L. REV. 1771, 1815 (2020).
[20] *See* Coates, *supra note* 4 at 809-811.
[21] *See* Gomtsian Suren, *Shareholder Engagement by Large Institutional Investors*, TILEC Discussion Paper No. 2019-014, at 6-17 (2019). Available at SSRN: https://ssrn.com/abstract=3412886 or http://dx.doi.org/10.2139/ssrn.3412886.

investment funds and pension funds.[22] Today, as it was 40 years ago, institutional investors are the largest shareholders of UK listed companies,[23] except that now the leading institutions are also known as funds advisors or general partners. In the UK, 2017 has seen BlackRock funds owning 5.84% of the FTSE 100 companies. Other big funds, like Legal & General, Norges Bank Investment Management, and Vanguard were slightly below 3%. The largest five assets managers controlled together about 13.5% of the FTSE 100 companies. Legal & General is one of the largest UK-based managers with substantial passively-managed funds. The voting power of those big asset managers becomes even higher when focusing on the listed companies of which they are the majority shareholders. For instance, BlackRock and Vanguard were among the top ten shareholders in 90% of the FTSE 100 companies. The situation is similar in the FTSE 350 companies, where, Legal & General, dominated the list of the largest shareholders: they appeared to be the top 10 shareholders in almost three-quarters of the companies included in the index. The clout of such funds is even stronger in practice given the actual corporate voting turnout.[24] In almost all the publicly-traded companies not all the out-standing shares vote during the general meetings. The average voting turnout at the FTSE 100 companies stood at 73% in 2017.[25] Those data make clear the concern arising from the concentration of power in the hand of few larges institutions: a shareholding of around 37-40% may give an effective control over the decision-making process.

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[22] *See* Gerald F. Davis, *A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States*, 5 EUR. MGMT. REV. 11, 15 (2008).

[23] *See* Erik P. Gilje, Todd A. Gormley, and Doron Levit, *Who's Paying Attention: Measuring Common Ownership and Its Impact on Managerial Incentives,* ECGI Finance WP No. 568/2018, 6-15 (Jul. 2018), https://ssrn.com/abstract=3165574

[24] *See* Gomtsian, *supra note* 19, at 6-17.

[25] *See* KPMG, *The 2017 AGM Season – Final Review, 3* (Jan. 2018), https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2018/01/makinson-cowell-review-of-the-2017-agmseason-january-2018.pdf (last visited Jul. 16, 2018).

In average, and combining their holdings, they have above 40% of the share of the great majority of the FTSE companies.[26]

C. The Rise of Sovereign Wealth Funds

Although they are nowadays under the spotlight, the earliest sovereign wealth funds trace their roots in the 70s and, until very recently, have operated in an opaque manner. What has changed over the years is the economic landscape in which they operate. For starters, the dimension of the Sovereign Wealth Funds (SWFs) increased dramatically[27]. Their investing strategy has switched from sovereign debt to corporate equities. SFWs are chiefly equity investment entities established and controlled by sovereign countries[28].

The peculiarity is that governments are owners of the funds, but that is a characteristic common also to other entities. Sovereign wealth funds are one of numerous investment vehicles available to governments: central banks are on one end of the spectrum, while state-owned enterprises are on the other. Sovereign stabilization funds, sovereign savings funds, and government investment firms sit in the center. Sovereign wealth funds are sovereign investment vehicles that are not monetary authorities in control of foreign reserves, central banks, or national pension funds, to name a few examples[29].

SWFs are classified on the ground of the source of their assets: the majority of wealth funds are financed with revenues stemming from the sale of commodities such as oil. Norway Government

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[26] *See*, Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. L. REV., at 721-741 (2019).
[27] *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1354 (2008).
[28] *See* Shasm Butt, et al., *Sovereign Wealth Funds: A Growing Global Force in Corporate Finance*, 20 J. APP. CORP. FIN., at 83 (2008).
[29] *See* Gerard Lyons, *State Capitalism: The Rise of Sovereign Wealth Funds*, 14 L. & BUS. REV. AM. 182 (2008).

Pension Fund and the various Middle Eastern SWFs fit the above description. SWFs that are often constituted by asset transfers from foreign-exchange reserves produced by trade surpluses are another kind of SWF. A noticeable example is the China Investment Corporation.[30]

It is difficult to encompass their objective and investment policies: they may include the balancement of the macroeconomic effects of abrupt surge in export earnings, the management of foreign-exchange reserves or pension assets, or the intertemporal transfer of wealth. The assets may be handled directly by a government body, or they may be entrusted to professional administrators both within and outside the nation. SWFs invest in a wide range of asset classes and use a variety of investment methods. Some of them invest only in sovereign bond, some of them buy stocks in several domestic and foreign companies but only hold small stakes in each one. [31]

There are also notable contrasts in transparency: the Norway Government Pension Fund makes its portfolio and investment strategies fully transparent[32], while most SWFs, conversely, by no means follow suit. Even among funds owned by the same sovereign, the level of transparency varies. Singapore's Temasek investments are trackable annually thanks to full disclosure, whereas Singapore Government Investment Corporation's policies and strategies are opaque.[33]

Present moment, the top twenty SWFs are estimated to have assets under management exceeding $2 trillion, when we consider that this is tantamount to half of the Tokyo Stock Exchange's market

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[30] *See* Ronald J. Gilson & Curtis J. Milhaupt, *supra note* 27 at 1354.

[31] *Id.*

[32]*See* Norges Bank, *Norges Bank Investment Management*, *available at* http://www.norges-bank.no/Pages/Article____41394.aspx (listing fund strategy, a benchmark portfolio, ethical guidelines and other fund information); *see also* Kristin Halvorsen, Comment, *Norway's Sovereign Fund Sets an Ethical Example*, Financial Times, Feb. 15, 2008, at 9 (by Norway's Minister of Finance).

[33] *See* Burton & Giles, *supra* note 35 (calling the GIC one of the "most secretive" of the SWFs).

capitalization, these are tremendous numbers.[34] If that isn't striking, surely the fact that SWFs' assets under management equal those in hedge funds and private equity funds combined would give us a better picture of the magnitude of their clout.[35]

If we consider the five largest SWFs, they all have assets under management exceeding 100 billion. The biggest is by far ADIA from the United Arab Emirates, followed by Norway's Government Pension Fund, Singapore's Government Investment Corporation, The Kuwait Investment Authority, and the China Investment Corporation. The dramatic growth of SWFs that took place in the last decades is the aftermath of several interrelated factors: one being the surge in world prices, that secured gargantuan revenues to oil exporters, the other one being the colossal accumulation of foreign-exchange reserves by Asian central banks. A controversial practice perpetrated by People's Bank of China to make their goods or services more competitive on an international level was to buy other currencies and sell domestic currency in order to depreciate their own.[36]

Since the combination of the aforementioned factors is not predicted to wane, analysts forecast that SWFs prominence will increase. Somebody predicts that if sovereign funds growth rate won't decrease, over the next ten years total funds managed by SWFs will peak to $13.4 trillion.[37]

China had roughly $347 billion in US treasuries as of November 2006, and Asian central banks owned a third of the total outstanding US government debt as of September 2006.[38] The appeal of dollar-denominated financial products to international investors has waned as the dollar has

[34] *See* Lyons, *supra note* 29, at 6 & 17 chart 3.
[35] *Id*. at 6.
[36] *See* Gilson, *supra note* 27 at 1356-1358.
[37] Lyons, *supra note* 29, at 5-6.
[38] *See* Mckinsey & Co., *The New Power Brokers: How Oil, Asia, Hedge Funds, And Private Equity Are Shaping Global Capital Markets* (last visited 5 May, 2021), https://www.mckinsey.com/featured-insights/employment-and-growth/how-the-new-power-brokers-are-shaping-global-capital-markets.

depreciated versus the euro and other major currencies. SWFs started diversifying away from dollar-denominated assets with poor returns, such as US government treasury securities. Furthermore, as an aftermath of aging societies in East Asia, that will cause a massive financial burden on their national public pension system in the years to come, there is a chase for higher returns.[39]

Some government investment funds, such as Singapore's Temasek Holdings, have actively engaged in the governance of their investee companies, and since success breeds imitation, also newly established funds in East Asia followed suit. Chinese State-owned enterprises (SOEs) deemed Singapore's Temasek Holdings' model a useful template for corporate governance.[40]

Norway's Government Pension Fund is not only one of the oldest SWFs, but it is also purported to be one of the best-managed and a model of prudent public management of financial assets..[41]

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[39] Gilson, *supra note* 27 at 1359.

[40] *Id.*

[41] *See* Emma Charlton, *Norway's Sovereign Fund Serving as Model*, WALL ST. J., 2007, at C7; Raphael Minder, *ADB Calls for Transparency of Asia Funds*, FIN. TIMES, 2007; *cf. Sovereign Wealth: A Code of Conduct Is Needed For Both Funds and Recipients*, FIN. TIMES, Jan. 28, 2008, at 8.

II. IMPLICATIONS

A. The Impact of Index Funds Concetration Over Corporate Governance

Until now, the legal literature has focused primarily on the possible anticompetitive consequences that may arise when large passive investors, especially the Big Three, hold a sizable portion of competing companies' stock.[42] Recently, legal and financial analysts have attempted to determine the consequences of passive investment on corporate governance, despite the fact that this line of study is already in its infancy.[43] The question they want to address is whether passive investor are also passive owners. In the one hand, since passive tracker funds seek to replicate the market while minimizing costs, they have little financial incentive to intervene in the stewardship of their portfolio firms; This is due to the fact that the indexes they mimic comprise thousands of firms, restricting the potential advantages of corporate governance action to only a few. Any investment in shareholder engagement, provided it improves the target company performance, is expected to benefit the benchmark index in general and all competing funds that follow the same index. Owing to the similarity of their offerings, the main aspect of rivalry between index funds is the fund provider's willingness to deliver the lowest management costs.[44] Meanwhile, shareholder participation is expensive, particularly for passively managed funds that usually lack company-specific expertise.[45] Indeed, index providers are forced to maintain a fairly hands-off approach.[46] They clearly lack the resources necessary to track and appreciate the activities of their portfolio

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[42] Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1267 (2016); *see also* Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L. J. 2026, 2027–28 (2018).
[43] Steven D. Bleiberg et al., *The Impact of Passive Investing on Market Efficiency*,7 (2017), https://bpmmagazine.com/wp-content/uploads/2017/05/The_Impact_of_ Passive_Investing_FINAL.pdf
[44] Strampelli, *supra note* 13; Coates, *supra note* 4.
[45] *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 511-12 (2018).
[46] Stephen Davis, Jon Lukomnik, and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (Harvard University Press, 2006) at 66.

companies on a quarterly basis, let alone regularly.[47] Additionally, index fund managers face a structural collective action issue, as Bebchuk, Cohen, and Hirst note, "a move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio, but without stewardship or higher fees." [48] Additionally, passive owners are incapable of successfully supervising investee firms because they lack the power to control managers by the possibility of withdrawal. Index funds, on the other hand, may play a more active role in their investee businesses' corporate governance for a number of reasons. To begin, since they are, by design, permanent owners[49], they are necessarily more reliant on the success of such firms.[50] In the second case, there is increasing reputational and regulatory pressure on the world's largest passive index fund managers (the big three) to take an active surveillance position. Both the US Securities and Exchange Commission (SEC) and the European Commission followed a disclosure-based regulatory strategy that invited institutional investors to vote on all portfolio shares without forcing them to do so. The big three feigned governance experience and, in practice, achieved a strategic edge over other institutional investors. They are constantly reiterating their commitment to controlling investee firms.[51]

For example, in his January 2018 letter to the CEOs of the world's largest firms, Larry Fink, CEO of Blackrock, said that as long as an organization exists in the index, they are obligated to have an interest in it and, as a consequence, to be actively engaged in the governance of their investee

[47] Coates, *supra note* 4, at 9.
[48] Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 100–01 (2017)
[49] Franks, Julian R., *Institutional Ownership and Governance* (January 30, 2020). European Corporate Governance Institute – Finance Working Paper No. 656/2020, at 11. Available at SSRN: https://ssrn.com/abstract=3530849 or http://dx.doi.org/10.2139/ssrn.3530849
[50] Goshen, *supra note* 1.
[51] Strampelli, *supra note* 13 at 814-817.

companies.[52] Index investors, in this context, are long-term investors that allow a business to succeed over time. Additionally, for the purposes outlined above, the Big Three have formed stewardship teams, which are responsible for two critical functions: oversight and voting at the annual general meeting. Where available research and scientific findings on the effect of passive investment on corporate governance are considered, none of the two competing positions is conclusively supported.[53] However, we might scrutinize the participation and voting figures provided by the Big Three on a quarterly basis to ascertain if they exercise their voting privileges at investee company meetings. We could examine the voting habits of the Big Three to determine if their stewardship engagement is getting "truly" involved and what motivates them to do so. If we look at the numbers, they mostly vote in favor of management proposals, even if this pattern seems to have marginally declined in recent years.[54] Surely, the Big Three's stewardship committees are incapable of "truly" devoting the same level of commitment to all portfolio firms. For example, under Blackrock's stewardship, 30 individuals are responsible for overseeing corporate governance matters at approximately 17,000 businesses and voting at approximately 17,000 shareholder meetings per year.[55] Indeed, as Edward Rock observed, it is a monumental challenge for the Big Three's stewardship teams to even get a vote on all portfolio firms, let alone the question of how to vote. The Big Three stewardship teams develop almost equal voting habits

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[52] See Larry Fink, *Larry Fink's Annual Letter to CEOs: A Sense of Purpose*, Blackrock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/LZ2A-XRQT].

[53] Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2911, 2922–26 (2016); *see also*, Fitchner, supra note 11 at 318.

[54] *Blackrock, Investment Stewardship Report: 2017 Voting And Engagement Report* 4–5 (2017), https://www.BlackRock.com/corporate/literature/ publication/blk-2017-annual-voting-and-engagment-statistics-report.pdf [http://perma.cc/ A63X-PDLH]; *Vanguard, Investment Stewardship 2017 Annual Report* 28–33 (2017), https://about.vanguard.com/investment-stewardship/annual-report.pdf [http://perma.cc/ VH29-RMU6]; *see also* Fitchner, *supra note* 11 at 317-318.

[55] Blackrock, *Investment Stewardship: Protecting Our Clients' Assets For The Long-Term* 5, 13, 17 (2018), https://www.blackrock.com/corporate/literature/ publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf

and generally adhere to them. In 2015, BlackRock reported that one of their funds voted against the proposal in 18 out of every 100,000 proposals, whereas Vanguard reported that one of their funds voted against the proposal in just 6 out of 100,000 proposals.[56] However, perhaps in response to mounting reputational and regulatory pressure on fund managers to have robust corporate oversight, the Big Thee insistently claim that they do not often follow proxy advisor advice.[57] For example, BlackRock notes that although it follows voting policy protocols for routine issues, it conducts in-depth research if a more major issue surfaces. Institutional investors do not often follow proxy advisor recommendations; as a result of this versatile strategy, index and active funds managed by BlackRock can vote differently on any particular topic where they have a differing opinion. As a result, even though accessible data indicates they generally take a "check the box" policy,[58] disregarding the unique requirements of a portfolio firm, an overview of their voting structure would not suffice to establish their "passive owning" strategy. Indeed, they do not vote against management; however, they exert control on managers through private interactions. Such a "secret force" seems to imply that when index funds buy a sizable portion of a business, corporate governance generally improves. Ian Appel, Todd Gormley, and Donald Keim, in particular, argue that passive index fund control increased board flexibility, rendered acquisition defenses useless, and encouraged more equitable voting privileges through opposition to dual class share arrangements. In the other hand, Cornelius Schmidt and Rüdiger Fahlenbrach demonstrate that when there is a heavy accumulation of shares in the possession of index funds, CEOs' influence is strengthened, an observation supported by the occurrence that they make it to Chairman or President more often, whereas the independent director's turnover drops. Furthermore, according

[56] Fitchner, *supra note* 11 at 317.
[57] Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 56–59 (2013)
[58] Lund, *supra note* 45

to Schmidt and Fahlenbrach, a bigger share of passive stock investors is linked to greater value-destroying mergers and acquisitions (M&A) activity.[59] Ergo, this result seems to support the theory that passive investors are less inclined to control managers.[60]

1. Courts' less central role

Corporate law has held that shareholder votes will serve as a replacement for increased judicial oversight of takeover agreements, allowing shareholders with a sizable interest in the business to determine the transaction's fate. The Delaware court has abdicated its position of judicial oversight of mergers and acquisitions proceedings, provided that shareholder approval is informed and uncoerced.[61] Due to the fact that decisions are often pre-arranged by the transacting groups, judicial oversight has become increasingly irrelevant. Increased monitoring was invented to address recurring conflict of interest issues that arise when a majority shareholder buys out minority owners or when a target business is acquired by an unaffiliated third party.[62] The jurisprudential standards were distinct: "entire fairness" in case of a controlling shareholder and "enhanced scrutiny" for third-party mergers because they differ in severity.[63] In the former situation, the conflict of interest is immediate and occurs as the controller's desire to spend as least as possible conflicts with the board's obligation to increase the company's sale value. In the latter situation, since there is no majority shareholder, the board can be more concerned with maintaining its status than with

[59] Appel, Ian and Gormley, Todd A. and Keim, Donald B., *Passive Investors, Not Passive Owners*, 121 J. FINANC. ECON., 111-141 (2016).
[60] Strampelli, *supra note* 13, at 818.
[61] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004).
[62] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993).
[63] *See* Revlon, *Inc. v. MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173, 182 (Del. 1986)

maximizing the company's worth at sale. Recently, Delaware jurisprudence reunified these two events, substituting an educated, uncoerced shareholder vote for the heightened judicial scrutiny.[64]

2. Conflict Arising from Mutual Funds Voting

The Big Three mutual fund sponsors, in particular, are the primary voices that determine the result of proxy fights,[65] shareholder motions,[66] and say on compensation.[67] Initially, researchers hypothesized that the growth of institutional investors, who hold massive and concentrated interests in businesses, may have supplanted individual investors' apathy. At some stage, their inadequacy of voting documents drew regulatory attention, prompting the "SEC" to enforce a rule forcing index funds to report their entire voting records. Additionally, the "SEC" mandated that index fund advisors have a fiduciary obligation to cast investors' proxies in their clients' best interests.[68] However, funds sponsors have considered this obbligation just as a duty to cast the votes in all of their portfolio companies. To handle this responsibility, the majority of mutual fund sponsors assign it to stewardship teams. These corporate governance departments tend to be very small: in January 2017, Vanguard employed two dozen people to engage and vote at approximately 12,000 businesses; BlackRock employed approximately 31 people to engage and vote at more than 13,000 companies; and State Street employed eleven people to engage and vote at more than 8,000 firms.[69] Stewardship managers rely on actively managed funds to provide details about portfolio firms prior

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[64] Griffith, Sean J. and Lund, Dorothy S., *Conflicted Mutual Fund Voting in Corporate Law*, 99 B. U. L. REV. 1151, 1158, 2019.
[65] Michael Blanding, *Vanguard*, *Trian, and the Problem of "Passive" Index Funds*, HARV. BUS. SCH. WORKING KNOWLEDGE (Jan. 30, 2017).
[66] Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST (May 31, 2017).
[67] Miguel Antón et al., *Research: Index Funds Are Fueling Out-of-Whack CEO Pay Packages*, HARV. BUS. REV. (Oct. 18, 2016).
[68] Securities Act Release No. 8188, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274).
[69] Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL STREET J.

to voting. In the opposite, index fund managers have no say about how their fund vote in their holdings. Morningstar published a survey in 2017 detailing the governance practices of various sponsors: several funds solicit feedback from active portfolio managers prior to voting, but the final judgment is taken by the corporate governance committee.[70] State Street and Vanguard, for example, delegate final voting power to their governance teams. The foregoing authority is conferred on them in order to avert future conflicts of interest arising from fund managers' divergent perspectives, thus maintaining continuity and effectiveness.[71] In plain terms, mutual fund sponsors accept the possibility of fund divergences and delegate final decision-making authority to stewardship teams. If a fund executive conflicts with the voting endorsement of the governance groups, the manager's sole option is to divest. As a result of this policy, both State Street and Vanguard funds have an dramatic uniform voting pattern; in fact, only 195 out of 100,000 of proposals at State Street had a fund voting differently than its other funds in 2015; at Vanguard, only 6 out of 100,000 proposals had different votes.[72] The fund sponsor and its investors have substantial and recurrent conflicts of interest when it comes to mutual fund voting.[73]

3. Cross-Ownership Conflict

In the majority of instances, voting rights of listed companies in the US is strictly proportional to the amount of securities owned, using the one-share-one-vote structure. According to scholars, this arrangement is more efficient because the greater one's financial interest in the firm, the greater one's incentive to increase the company's wealth. The rise of retail investing and extensively diversified ownership, on the other hand, calls into question this logic: today's major corporate

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[70] Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 921 (2011)
[71] Griffith et al., *supra note* 47 at 1169.
[72] Fitchner, *supra note* 11 at 316-317
[73] Griffith et al., *supra note* 47 at 1169.

owners are widely diversified mutual fund sponsors of other assets. Indeed, the topic of mutual fund empty voting is a rather popular one, provided that they are heavily diversified and often take opposing positions on issues. Their expansion has resulted in a major rise in cross-holdings.[74] The concentration of stock ownership has reached such a point that "in a hypothetical conflict between two S&P 500 firms in 2005, 15% of the equity in either firm would on average be held by institutional investors that prefer the other side to win."[75] This pattern will continue to grow as long as investor savings move into mutual funds, implying that cross-holdings will continue to grow. The majority of mutual fund sponsors also stated unequivocally that their arrangement requires them to combine all of their funds' votes and cast them in a consistent fashion, advancing the institution's overall interests. There are many instances in which this voting trend could be detrimental to one corporation while benefiting another. The most egregious ones include those of mergers and acquisitions, since mutual funds are typically involved with all sides of the transaction. Consider the following possible scenario: The management of Company A intends to acquire Company B; the public views the acquisition as an excellent chance for Company B, which is in a precarious financial situation. The market, on the other hand, views this deal negatively for corporation A, who would absorb many liabilities and debt incurred by corporation B. Regrettably, the owners of Business A vote to support the merger regardless of whether the company's stock price falls as a result of the announcement. Why does business A behave in such a manner? Without a doubt, the majority of company A's equity was retained by institutional block-holders who still owned a sizable portion of company B, thereby neutralizing or even reversing the deficit in

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[74] *Id.*

[75] Ann M. Lipton, Essay, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017); *see generally* Bebchuk, Lucian A., Reinier Kraakman, and George Triantis, *Stock pyramids, cross-ownership, and dual class equity: The mechanisms and agency costs of separating control from cash-flow rights, in Concentrated Corporate Ownership,* University of Chicago Press (2000).

company A. In this situation, institutional investors were not acting in the best interests of company A, but rather in their own.[76] For instance, a practical example can be found in 2003, where Bank of America planned to acquire FleetBoston Financial, and it was approved even though this transaction was value-destroying to Bank of America, making it's the value of all its outstanding shares fall by more than $8 billion once the merger was declared; however FleetBoston's total share value soared approximately by the same figures.[77] This due to the fact that Bank of America's most prominent stockholders were all institutional investors who held the same position in FleetBoston. They voted in favour of a value destroying merger because they wouldn't have been affected by the loss, thanks to their cross-ownership.[78] During 1998-2004 in 41.7% of the M&A deals in publicly traded companies, the target and the acquiring company shared some of the same owners. Furthermore, for the average merger, institutional investors held 18% of the acquirer stock and 21% of the target stock.[79]

To summarize, although it is evident that crossholdings create a genuine conflict of interest for mutual funds in M&A decisions, these conflicts are likely to manifest themselves in other contexts as well. If actively managed investment funds gain traction, it is more possible that these tensions will intensify.[80]

4. Conflict Between Investee Companies' Shareholders and Index Funds

Mutual funds sponsors face an even more severe conflict of interest with its own investors. Profits made by mutual funds derive from fees charged to funds, computed on the base of the fund's assets

[76] Griffith et al., *supra note* 47, at 1172.
[77] Gregor Matvos & Michael Ostrovsky, *Cross-Ownership, Returns, and Voting in Mergers*, 89 J. FIN. ECON. 391, 391 (2008).
[78] Griffith et al., *supra note* 47, at 1173.
[79] Chris Brooks, Zhong Chen & Yeqin Zeng, *Institutional Cross-Ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, 48 J. CORP. FIN. 187, 189 (2018).
[80] Griffith et al., *supra note* 47, at 1174-1175.

under management. The management of their portfolio companies is an important source of 401(k) funds invested in mutual funds, or even potential clients for other services. This is why this type of dispute has grown in popularity, since it encourages fund sponsors to cast investor proxies in favor of their client: the management.[81] For instance, take BlackRock, one of the globe's biggest asset managers having more than $5 trillion assets under management ("AUM").[82] BlackRock announced its willingness to engage actively in corporate governance matters, and although this may find someone sceptical, nobody can deny its influence. Furthermore, since BlackRock is a listed corporation, differently from Vanguard and Fidelity, it is compulsory to hand recurring reports with the SEC, those reports can give more insight about their business model. About 39% of BlackRock's assets under management, or more than $2 trillion, derive from corporate retirement programs.[83] BlackRock, like other big mutual fund sponsors, gives investors the option of active or passive management, although the majority of its assets are invested in passively managed funds—the company has around $2 trillion in actively managed funds and about $4 trillion in index funds and ETFs. The management fees collected by BlackRock allow it to benefit from such funds. Investment management costs are normally calculated as a percentage of assets under management by BlackRock[84], although active funds charge a substantially higher proportion of AUM in costs. As a result, BlackRock's smaller active fund segment generates the same amount of revenue as its passive funds: more than $1 billion a quarter. These fees taken together amount

[81] John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 672 (2001).
[82] Blackrock, https://www.blackrock.com/au/individual/about-blackrock
[83] Blackrock, *Blackrock 2017 Annual Report 6* (2017), http://ir.blackrock.com/ Cache/1500109547.PDF
[84] The average fee is 0.12%, 0.18%, and 0.11% for BlackRock, Vanguard and SSGA, respectively; *see* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV, at 3. Available at: https://ssrn.com/abstract=3282794

to about 88% of BlackRock's quarterly revenue.[85] Instead of lowering premiums and cutting margins, an easier approach for indexed funds to raise assets under administration is to establish and sustain a strong partnership with their primary source of corporate 401(k) assets: management. This kind of conflicts often affect institution voting patterns, that tends to be pro-management, even going against shareholders' best interests. In a SEC comment letter supporting a regulation mandating mutual fund vote transparency, Vanguard founder Jack Bogle explained: "Votes against management may jeopardize the retention of clients of 401(k) and pension accounts."[86] For example, in 2004, shortly after the Securities and Exchange Commission ordered mutual funds to release their voting records, it was revealed that a major mutual fund sponsor had opposed to stockholders plans to finance workers stock options. According to the New York Times, Fidelity opposed to a shareholder initiative at Intel, where Fidelity acted as the record keeper for $1 billion in Intel 401(k) plans. Additionally, a review of equity option expensing plans discovered that institutional investors with competition of interest were less inclined to accept proposition from the stockholders than institutional investors without competition of interest. Recent observational data champion the theory that passive funds have a conflict of interest that manifests itself in a pro-management voting trend.[87] Professors Ryan Bubb and Emilio Catan have proved that large mutual funds sponsors are more prone to support management than other institutions and third-party proxy advisers are, like for instance "ISS" and Glass Lewis.[88]

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[85] Blackrock, *Q4 2017 Earnings: Earning Release Supplement* 6 (Jan. 12, 2018), http://ir.blackrock.com/Cache/1001230788.PDF

[86] John C. Bogle, *Mutual Fund Secrecy*, N.Y. TIMES, Dec. 14, 2002, at A35.

[87] Griffith et al., *supra note* 47, at 1177; *see also* Gillan et al., *supra note* 2, at 9.

[88] Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds, 3* (Apr. 16, 2018). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039

The reputational and marketing concerns of investment advisors often cause complications. Consider issues such as climate change or biodiversity that fall under the financial, social, and governance (ESG) umbrella. Larry Fink's well-known letter reiterating BlackRock's dedication to ESG issues[89] can indicate his genuine conviction that a stronger emphasis on ESG would benefit portfolio companies' long-term value. However, it may also be seen as an excuse to bolster BlackRock's corporate profile, sell its funds, or avoid oversight. To the degree that advisors adopt decisions or vote in ways that diminish company value for reputational or marketing purposes, their interests contrast with those of at least some of their fund clients. To the extent that such contradictions exist, both economic demands and politics constrain advisors' ability to deviate from investor-interested targets.[90] On a competitive level, State Street replied to Larry Fink's letter by stressing its pursuit of "value, not values."[91]

In other terms, State Street attempted to cater to consumers who did not hold Fink's "values" or who were unable to forego "value" in order to promote them. In the political front, former Senator Phil Gramm has chastised large institutional investors for utilizing investment capital to further liberal objectives that they have been unable to accomplish by legislation.[92]

5. Intrashareholder Conflicts

A second well-known point of tension stems from stock pickers' desire to maintain cordial ties with the management of their portfolio companies.[93] Stock pickers profit from such partnerships because

[89] Larry Fink, *Larry Fink's 2017 Letter to CEOs*, BLACKROCK (2017), https://www.blackrock.com/corporate/investor-relations/2017-larry-fink-ceo-letter [https://perma.cc/9AE8-3E63].
[90] Marcel Kahan & Edward B. Rock, *Index funds and corporate governance: let shareholders be shareholders*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098
[91] Cyrus Taraporevala, *Index Funds Must Be Activists to Serve Investors*, FIN. TIMES, July 25, 2018, at 9. Douglas Beal Et Al., Bos. Consulting Grp., *Total Societal Impact: A New Lens For Strategy* 3-9, 38 (2017)
[92] Phil Gramm & Mike Solon, Opinion, *Keep Politics Out of the Boardroom*, WALL STREET J., July 19, 2018, at A17.
[93] *See* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1054-56 (2003)

they enable them to get answers to their questions in public forums and to get knowledge privately that might not be legally significant on its own but aids in filling in holes in their perception of the firm's activities.[94] They use this access to allow more accurate forecasts of equity market trends, which benefits fund owners. However, to the degree that they retain access by voting against management while doing so will increase company value, they do so at the detriment of all shareholders. Index fund advisors, which depend less on market pickers, will be less impacted by these disputes than active fund advisers.[95]

6. Fund Family Conflicts

Another type of dispute arises where funds run by the same adviser are in conflict with one another.[96] Consider a hypothetical merger of firms A and B. Assume that an investment advisor claims that the price offered by A for B is too poor.[97] This potentially causes conflicts of interest between funds that are evenly weighted in A and B (for which the price is irrelevant), funds that might be overweight in B (for which the price is a justification to resist the merger), and funds that are overweight in A. (for which the price is a reason to support the merger). Fundamentally, since active funds incur higher costs than index funds, advisors who run all forms of funds have an opportunity to favor active funds to the detriment of index funds.[98] Consider Amazon's latest purchase of online pharmacy PillPack.[99] The acquisition made the price of pharmacy stocks like

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[94] Susan Pulliam, *Analysts to Tell Congress That Skepticism Gets Them Abuse*, WALL STREET J., Mar. 19, 2002, at C1.

[95] Kahan and Rock, *supra note* 90 at 1810.

[96] Aneel Keswani, Anh Tran & Paolo Volpin, *Institutional Debt Holder Governance* 28-29 (European Corp. Governance Inst., Finance Working Paper No. 613/2019, 2020), https://papers.ssrn.com /sol3/papers.cfm?abstract_id=3282394 [https://perma.cc/D3XD-RSCQ]. Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS 175, 178-83 (2017). Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 32 (2019).

[97] Robert F. Bruner & Anna D. Buchanan, *The Merger Of Hewlett-Packard And Compaq (A): Strategy And Valuation* 9-10 (2004).

[98] Kahan, *supra note* 90 at 1811.

[99] *See* Matt Levine, *Profiting from Disruption Trades*, BLOOMBERG (June 29, 2018, 11:02 AM).

CVS, Walgreens, and Rite Aid rise dramatically.[100] Assume an active fund in a family that often has a significant index fund is overweight in Amazon and underweight in pharmaceutical stocks. Its portfolio manager also requested that the adviser vote the index fund's securities in favor of PillPack's takeover. The fact that the purchase will result in the decline of other stocks is irrelevant (or even joyful) to its portfolio manager. However, the index fund will own stock in both of those firms, and participants in that fund will lose as a result of the price decline. Take note of the subtlety of the problem: although Amazon's purchase of PillPack will harm index fund investors, it will have little impact on the index fund's relative performance relative to competing index funds — and hence will not harm the investment company's index fund competitiveness — but will boost the active fund's relative performance relative to other active funds. From this vantage point, managing an index fund may be a win-win situation for an advisor to active funds.[101] It increases an adviser's clout, which may be used to boost active fund returns and net fee revenue, and even if index fund returns fall, the index fund can remain competitive with other index funds.[102]

There are two fundamental approaches to resolving these conflicts: individually or structurally. If certain disputes occur, one may, for example, assign voting authority to the administrators of particular funds. This is Vanguard's policy about possible conflicts of interest within its funds.[103] For instance, some Vanguard funds voted in favor of the CVS-Caremark merger, while others voted against it.[104] Alternatively, as with Fidelity and Geode, one should assign voting on index fund

[100] Sharon Terlep & Laura Stevens, *Amazon Shakes Up Pharmacy Business— A $1 Billion Deal for Website PillPack Poses Direct Threat to the Industry*, WALL STREET J., June 29, 2018, at B1
[101] Kahan and Rock, *supra note* 90 at 1812.
[102] John Hechinger, *Fidelity Spins Off Geode Investors— Move Could Allay Concerns About Conflicts of Interest*, WALL STREET J., Aug. 5, 2003, at D7.
[103] Kahan and Rock, *supra note* 90 at 1812.
[104] *see* Patrick Dennis, Kristopher Gerardi & Carola Schenone, *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* 21 n.35, (Fed. Reserve Bank of Atlanta Working Paper Series, Working Paper No. 2019-15, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3423505 [https://perma.cc/TJ8A- 32MN].

shares to an individual firm.[105] Vanguard's strategy seems to be superior to Fidelity's for advisers of big index funds. Shareholders prosper together as advisors face substantial concrete incentives to vote wisely. Delegating voting rights to another body, on the other hand, eliminates direct rewards. By contrast, while material disputes are real, they do not occur regularly and may therefore be dealt with on an individual basis.[106]

B. Sovereign Wealth Funds Concentration

1. SWFs' Twisted Strategies

At a first glance it might be difficult to fathom why non-controlling equity investments by SWFs are contentious. By all means those investments accrue some benefits: they supply funds to the equity market recycling trade surpluses, thus reducing the cost of capital.[107] Not to mention the fact that equity investment is more stable, as compared to investment in debt, considering that its withdrawal does not provoke the same rowdy effects of a withdrawal from the debt market.[108]

On top of that, unlike in government debt, where once investments mature SWFs can elect not to reinvest, equity investments entangle funds in the well-being of the economies in whose corporations they invest: if anything happens, they still have to find a buyer to which sell the shares, and the SWFs themselves suffer the expense of any stock value drop. For the abovementioned reasons equity investments by SWFs are by all means a better way of investing trade surpluses. Furthermore, SWFs represent a fount of liquidity in situations when it is desperately required: as a

[105] Hechinger, *supra* note 102.
[106] Kahan and Rock, *supra note* 90 at 1813.

[107] Ronald J. Gilson & Curtis J. Milhaupt, *supra note* 27 at 1360.
[108] *See* Craig K. Elwell Et Al., *Congressional Research Service, Is China A Threat To The U.S. Economy?* 45 & n.80 (2007).

result of the capital erosion caused by the subprime loan crisis, U.S. commercial and investment banks have been provided with the needed capital that they would have had hard times finding available otherwise.[109]

All that being said, we might want to snoop into what could possibly be the real problem. According to the public controversy fomented by SWFs, the lack of transparency is the most prominent problem. Abu Dhabi, Qatar and China SWFs, which make some of the most significant stock investments, provide little to no information about their investing methods and holdings to the general public, as opposed to the Norwegian fund, which discloses both.[110] SEC Chairman Cox argues that the opaqueness of SWFs might conceal market injustices such as insider trading[111], this issue if pervasive could stir up the cost of capital by eroding investor confidence in the market. But by no means their opaque behavior can itself be the problem, ergo neither can increased clarity itself be the solution. All shareholdings are opaque unless a given jurisdiction imposes mandatory disclosures. [112]

In U.S., all those shareholders that detain five percent of the shares in a public company, or who aim to exert control over a company via a proxy battle or a tender offer are required to provide abrupt disclosure of the identity, mutual funds must provide periodic disclosure of their holdings.[113] On top of that, a compelling equity sale, even if below the 5% threshold, it is required to be immediately made public.[114] That was the case of Abu Dhabi SWF, which held stakes in Citigroup.

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[109] Gilson, *supra note* 27 at 1360.
[110] Lyons, *supra note* 28, at 20-21, 24, 27; *see also supra* note 31.
[111] *See* Kara Scannell, *Cox Cites Concerns over Sovereign Funds*, WALL ST. J., Oct. 25, 2007, at A8.
[112] Gilson, *supra note* 27 at 1360.
[113] Securities Exchange Act of 1934, §13(d), (f), 15 U.S.C. § 78m(d), (f) (2000); Securities Exchange Act of 1934, § 14(a), (d), 15 U.S.C. § 78n(a), (d) (2000).
[114] *See* Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11 (2008); Sec. & Exch. Comm'n, Form 8-K, General Instructions, *available at* http://www.sec.gov/about/forms/ form8-k.pdf.

Notwithstanding, for stockholders that possess below 5% of a company's shares there is no such requirement. For this reason, the equity holdings of the majority of the hedge funds have the same degree of transparency as that of SWFs. Regulations on disclosure in the EU and Asia are quite alike.[115]

SWFs distinguish themselves from other nontransparent shareholders in that they give raise to a different issue. Individuals hold diversified portfolios with shares in several public corporations, their wealth is affected by the performance of the company only to the extent of their holding in that very firm. All shareholders are mutually committed to profit maximization, what economist call the "unanimity principle". Notwithstanding, if there is one shareholder that can gain from the corporation activities in ways different from profit maximization, this unanimous commitment won't be such. For instance, let's suppose that a shareholder of a given company holds a restaurant near one of the company's manufacturing facility: that shareholder could possess a different perspective about the decision on whether or not closing that very factory, even if keeping it would translate in a bad business decision for the company.[116] Likewise, a SWF might have a secondary motive to hold a stake in a given company. An SWF might be interested in securing a technology or other know-how from a portfolio firm regardless of whether that action entails a dramatic reduction of the portfolio company's value, as the loss is shared by all shareholders while the potential gains amass in the hands of the SWF and its government.[117] The main concern with SWF is that their equity investments may come with strings attached: they might use their clout on portfolio companies to secure technology (as pointed out in the debate of the Abu Dhabi fund's

[115] Gilson, *supra note* 27 at 1361.
[116] *Id.*
[117] *Id.*

investment in AMD), obtain access to natural resources, or strengthen competitive advantages for local firms undermining national security for the country where the company is incorporated in.[118]Even though no one can have tangible evidence of such behavior, scholars take the rationale for such behavior acutely seriously.

III. ADRESSING INDEX FUND CONCENTRATION: LEGAL STRATEGIES

A. An alternative to Passive Fund voting

The main issue with passive investing is that index funds play a significant role in governance, unfortunately they have little to no incentive to maximize shareholders value through the clout they exert. Taken for granted that most likely investing in voting will result in substantial expenses for the fund, it's even more astonishing that they casted their votes. Fund managers think, erroneously, that SEC regulations require them to cast votes. Until the enactment of Investment Company Act of 1940, federal and state took a relatively hands-off approach.[119] But with the rise of institutional ownership and the consequent new governance dynamic, by the 1970s the SEC begun to deem right for investments funds to have fiduciary duties to vote their shares pursuant of the best interest of their beneficiaries.[120]

On January 23, 2003, in accordance with this belief, the SEC adopted a rule by which investment fund advisers, in corporate elections, are obliged to disclose their votes, as well as their voting

[118] *See Commission on the European Communities, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A Common European Approach to Sovereign Wealth Funds,* COM (2008) 115 final (Feb. 27, 2008). Press Release, U.S. Treasury Dep't, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (Mar. 20, 2008), *available at* http://www.ustreas.gov/press/releases/hp881.htm.
[119] *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1461–62 (2002).
[120] *Id.*

norms and procedures. The SEC provided: "the investment adviser to a mutual fund is a fiduciary that owes the fund a duty of . . . good faith. This fiduciary duty extends to . . . the voting of proxies relating to the fund's portfolio securities."[121]

All large asset managers, including the Big Three, deemed this rule as requiring to mandatorily cast the votes of all the shares of their portfolio companies and, as a result, they generally do so. The aforementioned clearly represents a misunderstanding. Freshly, the DOL made this clear in a case involving the application of ERISA fiduciary rules to the exercise of shareholder rights franchise[122]:

The fiduciary duties described at ERISA Sec. 404(a)(1)(A) and (B), require that, in voting proxies . . . the responsible fiduciary shall consider only those factors that relate to the economic value of a plan's investment and shall not subordinate the participants and beneficiaries to unrelated objectives . . . . *If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of . . . other restrictions, the fiduciary has an obligation to refrain from voting*.[123]

The SEC in an analogous fashion maintained: "We do not suggest than an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. *There may even be times when*

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[121] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239. 249, 270, 274).
[122] Lund, *supra note* 45 at 134.
[123] Supra note 102.

refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client."[124]

Basically, an institutional investor should weight the odds of casting a vote – including the cost of analysis and the risk that the vote could harm shareholders – and the supposed economic benefit attained with voting. Only If the balance is positive fund managers are required to cast their vote. If the inverse happens to be true, the duty is to not vote.[125]

It appears quite clear that, unless reliant on information obtained from an active fund manager that hold shares in the same company, the fund manager who cast its votes thoughtlessly would be most likely in breach of its fiduciary duties towards investors. Perhaps the SEC should emphasize once more that passive fund managers fail to fulfill their fiduciary responsibilities to investors when they recklessly cast their votes creating more expenses than benefits. By all means they would be more cautious when casting their votes. But surely that won't be enough to discourage such behavior as the fund might benefit from voting in two ways chiefly.[126] In the first place, since the fund would be seen as an active steward, they most likely would attract more clients, and thus more assets, notably from retirement funds or all those organizations that consider stewardship as critical. The above statement can be corroborated by the fact that the Big Three are increasingly trying to sell

[124] Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003) (codified at 17 C.F.R. pt. 275).

[125] *See* Charles M. Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, HAR V. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Apr. 6, 2010), https://corpgov.law.harvard.edu/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional- voting/

their supposed governance expertise, which means they deem relevant that feature for gaining clients. Voting, is the most cost-efficient way of showing their involvement in governance.[127]

Furthermore, if a fund were to abstain from voting, the market could perceive it as an indicator of poor quality, since other funds would continue to market their governance expertise. Basically, unless all index funds coordinated to give up their voting rights, it is plausible that there would be no room for any fund to voluntarily follow suit.[128]

Secondly, as an aftermath of fund's decision-making power in a firm, they hold a strategic position that might help them acquire another group of clients who might be interested: the corporations they are invested in. If the management of a company invests employee 401(k) assets in a given index fund, that institution would be more prone to cast pro management votes in proxy context.[129]

The above-mentioned are the main reasons why it is quite unlikely that index funds would refrain from casting their votes, if no legal intervention is put in place.[130]

1. Voting by Passive Fund Abolished

Passive funds could be restricted from voting, as a mechanism to curb this issue.[131] Simply speaking, to the law passive fund managers are just derivative holders, for what concerns voting.

[127] Lund, *supra note* 45 at 135.
[128] *Id.*
[129] *Id.*
[130] Gilson, *supra note* 27.
[131] To simplify compliance, the regulation would state that restricted shares would not be used in the denominator when calculating quorum or director election requirements. Additionally, the law does not encumber or devalue the shares—voting stock would retain the holder's ability to vote, although the passive institution would be prohibited from using

Because all index funds are marketed on the basis of their ability to follow an index, the legal rationale for such a law stems from the fact that any engagement in monitoring investee companies would result in an increase in costs for investors and they would find themselves in breach of fund's fiduciary duties. On the other hand, a reckless and automated voting pattern would as well most likely harm investors. A law refraining passive funds from thoughtlessly voting would make all parties better off.[132]

The rule could assume that are to be considered passive funds all those funds that use indexing as the main investment strategy. If the fund demonstrated that its strategy had carried out extensive portfolio company research, and the resources allocated to governance were above a determined threshold (depending on the size of the fund), that assumption could be eased to allow the passive fund be granted a "permission" for voting. That grant could also stem from the manifestation that the fund was granted information by actively managed funds holding shares within the selfsame corporation. In that case the index fund would have to demonstrate that the actively managed fund held a significant amount of shares in the company, and that it complied with the requirement for being granted a voting permission (i.e. analysis and investment threshold).[133]

Lastly, a passive fund could preserve the right of casting their votes if reflective of those of the other shareholders. That rule would be easily implemented as it implies little to no cost and would simply lift from passive funds the burden of governance, that has no benefits for their investors.[134] Moreover, they would overcome the coordination problem outlined above, and would most likely

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that right. Finally, the law may provide narrow exceptions to mitigate the possibility of corruption, such as granting voting privileges for company activities that would jeopardize the economic interests of passive investors.

[132]Lund, *supra note* 45 at 137.

[133] *Id.*

[134] *See* Alexandra Scaggs, *Investor Group to Exchanges: Stop Dual- Class Listings*, WALL ST. J. (Oct. 11, 2012, 12:29 PM), https://www.wsj.com/articles/SB10000872396390443749204578050431073959840.

favor such rule. In any case, if they were to increase their investments in governance, they could get back their permission to vote. The implementation of such rule would boost differentiation among funds and make the market more transparent, in fact investors could elect which kind of fund to put money in depending on the degree of governance they want. Higher level of governance would match with higher fees, but at least there would be more transparency. On the other hand, investors whose main purpose is to make steady returns could decide to invest in truly passive funds. The first by-product of this rule would be an abated prominence of thoughtless investors. This course of action, conversely, would preserve the role of active investors as they would be allotted a rise in voting power on a proportional basis.[135]

Even if voting is only one of the many tools that passive funds have at their disposal to exert influence, the enactment of this rule would increase active funds' bargaining power also behind the scenes. Finally, it would allow investors concerned in the long-term success of the company to help hedge fund activist secure successful campaigns. [136]

2. Introduce Direct Voting

A second suggestion would allow index funds' investors to cast their votes, for non-routine decisions, directly into the investee company by means of a phenomenon called "pass-through voting", instead of eliminating passive voting altogether.[137] This rule would translate in two main selection of investors controlling the funds' votes: retail shareholders and institutions as retirement funds. This would yield an effect similar to that of the first proposal, as retail shareholders would

[135] Lund, *supra note* 45 at 137-138.
[136] *Id.*
[137] See Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 888–89 (2009). Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 47–52 (1991).

face collective action problems and thus would most likely abstain from voting, while on the other hand institutions would be capable of casting votes in a thoughtful manner.[138] Fortunately, we already have some examples of pass-through voting, as in Employee Stock Ownership Plans participants to the plan have the right to vote.[139]

What's more is that, since there is a voting mechanism in place for index funds used for their own governance, the proposal may simply mandate index funds to share proxy information for portfolio businesses in the same way they provide information about their own firm. Of course, since passively management funds are a gathering of investments, mandating such a rule would be complicated both for the fund, that would be in charge of awarding the voting authorization for hundreds of businesses, and the investors that would like to be relatively hands-off. That's why the rule should apply solely to "non-routine" matters.[140]

The New York Stock Exchange (NYSE) already enables such a differentiation to be made, sure enough, on exceptional issues, brokers are unable to vote for shareholders., including director elections, proposals enacting some types of antitakeover provision overrides, eliminate supermajority voting requirements, proposals to disqualify the board of directors.[141]

In the same fashion, a pass-through voting rule could require that the right to vote for extraordinary matters would fall on investors. Since the passive fund would face some cost to implement that new rule, that mark-up could fall onto the investors, which in turn might find less appealing an

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[138] Press Release, SEC, Ensuring the Proxy Process (Feb. 19, 2015), https://www.sec.gov/news/statement/021915-psclaa.html.
[139] *See* 26 U.S.C.S. § 409(e)(2) (approved 1/10/2018).
[140] Lund, *supra note* 45 at 138.
[141] *See* N.Y.S.E. Manual Rule 452 (CCH) ¶ 2452 (2013). *NYSE Information Memo 12-4, Application of Rule 452 to Certain Types of Corporate Governance Proxy Proposals*, NYSE REGULATION, http://www.lexissecuritiesmosaic.com/gateway/nyse/info-memos/12-4.pdf.

index fund compared to an actively managed fund. There would be hence an additional benefit: a contraction in the assets migrate from actively managed funds to index funds.[142]

3. Introduce Direct Voting by Default

Another proposal would be mandating a pass-through voting on non-routine matters, but with investors being allowed to reassign the proxy back to the fund.[143]

As an aftermath of this rule competition would result strengthened and governance activity among passive funds would experience a differentiation process. Some index funds might actively monitor and analyze their portfolio companies. They would appeal to clients by selling themselves as being governance experts, thus attracting also their votes. They may also specialize in a certain field and demand larger fees than true passive funds, but nonetheless attract investors for whom governance matters, notwithstanding the mark-up.[144]

If this appears farfetched to you, look at the modest success of CSR funds, which attract investors on the ground of the criteria through which they select their portfolio companies, that are mainly environmental.[145]

Some investors might be interested just in low-cost diversification, for them would be possible investing in passive funds that conduct a passive approach also for what concerns governance.

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[142] Lund, *supra note* 45 at 138.
[143] The regulation must be written in such a manner that funds could not circumvent it by including a standard provision in any equity purchasing agreement reassigning voting rights to the fund managers. For instance, the law may enable investors to actively delegate voting rights.
[144] Lund, *supra note* 45 at 139.
[145] *Does Socially Responsible Investing Make Financial Sense?*, WALL ST. J. (Feb. 28, 2016, 10:18 PM), http://www.wsj.com/articles/does-socially-responsible-investing-make-financial-sense-1456715888.

Those investors who elect to invest in such funds would probably keep their right to vote and abstain from voting.[146]

This rule would make uninformed votes less likely to be cast. This rule would abate the influence of thoughtless voting by index funds in stewardship, but still keep informed investors' voices alive. There are additional benefits, since this would also highlight the benefits provided by active funds as compared to passive funds. Market transparency would be enhanced, as there will be a clear distinction between funds that provide governance expertise and funds that simply provide low-cost differentiated investments that secure stable market returns.[147] It would benefit active funds, because they would attract more investors in light of their heightened governance, and also discourage the phenomenon by which passive funds take advantage of active funds' investments in stewardship.[148]

At a first glimpse, these changes in rules might appear as a too radical change from the system of shareholders democracy. Commonly, associated with a common stock share there is not only the right to receive dividends, but also the right to cast votes, whose magnitude depend on the number of shares in possession. While every citizen in a parliamentary democracy has the constitutional right to vote, shareholder democracy works differently. Voting rights are allotted on the ground of

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[146] *See* Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 4–5 (2006).

[147] Lund, *supra note* 45 at 140.

[148] Another significant advantage of limiting the voting rights of uninformed and unmotivated owners is that it discourages them from voting. Delaware courts have gradually favored company actions approved by a plurality of disinterested owners.For example, *in Corwin* v. KKR Financial HoldingsIf such shareholder consent is given, the Delaware Supreme Court ruled that transactions subject to heightened inspection under *Revlon* would be checked under the corporate decision clause. 125 A.3d 304 (Del. 2015). This judgment was partially explained by the reality that public utilities are owned by sophisticated financial owners who have "an actual economic stake in the outcome." *See* Ian Ayres*, Menus Matter,* 73 U. CHI. L. REV. 3, 4–5 (2006).
However, for the purposes mentioned previously, passive fund voting creates organization challenges, challenging the argument that courts can defer to votes-based decisions.

the number of shares in one possession: the more the shares, the greater the voting power.[149] What's more is that, over the last century, the law has permitted companies to move away from the default rule (one share, one vote) and even remove voting rights from some classes of shareholders.[150]

It was created as a safeguard for claimants who were still owed money., afterwards has been deemed as adequate because the power is allotted on the basis of who has the best incentives to make the most of their vote in order to increase shareholder value.[151] Broadly speaking, voting is material to corporate welfare only, and the deprivation of the right to vote for uninformed shareholders is principled, because doing so would be beneficial to firm efficiency.[152]

But who are the players that could turn these proposals into law? One of the main functions of SEC is to regulate the proxy process, hence the agency could do the trick. Unfortunately, in 1990 SEC tried to adjust significant voting right but was hindered by the D.C. Circuit.[153]

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[149] Lund, *supra note* 45 at 140.

[150] State law today traditionally allows companies great latitude in allocating voting rights: almost all state corporate codes follow the default rule of one vote per common share but enable corporations to deviate from the standard.*See* Stephen Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights* 5 (UCLA Sch. of Law Research, Paper No. 07-16, 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=985707 [hereinafter Bainbridge, *SEC Authority*]; DEL. CODE ANN. tit. 8, § 151 (1953) (permitting a company to have several groups of stock with the privileges, powers, and interests specified in the certificate of incorporation or by the board, whether the certificate confers the authority on the board). Numerous companies circumvent the one-share-one-vote law by the use of dual class capital arrangements that are consistently enforced by courts. Indeed, restrictions on shareholder voting privileges predate the business form. Prior to the introduction of general incorporation laws in the mid-1800s, company charters issued by legislators used a variety of voting mechanisms. Some adopted a one-vote-per-share policy, while others restricted the voting privileges of major shareholders, for example, by capping the amount of votes that any one shareholder could cast. Bainbridge, *SEC Authority*, at 4. By the early 1900s, the vast majority of US companies had adopted the default norm of one vote per unit, allowing corporations to deviate from the legislative requirement. Ayres, *supra note* 129 at 5. During this era, the modern practice of restricting preferred stock's voting rights became widespread. Ayres, *supra note* 129 at 5. Additionally, businesses started issuing non-voting common stock—at least 288 corporations distributed non-voting or restricted voting privileges shares between 1927 and 1932. (which was almost half of the total number of such issuances).Ayres, *supra note* 129 at 7.

[151] *See, e.g*., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure Of Corporate Law* 63, 67 (1991).

[152] *See* Richard A. Posner, *Judicial Autonomy in a Political Environment*, 38 ARIZ. ST. L.J. 1, 5 (2006); Dmitry Bam, *Voter Ignorance and Judicial Elections*, 102 KY. L.J. 553 (2013); Charles Gardner Geyh, *Why Judicial Elections Stink*, 64 OHIO ST. L.J. 43, 52 (2003).

[153] *See* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

During the 1980s, the SEC adopted Rule 19c-4 in response to companies increasing awareness of dual class stock usefulness to defend against hostile takeover bids. The aforementioned rule forbade the issuing of securities or undertaking of any other corporate action resulting in quashing, curbing, or significantly abating the voting power of existing shareholders.[154] The Securities and Exchange Commission (SEC) introduced a new regulation to each national securities exchange and securities association's listing requirement.[155] The SEC had deemed having the power to enact the regulation according to Securities Exchange Act § 19(c), which allows SEC to alter exchange regulations as long as the change promotes the Act's objectives. The SEC maintained that § 14(a) epitomized the aim of safeguarding stockholders democracy. The D.C. Circuit dissented, ruling that § 14(a) did not provide for the right to regulate significant aspects of shareholder voting, SEC could only control how proxy solicitations are carried out, as well as proxy voting transparency.[156]

The decision was not reviewed by the Supreme Court, but there was a legal precedent, that had made clear Court's position on the matter, according to which corporate voting right were state concern only. As explained In *CTS Corp. v. Dynamics Corp*., "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[157]

Consequently, it is improbable that the Supreme Court would endorse the enactment of a law, carried out by the SEC, involving shareholders voting privileges. But the Securities Exchange Act's inclination toward stockholders democracy is meant to cushion against the "control of great

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[154] *See* Stephen Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights* 5 (UCLA Sch. of Law Research, Paper No. 07-16, 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=985707.
[155] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1290–92 (2008).
[156] Bus. Roundtable, 905 F.2d at 408.
[157] CTS Corp. v Dynamics Corp. of Am., 481 U.S. 69, 89 (1987)

corporations by a very few persons."[158] On the other hand, the distribution of voting rights on a level playing field might enhance the sway of a handful of index funds and thus represent something harmful for the economy. Here is where the federal government should intervene. Since a corporation by no means would deliberately rectify their certificates of incorporation to restrict a significant part of the shareholders to cast their votes, the only option available would therefore be a federal intervention. That's because states would not favor such decision, as it would cause large institutional investors to incorporate in other states.[159]

B. *Reconsidering Sovereign Wealth Funds' voting*

1. Suspension of Votes as a Minimalistic Solution

The solution to SWFs' investments with a twisted purpose, or to those who are most likely to carry out an opportunistic behavior should circumstances change in the future, is quite simple, at least conceptually. Strategic investments should be limited, but traditional investments should remain unaffected. SWFs' are no different from traditional investments, in that they share the same interests and provide the same contributions. On top of that SWFs, as we saw earlier, provide some important macroeconomic benefits. The course of action to be taken seems clear. What is still to be determined is its feasibility. Since SWF's investment rationales are quite opaque, notwithstanding the degree of their formal disclosure, conceiving a minimalist regulation is utterly arduous.[160]

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[158] SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).
[159] Lund, *supra note* 45 at 141.
[160] Ronald J. Gilson & Curtis J. Milhaupt, *supra note* 27 at 1361.

Suppose that an SWF affirms, in accordance with a new NGO-promulgated code of best practices, that is completely independent from its government owner. By all means this statement would find you skeptical. Even if the SWF was truly independent in the first place, this would hold true only to the extent of government willingness to let it be.[161] It seems quite implausible that an investment manager of China Investment Corporation or Singapore's Temasek would ever remain impassive to a senior government official's "advice" on how to handle a specific investment to further country's progress, but to the detriment of the portfolio company.[162]

That's why, mandating or encouraging enhanced transparency through codes of best practices it's not the right course of action: it doesn't address the real problem.[163] SWF enhanced transparency doesn't give us any clue on their real purpose. Conclusively, not only requiring more transparency is ineffective, but it might discourage government controllers of SWFs and likely cause divestments from developed countries. The governance principles sought by the US, EU, and IMF for SWFs are directly related to a government's ability to control its own properties and entities.[164]

It's a little simplistic to call the proposed codes voluntary. The SWF disclosure strategy is derived on the European comply or disclose strategy, which implies that if a business does not comply, the market will implement the voluntary requirements. If the noncomplying party is an SWF, however, the portfolio company's government is the only possible compliance agent. Thus, either the new

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[161] *Id.*
[162] We are not implying that individual foreign governments or foreign governments in general wield significant control on economic actors. Both governments wield this power. Recall that only one telephone firm in the United States failed to cooperate with a National Security Agency subpoena for consumer phone call information in the name of national security—a request with a dubious legal basis and for which Congress was unsuccessfully requested to grant retroactive immunity. Without objection, the three biggest telephone providers handed over their consumers' call logs.*See* Leslie Cauley, *NSA Has Massive Database of Americans' Phone Calls*, U.S.A. TODAY, May 11, 2006, at 1A.
[163] Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFF., Jan./Feb. 2008, at 119.
[164] Gilson, *supra note* 27 at 1361.

guidelines are completely unenforceable or they translate in a gross violation of the SWF's country owner's sovereignty.[165]

As a result, we arrive at a response that is focused on corporate governance. The set of processes that control how a corporation takes decisions is referred to as Corporate governance. They encompass administrative processes and operating routines, as well as the prescribed protocols defined in state corporate laws as expanded in legal rulings by the company's state of incorporation's courts. As a result, the stewardship scheme often serves as the framework by means of which an SWF investor must focus its energies in order to persuade the company in its portfolio to behave in the SWF's best interests, rather than the corporation's. In critical situations, the institutional aspects of corporate governance are crucial.[166]

Also nonlegal, informal components may exist under the shadow of constitutionally mandated decision frameworks. Assume that senior executives of a company oppose attempts by a major SWF stockholder to control the company’s actions in a way that benefits the SWF, such as by failing to approve a transfer of technology agreement with companies subject to the SWF's judicial authority. In this scenario, the SWF stockholder can move to get the disobedient managers replaced by the board of directors. When that fails, the SWF will aim to convince additional stockholder to accompany it in replacing the board. Ergo, an SWF's unofficial control is conclusively contingent on its official clout—the number of shares in its possession. If an SWF shareholder's power is contingent on the freedom to cast votes through its stock, the logical approach to discourage tactic

[165] *Id.*
[166] *Id.*

behavior—mannerisms that favors the SWF or its real owner in manners that do not favor other shareholders equally—is to refrain SWF from voting.[167]

Shares in publicly traded firms in the United States obtained by an SWF will forfeit their voting privileges (or be voted automatically in the same percentage as non-SWF shareholders' votes).[168] Naturally, the anticipated opposition to excluding voting privileges from SWF-held stock is that it would abate the value of the securities—non-voting shares are less valuable than voting shares. This statement contributes to the conclusively erroneous belief that this suggestion is protectionist since it devalues overseas SWF shares.[169]

The dilemma is compounded by the inability to correctly observe an SWF's investment motivations; without further information, the plan fails to effectively navigate the divide between strategic and non-strategic investors. Since an SWF's assertion according to which it functions without its sovereign owner or that it pursues just non-tactic investment objectives is unplausible, the deprivation of voting privileges would extend to all SWFs, even though the majority of SWFs pursue only conventional investment objectives (or the strategic option's importance to the individual SWF—say, Norway—is negligible). The logic goes that this would deter all Sovereign Wealth Funds from buying, not just those with ill-intentioned political objectives; all Sovereign Wealth Funds would be required to disburse a premium price for voting stock in exchange for receiving unvaluable, non-voting shares. One might imagine the critical benefits of SWF capital reinvestment to be jeopardized as a result. [170]

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[167] *Id.*
[168] Council Directive 2004/25, art. 11, 2004 O.J. (L 142) 12.
[169] Gilson, *supra note* 27 at 1361.
[170] *Id.*

This is far from legislative minimalism, and this approach would be impractical if it stopped there. This issue may be resolved by suspending the voting privileges of SWF-owned securities. But, once the SWF sells the securities to a non-government related third party, the shares recover their voting privileges. From this standpoint, an SWF purchases voting shares and disposes of voting shares. As a result, the SWF's right to trade voting shares, tender voting stock in a tender bid, or dispose of a cluster of voting stock, if anyone willing to buy them, will be unaffected. The lack of voting power during the SWF's ownership of the shares—that is, the SWF's inability to utilize the official and unofficial structures of stewardship for tactic purposes— only serves to distinguish between SWFs with tactic objectives, whose contribution should be hindered, and SWFs with solely investment objectives, whose contribution should be promoted. Most importantly, from a legislative minimalism standpoint, removing voting privileges for SWF-held securities avoids the need for an institutional assessment of an SWF's investment intentions, which might include the apparent inconvenience associated with forcing national governments to protect their stock market investments in an operation undertaken by another jurisdiction. Rather than that, suspension of voting leads in self-enforcement by SWFs., since the law creates a splitting state of balance: all Sovereign Wealth Funds that prioritize tactic value will actually refrain from investing, while those SWFs who, like other investors, are merely involved in value investing will remain unaffected. What's more is that, in contrast to the proposed standards of best practices, vote interruption would not exclude a sovereign nation from managing its properties or institutions in any way.[171]

[171] *Id.*

4. CONCLUSION

The rise of the Big Three, and index fund advisors in general, corresponds with a significant shift in the ownership structure of the world's biggest companies. Corporations became accustomed to a division between ownership and power in the mid-nineteenth century. During this time span, courts (particularly Delaware courts) played a critical role in corporate governance, ensuring that directors' priorities were matched with those of shareholders and attempting to minimize the agency cost associated with delegation of authority. Nowadays, the biggest index fund advisors along with sovereign wealth funds, are also the largest shareholders in great majority of the listed companies.

As data indicates, the Big Three mostly vote in favor of management proposals. Surely, the Big Three's stewardship committees are incapable of "truly" devoting the same level of commitment to all portfolio firms. For example, under Blackrock's stewardship, 30 individuals are responsible for overseeing corporate governance matters at approximately 17,000 businesses and voting at approximately 17,000 shareholder meetings per year.

At some stage, their inadequacy of voting records drew regulatory attention, prompting the "SEC" to enforce a rule forcing index funds to report all of the casted votes.

Additionally, the "SEC" mandated that index fund advisers have a fiduciary responsibility to vote proxies for investors in their customers' best interests. As a consequence of this policy's implementation, all State Street and Vanguard funds exhibit a dramatic degree of consistency with their voting patterns; in 2015, only 195 out of 100,000 of proposals at State Street had a fund vote in a different way compared to its other funds; at Vanguard, only 6 out of 100,000 (0.006 percent) of propositions had a fund vote differently than its other funds.

Furthermore, ownership has grown so concentrated that, in a hypothetical disagreement between two S&P 500 businesses in 2005, retail investors would typically own 15% of the shares in either company, preferring the other side to prevail. As an aftermath of cross-ownership, value-destroying transactions can be conducted. Another problem is that indexed funds can raise assets under management, rather than by decreasing fees and reducing margins, by establishing and sustaining a close relationship with their primary source of corporate 401(k) assets: management. Furthermore, these index fund supporters will expect to persuade management to use other sponsor-provided services. Conflicts of this kind often influence institutional voting practices, going against shareholders' best interests.

Then again, index funds may partake in environmentally friendly practices that harm the portfolio business. For example, it may be seen as a justification for enhancing BlackRock's corporate image, selling its funds, or evading regulatory scrutiny. Advisors' preferences conflict with that of at least some of their fund customers to the extent that they make recommendations or vote in ways that reduce company’s value for reputational or marketing purposes.

A further form of conflict occurs as funds managed by the same adviser clash with one another. Consider the potential case of a merger between two companies. Even if the transaction is detrimental to a passive fund but favorable to an active fund, advisors that manage both types of funds have an incentive to favour the latter.

Finally, a Sovereign Wealth Fund could have a secondary reason for investing in a particular business. An SWF might be involved in acquiring technologies or other skills from a portfolio company even though doing so results in a significant drop in the portfolio company's valuation,

since the loss is borne by all shareholders whilst the SWF and its government amass the future profits.

I firmly deem that depriving those gigantic funds of their voting power would abate both their formal and informal dominance, thus quashing all the possible conflicts of interest. Although some academics may contend that corporate law has shifted away from its traditional position in corporate governance[172], this is not the case. Indeed, the corporate structure has evolved over time, resulting in the disappearance of certain conflicts of interest but the emergence of others. In my view, and as evidence suggests, although this re-concentration can have a number of advantages, including resolving the action crisis that modern corporations have encountered since the 1930s, it can also prove critical. Courts can play a pivotal position in responding to the new business conditions now more than ever. Corporate law is not really dead[173], it has only become obsolete in light of the modern business structure and has struggled to achieve the original objective of reducing agency costs. The market will still change, and new agency relationships will emerge, as conflicts of interest are inextricably linked to corporations. As a result, corporate law must move as quickly as the economy. Stock pickers profit from such partnerships because they enable them to get answers to their questions in public forums and to get knowledge privately that might not be legally significant on its own but aids in filling in holes in their perception of the firm's activities.

[172] Goshen, *supra note* 1.
[173] *Id*.

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