COMMITTEE ON CAPITAL MARKETS REGULATION

An Analysis of Investment Stewardship: Mutual Funds and ETFs

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Executive Summary

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

This report is divided into five sections:

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

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

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

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

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

Contents

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

a. Mutual funds and ETFs

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

At the direction of their fund managers, mutual funds and ETFs invest in the securities of public companies (their "**portfolio companies**"). Together, they collectively hold approximately 32% of U.S. public equity at year-end 2019.[4] **Table 1** sets forth mutual fund and ETF ownership of the ten largest public companies by market capitalization as of December 31, 2019. Mutual funds and ETFs can therefore exert significant influence on portfolio companies through investment stewardship.[5]

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

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

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

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

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

Table 1. Mutual fund and ETF ownership of the largest U.S. public companies (December 2019).

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

b. Regulatory framework

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

i. Investment Advisers Act of 1940

Fund managers are regulated as "investment advisers" under the Advisers Act, which defines an "**investment adviser**" as "any person who, for compensation, engages in the business of advising

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

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

others… as to the value of securities or as to the advisability of investing in… securities[.]"[8] Because fund managers have mutual fund and ETF clients, they must register as investment advisers with the SEC.[9]

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

ii. Investment Company Act of 1940

Under the Company Act, an "**investment company**" is "any issuer which… is or holds itself out as being engaged primarily… in the business of investing, reinvesting, or trading in securities[.]"[15] Mutual funds and ETFs that primarily invest in securities (including the equity of U.S. public

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

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

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

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

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

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

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

[15] 15 U.S. C. § 80a–3(a).

companies) constitute "investment companies" under the Company Act.[16] Under the Company Act, investment companies are generally required to file a registration statement with the SEC that discloses, among other things, the fund's investment objectives and strategies, its fees and operating expenses, performance information and the fund's investment adviser.[17]

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

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[16] U.S. SEC. & EXCH. COMM'N, *Investment Companies* (July 9, 2013), https://www.sec.gov/fast-answers/answersmfinvcohtm.html; INVESTMENT COMPANY INSTITUTE, *ICI Research Perspective: Understanding Exchange-Traded Funds: How ETFs Work*, at 9 (September 2014), available at https://am.jpmorgan.com/blobgim/1383262775476/83456/1323398305717_ICI-RESEARCH-PERSPECTIVE.pdf.

[17] See 15 U.S.C. § 80a-8(b).

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

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

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

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

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

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

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

a. Investment adviser voting authority

According to the SEC, "in the context of voting, the specific obligations that flow from the investment adviser's fiduciary duty depend upon the scope of voting authority assumed by the adviser."[23] For mutual funds and ETFs, investment advisers' voting authority is determined by the advisory agreement governing their relationship.[24] Under this agreement, the fund board typically delegates voting authority to the investment adviser.[25]

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

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[23] U.S. SEC. & EXCH. COMM'N, *Commission Guidance Regarding the Proxy Voting Responsibilities of Investment Advisers* 3, Investment Adviser Act Release No. 5325, Investment Company Act Release No. 33605 (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf ["**2019 Voting Guidance**"].
[24] *2019 Voting Guidance*, *supra* note 23, at 2 fn. 7.
[25] *2019 Voting Guidance*, *supra* note 23, at 2 fn. 7.
[26] *Standard of Conduct*, *supra* note 10, at 33671.
[27] *2019 Voting Guidance*, *supra* note 23, at 3-4.
[28] U.S. SEC. & EXCH. COMM'N, *Proxy Voting by Investment Advisers*, 68 FED. REG. 6585, 6586 (Feb. 7, 2003), https://www.federalregister.gov/documents/2003/02/07/03-2952/proxy-voting-by-investment-advisers ["**Proxy Voting by Investment Advisers**"].

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

Although investment advisers currently tend to vote all or most of the proxies that they hold in clients' shares,[33] SEC Commissioner Elad Roisman recently noted that voting may entail greater costs than initially acknowledged, including "opportunity costs… such as foregone income from shares on loan that have to be recalled to be voted or shares that are restricted from being lent out for this same reason."[34] The 2019 Voting Guidance clarifies that clients can agree that investment advisers need not vote proxies in such instances.[35]

b. Voting policies, conflicts of interest & proxy advisors

The SEC requires investment advisers to "adopt and implement written policies and procedures that are reasonably designed to ensure that [investment advisers] vote client securities in the best interest of clients," including how to "address material conflicts that may arise between [investment advisers] interests and … clients."[36] The SEC does not prescribe specific content for these

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

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

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

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

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

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

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

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

policies, rejecting a "one-size-fits-all" approach, instead "leav[ing] advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face."[37]

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

In 2014, an SEC staff bulletin confirmed that investment advisers have a duty to select and oversee proxy advisors diligently when relying on their advice to vote client shares.[41] Even prior to this SEC guidance, most investment advisers reported conducting independent due diligence of proxy advisors to obtain reasonable assurances regarding conflicts of interest.[42] Subsequently, in its 2019 Voting Guidance, the SEC elaborated on the ways in which investment advisers should monitor proxy advisors to ensure that shares are voted in the best interest of clients.[43] The 2019 Voting Guidance recommends that investment advisers, among other things: (i) periodically sample and examine sets of recommended votes to ensure they would, if cast, meet the investment advisers fiduciary duties; (ii) consider outside information other than the proxy advisor's recommendation, including filings and supplemental input from issuers and shareholder proposal proponents; (iii)

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[37] *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587.
[38] *2019 Voting Guidance*, *supra* note 23, at 8.
[39] *Proxy Voting by Investment Advisers*, *supra* note 28, at 6588.
[40] Gary Retelny, Chief Executive Officer of Institutional Shareholder Services, *Why we are suing the SEC*, FINANCIAL TIMES (Nov. 5, 2019), https://www.ft.com/content/cdcb6ed7-18f4-4729-8dc4-6a577ac44f15?shareType=nongift.
[41] SECURITIES AND EXCHANGE COMMISSION, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) https://www.sec.gov/interps/legal/cfslb20.htm.
[42] *GAO Report*, supra 32, at 11.
[43] *See generally 2019 Voting Guidance*, *supra* note 23.

engage in greater in-house analysis on important or controversial proposals; and (iv) conduct a periodic review of their proxy advisors' voting policies and practices.[44]

c. Disclosure of voting policies and votes

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

d. Non-voting engagement with portfolio company management

Non-voting types of engagement consist of direct oral or written dialogue between an investment adviser and portfolio company management regarding investor concerns.[51] An investment adviser

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

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

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

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

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

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

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

[51] STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf (referring to "engagements conducted in-person or via conference calls and… letter-writing campaigns.");

may use such engagement to better understand portfolio company governance, to develop an informed position on specific votes or issues, and to advocate certain governance priorities.

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

Certain investment advisers have effectively agreed to voluntarily disclose their non-voting engagement policies, as recommended by the Investment Stewardship Group ("**ISG**"). The ISG is a non-profit group that includes BlackRock, Vanguard and State Street as members whereby large investment advisers and other institutional investors, such as pension funds, have agreed to six investment stewardship principles.[54] These principles are typically highly generalized and often do not go beyond existing regulatory requirements for investment advisers. For example, Principle A states that "institutional investors are accountable to those whose money they invest" and Principle E states that "institutional investors should address and attempt to resolve differences

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VANGUARD, *Investment Stewardship 2019 Annual Report*, 5 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf. ("Engagement: We meet with portfolio company executives and directors to share our long-term orientation and principled approach and to learn about companies' corporate governance practices.");
BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 3 (July 1, 2018 – June 30, 2019), https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2019.pdf ("The key to effective engagement is constructive and private communication. Engagement allows us to share our philosophy on and approach to investment and corporate governance with companies. Through dialogue, we make clear our expectations of companies in relation to their governance and business practices, including their management of relevant environmental and social factors.").

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

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

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

with companies in a constructive and pragmatic manner."[55] However, as to non-voting engagement, the ISG recommends that member firms, including investment advisers, should periodically disclose their "general engagement activities undertaken to monitor corporate governance,"[56] and "disclose, in general, what further actions they may take in the event they are dissatisfied with the outcome of their engagement efforts."[57] These principles thereby encourage investment advisers that are members of the ISG to disclose non-voting engagement activities and policies.

e. Select international approaches to investment stewardship

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

i. European Union

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

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

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[55] INVESTOR STEWARDSHIP GROUP, *Stewardship Principles* (last accessed May 11, 2020), https://isgframework.org/stewardship-principles/.
[56] INVESTOR STEWARDSHIP GROUP, *Stewardship Principles*, supra note 55, B.1-B.3.
[57] INVESTOR STEWARDSHIP GROUP, *Stewardship Principles*, supra note 55.
[58] *See SRD II*, *supra* note 61, at Article 1(1)(f).
[59] *See generally SRD II*, *supra* note 61, at Recital 9 and Article 3c.
[60] *See generally* Directive 2014/65 of the European Parliament and of the Council of 15 May 2014, Article 24(1), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065. *See also* EUROPEAN COMMISSION, In*terim Report: Financing a Sustainable European Economy* 22 (July 2017), https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf ("At the EU level, the duties of loyalty and prudence are partly codified in a number of directives, but standards differ greatly.").
[61] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the Encouragement of Long-term Shareholder Engagement, Recital 15 ("**SRD II**") https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN.

and stakeholders, and manage conflicts of interest.[62] With respect to conflicts of interest, investment firms "should provide proper information… on whether… conflicts of interests have arisen in connection with engagement activities and how the [investment firm] has dealt with them."[63] With respect to disclosure, SRD II also requires investment firms to publicly disclose: (i) their engagement policy;[64] and (ii) how that policy is implemented on an annual basis, including "a general description of voting behavior, an explanation of the most significant votes, and the use of… proxy advisors."[65] These requirements allow investors to monitor "whether and how the manager acts in the best long-term interests of the investor and whether the [investment firm] pursues a strategy that provides for efficient shareholder engagement."[66]

ii. Hong Kong

In Hong Kong, the Securities and Futures Commission ("**SFC**")[67] regulates firms that advise on the acquisition and disposition of securities[68] and firms that manage collective investment schemes (collectively referred to in this section as "investment firms").[69] The *Code of Conduct for Persons Licensed by or Registered with the SFC*[70] and the *Fund Manager Code of Conduct*[71] establish the regulatory requirements for such investment firms. As a general matter, investment firms must enter into written agreements with clients that "set out the precise terms and conditions under

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[62] *See SRD II*, *supra* note 61, at Article 3g(1)(a).
[63] *See SRD II*, *supra* note 61, at Recital 23.
[64] *See SRD II*, *supra* note 61, at Article 3g(1)(a).
[65] *See SRD II*, *supra* note 61, at Article 3g(1)(b).
[66] *See SRD II*, *supra* note 61, at Recital 20.
[67] *See generally*, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, *International Review of Equity Market Structure Regulation* (October 2019), https://www.pifsinternational.org/wp-content/uploads/2019/10/PIFS-International-Review-of-Equity-Market-Structure-Reg-for-website.pdf
[68] *See generally* HONG KONG SECURITIES & FUTURES ORDINANCE, *Schedule 5: Regulated Activities* (2018) https://www.elegislation.gov.hk/hk/cap571 (defining "advising on securities").
[69] HONG KONG SEC. AND FUT. COMM'N, *Fund Manager Code of Conduct* (Nov. 2018) https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/fund-manager-code-of-conduct/fund-manager-code-of-conduct.pdf.
[70] HONG KONG SEC. AND FUT. COMM'N, *Code of Conduct for Persons Licensed by or Registered with the SFC* (Mar. 2016) https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf.
[71] *Fund Manager Code of Conduct*, *supra* note 69.

which discretion will be exercised,"[72] including voting authority. In exercising voting authority, an investment firm must act "honestly, fairly, and in the best interests of its clients and the integrity of the market."[73]

Neither code of conduct requires investment firms to develop voting policies, nor do they require the disclosure of voting policies and actual votes. However, in March 2016, the SFC promulgated non-binding and voluntary *Principles of Responsible Ownership* (the "Principles")[74] that apply to investment firms that hold or manage investments on behalf of clients.[75] Investment firms are "encouraged to adopt the Principles," and apply the Principles in their entirety.[76] With respect to voting authority, the Principles provide that adopting investment firms "should seek to vote all shares held" and, if they have not done so, "disclose the reasons to their stakeholders."[77] Investment firms should also have clear policies on voting and managing conflicts of interests.[78] The Principles clarify that "ownership responsibilities extend beyond voting," and include "monitoring and engaging on matters such as strategy, performance, risk, capital structure and corporate governance."[79] With respect to disclosure of voting and non-voting engagement, the Principles provide

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[72] *See, e.g.*, *Fund Manager Code of Conduct*, *supra* note 69, at 31 ("A Discretionary Client Agreement should set out the precise terms and conditions under which discretion will be exercised and contain at least such information set out in the section 'Minimum Content of Discretionary Client Agreement' and be provided in a language understood by the client."). *See also* HONG KONG SEC. AND FUT. COMM'N, *Code of Conduct for Persons Licensed by or Registered with the SFC* 14 (Mar. 2016) https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf.

[73] HONG KONG SEC. AND FUT. COMM'N, *Code of Conduct for Persons Licensed by or Registered with the SFC* 1 (Mar. 2016) https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code%20of%20Conduct%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf.

[74] HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership* (Mar. 7, 2016) https://www.sfc.hk/web/EN/rules-and-standards/principles-of-responsible-ownership.html ["**SFC Principles**"].

[75] Paul Westover and Karen Lau, *Corporate Governance and Directors' Duties in Hong Kong: Overview*, THOMPSON REUTERS: PRACTICAL LAW (June 1, 2019) https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

[76] SFC Principles, supra note 74, at 1.

[77] SFC Principles, supra note 74, at 5.

[78] SFC Principles, supra note 74.

[79] SFC Principles, supra note 74, at 3.

that investment firms should: (i) report to their stakeholders their policies for discharging their ownership responsibilities; and (ii) at least annually, report to stakeholders on how they have discharged their ownership responsibilities.[80]

iii. Japan

In Japan, the Financial Services Authority (the "**FSA**") regulates "investment management businesses," or "investment managers," pursuant to the Financial Instruments and Exchange Act (the "**FIEA**").[81] Investment managers are firms that contract to invest and manage assets on behalf of clients, including through discretionary accounts, investment corporations, investment trusts, and collective investment schemes.[82] The relationship between the investment manager and its client is set forth in the relevant agreement, which typically addresses voting authority.[83] Like other financial business operators, investment managers must "operate their businesses in an honest and fair manner for the best interest of their clients" and "appropriately manage conflicts of interest."[84]

The FIEA does not impose specific requirements with respect to voting, voting policies, and related disclosure. However, in 2017, the FSA promulgated the *Principles for Responsible Institutional Investors* (the "**Stewardship Code**") in order to "enhance the medium- to long-term investment return" at Japanese companies.[85] The Stewardship Code was motivated by concern that "institutional investors" (including "asset managers" that "are entrusted to manage funds and invest in

[80] SFC Principles, supra note 74.

[81] FINANCIAL SERVICES AGENCY OF JAPAN, *Financial Instruments and Exchange Act*, Article 28(4) (Act No. 25 of 1948 up to the revisions of Act No. 99 of 2007, effective April 1, 2008), https://www.fsa.go.jp/common/law/fie01.pdf.

[82] FINANCIAL SERVICES AGENCY OF JAPAN, *FAQ on Financial Instruments and Exchange Act: Section 6 Financial Instruments Business Operator*, Q5 (last accessed Feb. 12, 2020), https://www.fsa.go.jp/en/laws_regulations/faq_on_fiea/section06.html#06-06.

[83] *See generally*, Kiyomi Kikuchi and Kazuyuki Wakasa of TMI Associates, *Fund Management*, LAW BUSINESS RESEARCH (July 2019), https://gettingthedealthrough.com/area/76/jurisdiction/36/fund-management-japan/.

[84] FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Customer-Oriented Business Operations* (Feb. 2017), https://www.fsa.go.jp/news/28/sonota/20170119-1/01.pdf. See also Christopher P. Wells and Tomoko Fuminaga, *Japan Releases Draft 'Principles for Consumer-Oriented Business Conduct*, MORGAN LEWIS (Feb. 2017), https://www.morganlewis.com/pubs/japan-releases-draft-principles-for-customer-oriented-business-conduct.

[85] PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS (May 29, 2017) Introduction, para. 4, *available at* https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/02.pdf [hereinafter, the "**Stewardship Code**"]; *see also* CORPORATE GOVERNANCE CODE (June 1, 2018), *available at* https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxr-att/20180602_en.pdf. Updated in 2017 and 2018, respectively. *See also* HONG

companies"[86]) were not using voting or engagement to hold portfolio company management accountable for underperformance.[87] The Stewardship Code is voluntary,[88] but those that adopt it are expected to comply with it in full or explain any deviations.[89]

According to the Stewardship Code, with respect to voting, asset managers "should seek to vote on all shares held."[90] In addition, asset managers should: (i) have a clear policy on how they fulfill their stewardship responsibilities generally; (ii) have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities; and (iii) develop a clear policy on voting "designed to contribute to sustainable growth of investee companies."[91] With respect to other non-voting engagement activities, the Stewardship Code states that asset managers should: (i) "monitor investee companies… with an orientation towards the sustainable growth of the companies;" (ii) "seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies;" and (iii) "have in-depth knowledge of the investee companies and their business environment."[92] With respect to disclosure, the Stewardship Code provides that asset managers should: (i) publicly disclose their stewardship, voting, and conflict-of-interest policies; and (ii) "report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries."[93] At a minimum, asset managers should disclose "aggregate voting records" broken down by proposal type and "voting records for each investee company on an individual agenda item basis."[94]

KONG SECURITIES & FUTURES COMMISSION, *Consultation Paper on the Principles of Responsible Ownership: Appendix B: Summary of the United Kingdom, Australia and Japan shareholder engagement models* (Mar. 2, 2015), https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=15CP2.

[86] Stewardship Code, supra note 85, at Background, para. 7.

[87] *See generally* Madison Marriage, *Foreign investors fear holding Japan Inc to account*, FINANCIAL TIMES (Jan. 9 2016), https://www.ft.com/content/080fd530-a7fe-11e5-9700-2b669a5aeb83; Attracta Mooney, *Japanese asset managers will reveal AGM votes*, FINANCIAL TIMES (June 4, 2017), https://www.ft.com/content/478ad316-4782-11e7-8d27-59b4dd6296b8.

[88] *Stewardship Code*, *supra* note 85, at Background, para. 7.

[89] *Stewardship Code*, *supra* note 85, at "Principles-Based Approach: and "Comply or Explain", para. 7.

[90] *Stewardship Code*, *supra* note 85, at Art. 5, para. 1.

[91] *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

[92] *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

[93] *Stewardship Code*, *supra* note 85, at Art. 5, page 8.

[94] *Stewardship Code*, *supra* note 85, at Art. 5, page 15.

iv. Comparative Analysis

In each jurisdiction,[95] an investment adviser's voting authority in respect of client assets is defined by an agreement between the adviser and its client (the investment fund). In exercising that authority, each jurisdiction also subjects the investment adviser to a fiduciary duty to act in the best interest of its client, which requires it to avoid conflicts of interest.[96]

In the US and EU, investment advisers are required by regulation to develop written policies that govern how they cast votes on behalf of clients and manage related conflicts of interest.[97] However, in Hong Kong and Japan, investment advisers are only subject to non-binding regulatory guidance that encourages voluntary adoption of voting policies.[98] As to non-voting engagements, the EU requires the adoption and disclosure of such policies, whereas the US does not.[99] The guidance in Hong Kong and Japan recommends the adoption of non-voting engagement policies.[100]

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[95] Each jurisdiction regulates firms that manage assets on behalf of clients, which include the foreign equivalents of U.S. investment advisers. Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 1(1)(f); HONG KONG SEC. AND FUT. COMM'N, *Fund Manager Code of Conduct* (Nov. 2018); HONG KONG SEC. AND FUT. COMM'N, *Code of Conduct for Persons Licensed by or Registered with the SFC* (Mar. 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Financial Instruments and Exchange Act*, Article 28(4) (Act No. 25 of 1948 up to the revisions of Act No. 99 of 2007, effective April 1, 2008); FINANCIAL SERVICES AGENCY OF JAPAN, *FAQ on Financial Instruments and Exchange Act: Section 6 Financial Instruments Business Operator*, Q5 (last accessed Feb. 12, 2020); 15 U.S.C. § 80b–2(a)(11).

[96] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Recital 9 and Article 3c; HONG KONG SEC. AND FUT. COMM'N, *Code of Conduct for Persons Licensed by or Registered with the SFC* 1 (Mar. 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Customer-Oriented Business Operations* (Feb. 2017); U.S. SEC. & EXCH. COMM'N, *Commission Guidance Regarding the Proxy Voting Responsibilities of Investment Advisers* 3, Investment Adviser Act Release No. 5325, Investment Company Act Release No. 33605 (Aug. 21, 2019).

[97] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 3g(1)(a); 17 C.F.R. 275-206(4)-6(a).

[98] HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership* (Mar. 7, 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, page 8 (May 29, 2017).

[99] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Article 3g(1)(a).

[100] HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership*, 30 (Mar. 7, 2016); FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, page 8 (May 29, 2017).

Both the US and EU require the disclosure of voting policies, but the US requirements go further by requiring public disclosure of every vote cast.[101] In Hong Kong, the guidance also states that investment advisers should disclose voting policies but does not recommend the disclosure of each vote cast.[102] Japan's voluntary guidance goes further than Hong Kong by recommending that investment advisers disclose voting policies and each vote cast.[103]

Therefore, investment advisers in all four jurisdictions are required to act in the best interests of their clients when voting their shares. However, only the EU and US apply binding regulations on the development and disclosure of voting policies and the US goes further than the EU in requiring the public disclosure of every vote cast. On the other hand, the EU requires the adoption and public disclosure of non-voting engagement policies, such as meetings between an investment adviser and portfolio company, whereas the US does not. In **Section 5**, we consider whether the SEC should mandate additional disclosure of non-voting engagement policies.

[101] 17 C.F.R. 275-206(4)-6; U.S. SEC. & EXCH. COMM'N, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 67 FED. REG. 60827 (2003).
[102] HONG KONG SEC. AND FUT. COMM'N, *Principles of Responsible Ownership* (Mar. 7, 2016).
[103] FINANCIAL SERVICES AGENCY OF JAPAN, *Principles for Responsible Institutional Investors*, Article 5, pages 8 and 15 (May 29, 2017).

3. Investment stewardship practices of certain investment advisers

Section 3 describes the voluntary investment stewardship practices of BlackRock, Vanguard, and State Street Global Advisors,[104] as mutual funds and ETFs managed by these three firms are the three largest shareholders in many U.S. public companies.[105] **Section 3** refers to each firm as an "investment adviser." [106]

a. Voting

As described in **Section 2(c)**, under the Advisers Act, the Company Act, and the rules thereunder, investment advisers and investment companies have certain disclosure obligations with respect to voting policies and actual votes cast. As further described below, BlackRock, Vanguard and State Street have elected to exceed these requirements by voluntarily: (i) disclosing detailed proxy voting guidelines; and (ii) disclosing consolidated voting statistics, although their practices differ.

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[104] PENSION & INVESTMENTS, *Money Managers* (Last accessed Feb.19, 2020), https://researchcenter.pionline.com/v3/rankings/money-manager/datatable (listing these firms as the three largest money managers by world-wide assets under management, both total and equity).

[105] *See, e.g.,* Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo, *Hidden power of the Big Three?*, 19(2) BUSINESS AND POLITICS 298, 314 (2017), https://pdfs.semanticscholar.org/e0f4/1af67167d2c7911393eeccf33f47d035cb59.pdf; *See also* MORNINGSTAR, *Proxy Voting by 50 U.S. Fund Families: Growing support for ESG Resolutions, but the largest lag behind*, 11 (Feb. 6, 2020), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Proxy_Voting_020620_jc-KG-Final_.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=20694&mod=article_inline; .

[106] Each firm's public proxy voting guidelines apply when voting shares on behalf of clients, sponsored funds, or both. *See, e.g.*, BLACKROCK, *Proxy voting guidelines for U.S. securities* 3 (January 2020) https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; VANGUARD FUNDS, *Proxy Voting Guidelines for U.S. Portfolio Companies* 2 (April 1, 2019) https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf.; FIDELITY INVESTMENTS, *Proxy Voting Guidelines*, 1 (Jan. 2020) https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Full-Proxy-Voting-Guidelines-for-Fidelity-Funds-Advised-by-FMRCo-and-SelectCo.pdf; BNY MELLON, *Summaries of Selected Proxy Voting Guidelines – Proxy Contests* (last accessed Feb. 5, 2020), https://im.bnymellon.com/us/en/individual/policies/proxy-voting-and-governance/summaries.jsp; CAPITAL GROUP AMERICAN FUNDS, *Proxy Voting Guidelines* 1 (2020) https://americanfundsretirement.retire.americanfunds.com/content/dam/rpassets/pdf/proxy_voting_guidelines.pdf.

i. Detailed voting policies

As noted earlier, the SEC has not prescribed specific content or procedures for the disclosure of voting policies.[107] Nevertheless, BlackRock, Vanguard and State Street set forth detailed voting policies and engagement practices on their public websites.[108] These websites represent a resource that investors can use to understand the investment adviser's general approach to voting and engagement.

BlackRock maintains "Proxy Voting Guidelines" setting out its general voting positions on governance matters, including board composition, governance structure and rules, shareholder rights, compensation, capital structure, M&A, anti-takeover devices, environmental and social issues, and corporate political activities.[109] Moreover, BlackRock, and Vanguard each specify enumerated factors to consider for contested director elections (State Street does not enumerate such factors). **Table 2** sets forth the specific self-reported factors considered by BlackRock and Vanguard when voting in a contested director election. Investors can use variations in approaches to contested director elections to help select an investment adviser with priorities that align with the investor.

[107] *See, e.g.*, *Proxy Voting by Investment Advisers*, *supra* note 28, at 6587 ("We did not propose, and are not adopting, specific policies or procedures for advisers. Nor are we, as some commenters requested, providing a list of approved procedures. Investment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable. By not mandating specific policies and procedures, we leave advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face.").

[108] *See* BLACKROCK, *Investment Stewardship* (2020) https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us; VANGUARD, *Investment Stewardship* (2020) https://about.vanguard.com/investment-stewardship/; STATE STREET GLOBAL ADVISERS, *Asset Stewardship* (2020) https://www.ssga.com/us/en/individual/etfs/about-us/asset-stewardship. *See also* FIDELITY INVESTMENTS, *Proxy Voting* (2020) https://www.fidelity.ca/fidca/en/proxy#ipl_guidelines; BNY MELLON, *Proxy Voting and Governance* (2020) https://im.bnymellon.com/us/en/policies/proxy-voting-and-governance/all.jsp; CAPITAL GROUP AMERICAN FUNDS, *Proxy voting and American Funds* (2020) https://americanfundsretirement.retire.americanfunds.com/about/proxy-voting.html.

[109] BLACKROCK, *Proxy voting guidelines for U.S. securities* (January 2020) https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [the "**BlackRock Voting Guidelines**"].

Table 2. Self-reported factors considered in contested director elections.

BlackRock[110]	For contested director elections, BlackRock considers: • the qualifications of the dissident and management candidates; • the validity of the concerns identified by the dissident; • the viability of both the dissident's and management's plans; • the likelihood that the dissident's solutions will produce the desired change; and • whether the dissident represents the best option for enhancing long-term shareholder value.
Vanguard[111]	For contested director elections, Vanguard considers: • the case for change at the target company, including performance relative to peers, deficient oversight, and the dissident's case to improve long-term strategy and returns; • the relative quality of the company and dissident's board nominees, including independence, engagement, focus on long-term shareholder interests, and the extent to which the nominee slates meet the company's current management needs; and • the general quality of company governance, including management's prior engagement with the dissident, the adoption of share-holder friendly governance practices at the company, and management's past efforts at shareholder engagement.

[110] BLACKROCK, *Proxy Voting Guidelines for U.S. Securities* 6 (Jan. 2020) https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.
[111] VANGUARD FUNDS, *Proxy Voting Guidelines for U.S. Portfolio Companies* 5-6 (April 1, 2019) https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf.

ii. Annual consolidated voting statistics

In addition to the required itemized disclosure of each vote cast,[112] BlackRock,[113] Vanguard,[114] and State Street[115] provide *consolidated* voting statistics reflecting all votes cast. A sample of self-reported consolidated voting statistics for these three investment advisers for the 12-month proxy season ended June 2019 is partially reproduced below in **Tables 3–5**. Based on this data, an investor can draw inferences about an investment adviser's voting priorities.

Table 3. BlackRock: Self-reported votes against *management, 2018-19 (% of total votes cast).*[116]

Management Proposals	Global	United States
Anti-takeover and related proposals	13%	7%
Capitalization	11%	5%
Election of directors and related proposals	8%	8%
Non-salary compensation	16%	6%
Mergers, acquisitions and reorganizations	11%	1%

[112] Firms take different approaches to meeting this requirement, from proxy vote search functions to fund-specific lists of votes. *See, e.g.*, BLACKROCK, *Proxy Voting Search* (last accessed April 30, 2020), http://vds.issproxy.com/SearchPage.php?CustomerID=10228; VANGUARD, *How our funds voted* (last accessed April 30, 2020), https://about.vanguard.com/investment-stewardship/how-our-funds-voted/.

[113] BLACKROCK, *2019 Investment Stewardship Annual Report:* (Aug. 2019) https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf; BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 6 (July 1, 2018 – June 30, 2019), https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2019.pdf.

In addition to voting statistics, BlackRock publishes "voting bulletins" that explain specific high-profile voting decisions. *See generally* BLACKROCK, *Investment Stewardship* (2020) https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us. In early 2020, BlackRock published twelve such bulletins. *See generally* BLACKROCK, *Investment Stewardship* (2020) https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us. *See, e.g.*, BLACKROCK, *Voting Bulletin: The Boeing Company* (April 2020), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-boeing-apr-2020.pdf.

[114] VANGUARD, *Investment Stewardship 2019 Annual Report*, 28 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

[115] STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 9-10 (2019) https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf.

[116] BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 6 (July 1, 2018 – June 30, 2019), https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2019.pdf.

Routine business	5%	2%
Shareholder Proposals		
Compensation	9%	3%
Corporate Governance	10%	48%
Election of directors and related proposals	3%	12%
Miscellaneous business	5%	6%

Table 4. State Street: Self-reported votes with *management, 2018-19 (% of total votes cast).*[117]

Management Proposals	**Global**
Anti-takeover and related proposals	19%
Capitalization	77%
Election of directors and related proposals	87%
Compensation	77%
Reorganization- and merger-related proposals	76%
Routine business	94%
Shareholder Proposals	
Compensation	61%
Corporate governance	71%
Election of directors and related proposals	96%
Environmental- and social-related proposals	72%
Routine business	85%
Other miscellaneous	68%

[117] STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 9-10 (2019) https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf; STATE STREET GLOBAL ADVISORS, *Asset Stewardship 2018–2019* (Sept. 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/asset-stewardship-highlights-2018-2019.pdf.

Table 5. Vanguard: Self-reported votes for *proposals, 2018-19 (% of total votes cast).*[118]

Management Proposals	**Global**	**United States**
Elect directors	91%	93%
Approve auditors	98%	100%
Executive compensation	91%	94%
Governance-related	87%	94%
Capitalization	98%	91%
Mergers and acquisitions	97%	98%
Shareholder Proposals		
Board-related	82%	22%
Environmental/social	6%	7%
Compensation-related	60%	3%
Governance-related	50%	42%

b. Disclosure of non-voting engagement activities and priorities

BlackRock, Vanguard, and State Street voluntarily release annual reports that review their past engagement activities and forward-looking engagement priorities.[119]

BlackRock releases: (i) an annual engagement report that reviews non-voting engagement efforts in a narrative style;[120] (ii) a global quarterly report on itemized engagements listing each company,

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[118] VANGUARD, *Investment Stewardship 2019 Annual Report*, 28 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

[119] STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf;
VANGUARD, *Investment Stewardship 2019 Annual Report*, 5 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf
BLACKROCK, *2019 Annual Engagement and Voting Statistics*, 3 (July 1, 2018 – June 30, 2019), https://www.blackrock.com/corporate/literature/publication/blk-voting-and-engagment-statistics-annual-report-2019.pdf.

[120] BLACKROCK, *2019 Investment Stewardship Annual Report* (Aug. 2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.

the sector, the region, the topics covered by that engagement, and the last engagement date;[121] and (iii) a regional quarterly report on engagement activities for the Americas,[122] the Asia Pacific,[123] and Europe, the Middle East, and Africa.[124] According to BlackRock's 2019 Investment Stewardship Report, which covered the 12-month period ended June 2019, BlackRock conducted 2,050 engagements with 1,458 portfolio companies representing 50.4% of equity assets under management.[125] The Report describes BlackRock's engagement priorities, including governance, corporate strategy, capital allocation, compensation that promotes long-termism, environmental risks and opportunities, and human capital management.[126] In addition, BlackRock's regional quarterly reports include statistics on (i) the total number of engagements and (ii) the percentage of engagements related to each engagement priority. For Q4 2019, this included 451 total engagements, of which 55% related to board composition and effectiveness, 49% corporate strategy, 42% compensation, 24% environmental impact, and 23% human capital management.[127] These quarterly reports also include narrative descriptions of specific engagements and their results.[128]

Vanguard and State Street Global Advisors take broadly similar approaches.[129] Over the same period, Vanguard engaged 868 portfolio companies representing 59% of global assets under management.[130] According to State Street's 2018-2019 Annual Stewardship Report, it engaged with 1,533 portfolio companies, including 686 in-person or teleconference engagements and 847 letter-

[121] *See, e.g.*, BLACKROCK, *Investment Stewardship Global Engagement Summary Report* (Q1 2020), https://www.blackrock.com/corporate/literature/press-release/blk-engagement-summary-report-q1-2020.pdf.
[122] BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas* (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf.
[123] BLACKROCK, *Q4 2019 Investment Stewardship Report: Asia -Pacific* (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-apac.pdf.
[124] BLACKROCK, *Q4 2019 Investment Stewardship Report: Europe, Middle East, and Africa* (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-emea.pdf.
[125] BLACKROCK, *2019 Investment Stewardship Annual Report,* 4 (Aug. 2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.
[126] BLACKROCK, *2019 Investment Stewardship Annual Report.* 9 (Aug. 2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.
[127] BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas*, supra note 122.
[128] BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas*, supra note 122, at 4-8.
[129] Investment advisers tend to define engagement as any substantive dialogue with the officers or directors of a portfolio company, from letters to direct meetings and negotiations.
[130] VANGUARD, *2019 Investment Stewardship Annual Report*, 8 (2019 https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

writing campaigns, which together represented 70% of equity assets under management.[131] **Table 6** provides a brief overview of BlackRock, Vanguard and State Street's recent self-reported engagement priorities. In each case, engagement priorities are described in more detail in the relevant disclosures.

Table 6. Self-reported engagement priorities by investment adviser.

BlackRock [132]	Engagement Priorities: • Governance • Corporate Strategy & Capital Allocation • Compensation that Promotes Long-termism • Environmental Risks & Opportunities • Human Capital Management
Vanguard [133]	Engagement Priorities: • Board Composition • Oversight of Strategy and Risk • Executive Compensation • Governance Structures
State Street Global Advisors[134]	Core Campaigns: • Fearless Girl Campaign for Board Gender Diversity • Climate Risk and Reporting Sector Focuses for 2018-2019: • Retail • Pharmaceuticals • Materials

131 STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf.
132 BLACKROCK, *2019 Investment Stewardship Annual Report* 9 (Aug. 2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.
133 VANGUARD, *Investment Stewardship 2019 Annual Report*, 4 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.
134 STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf

	Thematic Focuses for 2018-2019 • Compliance with Corporate Governance Principles in the US, UK, Australia, and Europe • Pay Strategies • Sustainability and Long-Term Strategy

Alongside these general engagement priorities, some investment advisers publicize their position on specific engagement issues. For example, Vanguard released a stand-alone document setting forth its expectations with respect to board diversity at U.S. public companies.[135] State Street's website includes "Guidelines and Attributes for Effective Independent Board Leadership"[136] and a "Climate Change Risk Oversight Framework for Directors."[137] Likewise, BlackRock has published commentaries covering its position on differential voting rights,[138] voting rights and index inclusion,[139] general engagement with agribusiness companies on sustainable business practices,[140] and specific engagement with the palm oil industry on sustainability, among other issues.[141] Ad-

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[135] VANGUARD, *Vanguard Investment Stewardship Perspectives: Board Diversity* (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp_board_diversity.pdf.

[136] STATE STREET GLOBAL ADVISORS, Guidelines and Attributes for Effective Independent Board Leadership (March 2019), https://www.ssga.com/content/dam/ssmp/library-content/products/esg/guidelines-and-attributes-for-effective-independent-board-leadership.pdf.

[137] STATE STREET GLOBAL ADVISORS, *Climate Change Risk Oversight Framework For Directors* (June 2019), https://www.ssga.com/content/dam/ssmp/library-content/products/esg/climate-change-risk-oversight.pdf/

[138] BLACKROCK, *Key Considerations in the Debate on Differentiated Voting Rights* (last accessed Aug. 12. 2019) https://www.blackrock.com/corporate/literature/whitepaper/blackrock-the-debate-on-differentiated-voting-rights.pdf. Letter from BlackRock to the Securities and Exchange Board of India regarding Consultation Paper on the Issuance of Shares with Differential Voting Rights (April 19, 2019) https://www.blackrock.com/corporate/literature/publication/securities-and-exchange-board-of-india-differential-voting-rights-response.pdf.

[139] BLACKROCK, *A Potential Solution for Voting Rights and Index Inclusion Issues* (Oct. 2017) https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf.

[140] BLACKROCK, Commentary: *Investment Stewardship's approach to engagement with agribusiness companies on sustainable business practices* (last accessed Feb. 6, 2020), https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-sustainable-agriculture.pdf.

[141] BLACKROCK, *BlackRock Investment Stewardship's approach to engagement with the palm oil industry* (May 2019), https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-palm-oil.pdf.

ditional engagement-related materials that BlackRock provides on its website range from comment letters to regulators in different jurisdictions,[142] to an analysis of best practices when using proxy advisors,[143] to an overview of the intersection of carbon emissions and engagement.[144]

The voluntary disclosure of engagement practices enables investors to evaluate whether an investment adviser's engagement activities and priorities accord with their fiduciary duties as well as the investor's own priorities. However, such disclosures are inconsistent across investment advisers and such inconsistencies may limit the value of these disclosures for comparing engagement practices across investment advisers. For example, self-reported engagement statistics can vary by investment adviser, including with respect to the types of engagement, their geographic breakdown, and the subject matter to which the engagement relates.

With respect to types of engagement, State Street *uniquely* distinguishes between "active" and "reactive" engagements as well as between "comprehensive" and other engagements.[145] With respect to the geographic breakdown of engagement statistics, Vanguard reports engagement in (1) the United States, (2) Americas ex-U.S., (3) Europe, Middle East & Africa, (4) Asia-Pacific, and (5) Australia & New Zealand; BlackRock reports in (1) the Americas, (2) Asia-Pacific, and (3) Europe, the Middle East, & Africa; and State Street reports in (1) North America, (2) Japan, (3) the U.K., (4) Europe ex-U.K., (5) Australia & New Zealand, and (6) the "Rest of the World".[146] With respect

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[142] BLACKROCK, *Letter to the SEC re: SEC Staff Roundtable on the Proxy Process; File No. 4-725* (Nov. 16, 2018), https://www.blackrock.com/corporate/literature/publication/sec-roundtable-proxy-process-111618.pdf; BLACKROCK, *Letter to Securities and Exchange Board of India re: Working group's report on issues related to Proxy Advisers* (Aug. 16, 2019), https://www.blackrock.com/corporate/literature/publication/consultation-to-securities-and-exchange-board-of-india-on-issues-related-to-proxy-advisors.pdf.

[143] BLACKROCK, *Best practices when using an independent fiduciary in proxy voting* (March 2020), https://www.blackrock.com/corporate/literature/publication/blk-best-practices-using-independent-fiduciary-proxy-voting.pdf.

[144] BLACKROCK, *Emissions, Engagement, and Transition to a Low-Carbon Economy* (March 2020), https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-emissions.pdf.

[145] STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 26 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf.

[146] VANGUARD, *Investment Stewardship 2019 Annual Report*, 8 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas* (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: Asia Pacific* (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-apac.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: EMEA* (Jan. 2020),

to subject matter, BlackRock, State Street and Vanguard each have differing approaches for disclosing the subject matter discussed at engagements. For example, BlackRock reports the percentage of engagements related to environmental impact whereas Vanguard does not.[147] We further address the issue of standardization for disclosure of non-voting engagement practices in **Section 5**.

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https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-emea.pdf; STATE STREET GLOBAL ADVISORS, *Stewardship Report 2018-2019*, 13 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf.

[147] Vanguard reports the primary topic of each engagements as either board composition, oversight of strategy and risk, executive compensation, and governance structures; BlackRock reports the percentage of engagements (non-exclusively) related to board composition and effectiveness, corporate strategy, compensation, environmental impact, and human capital management; State Street relates engagement to each of its core, sector, and thematic focuses. VANGUARD, *Investment Stewardship 2019 Annual Report*, 36 (2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf; BLACKROCK, *Q4 2019 Investment Stewardship Report: Americas* 11 (Jan. 2020), https://www.blackrock.com/corporate/literature/publication/blk-qtrly-commentary-2019-q4-amrs.pdf.

4. Empirical analysis of investment stewardship practices by investment companies

In **Section 4**, we review three bodies of empirical literature that relate to investment stewardship activities by investment companies.

First, we consider studies that evaluate voting by investment companies as compared to other investors. In doing so, we consider the literature regarding voting by index funds. We generally find that investment companies, are willing to challenge management and support shareholders' proposals thereby demonstrating that they are exercising considered independent judgment when voting.

Second, we review studies that measure the relationship between *holdings* by investment companies and firm performance, such as return on assets. In doing so, we also consider studies that focus on index fund holdings and firm performance. The studies we review generally find that firms that have a high share of holdings by investment companies outperform other firms. These studies often link such outperformance to effective "monitoring" of firms by investment companies. Investment stewardship is a means by which investment companies monitor firms through voting and non-voting engagements with firms.

Third, we review studies that link holdings by investment companies with corporate governance quality at firms, such as performance-sensitive executive compensation and board independence. In doing so, we also consider empirical research as to the link between holdings by index funds and corporate governance quality. The studies we review generally find that firms that have high shares of holdings by investment companies have improved measures of corporate governance quality. However, the evidence regarding index fund holdings and corporate governance quality at firms is mixed.

a. Voting by investment companies

Cotter, Palmiter and Thomas (2010) find that investment company support for management proposals is lower than shareholders overall and investment company support for shareholder proposals is higher than shareholders overall.[148] Morgan, Poulsen, Wolf and Yang (2010) find that investment companies are more likely than other investors to support shareholder proposals that would enhance corporate governance at portfolio companies, such as board declassification and

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[148] James Cotter, Alan Palmiter, Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 30 (2010), https://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1032&context=vlr.

majority voting for directors.[149] Morgan et. al. note that investment companies "appear better able to discern and more willing to vote for higher quality (i.e., potentially wealth increasing) proposals than other investors types…." and investment company "voting has a significant impact on the success of shareholder proposals; higher support by funds leads to a greater likelihood of passage of a proposal and a greater likelihood of subsequent implementation by management." [150]

Index funds also appear willing to challenge management. For example, Rothberg and Lilien (2006) find that index funds were less supportive of management recommendations than active funds, noting that index funds voted with management 81% of the time versus 95% for active funds.[151] Appel et al. (2016) also find that index funds are less supportive than active funds of management and more supportive than active funds of shareholder proposals.[152] More recently, Fichter, Heemskerk and Garcia-Bernardo (2017) report that BlackRock, Vanguard, and State Street tend to oppose management at a similar rate to active funds.[153]

However, for certain proposals, index funds may be more deferential to management than active funds. Heath et al. (2019) find that for contentious proposals—defined as those where management and proxy advisor recommendations conflict—index funds are more likely than active funds to vote with management.[154] And Brav et al. (2019) find that index funds are significantly less likely than active funds to vote with activist shareholders that oppose management.[155] Bebchuk and Hirst

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149 Angela Morgan, Annette Poulsen, Jack Wolf, Tina Yang, *Mutual funds as monitors: Evidence from mutual fund voting* (March 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572049.
150 *Id.* at 2-3.
151 Burton Rothberg and Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1(1) UNIVERSITY OF MARYLAND JOURNAL OF BUSINESS & TECHNOLOGY LAW (2006), https://digitalcommons.law.umaryland.edu/jbtl/vol1/iss1/13/.
152 Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), https://www.nber.org/papers/w22707.pdf.
153 Jan Fichtner, Eelke M. Heemskerk, Javier Garcia-Bernardo, Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk, Business & Politics (April 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2798653.
154 Davidson Heath, Daniele Macciocchi, Roni Michaely and Matthew Ringgenberg, *Do Index Funds Monitor?*, SWISS FINANCE INSTITUTE, 4 (July 6, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3259433&download=yes.
155 Alon Brav, Matthew Cain, and Jonathon Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, ECGI Working Paper No. 637 (Nov. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3387659.

(2019) find that index funds exhibit voting behavior aligned with management on say-on-pay proposals, siding with management more often than active funds.[156]

b. Investment company holdings and firm performance

An extensive body of literature finds that holdings by investment companies are associated with positive measures of firm performance. These studies often link improvements in firm performance to effective "monitoring" of firms by investment companies. As noted earlier, investment stewardship is a means by which investment companies monitor firms through voting and non-voting engagements with firms.

Elyasiani and Jia (2010) find a positive association between a firm's return on assets and the share of holdings by investment companies.[157] Based on these findings, the authors conclude that investment companies *monitor* portfolio companies more frequently and more effectively than other investors.[158] Cornett et al. (2007) also find a positive correlation between a firm's operating cash flow and investment company holdings.[159] And Chen, Harford and Li (2007) find a positive association between holdings by independent long-term institutions, which includes investment companies, and successful mergers and acquisitions, measured by the likelihood of deal completion and a firms' post-merger financial performance.[160] Chen et. al conclude that investment companies are effectively monitoring M&A activity and intervening through voting or non-voting engagements to reverse misguided acquisitions by these firms.[161] Aghion, Van Reenen and Zingales (2013) also find a positive association between institutional holdings, including investment companies, and firm spending on R&D, and the productivity of R&D spending.[162]

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[156] Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy* 119(8) COLUMBIA LAW REVIEW 2029, 2039 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

[157] Elyas Elyasiani and Jingyi Jia, *Distribution of institutional ownership and corporate firm performance*, 34 JOURNAL OF BANKING & FINANCE 606 (2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2451145.

[158] *Id.* at 615.

[159] Marcia Millon Cornett, Alan J. Marcus, Anthony Saunders, and Hassan Tehranian, *The impact of institutional ownership on corporate operating performance*, 31 JOURNAL OF BANKING & FINANCE 1771 (2007), https://www2.bc.edu/alan-marcus/papers/JBF_2007.pdf.

[160] Xia Chen, Jarrad Harford, Kai Li, *Monitoring: Which institutions matter?*, JOURNAL OF FINANCIAL ECONOMICS (2007), https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=1819&context=soa_research.

[161] *Id.* at 30.

[162] Philippe Aghion, John Van Reenen, and Luigi Zingales, *Innovation and Institutional Ownership*, 103(1) AMERICAN ECONOMIC REVIEW 277, 278 (2013), http://mitsloan.mit.edu/shared/ods/documents/?DocumentID=2566.

With respect to index funds, Appel et al. (2016) also find a positive correlation between index fund holdings and firm performance, as measured by a company's return on assets.[163] On the other hand, Qin and Wang (2018) find that increased index fund holdings correlate with lower company value (measured by Tobin's Q, which compares a company's market value to its book value).[164] And Schmidt and Fahlenbrach (2017) find that as the proportion of index fund holdings increase, management becomes more entrenched and more likely to engage in "empire building" through value destroying M&A activity.[165]

c. Investment company holdings and corporate governance

Other empirical studies consider the relationship between investment company holdings and corporate governance quality at portfolio companies. Almazan, Hartzell and Starks (2005), for example, consider the relationship between institutional holdings, including investment companies, on portfolio companies' executive compensation practices.[166] They find that higher holdings by institutional investors are associated with lower total executive compensation at portfolio companies and more performance-sensitive compensation at portfolio companies.[167] The authors conclude "the results imply that investment companies and independent investment advisers play a more active monitoring role than do other types of institutions."[168] Hartzell and Starks (2002) also find that holdings by institutional investors, including investment companies, are negatively related to total executive compensation and positively related to the performance-sensitivity of that compensation.[169] The authors conclude that "institutional investors [including investment companies]

[163] Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), https://www.nber.org/papers/w22707.pdf.
[164] Nan Qin and Di Wang, *Are Passive Investors a Challenge to Corporate Governance?*, 5 (March 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3148309.
[165] Cornelius Schmidt and Rüdiger Fahlenbrach, *Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?*, JOURNAL OF FINANCIAL ECONOMICS (June 2016), https://corpgov.law.harvard.edu/2017/05/20/do-exogenous-changes-in-passive-institutional-ownership-affect-corporate-governance-and-firm-value/
[166] Andres Almazan, Jay C. Hartzell, Laura T. Starks, *Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive Compensation* (2008), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.556.1603&rep=rep1&type=pdf.
[167] *Id.* at 31.
[168] *Id.* at 31.
[169] Jay Hartzell and Laura Starks, *Institutional Investors and Executive Compensation* (2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=236592.

influence executive compensation"[170] and " serve as a complementary monitoring device to incentive compensation".[171]

With respect to index funds, Appel et al. (2016) find that increased index holdings are associated with greater board independence and reduced takeover defenses.[172] However, focusing on other measures of corporate governance quality, Qin and Wang (2018) report that an increase in index fund holdings is associated with reductions in the sensitivity of manager pay to company performance and reduced probability of "performance-based disciplinary turnover" of senior management.[173]

[170] *Id.* at 20.
[171] *Id.* at 14.
[172] Ian R. Appel, Todd A. Gormley, and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, NBER Working Paper 22707 (Sept. 2016), https://www.nber.org/papers/w22707.pdf.
[173] Nan Qin and Di Wang, *Are Passive Investors a Challenge to Corporate Governance?* (March 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3148309.

5. Evaluating proposals to reform investment stewardship by index funds

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

In general, the proposals to reform voting by index funds are intended to address concerns that index funds lack an incentive to make informed voting decisions. According to Bebchuk, Cohen and Hirst (2017), index funds lack such an incentive, because making informed voting decisions is costly and the associated benefits of improved corporate governance or performance at public companies is widely dispersed.[174] Indeed, index funds primarily attract investors by minimizing costs and tracking the appropriate index, neither of which incentivize index funds to invest in improving the governance of specific portfolio firms.[175] Bebchuk, Cohen and Hirst (2017) therefore argue that index funds may not be voting in the best interest of their shareholders, and corporate governance outcomes and performance at public companies may be negatively affected.[176] However, a counterargument is made by Fisch, Hamdani and Solomon (2019), noting that index fund managers are indeed motivated to improve the performance of their portfolio companies since fund investors can withdraw their money at any time (even if the fund itself is locked into specific investments), which could be likely if an index were to exhibit poor performance.[177]

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[174] Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31(3) JOURNAL OF ECONOMIC PERSPECTIVES 89, 96 (2017), https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.31.3.89.
[175] Bebchuk, Cohen, and Hirst, *supra* note 174, at 97-98.
[176] Bebchuk, Cohen, and Hirst, *supra* note 174, at 100-101.
[177] *See* Jill Fisch, Assaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, Univ. of Penn. L. Rev. 1983 (2019).

a. Pass-through voting

Griffin (2019) has proposed a "pass-through voting approach," whereby investors would have the right to provide instructions to their index fund on how to vote shares in each portfolio company.[178] Griffin contends that pass through voting would better align index fund voting with investor preferences.[179] However, as noted by Bebchuk and Hirst (2019), investors would likely provide such voting instructions on an uninformed basis, as they lack the incentive to acquire relevant information necessary to make informed voting decisions.[180] Furthermore, as noted by Hirst (2016), the administrative costs from collecting voting instructions from shareholders would be costly and difficult to manage.[181] Moreover, pass-through voting would likely lead to the effective disenfranchisement of index fund investors, since most fund shareholders would fail to respond to the proxies.

In fact, investment companies already encounter administrative challenges when soliciting votes for their own shareholder meetings. For example, in November 2018, the Investment Company Institute surveyed 52 members representing 71% of U.S. registered fund assets under management.[182] When asked about their two most recent fund proxy campaigns, respondents reported that: (i) 37% were forced to adjourn at least one shareholder meeting for lack of quorum; (ii) 37% indicated that the total costs of their proxy campaigns were $1 million or more; (iii) five individual campaigns exceeded $10 million; and (iv) the largest cost for a single proxy campaign exceeded $100 million.[183] Pass-through voting could magnify these administrative difficulties by extending them to a much larger universe of votes. We therefore do not support proposals to mandate "pass through voting" by index funds.

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[178] Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, MARYLAND LAW REVIEW, 33-35 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365222.
[179] Griffin, *supra* note 178, at 35.
[180] Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119(8) COLUMBIA LAW REVIEW 2029, 2118-2119 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.
[181] Scott Hirst, *Social Responsibility Resolutions*, HARVARD LAW SCHOOL PROGRAM ON CORPORATE GOVERNANCE, 26 (Aug. 2016), https://pcg.law.harvard.edu/wp-content/uploads/2015/11/Scott-Hirst-Social-Responsibility-Resolutions.pdf.
[182] INVESTMENT COMPANY INSTITUTE, *Letter to the SEC re: SEC Roundtable on the Proxy Process (File No. 4-725)*, 4, fn. 13 (June 11, 2019), https://www.ici.org/pdf/19_ltr_fundproxy.pdf.
[183] INVESTMENT COMPANY INSTITUTE, *supra* note 182, at 4.

b. Polling

Alternative proposals put forward by Hirst (2016)[184] and Griffin (2019) would require index funds to "poll" investors as to how they would vote portfolio company shares and then vote their shares accordingly. Hirst (2016) suggests that index funds could randomly sample investors on their general preferences on recurring governance topics, such as executive compensation, board independence and ESG.[185] The managers of index funds would then vote their shares consistent with those preferences.[186] However, it is unlikely that individual investors have the *expertise* necessary to answer generalized polling questions that relate to complex issues such as executive compensation policies or board independence. Such polling could therefore result in index funds making voting decisions that are not in the best interest of investors and produce worse corporate governance outcomes at public companies. We therefore do not support requiring index funds to poll investors to inform their voting decisions.

c. Eliminating index fund voting rights

Lund (2018)[187] and Griffith (2019)[188] have each proposed that index funds should be required to vote in proportion to other shareholders. For example, assume that 86% of non-index fund shareholders support a specific director for re-election. Lund and Griffith's proposals would require that index funds "mirror" vote 86% of their shares in favor of that director. [189] This would have the same practical effect as eliminating index fund voting rights entirely, since index funds and their shareholders would be effectively prohibited from making independent voting judgments, and thereby increase the proportional voting power of other shareholders.[190] Lund contends that doing so would concentrate voting power with "active investors that have the motive and information

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184 Hirst, *supra* note 181, at 26-30.
185 Hirst, *supra* note 181, at 26-28.
186 Hirst, *supra* note 181, at 27-28.
187 Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43(3) J. CORP. L. 493 (2018); Lucian Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119(8) COLUMBIA LAW REVIEW 2029, 2117 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.
188 Sean Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE, 49-50 (July 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3404298.
189 Griffith, *supra* note 188, at 49-50. Bebchuk and Hirst, *supra* note 187, at 2117; *see also* M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, THE WALL STREET JOURNAL (June 22, 2017).
190 John Bogle, *Bogle Sounds a Warning on Index Funds*, THE WALL STREET JOURNAL (Nov. 29, 2018).

to vote intelligently."[191] This position presumes that the interests of active investors align with index investors' interests, which may not be the case. For example, active investors' interests may diverge from index investors' interests due to a shorter-term investment horizon among active investors. Lund's position also presumes that investment advisers that vote on behalf of index funds do not have the information and expertise necessary to vote effectively.

However, neither Lund nor Griffith provide evidence to support that other shareholders are better motivated or more informed than index funds at making voting decisions. Indeed, as noted by critics, these proposals would effectively increase the voting power of: (i) corporate insiders, which could negatively impact public shareholders; (ii) retail investors, who likely have weaker incentives than index funds to acquire information to cast informed votes;[192] and (iii) short-term oriented investors.[193] In addition, based on the Fisch et al. (2019) contention that index fund managers are incentivized by the performance of their portfolio companies, it may be that index funds are more concerned with shareholder voting than active managers.[194] Active funds can simply choose to sell a position, rather than engage in a shareholder vote to improve performance, while index funds do not have the option to sell, having no practical alternative to voting. We therefore do not support proposals that would eliminate the voting rights of index fund managers and their investors.

d. Enhancing disclosure of non-voting engagement policies

We now evaluate proposals to enhance disclosure of non-voting engagement by index funds, such as meetings between index fund managers and portfolio companies. Policy proposals generally do not focus on enhanced disclosure of voting by index funds,[195] as index funds must publicly disclose all votes and their voting policies and procedures.[196] And, as described in **Section 3**, BlackRock,

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[191] M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, THE WALL STREET JOURNAL (June 22, 2017).
[192] Bebchuk and Hirst, *supra* note 187, at 2117.
[193] John Bogle, *Bogle Sounds a Warning on Index Funds*, THE WALL STREET JOURNAL (Nov. 29, 2018).
[194] *See* Fisch, Hamdani, and Solomon, *supra* note
[195] James McRitchie (who has called for real-time, machine-readable, user-friendly voting disclosure by investment companies) is a notable exception. CORPORATE GOVERNANCE (A/K/A CORPGOV.NET), *File 4-748: Request to amendment of Title 17, §270.30b1-4, Report of proxy voting record* (July 9, 2019), https://www.sec.gov/rules/petitions/2019/petn4-748.pdf; James McRitchie (of Corporate Governance), *Proxy Scorecard and Fund Competition*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Sept. 7, 2019), https://corpgov.law.harvard.edu/2019/09/07/proxy-scorecard-and-fund-competition/.
[196] *See* Section 2(c).

State Street and Vanguard also voluntarily disclose their rationale for voting on certain governance matters, including contested director elections and environmental and social issues.[197]

However, there are no disclosure requirements that apply to non-voting engagement. As described in **Section 3**, BlackRock, State Street and Vanguard voluntarily disclose their non-voting engagement policies and certain summary statistics.[198] However, Bebchuk and Hirst (2019)[199] and Coates (2019)[200] both support going further and mandating disclosure of the detailed content of meetings between index fund managers and public companies.

Bebchuk and Hirst, and Coates support such mandatory disclosures for different reasons. For instance, Bebchuk and Hirst (2019) argue that index funds lack the incentive to adequately invest in informed voting and non-voting engagement,[201] and the enhanced disclosure of non-voting engagements would encourage index funds to invest more in non-voting engagement.[202] Specifically, with enhanced disclosure of non-voting engagement, index fund investors would better understand the impact of non-voting engagement, and this will motivate index funds to ensure their non-voting engagement achieves demonstrable results.[203] On the other hand, Coates (2019) argues that index funds have become excessively large and powerful, as their stake of ownership in U.S. public companies has increased dramatically over the past decade to approximately 15% today.[204] Coates argues that increased transparency of non-voting engagement may be necessary to ensure that investors and the public can be aware of how index funds are wielding their power in private meetings and, if necessary, hold them accountable for their conduct.[205]

In general, we support SEC rulemaking to require transparency of non-voting engagement policies by investment advisers, as transparency enables investors to determine whether non-voting engagement priorities are consistent with investors' best interests. However, we do not agree with proposals that the SEC should require that index funds provided detailed disclosures as to the content of each meeting between an index fund manager and its portfolio companies. As noted in

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[197] *See* Section 3(a)

[198] *See* Section 3.

[199] Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2123-2124.

[200] John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, 22-23 (Sept. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337.

[201] Lucian Bebchuk and Scott Hirst, *supra* note 187.

[202] Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2124.

[203] Lucian Bebchuk and Scott Hirst, *supra* note 187, at 2124-2126.

[204] Coates, supra note 200, at 13.

[205] Coates, *supra* note 200, at 22-23.

Section 3, the three largest index fund managers—BlackRock, State Street, and Vanguard—held 4,000 such meetings in 2018.[206] Requiring such detailed disclosures would be costly and burdensome for index fund managers. Additionally, requiring substantive disclosures of the contents of a meeting could chill discussion between index fund managers and portfolio companies, thereby limiting the positive effects of non-voting engagement. Furthermore, we believe that such disclosure requirements should apply equally to investment advisers acting on behalf of index funds and active funds. The principle that such disclosures enable investors to determine whether an investment adviser is acting consistent with an investor's best interest and engagement priorities applies equally to investors in index funds and active funds.

Instead, we recommend that the SEC require that investment advisers disclose their non-voting engagement policies, key non-voting engagement priorities, and certain annual summary statistics of those practices, including the total number of non-voting engagements. As described in **Section 3**, BlackRock, Vanguard and State Street already provide similar disclosures on a voluntary basis.[207] However, there are differences between such disclosures that limit the ability of investors to compare non-voting engagement activities across investment advisers.[208] We recommend that the SEC issue guidance setting forth a standardized method for such disclosures in a manner that is consistent with the formats required in other jurisdictions to the extent possible.

[206] *See* Section 3(b).
[207] *See* Section 3(b).
[208] *See* Section 3(b).

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