Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy

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Index funds—investment funds that mechanically track the performance of an index—hold an increasingly large proportion of the equity of U.S. public companies. The sector is dominated by three index fund managers—BlackRock, State Street Global Advisors (SSGA), and Vanguard, often referred to as the “Big Three.” The Big Three collectively hold about one fifth of the equity in U.S. companies, a figure that is steadily growing.

The stewardship decisions of these index fund managers—how they monitor, vote, and engage with their portfolio companies—therefore have a profound impact on the governance and performance of public companies and the economy. Understanding index fund stewardship, and how policy-making can improve it, is critical for corporate law scholarship. Our Article contributes to such understanding by providing a comprehensive theoretical, empirical, and policy analysis of index fund stewardship.

Index funds hold great promise for stewardship, and for corporate governance, because of their large stakes and their long-term commitment to the companies in which they invest. Leaders of the Big Three have repeatedly stressed the importance of stewardship, and their willingness to commit resources to it. Our article focuses on whether index funds will deliver on this promise, on possible impediments to their doing so, and on how to facilitate improvements in index fund stewardship.

We begin by putting forward an agency-costs theory of index fund incentives. Stewardship decisions by index funds depend not just on the interests of index fund investors but also the incentives of index fund managers. Our agency-costs analysis shows that index fund managers do not have incentives to make stewardship decisions that would maximize the value of their portfolios and would be in the best interests of their own investors. In particular, our analysis indicates that index fund managers have strong incentives to (i) under-invest in stewardship, and (ii) defer excessively to the preferences and positions of the corporate managers of the portfolio companies they invest in.

We then provide, based on hand-collected data, a comprehensive empirical analysis of the full range of stewardship activities that index funds do and do not undertake. We analyze four dimensions of the Big Three’s stewardship activities: the limited personnel time they devote to stewardship regarding most of their portfolio companies; the small minority of portfolio companies with which they have any private communications; their focus on divergences from governance principles, with limited attention to other aspects that could be significant for their investors; and their pro-management voting patterns. We also empirically investigate five ways in which the Big Three could well fail to undertake adequate stewardship: the limited attention they pay to financial underperformance; their refraining from involvement in the selection of directors and from devoting attention to important director characteristics; their failing to take actions that would bring about governance changes that are desirable by their own governance principles; their
staying on the sidelines regarding corporate governance reforms; and their avoidance of involvement in consequential securities litigation. We show that the body of evidence is, on the whole, consistent with the incentive problems that our agency-costs framework identifies.

We next put forward a set of policy reforms that should be considered in order to encourage index funds to invest in stewardship, to reduce their incentives to be deferential to corporate managers, and to address the concentration of power in the hands of the largest index fund managers. Finally, we discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism.

The policy measures we put forward, and the beneficial role of hedge fund activism, can partly but not fully address the incentive problems that we analyze and document. These problems are expected to remain a significant aspect of the corporate governance landscape, and should be the subject of close attention by policymakers, market participants, and scholars.