Opportunism in the Shareholder Voting and Engagement of the "Big Three" Investment Advisers to Index Funds

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The Big Three investment advisers to index funds (BlackRock, Vanguard, and State Street) need to be understood as agents of those who invest in the mutual funds and exchange-traded funds they manage. They are not institutional investors—the role performed by the funds they manage—but investment advisers. As such, they are agents, prone to acts of opportunism like other agents. Corrective measures are required to discourage their opportunistic behavior. To mitigate such behavior, this Article proposes both a market solution and the use of fiduciary duties.

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INTRODUCTION

The dominance of institutional investors in our domestic stock markets is a well-known phenomenon. It has been reported that institutional investors such as pension funds, mutual funds,[1] exchange-traded funds (ETFs),[2] endowment funds, etc., currently own approximately 70% of the market value of U.S. publicly traded equities,[3] compared to just 6% in 1950.[4]

A major reason for this dominance has been the changing preferences of the retail investor. The retail investor, "an individual investor who buys and sells securities for his or her personal account, and not for a company or organization,"[5] now prefers to invest in

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1. According to the Securities and Exchange Commission (SEC):

> A mutual fund is an SEC-registered open-end investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined securities and assets the mutual fund owns are known as its portfolio, which is managed by an SEC-registered investment adviser. Each mutual fund share represents an investor's proportionate ownership of the mutual fund's portfolio and the income the portfolio generates.

OFF. OF INV. EDUC. & ADVOC. U.S. SEC. & EXCH. COMM'N, MUTUAL FUNDS AND ETFS: A GUIDE FOR INVESTORS 4 (2016), https://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [https://perma.cc/HLG7-3LNF].

2. According to the SEC:

> ETFs are SEC-registered investment companies that offer investors a way to pool their money in a fund that makes investments in stocks, bonds, other assets or some combination of these investments and, in return, to receive an interest in that investment pool. Unlike mutual funds, however, ETFs do not sell individual shares directly to, or redeem their individual shares directly from, retail investors. Instead, ETF shares are traded throughout the day on national stock exchanges and at market prices that may or may not be the same as the NAV of the shares.

Id. at 6.

3. BROADRIDGE & PWC, PROXYPULSE: 2020 PROXY SEASON REVIEW 4 (2020), https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2020-review.pdf [https://perma.cc/Z3LG-9MG3].

4. MATTEO TONELLO & STEPHAN RABIMOV, CONF. BD. GOVERNANCE CTR., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 tbl.10 (2010), http://www.shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf [https://perma.cc/37VP-BEU3].

5. INV. CO. INST., 2021 INVESTMENT COMPANY FACT BOOK 318 (2021), https://www.ici.org/system/files/2021-05/2021_factbook.pdf [https://perma.cc/825E-5JUB].

"actively managed" equity funds or "passively managed" equity index funds, instead of spending the time and resources necessary to self-manage a portfolio of individual stocks held in a brokerage account[6] or perhaps even in the form of paper certificates.[7] This preference has created a significant "separation between ownership and control of financial wealth."[8] According to the *Investment Company Fact Book*, "retail investors (i.e., households) held the vast majority (89 percent) of the $23.9 trillion in US mutual fund net assets at year-end 2020."[9]

This "delegation of asset management"[10] has given rise to an equities market dominated by just five investment advisers: The Vanguard Group, Inc., BlackRock, Fidelity, American Funds, and State Street Global Advisors.[11] As of July 2021, Vanguard was reported to have under management $6.8 trillion in U.S. equities; BlackRock $2.65 trillion; Fidelity $2.4 trillion; American Funds $2.2 trillion; and State Street $970 billion.[12] In total, the "Big Five" investment advisers managed approximately $15 trillion in U.S. equities,[13] or roughly 30% of the total U.S. stock market value.[14]

Moreover, these investment advisers contract with mutual funds and ETFs to not only provide portfolio management services but also to be responsible for shareholder voting.[15] This industry practice has allowed for the parallel concentration of shareholder voting into the hands of these five investment advisers.

A. The Power of the Big Three

Of the five large investment advisers mentioned above, this Article specifically focuses on those three advisers who dominate the index fund sector: Vanguard, BlackRock,

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6. *Id.* at 38 ("US-registered investment companies play a major role in the US economy and financial markets, and a growing role in global financial markets. These funds managed nearly $30 trillion in total net assets at year-end 2020, largely on behalf of more than 105 million US retail investors.").

7. It is still possible to own stock in paper form. Matt Lee, *Stock Certificates Have Gone with the Winds of Change*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/06/stockcertificate.asp [https://perma.cc/ZM9M-T6PH].

8. COMM. ON THE GLOB. FIN. SYS., BANK FOR INT'L SETTLEMENTS, INCENTIVE STRUCTURES IN INSTITUTIONAL ASSET MANAGEMENT AND THEIR IMPLICATIONS FOR FINANCIAL MARKETS 17 (2003), https://www.bis.org/publ/cgfs21.pdf [https://perma.cc/DS94-8G6D].

9. INV. CO. INST., *supra* note 5, at 68.

10. COMM. ON THE GLOB. FIN. SYS., *supra* note 8, at 18.

11. Oisin Breen, *Suddenly Vanguard, BlackRock, State Street Not Only Have the Assets but the Power of ESG Mandates, Which Make Them a Growing Threat to Shareholder Democracy, Critics Say*, RIABIZ (July 28, 2021), https://riabiz.com/a/2021/7/28/suddenly-vanguard-blackrock-state-street-not-only-have-the-assets-but-the-power-of-esg-mandates-which-make-them-a-growing-threat-to-shareholder-democracy-critics-say [https://perma.cc/WL7D-5LTJ].

12. *Id.*

13. *Id.*

14. As of September 30, 2021, the total value of the U.S. stock market was approximately $48.6 trillion. *See Total Market Value of the U.S. Stock Market*, SIBLIS RSCH. LTD., https://siblisresearch.com/data/us-stock-market-value [https://perma.cc/6ZS8-VBWN]. This domination of the U.S. equities markets is consistent with what John C. Coates predicted in his 2018 article. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harv. Pub. Working Paper No. 19-07, 2018) ("[C]ontrol of most public companies – that is, the wealthiest organizations in the world, with more revenue than most states – will soon be concentrated in the hands of a dozen or fewer people.").

15. COMM. ON THE GLOB. FIN. SYS., *supra* note 8, at 18.

and State Street (the Big Three).[16] This focus is warranted because of their significant representation in the shareholder voting of those companies that make up the S&P 500, a market-value weighted compilation of the common stock issued by five-hundred companies that are considered to represent blue-chip America, i.e., "the most significant large-capitalization firms in the leading US industries."[17] The S&P 500 represents approximately 83% of the total value of the US stock market.[18]

As of year-end 2019, even though domestic equity index funds held only 14% of the value of U.S. stocks,[19] the Big Three collectively managed, on average, 21.4% of the shares of those companies that make up the S&P 500, and each managed positions of 5% or more in more than 95% of those companies.[20] This overrepresentation is primarily a result of the equity index fund investor having a preference for the S&P 500 index[21] as well as the Big Three having delegated voting authority for a smaller but still significant amount of actively traded equity funds under management.[22]

However, the Big Three's voting power is even greater than the percentage of shares they manage since they have a much greater propensity to vote their shares relative to those retail investors who hold their shares directly.[23] This explains Lucian Bebchuk and Scott Hirst's 2019 findings that, while on average the "Big Three" index fund managers controlled 21.4% of shares of the companies that make up the S&P 500, they cast a combined 23.5% of the proxy votes.[24]

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16. A stock market index fund is a mutual fund or ETF "in which the fund manager's goal is to track some underlying [stock market] index as closely as possible." *See* Adriana Z. Robertson, *The (Mis)Uses of the S&P 500*, 2 U. CHI. BUS. L. REV. 137, 141 (2023).

17. Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. ON REG. 1, 18–19 (2013).

18. *The Gauge of the Market Economy*, S&P DOW JONES INDICES (2018), https://investorsheritage.com/app/uploads/2020/09/sp-500-brochure.pdf [https://perma.cc/M7EK-QYAF].

19. INV. CO. INST., *supra* note 5, at 50.

20. Lucian Bebchuk & Scott Hirst, *Big Three Power, and Why It Matters*, 102 B.U. L. REV. 1547, 1558 (2022). It has been reported that the collectively held number has since grown to 22%. *See* Sam Potter, *BlackRock-Led 'Big Three' May Forestall Chaos in Stock Markets*, BLOOMBERG NEWS (July 20, 2021), https://www.bloomberg.com/news/articles/2021-07-20/blackrock-led-big-three-may-forestall-chaos-in-stock-markets [https://perma.cc/833H-NBYK].

21. For example, as of December 31, 2020, S&P Global reported that over $5.4 trillion of investment assets were tied to the S&P 500 index, representing approximately 73% of all assets tied to the universe of S&P indices ($7.47 trillion). *See Annual Survey of Assets as of December 31, 2020*, S&P DOW JONES INDICES (2020), https://www.spglobal.com/spdji/en/documents/index-news-and-announcements/spdji-indexed-asset-survey-2020.pdf [https://perma.cc/KB46-FLTT].

22. Bebchuk & Hirst, *supra* note 20.

23. Alon Brav, Matthew D. Cain & Jonathan Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 19, 2019), https://corpgov.law.harvard.edu/2019/11/19/retail-shareholder-participation/ [https://perma.cc/6K25-ST8H] ("On the decision whether to cast a ballot, we find that retail shareholders cast 32% of their shares, on average, which is significantly lower than the 80% rate of participation by the entire shareholder base."). According to a report from Broadridge and PwC, during the 2020 proxy season, institutional investors voted 92% of the shares they held while retail investors only voted 28% of the shares they owned. *See* BROADRIDGE & PWC, *supra* note 3, at 5.

24. Bebchuk & Hirst, *supra* note 20, at 13. Bebchuk and Hirst also estimated that Vanguard had an average voting influence of 10.3%, BlackRock 8.3%, and State Street 4.7%. *Id.* Consistent with Bebchuk and Hirst, Caleb Griffin finds that, while the Big Three control approximately 20.1% of shares at the 250 largest publicly traded

B. *The Issue*

It goes without saying that the creation of the index fund, whether in the form of a mutual fund or ETF, will go down as one of the greatest innovations in financial history. Index funds allow tens if not hundreds of millions of unsophisticated and uninformed stock market investors the opportunity to earn market returns and diversify away unsystematic risk at a very low cost.[25] There is, however, a downside to index fund investing. The current structure of index fund management creates the potential for significant *opportunism*[26] on the part of the Big Three.

The potential for *opportunism* begins when the Big Three contract with mutual funds and exchange-traded funds (ETFs) to manage their indexed portfolios.[27] These investment funds are the shareholders.[28] The Big Three's role is limited to that of an adviser.[29] Moreover, the Big Three do not contract with retail investors or any other type of investor in the index funds themselves.[30] These contractual arrangements result in an *agency relationship*[31] between the Big Three and the beneficial investors of those funds.

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companies in the United States, they cast a combined 25% of the proxy votes. Caleb N. Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals*, 73 SMU L. REV. 409, 418 (2020).

25. In theory, the financial performance of an index fund, assuming the index it uses accurately tracks the market it is meant to represent, should be quite satisfactory for most investors. This positive perspective begins with two assertions that make up what is referred to as William Sharpe's "equality": "(1) before costs, the return on the average actively managed dollar will equal the return on the average *passively managed* dollar and (2) after costs, the return on the average *actively managed* dollar will be less than the return on the average passively managed dollar." William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7, 7–9 (1991) (emphasis added).

26. According to Oliver Williamson, "Opportunism corresponds to the frailty of motive 'which requires a certain degree of circumspection and distrust' in the transaction cost economics scheme of things." Oliver E. Williamson, *Opportunism and Its Critics*, 14 MANAGERIAL & ECON. SCIS. 97, 97 (1993). Moreover, Williamson goes on to say that the term *opportunism* allows us to understand in somewhat less technical terms what economists are really talking about when discussing adverse selection, moral hazard, and more:

> Opportunism is a less technical term than adverse selection and moral hazard. It suggests, correctly, that the troublesome behavior in question is not an arcane economic condition but is familiar and pervasive. Not only are the failures to self-disclose true attributes *ex ante* (adverse selection) and true performance *ex post* (moral hazard) both subsumed under opportunism, but the failure to tell the truth, the whole truth and nothing but the truth is implicated by opportunism. The possibilities that economic agents will lie, cheat and steal are admitted. The possibility that an economic agent will conform to the letter but violate the spirit of an agreement is admitted. The possibilities that economic agents will deliberately induce breach of contract and will engage in other forms of strategic behavior are admitted. More generally, the unapologetic reference to opportunism invites attention to and helps to unpack a much wider set of phenomena than normally arise when reference is made to adverse selection and moral hazard.

Id. at 101.

27. Bernard Sharfman, *The Relationship Between BlackRock and Retail Investors*, REALCLEARMARKETS (Jan. 26, 2022), https://www.realclearmarkets.com/articles/2022/01/26/the_relationship_between_blackrock_and_retail_investors_813783.html [https://perma.cc/BR6M-XX6X].

28. *Id.*

29. *Id.*

30. *Id.*

31. Jensen and Meckling "define an agency relationship as a contract under which one or more persons (the

Of critical importance is the industry practice of delegating shareholder voting authority to the investment advisers of mutual funds and ETFs.[32] This creates the potential for the Big Three to act *opportunistically*, utilizing their large amounts of delegated voting authority as a means to maximize the profitability of their own investors or the utility of their executive management and not necessarily those of the index funds they manage. The realization of this potential can be referred to as the "agency costs of agency capitalism."[33]

The *agency relationship* that the Big Three have with the beneficial investors of index funds—the millions of retail investors who use index funds to finance their retirements—also forms an ethical and legal relationship between them. This is the result of the Big Three being entrusted with assets that index-fund investors beneficially own. This puts the Big Three in the role of fiduciary, with duties to act in the best interests of those investors.

The identification of the Big Three as agents and fiduciaries of the funds' beneficial investors is a central theme of this Article. Moreover, the Big Three are uniquely positioned to maximize their ability to act opportunistically because each utilizes an investment stewardship team to coordinate the voting and engagement of their fund families.[34] For example, a team can systemically integrate many of its adviser's own interests into its voting and engagement activities: the need to successfully implement its millennial marketing strategy;[35] the strategy to maximize its government support and thereby minimize regulatory risk;[36] the strategy to increase the market share of private pension fund assets held under management at their portfolio companies;[37] and the strategy to appease its own activist shareholders.[38] Such actions do not have the focus of being in the best interests of those who invest in the funds they manage.

While this Article is meant to apply to all types of Big Three opportunism in the context of voting and engagement, its focus will be on the opportunism associated with

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principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." *See* Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

32. The industry practice of delegating shareholders voting authority to the Big Three creates the "decoupling" or "unbundling" of voting interests from economic interests and is referred to as "empty voting." *See* Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 BUS. L. 347, 355 (2015).

33. This is a term first used by Gilson and Gordon to discuss the disincentives that some investment intermediaries, like mutual funds, have, relative to activist hedge funds, in actively monitoring portfolio company performance. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889–95 (2013). For purposes of this Article, the application of this term can be understood to include all agency costs generated by investment advisers to index funds. *See generally* Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1 (2019).

34. Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2076–86 (2019).

35. *See generally* Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020).

36. Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. 77, 86–87 (2022).

37. *Id.* at 88–89; *see generally* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007) (illustrating an empirical study of the variations in mutual fund voting with client versus non-client firms).

38. Sharfman, *supra* note 33, at 16.

their millennial marketing strategy.[39] The successful implementation of this strategy, as reflected in an increased market share of a U.S. stock market valued at approximately $50 trillion,[40] provides an opportunity for a Big Three member to potentially acquire over time trillions of dollars of assets under management (AUM) without having to rely on a rising stock market.

Part I of this Article describes the collective action problem that leads to uninformed voting by the Big Three. Part II provides principles of optimal voting and engagement that we should expect the Big Three to follow. Deviations from these principles, based on the objective of portfolio primacy (maximizing the value of the entire portfolio at any point in time),[41] indicate opportunistic behavior. Moreover, it is argued that the best approach for achieving portfolio primacy is simply to defer to the most informed locus of authority in a public company, the board of directors, as advised by executive management.

Part III critically looks at the Big Three's millennial marketing strategy and finds examples of opportunistic behavior. As a means to identify opportunistic behavior in voting and engagement, it is argued that the absence of a "business case" is the key identifier. That is, those voting and engagement activities where there is a lack of rigorously executed empirical evidence confirming causation in value enhancement on a portfolio basis or evidence of informed decision-making suggesting that the value of a company's stock will increase as a result of such activities. This Part also presents a simple, non-mathematical model describing the decision-making calculus that a Big Three member may go through when deciding how to use its shareholder voting and engagement power for opportunistic purposes. That calculus involves determining how much the opportunistic use of its voting and engagement power will reduce an index fund's value versus how much potential there is for a gain in the Big Three member's market share and the resulting increase in AUM. Finally, this Part tackles how this calculus interferes with the ability of the Big Three to act as informal regulators of public companies.

Part IV proposes a possible market solution to the issue of Big Three opportunism. Part V proposes a possible fiduciary duties solution to this issue. Given the authority already granted to them through existing statutory law, the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) will be the enforcers of those fiduciary duties.

I. THE "COLLECTIVE ACTION PROBLEM" IN BECOMING "INFORMED"

Before we can discuss the opportunistic voting and engagement of the Big Three, it is important to understand that just because shareholder voting is now in the hands of professional investment stewardship teams instead of retail investors, it does not necessarily mean that the voting is any more informed. This is a result of the collective

39. Of course, there may be other reasons for such opportunism. For example, Dorothy Lund argues that "the Big Three's interventions will be calculated to maximize support from the government." Lund, *supra* note 36, at 84. The hoped-for result is minimal government interference in their operations. *Id.*

40. As of September 30, 2021, the total value of the U.S. stock market was approximately $48.6 trillion. *See Total Market Value of U.S. Stock Market*, *supra* note 14.

41. Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 43 (1996) ("If shareholders own diversified portfolios, and if companies impose externalities on one another, shareholders do not want value maximization to be corporate policy. Instead, shareholders want companies to maximize portfolio values.").

action problem that permeates the voting of both retail and institutional investors, including the Big Three.

A. The Most Informed Locus of Authority

Corporate law concentrates company decision-making in the hand of the board of directors[42] and executive management.[43] The reason why corporate law takes such an approach is that channeling information into a centralized, hierarchical authority allows for the efficient management of for-profit corporations.[44] As a company becomes large, this becomes even more apparent. According to Kenneth Arrow, efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information."[45]

When this theory is applied to a public company,[46] it is clear that the board of directors, guided by the advice provided by executive management, has the greatest potential for efficient decision-making, not shareholders.[47]

Yet, despite this lack of being informed, shareholders do participate in corporate decision-making through voting. For example, they vote on major corporate actions such as the election of corporate directors,[48] merger agreements,[49] proxy contests,[50] changes to the articles of incorporation,[51] and the election of directors at the annual meeting.[52] However, while important, these decisions are extremely limited in number compared to the millions upon millions of decisions made annually in a public company.

B. The Collective Action Problem in Shareholder Voting and Engagement

A major reason why there is limited shareholder involvement in corporate decision-making is that shareholders suffer from a significant "collective action" problem.[53] According to Frank Easterbrook and Daniel Fischel, "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently, none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[54] As a result, when shareholders do not bother to become informed or even vote, they are

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42. *See* DEL. CODE ANN. tit. 8, § 141(a) (2019).
43. *See* DEL. CODE ANN. tit. 8, § 142(a) (2019).
44. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974).
45. *Id.*
46. *Public Company*, NASDAQ, https://www.nasdaq.com/glossary/p/public-company [https://perma.cc/6TSV-MXKW] (defining a public company as "[a] company that has held an initial public offering and whose shares are traded on a stock exchange or in the over-the-counter market. Public companies are subject to periodic filing and other obligations under the federal securities laws").
47. Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 86 TENN. L. REV. 691, 713–15 (2019).
48. DEL. CODE ANN. tit. 8, § 216(3) (2020).
49. *Id.* § 251(c).
50. 17 C.F.R. §§ 240.14a(1)–(104) (2020).
51. DEL. CODE ANN. tit. 8, § 242(b)(1) (2014).
52. *Id.* § 211(b).
53. Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, 73 SMU L. REV. 849, 854–58 (2020); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 606–16 (2006).
54. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).

not considered to be irresponsible but "rationally apathetic."[55]

This Article's author has previously summarized the positives and negatives of shareholder voting:

> Shareholder voting, when it happens, has an obvious and very important impact on a publicly traded company; it shines light on corporate decision-making, moving decision-making away from the private confines of the boardroom and into the public arena where the board's approach on how to proceed can be debated by those who have the authority to vote. According to Leo Strine, [former] Chief Justice of the Delaware Supreme Court, shareholder voting, even in its limited scope, is one of the components of corporate law that encourages the board to view decision-making through the lens of shareholder interests. However, at the same time, shareholder voting makes corporate decision-making much more unwieldy and potentially subject to the whims of uninformed and/or opportunistic shareholders. Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.[56]

C. The Collective Action Problem of the Big Three

This collective action problem is most obvious when retail investors hold shares of stock directly. As previously mentioned, a low percentage of retail investors cast their ballots at stockholder meetings. The collective action problem, however, also exists in the Big Three. This problem is manifested in the form of the Big Three voting almost all their shares even though they are also uninformed. The latter results from the Big Three existing in an environment where the resources to become informed shareholders are extremely limited.

Limited resources result from the management of passive funds existing in a super competitive industry with extremely low management fees, providing the Big Three with very little room to spend resources on shareholder voting. For example, the Vanguard Total Stock Market ETF that tracks the CRSP U.S. Total Market Index has an expense ratio of only 0.03%,[57] and Fidelity's ZERO® Total Market Index Fund that tracks the Fidelity U.S. Total Investable Market Index has an expense ratio of 0.00%.[58] Moreover, since the goal of an index fund is to meet, not beat, the market, the adviser would not derive any *competitive benefit* from becoming highly informed and, therefore, has no incentive to do

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55. *See generally* ROBERT C. CLARK, CORPORATE LAW 390–92 (1986) (discussing rational apathy).

56. *See* Sharfman, *supra* note 47, at 697–98.

57. *Vanguard Total Stock Market ETF*, Vanguard, https://investor.vanguard.com/etf/profile/fees/vti [https://perma.cc/5WJB-3W3K] (identifying an expense ratio of 0.03% as of Apr. 29, 2022).

58. *Fidelity's ZERO® Total Market Index Fund*, FIDELITY INVS., https://fundresearch.fidelity.com/mutual-funds/fundfactsheet/31635T708 [https://perma.cc/7SM9-7ULN] (identifying an expense ratio of 0.00% as of Dec. 30, 2022). Interestingly, it has been reported that Fidelity is "using the ZERO funds as loss leaders to get customers in the door and then cross-sell them other products and services, such as other funds and ETFs or advisory services." *See* David Dierking, *FZROX vs. VTI: Does Fidelity's 0% Fee Total Market Fund Beat Vanguard?*, THESTREET (Sept. 21, 2021), https://www.thestreet.com/etffocus/trade-ideas/fzrox-vs-vti-fidelity-vanguard-total-market-fund-etf [https://perma.cc/WM2E-2YBD].

so.[59]

Operating under these severe financial constraints, the Big Three and their investment stewardship teams cast tens of thousands of votes each year[60] at almost all of the approximately 4,000 public companies[61] that currently exist in the United States.[62] These portfolio companies exist in numerous industries and sub-industries, requiring the Big Three to obtain an extremely broad base of knowledge if they were to become adequately informed on how their votes will impact each company. For example, the Global Industry Classification Standard includes 11 sectors that are further subdivided into 24 industry groups, 69 industries, and 158 sub-industries.[63]

Therefore, it should not be a surprise that the Big Three do not even try to become informed. For example, BlackRock's global stewardship team—the largest of the Big Three—is made up of 45 people across 7 offices who have regional presence and local expertise across 85 voting markets.[64] Only 21 of those 45 people are based in the United States.[65] A BlackRock manager's description of her workload epitomizes how resource constrained its investment stewardship team is: "I cover industrials and materials in the US and Canada. I cover approximately 800 companies in those sectors and am responsible for the engagement and proxy voting with those firms."[66]

Bebchuk and Hirst provide further evidence: "Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that *their stewardship focuses on governance structures and processes* and pays limited attention to financial underperformance."[67] This "mitigating governance risk" strategy results in a significant economization of an investment advisors' resources. It also results in a one-size-fits-all voting policy on a number of important issues, including staggered boards, poison pills,

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59. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 98 (2017).

60. For example, the Vanguard Group cast over 30,000 votes at U.S. companies in both 2019 and 2020. Globally, Vanguard casted almost 170,000 votes in both 2019 and 2020. *See* VANGUARD GRP., INVESTMENT STEWARDSHIP 2020 ANNUAL REPORT 44 (2020), https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/policies-and-reports/2020_investment_stewardship_annual_report.pdf [https://perma.cc/ZHY4-7DDL].

61. For example, Vanguard voted at 3,727 shareholder meetings during the 2020 proxy season. *Id.*

62. Vartika Gupta, Tim Koller & Peter Stumpner, *Reports of Corporates' Demise Have Been Greatly Exaggerated*, MCKINSEY & CO. (Oct. 21, 2021), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/reports-of-corporates-demise-have-been-greatly-exaggerated [https://perma.cc/WC5L-9V2B] ("According to our analysis, the number of public companies listed in the United States dropped from about 5,500 in 2000 to about 4,000 in 2020.").

63. S&P GLOB., THE GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) 3 (2018), https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf [https://perma.cc/GZ9V-3BMT].

64. BLACKROCK, INC., BLACKROCK INVESTMENT STEWARDSHIP: PROTECTING OUR CLIENTS' ASSETS FOR THE LONG-TERM 5 (2020), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf [https://perma.cc/YP96-XUM4].

65. *Id.*

66. Ben Ashwell, *How BlackRock Connects the Dots on ESG*, CORP. SEC'Y (Oct. 12, 2020), https://www.corporatesecretary.com/articles/esg/32296/how-blackrock-connects-dots-esg [https://perma.cc/YL6T-F52E].

67. Bebchuk & Hirst, *supra* note 34, at 2039 (emphasis added).

and dual class shares.[68]

Finally, it is important to note that, while the Big Three may claim to use the expertise found in their actively traded funds,[69] it is very unlikely that the required expertise to make them informed voters will be found there. As argued by Bebchuk, Alma Cohen, and Hirst, many actively managed funds are, in reality, "closet indexers."[70] As such, they have relatively little in-house equity analysis expertise. In addition, it will always be more profitable for the portfolio managers of these funds, who are compensated based on performance, to use their limited resources to invest in stock valuation, such as fundamental analysis provided by equity analysts, than to spend their resources on costly voting recommendations.[71] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors.[72] Moreover, even though some of their actively traded funds may employ equity analysts internally or externally, it would be highly unlikely that these analysts, who typically cover no more than 5 to 15 companies at a time,[73] would have the needed expertise to opine on a vote beyond their sphere of expertise. As previously mentioned, around 4,000 public companies in the United States are classified into 11 sectors and are further subdivided into 24 industry groups, 69 industries, and 158 sub-industries.[74]

D. Proxy Advisors Are Not the Solution

The Big Three cannot solve their collective action problem through the use of proxy advisors.[75] The reason is that the collective action problem necessarily impacts proxy advisors as well.[76] Proxy advisors must exist in an environment where their institutional investor clients, including the Big Three, are only willing to pay a minimal fee for voting

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68. Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1001–02 (2020). According to Griffith:

> Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues. The voting guidelines of each of the Big Three, for example, announce voting positions against staggered boards, poison pills and dual class shares. These positions lack nuance. In spite of recent research showing that poison pills, staggered boards, and dual-class shares can create value for some firms, stewardship group guidelines apply a one-size-fits-all approach to governance terms, tempered only by the discretion to depart from the guidelines on a case-by-case basis.

Id. (footnotes omitted).

69. Sharfman, *supra* note 47, at 13–15.

70. Bebchuk, Cohen & Hirst, *supra* note 59, at 98.

71. Sharfman, *supra* note 47, at 13–15.

72. Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 35 (2019) ("This collective action problem, however, characterizes all institutional investor engagement in corporate governance—by both active and passive funds. Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies.").

73. Griffith, *supra* note 68, at 1001.

74. S&P GLOB., *supra* note 63.

75. Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, 73 SMU L. REV. 849, 858 (2020).

76. *Id.*

recommendations.[77] This makes proxy advisors' resources constrained.[78] In sum, institutional investors, including the Big Three, simply do not want better recommendations if it means having to spend more money.[79]

II. IDENTIFYING OPPORTUNISM IN THE BIG THREE'S USE OF ITS DELEGATED VOTING AUTHORITY

Over time, a large portion of shareholder voting power has been transferred from millions of uninformed small retail investors with direct, small, and dispersed holdings in the stocks that make up the S&P 500, to only three uninformed investment advisers with large concentrations of delegated voting authority. Unfortunately, while it can be assumed that retail investors who hold shares directly vote exclusively to serve their own interests, we cannot assume that the Big Three do the same for retail investors when voting or engaging with portfolio companies. This is an example of what is referred to as an *agency problem*.[80]

According to Robert Sitkoff, "an agency problem arises whenever one person, the principal, engages another person, the agent, to undertake imperfectly observable discretionary actions that affect the wealth of the principal."[81] If an agency relationship exists, then according to Michael Jensen and William Meckling, "[i]f both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal."[82] Moreover, "it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."[83] Therefore, as agents, the Big Three may be tempted to act opportunistically, utilizing their large amounts of delegated voting authority as a means to maximize the profitability of their own investors or the utility of their executive management, not the profitability of the beneficial investors of their index funds.

The issue then becomes, how do we know when the Big Three are acting opportunistically? Such identification requires principles of optimal voting and engagement that we can compare to what is happening in practice. Observed deviations from optimal principles allow us to identify when the Big Three are acting opportunistically. The first principle identifies the optimal objective.

A. The Objective: Portfolio Primacy

The Big Three's voting and engagement are intended to serve the interests of those tens of millions of beneficial investors[84] who invest in the mutual funds and ETFs that they manage. If these investors are investing in portfolios of stock tied to a certain index, such as the S&P 500, then the only reasonable objective for the Big Three to have in managing these funds at any time is to maximize the value of the entire portfolio. According to Sean

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77. *Id.*
78. *Id.*
79. *Id.*
80. Robert Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1040 (2011).
81. *Id.*
82. *See* Jensen & Meckling, *supra* note 31, at 308.
83. *Id.*
84. INV. CO. INST., *supra* note 5, at 71 (stating that over 100 million U.S. residents currently invest in funds).

Griffith, this is the most that the Big Three can assume about the voting and engagement preferences of the beneficial investors of a fund as a class.[85] It is the "lowest common denominator solution" to the Big Three's inability to form a coherent picture of the disparate interests of their funds' beneficial investors that would allow the Big Three to "coalesce around other objectives."[86]

Moreover, it is not necessary to utilize voting and engagement to maximize the value of each individual stock that makes up a fund's portfolio.[87] That is, the value of individual stocks may be sacrificed if it somehow has a beneficial impact on the total value of the fund.[88] Such an approach is called "portfolio primacy."[89]

According to Luca Enriques and Alessandro Romano, under portfolio primacy, it is possible to make the theoretical claim "that at least in some instances institutional investors [can] exercise their influence as shareholders of individual portfolio companies [shareholder voting and engagement] to induce them to internalize part of the externalities that negatively affect the performance of the investors' portfolio as a whole."[90] Jeffrey Gordon refers to this as "systematic stewardship."[91]

Underlying this approach is the argument that a significant majority of those beneficial investors "simply want to earn the highest risk adjusted financial return possible."[92] In addition, "this desire to earn the highest risk-adjusted financial return possible is also arguably shared by the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values, even though they give up some risk-adjusted return in terms of portfolio diversification."[93]

The issue then becomes how portfolio primacy is to be achieved in the real world of voting and engagement. As argued below, in most situations' portfolio primacy cannot be achieved unless the Big Three defer to board voting recommendations and decision-making.

1. *A Simple Example of Portfolio Primacy: Elon Musk and Twitter*

Elon Musk's attempt to acquire Twitter provides an ideal fact pattern for the use of portfolio primacy by the Big Three. Even though shareholders overwhelmingly approved

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85. This is an application of Sean Griffith's discussion of shareholders as a class. *See* Griffith, *supra* note 68, at 1009.

86. *Id.*

87. Roberto Tallarita discusses the conflicts of interests and dilemmas facing asset managers as fiduciaries in a forthcoming article. *See* Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3912977 [https://perma.cc/L5YK-KA9A] .

88. *Id.*

89. *Id.*

90. Luca Enriques & Alessandro Romano, *Rewiring Corporate Law for an Interconnected World*, 64 ARIZ. L. REV. 51, 59 (2022).

91. Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022).

92. George David Banks & Bernard Sharfman, *Standing Up for the Retail Investor*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/ [https://perma.cc/HNP2-SLUM].

93. Bernard S. Sharfman, *Commentary: Reforming a Broken System*, PENSIONS & INVS. (Aug. 27, 2018), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system [https://perma.cc/7Q2T-MF57].

the acquisition,[94] portfolio primacy could have provided a justification for turning down the offer.

For the acquisition to be completed, the shareholders needed to approve Musk's $54.20 per share offer, an offer that the board of Twitter thought so good that it agreed to modify the poison pill it implemented to defend against a Musk takeover so that it would not interfere with his offer.[95] But from the Big Three's perspective, there was an obvious problem with the Musk takeover of Twitter.[96] What happens if he devotes so much attention to Twitter that he neglects his duties at Tesla, causing significant harm to the market value of Tesla stock?[97] This issue is of real concern because in many of the index funds managed by the Big Three, the dollar holdings of Tesla stock dominated the dollar holdings of Twitter stock.[98] For example, the S&P 500 index is a market-value-weighted index.[99] When a fund is based on this index, it will have in its portfolio approximately 20 times more in dollar holdings of Tesla stock versus Twitter stock.[100] This means that any change in the market value of Tesla stock is much more important to the total market value of the S&P fund than a change in the market value of Twitter stock.[101]

Moreover, let's say that one or more of the Big Three investment stewardship teams come to the conclusion that a Musk takeover of Twitter will lead to a significant reduction in the market value of Tesla's stock.[102] If so, this expected reduction in the market value of Tesla stock could easily outweigh whatever positive value the index fund derives from Musk purchasing Twitter.[103] Therefore, a no vote on the Musk takeover based on portfolio primacy can be justified.[104]

2. *Taking Portfolio Primacy Beyond its Practical Limitations*

In a relatively simple situation where the cost of becoming informed is not high, like in the Musk proposed takeover as described above, even a Big Three member has the opportunity to come to an informed conclusion based on portfolio primacy. This is no longer the case, however, when complexity increases and the cost of becoming informed is magnified severalfold.

Some commentators, such as Madison Condon, believe the objective of portfolio primacy allows the Big Three to use their voting and engagement power to push companies

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94. *Twitter Stockholders Approve Acquisition by Elon Musk*, PR NEWSWIRE (Sept. 13, 2022), https://www.prnewswire.com/news-releases/twitter-stockholders-approve-acquisition-by-elon-musk-301623677.html [https://perma.cc/PPL8-EXU2].

95. Joanne Medero, *Elon Musk and Twitter: Acquisition Basics*, FED. SOC'Y (May 10, 2022), https://fedsoc.org/commentary/fedsoc-blog/elon-musk-and-twitter-acquisition-basics [https://perma.cc/2CZG-E9VL].

96. Bernard Sharfman, *Will "Portfolio Primacy" Throw a Monkey Wrench in Elon Musk's Plans to Acquire Twitter?*, PROMARKET (May 12, 2022), https://www.promarket.org/2022/05/12/will-portfolio-primacy-throw-a-monkey-wrench-in-elon-musks-plans-to-acquire-twitter/ [https://perma.cc/883C-AURN].

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. Sharfman, *supra* note 96.

102. *Id.*

103. *Id.*

104. *Id.*

that are responsible for high levels of carbon emissions, such as ExxonMobil and Chevron, to radically reduce their emissions. If successfully implemented, this significant reduction in carbon emissions should have a positive impact on the overall value of index fund portfolios. Condon provides the following example:

> Consider the analysis BlackRock makes when weighing whether or not to intervene to take a measure to curtail production at two firms, Chevron and Exxon. Assume this investor intervention forces each company to reduce its emissions by 40%, and this commitment results in that company's share price falling by 20%.
>
> . . . .
>
> BlackRock owns 6.65% of Exxon's total market capitalization of $260.1 billion, or $17.3 billion, and 6.89% of Chevron's total market capitalization of $206 billion, or roughly $14.2 billion. If it loses 20% of the value of each of these assets, it will lose $6.3 billion total.
>
> In order to estimate the mitigated damage impacts to BlackRock's portfolio, this emissions reduction was modeled using William Nordhaus's Dynamic Integrated Climate Economy Model (DICE). This model "is the most widely used" and cited macroeconomic model of the costs of climate change and models results using a wide range of temperature predictions. For present purposes, the BAU [business as usual] pathway was modeled, first as a baseline, and then again, removing 1% of industrial emissions each year through 2100. The difference in the value of damages between these two model runs was compared, aggregated over 100 years, and then discounted using a private sector discount rate of 7%. Through this method, DICE predicts that by intervening to reduce 1% of annual industrial emissions each year, BlackRock could avoid damages to its portfolio with a net present value of $9.7 billion.
>
> Because this value of mitigated damages outweighs the loss of share value from diminished expected fossil fuel profits by $3.4 billion, it would be in BlackRock's rational economic interest to pursue this intervention and internalize the intra-portfolio climate externalities.[105]

Before the reader leaps to conclude that the Big Three should gear its voting and engagement in this direction, it is important to note that Condon admits that this example is "an extreme oversimplification of the trade-offs an investor [investment adviser] must analyze in making a decision to support emissions reduction."[106] For example, it seems a gross understatement of expected loss to say that ExxonMobil and Chevron will only suffer a 20% reduction in stock value from a 40% reduction in emissions. The reason why the loss estimate is so low is because Condon assumes the losses to these companies are confined to the value of their proven reserves.[107] However, these companies do not just own oil and gas reserves. They are vertically integrated companies that refine and distribute

105. Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 45–47 (2020) (footnote omitted).

106. *Id.* at 47.

107. *See id.* at 45 n.225.

a variety of products in the fields of energy and petrochemicals. The emissions constraint will cause them significant business losses throughout their various divisions and subsidiaries, not just in the value of their proven reserves. The likely result will be bankruptcy.

Moreover, if ExxonMobil and Chevron are allowed to sell their high carbon emissions assets to meet new emissions constraints, then large fire sale losses may occur unless the companies are given ample time to sell off their high-carbon assets, including assets in their vertical chain of production. Even given this additional time, however, it is still quite possible that large losses will occur.

In addition, if ExxonMobil and Chevron were able to sell off their assets, then the above analysis overstates how much reduction in carbon emissions will occur, reducing the expected economic value to BlackRock. These assets and their emissions have simply been transferred to other companies, companies which may allow more emissions to occur than if they had been retained by Exxon. For example, BP sold off its entire Alaska oil operations to a private investor, resulting in the company having a much smaller carbon footprint.[108] The new buyer, a privately owned company, has allegedly allowed these assets to generate a significantly higher level of emissions than had occurred during BP's ownership.[109]

Condon's model also does not consider the impact that the forced emissions reduction at ExxonMobil and Chevron will have on the other companies in a stock portfolio, such as those found in an S&P 500 fund. The reduced output and distribution of their various products will result in higher costs and supply chain problems for many of these companies, resulting in lower valuations on a portfolio-wide basis. Unfortunately, the energy and products that are created with fossil fuels are an endemic feature of the world economy, making the transition away from fossil fuels a painfully slow process.[110]

Finally, and most importantly, the Big Three are far from being informed enough, if any investor really is, to even attempt such a cost-benefit calculation that this version of portfolio primacy requires. They would simply be guessing.

3. An Empirical Studies Approach to Portfolio Primacy

The above example is not meant to suggest that the Big Three cannot implement portfolio primacy in their voting and engagement; it just means that there are limitations on how and when it can be done. For example, many rigorously executed empirical studies show that "traditional" hedge fund activism is wealth-enhancing for investors.[111]

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108. Rachel Adams-Heard, *What Happens When an Oil Giant Walks Away*, BLOOMBERG (Apr. 14, 2021), https://www.bloomberg.com/graphics/2021-tracking-carbon-emissions-BP-hilcorp/?srnd=premium [https://perma.cc/F8HB-4F98].

109. *Id.*

110. Daniel Yergin, *Why the Energy Transition Will Be So Complicated*, ATLANTIC (Nov. 27, 2021), https://www.theatlantic.com/international/archive/2021/11/energy-shock-transition/620813/ [https://perma.cc/95XB-REEG] (describing how resistant the world economy is to a move away from fossil fuel dependence).

111. Alon Brav, Wei Jiang & Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence* 47–48 (Eur. Corp. Governance Inst., Working Paper No. 797/2021, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3955116 [https://perma.cc/6HVW-DPYR]. Based on a

Therefore, in determining how to vote on a proxy contest initiated by an activist hedge fund, the investment adviser can feel comfortable voting in support of a hedge fund activist who engages in what can be referred to as "traditional" hedge fund activism. This activism is characterized by taking a large but not controlling position in a target company's stock—commonly, around 5% to 10% of the stock outstanding—presenting value-enhancing recommendations that are expected to correct managerial inefficiencies, spending the time and resources communicating their recommendations to other target company shareholders, and being provided a market confirmation of the value of this activism with a positive and significant impact on the value of the company's stock at the time of or near announcement of the activism.[112] (Please note that the hedge fund activism initiated by Engine No. 1 at ExxonMobil was not an example of traditional hedge fund activism. This non-traditional form of hedge fund activism will be discussed in Part III.)

Of course, the temptation is to cherry-pick the empirical studies so as to support a particular position that may support opportunistic activities. That said, if used correctly and judiciously, rigorously executed empirical studies can legitimately support the Big Three's use of certain one-size-fits-all voting policies.

4. *The Default, Deferring to the Board of Directors*

As emphasized in this Article, the Big Three are uninformed when it comes to voting and engagement with portfolio companies. Therefore, in the absence of rigorous empirical studies to support a one-size-fits-all voting policy, or from time to time making the significant investment required to become informed regarding a particular vote, the only practical way for the Big Three to implement portfolio primacy is to implement a general policy of deferring to board authority at their portfolio companies.

It is true that significant bias may exist in some board recommendations. For example, the board—being so close in proximity to the firm—at times may have difficulty in being objective in its voting recommendations.[113] Or the board may itself suffer from agency costs. Here, agency costs are generated when the board's and executive management's interests do not align with shareholders.[114] The Big Three, however, being uninformed about the portfolio companies they manage, never know this for sure, requiring them to trust the board to use its position as the most informed locus of authority in the company

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thorough survey of empirical studies of hedge fund activism, they were able to conclude:

> Opponents of hedge fund activism argue that activists focus narrowly on short-term financial performance, and such "short-termism" may be detrimental to the long-run value of target companies. The empirical evidence, however, supports the conclusion that interventions by activist hedge funds lead to improvements in target firms, on average, in terms of both short-term metrics, such as stock value appreciation, and long-term performance, including productivity, innovation, and governance. Overall, the evidence from the full body of the literature generally supports the view that hedge fund activism constitutes an important venue of corporate governance that is both influence-based and market-driven, placing activist hedge funds in a unique position to reduce the agency costs associated with the separation of ownership and control.

Id. at 1–2.

112. Bernard S. Sharfman, *The Tension Between Hedge Fund Activism and Corporate Law*, 12 J.L. ECON. & POL. 251, 255–58 (2016).

113. Sharfman, *supra* note 47, at 705–06.

for purposes of obtaining portfolio primacy.

III. THE BIG THREE'S MILLENNIAL MARKETING STRATEGY

Given these principles of optimal voting and engagement, we can now apply them to see if opportunism can be found in the Big Three's millennial marketing strategy. Included in the following discussion are two important examples of millennial marketing: promoting gender diversity on the boards of public companies and Engine No. 1's recent proxy fight at ExxonMobil.[115]

A. Millennials

Millennials, the generation born between 1981 and 1996, are now the biggest U.S. generation, with 72.1 million people.[116] According to Michal Barzuza, Quinn Curtis, and David Webber, "The massive prize of managing millennial wealth has triggered a new high-stakes race among funds and has created strong competitive pressures to offer investment products that have high *social value*."[117] To do this, "[t]hese funds engage in vigorous competition to be branded as EESG [Employee, Environmental, Social, and Governance] promoters in order to attract and retain millennials as investors."[118] Fueling this competition among the Big Three is the millennials' strong interest in investing in index funds.[119]

Why millennial investors are so prized by the Big Three—even though they currently hold only around 5% of corporate equities and mutual fund shares versus 23.5% for baby boomers[120]—and how they are expected to differ from prior generations, is explained by Larry Fink, chief executive officer (CEO) of BlackRock, in his 2019 letter to the CEOs of BlackRock's portfolio companies:

> Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as *millennials* – who today represent 35 percent of the workforce – express new expectations of the

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115. Elsewhere, this Article's author recently wrote about Engine No. 1's proxy fight. *See* Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE, no. 3, 2021, at 1.

116. R.J. Shook, *Advice Industry Works to Win Millennials As Clients*, FORBES (Aug. 31, 2021), https://www.forbes.com/sites/rjshook/2021/08/31/advice-industry-works-to-win-millennials-as-clients/?sh=18f4b1e266b5 [https://perma.cc/K6XR-GMWU].

117. Barzuza, Curtis & Webber, *supra* note 35, at 1285.

118. Michal Barzuza, Quinn Curtis & David H. Webber, *The Millennial Corporation* (Working Paper, 2021), https://scholarship.law.bu.edu/faculty_scholarship/1172/ [https://perma.cc/9ACU-W6Q3].

119. Ethan Wolff-Mann, *Millennials Embraced Index Funds — And Now They're Day Trading*, YAHOO! (Sept. 3, 2020), https://www.yahoo.com/now/millennials-embraced-index-funds-and-now-theyre-day-trading-154353436.html [https://perma.cc/6CCF-9BQA].

120. *Distribution of Household Wealth in the U.S. Since 1989: Corporate Equities and Mutual Fund Shares by Generation*, BD. GOVERNORS FED. RSRV. SYS., https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/table/#quarter:119;series:Corporate%20equities%20and%20mutual%20fund%20shares;demographic:generation;population:all;units:shares [https://perma.cc/N8A8-5YEB].

> companies they work for, buy from, and *invest in*.
>
> Attracting and retaining the best talent increasingly requires a clear expression of purpose. With unemployment improving across the globe, workers, not just shareholders, can and will have a greater say in defining a company's purpose, priorities, and even the specifics of its business. Over the past year, we have seen some of the world's most skilled employees stage walkouts and participate in contentious town halls, expressing their perspective on the importance of corporate purpose. This phenomenon will only grow as *millennials* and even younger generations occupy increasingly senior positions in business. In a recent survey by Deloitte, *millennial* workers were asked what the *primary purpose* of businesses should be – 63 percent more of them said "improving society" than said "generating profit."
>
> In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing *the largest transfer of wealth in history: $24 trillion from baby boomers to millennials*. As wealth shifts and investing preferences change, environmental, social, and governance issues [ESG] will be increasingly material to corporate valuations. This is one of the reasons why BlackRock devotes considerable resources to improving the data and analytics for measuring these factors, integrates them across our entire investment platform, and engages with the companies in which we invest on behalf of our clients to better understand your approach to them.[121]

As stated by Fink, the future success of BlackRock and the rest of the Big Three depend on how well they market their products to millennials, the generational group that is expected to benefit the most from *inheriting* baby boomers' wealth of baby boomers. But from an agency perspective, this approach is disconcerting. A millennial marketing strategy puts the interests of millennial investors ahead of other generations, including baby boomers, the dominant generational group at present in terms of investment in the Big Three's investment products. In sum, this strategy is counting on a "silent majority" of retail investors (primarily baby boomers) to be oblivious to what the Big Three are doing in terms of opportunism.

B. Gender Diversity

In early 2017, State Street was the first of the Big Three to implement a millennial marketing strategy with its unveiling of the "Fearless Girl" statute on Wall Street and its "announcement of a new gender diversity voting policy in which it would vote against nominating committee chairs on boards that had no female directors."[122] This led to

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121. Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose & Profit*, BLACKROCK, INC. (2019), https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter [https://perma.cc/T2ZV-H7YJ] (emphasis added).

122. Barzuza, Curtis & Webber, *supra* note 35, at 1307; *see also* Jeff Green, *The Fearless Girl Is Worth $7.4 Million in Free Publicity for State Street*, BLOOMBERG NEWS (Apr. 28, 2017), https://www.bloomberg.com/news/articles/2017-04-28/fearless-girl-earns-7-4-million-in-free-media-for-state-street [https://perma.cc/manage/create?folder=69582-176912].

vigorous competition with BlackRock and Vanguard to see who could be the most supportive of gender diversity on the boards of public companies.[123] For example, in 2017, BlackRock announced it would focus on gender diversity and, in 2018, demanded that at least two female board members be on every public company board.[124] Vanguard followed suit in 2017 by publicly announcing that its shareholder voting would consider how much progress companies were making in promoting gender diversity.[125]

According to Todd Gormley, Vishal Gupta, David Matsa, and Sandra Mortal, the actions of the Big Three since 2017 have led to "a 76% increase in the net flow of new female board members and an 11% increase in the overall proportion of female directors."[126] Moreover, they found that the "[the Big Three's campaigns] led firms to add 2.5 times as many female directors in 2019 as they had in 2016," which they estimate accounts for "at least a third to two-thirds" of the 50% increase in "public-company board seats held by women."[127]

Based on a principle of fairness and a determination to end discrimination, many people believe that promoting gender diversity through shareholder voting and engagement is the proper thing for the Big Three to do.[128] If the Big Three were actual owners of the voting stock, there would be no problem. That is, they could vote and engage as they please. However, the Big Three are only agents, not principals, creating fiduciary limitations on how they can act.

For example, from a portfolio primacy perspective, there has yet to be published a peer-reviewed (i.e., rigorous) empirical study that identifies gender diversity as having a

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123. Barzuza, Curtis & Webber, *supra* note 118, at 42 ("BlackRock then raised the stakes, adopting a policy demanding at least two female board members and voting against non-compliance."); *see also* Sara Krouse, *BlackRock: Companies Should Have At Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407 [https://perma.cc/4AKN-D8X9].

124. Baruza, Curtis & Webber, *supra* note 118, at 42.

125. Todd A. Gormley et al., *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* 9 (Eur. Corp. Governance Inst., Working Paper No. 714/2020, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3724653 [https://perma.cc/K8ET-4KUP]. For example, Vanguard recently made the following statement:

> In the first half of 2021, Vanguard deepened our board diversity advocacy and engaged a greater number of companies on the topic, screening many of our largest holdings for a lack of gender diversity or a lack of racial or ethnic diversity. We provided feedback to companies on board diversity-related matters in at least 367 instances, through direct engagements and written communications. Of those instances, 290 resulted in further dialogue with company leaders, board members, or both. The funds ultimately voted against 173 directors at companies where we had concerns regarding the risks associated with the lack of progress or lack of a path forward to increase board diversity.

Vanguard Investment Stewardship Insights Voting Insights: Diversity-Related Proposals, January–June 2021, VANGUARD (Sept. 2021), https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/perspectives-and-commentary/DiversitySHP_1841014_092021_online.pdf [https://perma.cc/37UB-QVP6].

126. Gormley, *supra* note 125, at 2.

127. *Id.* at 38.

128. Alex Edmans, *Is There Really a Business Case for Diversity?*, MEDIUM (Oct. 30, 2021), https://medium.com/@alex.edmans/is-there-really-a-business-case-for-diversity-c58ef67ebffa [https://perma.cc/8CVA-N3RQ].

positive wealth effect.[129] Yes, several studies have made this claim, but according to prominent finance professor Alex Edmans of the London Business School, those studies are deeply flawed.[130] Moreover, as observed by Harvard Law Professor Jesse Fried, rigorous empirical work done in this area, much of it done by female economists, suggests that board diversity may even lead to a reduction in shareholder wealth.[131] In sum, using the terminology of Edmans,[132] a "business case" for gender diversity cannot be made based on available empirical evidence.[133]

Without such evidence, it is hard to support a one-size-fits-all voting policy that simply takes the approach, as BlackRock does, that "where gender diversity remains inadequate – we typically vote against the re-election of members of the committee responsible for nominating directors. This meant that in the Americas, insufficient board gender diversity was the top reason for voting against a director(s). We voted against 1,554 directors in the region."[134]

In terms of efficient decision-making and wealth maximization, what is lost from one or more of the Big Three taking this uninformed approach is the informational value provided by the board of directors when it recommends board nominees. In general, as this author has previously stated:

> The board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information.[135]

Yes, if one of the Big Three, on a company-by-company basis, actually does the leg

129. *Id.*

130. *Id.*

131. *See generally* Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?*, 12 HARV. BUS. L. REV. ONLINE, No. 1, 2021, at 3 (citing Renee Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291 (2009); Kenneth Ahern & Amy K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation*, 127 Q.J. ECON. 137 (2012); Daniel Greene, Vincent J. Intintoli & Kathleen M. Kahle, *Do Board Gender Quotas Affect Firm Value? Evidence from California Senate Bill No. 826*, 60 J. CORP. FIN. 1 (Feb. 2020)).

132. Edmans, *supra* note 128.

133. Lawrence Cunningham "advises advocates to avoid exaggerated claims about the economic payoffs from [gender] diversity, urging instead to focus on the *fairness* merits of the equation." Lawrence A. Cunningham, *Board Gender Diversity: Debate and Practice*, 63 CAN. BUS. L.J. 244, 244 (2020) (emphasis added); *see also* Edmans, *supra* note 128 (suggesting that corporations should consider sacrificing profits and consider fairness when identifying board nominees). If fairness is the correct criteria, then perhaps this issue may need to be resolved by statutory action, rather than board action, such as what is trying to be done, with much struggle, in California. *See* Theo Francis, *Judge Strikes Down California Law Mandating Women on Boards*, WALL ST. J. (May 16, 2022), https://www.wsj.com/articles/judge-strikes-down-california-law-mandating-women-on-boards-11652724832 [https://perma.cc/95HZ-3BNS] (discussing recent judicial rulings striking down California laws mandating women on boards).

134. BLACKROCK, INC., PURSUING LONG-TERM VALUE FOR OUR CLIENTS 10 (2021), https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf [https://perma.cc/ELC5-G2ZZ] (emphasis removed).

135. Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012).

work in seeking out female candidates that they believe would be equal or superior to those nominated by a board, it significantly enhances the legitimacy of the one-size-fits-all voting and engagement policies on gender diversity. If so, then they can debate with the board, either privately or in public, on why their candidate(s) would serve the company better than the board's nominee(s). However, being uninformed voters, that is not what the Big Three do.

C. Engine No. 1's Proxy Contest

Despite having only $40 million worth of ExxonMobil common stock in hand,[136] Engine No. 1 executed a proxy fight that succeeded in getting three of its four nominated directors elected to the board of ExxonMobil.[137] Engine No. 1 has two stated goals in its activism, "reducing . . . [ExxonMobil's] emissions that are warming the planet and lifting the profits and stock price of Exxon."[138]

Yet, it came to the fight like no other hedge fund activist. Hedge fund activism "typically begins with an unregulated investment fund (the [activist] hedge fund) accumulating a significant amount of a public company's stock, usually around 5% to 10% of the shares outstanding."[139] A large position is necessary for the activist hedge fund to earn a large enough return on the expected increase in the stock price to cover the costs of its activism.[140] It also helps in enhancing its voting power, giving it a better chance of eventually getting its way at the target company.[141]

Based on the above criteria, its stake of $40 million was extremely inadequate for the purposes of successful hedge fund activism.[142] Also, the recommendations that it provided to achieve its goals were not specific in terms of enhancing shareholder value or reducing the company's carbon emissions in a value-enhancing way.[143] Furthermore, there was no indication of how Engine No. 1's activism would lead to value enhancement from an individual company or portfolio primacy perspective.

The stock market's reaction to Engine No. 1's activism confirmed that it was not expected to accomplish anything in terms of enhancing company operations.[144] In that regard, there is no evidence that Engine No. 1's activism yielded positive abnormal returns to ExxonMobil's stockholders. As observed by Desai, Rajagopal, and Tomar, whatever increase in the price of ExxonMobil's stock since Engine No. 1's activism became public

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136. Scott Deveau, *Exxon Activist Reveals High $30 Million Cost of Boardroom Battle*, BLOOMBERG MKTS. (Mar. 18, 2021), https://www.bloomberg.com/news/articles/2021-03-18/exxon-activist-reveals-high-30-million-cost-of-boardroom-battle [https://perma.cc/8GF7-Q2J2].

137. Exxon Mobil Corp., Current Report (Form 8-K/A) (June 21, 2021).

138. Peter Eavis & Clifford Krauss, *Activists Crashed Exxon's Board, but Forcing Change Will Be Hard*, N.Y. TIMES (May 27, 2021), https://www.nytimes.com/2021/05/27/business/economy/exxon-board-climate-change.html [https://perma.cc/PX8T-YQ5T].

139. Bernard S. Sharfman, *The Tension Between Hedge Fund Activism and Corporate Law*, 12 J.L. ECON. & POL. 251, 258 (2016) (alteration in original).

140. Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 804–05 (2015).

141. *Id.* at 806.

142. Sharfman, *supra* note 115, at 3.

143. *Id.*

144. *Id.*

is attributable to a rise in oil prices that benefited all oil and gas companies.[145] Therefore, if the market thought Engine No. 1 was acting to enhance the value of ExxonMobil, it certainly did not reveal it.[146]

Yet, even without a significant stake in the company or specific recommendations to enhance shareholder value or move the company into profitable low-carbon emissions,[147] Engine No. 1 still convinced "enough ExxonMobil shareholders to elect three of its four nominees to ExxonMobil's board of directors."[148] This was an astonishing accomplishment given that the lack of specific recommendations was a clear signal to ExxonMobil shareholders that Engine No. 1 was not informed about the operations and strategies of ExxonMobil and what was necessary to make it a more successful company.[149]

How was Engine No. 1 able to do this? Undoubtedly, the timing was right.[150] ExxonMobil was floundering financially due to a high debt load, pandemic-reduced demand for its products, and the resulting low oil and gas prices.[151] Moreover, even when the consensus opinion of the scientific community had long suggested otherwise, ExxonMobil had a history of at least being perceived as denying climate change and funding organizations that supported that perspective.[152] Finally, company management did not see climate change as creating the need to change its primary strategy of focusing on fossil fuels.[153] Thus, it was extremely vulnerable to criticism by many different types of stakeholders, not just shareholders.[154] Yet, when Engine No. 1 filed its March 15, 2021 definitive proxy statement seeking the election of its partial slate of four director nominees,

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145. Hemang Desai, Shiv Rajagopal & Sorabh Tomar, *Opinion: Is an Activist Hedge Fund's Climate-Linked Coup of Exxon's Board Simply a Case of 'Greenwashing'?*, MARKETWATCH (June 8, 2021), https://www.marketwatch.com/story/is-an-activist-hedge-funds-climate-linked-coup-of-exxons-board-simply-a-case-of-greenwashing-11623103432 [https://perma.cc/AME7-BZ8D].

146. Sharfman, *supra* note 115, at 15.

147. *Id.*

148. *Id.* (citing Exxon Mobil Corp., Current Report (Form 8-K/A) (June 21, 2021), at 3). All three have experience in the oil industry. *See Board Candidates*, REENERGIZING EXXON, https://reenergizexom.com/board-candidates [https://perma.cc/EEW3-874N] (introducing Kaisa Hietala as a former Executive Vice President of Renewable Products at Neste, Gregory J. Goff as a former CEO of Andeavor, and Alexander Karsner as a former member of the National Petroleum Council). Interestingly, the fourth nominee, a former wind power company CEO, received the fewest votes of all the nominees on the ballot. Exxon Mobil Corp., Current Report (Form 8-K/A) (June 21, 2021), at 3; *see also Board Candidates*, REENERGIZING EXXON, https://reenergizexom.com/board-candidates [https://perma.cc/V5BG-FYLD] (introducing Anders Runevad as the former CEO of Vestas Wind Systems). This lack of votes for a wind power expert can be understood as a signal from market participants that ExxonMobil's clean energy future, if there is to be such a future, does not include significant investment in wind energy production. *See* Engine No. 1 LLC, Definitive Proxy Statement (Schedule 14A) (Mar. 15, 2021), at 10.

149. Sharfman, *supra* note 115, at 14–15.

150. *Id.* at 15.

151. *Id.*

152. *Id.* (citing Paul Krugman, Opinion, *Enemy of the Planet*, N.Y. TIMES (Apr. 17, 2006), https://www.nytimes.com/2006/04/17/opinion/enemy-of-the-planet.html [https://perma.cc/8QDF-UGRT]); *see also* Suzanne Goldenberg, *Exxon Knew of Climate Change in 1981, Email Says – But It Funded Deniers for 27 More Years*, GUARDIAN (July 8, 2015), https://www.theguardian.com/environment/2015/jul/08/exxon-climate-change-1981-climate-denier-funding [https://perma.cc/57Z9-GZGE].

153. John Schwartz, *Climate Change Activists Either Prod Exxon Mobil or Dump It*, N.Y. TIMES (May 25, 2016), https://www.nytimes.com/2016/05/26/science/exxon-mobil-annual-meeting.html?searchResultPosition=1 [https://perma.cc/2PPA-3G4G].

154. Sharfman, *supra* note 115, at 16.

ExxonMobil was still a $250 billion company and recognized as one of the top performing companies, based on decades of capital appreciation and dividend payouts, that have allowed the stock market to significantly outperform Treasuries over time.[155]

Engine No. 1 succeeded because it focused on gaining the support of the Big Three.[156] The Big Three owned approximately 21% of ExxonMobil's voting stock.[157] But, as we have already discussed, that percentage probably understated their actual voting power, especially since an above-average percentage of retail investors hold stock directly in the company, 47% of the stock.[158]

To garner the Big Three's support, Engine No. 1 cleverly appealed to their desire to be perceived as investment advisers who are making a difference in helping to mitigate climate change, an important issue for millennials.[159] So the Big Three were arguably in a bind.[160] They were under immense pressure to support Engine No. 1's efforts, or risk being perceived as not walking the talk on climate change, especially BlackRock, since it has taken the leadership role in espousing the use of shareholder voting and engagement for purposes of dealing with climate change.[161] Based on their voting, it appears that the need to market to millennials won out over the need to actually implement value-enhancing change at ExxonMobil.[162] BlackRock ended up supporting three Engine No. 1 director

155. Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 440 (2018). Hendrik Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016. *Id.* at 444. He found that "in terms of lifetime dollar wealth creation, the best performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills" with lifetime dollar wealth creation defined as "accumulated December 2016 value in excess of the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns." *Id.* at 440, 454. His results also showed that the sum of the individual contributions to lifetime dollar wealth creation provided by the top fifty companies (with ExxonMobil being number one on the list) represented almost 40% of total lifetime dollar wealth creation. *Id.* at 454. Thus, the returns earned by a relatively small number of best-performing companies were critical to the stock market earning returns above short-term Treasuries. *Id.* at 441. However, by the end of 2019, Exxon had fallen to number three on the list. Hendrik Bessembinder, *Wealth Creation in the U.S. Public Stock Markets 1926 to 2019*, 30 J. INVESTING 47, 51 (2021).

156. Sharfman, *supra* note 115, at 32.

157. EXXON MOBIL CORP., NOTICE OF 2021 ANNUAL MEETING AND PROXY STATEMENT 35 (2021), https://corporate.exxonmobil.com/-/media/Global/Files/investor-relations/annual-meeting-materials/proxy-materials/2021-Proxy-Statement.pdf [https://perma.cc/LEQ8-PFLT].

158. *Exxon Mobil Corporation*, YAHOO! FIN., https://finance.yahoo.com/quote/XOM/holders?p=XOM [https://perma.cc/H7TE-WT3M]. According to ExxonMobil's voting summary, 72% of outstanding shares were voted at the annual meeting. *See* Exxon Mobil Corp., Current Report (Form 8-K/A) (June 21, 2021), at 2. If the Big Three voted all their shares, which was highly likely given how critical the vote was in terms of their millennial voting strategy, then their voting power would have been approximately 29%.

159. Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021), https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html [https://perma.cc/6RSP-AAFF] ("The hedge fund reminded Vanguard, BlackRock and State Street that its campaign was in line with their own publicly stated goals to see the carbon emissions of the companies in their portfolios fall sharply over the next 30 years.").

160. Sharfman, *supra* note 115, at 17.

161. Larry Fink, *Larry Fink's 2021 Letter to CEOs: The Power of Capitalism*, BLACKROCK, INC., https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/ZS85-AMPR] ("There is no company whose business model won't be profoundly affected by the transition to a net zero economy.").

162. *Id.*

nominees,[163] while Vanguard and State Street Global Investors each supported two.[164]

D. The Calculus of Big Three Opportunistic Voting and Engagement

It is possible to create a simple model, "the calculus of Big Three opportunistic voting and engagement," to identify when the Big Three may be tempted to opportunistically vote and engage with portfolio companies and thereby forgo the need for a business case in their voting and engagement activities.

First, let us assume that each of the Big Three's management has as their primary objective wealth enhancement for their shareholders. One way they can achieve this objective is to increase management fees as a percentage of the funds they manage. As we already noted, however, the Big Three exist in a very competitive marketplace where raising fees is not possible. Another way is to hope that the stock market continues to increase over time, but the Big Three have no control over when and how much it gains.

The Big Three can also try to use their large amounts of shareholder voting power to increase AUM by spending the resources necessary to vote in an informed manner, thereby increasing share values and, in turn, AUM. However, as already mentioned, investing the significant resources necessary to become informed is a money-losing proposition because it is expensive and the index funds that the Big Three manage must share the gains that result from the resources spent with all the other shareholders of those companies, including the index funds managed by the other members of the Big Three.[165] It is also doubtful that the marginal gain in fee income, less the resources expended, will provide as much net return as simply voting based on the voting recommendations made by the board of directors.[166]

So what then can the Big Three do to proactively increase AUM? Well, they can try to implement a marketing strategy that attempts to gain a larger share of the almost $50 trillion equity market.[167] This approach has the benefit of not having to share the returns of this strategy with its competitors. This is why having a millennial marketing strategy, or any type of marketing strategy, as a means to gain market share is so important. Such a strategy can mean billions, if not trillions, of new AUM.

Here is where opportunistic voting and engagement enter the picture. To support its millennial strategy, a member of the Big Three may be tempted to vote in a way that increases market share—i.e., voting in a way that appeals to millennials (or any other demographic group)—without much regard for how it impacts the value of a portfolio of

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163. BLACKROCK, INC., VOTE BULLETIN: EXXON MOBIL CORPORATION 3–4 (May 26, 2021), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf [https://perma.cc/9ZF8-AT7S].

164. Richard J. Grossman & Neil P. Stronski, *What the Exxon Mobil Shareholder Votes Mean*, SKADDEN (June 16, 2021), https://www.skadden.com/insights/publications/2021/06/the-informed-board/what-the-exxon-mobil-shareholder-votes-mean [https://perma.cc/P6Y8-N9HX].

165. *See* Bebchuk, Cohen & Hirst, *supra* note 59, at 98 (explaining how increased spending on stewardship by investment managers can lead to increased costs).

166. *See* Sharfman, *supra* note 47, at 705 ("The combination of being the most informed locus of authority and the one with the most analytical firepower at its disposal, executive management, provides the board with the greatest potential for creating the most precise shareholder voting recommendations.").

167. As of September 30, 2021, the total value of the U.S. stock market was approximately $48.6 trillion. *See Total Market Value of U.S. Stock Market*, *supra* note 14.

stocks found in an index fund.[168] This is because an expected small positive movement in market share will, in terms of AUM, overwhelm any expected loss in the value of an index fund or family of funds.[169] For example, assume that one of the Big Three investment advisers currently has $5 trillion in U.S. stocks under management. Also, assume that the investment adviser has determined that it can implement an opportunistic voting and engagement policy that will increase its market share by 1% of the entire $50 trillion stock market. However, this will also result in a 1% loss in the total market value of the index funds that the advisor manages. The net increase in AUM is $445 billion, calculated from $495 billion from an increase in market share (the total market value is now $49.5 trillion; $50 trillion minus the 1% loss in total market value caused by the investment adviser's opportunistic voting) minus the $50 billion loss in value to the index funds it manages. As a result, the objective of portfolio primacy is sacrificed for the economic good of the investment adviser.

It is also possible that the executive managers of the Big Three prefer to use their delegated voting authority for purposes of increasing market share if their compensation is based on AUM. This would also enhance the pressure on the Big Three to use its voting power to maximize market share without regard for the impact on the value of the individual stocks that they manage. As a result, the objective of portfolio primacy is sacrificed for the economic good of an investment adviser's executive management.[170]

E. The Big Three as Regulators

While not the focus of this Article, the calculus of Big Three opportunism provides an occasion to address the issue of the Big Three as informal regulators of public companies. Since this calculus is so entity-centric, it does not appear that the Big Three are in a good position to serve this role. However, Dorothy Lund's new article, *Shareholders as Regulators*,[171] argues that the various interests the Big Three must serve—its current investor base, millennial investors and their growing importance, government, corporate sponsors of private pension fund assets, and the activist shareholders at their own

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168. The identification of increasing market share as a means of significantly increasing AUM is what distinguishes this Article from the writing of Kahan and Rock. *See generally* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771 (2020).

169. This is not a unique idea. *See, e.g.*, Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?*, 12 HARV. BUS. L. REV. ONLINE, No. 1, 2021, at 1, 8 (2021) ("For example, an index fund operator will benefit from engaging in activism that sacrifices 1% of aggregate portfolio company value but attracts 2% more in managed assets.").

170. However, it is not clear exactly how much AUM plays into the executive compensation of the Big Three's top management. For example, Vanguard, being privately held by the funds it manages, is very opaque in disclosing levels of executive compensation and how it is structured. Anders Melin, *How Well Does Running Vanguard Pay?*, BLOOMBERG NEWS (Jan. 19, 2017), https://www.bloomberg.com/news/articles/2017-01-19/how-well-does-running-vanguard-pay#xj4y7vzkg [https://perma.cc/FJK3-33KE]. In the case of BlackRock and State Street, the executive compensation discussions in their respective proxy statements indicated that AUM did have an impact, but it was not clear by just how much. BlackRock, Inc., Proxy Statement (Form DEF 14A) (2021), at 54–89, https://www.sec.gov/Archives/edgar/data/1364742/000119312522105534/d263204ddef14a.htm [https://perma.cc/RU5M-YJFN]; State Street Corp., Proxy Statement (Form DEF 14A) (Apr. 6, 2021), at 2874. https://www.sec.gov/Archives/edgar/data/93751/000114036121011843/nc10018789x1_def14a.htm#TOC [https://perma.cc/2G82-SPJF].

171. Lund, *supra* note 36.

companies—results in the Big Three using their delegated voting power and engagement abilities as tools to fill the regulatory void in some areas of societal concern, such as inequality and the environment. As Lund states, "the Big Three are providing a new form of privatized regulation—a body of standards and mandates that is more stringent than existing law, enforced with penalties, and applied across the market."[172]

Yet, Lund acknowledges that this private regulation has so far been "relatively benign."[173] She attributes this to the unwillingness of the Big Three to act unless it has a "broad consensus" of interests backing their voting and engagement activities.[174] This makes sense because the confluence of interests that the Big Three are trying to appease at any one time are always clashing, requiring significant restraint in the Big Three's voting and engagement. For example, the desire to appease millennial interests around climate change versus trying to get more private pension business from portfolio companies. Or trying to appease several attorneys general who believe the Big Three have gone too far in supporting ESG efforts at the expense of investors.[175] This creates the potential for the Big Three to always have to thread the needle when considering an important initiative. Therefore, restraint is called for.

However, there is a problem with Lund's consensus model. This coalition building does not appear to require the representation of interests of those fund investors who are rationally apathetic, those that should be most important to the Big Three, and those who make up the tens of millions of retail investors that invest in their products. In such matters, the interests of the "silent majority," those whose interests should be protected through the Big Three voting and engaging based on the objective of portfolio primacy, go unrepresented. Under the calculus of opportunism, this gives the Big Three a lot of leeway in maximizing their own interests, putting into question whether portfolio primacy can be achieved through voting and engagement.

It should be pointed out that such informal Big Three regulation is a very poor substitute for government action.[176] Despite the Big Three's shareholder voting and engagement and their big push to market higher-cost ESG funds to investors,[177] our

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172. *Id.* at 80.

173. *Id.* at 82.

174. *Id.* at 83.

175. Joseph Simonson, *State AGs Take Aim at $10 Trillion Investment Giant Over Woke Investments*, WASH. FREE BEACON (Aug. 10, 2022), https://freebeacon.com/latest-news/republican-ags-allege-blackrock-violating-law-with-woke-investing/ [https://perma.cc/E4X8-5CMS].

176. As observed by Tariq Fancy, BlackRock's former chief investment officer for sustainable investing, "one lesson COVID-19 has hammered home is that systemic problems—such as a global pandemic or climate change—require systemic solutions. Only governments have the wide-ranging powers, resources and responsibilities that need to be brought to bear on the problem." *See* Tariq Fancy, *BlackRock Hired Me to Make Sustainable Investing Mainstream. Now I Realize It's a Deadly Distraction from the Climate-Change Threat*, GLOBE & MAIL (Mar. 25, 2021), https://www.theglobeandmail.com/amp/business/commentary/article-sustainable-investing-is-a-deadly-distraction-from-actually-averting/ [https://perma.cc/W7UM-KQN4] (describing how the quick and aggressive government action during COVID-19 to flatten the curve should also be used regarding climate change to see real results).

177. Cam Simpson & Saijel Kishan, *How BlackRock Made ESG the Hottest Ticket on Wall Street*, BLOOMBERG NEWS (Dec. 31, 2021), https://www.bloomberg.com/news/articles/2021-12-31/how-blackrock-s-invisible-hand-helped-make-esg-a-hot-ticket [https://perma.cc/D5FZ-EKTF]; Jeff Benjamin, *BlackRock, Vanguard, Transamerica Roll Out Latest ESG Funds*, INVESTMENTNEWS (Sept. 24, 2020),

country's and the world's problems continue unabated—the increasing use of fossil fuels, inequality, and the ever-growing threat to voting rights and political democracy, among others societal issues. This is consistent with what Tariq Fancy, BlackRock's former chief investment officer for sustainable investing, has said about investors being encouraged to purchase shares in ESG mutual funds and ETFs—it is a "deadly distraction" that accomplishes very little, or nothing, in terms of mitigating climate change.[178] This statement can be generalized to all of the Big Three's efforts to solve our most pressing problems.[179]

Moreover, as Roberto Tallarita has pointed out, a major obstacle faced by the Big Three as informal societal regulators is that they can only target the activities of portfolio companies.[180] These public companies, while obviously significant, only represent a subset of our economy.[181] For example, in 2019, only 29% of nonfarm workers in the United States were employed by public companies.[182] In the area of climate change mitigation, the Big Three have no control over the carbon emissions of private or state-owned companies—companies that are expected to emit significantly more carbon emissions than public companies through 2050.[183] Index funds and investment funds, in general, just do not, and cannot, cover large swaths of the domestic and world economy. As a result, their regulatory effectiveness is quite limited.

IV. A Possible Market Solution

Entering into voting and engagement decisions without a business case only leads to wealth reduction for the funds and their retail investors. It is a result of ignoring the voting recommendations and decision-making of the most informed locus of authority in a public company: the board of directors, with the support of information provided by executive management. Doing so moves corporate decision-making from the most informed to the uninformed—a suboptimal approach to portfolio primacy. Corrective measures are required.

To mitigate the issue of Big Three voting and engagement opportunism, it is most desirable for the markets to simply self-correct. The preferred approach is simply to have retail investors retain their voting rights through some sort of pass-through voting. As Sean Griffith has observed, "Determining an investor's proportional voting interest is not dramatically different from determining NAV [Net Asset Value], something funds do every day."[184] To that end, BlackRock recently indicated that such an approach might be

https://www.investmentnews.com/blackrock-vanguard-transamerica-roll-out-latest-esg-funds-197441 [https://perma.cc/KCN9-8A22].

178. Fancy, *supra* note 176.

179. *Id.*

180. Tallarita, *supra* note 87, at 40.

181. *Id.* at 41.

182. *Id.* (citing Frederik P. Schlingemann & René M. Stulz, *Have Exchange-Listed Firms Become Less Important for the Economy?* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27942, 2020)).

183. Sarah George, *Report: Oil and Gas Companies Set to Eat Up 80% of Global Carbon Budget*, EDIE (July 22, 2021), https://www.edie.net/news/9/Report—Oil-and-gas-companies-set-to-eat-up-80—of-global-carbon-budget/ [https://perma.cc/L2R8-MQCE] (indicating that state-owned oil and gas majors will use up more than half (54%) of the world's total carbon budget through 2050).

184. Griffith, *supra* note 68, at 994.

technically viable by announcing that it is going to provide pass-through voting to some of its institutional investors in the United States and United Kingdom.[185] But, as Griffith argues, rational apathy does not make this a practical approach for retail investors:

> The real question with pass-through voting is thus not whether it can be done but whether it should be. Here, the problem is not technology. It is rational investor apathy. Individual investors vote their shares less than 30% of the time. For mutual fund investors, voting turnout would likely be far lower. Individual mutual fund investors can be expected to tire quickly of being asked each year to evaluate and vote on thousands of matters over which their miniscule [sic] voting stakes likely make no difference at all. This fractionalization of voting power combined with the information overload inherent in being asked to weigh in on so many matters suggests that passthrough voting threatens to vastly increase the problem of rational apathy and lead to less voting.[186]

Nevertheless, we can envision a viable market solution that mitigates the rational apathy of retail investors. This would require beneficial investors to demand that index funds provide them with the option of conforming their proportional voting interest—as represented by their percentage of ownership in a specific index fund—to a requirement that when voting occurs, the investment adviser is to vote according to general voting guidelines approved by the beneficial investor. For example, this could be a simple check-the-box approach on the part of the investor, whether retail or institutional, directing the fund to: (1) abstain from all voting; (2) vote according to the voting recommendations provided by the portfolio company's board of directors; or (3) defer to the discretion of the investment adviser.[187]

Alternatively, Paul Mahoney and Julia Mahoney suggest that if a pass-through voting system were available to retail investors of mutual funds and ETFs,[188] there would be a potential market opportunity for retail-investor-focused proxy advisors who could (for a small fee) advise the investor and handle the mechanics of proxy voting.[189] This voting

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185. Mark McCombe, Salim Ramji & Sandy Boss, *Expanding Proxy Voting Choice*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 19, 2021), https://corpgov.law.harvard.edu/2021/10/19/expanding-proxy-voting-choice/#more-141071 [https://perma.cc/RER9-KNAR].

186. Griffith, *supra* note 68, at 994–95 (footnotes omitted).

187. This is not the first time that this author has proposed that index funds provide retail investors the option of providing their voting preferences. *See* Bernard Sharfman, *Giving Index-Fund Investors a Voice in Shareholder Voting*, REALCLEARMARKETS (Mar. 17, 2021), https://www.realclearmarkets.com/articles/2021/03/17/giving_index-fund_investors_a_voice_in_shareholder_voting_768444.html [https://perma.cc/DRC7-XWHQ]; Bernard Sharfman, *The Problem of Three in the Voting of Public Company Shares*, REALCLEARMARKETS (Aug. 30, 2021), https://www.realclearmarkets.com/articles/2021/08/30/the_problem_of_three_in_the_voting_of_public_company_shares_792063.html [https://perma.cc/7D6B-SLW3]; Sharfman, *supra* note 115.

188. According to Jill Fisch, the advocacy for pass-through voting goes back to at least 1991. *See* Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 880 n.17 (2010) (citing Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective, 57 BROOK. L. REV. 1, 47–52 (1991)); *see also* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 529–32 (2018) (advocating for beneficial investors to have the right to vote on non-routine matters).

189. Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840, 876–77 (2022).

would be based on the investor's preferences, whether those are based on wealth maximization or furthering particular public policies.[190]

V. A FIDUCIARY SOLUTION TO AN AGENCY PROBLEM

Even if a check-the-box approach is available to retail investors, given their rationale apathy, many investors—perhaps the overwhelming majority of retail investors—will still prefer that the Big Three vote on their behalf. This does not mean, however, that the Big Three should vote any way they desire. They are still economic agents of the retail and institutional investors who provide the money that funds use to purchase their stock portfolios. If so, then some sort of fiduciary duties approach should apply.

According to Larry Ribstein, "[f]iduciary duties can be characterized as a hypothetical bargain – that is, contract terms the parties themselves would have agreed to in the absence of transaction costs."[191] In the context of this Article, they are the gap fillers in the investment advisory contract between the Big Three and the funds that they agree to manage. According to Robert Sitkoff, "[i]nstead of trying in advance to reduce to writing provisions for every future contingency, the parties need only address expressly those contingencies that are important and likely enough to warrant the transaction costs of express provision. For all other contingencies, the fiduciary obligation fills the gap."[192] These gap fillers include how the investment adviser is to vote the shares of stock they are to manage.

Fiduciary duties are needed because there is no way that beneficial investors—the principals—can adequately monitor the voting and engagement activity of the Big Three,[193] their agents. Such duties will act as a deterrent to Big Three voting that is not in the best interests of these investors. The fiduciary duties of the Big Three in the context of shareholder voting can be enforced under two statutes, the Employee Retirement Income Security Act (ERISA)[194] and the Investment Advisers Act of 1940 (Advisers Act).[195]

A. Fiduciary Duties Under ERISA

Both Vanguard and BlackRock are major players in the $10 trillion plus defined contribution market.[196] BlackRock has approximately $1 trillion of this market, while Vanguard and Fidelity has significantly more.[197] These plans are regulated by the

190. *Id.*

191. Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 541 (1997).

192. Sitkoff, *supra* note 80, at 1044.

193. *Id.* at 1041 ("Active monitoring is not a satisfactory answer to the agency problem.").

194. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. § 1001 et seq. (2012)).

195. 15 U.S.C. 80b-1 *et seq*.

196. Oisin Breen, *BlackRock's No Longer Secretive Strategy to Gain Ground on Vanguard and Fidelity in $10.3 Trillion DC Market Will Now Be Tested on 120,000 Employees at Five US Companies Where It Might Work—Or Not*, RIABIZ (Oct. 29, 2021), https://riabiz.com/a/2021/10/29/blackrocks-no-longer-secretive-strategy-to-gain-ground-on-vanguard-and-fidelity-in-103-trillion-dc-market-will-now-be-tested-on-120000-employees-at-five-us-companies-where-it-might-work-or-not [https://perma.cc/T9DR-WDW8].

197. *Id.*

Department of Labor under ERISA. In general, as investment advisers to mutual funds and ETFs, the Big Three do not have fiduciary duties under ERISA unless they directly manage all or part of an ERISA retirement plan.[198] That is, they only provide the index funds that the ERISA plan manager may invest in or, more commonly, the funds the manager provides as selected for a participant's self-directed account (defined contribution plan). This makes the application of fiduciary duties indirect, working through the ERISA plan manager.

1. The Issue Under ERISA

ERISA requires a plan manager to "discharge his duties with respect to a plan *solely* in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[199] The Department of Labor (DOL), the regulator of ERISA, first took the position in the "Avon Letter" back in 1988,[200] that the fiduciary act of managing plan assets includes the management of voting rights (as well as other shareholder rights) appurtenant to shares of stock.

When a plan manager utilizes index mutual funds and/or ETFs for its portfolio or offers them as selections in self-directed individual accounts, the plan has delegated away its voting authority to the investment advisers of those funds. These investment advisers, as long as they do not participate in managing an ERISA plan,[201] do not have fiduciary

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198. Section 3 of ERISA provides:

> If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a–1 et seq.], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B); *see also* Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 55,219, 55,234 (proposed Sept. 4, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550) ("ERISA does not govern the management of the portfolio internal to a fund registered with the SEC, including such fund's exercise of its shareholder rights appurtenant to the portfolio of stocks it holds. . . .").

199. Employee Retirement Income Security Act of 1974 § 404(a)(1)(B), *codified at* 29 U.S.C. § 1104(a)(1)(B).

200. U.S. Dep't of Lab., Pension & Welfare Benefit Admin., Opinion Letter on Avon Products, Inc. Employees' Retirement Plan (Feb. 23, 1988) [hereinafter Avon Letter].

201. ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B) provides:

> If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a–1 *et seq*.], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.

duties under ERISA. Therefore, the issue becomes whether an ERISA plan manager, investing in investment funds where the delegation of voting authority has occurred, either directly or through self-directed accounts, has a fiduciary duty to investigate the investment adviser's shareholder voting and engagement with portfolio companies? This author addressed that issue in a recent law review article, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*.[202]

2. Plan Manager Duties Under ERISA

An ERISA plan manager has a fiduciary duty, *the duty of prudence*, to investigate an investment adviser's shareholder voting and engagement with portfolio companies. This duty applies not only to the mutual funds or ETFs that an ERISA plan invests in, but also to those fund selections that it makes available to its participants and beneficiaries in self-directed accounts. The fiduciary objective in this investigation is to ensure that an investment adviser, such as one of the Big Three, is utilizing shareholder voting and engagement consistent with a plan manager's duty of loyalty under ERISA; that is, "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing *financial benefits*[203] to them. If that is not happening, these funds should be excluded from an ERISA plan.

Given this fiduciary duty of investigation, a plan manager investigating the Big Three's voting and engagement may find these activities—like the use of shareholder voting and engagement to increase the marketing of their investment products to millennials—to be in conflict with the plan manager's fiduciary duties. Another objective is to appease shareholder activists who threaten to attack the business decisions, procedures, and objectives of its own corporate management. In both cases, shareholder voting and engagement are not being executed *solely* in the interest of its beneficial investors, including those beneficial investors who are participants and beneficiaries of an ERISA plan. As a result, Big Three managed funds where delegated voting and engagement authority is used in this manner should not be allowed to become part of an ERISA plan until remedial action is taken.

B. Fiduciary Duties Under the Investment Advises Act of 1940

In a 2003 SEC Rule commonly referred to as the "Proxy Voting Rule," the SEC took

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> Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

202. Bernard S. Sharfman, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*, 71 CASE W. RSRV. L. REV. 1241 (2021).

203. Based on the U.S. Supreme Court's interpretation, the statutory language calls for:

> [T]he "exclusive purpose" to be pursued by all ERISA fiduciaries: "providing benefits to participants and their beneficiaries" while "defraying reasonable expenses of administering the plan." Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries. Cf. § 1002(2)(A) (defining "employee pension benefit plan" and "pension plan" to mean plans that provide employees with "retirement income" or other "deferral of income").

Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).

the position that an "investment adviser" "is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[204] This Rule was promulgated under the Investment Advisers Act of 1940 (Advisers Act).[205]

These duties require delegated voting authority to be executed "*in a manner consistent with the best interest of its client and must not subrogate client interests to its own*."[206] The authority for the Rule comes from the U.S. Supreme Court's holding in *SEC v. Capital Gains Research Bureau, Inc.*,[207] where the Court identified a fiduciary duty owed by investment advisers to their clients under the Advisers Act.[208]

The enforcement of these fiduciary duties appears to be restricted to actions taken by the SEC. In *Transamerica Mortgage Advisors v. Lewis*,[209] the U.S. Supreme Court held that clients and their shareholders have no express or implied private right of action under Section 206 of the Advisers Act.[210] That is, without a statutory fix, index funds or their beneficial investors do not have an express or implied private right of action to file suit for this type of breach.

According to Arthur Laby, "[b]y adopting rules and prosecuting enforcement actions, . . . the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry."[211] So far there has been only one incident, back in 2009, when the SEC has taken enforcement action against an investment adviser for opportunistic shareholder voting.[212] Therefore, the SEC must still fill in the details of what it will not tolerate in terms of opportunistic voting and engagement and get more proactive in enforcing the fiduciary duties that investment advisers, including the Big Three, have in regard to shareholder voting and engagement.

In regard to filling in those details, it would not be unreasonable for the SEC to provide guidance requesting that investment advisers with delegated voting authority be ready to demonstrate how their shareholder voting has met the preferences of fund investors. In terms of index funds with many retail investors, guidance should require how the voting of investment advisers, including the Big Three, meet the requirement of portfolio primacy unless it can be clearly demonstrated that this is not the optimal objective for these investors. Such guidance should focus both on voting policies—e.g. diversity policies and any other policies that systematically direct investment advisers to vote against board nominated directors without an associated business case—and individual votes on such items as proxy contests, as in the case of Engine No. 1's fight at ExxonMobil. If an

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204. Proxy Voting by Investment Advisers, 17 C.F.R. § 275 (2003).

205. 15 U.S.C. § 80b-1.

206. 17 C.F.R. § 275 (2003) (emphasis added).

207. 375 U.S. 180 (1963).

208. *See also* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17–18 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

209. 444 U.S. 11 (1979).

210. *Id.* at 24.

211. ARTHUR B. LABY, THE FIDUCIARY STRUCTURE OF INVESTMENT MANAGEMENT REGULATION, RESEARCH HANDBOOK ON MUTUAL FUNDS 8 (John D. Morley & William A. Birdthistle eds., 2016).

212. Intech Invest. Mgmt. LLC and David E. Hurley, Investment Advisers Act Release No. 2872 (May 7, 2009), http://www.sec.gov/litigation/admin/2009/ia-2872.pdf [https://perma.cc/7C2C-7RZ3].

investment adviser is the subject of investigation and is found not to be in compliance with the SEC guidance, then a cease and desist order should be executed.

For purposes of practicality in enforcement, such guidance need not apply to all investment advisers. Perhaps only to those who have $500 billion or more in U.S. equity securities under management or manage more than 5% of any one stock. Such guidance would obviously apply to the Big Three.

C. The Effectiveness of Fiduciary Duties

The effectiveness of fiduciary duties to deter opportunistic behavior in Big Three voting and engagement will depend on three factors. First, that one or both of the agencies mentioned above will take up the issue of fiduciary duties. Second, if they do take up the issue of fiduciary duties, how strongly will they enforce them? Third, even if they are not strongly enforced, how will the Big Three respond? It is quite possible that the Big Three may be very responsive even to weak enforcement if they fear that not doing so will put them in jeopardy of facing more severe regulation in other areas of the law such as antitrust.[213] Here, regulation under antitrust laws may limit the size or reduce the size of the Big Three's AUM.[214]

CONCLUSION

In this Article, a need to deal with the opportunistic voting and engagement of the Big Three has been identified. The entering into such decisions without a business case supporting those decisions can only lead to wealth reduction for investors. Corrective measures are required. One part of the solution is a market one, giving retail investors the opportunity to reveal their preferences through a simple check-box approach. However, many retail investors will still want investment advisers to vote the shares that are held in their index funds. Because the Big Three are economic agents of both the funds and their retail investors, fiduciary duties are still required when investment advisers are delegated the authority to vote the shares held in index funds. These fiduciary duties will help deter opportunistic behavior, helping to make sure that their voting and engagement are supported by a business case that will enhance shareholder wealth.[215] Such fiduciary duties can be found in both ERISA and SEC regulations, as currently promulgated under the Advisers Act of 1940. This author sincerely hopes that the DOL and the SEC seriously consider the issue and takes substantive action to restrain the potential for opportunistic behavior associated with the delegated voting authority of the Big Three.

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213. Dawn Lim, *Investment Giants Raise Voices in Debate Over Their Impact on Competition*, WALL ST. J. (Nov. 12, 2019), https://www.wsj.com/articles/investment-giants-raise-voices-in-debate-over-their-impact-on-competition-11573554601?mod=article_inline [https://perma.cc/QL4H-KNUQ].

214. *See generally* GRAHAM STEELE, THE NEW MONEY TRUST: HOW LARGE MONEY MANAGERS CONTROL OUR ECONOMY AND WHAT WE CAN DO ABOUT IT (2020).

215. Sitkoff, *supra* note 80, at 1043 ("Stripped of legalistic formalisms and moralizing rhetoric, the functional core of the fiduciary obligation is *deterrence*.") (footnote omitted).