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Giant Asset Managers, the Big Three, and Index Investing

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Center for Law and Social Science
Research Paper Series No. 23-13

March 31, 2023

Electronic copy available at: https://ssrn.com/abstract=4406204

Giant Asset Managers, the Big Three, and Index Investing

Dorothy Lund & Adriana Z. Robertson***

March 31, 2023

Abstract

A robust literature describes the incentives and stewardship practices of the "Big Three" asset managers (BlackRock, Vanguard, and State Street Global Advisors), often referring to these asset managers as "passive." This is so common that the "Big Three," "index fund," and "passive manager" are used almost interchangeably by both academics and practitioners. This shorthand emerged in the foundational scholarship in this area, and while they may remain useful in certain contexts, their casual use obscures important features of the market and contributes to misperceptions. In this chapter, we demonstrate that it is a mistake to equate passive investing with index funds; index funds with the Big Three; and the Big Three with giant asset managers.

Although they are major providers of index funds, the Big Three asset managers also control trillions of dollars in actively managed funds and differ substantially from one another in important ways. The Big Three are also not the only giants on the Street; to take just one example, Fidelity's growth over the last few years makes it hard to justify overlooking its role in corporate governance. Finally, the conflation of index fund with either the Big Three or "passive" obscures the fact that many index funds are sold by non-Big Three asset managers, as well as the enormous heterogeneity across index funds. All of this affects incentives to monitor and engage in stewardship. We sketch some of the consequences of these distinctions and set forth questions for further research.

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We thank Luca Enriques, Jill Fisch, Giovanni Stampelli, and Michael Younis for valuable suggestions and discussions. This article has benefited from comments by workshop participants at the 2022 Rome Corporate Governance Conference. Khadijah Omerdin and James Robertson provided exceptional research assistance. All errors are our own.

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INTRODUCTION

Within the world of corporate governance, there has hardly been a more important recent development than the rise of the "Big Three" asset managers—Vanguard, State Street Global Advisors, and BlackRock. Due to the popularity of index funds and ETFs, these asset managers have enjoyed steady inflows over the past decade and now represent some of the largest owners of U.S. public companies. As of 2021, the average combined stake in S&P 500 companies held by the Big Three was 21.9%, a proportion that has been steadily increasing for the last two decades.[1]

Because of their size and influence, a robust scholarly literature has identified the promises and perils of Big Three ownership. For example, some scholars have focused on potential advantages of large "universal owner" shareholders that exercise substantial influence over the market;[2] others have voiced concerns about antitrust problems[3] and stewardship challenges that can arise when the largest corporate owners are broadly diversified passive owners.[4] In this book chapter, we do not weigh in on the substance of these debates; our task is simply to identify a series of proxies, or shorthand terms, that first appeared in the foundational works in this literature. We further show how this shorthand, which has become commonplace in both scholarly articles and the financial press, can contribute to misperceptions and confusion.

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[1] Lucian Bebchuk & Scott Hirst, *Big Three Power, and Why It Matters*, 102 BOS. U. L. REV. 1547, 1556 (2022).
[2] *See* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2019); Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022).
[3] *See* Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 673 (2017); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291-92 (2016); *but see* Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (N.Y.U. L. & Econ. Rsch. Paper Series, Working Paper No. 17-05, 2017); José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).
[4] *See* Dorothy S. Lund, *The Case Against Passive Shareholding*, 43 J. CORP. L. 493 (2017); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 95 (2017).

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The first shorthand is the use of the term "Big Three" to refer to three distinct asset managers.[5] Each of the Big Three manage vast amounts of money in indexed products—amounts that have grown dramatically thanks to the rising popularity of index-based investing. However, there are important differences between them, both in terms of the composition of the assets they manage and their own institutional structure and operations. As such, it does not always make sense to lump these institutions together. The focus on these three institutions has also limited scholarly focus in important ways. For example, the term excludes Fidelity, even though it is larger than State Street in terms of AUM[6] and has also benefitted from a steady inflow of investor funds over the past several years.

The second shorthand is to equate the Big Three with "passive" funds. This misperception is widespread, with many papers—including prior work by one of us[7]—studying the Big Three's governance practices to better understand the incentives of passive fund managers.[8] Although this shorthand can be useful under certain circumstances, we show that it has important limitations. After all, each of the Big Three also manage large amounts of active money, and the index funds that they offer are themselves far from homogenous.

This brings us to the final shorthand—the idea that "index funds" are all passive and interchangeable. We explore the limitations of this shorthand by showing that the concept of "passive investing" is undertheorized, and that there is ample diversity across index funds. In other words, just as there are closet indexers, or active funds that are really quite "passive,"[9] index funds vary dramatically in terms of the discretion that is awarded to—and used by—portfolio managers, the fees that are levied, and the trading strategy that is used. As such, the active/passive dichotomy that is used both by scholars and portfolio managers to market their mutual funds obscures important features of this market.

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[5] While we critique the casual use of the term "Big Three" in this chapter, we nonetheless use the term throughout because of its ubuqity in the literature, while also highlighting its limitations in Sections I.A and II.A.

[6] *See* Leo E. Strine, Jr., *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 (2020) (describing the Big Four).

[7] *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4.

[8] *See infra* Section II.

[9] *See* Martijn Cremers & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay For? The Legal Consequences of Closet Index Funds* (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2695133.

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The final section of our chapter discusses the implications of these observations for future scholarship. Taken together, they shed light on conversations about how the rise of "passive" investing affects corporate governance. Beyond scholarly relevance, these observations matter for policymakers seeking to respond to these market developments with legislative action. For example, the INDEX Act, a bill recently introduced in the Senate, would require investment advisers to pass through the votes of "passively managed funds," defined as any fund that tracks an index or discloses that it is a passive fund or index fund.[10] As we show, this definition sweeps "closet active" funds under its umbrella.

Our analysis also sheds light on other pressing corporate governance conversations, and in particular, those about the growth and appropriate role of large asset managers. Our last section charts these implications in further detail and highlights questions for future research.

I. THE SHORTHAND

In this Part, we introduce the pervasive shorthand used by scholars studying mutual funds. First, scholars generally focus on "the Big Three" when studying large asset managers. In doing so, they tend to treat these three entities as a homogeneous block while simultaneously overlooking other important players. Second, scholars generally refer to the Big Three asset managers as "passive" investors, even going so far as to use their practices as a stand-in for the incentives of index funds more generally. Finally, scholars have treated all index funds as "passive" and homogenous. Together, the second and third shorthand have led to concerns about the stewardship practices of index fund managers, and in particular, the idea that they are likely to underinvest in stewardship and monitoring of portfolio companies.

A. The Focus on the Behavior of "the Big Three"

A first common shorthand involves the use of the term "the Big Three" to describe three asset managers: Vanguard, BlackRock, and State Street. As money poured into the index funds offered by these managers, academic attention turned towards these three institutions in the latter part of the 2010s. Professors Lucian Bebchuk, Alma Cohen and Scott Hirst made an early contribution to this literature,

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[10] INDEX Act, S. 4241, 117th Cong. (2d Sess. 2022).

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pointing out that collectively, the Big Three dominated the index fund market.[11] A large literature focusing on the Big Three—more or less to the exclusion of other asset managers—followed, which often treated these three institutions as a homogenous block. For example, scholars often describe the Big Three's size, and therefore its governance power, in the aggregate. They have pointed out that the Big Three (1) constitute the largest owner of most S&P 500 companies,[12] (2) collectively cast an average of 25% of the votes at S&P 500 companies,[13] (3) can together determine the outcome of most shareholder proposals at Fortune 250 companies,[14] and (4) will someday cast a majority of the votes at public companies.[15]

Much of the literature also seems to operate with the implicit assumption that the Big Three operate in identical competitive environments, and with identical governance practices. Consider, for example, statements suggesting that the Big Three employ "centralized voting strategies."[16] While this statement holds true for some of the funds within each institution's fund family, it is not universal.[17] And of course, the voting strategies are not the same across these asset managers.[18]

Or consider suggestions that "[t]he Big Three exist in a super competitive industry with extremely low management fees," rendering them unlikely to invest in stewardship.[19] There is no doubt that this is true for some of the products offered

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[11] Bebchuk et al., *The Agency Problems of Institutional Investors*, *supra* note 4, at 94. *See also* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298 (2017) for a roughly contemporaneous piece describing the rise of these asset managers.

[12] *See, e.g.*, Fichtner et al., *supra* note 9; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4.

[13] *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 BOS. U. L. REV. 721 (2019).

[14] *See* Caleb N. Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals*, 73 SMU L. REV. 409 (2020).

[15] *See supra* note 9.

[16] Fichtner et al, *supra* note 9; *see also* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4.

[17] *See infra* Section II.A.

[18] *See infra* Section II.A; *see also* Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* (European Corp. Governance Inst. Working Paper Series L., Working Paper No. 560/2020, 2020).

[19] Bernard S. Sharfman, *Looking at the 'Big Three' Investment Advisers Through the Lens of Agency*, OXFORD BUS. L. BLOG (Feb. 18, 2022), https://www.law.ox.ac.uk/business-law-blog/blog/2022/02/looking-big-three-investment-advisers-through-lens-agency.

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by each of the three asset managers, but there also important differences in the products they offer and the markets they serve.[20] Collapsing them into a single aggregate "Big Three" misses these important differences.

Perhaps an even more significant consequence of this shorthand is the intense scholarly interest and focus that has been devoted to the governance practices employed by BlackRock, State Street and Vanguard. While this focus has been extremely fruitful, it also means that other large asset managers have been largely overlooked.[21] This, in turn, has insulated important players outside of the Big Three from academic and regulatory scrutiny. We return to these consequences in Section II.A.

B. Index Funds and the Big Three

A second shorthand is to equate the Big Three with "passive" investment. More specifically, because the Big Three dominate the market for index funds in terms of assets under management, the terms "the Big Three" and "passive" or "index funds" have come to be used interchangeably.

Consider the following examples. First, in their influential paper, "Index Funds and the Future of Corporate Governance," Professors Lucian Bebchuk and Scott Hirst state: "We [] provide an empirical analysis of the full range of stewardship activities that index funds do and do not undertake, focusing on the three largest index fund managers, which we collectively refer to as the 'Big Three.'"[22] In a contemporaneous paper, one of us examined the Big Three's stewardship practices and concluded that these "largely passive institutions" were not active participants in governance.[23] Similarly, in their important response to these papers, Professors Edward Rock and Marcel Kahan "provide a systematic analysis of the incentive and information structures within which advisers to index funds operate" by studying the Big Three, their structure, and their governance practices.[24] In another thoughtful response, Professors Jill Fisch, Assaf Hamdani, and Steven Davidoff

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[20] *See infra* Section II.B.
[21] One notable exception to this is Leo Strine, who has argued that Fidelity should be considered alongside these other large asset managers. *See supra* note 5.
[22] Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, *supra* note 4, at 2030.
[23] Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4, at 515.
[24] Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B.U. L. REV. 1771, 1771 (2020).

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Solomon introduce a theory of passive fund incentives, and "demonstrate that the behavior of passive investors is consistent [with it]" by focusing on the stewardship practices of the Big Three.[25]

Like all shorthand, the use of "the Big Three" and "passive" or "index funds" as synonyms can sometimes be useful. But what began as a benign linguistic choice has had meaningful consequences for scholarship. First, it has contributed to the (incorrect) assumption, discussed in the previous section, that the institutions that make up the Big Three are homogenous and largely interchangeable. And second, when later scholars analyzed whether the Big Three's voting policies were consistent with the preferences of their investors, their focus has been on whether any given policy is consistent with a broad-based indexing strategy, not on whether it is consistent with their investors' actual preferences, or even their holdings.[26]

A related consequence of this shorthand is that scholars and policymakers considering how the Big Three should discharge their duties to investors often begin from the premise that the assets in question are broadly diversified index funds.[27] This, in turn, has motivated academics and advocates[28] to push the Big Three to pursue stewardship policies tailored towards an investor who owns the entire market.[29] For example, Professor Jeffrey Gordon has eloquently argued that the Big Three should pursue "systematic stewardship," which entails urging portfolio companies to reduce systematic risk consistent with "the investment

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[25] Jill Fisch, Asaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 43 (2019).
[26] *See, e.g.*, Caleb Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals*, 73 SMU L. REV. 409, 439 (2020) (arguing that "the Big Three's voting behaviors speak for themselves and in ways that are very likely to conflict with the views and values of their alleged principals" of index fund investors).
[27] BlackRock, Inc., *Rule 14a-8 Proposal – Public Benefit Corporation Request*, THE SHAREHOLDER COMMONS (Dec. 8, 2020), https://theshareholdercommons.com/wp-content/uploads/2021/02/BLK-Proposal-PBC.pdf ("These costs matter to our shareholders, the vast majority of whom are diversified."); *From Alpha to Beta: BlackRock and the ABCs of Sustainability*, THE SHAREHOLDER COMMONS (Jan. 2020), https://theshareholdercommons.com/from-alpha-to-beta-blackrock-and-the-abcs-of-sustainability/ ("To see why this is so, consider a typical BlackRock client, such as a pension fund or 401(k) investor: they are almost certainly invested in broadly diversified portfolios."); Gordon, *supra* note 2; Condon, *supra* note 2.
[28] *Id.*
[29] Gordon, *supra* note 2; Condon, *supra* note 2; John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (European Corp. Governance Inst. Working Paper Series L., Working Paper No. 541/2020, 2021).

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theory behind the creation of maximally diversified portfolios."[30] This shorthand becomes even more consequential when coupled with the third shorthand—that all index funds are passive and essentially identical. We turn to this shorthand now.

C. Passive Investing and Index Funds

Just as the Big Three have come to be equated with index funds, index funds have long been equated with passivity, and scholars often treat all index (or passive) funds as interchangeable with every other index (or passive) fund. Indeed, this shorthand is so entrenched that the terms "index fund" and "passive fund" are used interchangeably, to the point of being treated as synonymous.[31] Indeed, some scholars have even coined a new term—"passive index funds"[32]—which again represents the ubiquity of the idea that index funds are universally passive.

This perception starts from the premise that index funds and ETFs follow a low-cost investment strategy that involves tracking a broad market index as closely as possible and very little else. Accordingly, scholars employ the term "passive" in two separate (but related) ways: to say something about the fund's trading strategy, and to suggest something about the fund manager's involvement in corporate governance as a consequence of this trading strategy.

The leap from trading strategy to governance strategy occurs as follows. Because a "passive" fund's investors just want the fund to track the market (as opposed to trying to beat the market) as cheaply as possible, index fund managers get no benefit from investing in corporate governance. This, in turn, causes them to be "passive" monitors of their portfolio companies. We unpack this chain of reasoning in the next Section.

Combined with the first two, this shorthand has contributed to the common perception that the business model employed by the Big Three investors[33] is

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[30] Gordon, *supra* note 2, at 632.

[31] *See, e.g.*, Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803 (2018); Michael Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020); Jill Fisch et al., *supra* note 23.

[32] *See* Strampelli, *supra* note 29; Fichtner et al., *supra* note 9; *but see* Pat Akey, Adriana Robertson & Mikhail Simutin, *Closet Active Management of Passive Funds* (Univ. Toronto – Rotman Sch. Mgmt. Working Paper Series, Working Paper No. 3874582, 2021).

[33] Note that implicitly, this assumes that all three have *the same* business model, which is an echo of the first shorthand discussed in Section I.A.

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incompatible with informed and engaged stewardship of portfolio companies. That observation, in turn, has also led to legislative action. To take a prominent example, the press release supporting the INDEX Act, which would require investment advisers to pass through votes associated with a "passively managed fund,"[34] states that "because [] passive funds exist to track broad swaths of the market, the asset advisers are not truly invested in the governance or success of the hundreds or thousands of portfolio companies."[35]

Academics contributing to the common ownership literature, for their part, have taken this shorthand in a different direction: If the Big Three invest in broadly diversified portfolios that approximate the market, the thought goes, they have an incentive to use their governance rights to push companies to act anticompetitively. For example, a recent paper by Professor Jose Azar that charts the rise of passive investing and the Big Three and concludes that "[i]n an economy in which everyone holds the market portfolio, all companies have the same shareholders. If, in addition, firms act in the interest of their shareholders … the equilibrium outcome is equivalent to an economy-wide monopoly."[36] We return to this conversation in Section III.B.

II. THE REALITY

In this Part, we show that this shorthand misses important facts about the investing ecosystem. This is not to say that there are no circumstances under which this shorthand can be useful, only thatit must be used thoughtfully. Moreover, as we discuss in Part III, the ubiquity of shorthand in the passive investing literature has had important consequences for academic scholarship and policy. Before turning to those consequences, we demonstrate the ways in which shorthand paints an incomplete picture of the mutual fund investment ecosystem.

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[34] Under the bill, "passively managed fund" is defined as a fund that "(A) is designed to track, or is derived from, an index of securities or a portion of such an index; (B) discloses that the qualified fund is a passive fund or an index fund; (C) allocates not less than 40 percent of the total assets of the qualified fund to an investment strategy that is designed to track, or is derived from, an index of securities or a portion of such an index; or (D) discloses that an allocation described in subparagraph (C) follows an investment strategy that is passive or based on an index of securities." INDEX Act, S. 4241, 117th Cong. (2d Sess. 2022).
[35] Press Release, INDEX Act, Dan Sullivan – U.S. Senator for Alaska (May 2022), https://www.sullivan.senate.gov/imo/media/doc/DCGA_051722.pdf.
[36] José Azar, *The Common Ownership Trilemma*, 87 U. CHI. L. REV. 263, 263 (2020).

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A. The Focus on the Big Three Misses Important Features of the Market

The first shorthand is the common tendency to use the term "Big Three" when describing three distinct asset managers. This use leads to both improper lumping and incorrect slicing.[37] First, it has led commentators to lump BlackRock, Vanguard and State Street together without paying enough attention to important differences between the three asset managers. Second, it has caused scholars to carve the Big Three off from the rest of the market, and thereby overlooking or downplaying the role of other large asset managers.

We begin with the second of these observations. While it is indisputably true that each of BlackRock, Vanguard, and State Street manage mindbogglingly large amounts of investor money ($10T, $8.5T, and $4.1T, respectively),[38] they are far from the only game in town. Fidelity, for example, manages more capital than State Street (and even more capital in "passively managed" domestic equity mutual funds than State Street),[39] yet it receives only a fraction of the attention of the Big Three.

To be sure, not everyone has overlooked this reality. For example, Leo Strine, Jr. has included Fidelity in what he termed "the Big Four."[40] But our main point is not that the term "Big Four" should be used instead of the "Big Three," nor is it to propose a particular universe of giant asset managers that ought to be included on the list. The point is that a shorthand term (like the Big Three, or the Big Four, or something else entirely) might make sense at some point in time for some particular purpose, but given the dynamic nature of the market, any such term needs to be evaluated to ensure that it fits the particular context.

There are also important differences between these three (or for that matter, four) asset managers. Depending upon the particular context, these differences could have first order consequences. Take, for example, their ownership and corporate structures. Far from being homogeneous, these four entities are different in ways that can have important consequences for their approach to money management and corporate governance. It is noteworthy, in our view, that a literature that focuses on the effect that ownership structure can have on corporate

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[37] *See* LEE ANNE FENNELL, SLICES AND LUMPS: DIVISION AND AGGREGATION IN LAW AND LIFE (2019).
[38] *See infra* Table 1.
[39] *See infra* Table 1.
[40] *See* Strine, *supra* note 5.

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behavior at the portfolio company level has largely ignored the ownership structure at the *asset manager* level.

BlackRock is, in some ways, the asset manager with the simplest (and most transparent) corporate structure. While Larry Fink, its current CEO and one of its seven founders[41] is often treated as the personification of BlackRock,[42] BlackRock Inc. is a public company (and indeed, the only public company of the Big Three),[43] whose stock trades on the NYSE.[44] As of August 3, 3022, Fink owned about .3% of the company's stock.[45] While there is no doubt that Fink plays an important role at BlackRock, it is fair to say that BlackRock is subject to the ordinary mechanisms of corporate governance at large public companies. For example, it has many other large owners—including fellow members of the large asset manager club. As of December 31, 2021, the top 5 owners of BlackRock were: The Vanguard Group, Inc. (7.8%), BlackRock Inc (6.5%), Capital World Investors (5.0%), State Street Corp (4.2%), and Temasek Holdings Ltd. (3.28%).[46] In aggregate, institutions represent over 75% of the asset manager's owners.[47] As is to be expected for a large public company,[48] BlackRock's governance structure is conventional—the company has only a single share class, lacks a staggered board, utilizes majority voting for director elections, and has instituted proxy access for shareholders.[49]

State Street Global Advisors is a wholly-owned subsidiary of State Street Corporation ("State Street Corp."). While State Street Corp. is itself a public

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[41] *Larry Fink*, BLACKROCK, https://www.blackrock.com/corporate/about-us/leadership/larry-fink#:~:text=Laurence%20D.,in%20investment%20and%20technology%20solutions (last visited Dec. 23, 2022).
[42] *See, e.g.*, Yun Li, *BlackRock's Larry Fink, who oversees $10 trillion, says Russia-Ukraine war is ending globalization*, CNBC (Mar. 24, 2022), https://www.cnbc.com/2022/03/24/blackrocks-larry-fink-who-oversees-10-trillion-says-russia-ukraine-war-is-ending-globalization.html.
[43] BlackRock, Inc., Annual Report (Form 10-K) (February 25, 2022).
[44] *Id.*
[45] Authors' calculations based on BlackRock, Inc., Statement of Changes in Beneficial Ownership (Form 4) (Aug. 5, 2022) and BlackRock, Inc., Quarterly Report (Form 10-Q) (Aug. 5, 2022).
[46] Authors' calculations made using Thomson Reuters Institutional (13f) Holdings - s34 Master File, obtained through the Wharton Research Data Service (WRDS) on August 18, 2022. We recognize the limitations of relying on 13F filings for empirical research. Nevertheless, we believe that this is broadly informative for our limited purposes.
[47] *Id.*
[48] *See* Dorothy S. Lund, *In Search of Good Corporate Governance*, 131 YALE L. J. FORUM 854 (2022).
[49] BlackRock, Inc., Definitive Proxy Statement (Form DEF 14A) (Apr. 9, 2020).

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company[50] (which like BlackRock, counts the typical set of large asset managers as its major shareholders[51]), it is not an ordinary operating company. Instead, it is a financial holding company regulated under the Bank Holding Company Act of 1956,[52] and has been designated as a SIFI by the FSOC and a G-SIB by the BIS.[53] As a consequence of this, State Street Corp. is subject to extensive regulation by a variety of federal regulators, most notably the Federal Reserve. These include both prudential regulation and activity restrictions, which can, in turn, affect the business of the subsidiary, State Street Global Advisors. For example, in its most recent 10-K, State Street Corp. disclosed that "Volcker Rule compliance entails both the cost of a compliance program and loss of certain revenue and future opportunities" for State Street Global Advisors.[54]

Fidelity, for its part, is a privately held, family controlled company. For these reasons, it does not make the same public disclosures about its corporate governance as would be required of a public company. For example, while its website foregrounds its commitment to its customers, it provides very little detail about its ownership structure or governance. Notwithstanding this, some basic facts about it have been widely reported in the financial press. These include the fact that the company continues to be controlled by the Johnson family, which owns 49% of the company through a combination of individual ownership and family trust ownership.[55] The remaining 51% is owned by employees of the company.[56] Fidelity divides its voting shares into two classes—Series B (held by the family, subject to a voting agreement under which all shares will be voted in accordance with the

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[50] *See e.g.* State Street Corp., Annual Report (Form 10-K) (Feb. 17, 2022).
[51] As of December 31, 2021, the top 5 owners of State Street Corp were: The Vanguard Group (9.7%), BlackRock Inc (7.7%), Dodge & Cox (6.4%), T. Rowe Price Associates, Inc. (6.2%), and State Street Corporation (5.3%). In total, institutional investors held almost 94% of its shares. Authors' calculations. Based on Thomson Reuters Institutional (13f) Holdings - s34 Master File, *supra* note 44.
[52] State Street Corp., Annual Report (Form 10-K) 10 (Feb. 17, 2022).
[53] Id at 39.
[54] *Id.* at 16-17.
[55] Fidelity Advisor Series VII and Fidelity Select Portfolios, Definitive Proxy Statement (Form DEF 14A) (March 18, 2013).
[56] *Profile – Fidelity Investments*, FORBES, https://www.forbes.com/companies/fidelity-investments/?sh=6c6e105f370a (last visited Dec. 23, 2022).

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majority[57]), and Series A (held by non-family employees). The current CEO, Abigail Johnson, is the granddaughter of the company's founder.[58]

Vanguard's corporate structure is different still. Like Fidelity, the company is privately held, but it is "structured as a client-owned company….The company is owned by its funds, which are then owned by the shareholders."[59] The ownership structure is divided in proportion to a fund's share of Vanguard Group Inc's "aggregate assets and share in the total expenses incurred by the funds in their operations;" therefore, if a fund represents 1% of the aggregate assets, then it would own 1% of Vanguard Group's shares and assume 1% of operating expenses.[60] The company has suggested that this structure insulates it from conflicts of interest because it need not cater to outside shareholders.[61]

Beyond these institutional differences, each asset manager structures its governance practices and procedures in different ways. Although each institution has a centralized corporate governance group, these groups are composed of different professionals with different backgrounds and areas of expertise. Moreover, the degree of centralization varies by institution—for example, Fidelity delegates voting responsibilities of its index funds to its subadvisor, Geode.[62] Substantively, there is variation between each asset manager in terms of its

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[57] Fidelity Advisor Series VII and Fidelity Select Portfolios, Definitive Proxy Statement (Form DEF 14A) (March 18, 2013).
[58] Kris Frieswick, *Who's Afraid of Abby Johnson?*, BOS. MAG. (Aug. 7, 2018), https://www.bostonmagazine.com/news/2018/08/07/abby-johnson-fidelity/.
[59] *Who Owns Vanguard?*, https://investor.vanguard.com/investor-resources-education/news/who-owns-vanguard#:~:text=Unlike%20other%20investment%20management%20companies,30%20million%20Vanguard%20investors%20worldwide.
[60] John C. Bogle, Remark, *A New Order of Things—Bringing Mutuality to the "Mutual Fund"*, 27 REV. BANKING & FIN. L. 471, 473 (2008).
[61] However, longstanding claims that the company operated without a profit component and at an "at-cost basis" were dropped in response to litigation. Joseph N. DiStefano, *Vanguard SEC Filings Drop "At-Cost," "No-Profit" Claims that Were Dear to Late Founder John Bogle*, Philadelphia Inquirer (Feb 7, 2019) ("Indeed, company officials acknowledge that it is a for-profit company that earns profits and pays income taxes.").
[62] *See* Hortense Bioy, Jose Garcia-Zarate & Alex Bryan, *Passive Fund Providers and Investment Stewardship*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 21, 2017), https://corpgov.law.harvard.edu/2017/12/21/passive-fund-providers-and-investment-stewardship/; *see also* Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1170 (2019) (describing the many differences between stewardship groups and how they lead to different degrees of uniformity).

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willingness to oppose management[63] or support ESG issues,[64] to take two examples.[65]

Again, this is not to suggest that these entities have nothing in common (although of course they also have some things in common with other asset managers). The point is that the use of a term that aggregates all three institutions obscures important differences between them.

B. Index Equity Mutual Funds Represent a Only a Portion of Assets Managed by the Big Three

The second shorthand equates the Big Three with "the manager of broadly diversified passive equity mutual funds." Taking as given, for the time being, that funds can easily be divided between "active" and "passive," this notion, while widespread, misses a huge segment of each of BlackRock, Vanguard and State Street's business. While it is indisputably the case that the equity index funds that they manager represent tremendous amounts of investor money, their other offerings are also enormous. Table 1 illustrates this in a rough-and-ready way. In the first column, we present the total value of all assets under management at each of the "Big Four" asset managers as of December 31, 2021. These values are taken from the company's 10-Ks (in the case of BlackRock[66] and State Street[67]), the company's website (in the case of Fidelity[68]), or a company press release (Vanguard[69]). These figures are consistent with the "traditional" account of the size and importance of these asset managers.

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[63] *See* Bubb & Catan, *supra* note 16.
[64] *See* Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. (forthcoming 2022).
[65] These asset managers also differ along a number of other dimensions, including their approach to securities lending. *See generally* Jill Fisch et al., *supra* note 23.
[66] BlackRock, Inc., Annual Report (Form 10-K) (Feb. 25, 2022).
[67] State Street Corp., Annual Report (Form 10-K) (Feb. 17, 2022).
[68] *Fidelity by the Numbers: Asset Management*, FIDELITY, https://www.fidelity.com/about-fidelity/our-company/asset-management (last visited Dec. 26, 2022).
[69] *Vanguard Reports Expense Ratio Reductions for Active Equity and Bond Funds*, VANGUARD, https://corporate.vanguard.com/content/corporatesite/us/en/corp/who-we-are/pressroom/Press-release-VG-reports-expense-ratio-reductions-for-active-equity-and-bond-funds-020122.html (last visited Dec. 26, 2022).

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Table 1: Assets Under Management (By Selected Asset Type)
December 31, 2021

	BlackRock	Fidelity	SSGA	Vanguard
Panel A: All Assets Under management ($ Trillion)				
Total	10.0	4.5	4.1	8.5
Panel B: Mutual Fund Assets ($ Billion)				
All MF	5704	4178	1231	8570
Equity	3249	2506	955	6020
Domestic	2468	2131	905	5079
Passive	889	765	507	3002

The remaining rows in Panel B, however, reveal a much more nuanced story. We use mutual fund data from the CRSP to get a sense of where these assets are invested, and doing so reveals many interesting differences between asset managers. For example, BlackRock, Vanguard, and State Street are often referred to as the largest providers of passive funds in the market, but Panel B reveals that Fidelity's indexed mutual fund assets exceed State Street's. Not only that, Table 1 makes clear that each of these institutions also manages vast amounts of investor capital in *actively managed* mutual funds. In other words, referring to the "Big Three" (or Four) as managers of passive money completely misses the point that a huge percentage of their mutual fund AUM (and a large proportion of their income[70]) is invested in actively managed funds.

More broadly, these figures make clear that these asset managers focus on different clients: while the overwhelming majority of the assets managed by Fidelity and Vanguard are in mutual funds, they represent less than a third of the assets managed by State Street, and less than 60% of the assets managed by BlackRock. This distinction is of utmost importance, as most retail investors select mutual fund products; the remainder of non-mutual fund equity AUM, therefore, is presumably, in other types of structures like separately managed accounts selected by other institutions like pension funds, corporations, and governments.[71] To the extent that scholars and policymakers are advancing arguments that rely on the

[70] See Lund & Griffith, *supra* note 61, at 1177 ("As a result of these higher fees, BlackRock's smaller share of active funds generates an equal amount of revenue as its passive funds—approximately $1.3 billion each quarter.").

[71] To be clear, while retail money is overwhelmingly invested in mutual funds, some smaller institutional investors also invest in mutual funds and ETFs.

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desires of the underlying investors that these asset managers represent,[72] this distinction is crucial. For example, it suggests that BlackRock and State Street should be more sensitive to the preferences of their institutional clients than Fidelity and Vanguard, which are more geared towards individuals (either directly or through defined contribution pension plans), an implication that we return to in the next Part.[73]

Another important difference emerges when we concentrate on equity mutual funds. After all, while debt, commodities, and other asset classes are important, they do not carry the governance rights associated with common stock. Moreover, when discussing the size of these asset managers, comparisons are often made to the equity market. To compare apples to apples, we therefore focus on equity investments. And when we do this, BlackRock no longer looks like a giant: it remains larger than Fidelity, but the difference is not nearly as stark ($3.2T compared to $2.5T). Vanguard, in contrast, is almost as large as the other three combined. If size matters for governance and incentives, scholars would be wise to use the right measure.

Finally, since the focus (implicitly or explicitly) of much of the literature is on the corporate governance of American public companies, we zoom in on domestic equity mutual funds, which again affects the four asset managers differently. In particular, nearly a third of BlackRock's equity mutual funds focus on foreign markets, while the other asset managers' funds focus much more on domestic equities.

In sum, breaking down the total assets under management by these simple categories reveals many important differences between these asset managers. One implication of this is semantic: it is plainly incorrect to equate the Big Three with passively managed equity mutual funds, or to contend that they are uniquely important providers of index funds (to the exclusion of Fidelity). Normative implications also follow. For example, it is too simple to argue that the stewardship practices of these three asset managers should further the interests of their broadly

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[72] *See* note 25 supra.

[73] *See also* Lund, *Asset Managers as Regulators*, *supra* note 63, at 4 n.31 (discussing how Vanguard generally targets individual investors, rather than institutions, and how this could affect their governance practices). Note that this distinction also matters for empirical scholarship: to the extent that scholars that study mutual fund voting practices are focusing on votes recorded on Form NP-X, this form does not reflect votes cast on the basis of the non-mutual fund assets (which, for BlackRock and State Street, represents trillions of dollars).

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diversified "passive" investors, to the detriment of their many other investors.[74] And, particularly when combined with the other two, this shorthand also has implications for scholarship examining these asset managers' incentives to participate actively in corporate governance, as the next Section addresses in detail.

C. Index Funds are Not Interchangeable or Necessarily Passive

The last shorthand is the idea that all index funds are "passive" and are, for practical purposes, interchangeable with one another. Like the others, this shorthand can be useful in certain contexts, but it has important limits. Part of the challenge in correcting this misperception arises from the fact that "passive investing" seems to be more of a slogan than a well-defined concept: as discussed in Section I.C, it generally encompasses assumptions about the fund's trading strategy, but can also connote something about the fund's perceived involvement in stewardship. As we show here, those assumptions do not fully capture the breadth and diversity of the index fund market.

The term "passive" is sometimes used to denote funds that try to match a benchmark index rather than beat it.[75] Although this definition is consistent with an index fund's general trading strategy, it obscures an important point: someone has to create the underlying index, and doing so necessarily involves discretion.[76] Accordingly, this model simply tells us something about who is primarily responsible for selecting the fund's portfolio; it doesn't tell us anything about what that portfolio looks like. When a fund tries to match an index, the index provider in effect acts like a portfolio manager, with everything that entails. Indeed, the idea that the index provider is effectively the portfolio manager isn't just a metaphor:

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[74] Indeed, BlackRock made this very argument in response to a shareholder proposal filed by Shareholder Commons, which asked BlackRock to "adopt stewardship practices designed to curtail corporate activities that externalize social and environmental costs that are likely to decrease the returns of portfolios that are diversified in accordance with portfolio theory, even if such curtailment could decrease returns at the externalizing company." SEC Notice of Exempt Solicitation at BlackRock by Shareholder Commons, https://www.sec.gov/Archives/edgar/data/1364742/000121465922005689/b422225px14a6g.htm. In response, BlackRock explained, "In our view, shifting [our] policies ... in order to benefit 'diversified shareholders' would be inconsistent with our responsibility to our clients, and our legal duties, and create legal risks for BlackRock and our shareholders." BlackRock, Inc., Definitive Proxy Statement (Form DEF 14A) (Apr. 14, 2022).

[75] See supra Section I.C.

[76] *See* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. ON REGUL. 795 (2019); *see also* Paul G. Mahoney & Adriana Z. Robertson, *Advisers by Another Name*, 11 HARV. BUS. L. REV. 311 (2021).

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one of us has argued, in other work with Professor Paul Mahoney, that in many cases, the index provider is an investment adviser under the Investment Advisers Act,[77] something that the SEC supported in a recent request for comment.[78]

Moreover, by this logic, any trading strategy that can be reduced to an algorithm, no matter how complex that algorithm, could qualify as "passive." For example, this definition would encompass not just an S&P 500 index fund, but also a quant hedge fund and a hedge fund specializing in high frequency trading. While scholars and commentators might be concerned about the impact of quant hedge funds and high frequency traders on the market, those concerns are probably quite different from the standard concerns about "passive" funds. And one need not look to specialized indices to find discretion: even S&P 500, the most well-known index, tracked by index funds representing over $7 trillion in investor capital[79] expressly leaves the decision of which companies to add and delete, subject to eligibility rules, in the hands of a committee.[80]

Layered on top of that reality is the non-trivial amount of discretion that fund managers generally have in tracking the index. As one of us has shown in other work with Peter Molk, S&P 500 funds—including the very largest funds—retain for themselves substantial discretion in portfolio selection, and routinely exercise this discretion to deviate from the index.[81] As a result, the idea that an index fund portfolio manager mechanically tracks a benchmark index might be true for some index funds, but it is far from universal.

Second and relatedly, the term "passive" can encompass the idea that the fund tracks "the market" and is therefore maximally diversified and no different from

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[77] *See* Mahoney & Robertson, *supra* note 75.
[78] *See* Press Release, SEC, SEC Requests Information and Comment on Advisers Act Regulatory Status of Index Providers, Model Portfolio Providers, and Pricing Services (Jun. 15, 2022), https://www.sec.gov/news/press-release/2022-109; Press Release, SEC, Request for Comment on Certain Information Providers Acting as Investment Advisers (Jun. 15, 2022), https://www.sec.gov/rules/other/2022/ia-6050.pdf.
[79] *See S&P 500 Factsheet*, S&P DOW JONES INDICES LLC (Dec. 30, 2022) ("According to our Annual Survey of Assets, an estimated USD 15.6 trillion is indexed or benchmarked to the index, with indexed assets comprising approximately USD 7.1 trillion of this total (as of Dec. 31, 2021)").
[80] *See* Adriana Z. Robertson, *The (Mis)uses of the S&P 500*, 2 U. Chi. Bus. L. Rev. 137 (2023). This discretion amounts to roughly 5% of the total value of the Index.
[81] Peter Molk & Adriana Z. Robertson, *Discretionary Investing by 'Passive' S&P 500 Funds* YALE J. ON REG. (forthcoming) (on file with authors).

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any other index fund.[82] This characterization, however, fails to describe a large portion of the index funds available for sale in the United States. Research has shown that there is huge diversity in the types of indices that are tracked by index funds.[83] While some of these indices can plausibly be described as a proxy for "the market" (or at least the market for US equities[84]) most of them cannot. For example, some in this latter group track some segment of the market, like large or small stocks,[85] value or growth stocks,[86] or some industry segment like technology companies.[87] These indices, and the funds that track them, are already departing—sometimes quite considerably!—from conventional notions of "the market." Rather, these index funds are best understood as representing some investing style,[88] something that the funds themselves don't even deny.

Many other index funds follow strategies that are so bespoke that there is no meaningful notion of "the market" that would encapsulate them.[89] Some particularly colorful examples include the VanEck Social Sentiment ETF, which trades under the ticker "BUZZ" and tracks the BUZZ NextGen AI US Sentiment

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[82] *See* 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). One of us is guilty of using this shorthand. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4. *See also* Strampelli, *supra* note 29; Baruza et al., *supra* note 29.
[83] *See* Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, *supra* note 75; Akey et al., *supra* note 30.
[84] Two examples of broad based equity indices are the Russell 3000 and Wilshire 5000. *See Index factsheet: Russell 3000 Index*, FTSE RUSSELL (Nov. 30, 2022); *FT Wilshire 5000 Index Series Factsheet*, WILSHIRE ADVISORS LLC (Jun. 30, 2022).
[85] The most prominent large cap equity index is the S&P 500. *See S&P 500 Factsheet*, S&P DOW JONES INDICES LLC (Dec. 30, 2022). The Russell 2000 and the S&P SmallCap 600 are two examples of small cap equity indices. *See Index factsheet: Russell 2000 Index*, FTSE RUSSELL (Nov. 30, 2022); *S&P SmallCap 600 Factsheet*, S&P DOW JONES INDICES LLC (Dec. 30, 2022).
[86] Prominent examples of this category include the Russell 1000 Value Index and the Russell 1000 Growth Index. *See Index factsheet: Russell 1000 Growth Index*, FTSE RUSSELL (Nov. 30, 2022); *Index factsheet: Russell 1000 Value Index*, FTSE RUSSELL (Nov. 30, 2022).
[87] The NASDAQ 100 Index is perhaps the best known of these indices. *See NASDAQ-100 Fact Sheet*, NASDAQ, INC. (Dec. 30, 2022).
[88] Interestingly, they sometimes even describe themselves in style terms. One interpretation is that these funds want to "have it both ways": marketing themselves as passive while also being able to market themselves to investors interested in a particular investment style.
[89] *See* Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, *supra* note 75; Akey et al., *supra* note 30.

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Leaders Index,[90] and the (regrettably now defunct) Global X GuruActivist Index ETF, which tracked the Solactive Guru Activist Index.[91] In other words, not only do index funds engage in a dizzying array of different investment strategies, many of them engage in strategies that are hard to distinguish from a traditional actively managed mutual fund.

Third and finally, the term "passive" often embodies the assumption that all index funds are not proactive when it comes to issuer level corporate governance. This belief is often grounded in assumptions about the fund's trading strategy: if a fund is maximally diversified and tracking the same index as every other fund, it will have little incentive to monitor and engage with its portfolio companies.[92] It is also bolstered by the additional assumption that all index funds are "low-cost." If the funds charge very low fees, the portfolio manager will only reap a small fraction of the gains from stewardship while shouldering the full costs of its efforts. This, according to this theory, leads to a classic underinvestment problem.[93] However, this assumption about uniformly low fees also turns out to be incorrect. Akey, Robertson and Simutin find that, among ostensibly passive index funds, there is a wide dispersion of fees (using an all-in measure of fund expense ratio), from the well-known ultra (or even zero) fee funds all the way up to the 200 basis points (i.e., 2%) more familiar from the active management context.[94] A substantial mass of these fund charge fees of around 100 basis points.[95]

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[90] This index, according to the fund's regulatory filing, "is designed to identify the U.S. common stocks with the most "positive insights" collected from online sources including social media, news articles, blog posts and other alternative datasets. "Positive insights" are a measure of the degree of positive company sentiment as well as the breadth of active discussion about each company by participants on online platforms." VanEck Vectors Social Sentiment ETF, Registration Statement (Form N-1A) (Feb. 25, 2021).

[91] According to the fund's regulatory filing, the index "is comprised of U.S. listed equity positions reported on Form 13F and Schedule 13D by a select group of entities characterized as premier activist investors, as defined by Solactive AG, [the "Index Provider"]. Activist investors are selected from a universe of investors that aim to buy securities to put public pressure on management to increase shareholder value, as defined by the Index Provider." Global X Guru Activist Index ETF, 2015 Summary Prospectus (Form 497) (Apr. 27, 2015).

[92] Mutual fund portfolio managers are rewarded on the basis on their relative performance, and the broad-based, highly diversified index fund that invests in stewardship will ultimately benefit rival funds that track the same index. *See* Gilson & Gordon, *supra* note 81; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4.

[93] Bebchuk & Hirst, *supra* note 4.

[94] Akey et al., *supra* note 30, at Figure 7.

[95] *Id.*

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In short, the term "passive" seems to mean many things to many people, none of which apply to all, or even most, index funds. Perhaps more importantly, index funds are not all the same: The explosion of index funds and ETFs means that the term now encompasses a dizzyingly broad array of different funds: from mega-funds representing hundreds of billions of dollars in capital to tiny little $70 million funds. These funds encompass ultra-low fee funds tracking well known, broad-based market cap weighted indices, as well as funds tracking proprietary indices that execute a hyper specialized strategy. They also encompass explicit self-indexers—funds that track indices that are produced by an affiliate of the fund itself. The fund complexes that offer these funds are equally diverse, from the "Titans of Wall Street," to quant managers to new entrants. These funds are, in other words, anything but homogeneous or interchangeable, and not all should be considered "passive" in any sense of the word.

III. IMPLICATIONS

An important body of work—some of which was mentioned in Parts I and II—has examined the incentives and influence of three of the largest asset managers in the U.S. capital market. In doing so, it established a crucially important foundation for our understanding of these important issues, even as it often employed the shorthand discussed in Part I.

The next phase of scholarship in this area should build on this foundation while keeping in mind that this shorthand is just that: a simple way of discussing complex entities and their investment products, which may or may not be useful in a particular setting. Part II discussed the limits of this shorthand and also hinted at the problems that come from their overuse. Here, we extend that analysis and sketch how unpacking the assumptions that underlie these assumptions can advance scholarship in this area. We begin by discussing implications for the relationship between investors and the giant asset managers they invest through. We then turn to the implications for the relationship between the giant asset managers and the portfolio companies they invest in.

A. The Relationship Between Beneficial Owners and Giant Asset Managers

As discussed in Part I, scholars have generally treated the "Big Three" as homogenous providers of index funds. Part II showed the limits of this shorthand by highlighting some of the key differences between these asset managers. This Section further delves into the consequences of those differences and in so doing, sets an agenda for future scholarship studying the relationship between investors and giant asset managers.

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1. Retail vs. Institutional Clients

Much of the literature currently assumes (often implicitly) that much of the capital that the Big Three are currently investing comes from retail investors.[96] This assumption has colored the scholarship studying the governance practices of these asset managers. For example, Michal Barzuza, Quinn Curtiss, and David Webber contend in a series of important papers that the Big Three's ESG initiatives are the product of pressure from their millennial retail investors.[97]

While there is no doubt that these asset managers count on retail investors, Table 1 makes clear that there is another important piece of the story. In particular, the extent to which they are investing enormous pools of capital in either separate accounts or pooled investment funds for other large institutions has been either overlooked or brushed aside.[98] One of us has coined this phenomenon as "double intermediation," to indicate that two layers of institutional intermediaries often stand between beneficial owners and their portfolio company investments.[99]

As Table 1 indicates, the extent of double intermediation varies by institution. BlackRock and State Street count many institutions as their clients, whereas Vanguard and Fidelity rely on retail investors to a greater degree.[100] This difference in client base is more than just semantic: it matters for governance. In particular, retail investors likely exert influence over the asset manager in different ways than large institutions, which operate pursuant to their own fiduciary obligations.[101] This difference also matters when asking whether an institution's governance practices are consistent with the interests of the institution's investors. In particular, instead of worrying that BlackRock is, for example, engaging in ESG activism to the

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[96] *See* Lund, *Asset Managers as Regulators*, *supra* note 63, at 15 ("Beneficial owners sometimes invest directly with asset managers, and a robust literature considers the agency cost issues that arise from that single layer of intermediation.").
[97] Michael Barzuza, Quinn Curtis & David H. Webber, *The Millennial Corporation: Strong Stakeholders, Weak Managers* (Working Paper, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3918443; Barzuza et al., *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, *supra* note 29.
[98] Lund, *Asset Managers as Regulators*, *supra* note 63, at 15-16.
[99] *Id.* at 15.
[100] The fact that many of these retail investors are themselves investing through defined contribution pension plans, where the employer has significant influence over the set of available funds, is yet another important wrinkle.
[101] Lund, *Asset Managers as Regulators*, *supra* note 63, at 15-16.

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detriment of its investor clients, it might be more fruitful to focus explicitly on a triparty relationship: BlackRock, its institutional clients, and its retail clients.[102] We explore this implication further in the next Section.

2. Investor Preferences

The previous Section explored the ways in which the Big Three's client base is not homogenous in ways that matter for governance and beyond. This Section broadens this analysis to consider how and whether we can ever make generalizations about the preferences of a giant asset manager's investors.

Recall from Part I that scholars and policymakers often refer to the Big Three's investors as "broadly diversified indexed investors," and that this assumption leads to prescriptions about how these asset managers should use their governance power. But Part II revealed that this characterization often misses the mark—some of their investors are invested in index funds, others are invested in active funds, and some aren't invested in mutual funds at all. Compounding this problem is the fact that not all "passive" funds are the same—as Part II revealed, some track bespoke indices that look more active than passive, and even the relatively "passive" ones differ from one another. This lack of homogeneity is even more obvious when we remember that many investors are not individuals, but institutions like pension funds, which invest vast amounts of capital with, but also separately from, one of these asset managers.

All of this leads to an empirical problem: Because asset managers do not disclose how the capital in these separate accounts is invested (i.e., whether it tracks a standard index, a bespoke index, or is actively managed), it becomes particularly difficult to use publicly available information to determine what those clients would like, and therefore, whether an asset manager is acting in its client's interests. This empirical problem is attenuated somewhat in the case of retail investors and smaller institutional clients, who do invest through registered mutual funds. At least in their case, we can observe the portfolios of both the active and index funds. This means that here, at least, there is hope: Assuming that one was comfortable abstracting away from the fact that investors might (and likely do) own other assets, and perhaps even other mutual funds, it is at least possible to analyze the (hypothetical) preferences of these investors. Doing so, however, requires moving beyond the

[102] *Id.*

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assumption that indexed investors "own the market," and instead requires careful analysis of what these index funds actually hold, and the differences between them.

Even putting aside the fact that mutual funds typically represent only a portion of any client's portfolio, our analysis reinforces the fact that it is a mistake to focus on mutual fund offerings to understand the clients (and corresponding incentives) of these asset managers. While a focus on mutual fund offerings will do a good job of capturing how the asset manager invests on behalf of *retail* investors, it misses the separate accounts and pooled investment funds used by large institutions. Table 1 makes clear that these constitute trillions of dollars; not something that can be easily assumed away. While it is possible to back out the total equity holdings in these accounts,[103] doing so yields the aggregate across all these accounts, not what any particular portfolio looks like. And even if we were confident that a large portion of these assets are "indexed," that still doesn't tell us what those portfolios look like. As Part II revealed, there are many different indices, including a dizzying array of custom indices designed specifically for these large accounts. Layering on top of this reality is the fact that a substantial portion of giant asset manager capital is explicitly actively managed. Therefore, the idea that we can speculate about what their beneficial investors own—and further, what kind of decision-making would be beneficial to them—becomes implausible. Shedding light on this issue would represent an important contribution to the field.

B. The Relationship Between Giant Asset Managers and Portfolio Companies

We now move beyond the implications for the relationship between beneficial owners and asset managers and focus on two sets of implications for the relationship between giant asset managers and their portfolio companies. The first are conceptual and the second are empirical.

1. Conceptual

As discussed, scholars have discussed many corporate governance issues raised by the trend towards index investing. In particular, scholars have voiced concerns that a larger fraction of "passive" investors in the marketplace will reduce the level of shareholder monitoring, which in turn will reduce issuer performance.[104] We have identified common shorthand that appear in this conversation—and

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[103] 13f filings can shed light on the total AUM and one can subtract off the mutual fund holdings leaving, to a first approximation, the assets of interest.
[104] *See, e.g.*, Bebchuk & Hirst, *supra* note 4; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 4.

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specifically, the assumption that all index funds are passive in corporate governance—and we now address the limits of this shorthand in greater detail.

Researchers concerned by the rise of "passive" investing should be wary of the simple active/passive categorization offered by a fund sponsor. For some time now, research has pointed out that many active funds are actually "closet indexers": ostensibly actively managed funds that actually track an index quite closely.[105] Relatedly, we have described how many index funds more closely resemble the traditional conception of actively managed funds because they track a custom index or allow the exercise of ample discretion in investment selection.[106] They may also charge fees that more closely resemble those levied by active managers.

There is no question that some index funds are very likely to underinvest in stewardship and monitoring. But those funds may advertise themselves as being passive, active, or something else.[107] Therefore, rather than point to a broad category of index funds as the appropriate targets for scrutiny and legislative proposals,[108] a much more tailored approach, which goes beyond the size of the manager and the branding of the fund, is needed. For example, scholars concerned about the impact of low-cost investment vehicles on stewardship could focus directly on funds that charge low fees. Alternatively, scholars concerned about the rise of anticompetitive conduct due to cross-holdings could focus on the subset of funds—however they happen to be branded—that actually have disproportionate amounts of these types of holdings. For example, this feature may be more plausible for a fund (whether or not it tracks an index) focused on a particular industry segment than one that tracks a broad-based market index.

In addition to the substantial heterogeneity across "passive" funds, we have also flagged the each of the Big Three have a substantial fraction of their AUM invested in actively managed funds. This, under any analytical framework, should affect their incentives. Our analysis has also revealed substantial heterogeneity across the "Big Three" in terms of their size, ownership, and governance structure. By

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[105] *See* Cremers & Curtis, *supra* note 7.

[106] See discussion supre notes 75 to 95 and accompanying text. For additional research in the finance literature demonstrating the activeness of ETFs, see Itzhak Ben-David et al., *Competition for Attention in the ETF Space*, REV. FIN. STUD. (2022), David Easley et al., *The Active World of Passive Investing*, 25 REV. FIN. 1433 (2021).

[107] For example, quant funds also lack incentives to be engaged stewards, but they are excluded from the analysis when index funds are the proxy.

[108] *See* INDEX Act, S. 4241, 117th Cong. (2d Sess. 2022).

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lumping them together and describing them as a homogenous block, scholars are less likely to identify issues (and therefore research opportunities) in how these asset managers wield their governance power. While it may sometimes make sense to lump large asset managers together, the ubiquity of the term obscures important differences between institutions in a fast-moving market. It also makes it less likely that subsequent changes in the market will be identified. For example, we strongly suspect that the focus on the Big Three has helped to obscure Fidelity's growth.

These observations have implications for many important discussions involving asset managers and portfolio companies, including how the rise of giant asset managers might lead to anticompetitive conduct and the promise of systematic stewardship. They also matter a great deal for conversations about the stewardship potential of giant asset managers and their portfolio companies. For example, the very different governance structures across these giant asset managers cautions against making blanket assumptions about their incentives; moreover, the very different asset composition (beyond differences in "passive" investment vehicles) suggests different incentives to serve as informed and engaged stewards. All of these differences are worthy of significant scholarly attention.

2. Empirical

The second set of implications concern empirical analyses of the relationship between asset managers and the governance of their portfolio companies. Take something as basic as the relevant size of these asset managers. If we are interested in size for the sake of analyzing their influence on corporate governance, it is crucial to ensure that we are focusing on the right numbers. In this context, the top line AUM figures are misleading. After all, in the ordinary course, debt, commodities, and other asset classes do not have traditional corporate governance rights. Of course, all corporate stakeholders can exercise some limited influence on management, at the end of the day only equity gets to vote. And to the extent that we are concerned with corporate governance at American companies, we also need to exclude foreign equities. Focusing on the top line AUM figures vastly inflates the amounts in question. While careful scholars can avoid this trap, it is easy, and common, to simply equate size with governance power.

Our analysis raises even more challenges when it comes to empirical analysis of asset manager stewardship activities. If one is primarily interested in the stewardship behavior of these asset managers, the standard voting data that empirical scholars rely upon is massively incomplete. These datasets are drawn from Form NP-X, which only registered investment companies—like mutual funds (including ETFs)—are required to file. As discussed, there is no requirement that

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the separate accounts and pooled investment products—which are often favored by large institutional clients (and that make up a large fraction of the AUM at each of BlackRock, Vanguard, State Street, and Fidelity)—report their voting decisions, and we are aware of no source that even purports to have access to this information on a systematic basis. As a result, these votes are unknown and unknowable to researchers. While some of these votes are likely cast in accordance with the stewardship group's recommendations (meaning that scholars can make an educated guess about how some of the shares are voted),[109] others are retained by the underlying institution and cast according to their instructions.[110] As these institutions gradually expand this type of option by implementing passthrough voting and other voting choice programs, the focus on available voting data will become even more incomplete. Simply put, it is impossible to know how these asset managers vote with respect to vast amounts of the equities that they manage. Focusing only on mutual the available voting data therefore vastly understates the corporate governance might that they wield, and may lead to inaccurate conclusions.

IV. CONCLUSION

This book chapter has focused on three sets of shorthand common in the literature studying the giant asset managers and their role in corporate governance. While shorthand can be useful in certain contexts, its overuse can lead to problematic misperceptions and distort the evolution of scholarly research. We discuss some examples of how relying on this shorthand can lead scholars astray. We hope that the observations we raise in this book chapter will inspire future scholars to delve deeply into the issues we identify, to further enrich this important area of research.

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[109] *See* Sandy Bass et al., *It's all about choice,* BLACKROCK (2022), https://www.blackrock.com/corporate/literature/publication/its-all-about-choice.pdf.
[110] *Id.*

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