REFORMING U.S. CAPITAL MARKETS
TO PROMOTE ECONOMIC GROWTH

MAY 2020
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Reforming U.S. Capital Markets to Promote Economic Growth
This report was prepared by Committee staff, including John Gulliver, Executive Director, Megan Vasios, Deputy Director, and Jonathan Ondrejko, Senior Research Fellow, as well as Hillel Nadler, Senior Research Fellow at the Program on International Financial Systems. In addition, the Committee drew on the expertise of its members, who provided commentary and insight to our team. The members of the Committee are listed on the next page.
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Executive Summary

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This chapter is divided into five sections.

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

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

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

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

In Section 5, we evaluate proposals to reform voting by index funds. We begin by evaluating proposals that would require index funds to allow for “pass through voting,” whereby the millions of individual shareholders in index funds would provide instructions on how to vote. Second, we consider proposals that would require that index funds “poll” their shareholders to determine their voting decisions. Third, we evaluate proposals that would effectively eliminate index funds’ authority to vote their shares. We conclude by recommending enhanced transparency of non-voting engagement practices by investment advisers.
Chapter 1: The Rise of Dual Class Shares: Regulation and Implications
Summary

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

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

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

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

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

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1. Prevalence and regulation of dual class shares

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

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

a. United States

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

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

2 See Recommendation of the Investor as Owner Subcommittee: Dual Class and Other Entrenching Governance Structures in Public Companies, Investor Advisory Committee, Securities and Exchange Commission 1 (Feb. 27, 2018), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030818-investor-as-owner-subcommittee-recommendation.pdf. The index provider MSCI reports that as of September 1, 2017, 10.9% (by market cap) of the U.S. issuers included in the MSCI ACWI Index, its global flagship index, had multi-class share
of those included in the Russell 3000 had dual class share structures. The prevalence of dual class share structures has further increased since then: according to one measure, more than 20 percent of the companies listing shares on U.S. exchanges between 2017 and 2019 had a dual class structure (see Figure 1.2).

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

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

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5 See id.
6 See Dual Class Shares: Governance Risks and Company Performance, ISS Analytics: Governance Insights (June 14, 2019).
7 See id.
Dual class equity structures in the U.S. are more prevalent among small capitalization companies than larger companies. ISS reports 9 percent of non-S&P 1500 companies in the Russell 3000 have multi-class share structures, compared to less than 5 percent for S&P 1500 companies.\(^8\) Dual class equity structures are also more prevalent in certain industries than others. These industries include the tech industry, where notable companies like Google and Facebook maintain such structures.\(^9\) It also includes the media industry, where dual class share structures—such as the structure adopted by The New York Times Company—are widely considered necessary to insulate the editorial independence of media companies from shareholder pressure.\(^10\)

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

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

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

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

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


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

\(^12\) See Recommendation of the Investor as Owner Subcommittee at 3-4 (cited in note 2).
In addition, the We Company disclosed that its dual class structure could diminish the value, liquidity and trading price of its low-vote common stock.  

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

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

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

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

15 See id.

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

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

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

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

b. Europe

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

19 See id.
20 See id.
24 For another case in which a Delaware court emphasized the requirement for controlling shareholders of dual class companies to abide by corporate formalities, see Espinoza v. Zuckerberg, 124 A.3d 47 (Del. Ch. 2015) (holding that informal approval by controlling shareholder of dual class company was insufficient to authorize an increase in non-management director compensation and formal consent was required).
2007 survey, commissioned by the European Commission and conducted by ISS, reported similar results based on a sample of 464 companies in 16 European countries, though it differed noticeably in some cases. For example, ISS reported that 3 percent of U.K. companies in their sample used dual class shares (compared to 25 percent reported by Bennedsen and Nielsen). These differences could be explained by Bennedsen and Nielsen’s much larger sample, which included numerous small companies.26

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

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

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

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

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

29 See Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion, OECD Steering Group on Corporate Governance 16 (Dec. 2007), available at https://www.oecd.org/daf/ca/40038351.pdf. Italian law allows listed companies to issue loyalty shares that entitle shareholders to a double vote after a two-year
adopted a favorable approach to unequal voting rights more broadly: in 2014 France changed the
default voting structure from one in which each share is entitled to an equal vote to a tenure voting
structure, which entitles shareholders to a double vote after holding their shares for a loyalty period
(typically, two years). French law allows companies to opt out of the tenure voting default struc-
ture through a shareholder resolution and a two-thirds majority binding vote.\textsuperscript{30}

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

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

holding period, and non-listed companies to issue multiple-vote shares with a maximum of three votes per share.
See Marco Ventoruzzo, The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration

\textsuperscript{30} See Marco Becht, Yuliya Kamisarenka and Anete Pajuste, Loyalty Shares with Tenure Voting – A Coasian Bar-
398/2018 9–11 (April 2018), available at https://ecgi.global/sites/default/files/working_papers/documents/final-
bechtkamisarenkapajuste.pdf. French companies with tenure voting are not treated as having dual class equity
structures in the studies of dual class prevalence cited earlier.

\textsuperscript{31} See Lack of Proportionality Between Ownership and Control at 16 (cited in note 29).

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

\textsuperscript{33} See Bushell v. Faith (1970) 1 All ER 53 (enforcing unequal voting rights structure).

\textsuperscript{34} Financial Conduct Authority, Listing Rules 7.2.1A (Sep. 2018). As of May 31, 2019, 505 of the stocks (excluding
closed- and open-ended investment companies) listed on the London Stock Exchange’s Main Market had a
premium listing, compared to 241 that had a standard listing. See Companies and Securities: Instrument List, London
Stock Exchange, available at https://www.londonstockexchange.com/statistics/companies-and-issuers/com-
nies-and-issuers.htm.
must satisfy more restrictive corporate governance and transparency standards (including the one-share, one-vote principle). 35

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

c. Asia

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

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

35 See Andrew Bailey, Premium listing will not water down corporate governance, Financial Times (June 10, 2018), available at https://www.ft.com/content/5dbf33e0-6b24-11e8-aee1-39f34595f4fd.
37 See Attracta Mooney, Big investors fight back over dual class shares, Financial Times (Nov. 24, 2019), https://www.ft.com/content/bcc220535-5055-47ce-81fd-fc4356d32937; Daniel Thomas, Philip Stafford and Patrick Jenkins, UK seeks change in listing rules to lure tech start-ups, Financial Times (Nov. 4, 2019), https://www.ft.com/content/d4d2da3a-fe68-11e9-be39-e49b2a136b8d.
38 See Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights? at 22 (cited in note 2).
structure. A corporation can divide its stock into multiple classes and specify how many shares of each class are needed to count as one unit.39

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

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

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

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39 See Proportionality Between Ownership and Control in EU Listed Companies at 332-345 (cited in note 32).
40 See Companies Ordinance (Hong Kong), Cap. 622, Article 588(4).
41 See below, Section 2(a).
43 See Commercial Act (Republic of Korea), Articles 369, 370 (2012).
46 See Measures for the Administration of the Pilot Program of Preferred Shares, China Securities Regulation Commission (March 21, 2014).
authorities have taken several steps to loosen restrictions on dual class shares. In 2018, China’s cabinet approved a pilot program to allow large “red-chip” companies—companies whose main business is in mainland China but that are incorporated and listed abroad—to issue depository receipts that trade on China’s main stock exchanges. These red-chip companies include companies that opted out of listing in China in order to skirt various Chinese listing rules, including restrictions on dual class equity structures. More recently, in early 2019 China’s securities regulator approved the launch of a new science and technology innovation board that would allow companies with dual class share structures to go public.

2. Response of private actors to dual class shares

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

a. Exchanges

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

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48 See Promising startups to get backing for listing, State Council of the People’s Republic of China (September 27, 2018) (“[L]egislation and regulations related to the capital market will be improved to allow technological companies to adopt a management structure in which differentiated rights are given to the same amount of shares.”), available at http://english.www.gov.cn/policies/latest_releases/2018/09/27/content_281476320340892.htm.
49 See Gabriel Wildau, China clears path for foreign-listed tech unicorns to return home, Financial Times (March 30, 2018), available at https://www.ft.com/content/60859464-342b-11e8-ae84-494403e73f7f. Depository receipts avoid these restrictions because technically they are certificates issued by a bank that holds shares registered in another country, rather than the underlying shares themselves.
50 See Administrative Measures for the Management of the Pilot Registration System of Initial Public Offering on the Science and Technology Innovation Board (Trial), China Securities Regulation Commission (Jan. 30, 2019).
In the United States, the New York Stock Exchange (since the mid-1980s) and NASDAQ allow a company’s stock to be listed even if it has unequal voting rights, but both exchanges restrict the ability of listed companies to disparately reduce the voting power of already-issued shares by, for example, issuing shares of a new class of stock with greater voting rights.\footnote{See \textit{NYSE Listing Company Manual} Rule 313.00(A) & (B): Voting Rights (2018), available at \url{http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual%2Fclm%2Fsections%2Fclm-sections%2F; NASDAQ Stock Market Listing Rules Rule 5640: Voting Rights (2018), available at \url{http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F}. Both of these rules are based on SEC Rule 19c-4, and were adopted in response to SEC pressure after Rule 19c-4 was struck down. See note xx.}

Other exchanges allow companies to list with dual class equity structures as long as they include substantive protections for non-controlling shareholders. The Toronto Stock Exchange, for example, requires that listed dual class companies provide “coat-tail” protections, which provide that holders of ordinary shares must be allowed to participate in any change of control transaction on the same terms as the holders of high-vote stock.\footnote{See Toronto Stock Exchange, \textit{TSX Company Manual}, Sec. 624(l) (2019).} This kind of provision prevents controlling shareholders from selling their control stake at a premium at the expense of the company’s other shareholders.

Recently, after losing out on initial public offerings to exchanges in the United States, both the Hong Kong and Singapore stock exchanges have liberalized their listing rules to allow for dual class equity structures. Although the Hong Kong stock exchange continues to emphasize that the “one-share, one vote” principle is “the optimum method of empowering shareholders and aligning...
their interests in a company,” it amended its listing rules in April 2018 to allow for the listing of shares with unequal voting rights. The Singapore exchange subsequently adopted similar rules.

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

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

56 See Hong Kong Exchanges and Clearing Limited, Consolidated Main Board Listing Rules, Chapter 8A (2019).
57 See Emma Dunkley, China bourses plan reprieve on dual class Hong Kong shares, Financial Times (July 18, 2018), available at https://www.ft.com/content/db181df0-8a39-11e8-bf9e-8771d5404543.
58 See Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (Revised in 2019) Art. 2.1.4 (March 2019).
59 See Hudson Lockett, Shanghai’s Star Market fades after initial success, Financial Times (Sep. 29, 2019), available at https://www.ft.com/content/f5285292-e112-11e9-9743-db5a37048tbc.
b. Index providers

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

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

<table>
<thead>
<tr>
<th>Inclusion</th>
<th>Weighting</th>
<th>Hurdle</th>
<th>Exclusion</th>
</tr>
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<tbody>
<tr>
<td>CRSP US Total Market</td>
<td>None</td>
<td>Russell 1000</td>
<td>S&amp;P 500</td>
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<tr>
<td>Nasdaq 100</td>
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<td>S&amp;P MidCap 400</td>
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<tr>
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<td>Russell 1000 Growth</td>
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<tr>
<td>FTSE Emerging Markets All Cap China A Inclusion</td>
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<td>Russell 2000</td>
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<tr>
<td>MSCI Emerging Markets Investable Market</td>
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<tr>
<td>CRSP US Large Cap Value</td>
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<td>MSCI US Investable Market Real Estate 25/50</td>
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60 See Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights? at 13 (cited in note 2).
Exclusion approach

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

Hurdle approach

FTSE Russell has eschewed the strict exclusion approach in favor of a voting rights hurdle in order to ensure that minority investors have some minimum degree of control over companies they hold. Beginning in 2017, to be eligible for inclusion in certain FTSE Russell equity indexes, including the popular Russell 1000, 2000, and 3000 indexes, companies from developed markets must have at least 5% of their voting rights across all securities held by public investors.\(^\text{63}\) (Existing constituents are grandfathered for five years until 2022.\(^\text{64}\)) Because FTSE Russell already imposed voting rights restrictions on UK incorporated companies for inclusion in its UK Index Series, the effects of the new policy will be felt primarily in FTSE’s United States and global indexes.\(^\text{65}\)

Weighting approach

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


\(^{64}\) See id.

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

\(^{66}\) See Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights? at 14–15 (cited in note 2) (describing how a company’s weight in the index could be adjusted by multiplying the free float of its securities by the ratio of the voting power of listed shares to the total free float of the company).
incentive to reduce the gap between free float and voting power even if they do not eliminate it entirely.

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

c. Institutional investors

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

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67 See id; Winden and Baker, *Dual Class Index Exclusion* at 39–31 (cited in note 62).
While CII views “one-share, one-vote” as the optimal approach, it has supported the use of dual class shares with sunset provisions, whereby the unequal voting structure is automatically wound down by the seven-year anniversary of a company’s IPO unless it is approved by a majority of each share class on a one-share, one-vote basis. BlackRock has proposed that dual class companies obtain shareholder approval for their dual class structures on a periodic basis, giving shareholders the opportunity to keep the current share classes or convert to a one-share, one-vote structure.

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

3. Evidence for and against dual class shares

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

That policy debate would be improved by distinguishing between two questions: (1) whether it is better or worse for companies, their shareholders, and the economy as a whole for management to be protected from the demands of shareholders and (2) whether shareholders and entrepreneur-
ial management should have the option to agree to an arrangement whereby management is protected from the demands of shareholders. This section reviews arguments on both sides of these questions and considers the empirical evidence in support of those arguments.

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

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

a. Are dual class structures helpful or harmful?

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

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

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77 See Sanford J. Grossman and Oliver D. Hart, One Share–One Vote and The Market for Corporate Control, 20 J. of Fin. Econ. 175 (1988) (discussing the optimality of the one-share, one-vote rule).
80 See Karl V. Lins, Equity ownership and firm value in emerging markets, 38 J. of Fin. and Quant. Analysis 159 (2003).
when the controlling shareholders are families (Sweden); and Maury and Pajuste (2004) document that firm value is lower when large owners control firms through disproportionate ownership structures (Finland).

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

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

82 See Benjamin Maury and Anete Pajuste, Multiple Controlling Shareholders and Firm Value, 29 J. of Banking and Fin. 1813 (2004).
83 See Scott B. Smart, Ramabhadran S. Thirumalai and Chad J. Zutter, What's in a vote? The short- and long-run impact of dual class equity on IPO firm values, 45 J. of Acc. and Econ. 94 (2008).
84 See Gompers et al., Extreme Governance: An Analysis of Dual Class Firms in the United States (cited in note 76).
85 See Ronald W. Masulis, Cong Wang and Fei Xie, Agency Problems at Dual Class Companies, 64 J. of Fin. 1697 (2009).
86 See Renee Adams and Daniel Ferreira, One Share–One Vote: The Empirical Evidence, 12 Rev. of Fin. 51 (2008).
87 See Thomas J. Chemmanur and Yawen Jiao, Dual class IPOs: A theoretical analysis, 36 J. of Banking and Fin. 305 (2012) (predicting that multi-class initial public offerings are more likely to be prevalent in: companies operating in industries where value can be created by ignoring short-term trends; family firms and firms run by founders (who tend to build reputations for good management); and firms where large private benefits of control exist). See also Harry DeAngelo and Linda DeAngelo, Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock, 14 J. of Fin. Econ. 33 (1985) (suggesting that dual class structures encourage managers to make company-specific investment in their human capital); Jeremy Stein, Takeover Threats and Managerial Myopia, 96 J. of Pol. Econ. 61 (1988) (developing a model in which managers undertake costly methods of signaling, including investing in short-term projects, in order to avoid being replaced).
voting as a default rule.\textsuperscript{88}

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

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

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


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


share structures on company value.\footnote{See Bennedsen and Nielsen, The Principle of Proportional Ownership at 18–19 (cited in note 25) (finding that the regional differences correlate with investor protection and anti-self-dealing measures and explaining that controlling shareholders with increased voting rights—when they are not also managers—can be effective substitutes for investor protections in jurisdictions with weak investor protection regimes). See also Armando Gomez, Going Public without Finance: Managerial Reputation Effects, 55 J. of Fin. 615 (2000) (proposing a reputation-based explanation for why the value discount on unequal voting structures may be affected by investor protection regimes, according to which controlling shareholders build reputation through abstaining from exploiting non-controlling shareholders and lack of investor protection increases the potential gain from reputation building).} They also find no impact of unequal voting rights on operating performance, likelihood of bankruptcy, dividend policy, or growth.\footnote{See Bennedsen and Nielsen, The Principle of Proportional Ownership at 18–19 (cited in note 25).}

Another group of studies offers evidence that the effect of dual class share structures depends on a company’s maturity. Cremers, Lauterbach and Pajuste (2018) examine an extensive sample of U.S. dual and single class firms from the time of their IPO, and document that the valuation difference between dual and single class firms varies over their life cycle. They find that, around the time of the IPO, dual class firms tend to have higher valuations than single class firms. Over time, however, this valuation premium tends to dissipate.\footnote{See Martijn Cremers, Beni Lauterbach and Anete Pajuste, The Life-Cycle of Dual Class Firm Valuation, European Corporate Governance Institute (ECGI) – Finance Working Paper No. 550/2018 (Dec. 2018), available at https://ssrn.com/abstract=3062895.} Similarly, Kim and Michaely (2019) find that while young dual class companies trade at a premium and perform at least as well as single-class companies, as dual class firms mature, their valuation declines, and they become less efficient in their margins, innovation, and labor productivity compared to similarly situated single-class companies.\footnote{See Bennedsen and Nielsen, The Principle of Proportional Ownership at 18–19 (cited in note 25).}

b. Should dual class structures be prohibited?

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

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

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

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

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97 See text accompanying notes 85–92.
98 See Ronald Craig Anderson, Ezgi Ottolenghi and David M. Reeb, The Dual Class Premium: A Family Affair, Fox School of Business Research Paper No. 17-021 (August 14, 2017), available at https://ssrn.com/abstract=3006669. See also Chun-Keung Hoi and Ashok Robin, Agency Conflicts, Controlling Owner Proximity, and Firm Value: An Analysis of Dual-Class Firms in the United States, 18 Corp. Gov. 124 (2010) (dual-class structure overall is unrelated to firm value; value is correlated with the proximity of the controlling shareholder to the locus of management—whether the controlling shareholder is a top executive, board member or an outside); Belén Villalonga and Raphael Amit, How Are U.S. Family Firms Controlled?, 22 Rev. of Fin. Stud. 1047 (2009) (investors penalize the use of dual class shares by family-controlled companies compared to other control mechanisms).
shares might have negative consequences for the economy as a whole by increasing the cost of capital and reducing investment.\footnote{Cf. William D. Nordhaus, *Schumpeterian Profits and the Alchemist Fallacy*, Yale Economic Applications and Policy Discussion Paper No. 6 (2005) (estimating that companies captured only a small fraction of the overall benefits from technological advances over the 1948-2001 period).} The fact that individual companies—and their shareholders—might not take into account the broader economic consequences of a dual class structure is an alternative argument for restricting their ability to use them.

Recent experience in the United States, however, suggests that many dual-class companies have successfully raised capital in order to fund long-term investments. Indeed, as demonstrated by Figure 1.2 above, the prevalence of dual class share structures as a percentage of U.S. IPOs has substantially increased in recent years.\footnote{See Ritter, *Initial Public Offerings: Dual Class IPOs* (cited in note 4).}

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

The empirical literature on which companies adopt dual class equity structures and when is not extensive, but it suggests that many of them might not go public, or remain public, if they did not have the option of using unequal voting structures to maintain control rights while transferring economic rights. Amoako-Adu and Smith (2001), for example, find that family control of a large stake before an initial public offering increases the likelihood of going public with a dual class structure.\footnote{See Ben Amoako-Adu and Brian F. Smith, *Dual class firms: Capitalization, ownership structure and recapitalization back into single class*, 25 J. of Banking and Fin. 1083 (2001).} Families that cannot take their companies public without relinquishing control may decide to stay private. Notably, Amoako-Adu and Smith also find that, up to ten years after the IPO, control changes in dual class firms happened in roughly two-thirds of the cases, which is inconsistent with the idea that dual class structures serve to unduly entrench managers.\footnote{See id at 1098-99.}

Another group of studies indicates that dual class recapitalizations are an important tool for public companies seeking to pursue growth opportunities. Lehn, Netter and Poulsen (1990) compare public companies that go private with those that remain public but choose to adopt dual class share structures. They find that companies that choose dual class recapitalizations over going private have better growth prospects, as measured by growth in sales and the number of employees, the ratio of R&D to sales, advertisement expenditure-to-sales ratios, and market-to-book ratios.\footnote{See Kenneth Lehn, Jeffry Netter and Annette Poulsen, *Consolidating corporate control: Dual class recapitalizations versus leveraged buyouts*, 27 J. of Fin. Econ. 557 (1990).} Lehn et al. offer the following interpretation of their evidence: firms that wish to consolidate
control but have strong growth prospects prefer dual class recapitalizations because they allow the companies to pursue long-term projects while at the same time maintaining a public and less costly source of financing.\textsuperscript{105} Their findings suggest that if dual class recapitalizations were prohibited, companies that were looking to consolidate control would rely instead on more expensive private financing, which would increase their cost of capital and potentially cause them to forego growth opportunities.

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

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

\textsuperscript{105} See id at 578.


4. Evaluating policy responses

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

a. Sunset provisions

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

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

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108 See Jackson, Perpetual Dual Class Stock: The Case Against Corporate Royalty (cited in note 99).
110 The reasonableness of a dual class structure, according to ISS, depends on balancing a number of factors; a sunset period of more than seven years, however, is considered per se unreasonable. See United States Proxy Voting Guidelines: Benchmark Policy Recommendations, Institutional Shareholder Services 14 (November 18, 2019), available at https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.
However, mandatory sunset provisions have their critics. Govindirajan et al. (2018) argue that mandatory time-based sunset provisions are ill-advised, for two reasons. First, it is not clear when the sunset clause should take effect, and whether one size could fit all public companies: the number of years that it takes after IPO for a growth company to mature has been steadily declining, and differs based on the firm’s technology and business model. Second, given the increasing pace of disruption and the need for companies to consistently revise their business models, the assumption that companies actually reach a mature stage where further reinvention (and thus an unequal voting structure to facilitate it) is unnecessary is mistaken. Instead of mandatory sunset provisions, Govindirajan et al. argue that companies should be required, after a predetermined period, to gain majority approval from all shareholders to continue a multiple class share structure.

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

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

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

113 See id.
114 See id.
115 See id.
117 See id at 1083–84.
118 See id at 1084–86.
119 See id.
recommending *any* mandatory sunset provisions. Even mandatory sunset provisions that are tied to events such as the dilution of a founder’s economic interest may have unintended negative consequences. As discussed earlier, dual class recapitalizations can solve problems associated with the risk aversion of dominant shareholders, by allowing them to diversify their wealth while still maintaining control. Mandatory sunset provisions tied to the dilution of a founder’s interest would foreclose that possibility.

**b. Enhanced disclosure**

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

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

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120 See id at 1086–91.
122 See Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. of Fin. 537 (Apr. 2004) (premium paid for control is higher when the buyer comes from a country that protects investors less and thus is more willing or able to extract private benefits).
registered offerings and periodic reporting—risk factors relevant to an investment in the company.\textsuperscript{124} According to the SEC, these risk factors include “risks posed by non-traditional governance structures.”\textsuperscript{125} With respect to dual class shares, these increased risks arise from a divergence between economic ownership and control, and they may include: (i) additional barriers to holding management accountable; (ii) disagreements between shareholders and management yielding litigation because voting is no longer a fair dispute resolution mechanism; (iii) shareholders with disproportionate voting rights approving changes to the detriment of other shareholders; and (iv) exchange delisting or removal from major indexes, resulting in lost liquidity.\textsuperscript{126}

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

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

\textsuperscript{124} See 17 C.F.R. § 229.105.
\textsuperscript{125} See Recommendation of the Investor as Owner Subcommittee at 3 (cited in note 2).
\textsuperscript{126} See id at 5–6.
\textsuperscript{127} See id at 4.
\textsuperscript{128} See id.
\textsuperscript{129} See Recommendation of the Investor as Owner Subcommittee at 4 (cited in note 2).
\textsuperscript{130} See id at 5.
\textsuperscript{131} See id.
\textsuperscript{132} See id at 6–8.
Accordingly, we support additional disclosures by companies with dual class share structures. Specifically:

- Through its review of and comment on issuer disclosures, the SEC should encourage each company with a dual class structure to disclose data that illustrates the divergence between economic ownership and control at that company. Such data could include: (i) straightforward quantitative metrics illustrating the numerical gap between a person’s beneficial ownership and voting rights arising from the dual class share structure and (ii) the minimum beneficial ownership that persons with special voting shares can hold while still retaining majority control without further approval by other shareholders. To the extent the SEC is unsuccessful in eliciting satisfactory disclosure by scrutinizing public offerings and issuing guidance, then the SEC could require disclosure of this information under Regulation S-K Item 403, which requires companies to disclose the beneficial ownership of management and control persons.\textsuperscript{133}

- Through its review of and comment on issuer disclosures, the SEC should encourage companies with dual class share structures to enhance their risk factor disclosures under Regulation S-K Item 105.\textsuperscript{134} In particular, firms should disclose material risks related to dual class shares with greater specificity. For example, where applicable, such disclosures could identify the risk that the structure may result in delisting from major exchanges and removal from key indexes, reducing liquidity and the value of an investment in the company.

\textsuperscript{133} See 17 C.F.R. § 229.403.
\textsuperscript{134} See 17 C.F.R. § 229.105.
Chapter 2: Short-termism, Shareholder Activism and Stock Buybacks
Summary

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

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

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

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

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

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

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

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

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

a. Does short-termism exist?

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

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

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

Public company surveys

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

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7 Id at 46.
10 See Scott Latham and Michael Braun, Does Short-termism Influence Firm Innovation? An Examination of S&P 500 Firms, 1990–2003, 22 Journal of Managerial Issues 368 (Fall 2010) (“In general, the debate on how managers reconcile short-term results and long-term competitive advantage remains equivocal.”); Roe, Stock Market Short-Termism’s Impact at 14 (cited in note 6) (noting that the empirical literature on short-termism is “extensive but disputed”).
to satisfy the short-term expectations of public markets. The first survey, conducted by Graham, Harvey and Rajgopal (2005), found that 78% of corporate executives and directors would sacrifice long-term investment to meet short-term earnings expectations.\textsuperscript{11} A more recent McKinsey (2017) survey, updating previous surveys, found similar results, reporting that 87% of executives and directors felt pressure to deliver performance within 2 years or less, and that 65% said that short-term pressure had increased over the five-year period from 2011 to 2016.\textsuperscript{12} A comparison of the 2017 McKinsey study with an earlier 2013 McKinsey study shows that short-term pressure on executives may have increased. In the 2017 study, the percentage of respondents reporting feeling pressure to deliver performance within 2 years or less was 7% higher than in the 2013 study.\textsuperscript{13} Similarly, in the 2017 study, the percentage of respondents that were in favor of a planning horizon of 2 years or less was 10% higher than in the 2013 study.\textsuperscript{14}

\textbf{Firm-level comparisons: public versus private companies}

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

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

\textsuperscript{11} See John R. Graham, Campbell Harvey and Shiva Rajgopal, \textit{The Economic Implications of Corporate Financial Reporting}, 40 J. of Acc. and Econ. 3 (2005).
\textsuperscript{14} See id at 4.
\textsuperscript{16} See id at 355, 373.
and acquisitions) than private companies, and public companies are less responsive to new investment opportunities. Ultimately, the study argues that its “findings highlight short-termist pressures as a potentially important cost of a stock market listing.”

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

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

Aggregate public company data

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

17 See id at 355–56.
18 See id at 384.
20 See id at 19.
21 See Kaplan, Are US Companies Too Short-Term Oriented? at 122 (cited in note 8).
23 Id. See also Roe, Stock Market Short-Termism’s Impact at 29 (cited in note 6) (“[T]he American companies most strongly supported by the stock market – are Amazon, Apple, Alphabet (Google), Facebook, and Microsoft. All are quintessential long-term companies… Their current earnings cannot justify their current stock price; only a belief that they will grow long-term does.”).
of profit distribution to shareholders, through dividends and stock buybacks, at the expense of long-term investment. Specifically, the study shows that from 2003–2012, S&P 500 companies paid out more than 90 percent of net income in the form of stock buybacks and dividends.\textsuperscript{24} However, the statistics cited by Lazonick are not without dispute. Fried and Wang (2018) illustrate several flaws in Lazonick’s analysis, noting that public firms also raise capital through equity issuances, partially offsetting the capital drain that results from shareholder distributions.\textsuperscript{25} When considering net distributions (i.e. including capital raised over the same time period), S&P 500 companies only paid out 50% of net income in the form of dividends and share buybacks.\textsuperscript{26} A more complete discussion of the stock buyback debate can be found in the third section of this chapter.

Echoing Lazonick’s concerns, Coffee and Palia (2016) argue that short-termism is evidenced by the fact that a smaller percentage of public companies’ cash flows are being directed towards capital expenditures.\textsuperscript{27} In addition, Garel (2017) finds reductions in R&D investment.\textsuperscript{28} However, other empirical studies suggest that the decline in capital expenditures may not be the result of short-term pressures. Roe (2018) notes that much of the decline in capital expenditures occurred during the global financial crisis, as the result of a global recession and not due to otherwise increasing short-term pressures.\textsuperscript{29} In fact, as illustrated in Figure 2.1, capital expenditures as a percentage of GDP have increased since 2009.\textsuperscript{30} Additionally, Roe finds that capital expenditures have declined globally, with the rate of U.S.-decline being only half of other OECD countries (including non-stock market sectors),\textsuperscript{31} suggesting that other global macroeconomic factors may have caused a decrease in capital expenditures, rather than short-termism in U.S. public markets.\textsuperscript{32}

\begin{itemize}
\item \textsuperscript{27} See John C. Coffee and Darius Palia, \textit{The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance}, 1 Annals of Corp. Gov. 1 (2016).
\item \textsuperscript{28} See Alexandre Garel, \textit{Myopic Market Pricing and Managerial Myopia}, 44 J. of Bus. Fin. & Acc. 44 (Oct./Nov. 2017).
\item \textsuperscript{29} See Roe, \textit{Stock Market Short-Termism’s Impact} at 18–19 (cited in note 6).
\item \textsuperscript{30} See id at 17.
\item \textsuperscript{31} See id at 20.
\item \textsuperscript{32} See also Salman Arif and Charles M.C. Lee, \textit{Aggregate Investment and Investor Sentiment}, 27 Rev. of Fin. Stud. 3241 (November 2014) (finding that corporate investments peak during periods of positive sentiment and that higher aggregate investment precede lower earnings and macroeconomic growth).
\end{itemize}
b. Potential causes of short-termism

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

i. Short-term holding periods

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

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34 See Roe, Stock Market Short-Termism’s Impact at 19–20 (cited in note 6).
35 See id.
36 See, for example, Larry Summers and Ed Balls, Report of the Commission on Inclusive Prosperity, Center for American Progress 35 (January 2015) (noting that “[o]ne reason that economists have advanced for [the] transition to corporate short-termism is the overwhelming shift to stock-market-based compensation for CEOs and other highly compensated executives at publicly traded corporations.”).
from roughly 2 years in 1990 to less than 1 year in 2017.\textsuperscript{38} However, whether these statistics actually indicate a growing short-term focus among investors is dubious. Average holding periods are estimated based on share turnover: how much of a company’s outstanding stock is traded over a given period. Much of the recent increase in turnover is therefore driven by the rise of high-frequency trading, not changes in behavior by investors. In other words, trading volumes have largely increased due to an increase in the frequency with which liquidity providers such as market makers buy and sell stock. It would therefore be inaccurate to contend that the decrease in the average holding period of U.S. stocks is due to changes in the investment horizon for investors. The stability of holding periods for large institutional investors further suggests that reduced average holding periods do not reflect widespread changes in the investment horizon of investors.\textsuperscript{39} Recent academic studies confirm this interpretation.\textsuperscript{40}

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


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

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

their trading.”42

ii. Stock-based compensation

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

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

iii. Quarterly reporting and earnings guidance

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

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42 Id at 429.


44 See id.


47 See id at 13–23.


growth and sustainability.*

Quarterly reporting

In August 2018, President Trump requested via Twitter that the SEC consider moving from a quarterly reporting system to a six-month financial reporting system. In response, the SEC committed to studying public company financial reporting. In December 2018, the SEC issued a request for comment on quarterly earnings releases and quarterly reports, considering whether the current system “ fosters[s] an inefficient outlook among registrants and market participants by focusing on short-term results.” The SEC received over 80 comment letters, including comments from large public companies, national stock exchanges, major accounting and law firms, buy-side entities and other financial institutions. The majority of commenters did not support replacing the quarterly system, but instead recommended streamlining and simplifying the reporting process and discouraging quarterly earnings guidance. For example, FedEx Corporation encouraged the SEC to “streamline required disclosures and eliminate duplicative information in quarterly reporting.” BlackRock noted quarterly reporting may increase management’s focus on short-term results, but they “believe the loss in transparency and timely availability of information would outweigh potential benefits” and

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


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

History of quarterly reporting in the United States

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

The SEC quarterly revenues reporting rules were rescinded in 1953, and the SEC shifted to semi-annual reporting requirements in 1955. The SEC again began mandating quarterly financial reports on Form 10–Q in 1970, as part of a program to improve disclosures made under the Exchange Act prompted by a report from the legal and accounting profession, securities industry and business community to the SEC entitled “Disclosure to Investors—A Reappraisal of Administrative Policies under the ’33 and ’34 Acts.” This report issued at the direction of SEC Commissioner Francis Wheat was meant to find ways to, among other items, “clarify the law of disclosure and make its application more certain” and “enhance the utility to investors and to those who

58 See Butler et al., The effect of reporting frequency on the timeliness of earnings at 185 (cited in note 57).
59 See id at 186.
60 See id.
62 See Butler et al., The effect of reporting frequency on the timeliness of earnings at 186 (cited in note 57).
63 See id.
advise them of the documents generated under the Federal securities statutes.”65 The SEC “propos[ed] to adopt regular quarterly reporting which [would] provide detailed information as a back-up to” Form 8-K’s event-driven disclosure requirements, which the SEC was concerned were not widely used at the time by investors or their advisors to receive information pertinent to their investments.66 Quarterly reporting has been mandatory in the United States since the 1970s.

In the period between 1950 to 1970, as public firms in the United States began to increase the frequency of financial reporting, Kraft, Vashishtha and Venkatachalam (2018) found that there was a decline in investment after a firm increased their reporting frequency and that firms that reported more frequently were more likely to have a subsequent decline in operating efficiency and sales growth.67 They concluded these findings were due to increased capital market pressures to achieve short term performance objectives.68 On the other hand, Fu, Kraft and Zhang (2012) found that increased reporting frequency reduced the cost of capital in the period from 1931 through 1973 due to a reduction in information asymmetry between investors and executives at the company.69

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

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65 Id.
67 See Kraft et al., Frequent Financial Reporting and Managerial Myopia (cited in note 57).
68 See id at 274–75.
69 See Renhui Fu, Arthur Kraft and Huai Zhang, Financial Reporting Frequency, Information Asymmetry and the Cost of Equity, 54 J. of Acc. and Econ. 139 (2012).
performance and discourage[s] long-term investment.”

By November 2015, member states, including the U.K., had returned to mandatory semi-annual reporting regimes.

Regardless, many public companies in the EU continued to voluntarily report on a quarterly basis immediately after the EU rescinded its quarterly reporting requirement. For example, in 2015, 90% of U.K. public companies voluntarily published quarterly reports. Initially, the U.K. companies abandoning quarterly reporting were mostly small domestic companies. However, a much broader trend away from voluntary quarterly reporting is now evident in the U.K. Between October 2016 and August 2017, (i) the number of FTSE 100 companies voluntarily issuing quarterly reports fell from 70 to 37, and (ii) the number of FTSE 250 companies doing so fell from 111 to 83. Nevertheless, the trend away from quarterly reporting has varied by jurisdiction. For example, companies listed on the Deutsche Börse under the “prime standard”, a segment of the exchange with the highest transparency standards that exceed the “general standard” required by law, must publish quarterly reports. As of October 2019, 308 of the 502 companies listed on the Deutsche Börse were voluntarily listed on the prime standard, meaning that over 60% of companies on the Deutsche Börse still publish quarterly reports.

In examining the shift to and from mandatory quarterly reporting, researchers have reached differing conclusions as to the impact of quarterly reporting on short-termism. Ernstberger, Link, Stich, and Vogler (2013) examine how mandatory quarterly reporting affected R&D. To do so,

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74 See id.

75 See Owen Walker, The long and short of the quarterly reports controversy, Financial Times (July 1, 2018), available at https://www.ft.com/content/e61046bc-7a2e-11e8-8e67-1ea08464c75.


they analyzed EU firms that switched to mandatory quarterly reporting in 2007. They found that the shift to mandatory quarterly reporting was correlated with increased cuts to R&D to boost short-term performance metrics, and that these cuts weighed on operating performance after the first year. Conversely, Pozen, Nallareddy and Rajgopal (2017) analyzed the effect of quarterly reporting on capital investment at U.K. companies between 2005 and 2015. They found that when companies were required to report quarterly in 2007, rather than semiannually, the level of investment was generally unchanged. They also found that the change back from quarterly to semiannual reporting did not create any significant benefit, or harm, to firms that discontinued quarterly reporting.

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

Quarterly earnings guidance

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

Issuance of quarterly earnings guidance increased after the turn of the millennium, increasing from less than 10% of U.S. public companies in the mid-1990s to a peak of nearly 50% of large cap companies in 2004. Many market participants assume that quarterly earnings guidance continues

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79 See id at 34.
80 See id at 36.
81 See Pozen et al., Impact of Reporting Frequency on UK Public Companies at 5 (cited in note 73).
82 See id at 6–7.
84 See Securities and Exchange Commission, Request for Comment on Earnings Releases and Quarterly Reports at 65604 (cited in note 52).
85 FCLT Global, Comment Letter Regarding Earnings Releases and Quarterly Reports (March 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5167609-183488.pdf. See also Ariel Fromer Babcock and Sarah Keohane Williamson, Moving Beyond Quarterly Guidance: A Relic of the Past, FCLT Global 5 (Oct. 2017) (“Companies that choose to offer shareholders a long-term vision and strategy benefit not only from a reduced focus on short-term metrics but also by attracting and building a long-term investor base.”).
86 See id at 8.
to be a widespread practice, but U.S. public companies have been shifting away from quarterly earnings guidance.\textsuperscript{87} As of 2016, only 28\% of the S&P 500 issued quarterly earnings guidance, down from 36\% in 2010.\textsuperscript{88}

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

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

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

\textsuperscript{87} See id at 8–11.
\textsuperscript{88} See id at 6.
\textsuperscript{90} See Babcock and Williamson, Moving Beyond Quarterly Guidance at 11–12 (cited in note 85).
\textsuperscript{91} When comparing volatility and price-to-book ratios for U.S. firms that decreased the frequency of their earnings-per-share guidance, no effect on volatility or P/B ratios were found from the guidance change. See id at 12.
\textsuperscript{92} See Yongtae Kim, Lixin (Nancy) Su and Xindong (Kevin) Zhu, Does the Cessation of Quarterly Earnings Guidance Reduce Investors' Short-Termism?, 22 Rev. of Acc. Stud. 715 (2017).
\textsuperscript{94} See id.
information that lowers uncertainty and, as a result, lowers a firm’s cost of equity capital. In studying this effect, Chen, Matsumoto and Rajgopal (2011) find evidence that ceasing quarterly earnings guidance can lead to an increase in a firm’s cost of capital, driven by the theory that investors typically reward firms that provide guidance with lower equity capital costs. This result is consistent with other empirical studies finding more generally that earnings guidance reduces a firm’s cost of capital. For example, Baginski and Rakow (2012) find that firms with more frequent earnings forecasts tend to have lower costs of equity capital. Additionally, in looking at firms globally (i.e. U.S. and non-U.S.), Cao et al. (2017) determine that equity capital costs are 30 to 60 basis points lower for firms issuing earnings guidance.

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

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

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95 See Shuping Chen, Dawn Matsumoto and Shivaram Rajgopal, *Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance*, 51 J. of Acc. and Econ. 134 (2011). However, the findings of Chen et al. only find a relatively weak link between quarterly earnings guidance and cost of capital, arguably due to the relatively high variance in cost of capital measures across firms.
99 See id at 14–15. However, these firms are more likely to provide revenue guidance. See id.
100 See id.
101 See id, Is Silence Golden? at 140–42.
102 See id at 140. (“Because analysts are the primary beneficiaries of earnings guidance, firms with increases in analyst following also likely feel greater pressure to continue providing guidance.”) However, Chen et al. suggest that firms may cease providing guidance—stopping a practice associated with a short-term focus—in an attempt to attract more long-term institutional investors. See id.
that “[t]he role of activists is getting larger.”

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

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

### c. Effects of short-termism

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

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

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

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

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

106 See id at 4-7.

107 See id at 6.


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


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

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

2. Shareholder activism

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

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

113 See Kaplan, Are US Companies Too Short-Term Oriented? at 109–11 (cited in note 8).
114 See id.
116 See id.
118 See, for example, Lucian Bebchuk, Alon Brav and Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085 (June 2015); Coffee and Palia, The Wolf at the Door (cited in note 27).
119 See id at 7 (noting that “[a]ll studies have found that activist campaigns result on average in short-term gains for shareholders, but the evidence…is decidedly more mixed with respect to long-term gains.”).
a. Prevalence of activism

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

Figure 2.3. Annual campaign activity.120

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

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

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121 See id at 6.
122 See Roe, Stock Market Short-Termism’s Impact at 12 (cited in note 6). Lazard limits its figures to campaigns against companies with a market capitalization of $500 million or greater, while it is unclear whether the Roe data is limited by market cap. This may explain the higher Roe numbers.
activist engagements from 1994 through 2016 according to Roe. While there were almost no activist campaigns in the mid-1990s, the number of campaigns rose to over 300 more recently.

b. Effects of activism

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

Short-term effects

While the precise magnitude of the stock price impact of activist campaigns varies by study, most studies find that stock prices experience average positive abnormal returns of six to eight percent following the announcement of an activist intervention. The range of abnormal returns largely depends on the study’s definition of the short-term window (the time frame over which stock returns are calculated) and the time period studied. For example, Bebchuk, Brav and Jiang (2015) find abnormal returns of six percent measured over a 40-day period, from 20 days prior to the announcement of an activist campaign to 20 days after the announcement, during the period of 1994 to 2007. Klein and Zur (2009) find average abnormal returns of more than seven percent in activist campaigns that occurred primarily from 2003 to 2005, measured from 30 days prior to 30 days after the announcement. And Boyson and Mooradian (2011) find, in the study period of 1994 through 2005, average abnormal returns of more than eight percent, measured from 25 days prior to 25 days after the announcement of an activist campaign.

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

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123 “Abnormal” return is the portion of the stock return in excess of the return that would be expected based on traditional factors (e.g. overall stock market factors).
124 See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* (cited in note 118).
(2008) reported that 37 percent of targeted firms from 1998 through 2005 experienced negative abnormal returns.\(^\text{128}\)

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

**Long-term effects**

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

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

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


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


\(^{134}\) Lipton acknowledges that econometric evidence that appear to undermine his claims, but cites Allaire and Dauphin (2014) to call into question the value of empirical studies relative to observations based on real-world experience. According to them, “[e]conometrics provides a crude tool kit, a weak lens through which the researcher can, at best, view the blurred contours of complex phenomena.” See Yvan Allaire and Francois Dauphin, “Activist Hedge Funds: Creators of Lasting Wealth?”, Institute for the Governance of Private and Public Organizations 2 (July 2014).
Several studies examine the long-term stock returns of companies targeted by activists, testing whether the short-term gains in stock price are subsequently reversed. Bebchuk, Brav and Jiang show that, during the period of 1994 to 2007, targets of activism experience average abnormal returns of 2.6 percent over the three years following activist intervention and 5.8 percent over the five years following activist intervention.\textsuperscript{135} Klein and Zur find that target companies earned abnormal returns of 11.4 percent over the year following an activist intervention from 2003 to 2005.\textsuperscript{136} And Greenwood and Schor (2009) find abnormal returns of 10.4 percent over the following 18 months following an activist intervention in the study period of 1993 through 2006.\textsuperscript{137}

On the other hand, deHaan, Larcker and McClure (2019) found that on a value-weighted basis pre- and post-activism long-term returns (from one month before intervention through one to two years following intervention) insignificantly differ from zero during the study period of 1994 through 2011.\textsuperscript{138} They found that positive gains following activist intervention were primarily driven by the smallest 20\% of target firms, and that nearly all the positive long-term returns following activist interventions were concentrated among firms that were later acquired.\textsuperscript{139}

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

Brav, Jiang and Kim (2015) examine the impact of hedge fund activism on target company productivity in the study period of 2001 through 2006.\textsuperscript{142} They find that productivity at manufacturing plants improves over the three years following an activist intervention. In the same vein, they find that investment in information technology increases at target companies, which is also positively associated with productivity improvements. Brav et al. argue that their empirical find-

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

\textsuperscript{136} See Klein and Zur, \textit{Entrepreneurial Shareholder Activism} (cited in note 125).


\textsuperscript{139} See id at 540.

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

\textsuperscript{141} See id at 1103–06.

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

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

c. Passive investors and activist strategies

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

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

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143 See id. at 2726.
146 See id at 247–56.
148 See id at 41.
specifically analyzing whether the “increasingly large and concentrated ownership stakes of passive institutional investors influence the types of campaigns undertaken by activists, the tactics they employ, and their eventual outcomes.” They predict that the increased presence of passive institutional investors—in particular, the increased concentration of public company ownership—may facilitate activist campaigns, so long as the campaigns are focused on improving long-term value, as opposed to temporary short-term gains: “[t]he large and concentrated ownership stakes of passive institutions might help…facilitat[e] activist investors’ ability to rally support for their demands…and decreas[e] the coordination costs of activism.”

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

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151 See Ian R. Appel, Todd A. Gormley and Donald B. Keim, Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism, 32 Rev. of Fin Stud. 2720, 2721 (July 2019).
152 Id at 2721–22. See also Jill E. Fisch, Asaf Hamdani and Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev. 17, 42 (2020) (“Passive funds also play a complementary role in the more focused engagement provided by hedge funds by serving as gatekeepers for activism…[H]edge funds typically purchase less than 10% of an issuer’s shares and, as a result, cannot wage a successful campaign unless they have the support of institutional investors (and thus passive funds).”).
153 An earlier study by Appel, Gormley and Keim found “evidence that a larger ownership stake by passive funds is associated with a decline in hedge fund activism; a one standard deviation increase in ownership by passive mutual funds is associated with a 1.6 percentage decline in the likelihood of a hedge fund activism event (statistically significant at the 10% level).” This decline is attributed to “the engagement of passive investors reducing the need for activism by other investors.” Ian R. Appel, Todd A Gormley and Donald B. Keim, Passive Investors, Not Passive Owners, 121 J. of Fin. Econ. 111, 114 (2016).
154 Less ambitious campaigns include shareholder proposals and exempt solicitations. See Appel, Gormley and Keim, Standing on the Shoulders of Giants at 2724–26 (cited in note 151).
155 Hostile tactics include proxy battles against incumbent directors. See id.
156 See id.
(dividends and share repurchases) or other changes to the capital structure.

3. Stock buybacks

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

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

a. Regulation of stock buybacks in the United States

Stock buybacks were not a common practice until the 1980s, as they were generally perceived to be prohibited by the Exchange Act. A company purchasing its own shares could be considered manipulative and therefore liable under the Exchange Act. In 1982, the SEC promulgated Rule 10b-18, which provided for a safe harbor from liability for manipulation for engaging in stock
buybacks.\textsuperscript{162}

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

As a general matter, companies are required to disclose certain material events on Form 8-K within four days of their occurrence, but only if they fall into a specific item listed on the form.\textsuperscript{166} Stock repurchase programs are not a specific item on Form 8-K, so their disclosure is not required.\textsuperscript{167} However, companies may elect to disclose other material events on Form 8-Ks not otherwise required to be immediately disclosed.\textsuperscript{168} Therefore, some companies promptly disclose the approval of stock repurchase programs, including their size and occasionally their intended duration, on Form 8-Ks under Item 8.01.\textsuperscript{169}

Separately, NASDAQ and NYSE require the immediate disclosure of certain material information.\textsuperscript{170} Under NASDAQ Rule 5250(b)(1), a listed company must “make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors’ decisions.”\textsuperscript{171} Likewise, under NYSE rules, “a listed company is ex-
pected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." These obligations are generally understood to capture the adoption of repurchase programs, but they do not require the disclosure of specific program details like intended duration and authorized amount. Moreover, they can be satisfied by any disclosure “reasonably designed to provide broad, non-exclusionary distribution of the information to the public.” In addition to Form 8-Ks, this can include press releases, conference calls, webcasts, and posts to the company’s website.

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

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

Public companies must also disclose:

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

172 NYSE Listed Company Manual, Rule 202.05.
174 17 C.F.R. § 243.101(e)(2) (“An issuer shall be exempt from the requirement to furnish or file a Form 8-K if it instead disseminates the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”).
175 See, for example, NYSE Listed Company Manual, Rules 202.05, 204.00.
176 See 17 C.F.R. § 229.703.
177 See Fried, Informed Trading and False Signaling with Open Market Repurchases at 1340-1341 (cited in note 161).
178 See 17 CFR § 229.703.
179 See id.
b. Data on total payouts

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

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

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

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

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

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

c. Motivations for stock buybacks

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

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182 See Lazonick, Profits without Prosperity (cited in note 24).
183 See Schumer and Sanders, Limit Corporate Stock Buybacks (cited in note 159).
186 See id.
187 See, for example, Lazonick, Profits without Prosperity (cited in note 24); Schumer and Sanders, Limit Corporate Stock Buybacks (cited in note 159).
Most importantly, stock buybacks are an alternative method for distributing cash to shareholders that would otherwise be paid as dividends. Management may prefer stock buybacks over dividends for several reasons. First, stock buybacks offer tax advantages for shareholders, since dividends are immediately taxable at ordinary income rates, while stock buybacks allow shareholders to defer tax—they can choose to hold onto their shares, rather than sell—and pay capital gains rates. Second, stock buyback programs offer more flexibility than dividends, allowing management to appropriately time repurchases and adjust payouts in response to investment opportunities and accommodate impacts on earnings-per-share or stock valuation. Stock buybacks are also preferable for employees since they do not entail stock price declines as occurs with dividends and therefore do not devalue employee stock options. Stock buybacks may also signal firm value to the market, since firms typically repurchase shares that management views as undervalued. In a survey of CFOs, Brav et al. (2005) note that 85% believe that stock buybacks do indeed convey positive information to shareholders. Finally, another motivating factor for stock buybacks is to lower overall costs of capital by replacing equity with debt. A new issuance of debt is preferable from a tax perspective, as the interest payments are tax deductible and result in a lower tax burden. Roe (2018) notes that stock buy-
backs have increased when interest rates are low and have declined when interest rates have increased, which is consistent with the argument that firms engage in buybacks to recapitalize their balance sheet with relatively cheaper debt.196

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

Effect of stock buybacks on EPS and stock price

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

Evidence that management engages in buybacks for short-term goals

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

196 See Roe, Stock Market Short-Termism’s Impact at 22 (cited in note 6).
197 Paul Hribar, Nicole Thorne Jenkins and W. Bruce Johnson, Stock Repurchases as an Earnings Management Device, 41 J. of Acc. and Econ. 3, 6 (2006).
198 See id at 12.
200 See Brav et al., Payout Policy in the 21st Century at 515 (cited in note 190).
202 See id at 468.
below the bonus threshold in their compensation agreement. SEC research also found that executives are twice as likely to sell shares in the eight days following a buyback program announcement compared to an ordinary trading day. We therefore find evidence that stock buybacks may be used to support certain short-term goals, such as increases in executive compensation.

d. Stock buybacks and long-term investment

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

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

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

Finally, even if individual firms were to divert cash from investment spending for use in buybacks, that cash is not necessarily withdrawn from the capital markets. The capital that shareholders receive from buybacks can be invested in other companies that can use the funding in more productive ways. In this case, instead of stock buybacks draining investment capital from the economy, buybacks free up capital to be deployed more productively. For example, while the largest public companies have experienced net outflows of capital over the past decade, smaller public growth companies have experienced net inflows of over $400 billion from 2007-2016. Roe (2018) argues that recent data shows that cash is flowing from larger firms, including those participating in largescale buybacks, to smaller firms that may be better suited to drive innovation. In addition, Steil and Rocca (2019) show that it is the companies with the least productive use for excess cash, as measured by average return on capital, that constitute a majority of buyback activity.

Because of this, buybacks may actually mitigate overinvestment problems by returning capital to shareholders in cases where productive uses of capital are scarce, and avoiding so-called empire building, whereby managers deploy excess cash in projects simply to increase the size of the firm that they manage, even if the projects are poor investments.

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211 Id.
213 See Kostin and Hunter, Buyback Realities at 4 (cited in note 207).
215 See id.
216 See Benn Steil and Benjamin Della Rocca, Why Schumer and Sanders Are Wrong on Buybacks, Council on Foreign Relations Blog (Feb. 15, 2019) (finding that “the three sectors experiencing the largest decline in return on capital – IT, Health Care, and Energy – account for nearly 80 percent of the rise in buyback activity in the first half of last year.”), available at https://www.cfr.org/blog/why-schumer-and-sanders-are-wrong-buybacks.
217 See Dennis Oswald and Steven Young, Share reacquisitions, surplus cash, and agency problems, 32 J. of Bank. and Fin. 795 (May 2008).
218 See, for example, Asness et al., Buyback Derangement Syndrome at 53 (cited in note 194) (noting that “[t]his kind of agency cost is often characterized as empire building, and avoiding it has long been viewed as one of the benefits of returning cash to shareholders.”).
4. Recommendations

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

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

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

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

- U.S. public companies should weigh carefully the costs and benefits of quarterly earnings guidance and consider ending the practice if it discourages them from committing to long-term investments.
- The SEC should issue precatory guidance clarifying that companies should publicly disclose certain material elements of a stock buyback program after authorization by a com-
pany’s Board of Directors. Such material elements should include the maximum repurchase amount of shares (number of shares and total dollar value) and the approximate intended duration of the plan. Public companies should publicly disclose such elements within five business days of the authorization of a stock buyback plan. Public companies should be permitted to provide public disclosure through press releases or other Regulation FD-compliant methods that ensure broad public dissemination.
Chapter 3: The Rise of Index Investing: Price Efficiency and Financial Stability
Summary

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

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

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1 See Clifford Asness, The Value of Fundamental Indexing, INSTITUTIONAL INVESTOR (Oct. 15, 2006), https://www.institutionalinvestor.com/article/b150nsjc4ph3y/the-value-of-fundamental-indexing (“What is an index? … [A]ny rule-based method of constructing a portfolio. The method can be completely mechanical — this is how we usually think of it — but it can also be the result of a committee decision, such as that undertaken to construct the Standard & Poor’s 500 index. What is important is that it is defined ex ante, so we know the components before we see the results.”); Jeffrey Wurgler, On the Economic Consequences of Index-Linked Investing, in Gerald Rosenfeld, Jay W. Lorsch, and Rakesh Khurana, Challenges to Business in the Twenty-First Century 20 (2010).

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

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

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


6 See, e.g., Inigo Fraser-Jenkins, The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism, BERNSTEIN RESEARCH (Aug. 23, 2016).
1. Index investing in U.S. equity markets  
   a. Mutual funds and ETFs  
   b. The rise of index investing in U.S. equity markets  
   c. Cost of index investing as a driver of growth  
   d. Ambiguity regarding the “true” size of the indexed market  

2. Effects of indexing on stock market efficiency  
   a. Index premium  
   b. Co-movement  
   c. Price efficiency impact of ETFs  

3. Index investing and financial stability  
   a. Potential contribution to stock market bubbles  
   b. Concentration of asset managers  
   c. Liquidity and redemption risk  

4. Conclusion
1. Index investing in U.S. equity markets

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

a. Mutual funds and ETFs

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

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

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


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

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


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

7 iShares Investigates: The ETF Ecosystem, supra note 5, at 2.
b. The rise of index investing in U.S. equity markets

Equity indexing experienced an early period of rapid growth during the late 1970s and early 1980s, with assets invested in index mutual funds swelling from 0.5 percent of S&P 500 market capitalization in 1975 to 3.1 percent in 1983. In 1993, the first index ETF was introduced in the United States. However, index investment languished through the end of the dot-com boom: in 2001, index mutual funds and ETFs still held just 3 percent of U.S. equity market capitalization. Once the tech bubble burst, indexing began to grow again. As Figure 3.1 demonstrates, the fraction of U.S. equity market capitalization held by index mutual funds and ETFs grew from 4 percent in 2005 to 15 percent as of year-end 2019. Over the same period of time, the fraction of market capitalization held by actively managed funds declined from 20 percent to 15 percent. In other words, the ratio of actively managed funds to index funds declined from 5-to-1 in 2005 to 1-to-1 in 2019. As of January 31, 2020, according to Morningstar, equity index funds that invest primarily in U.S. companies had $4.7 trillion in assets under management, compared to $4.5 trillion for similarly-focused active equity funds.

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8 See Andrei Shleifer, Do Demand Curves for Stocks Slope Down, 41 J. OF FIN. 579, 584 (July 1986).
Between 2005 and 2019, the total net assets held by U.S. domestic equity index mutual funds grew from $505 billion to more than $2.8 trillion (see Figure 3.2).15 The rise of index ETFs has been equally dramatic. The total net assets held by U.S. domestic equity ETFs, the overwhelming majority of which are indexed,16 increased from $216 million in 2005 to more than $2.58 trillion by year-end 2019 (see Figure 3.2).17

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

17 2020 Investment Company Fact Book, supra note 11, at 206. See also FEDERAL RESERVE SYSTEM: FEDERAL RESERVE BANK OF ST. LOUIS, Exchange-Traded Funds; Total Financial Assets in Domestic Equity Funds, Level, (last accessed 2019), https://fred.stlouisfed.org/series/BOGZtFL56409t600Q.
The rise of index funds in the U.S. has been paralleled globally. According to Sushko & Turner (2018), index funds and ETFs managed about $8 trillion globally as of June 2017, which represented 20% of aggregate fund assets, up from 8% in 2007.18 And according to one analysis by the Investment Company Institute, index-tracking funds managed over $10 trillion world-wide as of year-end 2019, compared to approximately $2 trillion in 2007.19

c. Cost of index investing as a driver of growth

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

18 Sushko & Turner (2018), supra note 5, at 114.
19 Robin Wigglesworth and Alex Janiud, Index funds break through $1tn-in-assets mark amid active exodus, THE FINANCIAL TIMES (Jan. 7, 2020), https://www.ft.com/content/a7e20d96-318c-11ea-9703-ee0c93f03e.
20 See text accompanying notes 2–4.
funds have failed to outperform their benchmark index net of fees, and funds that have outperformed their benchmark have often failed to do so consistently. Historically, empirical research has also found that over long horizons, the average active equity fund underperforms its benchmark due in part to the higher costs associated with active investing. And more recent research shows that “the majority of active U.S. mutual funds underperformed their benchmarks over [a] 10-year period, even before accounting for fees.”

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

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

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24 See e.g., Mark M. Carhart, On Persistence in Mutual Fund Performance, 52 J. of Fin. 57 (1997) (the best past-performance active mutual funds earn back their expenses and transaction costs; the majority of active funds underperform by approximately their investment costs).
27 See id.
28 See Joseph Chen, Harrison Hong, Ming Huang, and Jeffrey Kubik, Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, 94(5) THE AMERICAN ECONOMIC REVIEW 1276, 1293 (2004), http://www.columbia.edu/~hh2679/AER-SIZE.pdf (“It is well known that there are tremendous economies of scale associated with trading commissions and lending fees at the family level. Bigger families like Fidelity are able to get better concessions on trading commissions and earn higher lending fees for the stocks held by their funds.”); Gjergji Cici, Laura Dahm, and Alexander Kempf, Trading efficiency of fund families: Impact on fund performance and investment behavior, 88(C) JOURNAL OF BANKING & FINANCE 1-12 (2018).
30 2020 Investment Company Fact Book, supra note 11, at 129.
d. Ambiguity regarding the “true” size of the indexed market

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

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

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

³⁵ CHIEF INVESTMENT OFFICER, Exclusive: CalPERS Fires Most of Its Equity Managers (Dec. 4, 2019) https://www.ai-cio.com/news/exclusive-calpers-fires-equity-managers/. See also CALPERS, California Public Employees' Retirement System Total Fund Investment Policy (June 17, 2019) (“CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management.”).
³⁶ Id.
MANAGERS OF ACTIVE FUNDS MAY ALSO PURSUE INVESTMENT STRATEGIES THAT ARE SIMILAR TO INDEX TRACKING. WURGLER (2010) NOTES THAT, GIVEN THE CHOICE BETWEEN A STOCK THAT IS A MEMBER OF THE BENCHMARK INDEX AND A STOCK THAT IS NOT A MEMBER, AN ACTIVE MANAGER WILL PREFER THE INDEX MEMBER STOCK, AS LONG AS BOTH STOCKS ARE EXPECTED TO PERFORM EQUALLY WELL. CHOOSING THE INDEX MEMBER STOCK OVER THE NONMEMBER STOCK REDUCES THE LIKELIHOOD THAT THE ACTIVE PORTFOLIO WILL DEVIATE FROM THE BENCHMARK INDEX, THEREBY MINIMIZING THE PROBABILITY OF UNDERPERFORMANCE.

TO ACCOUNT FOR SUCH INVESTMENT BEHAVIOR BY ACTIVE FUNDS, CREMERS AND PETAJISTO (2009) PROPOSE A MEASURE CALLED “ACTIVE SHARE” THAT QUANTIFIES THE FRACTION OF A FUND’S HOLDINGS THAT DIFFERS FROM ITS BENCHMARK INDEX. THEY FIND THAT FUNDS WITH AN ACTIVE SHARE OF LESS THAN 50% GREW FROM LESS THAN ONE PERCENT OF ACTIVE EQUITY MUTUAL FUND ASSETS IN THE 1980S TO NEARLY 35 PERCENT OF ACTIVE EQUITY MUTUAL FUND ASSETS IN 2003. IN OTHER WORDS, AS OF 2003, NEARLY 35% OF ACTIVE EQUITY MUTUAL FUNDS WERE PRIMARILY TRACKING AN INDEX. HOWEVER, CREMERS (2016) FINDS THAT, BY THE END OF 2015, THE PERCENTAGE OF ASSETS IN ACTIVE FUNDS THAT ARE PRIMARILY TRACKING AN INDEX HAD DECLINED FROM 35 TO 12 PERCENT OF ASSETS IN ACTIVE EQUITY MUTUAL FUNDS.

SIMILARLY, SOME INDEX FUNDS MAY IMPLEMENT INVESTMENT STRATEGIES THAT SEEK TO MIMIC INVESTMENT STRATEGIES THAT INVOLVE INVESTMENT DISCRETION. SMART-BETA OR FACTOR INDEX FUNDS, FOR EXAMPLE, TRACK INDICES THAT ARE CONSTRUCTED USING ALTERNATIVE RULES (SUCH AS WEIGHTING FOR VALUE, VOLATILITY OR DIVIDEND YIELD) THAT ARE MEANT TO PROVIDE INVESTORS WITH PATTERNS OF RETURNS DIFFERING FROM THOSE OF A CAPITALIZATION-WEIGHTED MARKET INDEX. THOUGH THESE FUNDS TRACK AN UNDERLYING INDEX, THE UNDERLYING INDEX IN QUESTION IS OFTEN BUILT SPECIFICALLY BY THE VERY FUND THAT TRACKS IT. IN FACT, MORE THAN 75 PERCENT OF PUBLISHED INDICES ARE TRACKED BY ONLY A SINGLE FUND (ALbeit REPRESENTING AN AVERAGE OF ONLY $1.4 BILLION IN ASSETS UNDER MANAGEMENT PER FUND). ACCORDINGLY, WHILE THESE FUNDS

38 See Wurgler, On the Economic Consequences of Index-Linked Investing, supra note 1.
40 See id.
are index funds in the sense that they track indices constructed using mechanical rules, the construction of these indices involves varying degrees of discretion by the index providers, based on the stated objective of the particular index.\footnote{BLACKROCK, Index Investing Supports Vibrant Capital Markets, 6(2017), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf.} In turn, the fund manager ultimately has discretion in selecting which index to use and deciding how closely to track the index. These examples illustrate the challenge in measuring the aggregate size of index investing in U.S and global equity markets. Rather than simply summing the value of the shares held by index mutual funds and index ETFs, a more nuanced approach would recognize that investment strategies can be measured along different axes, including the degree of investment discretion involved, and that certain investors may execute index investing strategies without investing in a fund.

2. Effects of indexing on stock market efficiency

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

Under standard finance theory, an efficient stock price should incorporate only fundamental information, which includes both stock-specific information that is relevant to the future cash flows of the individual firm as well as market-wide information that is relevant to the overall risk faced by all firms (so-called systematic risk).\footnote{See Lawrence Summers, Does the Stock Market Rationally Reflect Fundamental Values, JOURNAL OF FINANCE (July 1986).} A stock’s price is said to be perfectly efficient when it is \textit{solely} determined by all available fundamental information.\footnote{See Joseph Stiglitz and Sanford Grossman, On the Impossibility of Informationally Efficient Markets, AMERICAN ECONOMIC REVIEW (June 1980), http://www.dklevine.com/archive/refs41908.pdf.} Conversely, stock prices become less efficient when they incorporate non-fundamental information, such as the mere effects of index inclusion.\footnote{See Andrei Shleifer, Do Demand Curves for Stocks Slope Down?, THE JOURNAL OF FINANCE (1986).}

Active investors seek fundamental information, and their trading incorporates that information into public stock prices.\footnote{See Stiglitz and Grossman (1980), supra note 47.} If stock prices deviate from their fundamental underlying value, active investors exploit the mispricings until prices realign.\footnote{See id.} Without such trading by active investors, mis-pricings would perpetuate. In this way, the presence of active investors promotes market efficiency.\footnote{See id.} Index investors, by contrast, do not trade based upon stock-specific fundamental information. As index investing grows and replaces active investing, the concern arises that markets

\textit{Sushko and Turner (2018), supra note 5.}
become less efficient. However, an important counter is that when assets move from active funds to index funds, the least skilled (i.e., worst-performing) active managers are likely to experience the largest withdrawals. In addition, it is active trading that promotes market efficiency, not merely active assets under management. While the total assets under management of index funds have increased significantly, the share of trading by index funds versus active funds has been less so. For example, an analysis by S&P Dow Jones illustrates that even if index funds constituted more than 90% of assets under management, they would only account for less than 50% of trading. Furthermore, the substantial trading of index-linked products, which often exceeds the trading volumes in the individual stocks, itself contributes to market efficiency at a macro level, i.e. reflecting investors’ views of the appropriate value of the market as a whole.

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

a. Index premium

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

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


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

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

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

60 Id.
61 Id.
64 Antti Petajisto, *The Index Premium and Its Hidden Cost for Index Funds*, J. OF EMPIRICAL FINANCE (March 2011).
– suggesting that index inclusion makes previously less-known, less-liquid stocks more valuable by increasing the supply of public information about them.\(^ {67}\) For index exclusion, they find no significant price patterns, and suggest this may be attributable to short-sale constraints.\(^ {68}\)

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

However, more recent studies find that the index premium has decreased or even disappeared in recent years, suggesting that such suboptimal capital allocation may not be an issue. Petajisto (2011) finds that the index premium \textit{declined} from 10.3% in 1990–2000 to 4.6% in 2001–2005.\(^ {73}\) Scari (2016) finds that the index premium declined starting in the late 1990s and disappeared entirely by 2010.\(^ {74}\) Schitzler (2016) and Patel and Welch (2017) also find that the index premium has effectively disappeared.\(^ {75}\) Therefore, while the presence of an index premium has been established historically to varying degrees, its continued existence has been challenged by recent empirical studies, most of which find a decline in or disappearance of the index premium over the time period that coincides with the greatest growth of index investing.

\(^ {67}\) Kaptein (2016), \textit{supra} note 66, at 30.
\(^ {68}\) Kaptein (2016), \textit{supra} note 66, at 30.
\(^ {70}\) Id.
\(^ {71}\) Id.
\(^ {72}\) Massa et al. (2005), \textit{supra} 69.
\(^ {73}\) Antti Petajisto, \textit{The Index Premium and Its Hidden Cost for Index Funds}, J. OF EMPIRICAL FINANCE (March 2011).
\(^ {74}\) Cameron Scari, \textit{On the Changes to the Index Inclusion Effect with Increasing Passive Investment Management} (2016), https://repository.upenn.edu/cgi/viewcontent.cgi?article=1020&context=joseph_wharton_scholars.
b. Co-movement

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

Barberis et al. (2005) examine changes to the S&P 500 index from 1976 to 2000, finding that after a stock is added to the S&P 500, the co-movement of its price with other S&P 500 stocks increases, while co-movement with non-index stocks decreases. Specifically, a stock that is added to the S&P 500 index experiences an increase in beta (i.e. an approximate measure of correlation) with the S&P 500 of 0.357 and a decrease in beta with non-S&P 500 stocks of 0.373. Coles et al. (2017) find a similar effect with respect to the Russell 2000 index, finding an increase in correlation of 0.055 between the included stock and the Russell 2000 index. Finally, Da & Shive (2018) show that ETFs contribute to co-movement of index-component stocks, finding that a one-standard-deviation increase in ETF turnover (i.e. a change in the ETF’s underlying portfolio, which is

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

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

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

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

However, the empirical evidence is mixed as to whether the co-movement effect has increased with the growth of index investing overall. Kamara, Lou, and Sadka (2008, 2010) show that average co-movement of large stocks increased between 1968 and 2008.\textsuperscript{84} Similarly Bolla, Kohler, and Wittig (2017) examine co-movement in the U.S. and Europe, finding that co-movement generally increased from 2002 to 2014, consistent with the growth period of index investing.\textsuperscript{85} However, when Chen, Singal, and Whitelaw (2016) examine index inclusion over differing time periods, they find that co-movement effects were smaller from 2001 to 2012 than in the previous decade, even though index investing had become much more widespread in the latter period.\textsuperscript{86}

Most importantly, S&P Global notes that correlations among S&P 500 stocks recently have been at the lowest levels since 1991.\textsuperscript{87}

Figure 3.3. S&P 500 correlation (1991-2020).

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

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

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

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

\textsuperscript{86} Chen Honghuia, Vijay Singalb, Robert Whitelaw, Co-movement revisited, 121(3) JOURNAL OF FINANCIAL ECONOMICS 624 (Sept. 2016).


\textsuperscript{88} Nicholas Barberis, Andrei Shleifer, Jeffrey Wurgler, Comovement, 75(2) JOURNAL OF FINANCIAL ECONOMICS 283 (2005)
Barberis (2015), systematic fundamental information can be incorporated more efficiently into the prices of index stocks, because stocks included in indices have higher liquidity and lower trading costs than non-index stocks. These benefits may also be found in indices of smaller companies if index funds make their component stocks relatively more liquid, even if not as liquid as stocks in major indices. Similarly, Madhavan and Morillo (2018) examine volume changes in ETFs and their underlying securities, attributing cross-stock correlations to the macro environment rather than ETF growth.  

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

c. Price efficiency impact of ETFs

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


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

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

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

95 Doron Israeli, Charles Lee & Suhas Sridharan, Is There a Dark Side to Exchange Traded Funds? An Information Perspective, REVIEW OF ACCOUNTING STUDIES (Sep. 2017).
96 Israeli et al. (2017), supra note 95.
97 Israeli et al. (2017), supra note 95.
98 Israeli et al. (2017), supra note 95.
99 Israeli et al. (2017), supra note 95.
100 Lawrence Glosten, Suresh Nallareddy & Yuan Zou, ETF Activity and Informational Efficiency of Underlying Securities (April 27, 2017). See also Thomas Ernst, Online Appendix to Stock-Specific Price Discovery From ETFs (Feb. 8, 2020), http://www.mit.edu/~ternst/docs/online_appendix.pdf.
101 Glosten et al. (2017), supra note 100 (noting also the absence of a similar increase in informational efficiency for large-cap stocks and stocks that trade in competitive markets).
102 Glosten et al. (2017), supra note 100.
Overall, these contrasting studies demonstrate that the empirical evidence on the impact of ETFs on price efficiency is mixed.

3. Index investing and financial stability

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

   a. Potential contribution to stock market bubbles

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

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

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104 See text accompanying notes 69–75.


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

b. Concentration of asset managers

The growth of index investing has been associated with an increase in the concentration of the asset management industry, with the largest asset managers accounting for an increasing share of index fund assets. For example, since 2010 the three largest asset managers—Vanguard, BlackRock and State Street—have received 70 percent of cumulative index fund inflows and, the share of all mutual fund and ETF assets at the five largest fund families increased from 35 to 51 percent over 2005 to 2018.

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

107 Anadu et al. (2018), supra note 78; Kaptein (2016), supra note 66.
Furthermore, although concentration in the registered fund industry has increased, it remains a competitive market. According to Anadu (2017), between 2005 and 2018, the Herfindahl–Hirschman Index ("HHI")—a commonly-used measure of industry concentration—of registered funds (including mutual funds and ETFs) has increased from approximately 500 to more than 800. The increase has largely been driven by the growth of index funds, which tend to be more concentrated than active funds. However, the concentration of registered funds is still relatively low—a market is not considered concentrated for antitrust purposes unless its HHI is above 1,500 and the HHI of registered funds is approximately half of that at 800.

### c. Liquidity and redemption risk

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

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


prices, redemptions by index funds could amplify stock market losses. However, such concerns have not materialized during the COVID-19–related market stress as of May 2020.\footnote{For example, in 2020 U.S. ETFs have seen year-to-date net inflows of $115.8 billion, up from the net inflows of $70.9 billion over the same time frame in 2018. See Sumit Roy, \textit{First Weekly ETF Outflow Since March}, ETF.COM (May 8, 2020), https://www.etf.com/sections/weekly-etf-flows/weekly-etf-flows-2020-05-07-2020-05-01.}

Kamara, Lou, and Sadka (2008, 2010) and Bolla, Kohler, and Wittig (2017) find increases in correlated liquidity shocks among stocks in the U.S. equity market, which they attribute to the spread of index investing.\footnote{See A. Kamara, X. Lou, and R. Sadka, \textit{The Divergence of Liquidity Commonality in the Cross-section of Stocks}, \textit{89 Journal of Financial Economics}, 444 (2008); Lidia Bolla, Alexander Kohler, and Hagen Wittig, \textit{Index-linked investing—A curse for the stability of financial markets around the globe?}, \textit{42 Journal of Portfolio Management} 26 (2017).} Their findings suggest that the growth of index investing might make stocks more likely to become illiquid simultaneously, which would magnify the effect of a “run” on index funds.

On the other hand, Anadu et al. (2018) provide evidence that the sensitivity of investor inflows and outflows to performance for index funds is weaker than for active funds: while a one percent decrease in monthly net return is associated with a 2.5 percent outflow from active stock funds, the same decrease correlates with only a 0.7 percent outflow from index funds.\footnote{Anadu et al. (2018), supra note 78.} Recent prominent liquidity crises at mutual funds (such as those at H2O, Woodford and GAM) have all occurred at active funds that held illiquid assets, including stock of private companies and illiquid debt securities, that are typically not held by index equity funds.\footnote{Anadu et al. (2018), supra note 78.}

Sushko and Turner (2018) analyze several recent stress episodes and compare the stability of fund flows across index mutual funds, index ETFs and active mutual funds.\footnote{Sushko & Turner (2018), supra note 5.} They find that index mutual fund flows were the least volatile; index ETFs exhibited the largest fund inflows and outflows relative to asset size (active mutual fund flows were the largest in absolute terms); and active mutual funds experienced the most persistent outflows.\footnote{Sushko & Turner (2018), supra note 5.} Their findings are consistent with evidence from Ben–David, Franzoni and Moussawi (2017) that ETFs attract short-term investors.\footnote{Itzhak Ben–David, Francesco Franzoni, Rabih Moussawi, and John Sedunov, \textit{The Granular Nature of Large Institutional Investors}, CEPR Discussion Paper (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2620271.} Their findings also suggest that while index mutual funds are a stabilizing influence in times of market stress, index ETFs (and their investors) tend to be more sensitive to market conditions.\footnote{Ben–David et al. (2019), supra note 120.}
4. Conclusion

The first section of this chapter measured the rise of index investing, finding that approximately 15% of U.S. equities were owned by index mutual funds and ETFs as of year-end 2019. We also considered the drivers of index fund growth and challenges in measuring the rise of index investing.

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

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

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

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122 2020 Investment Company Fact Book, supra note 11, at 40.
Chapter 4: An Analysis of Investment Stewardship: Mutual Funds and ETFs
Summary

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

This chapter is divided into five sections:

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

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

Section 3 describes the voluntary investment stewardship practices of BlackRock, Vanguard and State Street, whose mutual funds and ETFs are the three largest holders of many U.S. public companies. With respect to voting, we find that these investment advisers voluntarily disclose highly detailed voting guidelines and consolidated voting statistics. With respect to non-voting engagement, including meetings with public companies, we find that these investment advisers disclose their engagement priorities and efforts undertaken to advance them. Such disclosures allow investors to evaluate whether investment advisers’ investment stewardship policies are consistent with investor priorities.
Section 4 reviews the empirical literature as it relates to investment stewardship by investment companies. First, we consider studies that evaluate the frequency with which investment companies oppose management proposals and support shareholder proposals. Second, we consider studies that evaluate whether holdings by investment companies are positively correlated with improved performance of public companies. Third, we review studies that assess whether holdings by investment companies are correlated with positive measures of corporate governance at public companies. In doing so, we also consider empirical studies that are focused exclusively on index funds as a subset of investment companies.

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

2. Regulation of investment stewardship: U.S. requirements and an international perspective
   a. Investment adviser voting authority
   b. Voting policies, conflicts of interest & proxy advisors
   c. Disclosure of voting policies and votes
   d. Non-voting engagement with portfolio company management
   e. Select international approaches to investment stewardship

3. Investment stewardship practices of certain investment advisers
   a. Voting
   b. Disclosure of non-voting engagement activities and priorities

4. Empirical analysis of investment stewardship practices by investment companies
   a. Voting by investment companies
   b. Investment company holdings and firm performance
   c. Investment company holdings and corporate governance

5. Evaluating proposals to reform investment stewardship by index funds
   a. Pass-through voting
   b. Polling
   c. Eliminating index fund voting rights
   d. Enhancing disclosure of non-voting engagement policies
1. Introduction to mutual funds, ETFs, and fund managers

   a. Mutual funds and ETFs

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

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

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Table 4.1. Mutual fund and ETF ownership of the largest U.S. public companies (December 2019).

<table>
<thead>
<tr>
<th>Largest U.S. Public Companies</th>
<th>Mutual Fund &amp; ETF Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple Inc.</td>
<td>28.80%</td>
</tr>
<tr>
<td>Microsoft Corp.</td>
<td>42.14%</td>
</tr>
<tr>
<td>Alphabet Inc.</td>
<td>39.58%</td>
</tr>
<tr>
<td>Amazon.com Inc.</td>
<td>32.14%</td>
</tr>
<tr>
<td>Facebook Inc.</td>
<td>45.93%</td>
</tr>
<tr>
<td>Berkshire Hathaway Inc</td>
<td>32.56%</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co.</td>
<td>39.20%</td>
</tr>
<tr>
<td>Visa Inc.</td>
<td>50.19%</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>33.89%</td>
</tr>
<tr>
<td>Wal-Mart Stores Inc</td>
<td>14.77%</td>
</tr>
<tr>
<td>Bank of America Corp.</td>
<td>34.82%</td>
</tr>
</tbody>
</table>

b. Regulatory framework

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

i. Investment Advisers Act of 1940

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

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


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

**ii. Investment Company Act of 1940**

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

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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”).


The Company Act also requires investment companies to have a board of directors elected by investors. The board of directors is responsible for overseeing an investment company’s compliance with certain legal requirements, and is subject to fiduciary duties of care and loyalty that arise under federal and state law. 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. The duty of loyalty requires directors to place the best interests of investors over their own interests and avoid self-dealing.

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.” For mutual funds and ETFs, investment advisers’ voting authority is determined by the

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

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; and (iii) conduct an investigation “reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information.” 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.

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, because refraining from voting in these circumstances would be in the best interest of the client. 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. In its August 2019 Guidance on the Proxy Voting Responsibilities of Investment Advisers (the “2019 Voting Guidance”), the SEC clarified that an investment adviser’s duty to vote shares can be determined by an agreement with the client taking into account specific parameters designed to serve the client’s best interest.

Although investment advisers currently tend to vote all or most of the proxies that they hold in clients’ shares, 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

26 Standard of Conduct, supra note 10, at 33671.
29 Proxy Voting by Investment Advisers, supra note 28, at 6587.
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.”).
33 SEC Commissioner Elad Roisman, Keynote Remarks: ICI Mutual Funds and Investment Management Conference (Mar. 18, 2019) https://www.sec.gov/news/speech/speech-roisman-031819 (“For example, it appears to be the default position of many advisers that they vote every proxy, for every company, in every fund’s portfolio.”).
for this same reason.” The 2019 Voting Guidance clarifies that clients can agree that investment advisers need not vote proxies in such instances.

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.” The SEC does not prescribe specific content for these policies, rejecting a “one-size-fits-all” approach, instead “leav[ing] advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face.”

With respect to conflicts of interest, “an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest.” 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.” 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.”

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. Even prior to this SEC guidance, most investment advisers reported conducting independent due diligence of proxy

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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.”).
36 17 C.F.R. 275-206(4)-6(a) (2003); Proxy Voting by Investment Advisers, supra note 28, at 6592.
37 Proxy Voting by Investment Advisers, supra note 28, at 6587.
39 Proxy Voting by Investment Advisers, supra note 28, at 6588.
40 Gary Retelny, Chief Executive Officer of Institutional Shareholder Services, Why we are suing the SEC, Financial Times (Nov. 5, 2019), https://www.ft.com/content/cdcb6ed7-18f4-4729-8dc4-6a577ac44f15?share-Type=nongift.
advisors to obtain reasonable assurances regarding conflicts of interest. 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. The 2019 Voting Guidance recommends that investment advisers, among other things: (i) periodically sample and examine sets of recommended votes to ensure they would, if cast, meet the investment advisers’ fiduciary duties; (ii) consider outside information other than the proxy advisor’s recommendation, including filings and supplemental input from issuers and shareholder proposal proponents; (iii) engage in greater in-house analysis on important or controversial proposals; and (iv) conduct a periodic review of their proxy advisors’ voting policies and practices.

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. The SEC further requires that each registered investment company: (i) “disclose in its registration statement... the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities”; 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”). 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. If an investment company casts votes in a manner inconsistent with its own policy, then it must explain the reason for the deviation.

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42 GAO Report, supra 32, at 11.
47 The policies are reported on Forms N-1A, N-2, N-3, and N-CSR.
48 Investment Company Adopting Release, supra note 46.
50 Investment Company Adopting Release, supra note 46, at 60822.
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. An investment adviser may use such engagement to better understand portfolio company governance, to develop an informed position on specific votes or issues, and to advocate certain governance priorities.

The Advisers Act, the Company Act, and the regulations promulgated thereunder do not explicitly require investment advisers to undertake or disclose non-voting engagement activity. However, an investment adviser’s legal obligations, particularly its fiduciary duty to clients, inform its non-voting engagement decisions, including whether and how to engage with portfolio company management. For example, in its voting-related guidance, the SEC states that “the duty of care requires an adviser with proxy voting authority to monitor corporate events and to reasonably investigate facts underlying voting determinations.” 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. These principles are typically highly generalized and often

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52 Proxy Voting by Investment Advisers, supra note 28, at 6987.


do not go beyond existing regulatory requirements for investment advisers. For example, Principle A states that “institutional investors are accountable to those whose money they invest” and Principle E states that “institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.” 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,” and “disclose, in general, what further actions they may take in the event they are dissatisfied with the outcome of their engagement efforts.” 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.” As a general matter, an investment firm’s voting authority is determined by its agreement with the client. 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.

Investment firm voting and non-voting engagement is governed by the Shareholder Rights Directive II (“SRD II”). 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

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(i)(f).
59 See generally SRD II, supra note 61, at Recital 9 and Article 3c.
and stakeholders, and manage conflicts of interest. 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.” With respect to disclosure, SRD II also requires investment firms to publicly disclose: (i) their engagement policy; 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.” 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.”

ii. Hong Kong

In Hong Kong, the Securities and Futures Commission (“SFC”) regulates firms that advise on the acquisition and disposition of securities and firms that manage collective investment schemes (collectively referred to in this section as “investment firms”). The Code of Conduct for Persons Licensed by or Registered with the SFC and the Fund Manager Code of Conduct establish the regulatory requirements for such investment firms. As a general matter, investment firms must enter into written agreements with clients that “set out the precise terms and conditions under which discretion will be exercised,” including voting authority. In exercising voting authority,

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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.
71 Fund Manager Code of Conduct, supra note 69.
72 See, e.g., Fund Manager Code of Conduct, supra note 69, at 31 (“A Discretionary Client Agreement should set out the precise terms and conditions under which discretion will be exercised and contain at least such information set out in the section ‘Minimum Content of Discretionary Client Agreement’ and be provided in a language understood by the client.”). See also HONG KONG SEC. AND FUT. COMM’N, Code of Conduct for Persons Licensed...
an investment firm must act “honestly, fairly, and in the best interests of its clients and the integrity of the market.”\textsuperscript{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 \textit{Principles of Responsible Ownership} (the “Principles”)\textsuperscript{74} that apply to investment firms that hold or manage investments on behalf of clients.\textsuperscript{75} Investment firms are “encouraged to adopt the Principles,” and apply the Principles in their entirety.\textsuperscript{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.”\textsuperscript{77} Investment firms should also have clear policies on voting and managing conflicts of interests.\textsuperscript{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.”\textsuperscript{79} With respect to disclosure of voting and non-voting engagement, the Principles provide that investment firms should: (i) report to their stakeholders their policies for discharging their ownership responsibilities; and (ii) at least annually, report to stakeholders on how they have discharged their ownership responsibilities.\textsuperscript{80}

\textit{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 \textit{Financial Services and Commodity Exchange Act}).

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duct%20for%20Persons%20Licensed%20by%20SFC%20Regis-
\textsuperscript{76} Paul Westover and Karen Lau, \textit{Corporate Governance and Directors’ Duties in Hong Kong: Overview}, THOMPSON REUTERS: PRACTICAL LAW (June 1, 2019) https://uk.practicallaw.thomsonreuters.com/7-506-8920?transition-Type=Default\&contextData=(sc.Default)\&firstPage=true\&comp=pluk\&bhcp=1.
\textsuperscript{77} SFC Principles, supra note 74, at 1.
\textsuperscript{78} SFC Principles, supra note 74, at 5.
\textsuperscript{79} SFC Principles, supra note 74.
\textsuperscript{80} SFC Principles, supra note 74.
“FIEA”). 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. The relationship between the investment manager and its client is set forth in the relevant agreement, which typically addresses voting authority. 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.”

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. The Stewardship Code was motivated by concern that “institutional investors” (including “asset managers” that “are entrusted to manage funds and invest in companies”) were not using voting or engagement to hold portfolio company management accountable for underperformance. The Stewardship Code is voluntary, but those that adopt it are expected to comply with it in full or explain any deviations.

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/080fd130-a7fe-11e5-9700-2b669a5aebe8; Attracta Mooney, Japanese asset managers will reveal AGM notes, FINANCIAL TIMES (June 4, 2017), https://www.ft.com/content/478ad316-4782-11e7-8d27-99b44d6296b8.
88 Stewardship Code, supra note 85, at Background, para. 7.
89 Stewardship Code, supra note 85, at “Principles-Based Approach: and “Comply or Explain”, para. 7.
According to the Stewardship Code, with respect to voting, asset managers “should seek to vote on all shares held.” 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.” 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.” 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.” 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.”

iv. Comparative Analysis

In each jurisdiction, 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.

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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.
96 Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 as regards the Encouragement of Long-term Shareholder Engagement, Recital 9 and Article 3c; HONG KONG SEC. AND FUT. COMM’N, Code of Conduct for Persons Licensed by or Registered with the SFC 1 (Mar. 2016); FINANCIAL SERVICES AGENCY
In the US and EU, investment advisers are required by regulation to develop written policies that govern how they cast votes on behalf of clients and manage related conflicts of interest.\textsuperscript{97} However, in Hong Kong and Japan, investment advisers are only subject to non-binding regulatory guidance that encourages voluntary adoption of voting policies.\textsuperscript{98} As to non-voting engagements, the EU requires the adoption and disclosure of such policies, whereas the US does not.\textsuperscript{99} The guidance in Hong Kong and Japan recommends the adoption of non-voting engagement policies.\textsuperscript{100}

Both the US and EU require the disclosure of voting policies, but the US requirements go further by requiring public disclosure of every vote cast.\textsuperscript{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.\textsuperscript{102} Japan’s voluntary guidance goes further than Hong Kong by recommending that investment advisers disclose voting policies and each vote cast.\textsuperscript{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.
3. Investment stewardship practices of certain investment advisers

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

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.pi-online.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).


i. Detailed voting policies

As noted earlier, the SEC has not prescribed specific content or procedures for the disclosure of voting policies. Nevertheless, BlackRock, Vanguard and State Street set forth detailed voting policies and engagement practices on their public websites. 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. Moreover, BlackRock, and Vanguard each specify enumerated factors to consider for contested director elections (State Street does not enumerate such factors). Table 4.2 sets forth the specific self-reported factors considered by BlackRock and Vanguard when voting in a contested director election. Investors can use variations in approaches to contested director elections to help select an investment adviser with priorities that align with the investor.

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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 commentators 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.”).


Table 4.2. Self-reported factors considered in contested director elections.

<table>
<thead>
<tr>
<th><strong>BlackRock</strong>&lt;sup&gt;110&lt;/sup&gt;</th>
<th>For contested director elections, BlackRock considers:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• the qualifications of the dissident and management candidates;</td>
</tr>
<tr>
<td></td>
<td>• the validity of the concerns identified by the dissident;</td>
</tr>
<tr>
<td></td>
<td>• the viability of both the dissident’s and management’s plans;</td>
</tr>
<tr>
<td></td>
<td>• the likelihood that the dissident’s solutions will produce the desired change; and</td>
</tr>
<tr>
<td></td>
<td>• whether the dissident represents the best option for enhancing long-term shareholder value.</td>
</tr>
<tr>
<td><strong>Vanguard</strong>&lt;sup&gt;111&lt;/sup&gt;</td>
<td>For contested director elections, Vanguard considers:</td>
</tr>
<tr>
<td></td>
<td>• 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;</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
</tr>
<tr>
<td></td>
<td>• the general quality of company governance, including management’s prior engagement with the dissident, the adoption of shareholder friendly governance practices at the company, and management’s past efforts at shareholder engagement.</td>
</tr>
</tbody>
</table>


ii. Annual consolidated voting statistics

In addition to the required itemized disclosure of each vote cast,\textsuperscript{112} BlackRock,\textsuperscript{113} Vanguard,\textsuperscript{114} and State Street\textsuperscript{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 4.3-4.5. Based on this data, an investor can draw inferences about an investment adviser’s voting priorities.

*Table 4.3.* BlackRock: Self-reported votes against management, 2018-19 (% of total votes cast).\textsuperscript{116}

<table>
<thead>
<tr>
<th>Management Proposals</th>
<th>Global</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anti-takeover and related proposals</td>
<td>13%</td>
<td>7%</td>
</tr>
<tr>
<td>Capitalization</td>
<td>11%</td>
<td>5%</td>
</tr>
<tr>
<td>Election of directors and related proposals</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Non-salary compensation</td>
<td>16%</td>
<td>6%</td>
</tr>
<tr>
<td>Mergers, acquisitions and reorganizations</td>
<td>11%</td>
<td>1%</td>
</tr>
<tr>
<td>Routine business</td>
<td>5%</td>
<td>2%</td>
</tr>
<tr>
<td><strong>Shareholder Proposals</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation</td>
<td>9%</td>
<td>3%</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Corporate Governance</th>
<th>10%</th>
<th>48%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Election of directors and related proposals</td>
<td>3%</td>
<td>12%</td>
</tr>
<tr>
<td>Miscellaneous business</td>
<td>5%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Table 4.4. State Street: Self-reported votes with management, 2018-19 (% of total votes cast).117

<table>
<thead>
<tr>
<th>Management Proposals</th>
<th>Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anti-takeover and related proposals</td>
<td>19%</td>
</tr>
<tr>
<td>Capitalization</td>
<td>77%</td>
</tr>
<tr>
<td>Election of directors and related proposals</td>
<td>87%</td>
</tr>
<tr>
<td>Compensation</td>
<td>77%</td>
</tr>
<tr>
<td>Reorganization- and merger-related proposals</td>
<td>76%</td>
</tr>
<tr>
<td>Routine business</td>
<td>94%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholder Proposals</th>
<th>Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation</td>
<td>61%</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>71%</td>
</tr>
<tr>
<td>Election of directors and related proposals</td>
<td>96%</td>
</tr>
<tr>
<td>Environmental- and social-related proposals</td>
<td>72%</td>
</tr>
<tr>
<td>Routine business</td>
<td>85%</td>
</tr>
<tr>
<td>Other miscellaneous</td>
<td>68%</td>
</tr>
</tbody>
</table>

Table 4.5. Vanguard: Self-reported votes for proposals, 2018-19 (% of total votes cast).118

<table>
<thead>
<tr>
<th>Management Proposals</th>
<th>Global</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elect directors</td>
<td>91%</td>
<td>93%</td>
</tr>
<tr>
<td>Approve auditors</td>
<td>98%</td>
<td>100%</td>
</tr>
<tr>
<td>Executive compensation</td>
<td>91%</td>
<td>94%</td>
</tr>
<tr>
<td>Governance-related</td>
<td>87%</td>
<td>94%</td>
</tr>
</tbody>
</table>


**b. Disclosure of non-voting engagement activities and priorities**

BlackRock, Vanguard, and State Street voluntarily release annual reports that review their past engagement activities and forward-looking engagement priorities.\(^{119}\)

BlackRock releases: (i) an annual engagement report that reviews non-voting engagement efforts in a narrative style;\(^{120}\) (ii) a global quarterly report on itemized engagements listing each company, the sector, the region, the topics covered by that engagement, and the last engagement date;\(^{121}\) and (iii) a regional quarterly report on engagement activities for the Americas,\(^{122}\) the Asia Pacific,\(^{123}\) and Europe, the Middle East, and Africa.\(^{124}\) According to BlackRock’s 2019 Investment Stewardship Report, which covered the 12-month period ended June 2019, BlackRock conducted 2,050 engagements with 1,458 portfolio companies representing 50.4% of equity assets under management.\(^{125}\) The Report describes BlackRock’s engagement priorities, including governance, corporate strategy, capital allocation, compensation that promotes long-termism, environmental risks

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and opportunities, and human capital management. 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. These quarterly reports also include narrative descriptions of specific engagements and their results.

Vanguard and State Street Global Advisors take broadly similar approaches. Over the same period, Vanguard engaged 868 portfolio companies representing 59% of global assets under management. According to State Street’s 2018-2019 Annual Stewardship Report, it engaged with 1,533 portfolio companies, including 686 in-person or teleconference engagements and 847 letter-writing campaigns, which together represented 70% of equity assets under management. Table 4.6 provides a brief overview of BlackRock, Vanguard and State Street’s recent self-reported engagement priorities. In each case, engagement priorities are described in more detail in the relevant disclosures.

Table 4.6. Self-reported engagement priorities by investment adviser.

<table>
<thead>
<tr>
<th>BlackRock</th>
<th>Engagement Priorities:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Governance</td>
</tr>
<tr>
<td></td>
<td>Corporate Strategy &amp; Capital Allocation</td>
</tr>
<tr>
<td></td>
<td>Compensation that Promotes Long-termism</td>
</tr>
<tr>
<td></td>
<td>Environmental Risks &amp; Opportunities</td>
</tr>
<tr>
<td></td>
<td>Human Capital Management</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Vanguard</th>
<th>Engagement Priorities:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Board Composition</td>
</tr>
<tr>
<td></td>
<td>Oversight of Strategy and Risk</td>
</tr>
<tr>
<td></td>
<td>Executive Compensation</td>
</tr>
</tbody>
</table>

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.
<table>
<thead>
<tr>
<th>State Street Global Advisors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Core Campaigns:</strong></td>
</tr>
<tr>
<td>• Fearless Girl Campaign for Board Gender Diversity</td>
</tr>
<tr>
<td>• Climate Risk and Reporting</td>
</tr>
<tr>
<td><strong>Sector Focuses for 2018-2019:</strong></td>
</tr>
<tr>
<td>• Retail</td>
</tr>
<tr>
<td>• Pharmaceuticals</td>
</tr>
<tr>
<td>• Materials</td>
</tr>
<tr>
<td><strong>Thematic Focuses for 2018-2019:</strong></td>
</tr>
<tr>
<td>• Compliance with Corporate Governance Principles in the US, UK, Australia, and Europe</td>
</tr>
<tr>
<td>• Pay Strategies</td>
</tr>
<tr>
<td>• Sustainability and Long-Term Strategy</td>
</tr>
</tbody>
</table>

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, voting rights and index

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inclusion, general engagement with agribusiness companies on sustainable business practices, and specific engagement with the palm oil industry on sustainability, among other issues. Additional engagement-related materials that BlackRock provides on its website range from comment letters to regulators in different jurisdictions, to an analysis of best practices when using proxy advisors, to an overview of the intersection of carbon emissions and engagement.

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. 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.,

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(4) Europe ex-U.K., (5) Australia & New Zealand, and (6) the “Rest of the World”. With respect to subject matter, BlackRock, State Street and Vanguard each have differing approaches for disclosing the subject matter discussed at engagements. For example, BlackRock reports the percentage of engagements related to environmental impact whereas Vanguard does not. We further address the issue of standardization for disclosure of non-voting engagement practices in Section 5.

4. Empirical analysis of investment stewardship practices by investment companies

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

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

Second, we review studies that measure the relationship between holdings by investment companies and firm performance, such as return on assets. In doing so, we also consider studies that focus on index fund holdings and firm performance. The studies we review generally find that firms that have a high share of holdings by investment companies outperform other firms. These studies

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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. Morgan, Poulsen, Wolf and Yang (2010) find that investment companies are more likely than other investors to support shareholder proposals that would enhance corporate governance at portfolio companies, such as board declassification and majority voting for directors. 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.”

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. 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. 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 (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

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158 Id. at 615.
companies, and successful mergers and acquisitions, measured by the likelihood of deal completion and a firms’ post-merger financial performance. 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. 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.  

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. 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). 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.

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. 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. The authors conclude “the results imply that investment companies and independent investment advisers play a more

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161 Id. at 30.
167 Id. at 31.
active monitoring role than do other types of institutions." 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. The authors conclude that “institutional investors [including investment companies] influence executive compensation" and “serve as a complementary monitoring device to incentive compensation”.

With respect to index funds, Appel et al. (2016) find that increased index holdings are associated with greater board independence and reduced takeover defenses. 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.

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. Indeed, index funds primarily attract investors by minimizing

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168 Id. at 31.
170 Id. at 20.
171 Id. at 14.
costs and tracking the appropriate index, neither of which incentivize index funds to invest in improving the governance of specific portfolio firms. 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. 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.

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. Griffin contends that pass through voting would better align index fund voting with investor preferences. 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. Furthermore, as noted by Hirst (2016), the administrative costs from collecting voting instructions from shareholders would be costly and difficult to manage. 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. 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%

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175 Bebchuk, Cohen, and Hirst, supra note 174, at 97–98.
176 Bebchuk, Cohen, and Hirst, supra note 174, at 100–101.
179 Griffin, supra note 178, at 35.
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. Pass-through voting could magnify these administrative difficulties by extending them to a much larger universe of votes. We therefore do not support proposals to mandate “pass through voting” by index funds.

b. Polling

Alternative proposals put forward by Hirst (2016) 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. The managers of index funds would then vote their shares consistent with those preferences. 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) and Griffith (2019) 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. 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

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183 Investment Company Institute, supra note 182, at 4.
184 Hirst, supra note 181, at 26–30.
185 Hirst, supra note 181, at 26–28.
186 Hirst, supra note 181, at 27–28.
189 Griffith, supra note 188, at 49–50. Bebchuk and Hirst, supra note 187, at 2117; see also M. Todd Henderson and Dorothy Shapiro Lund, Index Funds Are Great for Investors, Risky for Corporate Governance, THE WALL STREET JOURNAL (June 22, 2017).
thereby increase the proportional voting power of other shareholders. Lund contends that doing so would concentrate voting power with “active investors that have the motive and information to vote intelligently.” 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; and (iii) short-term oriented investors. 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. 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, as index funds must publicly disclose all votes and their voting policies and procedures. And, as described in Section 3, BlackRock,

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190 John Bogle, Bogle Sounds a Warning on Index Funds, THE WALL STREET JOURNAL (Nov. 29, 2018).
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
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. 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. However, Bebchuk and Hirst (2019) and Coates (2019) 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, and the enhanced disclosure of non-voting engagements would encourage index funds to invest more in non-voting engagement. 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. 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. 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.

In general, we support SEC rulemaking to require transparency of non-voting engagement policies by investment advisers, as transparency enables investors to determine whether non-voting engagement priorities are consistent with investors’ best interests. However, we do not agree with proposals that the SEC should require that index funds provided detailed disclosures as to the content of each meeting between an index fund manager and its portfolio companies. As noted in Section 3, the three largest index fund managers—BlackRock, State Street, and Vanguard—held 4,000 such meetings in 2018. Requiring such detailed disclosures would be costly and burdensome for index fund managers. Additionally, requiring substantive disclosures of the contents of a

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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.
201 Lucian Bebchuk and Scott Hirst, supra note 187.
202 Lucian Bebchuk and Scott Hirst, supra note 187, at 2124.
203 Lucian Bebchuk and Scott Hirst, supra note 187, at 2124–2126.
204 Coates, supra note 200, at 13.
205 Coates, supra note 200, at 22–23.
206 See Section 3(b).
meeting could chill discussion between index fund managers and portfolio companies, thereby limiting the positive effects of non-voting engagement. Furthermore, we believe that such disclosure requirements should apply equally to investment advisers acting on behalf of index funds and active funds. The principle that such disclosures enable investors to determine whether an investment adviser is acting consistent with an investor’s best interest and engagement priorities applies equally to investors in index funds and active funds.

Instead, we recommend that the SEC require that investment advisers disclose their non-voting engagement policies, key non-voting engagement priorities, and certain annual summary statistics of those practices, including the total number of non-voting engagements. As described in Section 3, BlackRock, Vanguard and State Street already provide similar disclosures on a voluntary basis. However, there are differences between such disclosures that limit the ability of investors to compare non-voting engagement activities across investment advisers. 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.

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207 See Section 3(b).
208 See Section 3(b).