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SHAREHOLDER VALUE(S): INDEX FUND ESG ACTIVISM AND THE NEW MILLENNIAL CORPORATE GOVERNANCE

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Abstract

Major index fund operators have been criticized as ineffective stewards of the firms in which they are now the largest shareholders. While scholars debate whether this passivity is a serious problem, index funds' generally docile approach to ownership is broadly acknowledged. However, this Article argues that the notion that index funds are passive owners overlooks an important dimension in which index funds have demonstrated outspoken, confrontational, and effective stewardship. Specifically, we document that index funds have taken a leading role in challenging management and voting against directors in order to advance board diversity and corporate sustainability. We show that index funds have engaged in a pattern of competitive escalation in their policies on ESG issues. Index funds' confrontational and competitive activism on ESG is hard to square with their passive approach to more conventional corporate governance questions.

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To explain this dichotomy in approaches, we argue that index funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives. With fee competition exhausted and returns irrelevant for index investors, signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization. For index funds, the threat of millennial migration to another fund is more significant than the threat of management retaliation. Furthermore, managers themselves, we argue, face intense pressure from their millennial employees and customers to respond to their social preferences. This three dimensional millennial effect—as investors, customers and employees—we argue, is an important development with the potential to provide a counterweight to the wealth-maximization paradigm of corporate governance.

We marshal evidence for this new dynamic, situate it within the existing literature, and consider the implications for the debate over index funds as shareholders and corporate law generally.

> [M]illennial workers were asked what the primary purpose of businesses should be – 63 percent more of them said "improving society" than said "generating profit.". . . [T]he sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to millennials.[1]

—Larry Fink, CEO of BlackRock, the world's largest asset manager

I. INTRODUCTION

Recently, the attention of business law scholars, corporate law practitioners, executives, and corporate directors has turned to the role of giant index mutual funds as the most important shareholders in many large companies. Together, the "big three," BlackRock, Vanguard, and State Street ("SSGA"), control a staggering 25 percent of the shares of all S&P 500 companies, and this share is growing.[2] Across the pages of top law reviews,[3] at prestigious roundtables, and in board rooms around the world, commentators have debated whether index funds, which seek only to track the market at low cost and not outperform it, will nevertheless invest the resources necessary to be vigilant shareholders.

In broad strokes, the debate over index funds as shareholders has resolved into camps. Critics argue that index funds, as cost-conscious, passive investors, have essentially zero incentive to ensure that the companies they invest in are well-run.[4] Since index funds hold the same companies as their competitors, investing in improving the value of their portfolio will not provide a competitive advantage, and might upset managers who could in turn direct their firm's retirement savings to other funds. These critics point to evidence showing that across a range of governance issues, index funds take a "don't rock the boat" approach. They

1. Larry Fink, *2019 Letter to CEOs*, BLACKROCK (2019) https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

2. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033 (2019).

3. *See, e.g.*, *id*.; Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, PENN. L. REV. 17 (2019); Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. of Corp. L. 101 (2018); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. Rev. 863 (2013).

4. *See generally* Bebchuk & Hirst, *supra* note 2; Lund, *supra* note 3.

rarely challenge executives,[5] lag other institutions in promoting corporate governance best practices, never bring shareholder proposals,[6] and tend to side with incumbent managers in contested elections.[7] Relative to their portfolio size, the big three have tiny corporate stewardship teams that, purely as a matter of personnel, can dedicate little time to individual companies.[8]

To be sure, scholars and index fund advisors themselves identify some reasons that index funds might worry about firms' success, such as advising fees and competition from active funds.[9] Even those scholars and fund advisors who defend index funds' stewardship, however, argue that index funds are likely to undertake only those interventions with the potential to have wide and significant impact on firms' value.[10] Furthermore, both sides largely agree that index funds have disincentives to actively promote governance improvements against management interests.[11] While the debate

5. Leo E. Strine, *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007, 1025 (2020) (highlighting index funds' passivity in monitoring management political spending).

6. *See, e.g.*, Bebchuk & Hirst, *supra* note 2, at 2040 (finding that index funds do not submit shareholder proposals).

7. *Id.* at 2094. *S*ee *also* Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 18-19 (Colum. Bus. Sch., Research Paper No. 18-16, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473 (finding index funds more likely than other funds to vote against hedge fund nominees in contested elections).

8. Bebchuk & Hirst, supra note 2, at 2076-83.

9. *See, e.g.*, Fisch, Hamdani & Davidoff, supra note 3, at 33 ("If investors believe that passive funds cannot offer a better rate of return than active funds, they will flee to active funds, and vice versa."); Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* 1 (N.Y.U. Law and Economics Research Paper No. 18-39) ("With regard to the highest profile contests that will likely affect firm value, the strong direct incentives should assure that the Big Three will vote intelligently."), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098.

10. *See e.g.*, Fisch, Hamdani & Davidoff, *supra* note 3, at 18 (arguing that index funds "focus on issues with a broad market impact, such as potential corporate governance reforms, that have the potential to reduce the underperformance and mispricing of portfolio companies."); Kahan & Rock, *supra* note 9, at ("When institutional investors are acting as "deciders", especially in the small number of controversies with significant implications for firm value, the evaluation of their incentives and capacities are both fundamentally different than with regard to routine and continuous "stewardship" of portfolio firms.").

11. Bebchuk & Hirst, *supra* note 2 at 2037 ("When index fund managers face qualitative stewardship decisions, we show that they have incentives to be excessively deferential—relative to what would best serve the interests of their own beneficial investors—toward the preferences and positions of the managers of portfolio companies."); Kahan & Rock, *supra* note 9 at 47-48 ("A second, long recognized source of conflicts is the desire of stock-pickers for investment advisors to maintain cordial relationship with management of their portfolio companies . . . by not casting votes against management when voting against management would enhance firm value, they do so at the expense of shareholders-

is vigorous thus, there is reasonable consensus that index funds are mostly reticent, largely docile shareholders, except maybe with respect to interventions with a dramatic effect on firms' value.

This Article makes several contributions to the literature. We first show that the consensus view of index fund stewardship is both factually and theoretically incomplete: When it comes to ESG (environmental, social and governance) issues, index funds are far from docile.[12] With respect to these salient social issues, index funds boldly challenge managers, vote out directors, and demonstrate vocal leadership in thought and deed—activities that are sharply at odds with the conventional account of index fund passivity. Importantly, index fund activism on these issues is not just cheap talk, rather, it directed problematic firms systematically, and generated notable effects. In 2017 for example, after State Street announced its objection to all male boards in its portfolio firms, the index fund voted against 400 of the 476 firms in its portfolio that did not have any female director. By the end of 2018 more than 300 of these firms added a female director. Accordingly, that in July 2019 the last all-male board in the S&P 500 added a woman to its ranks, is largely attributable to the outspoken and confrontational efforts of the big three, and BlackRock and State Street in particular.

Our second contribution is to show that, in contrast to conventional wisdom, funds compete aggressively with each other in escalating their ESG policies. For example, in pressing for increased representation of women on corporate boards, index funds have voted against directors, proactively publicized these votes, and used the media to highlight their confrontations with management. State Street and BlackRock have engaged in a pattern of escalating demands with respect to board diversity. As a result, these asset managers are currently well ahead of other corporate governance institutions, like Institutional Shareholder Services (ISS), in pressing this issue.

at-large"); Fisch, Hamdani & Davidoff, *supra* note 3, at 65 ("One concern is that potential business ties between sponsors and companies' management may affect passive funds' voting behavior. . . . These services create the risk that Vanguard and Fidelity will vote the shares of their funds in favor of management rather than in the best interests of the fund shareholders, in order to curry favor from management and win or retain 401(k) plan business.").

12 *See, e.g.*, Paul Rissman & Diana Kearney, *Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability Accounting, and Their Effects on Corporate Social Responsibility*, 49 Envtl. L. Rep. 10155 (2019).

Similarly, while efforts on the environmental front were initiated with a general request for companies to address "sustainability," Blackrock has recently announced a significant push related to climate change, including divesting its active funds from coal stocks.[13] While index funds are generally thought to keep a low profile to avoid backlash from managers or regulators, we show that funds have pressed ahead despite political backlash to some of these interventions. Consequently, we argue that on ESG issues, index funds are far from reticent shareholders—they are perhaps more active and influential than institutional shareholders have ever been.

Our third contribution is to offer an explanation of why index funds' actions with respect to ESG issues bear so little resemblance to their activities on more traditional matters of shareholder stewardship. The former cannot be explained within the literature's existing theoretical framework, which approaches shareholder stewardship largely as a trade-off between asset management fees and the fear of management retaliation. While index funds might fear management retaliation, we show that a more potent concern is on the horizon: In the next two decades, somewhere between $12 and $30 trillion will pass to the millennial generation in what BlackRock CEO Larry Fink has called "the largest transfer of wealth in history."[14] This staggering wealth, which dwarfs the cumulative assets under management of the big three, is the prize sought by asset managers across the economy as the millennial generation begins to enter its wealth accumulation phase. To win the millennial generation, index funds have turned their attention not simply to share price—the conventional marker of shareholder value—but to the social issues that millennial investors care about: shareholder values.

When it comes to investment preferences, millennials are markedly different than their predecessors. The literature and market research

13. *See infra* notes 86-88 and accompanying text.

14. *See* Gillian Tett, *Millennial Heirs to Change Investment Landscape*, FIN. TIMES, (Sep. 20, 2018), https://www.ft.com/content/59f6562a-786d-11e8-af48-190d103e32a4 [https://perma.cc/F2R6-U5C7] (citing U.S. Trust estimate that $12 trillion in assets will pass to Millennials over the next decade, and Deloitte estimate that $24 trillion will be transferred over the next fifteen years); Fink, *supra* note 1 ("In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to Millennials."; Liz Skinner, *The Great Wealth Transfer is Coming, Putting Advisers at Risk*, INV. NEWS (Aug. 7, 2015). https://www.investmentnews.com/article/20150713/FEATURE/150719999/the-great-wealth-transfer-is-coming-putting-advisers-at-risk ("Over the next 30 years, an epic $30 trillion will be passed down from baby boomers to Generation X to Millennials.").

unanimously concludes that, compared to prior generations, millennials are less interested in investment returns and more interested in their investments reflecting their social values.[15] It is no surprise that index funds are out front in the race to demonstrate a commitment to millennial social values: With prices for index funds already cut to the bone, and investment performance an irrelevant consideration for index investors, index funds must seek out differentiation in the market where they can find it. Using their voting power to promote their investors' social values, and doing so publicly and loudly, is a way for these funds, which otherwise risk becoming commodities, to give millennial investors a reason to choose them.

That index funds are chasing millennial wealth explains their aggressive, competitive approach to ESG issues. First, we argue, it is in the interest of index funds to not only respond to existing shareholder preferences for social values, but to find new issues that can be made salient and become first movers on those as well. Second and related, we show that funds caught flat footed tend to respond with more aggressive policies than funds that acted earlier. Thus, after State Street scored a global sensation with its Fearless Girl statue on Wall Street and announced that it would vote against directors of firms with no female directors, BlackRock announced that it would expect all boards to have a minimum of two female directors. And it did not end there—State Street followed with more stringent voting policies, and BlackRock then responded with an even more aggressive approach, voting against boards at firms with which they had not previously engaged.[16]

Third, while funds must still be wary of management backlash— the Article shows that investors' preference for social values is a critical factor that will act as a counterweight to those forces. Eventually, managers—who face pressure on social issues not just from index fund shareholders, but from *employees* and *customers* as well—will have to respond. For example, following its explosive scandal, Papa Jones' income from selling pizza dropped from $22.8 million to $4.6 million,.[17] Indeed, on August 19, 2019, the Business Roundtable, a group of CEOs of the largest corporations in the world, announced that they "share a fundamental commitment to all of our

15. *See infra* Section III.
16. *Id*.
17. *Id*.

stakeholders," including customers, employees, and communities.[18] In invoking the stakeholder value theory, the titans of mainstream capitalism suggest that changing shareholder values are having an effect on firms.

The importance of these developments should not be understated. What we are witnessing is an emergence of a new framework for corporate governance that has already reshaped hundreds of boards. The consequences of this shift are just beginning to be realized. In response to competition for money to manage, the largest pools of assets in our economy have turned their power as shareholders to advancing investors' social agenda. Far from being asleep at the switch as shareholder stewards, these funds are reconceiving what it means to act in shareholders' interests. Similarly, in response to pressure from their millennials' employees and consumers, managers across firms conform in advancing social goals.

Our fourth and final contribution is to begin to consider the impact of these developments on corporate law. Shareholder value assumption influences the law as well. While corporate scholars are acquainted with theories of the firm that ask managers to subordinate shareholder value to the interests of other constituencies under some circumstances, the consequences of a world in which shareholders themselves have strong preferences for social responsibility and are positioned to act on those preferences through the traditional levers of corporate power are less explored. Already, the Trump administration has pushed back against funds' efforts to promote social values in the context of retirement plans. However, we argue that if shareholders own the firm, then their preferences, broadly construed, should be taken seriously.

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This article proceeds as follows. In Part I, we describe the existing debate over the role of index funds as reticent shareholders. In Part II, we offer contrasting evidence of index funds' aggressive approach to social issues and argue that the existing account of index funds' incentives cannot explain what we observe. In Part III, we establish that Millennial investors have the potential future wealth to move markets and that social values drive many of their economic decisions. In Part IV, we analyze index funds' incentives in light of the new Millennial economy, show that funds face

18. Our Commitment, BUS. ROUNDTABLE, https://opportunity.businessroundtable.org/ourcommitment/ (last visited June 20, 2020).

fierce competition to cater to Millennials' preferences, assert that index funds' observed activism is explained by the pursuit of Millennial investors' assets, and argue that this is an essential extension of the existing literature. In Part V, we discuss the implications of this new approach to corporate governance.

II. THE DEBATE OVER INDEX FUNDS AS SHAREHOLDERS

As corporations have replaced defined benefit pension plans with defined contribution retirement plans (e.g., 401(k) plans), huge pools of assets have accumulated in mutual funds. These funds, which offer simple and low-cost diversification across a portfolio of many companies, have grown by more than 50 percent since 2010.[19] As how workers save for retirement evolves, a second transformation is underway in the mutual fund industry: mutual fund assets are now largely flowing to index funds that seek only to match the performance of the market at the lowest possible cost, rather than to actively managed funds that seek to beat the market through skilled stock picking by a portfolio manager.[20] This is a significant development because a small set of index funds have become, by dollar value, the most important shareholders in the capital markets. Currently, the largest index fund operators, Vanguard, BlackRock, and Fidelity, hold about 25 percent of the voting power in all S&P 500 companies.[21]

It is axiomatic that firms are owned by their shareholders, but the practical meaning of this ownership relationship has evolved considerably over time. For decades, the dominant paradigm of corporate governance was the Berle and Means[22] view of dispersed, rationally passive shareholders at the mercy of managers who exercised de facto control over both the operation of the firm and the membership of the board of directors. Over the last several decades, this paradigm has been displaced by successive waves of financial and legal innovation, with dramatic consequences for corporate governance. The leveraged buyout wave of the 1980s, enabled by the creation of markets for high-yield debt instruments, disrupted the all-too-

19. *2019 Investment Company Factbook*, INVESTMENT COMPANY INSTITUTED 11 (2019), https://www.ici.org/pdf/2019_factbook.pdf.

20. Kevin McDevitt and Michael Schramm, *2018 U.S. Fund Flows Trends in 5 Charts*, MORNINGSTAR (Jan. 28, 2019), https://www.morningstar.com/blog/2019/01/28/us-fund-flows-trends.html.

21. Bebchuk and Hirst, *supra* note 2 at 2033.

22. ADOLF BERLE & GARDINER MEANS, The Modern Corporation and Private Property (1932).

comfortable position of managers by activating the market for corporate control. The subsequent development of the poison pill created a substantial obstacle to buyouts, but led to the rise of shareholder activist campaigns, largely initiated by hedge funds that sought to profit by influencing firm strategy rather than by buying the firm entirely. Modern corporations operate under the threat of these hedge fund interventions.

Now, the realities of firm ownership have evolved further to put index funds at the forefront. Hedge fund activism depends critically on persuading other shareholders that the hedge fund's preferred strategy is a good one. With a relatively small number of funds holding large stakes in many of the largest firms, the big three have become the pivotal shareholders across the market. The question of the moment in corporate law is thus how index funds will wield their considerable power.

A. THE INSTITUTIONAL STRUCTURE OF MUTUAL FUNDS

It is helpful to review the structure of mutual funds, whether index or actively managed. We will first give a very brief overview of mutual funds and their advisors, distinguish active and index funds, discuss how mutual funds vote their proxies, and examine the consequences of those decisions for firms.

1. The Institutional Structure of Mutual Funds

Mutual funds are pools of assets with a distinct legal identity and unique regulatory regime. Mutual funds take in assets from investors and issue shares in return. These assets are invested in any number of securities, but most mutual funds invest in the common stock of public companies.[23] Mutual fund investors can redeem their shares at any time. Redemption means that the mutual fund must return cash to investors equivalent to their pro rata share of the fund's portfolio at its then current value. Unlike with an operating company, investors in mutual funds do not need to find a buyer for their shares; they can simply ask for their investment back, and the mutual fund has a legal obligation to return it.[24]

Each mutual fund is a separate legal entity with its own board of directors, but, as a practical matter, mutual funds are operated by complexes

23. *2019 Investment Company Factbook*, *supra* note 19.

24. Investment Company Act, 15 U.S.C. § 80a-1.

that manage multiple funds.[25] We generally associate these complexes with mutual fund operation: Vanguard, Fidelity, T. Rowe Price, and others. Complexes may sponsor hundreds of mutual funds offering different investment goals and management styles. Mutual fund complexes make money by charging advisory fees to manage the assets in the fund. These fees are determined as a percentage of the assets under management and generally do not depend on how the fund performs. While hedge fund managers reap huge rewards when their funds have strong returns, mutual funds have a far tamer compensation profile as a result of statutory limits on investment advisor incentive.[26] Specifically, while hedge fund managers can charge fees that allow them to share in the appreciation of the portfolio, mutual funds can only charge such fees if they also refund fees should there be a shortfall.[27] In practice, most mutual funds simply charge a percentage of assets under management. As a result, mutual fund managers are rewarded for managing large funds, but not directly for performance.

There are two broad classes of mutual funds: actively managed funds that seek to beat the market by picking stocks that are likely to perform better than average and index funds that seek only to track the market at the lowest possible cost. While both types of mutual funds charge fees as a percentage of assets and not based on performance, active funds nevertheless have powerful incentives to worry about the performance of their funds. Competition for assets is the primary mode of competition among active funds. Active funds sell the capacity to beat the market, and research has shown that active funds that outperform the market are likely to grow.[28] Since fees are a percentage of fund assets, large funds generate more revenue. As a result, active fund managers care deeply about performance. In particular, active funds seek strong performance relative to other active funds of similar investing styles. An active fund that posts a strong year can expect a dramatic influx of assets to manage and—even holding the fee constant as a percentage of assets—will generate more revenue the following year.

25. *See generally*, John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. (2010).

26. For an overview of the regulation of compensation, *see* Ian Ayres and Quinn Curtis, *Protecting Consumer Investors by Facilitating "Improved Performance" Competition*, 2015 ILL. L. REV 1, 28-31.

27. *Id.*

28. Eric Siri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1595 (1998).

The same performance incentive does not occur in index funds. Index fund operators care about their funds being as large as possible, because, like active funds, they will generate more revenue from asset-based fees. However, index funds do not seek to beat the market, so they cannot grow large via eye-popping performance. Instead, index funds compete largely on price. Since all index funds that track the same index sell the same portfolio, tracking the index in question at the lowest possible price is the most important means of attracting new investments.

Both index funds and actively managed funds have the power to vote the shares they hold in their portfolios on behalf of their investors. In fact, the large pools of assets these funds represent mean that these funds have—at least potentially—considerable influence over companies in which they invest.[29] Since 2003, the SEC has required that funds disclose how they vote their proxies.[30] Funds have responded by voting their proxies at nearly every opportunity.[31] Given the diversity of their portfolios, mutual funds cast ballots on a large number of issues, and mutual fund complexes, with several hundred funds under management, cast thousands of votes.[32] Voting policies are largely set at the complex level, and individual funds—which have legal authority to vote their shares—may delegate that authority to a central authority within the mutual fund complex.[33] An industry has sprung up selling proxy-advisory services to help asset managers manage voting on numerous complex issues.[34]

As major shareholders, mutual funds' activities as shareholders have the potential to strongly influence management, but the degree to which mutual funds have an incentive to invest in using "voice"[35] to enhance corporate performance is unclear. Given the number of votes mutual funds cast, a debate—considered in detail below—has sprung up around whether mutual funds invest sufficiently to cast informed votes.

29. Gilson & Gordon, *supra* note 3, at.

30. Fisch, Hamdani & Davidoff, *supra* note 3, at 44.

31. *Id.*

32. *Id.*

33. *Id*.

34. Stephen Choi, Jill Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650 (2009).

35. Henry Hansman & Reinier Kraakman, *Exit, Voice, and Liability: Legal Dimensions of Organizational Structure* (characterizing the ability to sell, engagement management, and sue for breach of fiduciary duties, as "exit," "voice," and "liability" in corporate law).

2. The Promise and Pitfalls of Mutual Funds as Corporate Monitors

The significant influx of invested assets into mutual funds over the last several decades raised hopes that mutual funds might overcome the problems of dispersed, rationally disinterested shareholders that tended to concentrate power in the hands of managers.[36] For several reasons, mutual funds, whether index or active, did not become the fierce advocates for shareholder interests that some had hoped, at least not with respect to the traditional concerns of corporate governance. The reasons for this are slightly different with respect to active funds and index funds. While there are many common factors, it is worth laying out the reasons why active funds are often, in the words of Gilson and Gordon, "reticent"[37] when it comes to engaging in controversial corporate governance issues.

The reticence of active mutual funds is best understood in contrast to the aggressive stance of activist hedge funds when it comes to challenging management. It is common for a hedge fund to take a concentrated stake in a struggling company and use the voting power associated with that stake to influence the company's directors to make changes or to run a proxy campaign to replace the board. If the market responds positively to these changes, which it often does, the hedge fund stands to profit as the value of its stake increases. In principle, an actively managed mutual fund could similarly profit by investing in a firm and using the tools of shareholder control to improve that firm's operations, thereby increasing its stock price and increasing the value of the fund's portfolio. But the realities of active mutual fund management render this type of intervention only rarely attractive.

First, whatever benefits actively managed mutual funds would obtain from such a strategy would be shared by all other owners of the firm. This is—of course—true for activist hedge funds as well, but the effect of this dilution is more acute for active funds for two reasons. To begin, other active funds with the same investment style are likely to have similar stakes in the same company. By investing in improving the governance of one such company, the active fund benefits, not just other market participants, but its direct competitors. Since active funds care about relative performance, this

36. BERLE & MEANS, *supra* note 22.
37. Gilson & Gordon, *supra* note 3 at 889.

is a significant disincentive to activism.[38] To be sure, the fund could overweight the stock in its portfolio, but its differential benefit relative to other funds with similar stakes would nevertheless be diluted. This is related to the second obstacle to this strategy, which is that legal limits on concentrated ownership for mutual funds restrict the degree to which they can focus their holdings on a particular company. Since mutual funds must be diversified,[39] their stake in any particular company must inevitably be fairly small, meaning the profits from intervention will not only be shared with the shareholders in the target company, but diluted by the other holdings in the fund's portfolio. Hedge funds are free to take much more concentrated stakes, and therefore are less susceptible to this problem.

Second, and probably most importantly, the fee structure of mutual funds provides weaker incentives for this type of intervention. Since hedge fund managers typically receive 20 percent of the portfolio growth they generate, they have strong incentives to invest in identifying and pursuing value-creating activist opportunities. Mutual funds, which benefit from strong performance only by increasing assets under management after posting strong performance, have less powerful incentives, and so are less apt to pursue challenging strategies. Put more bluntly, asset managers with the ability to conduct value-increasing activist campaigns are likely to find the hedge fund sector a more lucrative place to apply their skills.

These obstacles do not mean that actively managed mutual funds are indifferent to low-quality companies. Rather, in ordinary circumstances, an actively managed mutual fund has a far easier remedy than to challenge management: simply sell the stock. By selling stocks of companies with poor management, actively managed mutual funds increase the chance of their portfolio beating the market without incurring the cost of engaging in an activist campaign. Moreover, to the extent active mutual funds are better than their competitors at finding such companies, the benefits of selling will not be shared in the way that the benefits of activism are.[40]

38. *Id*. at 889-90.

39. Investment Company Act, 15 U.S.C. § 5(b).

40. Gilson & Gordon, *supra* note 3, at 893.

B. INDEX FUNDS AND CORPORATE GOVERNANCE: THEORY

Many obstacles to shareholder activism in active mutual funds apply to index funds as well, including diversified portfolios, fees based on assets under management, and regulatory obstacles. However, index funds differ in that they cannot sell a stock just because it appears likely to underperform. Index funds sell market exposure to a particular index and therefore are not in the business of picking and choosing stocks. Even if the portfolio manager is confident that a stock will underperform, index fund investors are locked in. Thus, index funds lack that "exit" option that dominates for active funds and have very long-term time-horizons for stocks they hold. Perhaps the absence of an exit option, the long-term horizon, and the enormous (and growing) shareholder power of index funds mean that they will be less reticent than active funds. Whether this is the case is the subject of an ongoing debate, described in some detail below.

1. Obstacles to Effective Index Fund Governance

The absence of an option to sell might increase index funds' willingness to use voice, but index funds also differ from active funds in that they do not compete on performance, at least with other index funds.[41] All index funds that track the same index will deliver performance that is all-but identical performance before fees, with fees being the primary differentiator among funds. Index funds cannot, even in principle, outperform the market and can only outperform their competitors by charging less. Any expenditure on informed shareholder voting increases costs with no direct competitive benefits, and—as with active funds—any improvements in companies due to these expenditures would be shared among competitive index funds holding the same companies.[42] There is simply no competitive edge against other index funds that can be gained by investing in governance.[43]

Ensuring that companies in the index perform well may increase the return of the index as a whole and thus increase assets under management and the fees that index funds collect, but the economic significance of this is

41. Fisch, Hamdani & Davidoff, *supra* note 3, argue that index funds face competition from active funds.

42. *See* Bebchuck & Hirst, *supra* note 2, at 2037.

43. *See, e.g.*, Sean J. Griffith, *Opt-in Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, Eur. Corp. Gov. Inst. Working Paper No. 463 (2019); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. Rev 1151 (2019).

minimal. A fund with a 0.1 percent fee and a very large five percent ownership stake would invest only $1,000 to attain a $20,000,000 enhancement to the value of a portfolio company.[44] There is simply not enough direct impact on fund advisor income to support significant shareholder activism based solely on assets under management.

Bebchuk and Hirst note that index funds have a more conventional agency problem. Many of the largest fund managers also have significant 401(k) practices that involve selling retirement plan services to companies who might be the subject of activist campaigns. Challenging management at these firms could risk these lucrative contracts. Indeed, empirical evidence supports such a claim.[45] But even absent a direct client relationship, these business relationships might motivate index fund advisors to take a more management-friendly approach to corporate governance issues generally, even without engaging in favoritism directed at particular firms.[46]

Finally, it should be noted that the other obstacles to active fund activism apply to index funds with equal force. They hold diversified portfolios and so lack the large stakes needed to support profitable activism, and their fee structure gives their advisors little incentive to find value-creating activist opportunities.

2. Potential Incentives for Index Fund Governance

It may seem that index funds have no incentive to spend on exercising shareholder power, but this is not strictly true. There are some countervailing factors that might induce index funds to engage in activism and invest in governance. This section analyzes some of the arguments suggesting that index funds have incentives to invest in activism.

First, mutual funds own shares on behalf of their investors, and have fiduciary duties to exercise their ownership rights in the interest of investors.[47] The SEC has specifically encouraged that these fiduciary duties encompass a duty to vote their shares.[48] As noted above, mutual funds generally do vote their proxies.

44. *See* Bebchuck & Hirst, *supra* note 2, at 2042.

45. *Id.*

46. *Id.*

47. Investment Company Amendments Act of 1970 § 36(b).

48. *See* Disclosure of Proxy Voting Policies Voting Records By Registered Management Investment Companies Investment Company Act Release No. 25922, 17 C.F.R. 239, (Jan. 31 2003).

Second, index funds, which have become shareholders of enormous significance in recent years, may fear regulation and be at pains to demonstrate that they are responsible stewards as a means of forestalling government intervention.[49] By demonstrating that they are engaged owners and "good citizens" through investments in oversight and stewardship, index funds might make it less likely that they would become the subjects of costly regulation. Of course, index funds might invite regulatory scrutiny by being too aggressive as well, so avoiding regulation might motivate funds to take relatively safe, pro-management stances, even as they demonstrate their diligence by reliably voting their proxies.

Index funds might face competitive pressure from non-index funds as well. Fisch, Davidoff-Solomon and Hamdani dispute the notion that index funds have no incentive to worry about firm performance.[50] They argue that index funds compete not only against other index funds, but also against actively managed funds generally. That is, if index funds begin to lag behind active funds, assets will flow out of index funds collectively, reducing the revenue they generate. Ensuring that companies are well-run in general helps mitigate the potential ability of active managers to beat the market, ensuring that index investing remains a viable strategy.

This important argument surely captures a competitive dynamic that is true as far as it goes, but how far it goes is quite unclear. First, while index funds might collectively fear a flight to active management, engaging in stewardship to prevent such a flight would nevertheless be subject to a classic collective action problem. That is, an investment an individual fund made in preventing the outperformance of active funds by improving corporate governance would produce benefits shared among all index funds. Under such circumstances, we would expect index funds to systematically underinvest in governance. Secondly, the large index fund managers also provide active management services.[51] While outflows from index funds would be undesirable from the point of view of these managers, they would nevertheless be positioned to capture at least a portion of funds moving to active management.

49. Bebchuk & Hirst, *supra* note 2, at 2130.
50. Fisch, Hamdani & Davidoff, *supra* note 3, at 32.
51. Kahan & Rock, *supra* note 9, at 20.

It is also notable that mutual funds are able to free-ride on the efforts of activist hedge funds who have more powerful incentives.[52] Activist hedge funds take large stakes, but index funds' holdings are larger still and—as neutral, sophisticated parties—the position of index funds in proxy contests is influential. As such, index funds are increasingly the swing voters in contested director elections and other activist interventions. One the one hand, the ability to free ride means that index funds' investment in governance can be lower than it otherwise might—perhaps much lower. On the other hand, their role as swing voters raises the stakes on index funds getting it right, and means that a pro-management bias from index funds could be damaging to shareholder value in macro terms.

Without taking sides in the debate over index fund activism, it is clear that there are reasons that index funds might not engage in optimal oversight of the companies they own. That is, they may invest less in oversight, stewardship, and governance than the ultimate owners of the index funds, their investors, would prefer. Index funds might also be biased toward management as a means of keeping the peace with managers or regulators who might be influenced by regulators. We need not settle this debate in order to characterize the new dimension our argument brings to the table.

C. INDEX FUNDS AND CORPORATE GOVERNANCE: THE CONVENTIONAL VIEW OF PRACTICE

While there is some dispute as to the incentives that index funds have to invest in corporate governance, there is relative agreement that funds have limited incentives to intervene in corporate governance and can be expected to do so only when the economic benefits in terms of improved firm value are large, and the activism is not firm specific so that the index fund can benefit from economies of scale.[53] Thus, index funds can be expected to focus on market wide activism and primarily engage on issues that have significant potential to improve the value of companies. Confrontations with

52. Gilson & Gordon, *supra* note 3, at 908.

53. Kahan & Rock, *supra* note 9, at ("When institutional investors are acting as "deciders", especially in the small number of controversies with significant implications for firm value, the evaluation of their incentives and capacities are both fundamentally different than with regard to routine and continuous "stewardship" of portfolio firms.")

management will likely be avoided wherever possible to reduce the risk of backlash.[54]

With respect to conventional types of corporate governance activism, index fund practice is largely consistent with this theoretical picture, as documented in a recent, comprehensive overview of index fund activism by Bebchuck and Hirst.[55] Put briefly, the evidence shows that index funds vote their proxies, but rarely initiate shareholder action, and have small—but growing—corporate governance operations. The current debate turns less on disagreement about the facts on the ground when it comes to index fund corporate governance practices than it does on the harder-to-settle question of whether these practices are sufficient.

The big three index fund operators have surprisingly small corporate governance teams. BlackRock, Vanguard and State Street have forty-five, twenty-one, and twelve personnel working on corporate governance issues, respectively.[56] Of course, it is not possible to specify what appropriate staffing levels *ought* to be, but it is striking that firms that each hold more than 17,000 portfolio companies and control 20 percent of the S&P 500 have fewer than 100 individuals charged with dealing with corporate governance issues at those companies. As Bebchuk and Hirst note, this amounts to between one-sixth and one-half day of an individual's time per portfolio company per year.

Bebchuk and Hirst find that the big three index fund operators did not bring a single shareholder proposal under 14a-8 in the ten years from 2008-

54. Bebchuk & Hirst, *supra* note 2, at 2037 ("When index fund managers face qualitative stewardship decisions, we show that they have incentives to be excessively deferential—relative to what would best serve the interests of their own beneficial investors—toward the preferences and positions of the managers of portfolio companies."); Kahan & Rock, *supra* note 9, at 46 ("A second, long recognized source of conflicts is the desire of stock-pickers for investment advisors to maintain cordial relationship with management of their portfolio companies . . . by not casting votes against management when voting against management would enhance firm value, they do so at the expense of shareholders-at-large."); Fisch, Hamdani & Davidoff, *supra* note 3, at 65 ("One concern is that potential business ties between sponsors and companies' management may affect passive funds' voting behavior. Commentators have identified some of the potential conflicts arising from business ties between public companies and fund sponsors. For example . . . Vanguard and Fidelity provide extensive services to employer-sponsored 401(k) plans. These services create the risk that Vanguard and Fidelity will vote the shares of their funds in favor of management rather than in the best interests of the fund shareholders, in order to curry favor from management and win or retain 401(k) plan business.").

55. *See generally* Bebchuck & Hirst, *supra* note 2.

56. *Id*. at 2077.

2017 when nearly 4,000 such proposals were made, many of which the index funds supported. The big three index fund complexes are not averse to supporting these proposals, particularly when they pertain to important matters of corporate governance.[57] And shareholder proposals are quite inexpensive to initiate; they are often undertaken by small investors or even individuals. Many portfolio companies have not yet adopted the corporate governance arrangements that the big three advocate, yet the large index investors have not seen fit to initiate the low-cost and effective intervention of a shareholder proposal, even once. This is consistent with the view that index funds generally have incentives to be reticent when it comes to interventions in corporate governance.

Index funds are also reticent when it comes to individual director nominations. Bebchuk and Hirst find that the big three did not directly nominate any directors to the boards of portfolio companies, nor do they find evidence that the big three highlight efforts to appoint specific directors in the stewardship reports.[58] It may be that index fund operators work quietly with nominating committees to encourage particular choices for director nominations, but if this is the case, the big three have not chosen to highlight these efforts publicly, even as they are at pains to demonstrate their stewardship efforts in other contexts.

Index funds tend to be followers rather than leaders in their published guidelines for corporate governance. Many routine matters are outsourced to proxy advisory services, with funds spending their limited resources on issues only when ISS or Glass Lewis identify potential problems.[59] While each of the big three publishes detailed voting guidelines, they are mutually similar and similar to the ISS and Glass Lewis guidelines in most respects.

There are countervailing points of evidence, though. The big three consistently point to engagement efforts that occur directly with managers of portfolio companies. As major shareholders, the big three are in a position to access management directly and get their attention. Index fund sponsors point to these activities as their preferred channel of stewardship and a basis for eschewing shareholder proposals. While these activities are largely undocumented so their extent and influence on managers is difficult to

57. Id.
58. Id.
59. Lund, *supra* note 3, at 124.

observe, it is clear that the low staffing of the big three as applied to corporate governance functionally limits the scope of these activities.

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The above evidence reflects index funds' limited incentives to engage in conventional activism, but the existing literature does not address an important dimension of index fund activism that is largely inconsistent with this general characterization: as the next section will demonstrate, index funds have been leaders in demanding gender diversity on the boards of their portfolio companies.

III. INDEX FUNDS AS SOCIAL ACTIVISTS

Contrary to the existing account of index fund passivity, there are areas where index funds have in fact been aggressive in challenging management, withholding votes from unsatisfactory directors and changing corporate practice. This section documents extensive index fund activism around board diversity and other social issues. We review in detail how these efforts differ from index funds' engagements on more conventional dimensions of shareholder activism. We consider and dismiss elements of the current theoretical framework that have been offered to explain why index funds engage in significantly more aggressive activist behavior related to board diversity. Lastly, we conclude that the theoretical framework needs expansion.

A. INDEX FUND ACTIVISM ON SOCIAL ISSUES

Calls for public companies to increase the gender diversity of their boards of directors are not new, but in recent years, calls for diversification have come not just from social activists, but from investors, and companies have responded. In light of the foregoing discussion, it is surprising that index funds have been at the forefront of this movement. Despite their reticence in other areas of corporate governance, index funds have been vocal and aggressive in demanding more diverse boards, even more so than other corporate governance players like Institutional Shareholder Services (ISS) or actively managed funds. As the following parts show, index funds have engaged in broadly publicized campaigns, publicly announced votes against specific companies, adopted policies of voting against boards that fail to diversify, and have pressed increasingly stringent diversity requirements.

1. Index Funds' Outspoken Support for Diversity

Existing accounts of index fund activism are factually correct that index funds are typically reticent followers when it comes to corporate governance reforms, but when the subject matter of activism turns from conventional governance reforms to demands for increased gender diversity on boards, index funds have been notably outspoken, both in communications directed primarily at corporate managers and in marketing efforts directed at the general public.

By far the highest profile public action around board diversity was State Street's "Fearless Girl" statue, commissioned as part of a marketing campaign conceived by advertising agency McCann New York. The statue, a defiant young girl, was placed opposite the Charging Bull statue on Bowling Green in the Manhattan Financial District so as to appear to be staring it down. The campaign was meant, in part, to promote a fund operated by State Street that selectively invested in companies with gender-diverse boards. The index fund trades under the ticker symbol SHE, and a plaque at the base of the statue read "Know the power of women in leadership. SHE makes a difference." Erected on March 7, 2017, the day before International Women's Day, the statue drew immediate news coverage and social media attention. While initially given only a week-long permit, it ultimately remained in place for eighteen months, and a petition drive sought to make it permanent. Fearless Girl was a resounding success as a marketing campaign, but as described in more detail below, State Street followed this marketing coup with action. Concurrent with the placement of the statue, State Street announced that it would demand accountability from companies that lacked gender diversity on their boards.[60]

While the Fearless Girl campaign garnered significant news coverage, other index fund managers' efforts have been more specifically directed at corporate managers. In 2018, index fund giant BlackRock reached out to more than 300 companies in the Russell 1000 with fewer than two women

60. *See* Joann S. Lubin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J., (Mar. 7, 2017), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863 [https://perma.cc/WWL6-ZRNP].

on their boards "asking that they justify" the lack of diversity.[61] Unlike most engagement efforts, this engagement was widely publicized, and the tone—at least publicly—was far more confrontational than other types of index fund engagement: "It is absolutely not a thing that we do over bottles of wine. If they're lucky, they get a really nasty cup of BlackRock coffee," said BlackRock's head of global stewardship Michelle Edkins.[62] When interviewed by Bloomberg, Edkins' dissatisfaction with the responses from some firms' management was clear: "On board diversity, frankly some of the answers we got were from the 1880s . . . . There aren't any qualified women . . . . We don't need a woman director. We're not a consumer-facing company."[63]

For its part, Vanguard has also emphasized diversity in its engagement efforts. In a 2019 policy statement, Vanguard wrote "We have long believed in the importance of diversity in the boardroom, and we have increasingly advocated for greater representation of women on corporate boards."[64] As with BlackRock, Vanguard took a pro-diversity position in a letter to corporate directors, outlining its expectations that companies would make progress toward increased diversity.[65] Vanguard backed this expectation with an implied threat to vote against boards that failed to meet these expectations: "[Boards'] demonstration of meaningful progress over time will inform our engagement and voting going forward."[66]

61. *See* Emily Chasan, *BlackRock Asks Companies to Explain Dearth of Women on Boards*, BLOOMBERG (Feb. 2, 2018), https://www.bloomberg.com/news/articles/2018-02-02/blackrock-asks-companies-to-explain-dearth-of-women-on-boards.

62. *See* Sarah Krouse, *At BlackRock, Vanguard and State Street, 'Engagement' Has Different Meanings*, WALL ST. J., (Jan. 20, 2018), https://www.wsj.com/articles/at-blackrock-vanguard-and-state-street-engagement-has-different-meanings-1516449600?mod=article_inline.

63. See Emily Chasan, *BlackRock is Sick of Excuses for Corporate Boards Lacking Women*, BLOOMBERG (Nov. 3, 2018) https://www.bloomberg.com/news/articles/2018-11-03/blackrock-is-sick-of-excuses-for-corporate-boards-lacking-women.

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

65. *See* Ryan Vlastelica, *Vanguard Calls for More Diverse Corporate Boards, Better Climate-Change Disclosures*, MARKETWATCH (Sep. 1, 2017), https://www.marketwatch.com/story/vanguard-calls-for-more-diverse-corporate-boards-better-climate-change-disclosures-2017-08-31.

66. *Id.*

2. Backing Advocacy with Votes

These calls to action, both public and through back channel engagement with individual companies, were not idle talk. Index fund operators have not been afraid to aggressively challenge boards when companies are not responsive to calls for gender diversity, including voting against current directors.

In March of 2017, State Street announced that it would vote against the chair of the nominating committee of boards that failed to show progress on gender diversity.[67] Since the nominating committee is charged with identifying director candidates, the threat was targeted against the board member best positioned to address a lack of diversity. While State Street initially did not attach numerical requirements to this policy, it made clear that there is no justification for having no female directors at all.[68] State Street backed its demands for action with the substantial power of its proxy ballots. In June 2017, the advisor announced that it had voted against directors at 400 companies without female directors that did not persuade State Street that they were making adequate efforts to diversify.[69]

In September of 2018 State Street further escalated its diversity voting guidelines, stating that, beginning in 2020, it would withhold votes from the *entire* nominating committee if a company did not have at least one woman among its directors and had not satisfied State Street that it was making efforts to improve.[70] This expansion of the policy put the entire nominating committee in play and also attached a numerical goal (albeit a minimal one) to diversity efforts.

67. *See* Lubin & Krouse, *supra* note 60.

68. *Id*.

69. State Street identified 476 companies that had no female directors and determined that 76 demonstrated significant progress. They voted against directors at the remaining 400 firms. *See* Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J., (July 25, 2017) https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490.

70. *See* STATE STREET, *State Street Global Advisors Reports Fearless Girl's Impact: More than 300 Companies Have Added Female Directors* (Sep. 27, 2018), https://newsroom.statestreet.com/press-release/corporate/state-street-global-advisors-reports-fearless-girls-impact-more-300-companie [hereinafter STATE STREET, *Fearless Girl*]; Amy Whyte, *State Street to Turn Up the Heat on All-Male Boards*, INSTITUTIONAL INV. (Sep. 27, 2018), https://www.institutionalinvestor.com/article/b1b4fh28ys3mr9/State-Street-to-Turn-Up-the-Heat-on-All-Male-Boards [https://perma.cc/MJE5-RS57].

BlackRock followed a similar pattern in its approach to voting. After the public campaign, letters, and engagement efforts described above, BlackRock announced in February 2018 that it would vote against the entire nominating committee at firms that did not show progress on gender diversity, and said that it "would normally expect to see at least two women directors on every board."[71]

This sequence of events reflects an escalating, and, as we argue below, ultimately competitive dynamic among index funds to press firms to increase the representation of women on their boards.

B. INDEX FUND OPERATORS AS THOUGHT LEADERS

Index funds are not simply following the herd in their diversity efforts. It is instructive to compare the position of the big three index fund operators on board diversity, as outlined above, to that of the largest proxy advisory firm, Institutional Shareholder Services (ISS), and other large mutual fund complexes such as Fidelity and T.Rowe Price.

ISS, which is in the business of selling proxy-voting information and recommendations to asset managers, has been a pioneer in pressuring companies, through its proxy recommendations, to adopt a number of corporate governance reforms, including strong opposition to "clear day" poison pills, among others. But when it comes to diversity, ISS has lagged behind the big three index fund complexes and continues to have a policy on diversity that is materially less stringent than the big three. While the big three emphasize that they do not blindly follow ISS guidelines, they all pay attention to ISS's policies and recommendations. Further, ISS remains influential among other asset managers and is thought to swing a considerable share of the proxy vote, either directly through its recommendations or through the supporting reasoning and research it provides. ISS issues voting policy guidelines that outline circumstances under which it will recommend votes against directors as a result of perceived governance deficiencies. Because of ISS's influence in the marketplace, these guidelines have a pseudo-regulatory effect.

71. Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J., (Feb. 2, 2018), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407.

Along several dimensions, ISS stakes out fairly aggressive stands on matters of corporate governance. For example, ISS is opposed to companies adopting "clear-day" poison pills absent a shareholder vote, and will recommend a vote against boards that do so. By contrast, the big three index fund managers have relatively ambiguous policies.

However, when it comes to diversity on boards, the policies of the big three, outlined above, stake a position well ahead of ISS, both in terms of timing and in terms of what the policies ask of companies. State Street was the first complex to make a strong public stand in favor of diversity in March of 2017, and State Street's statement required companies to show progress, explain their lack of progress, or face withheld votes. Only in November of 2017 did ISS add a diversity component to its guidelines, and its position was that it would "highlight" insufficiently diverse boards, but would not recommend withholding votes.[72] A year later, in November 2018, ISS announced that it would include diversity as a component of its corporate governance quality score, but, by that point, BlackRock had already announced—in February of 2018—that it would ordinarily expect to see two women on each board, and State Street was already voting against directors en masse and had recently announced it would expand its withhold campaign to the entire nominating committee.[73]

The most recent version of ISS's voting guidelines has finally caught up to where BlackRock and State Street were over a year ago, but these changes only took effect earlier this year. ISS now states that:

For companies in the Russell 3000 or S&P 1500 indices, effective for meetings on or after Feb. 1, 2020, generally vote against or withhold from the chair of the nominating committee (or other directors on a case-by-case basis) at companies when there are no women on the company's board.[74]

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72. Zachary L. Cochran, Alana L. Griffin, Jeffrey M. Stein, Keith M. Townsend & James C. Woolery, *King & Spalding Discusses ISS Voting Policies for 2018*, COLUM. L. SCH. BLUE SKY BLOG (Dec. 20, 2017), http://clsbluesky.law.columbia.edu/2017/12/20/king-spalding-discusses-iss-voting-policies-for-2018/ ("ISS added sufficient board diversity to the fundamental principles it considers in voting for board nominees and will now highlight boards that are lacking gender diversity (specifically, those with no female directors), although this will not lead to an adverse vote recommendation.").

73. STATE STREET, *Fearless Girl*, *supra* note 70.

74. ISS, *Americas Proxy Voting Guidelines Update for 2019*, (Nov. 19, 2018), https://www.issgovernance.com/file/policy/active/updates/Americas-Policy-Updates.pdf.

ISS then lists three mitigating factors, including a "firm commitment . . . to appoint at least one female to the board in the near term" that would avoid an adverse recommendation.[75] This policy closely corresponds to State Street's 2017 voting behavior but took effect three years later.

High profile active fund managers have also lagged on the diversity issue. For example, the following statement from Fidelity's voting guidelines is unlikely to strike fear into the hearts of board nominating committees:

Fidelity may support shareholder proposals that request additional disclosures from companies regarding environmental or social issues, where it believes that the proposed disclosures could provide meaningful information to the investment management process without unduly burdening the company.[76]

T. Rowe Price offers a somewhat stronger statement that nevertheless trails the big three index fund managers:

> We recognize diversity can be defined across a number of dimensions. However, if a board is to be considered meaningfully diverse, in our view some diversity across gender, ethnic or nationality lines must be present. At this time, we have not changed our voting guidelines for director elections for companies without any outward evidence of board diversity. However, these situations are a focus of our engagement program, and may in the future form the basis of new voting guidelines.[77]

Notably, both Fidelity and T.Rowe Price primarily manage active funds.

Comparing the big three's stance on board diversity to either ISS or other large mutual fund complexes highlights the degree to which index funds are taking a leadership position on the issue of board diversity. Index fund managers approach board diversity differently from other issues of corporate governance. In the next section we explore whether the theoretical account of index fund incentives can explain why.

75. *Id.*

76. FIDELITY, *Proxy Voting Guidelines*, (Mar. 2019), https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Full-Proxy-Voting-Guidelines-for-Fidelity-Funds-Advised-by-FMRCo-and-SelectCo.pdf.

77. T. ROWE PRICE, *Proxy Voting Guidelines*, (2019), https://www3.troweprice.com/usis/content/trowecorp/en/utility/policies/_jcr_content/maincontent/polices_row_1/para-mid/thiscontent/pdf_link/pdffile.

C. INDEX FUND ACTION ON CLIMATE CHANGE

There is no doubt that index funds have acted most aggressively and decisively on the issue of board diversity, but the big three have also been vocal about other social issues, namely climate change. While the big three tend to frame their approach to climate change and associated regulation as an issue of investment risk, BlackRock in particular often discusses its climate change engagement as part of a larger debate over corporate sustainability. As early as 2015, BlackRock argued that long term investors needed to engage on issues of climate change. BlackRock issued a report highlighting the importance of climate change as an issue with significant impact on future portfolios.[78] The report noted that climate change posed both physical risks—the impact of a changing climate—and regulatory risks—the impact of legal changes designed to mitigate climate change or reduce emissions. From the investors' point of view, the report stated:

> Divesting from climate-unfriendly businesses is one option. The biggest polluting companies, however, have the greatest capacity for improvement. Engagement with corporate management teams can help effect positive change, especially for big institutional investors with long holding periods.[79]

This language suggests a role for investors in mitigating the effect of polluting companies on the environment.

This theme was echoed in BlackRock CEO Larry Fink's 2018 letter to CEOs, which focused on the importance of corporations articulating a "social purpose."[80] Fink stated that "[t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society," ending with a call to boards to consider a series of questions:

> Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and

78. *See generally* BLACKROCK INV. INST., *The Price of Climate Change: Global Warming's Impact on Portfolios*, (Oct. 2015), http://blueandgreentomorrow.com/wp-content/uploads/2015/11/The-Price-of-Climate-Change-BlackRock.pdf.

79. *Id.* at 2.

80. Larry Fink, *2018 Letter to CEOs*, BLACKROCK (2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

> our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?
>
> As we enter 2018, BlackRock is eager to participate in discussions about long-term value creation and work to build a better framework for serving all your stakeholders. Today, our clients – who are your company's owners – are asking you to demonstrate the leadership and clarity that will drive not only their own investment returns, but also the prosperity and security of their fellow citizens. We look forward to engaging with you on these issues.[81]

More recently, BlackRock issued another report with a somewhat different tone. In April 2019, BlackRock published *Getting Physical*, which highlighted BlackRock's efforts to use big data and climate modeling to "increase portfolio resilience" to the increasing frequency of adverse weather events and other impacts of climate change.[82] The discussion of engagement in the report focuses on companies as entities impacted by the external force of climate change, not as contributors to the problem and focuses on engagement to ensure companies are prepared, not to advocate reduced emissions.

Following the pattern of escalation we've observed in the context of board diversity, BlackRock has announced that it would make climate change a central part of its investment approach going forward.[83] BlackRock CEO Larry Fink dedicated his annual letter to climate issues, which he argued would reshape the economy and asset management. [84] In addition to calling for additional disclosure to permit investors to better manage climate-related investment risk, BlackRock announced that it would divest the firm's actively managed portfolios (about $1.8 trillion) from coal stocks.[85] While

81. *Id.*

82. BLACKROCK INV. INST., *Getting Physical: Scenario Analysis for Assessing Climate-Related Risks*, (Apr. 2019) https://www.blackrock.com/us/individual/literature/whitepaper/bii-physical-climate-risks-april-2019.pdf.

83. Laurel Wamsley, *World's Largest Asset Manager Puts Climate At The Center Of Its Investment Strategy*, NPR, (Jan. 14, 2020.), https://www.npr.org/2020/01/14/796252481/worlds-largest-asset-manager-puts-climate-at-the-center-of-its-investment-strate.

84. Fink, *supra* note 2.

85. Bill McKibben, *Citing Climate Change, BlackRock Will Start Moving Away From Fossil Fuels*, THE NEW YORKER (Jan. 16, 2020), https://www.newyorker.com/news/daily-comment/citing-climate-change-blackrock-will-start-moving-away-from-fossil-fuels.

divestment from one fossil fuel and pressure on firms to disclose risks are somewhat modest steps, they are nevertheless concrete, and transition of the world's largest asset manager away from coal in its managed portfolios is a significant development.

State Street has also foregrounded its climate change efforts, writing:

> Sustainability has been at the center of SSGA's asset stewardship program for a number of years. SSGA has had approximately 2,200 engagements on ESG issues with over 1,200 companies in our global portfolio since 2013. While board governance has been a significant focus of our thought leadership efforts in the past, we have also been engaging with companies and developing our views on environmental and social considerations and their effect on our stewardship obligations.[86]

They add, "We are certain that over time these issues pose both risks to and opportunities for long-term returns. Therefore, as stewards we are convinced that, as part of good business practice, ESG issues must be part of effective board leadership and board oversight of long-term company strategy."[87]

For its part, Vanguard also highlights climate change and has used its position as a shareholder to argue for broader disclosures around the risks posed by climate change. Like the others, it adopts a climate-change as financial risk model in its governance policy: "We consistently engage with portfolio companies about climate risk, especially companies in carbon-intensive industries. We believe that climate risk can potentially have a long-term impact on companies in many sectors."[88] Notably, Vanguard has largely oriented its stewardship efforts towards encouraging companies to make more detailed disclosures related to the risks that climate change creates for business, identifying this issue as one of its engagement priorities.[89]

86. Rakhi Kumar, Michael Younis, and Caitlin McSherry, *Incorporating Sustainability Into Long-Term Strategy*, SSGA (Feb. 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/02/incorporating-sustainability-into-long-term-strategy.pdf.

87. SSGA, *ESG Investing*, https://www.ssga.com/eu/ie/pensions-charities-investor/en/our-insights/viewpoints/esg-investing.html.

88. Glenn Booraem, *What We Do. How We Do It. Why It Matters.*, VANGUARD 13 (Apr. 2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf; STATE STREET, *Fearless Girl*, *supra* note 70.

89. *Vanguard Investment Stewardship: Update on the 2020 Proxy Season*, VANGUARD (Apr. 1, 2020), https://about.vanguard.com/investment-stewardship/VISPRX_042020.pdf.

There is little question that the index managers' rhetoric around board diversity is backed by meaningful action and a confrontational approach to unresponsive firms. Their approach to climate change, so far, has been less confrontational, perhaps reflecting the centrality of environmental issues to corporate operations at many companies. While these steps are tentative, it is clear that the big three are eager to highlight them for investors, and it is equally clear that index funds' engagement on these issues has led corporate boards to more frequently and publicly discuss the issue of climate change.

D. THE PUZZLE OF INDEX FUND SOCIAL ACTIVISM

Can the existing account of index fund activism account for index funds' approach to board diversity? As argued above, the general consensus of the literature is that index funds can be expected to focus on market-wide interventions with significant upside and a low propensity to upset management. We argue that index fund social activism does not fit this profile.

1. Activism is High Impact

We can easily dispense with the notion that index fund activism for diversity is merely window-dressing or marketing puffery. Companies frequently build marketing campaigns around salient social issues without accompanying action, so it is natural to be skeptical of high profile campaigns. However, the evidence above establishes that index funds have taken concrete, effective action to back up their public comments on diversity, devoting their very limited shareholder engagement resources to diversity and voting proxies to punish recalcitrant boards. These are concrete interventions with real costs and consequences.

These activist actions have been effective – it is clear that companies feel real pressure to respond to calls for board diversity. On September 27, 2018, SSGA reported that since its announced intention to vote against all male boards in March 2017, more than 300 companies had added female directors to their boards.[90] In its recent annual report for 2018, SSGA reported this increased to more than 400 companies and more firms had pledged to follow suit.[91] According to Equilar, the percentage of newly

90. STATE STREET, *Fearless Girl*, *supra* note 70.

91. *See* STATE STREET, *State Street Releases 2018 Corporate Responsibility Report*, SSGA (2019), http://www.statestreet.com/content/dam/statestreet/documents/values/2018_STT_CR_Report.pdf; *See*

elected directors who are women has increased 75 percent in three years, from 20.1 percent in 2015 to 35.6 percent in the third quarter of 2018. The last S&P 500 company with an all-male board recently appointed a woman as a director.[92]

2. Board Diversity and Value Creation

Is intervention on board diversity the sort of market-wide, high-impact, value-creating change we might expect index funds to undertake? It is certainly true that index funds have framed their diversity efforts in terms of long-term value creation. However, recall that index funds have only weak incentives to pursue value-enhancing interventions in the first place. For value-creation to be a plausible motive for index fund action on board diversity, such intervention would need to be particularly profitable. As it is, two aspects of board diversity activism are inconsistent with the purported value-creation motive.

First, though index fund operators appeal to the academic literature in making the case for increased diversity, the academic record is more ambiguous than these arguments would suggest. An extensive literature has examined the effect of board gender diversity on firm value. The results of this literature are mixed,[93] but this is likely because a fundamental difficulty plagues this research area, the issue of correlation versus causation. As one study put it: "[I]n equilibrium it is difficult to distinguish if knowledgeable board members increase firm value through their actions or if highly valued firms simply attract knowledgeable board members."[94] For example, a 2009 study found that differences in board monitoring intensity were correlated with the gender of board members, suggesting that boards with more women tended to be more conscientious monitors, and found that, in a simple regression, companies with more women directors performed better.

also BUSINESS WIRE, *State Street Releases 2018 Corporate Responsibility Report*, YAHOO FIN. (July 11, 2019), https://finance.yahoo.com/news/state-street-releases-2018-corporate-194700589.html.

92. Vanessa Fuhrmans, *The Last All-Male Board on the S&P 500 is No Longer*, WALL ST. J. (July 24, 2019), https://www.wsj.com/articles/the-last-all-male-board-on-the-s-p-500-is-no-longer-11564003203.

93. *See generally* Renée B. Adams, Jakob de Haan, Siri Terjesen, & Hans van Ees, *Board Diversity: Moving the Field Forward*, 23 CORP. GOVERNANCE: INT'L REV. 77 (2015); Kenneth R. Ahern & Amy K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation*, 127 Q. J. ECON. 137 (2012).

94. Ahern, *supra* note 93.

However, the researchers noted that the "correlation disappears once we apply reasonable procedures to tackle omitted variables and reverse causality problems" and found that, in a richer empirical design, "firms perform worse the greater is the gender diversity of the board".[95] Other studies have found a positive link between diversity and firm value,[96] and still others have found no link.[97] The literature is, to be sure, still in flux, but it cannot be said that current empirical evidence unambiguously supports the claim that board diversification is a particularly effective way for shareholders to generate returns.

To illustrate, some studies address this endogeneity problem by studying reforms that have required companies to diversify boards. In 2003, Norway required, by law, that 40 percent of directors be women at a time when only nine percent of directors were female. In examining the effects of this law, one study concluded that the adoption of the law had a large, negative effect on firm value both at the time of adoption and in measured performance after the change took effect.[98] By contrast, another study found no effect on firm value when studying the same change.[99] Yet another 2013 study found higher labor costs and lower short-term profits among firms affected by the change.[100] Even if these papers told an entirely consistent story, the dramatic nature of the Norway intervention (with a 40 percent representation requirement imposed on a short timeline, punishable by dissolution) and the absence of a clear control group for the Norway change would raise questions about what it could teach us about other contexts. More recently, California adopted a law requiring companies headquartered there to comply with a mandatory gender quota. An initial study of the

95. Renée B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291, 292 (2009).

96. *See* Kevin Campbell & Antonio Mínguez-Vera, *Gender Diversity in the Boardroom and Firm Financial Performance*, 83 J. BUS. ETHICS 435 (2008); Cristian L. Dezsö & David G. Ross, *Does Female Representation in Top Management Improve Firm Performance? A Panel Data Investigation*, 33 STRATEGIC MGMT. J. 1072 (2012).

97. *See* Larelle Chapple & Jacquelyn E. Humphrey, *Does Board Gender Diversity Have a Financial Impact? Evidence Using Stock Portfolio Performance*, 122 J. BUS. ETHICS 709 (2014); Corinne Post & Kris Byron, *Women on Boards and Firm Financial Performance: A Meta-Analysis*, 58 ACAD. MGMT. J. 1546 (2014).

98. *Id.*

99. B. Espen Eckbo, Knut Nygaard, & Karin S. Thorburn, *Does Gender-Balancing the Board Reduce Firm Value?* (Finance Working Paper No. 463/2016).

100. David A. Matsa & Amalia R. Miller, *A Female Style in Corporate Leadership? Evidence from Quotas*, 5 AM. ECON. J. APPLIED ECON. 136 (July 2013).

market response to this rule suggests that firms that would be affected by the change showed significant decreases in firm value when the change was announced.[101] However, the authors of this study call into question the interpretation that the diversity quota was directly responsible for the decline in value, suggesting instead that the reform demonstrated political willingness to impose potentially costly regulatory requirements on California firms and arguing that the resulting fall in value reflected investors' fears of what might come next rather than any real impact of the quota on firm performance.[102]

Second, even if diversifying boards represented low-hanging fruit for value creation, this would still not explain why index funds are being more proactive on this front than other money managers. Index funds' incentives to engage in value-creating activism are weaker than those for actively managed funds or hedge funds. As such, we would expect these other investors to lead the charge as they do with more conventional corporate governance interventions. Instead, hedge funds are lagging behind a group of investors with only weak incentives to worry about firm value. This is inconsistent with a shareholder-value creation account of board diversification.[103]

In arguing that conventional shareholder value creation is unlikely to explain index funds' commitment to promoting diversity, we do not mean to disparage these efforts. In the wake of the Me Too movement, there are sound reasons for companies to seek diverse leadership. And, even if the economic evidence is ambiguous, there are legitimate concerns of social

101. Felix von Meyernick, Alexandra Niessen-Ruenzi, Markus Schmid & Steven Davidoff Solomon, *As California Goes, So Goes the Nation? The Impact of Board Gender Quotas on Firm Performance and the Director Labor Market*, SSRN (Feb. 22, 2019), https://papers.ssrn.com/abstract=3303798.

102. *Id.*

103. A rejoinder might be that board diversification is a long-term play that is uniquely attractive to index investors with permanent stakes in large companies. Perhaps hedge fund managers and active fund managers, with their eye on beating the market in the short-term are simply less worried about issues of board structure that will play out over the long-term. However, this argument impounds a questionable claim: though board diversity is an eminently observable feature of a firm, somehow the market fails to anticipate this future value and impound it in the current price. This type of "short-termism" argument is a familiar one, and is frequently made by corporate managers against hedge funds launching activist campaigns against struggling companies. While it is difficult to conclusively rebut an argument that turns on an ad hoc invocation of market inefficiency, we see no reason why investors collectively would fail to appropriately price board diversity. As such, the argument that index funds are uniquely suited to pursue this value-creation strategy should be regarded as suspect.

justice and equity in play. A well-run company in 2019 ought to have a diverse board, full stop. But the entire thrust of the index fund corporate governance literature is that index funds have very weak incentives to invest in ensuring that the companies whose equities they hold are well run. As such, index funds' activism on this issue is conspicuous, and the empirical literature does not explain it.

3. Activism is Not Risk-Free

Index funds' intervention on socially salient issues is not risk free to index fund complexes. It is fair to say that board diversity is not an issue that is likely to draw public backlash from a CEO, though proxy votes cast against directors always carry the possibility of acrimony. But CEOs are not the only actors in play. Any financial institution that compares in size to the big three index fund managers is likely to be concerned about regulation. The influence of index funds over public companies has not escaped the notice of policy makers. Perhaps, by engaging so publicly and aggressively on a salient issue, index funds hope to signal their commitment to be good stewards of their investments and therefore good citizens of the corporate landscape. One reasonable account is that these campaigns are designed to forestall regulation.

While plausible, it is notable that, if the motivation of index funds to engage in activism on diversity and other social issues is to avoid regulation, then it has not been entirely successful. Asset managers have attracted the attention of the Trump administration, which has responded with guidance designed to brush back campaigns oriented toward social issues. On April 23, 2018, the Department of Labor issued a Field Assistance Bulletin that "reiterated" that "plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals."[104] On April 10, 2019, the Trump administration issued an executive order on energy infrastructure,[105] which included a directive to the Department of Labor to "complete a review of existing Department of Labor guidance on the fiduciary responsibilities for proxy voting to determine whether any such

104. John J. Canary, *Field Assistance Bulletin No. 2018-01*, U.S. DEPARTMENT OF LABOR (Apr. 23, 2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

105. Promoting Energy Infrastructure and Economic Growth, 84 Fed. Reg. 15495 (Apr. 10, 2019).

guidance should be rescinded, replaced, or modified to ensure consistency with current law and policies that promote long-term growth and maximize return on ERISA plan assets."[106] That executive order was framed as an effort to aid the energy industry by questioning whether filing and voting in support of environmental shareholder proposals was consistent with the fund trustees' fiduciary duties to their participants and beneficiaries.[107] The executive order was a strong signal from the White House that it disapproved of this fund-driven activism and viewed such activism as, at best, a distraction and, at worst, a direct undermining of the American energy sector. Further, while it did not specifically address voting on gender diversity issues, the arguments raised suggest disapproval of these voting policies too.

While these directives were likely targeted primarily at pension funds, they are far from irrelevant to the big three. ERISA covers 401(k) plans, and the index funds operated by the big three hold vast sums of 401(k) investments. Given employers face potential liability for the funds they include in their 401(k) menu, the DOL guidance, in particular, made it risky for employers to offer specialized mutual funds with an ESG focus.[108] While the DOL guidance poses relatively little risk to the big three, at least as currently formulated, the Trump administration pushback creates a spectrum of regulatory uncertainty around index funds' social activism and is evidence against the view that these governance interventions are explained as a means of staving off regulatory intervention for index funds.

It is difficult to imagine how the administration could have provided better cover to funds wanting to retreat from their activism than this executive order. It would have been perfectly plausible for the big three to suggest, with regret or otherwise, that White House hostility meant that they had to tread carefully in this arena. It could have easily led the funds to reemphasize their core mission of pursuing returns and point out that they had done what they could but that this activism had put a significant target on their backs as well as note that the proper forum for pursuing environmental change was the political process. The funds may have even announced new efforts to engage or lobby inside the traditional political

106. *Id.*

107. *Id.*

108. *See* Nick Thornton, *ESG Investing in 401(k)s Faces Fiduciary, Regulatory Questions*, BENEFITS PRO (Mar. 19, 2019), https://www.benefitspro.com/2019/03/19/esg-investing-in-401ks-faces-fiduciary-regulatory-questions.

apparatus on these issues while separating these efforts from their shareholder voting policies. Alternatively, the funds could have gone on saying all the right things while actually stepping back from their confrontational voting stances on this issue.

When combined with the existing managerial pressure, the executive order could have provided all the necessary incentive to retreat, however the evidence suggests that the funds ignored this executive order and continued on their more aggressive course. BlackRock's new, more aggressive voting policy postdates it.[109] And if one examines not just how these funds voted in the 2019 proxy season, but also how they have publicly trumpeted those votes, it appears that they intend to resist the signal in that executive order, not yield to it.[110] This is not the behavior of funds determined to avoid confrontation.

In addition, to deflect some of the managerial and political pressure that they face, the funds could commit to following ISS recommendations in word and deed. ISS, the shareholder-friendly proxy advisory firm, has long taken positions on environmental and gender diversity issues, sometimes in favor of such proposals.[111] One could therefore imagine the funds publicly committing to follow ISS's recommendations on these proposals, perhaps even announcing their intent to push ISS to take particular stances. This could have relieved the funds of pressure to act on environmental and diversity issues while retaining a buffer between themselves and the managerial or political pressure. However, the funds' behavior shows that

109. *See* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities*, BLACKROCK 5 (Jan. 2019), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [https://perma.cc/7NGS-HF5G] ("To the extent that we believe that a company has not adequately accounted for diversity in its board composition within a reasonable time frame, we may vote against the nominating / governance committee for an apparent lack of commitment to board effectiveness.").

110. *See, e.g.*, John Manganaro, *ESG, Proxy Voting Trends Unlikely to Shift on Executive Order*, PLANSPONSOR (Apr. 12, 2019), https://www.plansponsor.com/esg-proxy-voting-trends-unlikely-shift-executive-order/ ("The impact of the executive order is likely to be more symbolic than substantive when it comes to the real-world activities of retirement plan fiduciaries and investment managers. 'Less than one year ago . . . the DOL clarified its views on how shareholder engagement could be conducted in a manner consistent with ERISA's fiduciary duties' . . . 'Proxy voting and other forms of engagement are fiduciary functions under ERISA.'").

111. *See, e.g.*, INSTITUTIONAL SHAREHOLDER SERVICES, *Environmental, Social, and Governance QualityScores to be Reflected in ISS Proxy Research Reports* (Feb. 5, 2018), https://www.issgovernance.com/iss-announces-launch-of-environmental-social-qualityscore-corporate-profiling-solution/ [https://perma.cc/WWE2-2SDM].

they do not want the buffer; they want the credit for taking direct action. Far from marching in lockstep with ISS recommendations and deferring to its judgment, these funds have gotten out ahead of ISS on these issues.[112]

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On balance, the evidence suggests that index funds' activism around social issues is inconsistent with the incentive structure that has been posited in the existing literature. Index fund social activism simply stands apart from other corporate governance interventions in both the approach the funds take and the impact of these efforts on corporate practice. In the balance of this paper, we outline an extension of the conventional framework that accounts for many of the facts above. We explain why issues of social importance have burst onto the asset management scene, why index funds' approach to these issues is different than other corporate governance interventions, and why index funds are uniquely situated to respond to the incentives we identify.

IV. THE COMING GENERATIONAL SHIFT

While index funds' overall passivity with respect to traditional corporate governance issues is consistent with the conventional wisdom that managerial and political pressures keep them from exercising much shareholder voice, index funds are actually significantly active on several socially responsible investment issues, namely board diversity and the environment. In contrast to the conventional view that funds avoid challenging management because they fear loss of access to companies' 401(k) platforms, funds are in fact quite confrontational towards management on these issues. There is hardly a more aggressive stance one can take towards a corporate board than voting against its members, yet the evidence shows that these funds have repeatedly taken such aggressive action. They persist in that activism even in the face of intense managerial and political pressure and trumpet that activism. They avoid obvious opportunities to retreat from it as well as alternative approaches that would enable them to claim to be doing what's right while following someone else's

112. *See ISS 2019 Policy Updates May Affect Board Gender Diversity and Pay-for-Performance Methodology*, COMPENSIA 3 (Oct. 23, 2018), http://compensia.com/gics-code-changes-will-affect-many-technology-companies-2/ [https://perma.cc/2AHZ-GE9N] (noting that the ISS gender diversity policy would "simply mirror" the "broader trend" among institutional investors like BlackRock and State Street).

lead. This strongly suggests that there is another, countervailing force that is driving this behavior that has been overlooked in the academic literature.

Moreover, social activism is trending decisively towards increased confrontation with boards and management. In the early phase of this new social activism, funds merely voted against the chairs of nomination committees for failing to include women on boards.[113] These policies have been revised in favor of more aggressive approaches ranging from voting against the entire nomination committees to even voting against the entire board.[114] This behavior is not characteristic of funds that are acting in fear of managerial retaliation or rendered reticent by weak incentives. Further, funds persist in this behavior not only in the face of concerns about managerial retaliation, but in the face of political pressure. Consider the funds' response to the Trump White House's recent executive order directing the U.S. Department of Labor to revisit trustee fiduciary duties under ERISA.[115]

To be sure, index funds do fear retaliation, but they fear something else more. That force is the rise in economic importance of the Millennials, a generation with a pronounced and novel preference for social responsibility in corporate governance. Index funds—unable to distinguish themselves with superior returns—are sensitive to these investor preferences as a threat to their asset base and as a means to create investor affinity in an otherwise commoditized industry. As the giant index funds rush to demonstrate their bona fides in this new reality, we are witnessing the rise of a new, Millennial-driven corporate governance, one that is values-driven, not value driven. Current fund and market behavior, notably the behavior just described, cannot be fully explained without understanding this development. It is already transforming the investment arena and we believe it will have implications for decades.

A. THE RISE OF THE MILLENNIALS AS SAVERS

The business community is facing a generational shift, from baby boomers to Millennials. Over the next decade, Millennials will assume a rising role among investors, employees, and consumers, and they will become the most dominant generation not long thereafter, outstripping their

113. *See, e.g.*, Lubin & Krouse, *supra* note 60.

114. *See, e.g.*, Whyte, *supra* note 70.

115. Promoting Energy Infrastructure and Economic Growth, *supra* note 105.

Generation X parents.[116] As a result of that current and future prominence, a large body of research has developed to study this generation, the largest since the Baby Boomers. That research has taken almost every imaginable form, assessing this generation's political, consumer, cultural, employment, and investment preferences. These studies are ongoing but certain distinct features are already well documented.

Most relevant for our purposes, Millennials are less focused on their investment returns than any generation since such questions were first asked. The evidence suggests not that they are indifferent to investment returns, but that they have a greater tendency to assess and even prioritize the social and other real world effects of their investments.[117] Prior generations viewed larger social questions as belonging to the political sphere, the sphere of political campaigns, legislation, and perhaps litigation. The investment sphere was the place to make money and save for retirement. But Millennial views and attitudes towards investment suggest a collapsing, or at least eroding, distinction between what were once thought of as distinct spheres of activity.

This broader, more socially conscious attitude towards investment is creating bottom up pressure for investment funds to demonstrate how they advance socially important goals. That bottom-up pressure has now reached the upper-echelons of the market and is reshaping how these massively powerful institutional investors engage in activism. The reason why this bottom-up pressure has reached the upper echelons of the market is straightforward. The Millennial generation will wield massive wealth and the race to manage that wealth has already begun.

The massive prize of managing Millennial wealth has triggered a new high-stakes race among funds and has created strong competitive pressures to offer investment products that have high social value. Millennials are just now getting introduced to "brands" like BlackRock, Vanguard, and State

116. See Richard Fry, *Millennials are Projected to Overtake Baby Boomers as America's Largest Generation*, PEW RES. CTR. (Mar. 1, 2018), https://www.pewresearch.org/fact-tank/2018/03/01/Millennials-overtake-baby-boomers/ ("[T]he Millennial population is projected to peak in 2036 at 76.2 million. . . . The Census Bureau projects that the Gen X population will peak at 65.6 million in 2018").

117. *See, e.g.*, Fink, *supra* note 1 ("In a recent survey by Deloitte, millennial workers were asked what the primary purpose of businesses should be – 63 percent more of them said 'improving society' than said 'generating profit.'").

Street. State Street has chosen to introduce itself to a new generation with the Fearless Girl—Google "Fearless Girl" and one of the first links that comes up is a State Street link titled, "About Us—Who We Are—Fearless Girl—State Street Global Advisors." Instead of "Retire in style," "Trust us with your nest egg," "We're so smart we'll make you a lot of money," the message is "We are Fearless Girl." When Millennials think of State Street, they now think of the Fearless Girl, wearing a pink hat knitted by admirers who pose for Instagram selfies with her, standing up to the Wall Street bull. In addition, as we write this, the State Street home page features a picture of Michael Bloomberg with State Street CEO Ron O'Hanley captioned, "Tackling Climate Change Risk: Ron O'Hanley and Mike Bloomberg discuss how grassroots efforts like Beyond Carbon and institutional capital can promote a cleaner and more sustainable world."[118] This directly marries Millennials' concern about gender diversity and the environment to the investment products State Street offers.

Our thesis is that management of Millennial wealth is driving the funds' environmental and diversity activism. The prize is so large that winning it is the countervailing force that pushes funds to overcome managerial and political pressure to remain passive. For our thesis to be correct, two things must also be true: (1) Millennial wealth will be massive such that the time to compete for it is now; and (2) the way to reach that Millennial wealth is to target this generation's political preferences. In the next Parts, we address both propositions.

B. MILLENNIALS' WEALTH AND "THE GREAT TRANSFER"

In the coming decades, somewhere between $12 and $30 trillion will be transferred to Millennials.[119] Even the low end of that spectrum will mark the largest intergenerational wealth shift in history.[120] It is comparable to the

118. *Tackling Climate Change Risk: A Conversation with Ron O'Hanley and Mike Bloomberg*, STATE STREET (July 2019), http://www.statestreet.com/ideas/articles/ohanley-bloomberg-climate-change.html [https://perma.cc/Q37M-JDY4].

119. *See* Tett, *supra* note 14 (citing U.S. Trust estimate that $12 trillion in assets will pass to Millennials over the next decade, and Deloitte estimate that $24 trillion will be transferred over the next fifteen years); Fink, *supra* note 1 ("In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to millennials."; Skinner, *supra* note 14 ("Over the next 30 years, an epic $30 trillion will be passed down from baby boomers to Generation X to Millennials.").

120. *Id.*

gross domestic product of the U.S,[121] far exceeding the current assets under management by any given U.S. mutual fund complex.[122] And it is no secret. Investment professionals are aware of it. It has been reported in the press and industry-generated studies. Paul Donovan, chief global economist of UBS' Wealth Management, put it best:

> It's worth pointing out that the Millennial generation, which we're all wringing our hands about — these poor people not able to own houses! — this is going to be the wealthiest generation ever that we've experienced. The basic fact is that wealth does not disappear in a puff of smoke. The wealth is still there in the economy . . .
>
> When I die my nieces will inherit the assets that I have accumulated. And indeed the assets my parents have accumulated . . . There are fewer Millennials than baby boomers. The concentration of wealth will increase, and fewer people will share the national wealth.[123]

According to one estimate, this intergenerational transfer will peak from 2031-2045, when roughly 10 percent of all U.S. wealth will change hands every five years.[124]

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121. News Release, *Gross Domestic Product, Second Quarter 2019 (Advance Estimate) and Annual Update*, U.S. BUREAU OF ECONOMIC ANALYSIS (July 26, 2019), https://www.bea.gov/news/2019/gross-domestic-product-2nd-quarter-2019-advance-estimate-and-annual-update [https://perma.cc/T2ZZ-9Q5S] ("Current-dollar GDP increased . . . to a level of $21.34 trillion.").

122. *See* Jeff Benjamin, *10 Largest Mutual Fund Companies By Assets*, INV. NEWS (Aug 16, 2018), https://www.investmentnews.com/gallery/20180824/FREE/824009999/PH/10-largest-mutual-fund-companies-by-assets ("The mutual fund industry currently has $18.9 trillion in total assets, $10.8 trillion of which is held by 10 companies.").

123. Jim Edwards, *Millennials Will Be the Richest Generation Ever, According to UBS — so perhaphs they ought to stop complaining about the housing market*, BUS. INSIDER (Jan. 24, 2018), https://www.businessinsider.com/interview-with-ubs-paul-donovan-on-Millennials-and-inequality-2018-1 [https://perma.cc/3T2R-T2FU].

124. *See The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth*, ACCENTURE (2015), https://www.accenture.com/nl-en/~/media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Industries_5/Accenture-CM-AWAMS-Wealth-Transfer-Final-June2012-Web-Version.pdf [https://perma.cc/8VJN-K7A4] ("While the 'Great Transfer' will see over $12 trillion shift, the 'Greater' wealth transfer is much larger, estimated at over $30 trillion in financial and nonfinancial assets in North America. At its peak between 2031 and 2045, 10 percent of total wealth in the United States will be changing hands every five years. The accelerating pace of this transfer, combined with the generational differences in the demands and expectations of wealth management service providers, makes this massive transfer of wealth between generations a defining issue for the wealth management industry.").

True, Baby Boomers will retain the largest percentage of disposable capital for some years to come,[125] but the capital shift to Generation X and the Millennials has already begun, and it will only accelerate over time.[126] While the actual size of that wealth transfer is debatable, the economic significance of managing it is not. In BlackRock CEO Larry Fink's now famous 2019 shareholder letter, he described the forthcoming asset transfer from Baby Boomers to Millennials—which he estimated at $24 trillion—as "the largest transfer of wealth in history."[127]

Even if one were to assume that the bulk of disposable wealth will remain in the hands of Baby Boomers for some time, it does not follow that investment fund activism will prioritize that generation's preferences. Barring some catastrophe, we think it is exceedingly unlikely that Baby Boomers, who have begun to retire, are still "in play" from a marketing perspective. That generation already has established investment advisers who have already made the bulk of their profits off of managing that money. Further, Baby Boomers are also entering the most risk-averse stage of life. The real competition is for future revenues and new market entrants, and that is why the current absolute size of a generation's wealth should not be the only factor. One can readily imagine that a retiree who has already worked with State Street for decades may not have heard of Fearless Girl or State Street's diversity voting policies, and if he did and somehow objected to

125. *See* Meredith Jones, *Opinion: Millennials Have More Money Than You Think — So Expect ESG Funds in Your 401(k)*, MARKETWATCH (Oct. 24, 2018), https://www.marketwatch.com/story/Millennials-have-more-money-than-you-think-so-expect-esg-funds-in-your-401k-2018-10-23 [https://perma.cc/33GL-9LAG] ("To be clear, baby boomers still contain the largest segment of millionaires AND control 70% of disposable capital, but they are aging and will transfer up to another $30 trillion (with a 'T') to their Gen X and millennial children and grandchildren over the next decade and a half-ish. Based on these figures, it would seem that millennials can (or will) be able to put their money where their mouths are when it comes to responsible investments, and why there are a host of investing options no matter where millennials fall on the income spectrum. In addition, now that millennials are the dominant force in the workplace, there will likely be more adoption of responsible investment options within 401(k) plans, making it even easier for millennials investors to align their values with their investments. Although less than 10% of 401(k)s currently offer ESG options, large financial firms (think BlackRock, Wells Fargo and Natixis to name a few) are betting that will change and are developing products for the 401(k) marketplace.").

126. *Id.*

127. Fink, *supra* note 1 ("In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to millennials.")

either, it seems unlikely that he would switch to BlackRock over it, where he would find an institution pursuing largely the same objectives anyway.

BlackRock itself has observed this basic marketing point in its report, "Understanding Millennial Investors." In a section titled 'Affiliation: Brand loyalty is earned', the report states: "[M]illennials are still forming loyalties, and are therefore more likely to switch or supplement their provider for the right incentive… Both gen X and Millennials agree on common characteristics that give a brand strength… but it is the latter group that not only expect but are demanding to see companies doing things the 'right' way – especially in financial services."[128]

The list of financial institutions and major media outlets that have studied and reported on the issue of future Millennial wealth, having all reached more or less the same conclusion, is extensive. It includes many of the leading financial institutions and journals of our day, including Deloitte, BlackRock, PWC, Morgan Stanley, Wells Fargo, The Harvard Business Review, The Financial Times, The Economist, CNN, Pensions and Investments, etc.[129]

128. Understanding Millennial Investors, *A generation game: Gen X and millennials*, BLACKROCK (2019) https://www.blackrock.com/uk/intermediaries/insights/millienial-investors [https://perma.cc/P3XU-XBPL]

129. *See* Fink, *supra* note 1 ("Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as millennials – who today represent 35 percent of the workforce – express new expectations of the companies they work for, buy from, and invest in. Attracting and retaining the best talent increasingly requires a clear expression of purpose. With unemployment improving across the globe, workers, not just shareholders, can and will have a greater say in defining a company's purpose, priorities, and even the specifics of its business. Over the past year, we have seen some of the world's most skilled employees stage walkouts and participate in contentious town halls, expressing their perspective on the importance of corporate purpose. This phenomenon will only grow as millennials and even younger generations occupy increasingly senior positions in business."); Tett, *supra* note 14 ("That raises a crucial question: will the recipients of this wealth have different attitudes towards how they use it? If so, what will this mean for the world of impact investing?"); Julia Horowitz, *BlackRock is Getting Ready for Millennial Investors*, CNN (Dec. 4, 2018) https://edition.cnn.com/2018/12/04/investing/blackrock-Millennial-push/index.html [https://perma.cc/TZE8-65D2]; *Swipe Right to Invest: Millennials and ESG, the Perfect Match?*, MSCI (Nov. 2017) https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b [https://perma.cc/YF8M-FXT9] ("'The No. 1 question I get from advisers is how to handle the coming generational wealth transfer,' said ETF.com's Mr. Nadig, 'some $30 trillion that will make its way from the baby boomers to millennials in the coming two decades. ESG has emerged as one of the dominant answers to that question.'"); *Millennials Drive Growth in Sustainable Investing*, MORGAN STANLEY INST. SUSTAINABLE INV. (Aug. 9, 2017), https://www.morganstanley.com/ideas/sustainable-socially-

responsible-investing-Millennials-drive-growth [https://perma.cc/7AET-BX7R]; Mark R. Kramer, *The Backlash to Larry Fink's Letter Shows How Far Business Has to Go on Social Responsibility*, HARV. BUS. REV. (Jan. 31, 2019), https://hbr.org/2019/01/the-backlash-to-larry-finks-letter-shows-how-far-business-has-to-go-on-social-responsibility (quoting Charles Elson as saying "This is fundamentally not the role of a public company, and it's unfair to investors who may not agree with his politics. A CEO shouldn't use house money to further a goal that may not create economic returns."); Val Srinivas & Urval Goradia, *The Future of Wealth in the United States: Mapping Trends in Generational Wealth*, DELOITTE CTR. FIN. SERV. (2015), https://www2.deloitte.com/content/dam/insights/us/articles/us-generational-wealth-trends/DUP_1371_Future-wealth-in-America_MASTER.pdf ("Millennials, already seen as a segment with quirky tendencies and limitless potential, will affirm their status as the new drivers of consumption going forward. Their financial commitments (for example, education, homes, and cars) will fuel growth in the banking sector. Once they graduate to higher incomes, their share of assets will also pick up, although their lower per-capita wealth will demand differentiated service levels. However, their most pronounced impact on financial services may be driven by their value-conscious behavior and how they buy products and services, which may force a revamp of long-entrenched operating models."); Jones, *supra* note 125 ("Meanwhile, surveys of investors almost universally point to millennials as the biggest fans of responsible or sustainable investors. Morgan Stanley surveyed 1,000 active investors in 2015 and 2017 and found that millennials were not only more interested in responsible investing (86% vs. 75% of the total population in 2017), but that their interest was growing. Between 2015 and 2017, the percentage of millennials who were 'strongly interested' in sustainable investing jumped a massive 10 percentage points. A more recent survey from Crossmark Global Investments showed an even starker contrast between millennials and their older investing peers. While a mere 6% of seniors were even familiar with ESG investing, a whopping 80% of those aged 23 to 39 were aware of the strategy and 26% had already made ESG investments."); Generation SRI, *Sustainable Investing Joins the Mainstream*, ECONOMIST (Nov. 25, 2017), https://www.economist.com/finance-and-economics/2017/11/25/sustainable-investment-joins-the-mainstream ("In 2008, when she was in her mid-20s and sitting on a $500m inheritance, Liesel Pritzker Simmons asked her bankers about 'impact investing'. They fobbed her off. 'They didn't understand what I meant and offered to screen out tobacco,' recalls the Hyatt Hotels descendant, philanthropist and former child film star. So she fired her bankers and advisers and set up her own family office, Blue Haven Initiative. It seeks investments that both offer market-rate returns and have a positive impact on society and the environment. 'Financially it's sensible risk mitigation,' she says. 'Our philanthropy becomes far more efficient if we don't need to undo damage done in our investment management.' Such ideas are gaining ground, particularly among the young. Fans of 'socially responsible investment' (SRI) hope that millennials, the generation born in the 1980s and 1990s, will drag these concepts into the investment mainstream. SRI is a broad-brush term, that can be used to cover everything from divestment from companies seen as doing harm, to limiting investment to companies that do measurable good (impact investing). The U.S. Forum for Sustainable and Responsible Investment, a lobby group, estimates that more than a fifth ($8.7trn) of the funds under professional management in America is screened on SRI criteria, broadly defined, up from a ninth in 2012."); Julien Courbe, *Managing Millennial Money*, PWC (Mar. 2017), https://www.pwc.com/us/en/industries/financial-services/library/managing-Millennial-money.html **("**Millennials' lifestyle priorities will challenge traditional advisor models. This group's savings objectives are far different from those of other demographics and appear eager to pursue goals that are less focused on wealth accumulation. Plus, major life choices such as marriage, children, and college funding are being pushed to later in life, so it may be some time before millennials prioritize savings. These preferences will defer the need for traditional financial advice. . . . [B]ut it is critical to engage the millennial group and make inroads as early as possible. To do so, incumbents will have to

It is possible that they are all wrong. Some dissenters have argued that Millennials' future wealth has been overstated, in part because current trends suggest that Baby Boomers will live longer than prior generations and are much more likely to spend their resources on themselves than pass it on as inheritance.[130] A recent report by the Federal Reserve concludes that Millennials have fewer resources than either Generation X or Baby Boomers had at the same age[131] and student debt loads and the Great Recession further hurt Millennials.[132] On the other hand, the Pew Research Center concluded that household incomes are up, even though the Fed found that individual incomes may be down, because more Millennial women are working than in preceding generations.[133] What seems beyond peradventure, though, is that the fund complexes themselves are taking Millennial wealth seriously. They are the future of investing, and competition for their assets—and future assets—has already begun in earnest.

C. MILLENNIALS' PREFERENCES—VALUES RATHER THAN RETURNS

We have just established that Millennials will wield massive economic power in the coming decades. In this section, we review the evidence suggesting that Millennials differ sharply from prior generations in their attitudes towards socially responsible investment.

Survey results, from the Third Annual Responsible Investor Survey conducted by Nuvee, [134] are consistent with a large body of research showing that Millennials weigh the environmental impact of investments

understand these preferences and, in response, create a more human and credible marketplace position by using the tools this demographic prefers.)

130. *See* Gabriel Garcia, *That $30 Trillion 'Great Wealth Transfer' is a Myth*, CNBC (May 22, 2018), https://www.cnbc.com/2018/05/22/that-30-trillion-great-wealth-transfer-is-a-myth.html.

131. *See* Christopher Kurz, Geng Li, & Daniel J. Vine, *Are Millennials Different?*, FED. RES. BOARD FIN. & ECON. DISCUSSION SERIES 2018-080 (2018), https://www.federalreserve.gov/econres/feds/files/2018080pap.pdf; Hillary Hoffower, *Millennials Have Been Called the 'Brokest' and the 'Richest' Generation, and Experts Say Both of Those are True*, BUS. INSIDER (Jan. 29, 2019), https://www.businessinsider.com/Millennials-wealth-generation-experts-data-2019-1.

132. *Id.*

133. Richard Fry, *Young Adult Households are Earning More than Most Older Americans Did at the Same Age*, PEW RES. CTR. (Dec. 11, 2018), https://www.pewresearch.org/fact-tank/2018/12/11/young-adult-households-are-earning-more-than-most-older-americans-did-at-the-same-age/?amp=1.

134. Third Annual Responsible Investing Survey, *Investor Interest in Responsible Investing Soars*, NUVEEN (2018), https://www.tiaa.org/public/pdf/investor_interest_in_responsible_investing_soars.pdf.

considerably more than their elders do. The Financial Times recently summarized that research as follows:

> US Trust found 75 percent of wealthy Millennials "consider the social and environmental impact of the companies they invest in to be an important part of investment decision-making". Two-thirds "view their investment decisions as a way to express their social, political, or environmental values". Similarly, according to a survey by Morgan Stanley, "Millennials are twice as likely to invest in a stock or a fund if social responsibility is part of the value-creation thesis". A report by Fidelity says "a majority of affluent Millennials (77 percent) and Generation X donors (72 percent) indicated they had made some form of impact investment, such as investing in a publicly traded company with good social or environmental practices". Among the Baby Boomer and older generation the ratio was a mere 30 per cent.[135]

TABLE 1: Survey Results from the Third Annual Responsible Investor Survey Conducted by Nuvee

…	*Total Investors*	*Millennial*	*Non-Millennial*
Base	*1012* *1103**	*197*	*815*
I tend to recycle everyday	88% 86%*	93%	86%
I'd like to work for an employer that makes a positive social impact on the world	76% 73%*	91%	70%
I prefer to use reusable bags, rather than paper or plastic, because it is more environmentally sustainable	76% 71%*	91%	70%
I'd like to work for an employer that makes a positive impact on the world	76% 70%*	92%	70%
The Recession has made me more financially conservative than previous generations	76% 72%*	89%	70%

135. Tett, *supra* note 14.

I prefer to shop for brands that have environmentally sustainable business practices	72% 61%*	90%	64%
Given today's political climate, I prefer to invest in ways that will positively impact the environment	72%	95%	63%
I grew up learning to care for the environment from TV shows, books and my parents	69% 60%*	93%	59%
I care more about having a positive impact on society than doing well financially	64% 49%*	92%	52%

Notes: Survey results from 2017; * survey results from 2015

Similarly, in 2015 and again in 2017, Morgan Stanley conducted online surveys of 800 investors, a quarter of whom were Millennials.[136] The survey found that Millennials were significantly more likely to invest in companies or funds that target specific social or environmental outcomes, and more than twice as likely to exit an investment position because of objectionable corporate activity.[137] In its 2017 survey, Morgan Stanley found that Millennials are the driving force in the adoption of socially responsible investment strategies.[138]

We have found effectively no research refuting the notion that Millennial attitudes differ from those of prior generations. Most of the resistance to the Millennials thesis comes either from the idea that their future financial power has been overestimated, as noted above, or because of the failure of some businesses to profit from socially responsible investment strategies that cater to Millennials. For example, Pacific Life Insurance Co. launched a socially conscious online investing platform in 2015 called Swell Investing. However, it closed on August 30, 2019 after failing to attract

136. *Sustainable Signals: New Data from the Individual Investor*, MORGAN STANLEY INST. SUSTAINABLE INV. (2017), https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf.

137. *Id. See also Sustainable Signals: The Individual Investor Perspective*, MORGAN STANLEY INST. SUSTAINABLE INV. (Feb. 2015), https://www.ibe.org.uk/userassets/surveys/2015 percent2002 percent20morgan percent20stanley percent20- percent20sustainable percent20investing.pdf.

138. *Id.*

enough customers.[139] Some might suggest that the Millennial market for socially responsible investment products has been exaggerated. However, at least one reason for Swell's closure is that "[g]iants like BlackRock Inc. and The Vanguard Group . . . have attracted billions in ESG assets after dramatic price cuts on new socially-conscious ETFs."[140] Swell's closing could just as easily be seen as evidence supporting our hypothesis, not refuting it.

It is also possible that Millennial investment attitudes will change over time. Perhaps as this generation ages, it will become more conservative, and its preferences will change. But the funds are looking to recruit Millennial clients now, and we believe this is what explains their pursuit of these initiatives currently. It could be that the funds will change course if Millennial attitudes change, or if the generation that follows Millennials has different preferences. Our point is that the funds' behavior is geared towards winning those Millennial clients now by catering to their preferences now. Perhaps more potently, the funds are portraying these efforts as cohering with traditional investment preferences, often by arguing that pursuing ESG priorities is actually value maximizing.[141] In that instance, the socially responsible choice is really no choice at all. ETF.com's Nadig says that "[t]he No. 1 question I get from advisers is how to handle the coming generational wealth transfer… some $30 trillion that will make its way from the baby boomers to Millennials in the coming two decades. ESG has emerged as one of the dominant answers to that question."[142]

Millennials' behavior in other contexts—as employees and as consumers—supports the argument that they are more likely to respond to

139. Ryan W. Neal, *Pacific Life Shutters ESG Robo-Adviser Swell Investing*, INV. NEWS (July 25, 2019), https://www.investmentnews.com/article/20190725/FREE/190729956/pacific-life-shutters-esg-robo-adviser-swell-investing (citing Swell spokesman's comment that "the company was not able to achieve the necessary scale in the current market to sustain operations.").

140. *See* Emily Chasan, *Pacific Life Lost the Bet on Socially Minded Millennials*, BLOOMBERG (July 26, 2019), https://www-bloomberg-com.cdn.ampproject.org/c/s/www.bloomberg.com/amp/news/articles/2019-07-26/pacific-life-s-bet-on-socially-minded-Millennials-didn-t-pay-off.

141. *See, e.g.*, *Sustainable Investing: A 'Why Not' Moment*, BLACKROCK INV. INST. (May 2018), https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainable-investing-may-2018-international.pdf ("ESG investing is not just about doing good. A growing body of research points to a link with asset performance. Companies that manage sustainability risks and opportunities well tend to have stronger cash flows, lower borrowing costs and higher valuations. . . . Good governance translates to lower corporate risk, we believe, and in turn, a lower cost of doing business. Findings are similar for environmental and social risk management . . . .").

142. *See Swipe Right to Invest*, *supra* note 129.

social issues than prior generations, and is certainly playing a role in how mutual fund complexes will court their business.

1. Millennials as Employees

Within two years, Millennials are predicted to cross a significant threshold: they will comprise 50 percent of the workforce, a figure the Bureau of Labor Statistics projects will rise to 75 percent by the year 2030.[143] Already, that demographic change is having significant effects in the workplace. Some recent case studies illustrate the point.

Wayfair is a Boston-based furniture manufacturing and distribution company.[144] Its employees recently discovered that the company had entered into a $200,000 contract with BCFS Health and Human Services to supply bedroom furniture to an immigrant detention center at the U.S.-Mexico border.[145] Hundreds of employees signed a letter to the company's leadership team requesting that it cease all business with BCFS and others supplying detention centers and that it craft a code of conduct "that empowers Wayfair and its employees to act in accordance with our core values."[146] For our purposes, it is noteworthy that the signers identified themselves as "company employees and shareholders."[147] The company responded that it was "proud to have such an engaged team that is focused on impacting our world in meaningful and important ways"[148] but restated its policy of fulfilling all lawful orders. This did not satisfy the employees—they staged a walkout and 500 people, ten percent of employees, participated.[149] A week before the walkout, Wayfair's stock was trading at $162.47,[150] but by June 26, the date

143. See Mark Emmons, *Key Statistics About Millennials in the Workplace*, DYNAMIC SIGNAL (Oct. 9, 2018), https://dynamicsignal.com/2018/10/09/key-statistics-Millennials-in-the-workplace/; Richard Fry, *Millennials are the Largest Generation in the U.S. Labor Force*, PEW RES. CTR. (Apr. 11, 2018), https://www.pewresearch.org/fact-tank/2018/04/11/Millennials-largest-generation-us-labor-force/.

144. *See* Meghan B. Kelly & Laney Ruckstuhl, *Wayfair Employees Protest Sale of Furniture to Migrant Detention Center*, NPR (Jun. 26, 2019), https://www.npr.org/2019/06/26/736308620/wayfair-employees-protest-sale-of-furniture-to-migrant-detention-center.

145. *Id.*

146. *Id.*; See also (@sun_daiz), TWITTER (June 25, 2019, 11:55 AM), https://twitter.com/sun_daiz/status/1143548274240102401 [https://perma.cc/T6LA-WZEA].

147. *Id.*

148. *Id.*

149. *Id.*; Cristina Alesci, Nathaniel Meyersohn, & Kate Trafecante, *Wayfair Donates $100,000 to the Red Cross After Employee Backlash*, CNN (June 26, 2019), https://www.cnn.com/2019/06/26/business/wayfair-donation-migrant-facility/index.html.

150. *See Wayfair Inc. (W)*, YAHOO! FINANCE, https://finance.yahoo.com/quote/W/.

of the walkout, the stock had dropped more than ten percent to $145.81.[151] Immediately before the walkout, Wayfair donated $100,000 to the American Red Cross, but this did not mollify the protesters.[152] The day of the walkout, Forbes ran an article, "3 Reasons To Sell Wayfair On Today's Employee Walkout," arguing, among other things, that the company had engaged in "weak cost-benefit analysis" by concluding that "angering its employees and tarnishing its brand were costs that were smaller than the $86,000 in profit it will generate from the … contract" and that it "put[] Wayfair into a political firestorm that could damage its brand" and "make it harder for Wayfair to attract and retain talented employees."[153] The sides remain at an impasse over the issue.

Other examples of this worker-driven activism are easy to find. Google employees recently protested a company project with the Chinese government to develop a search engine that would censor sensitive information and facilitate surveillance.[154] Microsoft and Amazon employees have acted similarly.[155] These episodes reflect observable trends, much as the new index fund activism reflects those trends on the investor side.

According to a recent study by communications and marketing firm Weber Shandwick, Millennials play a particularly prominent role in this new employee-driven activism.[156] Among other things, the study asked employees whether they had "'spoken up to support or criticize' their employer's 'actions over a controversial issue that affects society.'"[157]

151. *Id.*

152. *Id.*

153. Peter Cohan, *3 Reasons to Sell Wayfair on Today's Employee Walkout*, FORBES (June 26, 2019), https://www.forbes.com/sites/petercohan/2019/06/26/3-reasons-to-sell-wayfair-on-todays-employee-walkout/#2eebe440492f.

154. Rakeen Mabud, *Two Lessons From the Wayfair Walkout*, FORBES (July 12, 2019), https://www.forbes.com/sites/rakeenmabud/2019/07/12/two-lessons-from-the-wayfair-walkout/#6423396c3a88.

155. *See, e.g.*, Sheera Frenkel, *Microsoft Employees Question C.E.O. Over Company's Contract With ICE*, N.Y. TIMES (July 26, 2018), https://www.nytimes.com/2018/07/26/technology/microsoft-ice-immigration.html; Emily Stewart & Alexia Fernandez Campbell, *8,000 Amazon Employees Asked the Company to Do More on Climate Change. Shareholders Just Said No.*, VOX (May 22, 2019), https://www.vox.com/recode/2019/5/22/18635604/amazon-shareholder-meeting-2019-climate-change-proposal.

156. *See Employee Activism in the Age of Purpose: Employees (Up)Rising*, WEBER SHANDWICK (May 29, 2019), https://www.webershandwick.com/wp-content/uploads/2019/06/Employee-Activism-in-the-Age-of-Purpose-FINAL.pdf.

157. *Id.* at 8.

Thirty-eight percent of employees said yes.[158] But among Millennials, 48 percent said yes, compared to 33 percent of Generation Xers and 27 percent of Baby Boomers.[159] Seventy percent of Millennial employees agreed with the statement "employees can make a difference by speaking out on controversial issues that affect society" compared to 68 percent and 65 percent of Generation Xers and Baby Boomers respectively.[160] Seventy percent of Millennials agreed with the statement, "employees can make an even greater impact on the world than leaders who run organizations," compared to 60 percent of Generation Xers and 54 percent of Baby Boomers.[161] Thus, like Millennial investors, Millennial employees feel empowered, believe that activism can make a difference, have themselves participated in activism, and see the workplace as an appropriate and necessary forum for activism. It is easy to imagine these same employees demanding ESG activism by their investment managers.

2. Millennials as Consumers

There are also consumer-side examples of how rapidly a company can enter into a near-death spiral by tarnishing its brand.

Papa John's, a once thriving company, suffered massive business harm after its founder was publicly accused of making racist comments. The saga began when its CEO, board chair, and founder John Schnatter criticized the National Football League for showing "poor leadership" in dealing with football players who kneeled during the national anthem as a form of political protest.[162] Schnatter, who had donated $1,000 to the Trump presidential campaign, argued that the protests should have been "nipped in the bud" during the preseason rather than allowed to grow.[163] Papa John's was the most recognized NFL sponsor at the time and advertised heavily during games, so Schnatter blamed the company's sagging sales on the

158. *Id.*
159. *Id.*
160. *Id.* at 5.
161. *Id.*
162. Cindy Boren & Des Bieler, *Papa John's Owner Blames Sagging Sales on NFL Anthem Protests and League Leadership*, WASH. POST (Nov. 1, 2017), https://www.washingtonpost.com/news/early-lead/wp/2017/11/01/papa-johns-owner-blames-sagging-sales-on-nfl-anthem-protests-and-league-leadership/.
163. *Id.*

reduced viewership of NFL games caused by the kneeling controversy.[164] Schnatter's comments drew all the wrong kinds of attention to the company. First, rivals DiGiorno and Pizza Hut engaged in a "Twitter war" with the company, mocking its declining sales.[165] Worse, in response to Schnatter's remarks, white supremacist website The Daily Stormer named Papa John's "the official pizza of the alt-right."[166] As a result, Schnatter announced that he would step down as the company's CEO, though he retained his role as board chair.[167] The following July, Forbes reported that Schnatter used a racial slur on a conference call in May.[168] This explosive scandal, following Schattner's troubling comments from the prior winter, had a devastating effect on the company. Sales dropped 7.1 percent for the year and 8.1 percent in the fourth quarter.[169] Fourth quarter income dropped from $22.8 million the prior year to $4.6 million.[170]

The company's response to the decline in sales reveals its diagnosis of the problem. In March 2019, its new CEO, Steven Ritchie, announced the launch of a TV and digital marketing campaign to "show Papa John's leaning into the story of our products and ingredients and doing it in a way that is relevant to Millennial and Gen Z customers" in an attempt to "ensure the new generation of pizza customers understand [sic] the quality foundation of our brand so that we can attract new customers."[171]

Other examples include the rapid collapse into bankruptcy of the once storied film studio, The Weinstein Company, after 100 women accused

164. *Id.*

165. *See, e.g.*, Ed Mazza, *Papa John's Gets Badly Burned in Twitter War with DiGiorno*, HUFFINGTON POST (Nov. 2, 2017), https://www.huffpost.com/entry/papa-john-digiorno-twitter-war_n_59fbcb4be4b0b0c7fa393cb5.

166. *See* Cristina Maza, *Alt-Right White Supremacists Claim Papa John's as Official Pizza*, NEWSWEEK (Nov. 3, 2017), https://www.newsweek.com/papa-john-alt-right-nazis-white-supremacists-nfl-pizza-701648.

167. *See* Thomas Moore, *Timeline of a Crisis: Papa John's Deletes Founder From Marketing*, PR WEEK (July 13, 2018), https://www.prweek.com/article/1487792/timeline-crisis-papa-johns-deletes-founder-marketing.

168. *Id.*

169. *See* Grace Schneider, *Papa John's Sales Dropped Again, This Time By 8.1 percent Last Quarter*, LOUISVILLE COURIER JOURNAL (Feb. 26, 2019), https://www.courier-journal.com/story/money/companies/2019/02/26/papa-johns-lost-72-million-adjusted-net-income-2018/2993974002/.

170. *Id.*

171. *See* Danny Klein, *Papa John's Faces an Uphill Battle in 2019*, QSR MAG. (Feb. 2019), https://www.qsrmagazine.com/pizza/papa-john-s-faces-uphill-battle-2019.

company CEO and co-founder Harvey Weinstein of sexual harassment, assault, or rape.[172] Alternatively, other examples also include more positive steps to signal social responsibility on the consumer side. For example, in direct opposition to the Papa John's scandal, Nike launched an ad campaign featuring Colin Kaepernick, the most prominent kneeling football player who was largely credited with starting the protest (and whose career ended because of it).[173] Dick's Sporting Goods decided to stop selling guns, and Bank of America recently announced it would not finance private prisons or detention centers.[174]

In our view, each of these companies concluded that the marketing benefits outweighed the costs of giving up certain businesses or associating themselves with particular political movements. Index funds are facing similar calculations.

3. Millennials as Investors

Developments in the investment world outside the context of index funds provide additional evidence of the market responding to the looming entry of Millennials. In addition to deploying existing and previously unused voting power to advance ESG goals, funds are also creating new financial products to meet Millennial demand. For the first time, BlackRock and Wells Fargo are developing ESG funds for retirement savings plans, specifically target-date retirement funds for use in 401(k) plans.[175] BlackRock's plan launched in 2018.[176] Bloomberg reported that assets in ESG funds rose 37 percent in 2017.[177] As reported by Investment News: "The move is aimed at spurring reluctant Millennials to invest more for retirement. There is evidence that a younger generation of investors want such options and have

172. *See* Brooks Barnes, *Weinstein Company Files for Bankruptcy and Revokes Nondisclosure Agreements*, N.Y. TIMES (Mar. 19, 2018), https://www.nytimes.com/2018/03/19/business/weinstein-company-bankruptcy.html.

173. *See* Daniel Roberts, *Wayfair is Just the Latest Example of Brands Getting Burnt By Politics*, YAHOO! FINANCE (June 28, 2019), https://finance.yahoo.com/news/wayfair-is-just-the-latest-example-of-brands-getting-burnt-by-politics-173541818.html.

174. *Id.*

175. *See BlackRock, Wells Fargo Reportedly Preparing ESG Funds for 401(k) Plans*, INV. NEWS (June 13, 2018), https://www.investmentnews.com/article/20180613/FREE/180619973/blackrock-wells-fargo-reportedly-preparing-esg-funds-for-401-k-plans.

176. *Id.*

177. *Id.*

yet to create a nest egg for the future."[178] Not surprisingly, the other big two have done the same, with State Street having created its SPDR SSGA Gender Diversity Index ETF and Vanguard having similarly created a long list of ESG ETFs for both U.S. and international stocks.[179]

A list of recently related financial products targeting this space drives the point home. As Marketwatch describes it, in an article titled: "Millennials have more money than you think — so expect ESG funds in your 401(k)":

> Want a low carbon footprint? The SPDR S&P 500 Fossil Fuel Reserves Free, the iShares MSCI ACWI Low Carbon Target ETF, or the American Funds New Economy Fund could be worth a look.
>
> Want more social justice? The Impact Shares NAACP Minority Empowerment ETF, SPDR SSGA Gender Diversity Index ETF, or the Pax Ellevate Global Women's Leadership Fund are just a few options available.
>
> Interested in supporting companies with good environmental, social and governance characteristics? The Parnassus Endeavor Fund, the iShares MSCI USA ESG Select ETF, or one of Vanguard's new ESG ETFs — the Vanguard ESG US Stock ETF, and the Vanguard ESG International Stock ETF — are a few of a growing number of fund offerings.
>
> In short, if Millennial investors want to invest responsibly through their employer's retirement offering or from the comfort of their parents' basement, a growing number of them can, and likely will.[180]

Interestingly, as a reflection of the long term thinking deployed by those who are creating these products, all of them have low investment minimums, with the ETF funds requiring purchase of no more than one share.[181] We think this is further evidence of our contention that the funds anticipate a massive future wealth transfer, that they believe at least one way to reach Millennials is through socially responsible investment, and that the time to do so is now, explaining the funds' current activism.

Other, smaller transactions similarly reflect the funds' interest in Millennials and socially responsible investing. For example, BlackRock

178. *Id.*
179. *See* Lara Crigger, *ETF Investors Embrace ESG 'Lifestyle'*, ETF.COM (July 17, 2019), https://www.etf.com/sections/features-and-news/etf-investors-embrace-esg-lifestyle?nopaging=1.
180. Jones, *supra* note 122.
181. *Id.*

recently acquired a stake in Acorns, an app that invests spare change.[182] Its stated purpose in so doing is to give BlackRock "insight into the behavior of a younger investors, so it can develop products to suit their needs down the line. The company is also fleshing out its suite of ethical and sustainable investing funds, which it expects to appeal to younger clients."[183]

Unsurprisingly, index fund ESG voting patterns and product generation directly reflect the views of the executives who are running these organizations. This was confirmed by a recent survey of seventy senior executives at forty-three investment firms, including leaders at the big three, large public pension funds like CalPERS and CalSTRS, and the government pension funds of Japan, Sweden, and the Netherlands.[184] Quoting Cyrus Taraporevala, president and CEO of State Street Global Advisors: "ESG issues have become much more important for us as long-term investors… We seek to analyze material issues such as climate risk, board quality, or cybersecurity in terms of how they impact financial value in a positive or a negative way. That's the integrative approach we are increasingly taking for all of our investments."[185] The self-reporting by these ESG managers is supported by the data:

> In 2006, when the UN-backed Principles for Responsible Investment (PRI) was launched, 63 investment companies (asset owners, asset managers, and service providers) with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. By April 2018, the number of signatories had grown to 1,715 and represented $81.7 trillion in AUM. According to a 2018 global survey by FTSE Russell, more than half of global asset owners are currently implementing or evaluating ESG considerations in their investment strategy.[186]

Interestingly, the survey also concluded that corporate managers tend to underestimate the extent to which their investors are committed to ESG investing. Corporate managers estimate that responsible investors constitute roughly 5 percent of their shareholder base when in fact that actual

182. *See* Horowitz, *supra* note 126.

183. *Id.*

184. *See* Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, HARV. BUS. REV. (May 2019), https://hbr.org/2019/05/the-investor-revolution.

185. *Id.*

186. *Id.*

percentage is closer to 25 percent.[187] The disconnect between manager perception and the underlying investor reality is the space in which this new index-fund activism operates. To some extent, much of the activism we describe is dedicated to closing that gap, deploying the massive shareholder voting power of index funds to push companies to orient their activities in the direction their customers want. Finally, and most relevant for our purposes, the survey observes that, "the workforce is increasingly made up of Millennials, for whom ESG is central to any business analysis." One survey respondent summed it up: "They expect us to integrate sustainability as a natural part of our daily work."[188]

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The weight of the evidence suggests we are at the beginning of a massive wealth transfer from Baby Boomers to Millennials and that Millennials' attitudes towards investment are sharply different from those of prior generations. In the next section, we show that the large index funds are creating a new values-driven corporate governance and argue that a complete picture of index funds' approach to corporate governance must take account of these incentives.

V. THE NEW MILLENNIALS' CORPORATE GOVERNANCE

The existing theory of index funds' approach to corporate governance, as developed in the literature, cannot explain why index funds have acted so aggressively to promote diversity on boards. Our argument is that the observed behavior of the big three index fund advisors across *all* governance matters, both conventional and social, can only be explained by enriching the incentive picture to account for index funds' pressure to respond to the social values of Millennial investors. Index funds act because it signals responsiveness to Millennials' values. Index funds will worry about governance when governance issues are salient (or can be made salient through marketing) to their investors. And it is no surprise that index funds are the leaders here: It is precisely because index funds cannot compete on returns that they face pressure to be particularly responsive to social issues. In an industry full of interchangeable indexed products, branding and customer affinity loom large.

187. *Id.*
188. *Id.*

A. INDEX FUNDS AND MILLENNIALS' SOCIAL VALUES: A HIGH STAKE COMPETITION

The existing literature correctly notes that index funds have, at most, fairly weak incentives to invest in governance, but in contrast to both Fisch et al.[189] and Kahan and Rock,[190] we argue that they face fierce, high stakes competition from each other over their ability to fulfill the social goals of their investors, particularly Millennials. This competition is one in which, as the Papa John's case indicates, if an advisor missteps, it could lose everything. If Millennials perceive a fund as not promoting social values, it may lose a branding advantage forever.

As discussed above, index funds cannot differentiate themselves from their indexed competitors by creating value through conventional governance interventions to generate superior returns.[191] But if index funds cannot gain an edge through enhanced performance, this does not mean that the big three will simply stand pat; they will seek a competitive edge elsewhere. Price competition is an obvious place to look, but the large index funds are already so inexpensive that competition on price is approaching a natural limit, and of course cutting prices reduces profitability. By aggressively and publicly staking out a progressive position on board diversity, index funds credibly signal that they are in tune with Millennial values and differentiate themselves from less aggressive competitors.

Each index fund faces pressure to make sure it is not perceived as less committed to social values than its competitors. To secure and enhance its reputation, each fund will seek to be a first mover on social goals, or, if caught being a second mover, to adopt a more robust policy than the first mover. To credibly signal their commitment, funds will pursue these goals through voting policies and other forms of activism, even at the cost of alienating management. Finally, we expect them to publicize evidence of those efforts and their methods for obtaining them. All of this is entirely consistent with index funds' observed behavior. The importance of this phenomenon should be emphasized: The aggregation of vast sums of money in index funds has given index funds substantial voting power. Index funds'

189. Bebchuk & Hirst, *supra* note 2.
190. *Id*.
191. *See infra* Section I.C.

status as essentially commoditized financial assets means that they must seek a competitive edge where they can find it.

The remarkable result is that the most important shareholders in our economy are now beholden to the social values of the up-and-coming generation of investors. Decades ago, shareholders were so dispersed and ineffective that managers ran roughshod of their interests, whereas now we appear to be entering a world in which funds cannot only discipline managers, but that discipline must be responsive to the non-economic preferences of investors. In recent years, much ink has been spilled lamenting the relative dominance of the corporate world over our politics—the classic tension between Wall Street and Main Street. But the political polls are not the only ballot boxes: investors may now be waking up to the reality that, to a significant degree, while Wall Street can put a thumb on Main Street's political scale, Main Street controls Wall Street's proxy.

This development may reshape corporate governance. The market for index fund assets is fiercely competitive, and the big three are enormous. Index fund advisors have incentives to identify areas where investor preferences are strong and develop engagement campaigns focused on those areas. Other funds will feel pressure to follow suit or risk losing investors. Index fund social activism may be about branding, but it is not cynical or superficial. Rather, it is a response to a complex, but robust, set of economic incentives. It is the market for asset management, and the need to be responsive to Millennial values that motivates index funds.

Another reason that index funds will be the leaders here is that they have fewer conventional money management worries than investors that try to beat the market. Because index funds are largely indifferent to returns, they are better positioned to respond to the preferences of their investors without worrying about whether those preferences might negatively affect firm value. If pressing firms to conduct themselves in a socially responsible way is a drag on share price, that is of little consequence to index funds that sell only market-tracking performance in any case.

However, these incentives to be responsive to investor demands sit within a nexus of other pressures. The existing consensus on index funds' incentives is not incorrect, just incomplete: Index funds really do have incentives to avoid confrontation with management and underinvest in stewardship, and they do not benefit substantially from higher returns in their portfolio companies.[192] The fear of confronting management may explain index funds' more cautious approach to climate change so far. While Millennials care about both diversity and climate, the gender composition of a corporate board is a far less sensitive issue for most firms than their carbon footprint. Index funds intervene aggressively when the cost is low and tread lightly when it is not.

The current literature focuses on whether fund managers have incentives to invest in corporate governance to increase shareholder returns. As outlined in more detail in Section I.C, index fund incentives to invest in stewardship are limited.[193] First, even if an engagement improves returns, the improvement is likely to be quite small.[194] Second, increased returns inure to the benefit of all shareholders, but only the activist bears the cost.[195] Finally, there is also the threat of retaliation from corporate managers.[196] Thus, current literature on index funds argues that their activism will be minimal and focused on those cases in which it could generate high shareholder returns.

Our theory is a critical contribution to the literature because it explains observable fund behavior that otherwise remains puzzling. Current scholarship mostly focuses on the historical fact that index funds have remained passive. We do not challenge the historical view; we agree that, even today, funds remain passive across most of their portfolios with respect to most issues. But the existing literature, designed to explain the reticence of index funds, fails to explain the sharp move towards activism that we observe in certain areas by dismissing it as insignificant or by stressing that it is somehow anomalous or a quixotic departure from the norm. However, this move towards activism, though so far narrow in scope, is new, real, important, and a glimpse into the future. The existing literature's failure to

192. *See generally* Bebchuk & Hirst, *supra* note 2.

193. *Id.*

194. *Id.* at 2037 ("Index fund managers, however, are remunerated with a very small percentage of their assets under management and thus would capture a correspondingly small fraction of such increases in value. They therefore have much more limited incentives to invest in stewardship than their beneficial investors would prefer.").

195. *Id*. ("if stewardship by an index fund manager increases the value of a portfolio company, rival index funds that track the same index (and investors in those funds) will receive the benefit of the increase in value without any expenditure of their own.").

196. *Id.* ("we show that they have incentives to be excessively deferential—relative to what would best serve the interests of their own beneficial investors—toward the preferences and positions of the managers of portfolio companies.").

focus on it or explain it is rooted in the literature's historically narrow focus on returns alone. This new activism is not about returns, and it is therefore insufficient to try to explain it by focusing on returns. Millennial corporate governance is rooted in shareholder values, not shareholder value.

B. THE DYNAMICS OF INDEX FUND INCENTIVES: FIRST MOVER ADVANTAGE AND ESCALATING INTERVENTION

The most famous recent example of an index fund becoming a prominent first mover on a social issue was State Street Global Advisors' 2017 announcement of a new gender diversity voting policy in which it would vote against nominating committee chairs on boards that had no female directors.[197] In conjunction with this robust new policy, State Street also prominently unveiled the "Fearless Girl" statue on Wall Street.[198] Unveiled around the time of the Women's March, a protest against the election of Donald Trump, Fearless Girl rapidly became a cultural icon.[199] It obtained an enormous amount of overwhelmingly positive press coverage, becoming a tourist destination in lower Manhattan and the subject of countless social media posts.[200] It also introduced State Street and its voting policy to a new audience.

BlackRock and Vanguard were caught flatfooted by State Street's Fearless Girl marketing coup and its accompanying voting policy. There was little they could do to match that publicity, but now that State Street had so prominently raised the issue, they needed a response to answer to investors raising questions about where they stood on gender diversity. The answer quickly became, "we're doing more than State Street is." In 2018, BlackRock announced that it would vote against boards with fewer than two female directors, outdoing State Street's own policy targeting all-male boards.[201]

This literal one-upswomanship is enormously difficult to explain by focusing on returns alone. The data on gender diversity and returns is mixed

197. *See* Lubin & Krouse, *supra* note 60.

198. STATE STREET, *Fearless Girl*, *supra* note 70.

199. *See* Sapna Maheshwari, *Statute of Girl Confronts Bull, Captivating Manhattanites and Social Media*, N.Y. TIMES (Mar. 8, 2017), https://www.nytimes.com/2017/03/08/business/media/fearless-girl-statue-wall-street-womens-day.html.

200. *Id.*

201. *See* Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J., (Feb. 2, 2018), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407.

at best and the data on one woman versus two women on boards is virtually nonexistent given the small sample size. Moreover, there is no evidence that the kinds of active funds that might plausibly compete with the indexes were pushing this particular issue in this particular way. The diversity voting policies applied across a large swath of investees with doubtful links to high-value interventions.

Finally, and most importantly, if announcing a new policy on gender diversity really is traditional activism focused on maximizing returns, then why not free ride? Why shouldn't BlackRock tell its clients the good news that because State Street is bearing the cost of activism at the same firms BlackRock invests in, it can pass those cost savings along to the clients? Wouldn't that be the rational thing to do from the perspective of returns? Far from free riding, BlackRock is increasing its own costs to engage in activism and make it more extreme than that of competitors, and further adding to its own costs by advertising and promoting that activism. In our view, the standard literature cannot explain either State Street's initial move into this space or BlackRock's subsequent escalation. There is little evidence that adopting such a policy helps (or hurts) returns. Here, too, our thesis explains what the existing literature does not.

C. MILLENNIAL INVESTORS AS A COUNTERWEIGHT TO MANAGERIAL RETALIATION

Another traditional explanation for index fund passivity is the threat of management retaliation.[202] Public company employees' 401(k) retirement funds are a critically important revenue source for index funds, and managers of those companies have a crucial source of leverage over index fund investors: final say over which funds to offer on their 401(k) platforms.

Activism tends to alienate corporate boards and managers. By definition, managers work at the companies daily, they and their boards have access to inside information unavailable to investors, and they are often highly-skilled and accomplished people. They often see activism as a threat to their leadership and authority and believe themselves best positioned to decide, for example, who should sit on the board. Among diversified investors, index funds and mutual funds generally have been far more passive than public pension funds and labor union funds, which file many

202. Bebchuk & Hirst at 2037.

more shareholder proposals and are also significantly more litigious than their index fund peers. At least part of the explanation for that activism gap lies in the fact that public pension funds and labor union funds are not simultaneously trying to solicit business from the very companies where they engage in activist strategies. Unlike at pension funds and labor funds, boards and managers can retaliate against index funds by removing them from their 401(k) platforms or never adding them in the first place.

That threat of retaliation has at least partially explained mutual fund passivity as can be shown by actual evidence.[203] For the most part, we agree with the existing literature that the threat of managerial retaliation is real and induces index fund passivity. For example, index funds rarely, if ever, file shareholder proposals. In contrast to the diversity and environmental activism, they have been comparatively silent on the governance front, frequently voting in support of executive pay packages. (It is difficult to imagine a better way to trigger managerial retaliation than voting against its pay). That silence and passivity is ironic, given that as between E, S, and G, governance reform has the strongest claim to be value enhancing.

Given the hostility to activism and the threat of managerial retaliation, we need an explanation for why the funds have become so active on these particular topics. As already argued, we do not think it can be explained by returns. Simply put, we think the index funds have identified socially responsible investment as a means of inducing Millennials to save and attracting them as clients and the fear of missing out on managing the next generation's wealth exceeds the fear of managerial retaliation, driving the observable activism and explaining ongoing passivity in other areas. Index funds remain passive on other issues of less importance to Millennials and are only active where it counts.

Simply put, we think the funds' activism on diversity and the environment reflects a straightforward cost-benefit calculation. The threat of missing out on Millennials and being named a bad actor outweighs the threat of managerial retaliation. Of course, it is true that the same forces to which the funds are responding reduce the risk of managerial retaliation—an all-male board likely would not retaliate against an investment fund that pushed

203. *See* Rasha Ashraf, Narayanan Jayaraman & Harley E. Ryan, *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANTITATIVE ANALYSIS 567, 587 (2012).

it to hire a woman precisely because such retaliation could backfire against the company, triggering a Papa John's-like debacle. That likely gives the funds added comfort in staking out these activist positions.

Apart from competitive pressures, the funds' social activism may have another purpose: inducing Millennials to invest in the first place. To date, Millennials have put less money into retirement funds than preceding generations.[204] Connecting their social goals to saving for personal retirement may also be a way that the funds have identified, collectively, to speak to this new generation of investors and induce them either to begin saving for retirement, to increase their contributions to their retirement funds, or both. Put differently, the threat of management retalitation has eroded also because millennials are investing less in 401k and more in other ESG focuse investments.

D. THE PROMISES AND PITFALLS OF MILLENNIAL CORPORATE GOVERNANCE

In arguing that index funds are responding to the preferences of customers in advancing board diversity and—to a lesser extent—the mitigation of climate change, it is important to emphasize that we do not regard index funds' behavior as cynical or insincere. An equilibrium in which index funds feel genuine market pressure to respond to the values of their customers is likely a more robust and stable equilibrium than one in which fund managers simply happen to share those values. So long as index funds are backing their marketing with real, effective action, identifying funds' social activism as a matter of seeking new customers is not meant to diminish its importance. In a sense, attention to social issues from institutional investors on behalf of retail clients will simply add to the list of stakeholders to whom modern managers, especially those of public-facing firms, will have to attend to. As noted above, firms already face pressure from customers and employees to demonstrate their bona fides when it comes to salient social issues. The effect of the developing dynamic in the index fund market will be to add investors to the list of constituencies that care about these issues.

204. *See BlackRock, Wells Fargo Reportedly Preparing ESG Funds for 401(k) Plans*, *supra* note 175 ("About two-thirds of millennials have saved nothing for retirement, according to a National Institute on Retirement Security report in February.").

1. The Promise of Index Fund Social Activism

In our view, increased attention to social issues is likely to be a positive development in the sense that the assets of many small investors will effectively be mobilized to promote issues that those investors care about. When this activism is well-targeted and effective, the result will be a tendency for companies to exhibit behavior that is more consistent with the widely shared values of the investor class, if not society at large. While index funds do not internalize the costs of social activism that might decrease share prices, investors do, and socially conscious investors are in a position to trade off their values against their concerns about returns. Index funds' behavior should be expected to reflect this trade off as aggregated across their customer base, as modified by the additional incentives that index funds have to not upset corporate management. While the net effect of this is naturally speculative, one would expect a modest increase in socially responsible behavior, even when costly, across a large number of firms.

Index fund activism will also expand the list of companies giving attention to risks associated with salient social issues. It will come as no surprise—for example—that a large manufacturer of consumer goods must worry about the treatment of workers in its supply chain or risk consumer backlash, but companies in extractive industries or business-to-business firms have generally had less to worry about. The market-wide holdings of index funds mean that any large firm could conceivably have to address concerns about social issues coming not from the customer base, but from their beneficial owners.

One important observation is that these effects are likely to be cumulative. Firms are simultaneously facing new pressures from customers, employees, and now investors as well. Firms that are not generally consumer-facing are often part of a supply chain for firms that are. Social media has increased the pace at which issues of social concern can become rallying points for stakeholders. Witness the timeframe in which an incendiary political comment from a talk show host can lead to calls for an advertiser boycott, for example. Increasingly, engagement—even indirectly—in unpopular commercial activities will create business risk that will steer firms away from anti-social conduct.

2. The Pitfalls of Index Fund Social Activism

Index fund activism is not risk-free. The literature is correct in arguing that index funds have only weak incentives to be concerned about returns. So long as Millennials' preferences for social interventions reflect well-thought out trade-offs between issues of social concern and firm value, then index funds can be expected to mirror these preferences. But it may well be the case that some social preferences of Millennials will have a more negative effect on firm value than anticipated, or that their preferred social interventions will be poorly thought out or not actually achieve the ends they seek, even as they have negative effects on firm value.

The challenge of index fund social activism is that index funds have weak incentives to sort value-creating, worthwhile interventions from questionable ones that might nevertheless catch the popular imagination. While active funds might resist pressure to implement governance interventions that would be value-destroying while generating little public benefit, perhaps by proposing alternatives, index funds—given their incentive structure—may be more inclined to give investors what they want, even if it is ill advised. Given the power of index funds as shareholders, this is a potential concern.

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In our view, Millennial corporate governance is primarily a welcome development: investors' assets will be mobilized to achieve goals that those investors, collectively, find important. However, social activism is not without risks to social welfare, and corporate law scholars should be attentive to the potential problems discussed above.

VI. IMPLICATIONS

The effect of competition for Millennials' dollars on corporate governance is only beginning to be realized and is likely to evolve over time. At this point, much of what can be said is necessarily speculation. In identifying this important set of incentives, we hope to open a line of inquiry rather than have the final word on the matter. Nevertheless, it is possible to frame some of the important implications of Millennial corporate governance and provide a foundation for the debates to come.

In this Part, we discuss the normative consequences of index fund social activism. First, we discuss the implications for funds as corporate monitors.

We argue for a light regulatory touch when it comes to social activism, both from the Trump administration, which has attempted to rein in asset managers, and from those who advocate encouraging index funds to invest more in conventional corporate governance. Second, we discuss the implications for corporate law. While social activism as currently practiced can be accommodated within the existing framework of corporate law, the consequences of a base of shareholders pressing to promote social goals raises interesting questions about fiduciary duties.

A. IMPLICATIONS FOR INDEX FUNDS' STEWARDSHIP

It has been suggested,[205] as a result of index funds' weak incentives to invest in corporate governance, that index funds should not be permitted to vote as shareholders at all or that their votes should be mechanically linked to the votes of other non-management shareholders. The argument is that allowing large institutions with no economic stake in the shareholder votes to nevertheless sway the outcome will dilute the power of hedge fund activists and other share owners with real exposure to firm performance. In this provocative approach to solving the problem, index funds would simply be sidelined as important shareholders.

One of the contributions of our analysis is to throw into stark relief what would be lost with such an approach. If index funds are treated as non-entities when it comes to voting their proxy, then their social activism would have no leverage, except perhaps as a public advocacy. As described above, it was precisely State Street's and BlackRock's threat, backed by action, to vote against directors who did not show progress on gender diversity that pressed recalcitrant firms to act. Without the serious consequences of "no" votes for directors, it is not at all clear that firms would have responded to merely rhetorical pressure. After all, the lack of diversity has been a subject of discussion for years.

Another proposal to address index funds' perceived lack of governance diligence is to require index funds to pass through their voting rights to investors.[206] If index funds have poor incentives, then perhaps allowing investors to vote their own interests would solve the problem. This solution is perhaps more initially attractive in light of index fund social activism

205. Lund, *supra* note 3.

206. Lund, *supra* note 3, at 23.

because it would permit investors themselves to press their interests. In our view, though, handing proxies over to retail investors would be likely to greatly reduce the effectiveness of social activism campaigns because index fund shareholders would face a near-insurmountable collective action problem. One of the reasons that index fund social activism has been effective is that it has been focused on specific goals at specific times: State Street was able to make gender diversity *the* issue for boards in 2017, just as BlackRock is now pressing sustainability. By leveraging the full voting power of the fund to achieve a specific end, index funds are able to maximize their (and their investors') leverage. A pass-through voting arrangement would squander this advantage.

A number of options for increasing index funds' investment in stewardship have been suggested, including making index fund stewardship expenditures mandatory, passing through costs to investors, and prohibiting other business relationships with managers like managing 401(k) plans.[207] All of these reforms would make it easier for index funds to undertake costly shareholder oversight without disadvantaging themselves in a market that is extremely price sensitive as well as to reduce conflicts of interest that might stop them from challenging management. To be clear, these policies are meant to address the perceived underinvestment of index funds in stewardship with respect to traditional matters of shareholder value.

Our argument suggests that caution is warranted in regulating index fund stewardship. Funds' incentives are not as weak as they seem because funds have incentives to demonstrate governance diligence when such diligence is directly salient to investors. Since conventional matters of corporate governance are probably not salient, and in any case are subject to a substantial collective action problem, it is not unreasonable to think that a regulatory thumb on the scale is necessary with respect to some issues that investors are inattentive to. On the other hand, it is important to consider what the yardstick of effective stewardship should be. The evidence suggests that Millennials explicitly subordinate profits to other social values. This does not mean that sound corporate governance practices, in the traditional sense, are irrelevant to them, but it does mean that index fund stewardship should not be evaluated strictly with respect to its commitment to increasing share value. Indeed, corporate governance structures that press managers to

207. Bebchuck & Hirst, *supra* note 2, at 2118.

relentlessly pursue profits at the expense of social goals could be counterproductive for the interests of investors to whom both are important. As for regulations that would bar other business relationships with firms in index fund portfolios, eliminating this conflict of interest would make index funds more active on both conventional and social issues. Our contribution here is simply to point out that, at least with respect to social issues, the pursuit of Millennial investors is a counterweight to the threat of managerial retaliation.

We also object to the Trump administration's push against social activism, at least as applied to mutual fund investments.[208] While the guidance offered by the DOL was couched in terms of protecting investors by focusing asset managers on returns, our argument suggests that index fund social activism is undertaken precisely out of a desire to operationalize investors' preferences. In pressing funds to hew to the shareholder value maximization orthodoxy, the DOL is pressing funds to act contrary to their investors' preferences, and paradoxically couching that guidance in the language of fiduciary duty.

A lingering objection is that not all shareholders in index funds share Millennial values (needless to say, not all Millennials share them either), and there are surely many who might prefer a more conventional approach to corporate governance. Should we worry that their assets are being appropriated to press an agenda that they don't share? In our view, the appropriate venue to settle such disputes is the marketplace for assets. If social activism originates in the fierce competition among funds for assets to manage, then that market has every potential to solve any excesses that result. An investor genuinely chagrined at State Street's Fearless Girl campaign can simply move to another fund; they will find no shortage of options. If the big three fail to represent the aggregate preferences of investors, then new market entrants may seek assets offering different approaches to governance. Unless and until evidence of market failure arises, this new dynamic in the index fund market should be allowed to evolve.

208. Pension fund social activism is beyond the scope of this article, *but see* DAVID WEBBER, THE RISE OF THE WORKING CLASS SHAREHOLDER (2019) for a defense of activism in that context.

B. IMPLICATIONS FOR HEDGE FUND ACTIVISM

As discussed above, index funds have become the swing voters of hedge fund activism campaigns. Unlike index funds, hedge funds have huge monetary incentives to create value by intervening in corporate governance and can come and go as shareholders. The pressing question for hedge funds is whether the interventions they promote through their activist campaigns reflect long term value creation or merely a short term sugar-rush that lets hedge funds cash out while long term investors are left to clean up a long-term mess.[209] Since index funds are the quintessential long-term investor, they are well positioned to evaluate whether a proposed hedge fund intervention is a good idea. The problem is their weak incentives to invest much effort in making an informed decision. As a result, the suggested interventions in the current literature, outlined in the foregoing Part, are aimed at increasing their incentive to evaluate campaigns.

Understanding index funds' incentives to demonstrate adherence to a particular set of social values, though, provides new insight into index funds' approach to hedge fund activism. Many, though by no means all, interventions undertaken by hedge funds may create tension with the social goals of Millennials. Hedge funds may advocate plan closures, layoffs, outsourcing, offshoring, and automation. There is evidence that much of the value created by hedge funds for shareholders reflects wealth transfers from labor.[210] Under pressure to keep stock prices high to stave off activist campaigns, firms may be likely to slide on the longer-term values of environmental responsibility, sustainability, and workforce relations.

Index funds' incentives to court Millennials may induce them to resist hedge fund campaigns that create tension with those values. For example, BlackRock's public commitment to sustainability may well be aimed at putting certain types of hedge fund activists on notice that they should not expect BlackRock's support. It is of course difficult to attribute an index fund's decision to oppose a hedge fund activist campaign to a particular cause, but that is precisely our point: If commentators are not attentive to index funds' incentives toward social values, then opposition to hedge fund activism that is rooted in those values may be interpreted as pro-management bias instead. This would mistakenly create the impression that index funds

209. Barzuza and Tally.
210.

are asleep at the switch when in reality, they are acting to vindicate investors' interests, just not to maximize shareholder value.

C. THE CHALLENGE TO THE SHAREHOLDER VALUE PARADIGM

So far, index funds' activism around social values has been couched in the language of shareholder value, particularly in communications with management. State Street and BlackRock both cited an alleged consensus of research when launching their gender diversity campaigns, and action on environmental issues is framed in terms of investment risk. Their marketing is a different story: the Fearless Girl is standing defiantly, not holding a piggy bank. In fact, with respect to gender diversity in particular, our thesis is that index fund activism reflects a sincere commitment to social values, while the claimed profit motive is more tenuous. To be sure, our claim is not that index fund social activism cannot be defensibly framed in terms of value creation, the evidence is legitimately ambiguous at this point, but rather that shareholder value is not the true motivation. Put differently, if the empirical evidence mounted that firms that diversified boards in response to the Fearless Girl had measurable declines in stock price, would we expect the big three to reverse their demands?

But what is the consequence for corporate law when the largest shareholders internalize other values alongside profit maximization? Since the beginning of the corporate governance literature, the touchstone of good governance has been value-creation as measured by share price. Hundreds, if not thousands, of papers have used "Tobin's Q", stock price adjusted by firm book value, as the key measurement of effective governance. This method of thinking is so ingrained into our thinking about firms that even the most hotly contested debates over features of firm governance internalize value-creation as the appropriate metric.

The maximization of shareholder value is etched into law as well. There is of course *Dodge v. Ford*'s[211] language that:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself…

211. Dodge v. Ford Motor Company, 204 Mich. 459 (Mich. 1919).

The case is often cited for the proposition that boards and managers have a legal obligation to maximize shareholder value.[212] Similar language in the Delaware case *eBay v. Newmark* highlights the obligations of directors there:

> Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.[213]

Dozens of other decisions make similar assertions.

Nothing currently proposed or on the horizon for index fund social activism risks running afoul of corporate fiduciary duties, at least as a matter of creating liability. The business judgment rule gives blanket protection to any decision that can be framed, in good faith, as linked to shareholder value. Indeed, both *Dodge v. Ford* and *Newmark* are unique in that the defendants steadfastly refused to assert that their decisions were motivated by shareholder value when such assertions would have been at least facially plausible and the mere assertion of such reasons would have placed their decisions within the protection of the business judgement rule.

Nevertheless, when shareholders have sincere commitments to social values that may be in tension with profit maximization, the notion that the purpose of the corporation is to maximize profit comes under stress. Note the language in the quotations above: "for the profit of the stockholders" and "promote the value of the corporation for the benefit of its stockholders." In each case, the court treats the claim that *the firm is run for the benefit of the shareholders* as implicitly equivalent to the claim that *the firm must be run to profit the shareholders*. However, if the goals of shareholders incorporate values other than profit, then the latter does not follow automatically from the former.

As it happens, Delaware and other states have a corporate form that is designed to incorporate other goals. Public benefit corporations[214] are a specialized variant of the corporation that, while still for-profit, "is intended

212. Whether the case actually demands this reading is disputed. *See* LYNN STOUT, THE MYTH OF SHAREHOLDER VALUE: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

213. Ebay Domestic Holdings v. Newmark, 16 A.3d 1, 34 (2010).

214. Del. Gen. Corp. L. 361 et seq.

to produce a public benefit or public benefits and to operate in a responsible and sustainable manner…A public benefit corporation shall be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation."[215] Unsurprisingly, Millennial-focused brands like Warby Parker and New Belgium Brewing are organized under public benefit corporation laws. No large public companies are organized as benefit corporations, though, and critics of index fund social activism might argue that it is therefore inappropriate to press these companies on social issues. Such an argument would effectively use the availability of the benefit corporation form as a cudgel to argue that conventional corporations must maximize profits. However, this is a misreading of the role of benefit corporations in the legal framework. To become a benefit corporation requires a supermajority vote, and for a benefit corporation to be acquired by an ordinary corporation also requires a supermajority vote. The benefit corporation form is essentially a takeover defense for firms that are consciously not value-maximizing and therefore might be vulnerable to activism aimed at increasing profits by abandoning their public mission.

The notion that a corporation ought to give attention to the social values of its investors, particularly when the value impact is ambiguous, is far different than consciously subordinating profit to a public mission. The latter is far removed, not just from the current state of index fund social activism, but from anything on the horizon. Our argument is simply that the proper way to settle debates over the goals of an ordinary corporation, at least so long as those goals qualify for the protection of the business judgment rule, is through the shareholder franchise. Investors seeking increased recognition of social goals in an ordinary, for-profit firm ought to be free to press their case and vote for managers who are sympathetic to those goals and those seeking shareholder value maximization can do the same. Neither regulators nor judges need to settle the issue of what it means to run a corporation "for the benefit of its stockholders."

As a final point, it is worth distinguishing the dynamic we identify from existing rivals to the shareholder value account of corporate law. Many states have "other constituency" statutes that allow managers to consider the

215. Del. Gen. Corp. L. 361.

interests of non-shareholders when making certain decisions. In Delaware, the *Unocal*[216] case permits firms facing a hostile takeover to consider its impact on non-shareholders, including the "community generally."[217] The stakeholder theory of the firm similarly pushes back against the notion of shareholders as the sole beneficiaries of the corporate form.[218] However, each of these alternatives to shareholder value maximization subordinates the interests of shareholders to some other goal or constituency. Indeed, the subtitle of professor Stout's book on the subject[219] is "How Putting Shareholders First Harms Investors, Corporations, and the Public."

Millennial corporate governance centered on shareholder values is subtly different than an "other constituency" account of running the firm. In index fund shareholder activism, shareholders are still the most important constituency, but it is not assumed that share value is the only value they care about. In this sense, this is a more conventional take on corporate governance than some of the extant alternatives. Nevertheless, a shareholder-centric theory of corporate law that incorporates social values—an "other values" rather than "other constituencies" approach—deserves deeper theorization.

VII. CONCLUSION

The ongoing debate over index funds' purported lack of activism has overlooked the dramatic ways in which index funds are, in fact activist. Index funds are outspoken leaders on social issues. But more important than the fact of index funds' social activism is the reason behind it: index funds face immense pressure from the next generation of investors to demonstrate commitment to the social values that Millennials have already shown are important to them. Given the fierce competition among the big three and the stakes of winning over the new generation of investors, these pressures are likely only to increase. The issue of social values in investment management and corporate decision making cannot be ignored. In integrating the phenomenon of index fund social activism into the larger debate over index funds as shareholders, we hope to begin the conversation regarding this new era in corporate governance.

216. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

217. *Id.* at 955.

218. Margaret M. Blair and Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248 (1999).

219. Stout, THE MYTH OF SHAREHOLDER VALUE, *supra* note 212.