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Index Funds Have Too Much Voting Power: A Proposal for Reform

Issue Brief

James R. Copland

Senior Fellow & Director of Legal Policy
Manhattan Institute

Introduction

Two recent trends are increasingly reshaping American investing: the rise in passive index investing by institutional asset managers; and the rise in environmental, social, and governance ("ESG") investing led by those same institutional asset managers.

In passive index investing, a mutual fund, exchange-traded fund (ETF), or other institutional investing vehicle buys and sells corporate securities to replicate the holdings of an investing "index" determined by a third party to represent some significant swath of the stock market. For example, the investing vehicle might be attempting to replicate the Standard & Poor's (S&P) 500 Index, which tracks 500 large corporate stocks that together constitute some 85% of the total U.S. equities market. Because passive investing strategies can offer a broadly diversified "stock market" return at a low investing cost, they have become favored vehicles for long-term buy-and-hold investors, including individuals, pension plans, insurance companies, and endowments.

ESG investing, of more recent provenance, is an offshoot of long-standing "socially responsible investing" that traditionally avoided certain "sin" stocks (e.g., those involving gambling, alcohol, tobacco, or munitions) and/or allocated monies toward industries aligned with investors' idea of the public good. In addition to these exclusionary and inclusionary investing models, however, many modern ESG-oriented investment vehicles embrace "impact" investing, in which funds holding diversified portfolios seek to change corporate behavior to match investors' preferred environmental, social, or governance strategies. Proponents of ESG investing argue that it both promotes the public good (at least when oriented around environmental and social causes consistent with the funds' worldviews) and enhances investing returns (because markets have not properly incorporated the risks of companies' disfavored environmental or social policies or governance structures).

This report briefly assesses the rise in both passive and ESG investing; discusses the extensive pushback against large index fund companies' increasingly aggressive ESG-focused shareholder voting, including legislative remedies proposed in Congress; and advances an alternative idea for reform.

The Rise of Passive Index Investing

The share of U.S. equities held in passive index funds, whether mutual funds or ETFs, has more than doubled in the past decade.[1] Over that period, these passively managed funds have received more than $2.5 trillion in new cash inflows, while actively managed funds have lost more than $2.3 trillion in cash outflows.[2]

By the end of 2021, for the first time, assets in passive investment vehicles exceeded those in actively managed funds among U.S. equities held in mutual funds and ETFs.[3] By year-end 2022, 18% of U.S. stock-market assets were held in passively managed mutual funds and ETFs, as compared with 14% in actively managed funds.[4]

As those numbers imply, less than one-third of all stock equities overall are held in mutual funds and ETFs, but that understates the impact of passive index investing in corporate ownership, since many other institutional investing vehicles—including pension funds, insurance companies, and endowments—also follow passive investing strategies. According to academic research analyzing stock-market movements based on revisions to the composition of stock indexes, more than one-third of all U.S. equities are ultimately held through passive investing vehicles.[5]

Passive index investing not only constitutes a sizable share of all U.S. stock ownership; it is also heavily concentrated. By year-end 2022, the top five asset-management fund families controlled 55% of U.S. equities held in mutual funds and ETFs—up from 35% in 2005.[6] And the "Big Three" asset managers—BlackRock, Vanguard, and State Street Global Advisors—collectively control 43% of the U.S. fund market, with $10.3 trillion in assets under management.[7] Of that sum, $8.9 trillion is invested in passive index funds.[8] In approximately 90% of U.S. publicly traded companies, one of the Big Three is the largest shareholder.[9]

The Rise of ESG Investing

While various forms of socially responsible investing have a long provenance,[10] ESG investing traces to a December 2004 report commissioned by the United Nations, with buy-in from a host of big banks around the globe.[11] By 2006, the New York Stock Exchange and others around the world were adopting ESG principles following the UN protocol.

ESG is the modern successor to socially responsible investing, but emphasis has shifted from mere divestment to a more concerted pressure campaign, where groups of activist shareholders work to force companies to divest themselves of disfavored activities.[12] Moreover, ESG investing openly conflates classic questions of board governance and organization and shareholder voting and oversight—the "G" in ESG—with environmental and social concerns that are either the traditional domain of companies' "ordinary business" judgments or of broader social concern and thus with an attenuated relevance to shareholder value.

Although ESG funds constitute a relatively small minority of shares held in U.S. equities, the relative share of ESG-invested funds has been rising rapidly—at least until recently. In 2020, ESG-related investment funds constituted nearly 25% of new U.S. mutual dollar inflows—double the level in 2019 and up from just 1% in 2014.[13] Overall, the value of assets held in ESG funds invested in U.S. equities nearly doubled from year-end 2019 through year-end 2021, increasing from $276

billion to $550 billion in two years' time.[14] By year-end 2022, the total amount invested fell back somewhat, to $460 billion, due to overall stock-market declines as well as outflows driven by ESG fund underperformance.[15]

ESG funds are a profit center for asset managers, especially those focusing on low-cost passive indexing. At the end of 2020, ESG funds had average fees of 0.2%, while standard ETFs that invest in U.S. large-cap stocks had a 0.14% fee on average—a relative 43% difference.[16] Even such a seemingly small increase in fees can have a big impact when scaled. Michael Wursthorn explains: "A firm managing $1 billion in a typical ESG fund, for example, would garner $2 million in annual fees versus managing the standard ETF's $1.4 million."[17] BlackRock has $10 trillion in assets under management, so the potential for profits is staggering.[18]

While asset managers' *fiduciary* duties to their customers require maximizing rates of return, their *pecuniary* interests lie in maximizing assets under management and increasing fees. This calculus is driving asset managers to turn to higher-priced products to drive higher revenue. "Green" funds provide a suitable vessel. BlackRock, for example, pulled $68 billion into its sustainable products in 2020, representing more than 60% of all annual growth.[19]

In his 2022 letter to corporate chief executive officers, BlackRock CEO Larry Fink said the quiet part aloud:

> It's been two years since I wrote that climate risk is investment risk. And in that short period, we have seen a tectonic shift of capital. Sustainable investments have now reached $4 trillion. Actions and ambitions towards decarbonization have also increased. This is just the beginning—the tectonic shift towards sustainable investing is still accelerating. Whether it is capital being deployed into new ventures focused on energy innovation, or capital transferring from traditional indexes into more customized portfolios and products, we will see more money in motion.[20]

Incorporating ESG Principles into Passive Voting

With ESG funds representing a profit center for large asset-management companies—especially relative to low-cost passive index funds—it is perhaps unsurprising that ESG principles have crept into the shareholder voting and "engagement" strategies of these large asset-management fund families, including in their passive index holdings. For instance:[21]

- In 2023, BlackRock supported 55% of all "key" ESG-related shareholder proposals as rated by Morningstar advisors, including 70% of civil-rights and racial-equity-related proposals, 57% of environmental proposals, and 55% of other socially related proposals.
- State Street Global Advisors supported 60% of ESG proposals, including 90% related to civil rights and racial equity, 61% related to the environment, and 60% related to other social issues.
- Vanguard supported 28% of ESG proposals, none relating to civil rights or racial equity, 30% related to the environment, and 27% related to other social issues.

It was not always this way. Indeed, until 2017, not a single environment-related shareholder proposal received majority shareholder support over board opposition at one of the 250 largest publicly traded U.S. companies, dating back to 2006, the first year tracked in the Manhattan Institute's Proxy Monitor database.[22] That's not surprising. For example, in 2016, BlackRock and Vanguard did not support a single shareholder proposal involving corporate board diversity or climate change.

But by the next spring, large asset managers began to campaign much more aggressively on behalf of environmental and social causes. On March 7, 2017, State Street, the world's third-largest institutional investor, launched a campaign to pressure companies to add more women to their boards—symbolically installing a bronze statue, "Fearless Girl," facing the iconic "Charging Bull" that has graced Wall Street since 1989.[23] Less than a week later, BlackRock, the world's largest mutual fund company, announced that it, too, would prioritize talking with companies about "gender balance on boards," as well as "climate risk."[24] In a winter 2018 letter to shareholders, BlackRock CEO Fink suggested "a social purpose" for corporations benefiting all "stakeholders," not merely corporate shareholders:

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.[25]

To some degree, Fink's letter evoked a truism.[26] But Fink nevertheless provoked controversy because the letter weighed in on one side of a shareholders' vs. other stakeholders' debate that has raged on for a century—and, in one reading, embraced what has generally been the minority view, at least in terms of legal responsibilities.[27]

One reason that BlackRock and State Street shifted aggressively toward more full-throated support of environmental and social issues in 2017 is that they were themselves reacting to a pressure campaign against fund families by shareholder activists.[28] Earlier in 2017, the social-investing fund Walden Asset Management, alongside other social-investing and public pension investors, had introduced a shareholder proposal for consideration at BlackRock's own May 2017 annual meeting, which would have prompted the investing giant to clarify its own proxy voting priorities.[29] Reportedly, the social investors' move was "partly motivated by frustration [that] BlackRock and some other large shareholders like Vanguard ... declined to support a single shareholder proposal on board diversity or climate change in 2016."[30] The shareholder activists withdrew the proposal after discussions with BlackRock, which promptly announced its new commitment to environmental and social concerns.

The relatively swift sea change in shareholder voting behavior by BlackRock and other large asset managers is more understandable in light of the concerted pressure campaign that they faced from some of their own investors—even if such investors held relatively small percentages of the large asset managers' sizable assets. Indeed, it likely helps explain why Vanguard has been generally less likely to support environmental and social proposals at corporations than BlackRock and State Street: the latter two are themselves organized as publicly traded corporations subject to shareholder pressures, whereas Vanguard has a private ownership structure operating outside the SEC's proxy process.

Political Pushback Against the Passive Asset Managers

If large asset managers decided to lean into corporations that support environmental and social causes, based on pressures from social-investing funds and public pension funds controlled by political partisans, it's unsurprising that they would eventually face a backlash from policy advocates and political actors on the other side of the underlying policy debates. After all, the quote often attributed to a young Michael Jordan, in declining to make an endorsement in the 1990 campaign for U.S. Senate in his native North Carolina[31]—"Republicans buy sneakers, too"[32]—may be apocryphal;[33] but its underlying sentiment is surely sound.

Some observers of corporate governance, of course, had been ringing alarm bells about the rise in socially focused shareholder activism for years.[34] But as large institutional investors increasingly pushed companies to adopt implicit race and gender quotas on their boards and commit to environmental commitments like the Paris Climate Accords—commitments that had never been accepted by the U.S. Senate—more and more people took notice. In February 2021, political commentator Stephen Soukup released a book, *The Dictatorship of Woke Capital*,[35] which was followed up that August, to more fanfare, by biotech investor and entrepreneur Vivek Ramaswamy's *Woke, Inc.*[36] During his recent presidential campaign, Ramaswamy called the Big Three asset managers "arguably the most powerful cartel in human history."[37]

Red-state officials began acting, too, but were late to the game: state and local officials with heavily Democratic constituencies—including those in New York City and State, California, Connecticut, and Philadelphia—had long agitated for social and environmental causes with corporations in which their pension funds for public employees were invested.[38] These efforts had intensified in 2014, when New York City's elected comptroller, Scott Stringer—a politician with no special investing experience—launched his "boardroom accountability project" seeking ballot access in corporate director elections to promote board diversity and climate change.[39] And various blue-state and city pension funds supported Walden's successful 2017 effort to pressure BlackRock to back more environmental and social shareholder proposals.

In the face of such activism, elected Republican officials controlling their states' investment assets began setting new rules and even divesting from asset managers. This correction began in Florida, where the chief financial officer cited BlackRock's environmental and social activism in announcing that the state was pulling $2 billion in assets from the investment manager.[40] Various state attorneys general also began to investigate institutional investors' behavior, under fiduciary, fraud, and antitrust theories; in spring 2023, 21 state attorneys general sent letters to Vanguard, State Street, and several other asset managers, warning that their pursuit of environmental goals, "racial justice," and other policy objectives at the expense of financial returns may violate their fiduciary duties to investors and other state and federal laws.[41]

Congressional leaders also introduced new legislation designed to clarify passive index funds' fiduciary voting obligations. In 2022, Senator Dan Sullivan (R-Alaska) introduced the INvestor Democracy is EXpected (or "INDEX") Act, later sponsored in the House by Congressmen Bill Huizenga (R-Michigan) and Blaine Luetkemeyer (R-Missouri).[42] In essence, the bill amended the Investment Advisers Act of 1940 to require index fund managers that held at least 1% of the outstanding shares of a publicly listed U.S. corporation to "pass through" shareholder voting to beneficial owners—i.e., the individuals and other investors who own shares in regulated mutual funds and ETFs. (See Appendix A for the bill's full text.)[43]

In July 2023, the leadership of the House Financial Services Committee held multiday hearings looking into environmental and social investing and how it relates to financial policy.[44] In addition to testimony from various expert witnesses,[45] the committee staff distributed various pieces of proposed legislation, modeled as "discussion drafts," for consideration. Among these was a model bill somewhat parallel to the INDEX Act, but it allowed for a greater variety of options for institutional investors managing passive index funds. Under the proposed bill, these investors could vote to support corporate boards' recommendations on various proxy proposals, or to abstain from voting, in addition to voting according to beneficial owners' instructions. (See Appendix B for the discussion draft bill's full text.)[46]

Discussion of Passive Index Voting

By definition, passive index fund managers do not buy and sell equity securities based on any subjective market viewpoint. Instead, they are *passive*. Fund managers strive to replicate a basket of securities representing all or a slice of the broader stock market—a basket selected by third parties such as S&P.

Index investing is exceptionally valuable for ordinary investors, who generally lack the resources and sophistication to buy and sell stocks to build their own diversified portfolios of securities, or to assess active investment advisors' stock-market strategies. And because they operate at such low cost—merely replicating, not analyzing—they pass through the savings to their investors. A wealth of research suggests that it is hard for ordinary stock pickers to best passive investing in the market basket, after expenses,[47] and that an unsophisticated investor choosing among funds is better served by a passive, rather than by an active, portfolio investing strategy.[48]

But precisely because passive index investors do *not* act upon information to buy or sell securities with a view toward any mismatch between current market pricing and underlying value, it is peculiar that the now-large share of investing capital held through passive index investing funds has increasingly been flexing its voting muscle over all of corporate America. As Bernard Sharfman wrote in 2022:

> The Big Three [asset-management companies] exist in a super competitive industry with extremely low management fees, providing the Big Three with very little ability to spend resources on becoming informed about portfolio companies.... Since the Big Three are generally uninformed, they cannot enhance the value of the stock market through their uninformed voting and engagement.[49]

To be sure, large asset-management companies, in general, and Fink of BlackRock, in particular, have *argued* that their shareholder voting and engagement strategies add value to their portfolio companies. But it generally strains credulity to believe that investment vehicles that by definition eschew *any* discernment in a company's valuation should nevertheless be playing a major role in telling that same company how to reorganize its affairs. A fixation on ESG has led the large institutional fund families to build out their shareholder-engagement staffs: BlackRock boasts in its 2022 Annual Stewardship Report that its engagement team grew "from 16 in 2009 to over 70 as of December 2022." But a December 2023 academic study observed that Big Three asset managers' staffing for shareholder engagement remains "meager," with BlackRock, the largest, employing "just 13 individuals responsible for engagements with U.S. companies.[50]

There is substantial empirical evidence that certain activist hedge funds have, over the long run, been significantly wealth-enhancing for investors.[51] Successful activist hedge funds accumulate sizable concentrated holdings in idiosyncratic companies based on "a determination by the hedge

fund that the target company is currently not maximizing returns, but that if management would implement the hedge fund's recommended changes, company performance would improve, the stock would increase in value, and the hedge fund would reap excess returns," in the description of a 2014 scholarly report.[52] But there is little reason to believe that large passive index funds—controlled by concentrated asset-management fund families subject to outside pressures and conflicts of interest—will not *interfere with* rather than enhance the functioning of true activist investors' efforts.

Instead, the substantial concentration of passive index funds (which are, by definition, subject to uninformed ownership), increasingly exercising their authority, introduces very real systemic risks into the capital markets. Moreover, that concentration of ownership, combined with an increasing willingness to weigh in on matters of general economic, environmental, or social concern—regardless of whether the matters are material to a specific company's business interests—obviously threatens an oligarchic end run around our constitutional lawmaking process, which, by design, involves consensus-building policy through bicameral legislative enactment and supermajorities absent executive consent.[53]

Analyzing the Proposed Legislation

The two variants of proposed legislation—the 2022 INDEX Act and the discussion draft legislation circulated concurrent with last summer's House Financial Services hearing—seem eminently sensible on the surface. Or, at least, it is salutary to challenge the notion that large passive index funds controlled by functionaries with no actual investing skin in the game should be making sweeping policy decisions for the broad swath of corporate America.

The INDEX Act

As noted, in May 2022, Republican Senator Dan Sullivan of Alaska, along with 12 cosponsors, introduced the INDEX Act.[54] The INDEX Act would directly act upon passive index investment vehicles through the Investment Advisers Act of 1940,[55] which, along with the concurrently enacted Investment Company Act of 1940,[56] governs the duties of mutual fund companies and other investment advisors.[57]

The INDEX Act essentially works to require large passively managed funds in a company to *pass through* voting rights to underlying investors—i.e., to empower underlying investors in the fund to direct their ownership share's vote on proxy ballot items for the underlying securities held by the index fund. To qualify as a passively managed fund, a fun must be "designed to track, or ... [be] derived from, an index of securities or a portion of such an index," at least in significant part, or disclose such a strategy to investors.[58] Also, the law applies only to funds' voting when those funds hold "more than 1 percent of the voting authority of the outstanding securities" of the corporation issuing those securities.[59] This ownership threshold would generally make the statute's voting requirements applicable to the largest institutional investors, including, in a large percentage of cases, BlackRock, Vanguard, and State Street.

The INDEX Act would not require all voting matters to be passed through to underlying investors. For "routine matters," such as the ratification of company auditors, institutional owners of passive funds could continue to vote their shares at their discretion.[60] But the act defines "routine" rather narrowly; among the proxy ballot items deemed not routine—and thus subject to the

act's pass-through requirements—are proposals for a corporate merger or acquisition, proposals to sell substantially all of the corporate assets, the election of corporate board directors, and shareholder proposals.[61]

For the broad category of proxy ballot matters under which the INDEX Act requires pass-through voting, affected passive fund managers are prohibited from voting, absent instructions from underlying investors. And fund managers are prohibited from charging underlying investors for soliciting voting instructions, or from soliciting voting instructions from only a portion, rather than all, of underlying investors in the fund.

From Delegating to Decision-Making

The INDEX Act implicitly is designed not only to diminish the concentration of shareholder voting influence by the small number of asset managers with large passive fund holdings but also to empower underlying retail investors in such funds to vote. However, there are conceptual and logistical problems with this approach.

Retail investors (nonprofessional investors) who invest in corporate securities through mutual funds, ETFs, and comparable investment vehicles—particularly if investing in passive index funds—are implicitly deciding to *delegate* their analysis of corporate valuations, governance, and performance. At least some retail investors in actively managed funds may retain a belief—misguided or not—that they can outperform market indexes, or at least structure investment strategies more tailored to their idiosyncratic financial needs, through fund selection.[62] But an investor in a passively managed fund is implicitly delegating his investing choices to the broader buy-and-sell decisions of the stock market itself, at least as defined in a market basket selected by S&P or the like.

It is theoretically strange to devolve shareholder voting rights to such retail investors in these cases. Investors who are affirmatively opting *not* to make their buy-and-sell decisions on securities hardly seem well equipped to evaluate the host of potential governance decisions presented on modern proxy ballots for publicly traded companies. Devolving shareholder voting to individual shareholders owning passive index funds seems as logically incoherent as allowing the managers of such funds to weigh in on such ballot items—even if it would have the salutary effect of breaking up the voting clout of the small number of asset managers with large passive fund holdings.

Indeed, most retail investors' interests in shareholder ballot items might be most focused on those issues that really should *not* be subject to shareholder votes at all—namely, those questions that require little expertise in corporate governance or investing but rather have a social policy valence. That would complicate an existing trend. There are significant overall legal problems with the U.S. Securities and Exchange Commission's (SEC) adoption of shareholder-proposal proxy rules under Rule 14(a)(8).[63] But at least when the rule was initially promulgated, the commission did not "permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature."[64] In contrast, the commission's current position essentially *inverts* this original rule and instead forces any publicly traded company to put before its shareholders any otherwise-qualifying shareholder's proposal of "social policy significance," regardless of whether there is any "nexus between a policy issue and the company."[65]

Allowing corporate proxy ballots to become general shareholder plebiscites for all manner of social policy issues undercuts one of the principal reasons that large, complicated business entities have overwhelmingly opted for the shareholder-ownership form in the first place: that by orienting shareholders around a single *homogeneous* concern—share value[66]—such entities avoid the high costs of *heterogeneous* collective decision-making.[67] Many benefits of common-stock ownership—such as dispersing risk and eschewing regular cash payments in lieu of an interest in residual earnings—could exist under alternative ownership structures, such as ownership divided among employees, customers, or suppliers. Such ownership forms are far from unknown; they are just

quite uncommon for most large business enterprises. Instead, common-stock ownership is the dominant form of organization, although it has *larger* "agency costs" than alternative structures (i.e., customers, suppliers, and employees are generally better positioned than outside shareholders to oversee management). But employees, suppliers, and customers also have conflicting interests in firm behavior—precisely the sort of ownership cost that common-stock ownership seeks to avoid. As such, the SEC's original position, allowing companies to preclude shareholder ballot items on socially fraught questions, is assuredly the correct one.[68] And it is not at all clear that the INDEX Act's voting approach would ameliorate, rather than exacerbate, the current ESG voting problem.

Logistical Challenges to "Pass Through" Voting

In addition to such theoretical problems, there are real logistical problems with the INDEX Act's approach. It is not clear that asset managers could effectuate true "pass through" voting as called for in the INDEX Act—even limited, as it is, to the largest fund families (i.e., those that own at least 1% of the outstanding shares in a given issuer).[69]

For example, BlackRock announced last summer that it was considering allowing retail investors in its largest exchange-traded fund (IVV), which tracks stocks in the S&P 500 Index, to exercise more control over how the shares corresponding to their fund holdings are voted in corporate annual meetings.[70] But, as with earlier policy shifts by BlackRock and other asset-management fund families overseeing passive index funds for institutional clients, BlackRock is *not* proposing to get specific voting instructions from ordinary investors on share voting. Rather, it is proposing to allow such investors to choose between: (1) allowing BlackRock to exercise discretion on their behalf; and (2) selecting among six general "voting strategies" determined by one of the two main proxy advisory services, Institutional Shareholder Services (ISS) and Glass Lewis. It is not at all clear that this proposal would suffice to satisfy the INDEX Act's requirements.

Moreover, given that those two relatively small, foreign-owned entities are, in many respects, more opaque, more subject to agency costs, and more subject to institutional capture than the asset-management fund families themselves,[71] BlackRock's proposed cure—at least if not amended to allow investors more choice beyond those offered by the "Big Two" proxy advisors—could be worse than the disease. ISS and Glass Lewis control 97% of the U.S. proxy advisory market. Thus, they already wield enormous influence over shareholder voting because smaller investment funds often delegate their votes to their advisor. ISS alone essentially controls approximately 15% of the vote on large-company shareholder proposals.[72]

It is unsurprising that BlackRock would not actually seek to delegate all shareholder voting for the beneficial owners of its passive index funds to the beneficial owners themselves, which would be an extraordinary administrative hurdle and nigh impossible for most such beneficial investors to execute, even if feasible. The principal reason that ordinary investors like index funds to begin with is that they offer a low-cost way to capture stock-market returns without having to do research on and analysis of individual companies or portfolio managers.

A final logistical issue with the INDEX Act's approach is that it could serve, in at least some cases, to *entrench* existing boards and managers—insulating status quo management from shareholder influence that would enhance share value. While socially oriented shareholder activism tends to be associated with lower share value,[73] hedge-fund investors who deeply research companies and engage in activist investment strategies designed to enhance share value—investing a lot of their own skin in the game—tend, on average, to enhance share value and improve efficient market pricing.[74] The INDEX Act likely would inhibit such value-creating investing by requiring passive index fund managers to abstain from voting, absent affirmative voting recommendations from beneficial investors, which could very well wind up being the case for a large percentage of all fund assets. In so doing, the act could work to block shareholder majorities opposing management in all but the "routine" cases exempted by the act's provisions.

The voting rules of corporations are generally set by state law—with significant variations, depending on corporate bylaws. The state law of Delaware, in which most large public corporations are chartered,[75] is clear that "the certificate of incorporation or bylaws of any corporation authorized to issue stock may specify the number of shares and/or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business."[76] The default rule under Delaware law, absent a bylaw specification, is "in all matters other than the election of directors," to count "the affirmative vote of the majority of shares of such class or series or classes or series present in person or represented by proxy at the meeting."[77]

In layman's terms, these provisions mean that for any corporation following the Delaware corporate law default rule, a shareholder-majority vote requires an affirmative vote from the majority of shareholders *present*—not *shareholders outstanding*, or merely those *present and voting*. But that rule is just a default. Depending on corporate bylaws, shareholder voting matters may become operative based only on a majority of *outstanding* shares; a majority of all shares represented at a corporate meeting; a majority of *voting* shares; a plurality of voting shares; or, in some cases, a supermajority of shares present, voting or outstanding.

With such variation in voting rules, a requirement that an asset manager would abstain from casting a vote if some less-than-certain eventuality were not to occur could be outcome-determinative. If, for example, 20% of represented shareholders abstained from a given vote—due to a lack of direction from the beneficial owners of passive index funds' securities—a majority voting rule would become, in effect, a 62.5% voting rule (because 50% of shareholders represented would constitute 5/8 of the 80% of shareholders voting).

To be sure, the INDEX Act incorporates two mechanisms designed to mitigate the unintended problems that it might trigger through implicitly forcing abstentions when pass-through voting is impossible:

1. Separating out "routine" and "nonroutine" voting from the act's requirements

2. Allowing for "mirror voting"—i.e., empowering passive index managers to cast "For" and "Against" votes in keeping with *all other* shareholders' votes—in certain cases in which an outright majority of shares outstanding is required to approve certain actions under corporate bylaws.

These prophylactics might be inadequate. That the list of votes considered "routine" or "not routine" itself varies somewhat between the INDEX Act and the House discussion draft legislation highlights the risk of legislation getting the balance of new voting rules wrong. Even assuming that "mirror voting" as prescribed in the act is feasible and consistent with funds' existing fiduciary duties, the INDEX Act as drafted would apply mirror voting only to situations in which a *majority of outstanding shares* is required under the bylaws—a situation that departs from the Delaware law's default, as well as various other actual bylaw requirements. The mirror-voting mechanism as written would not seem to apply at all to *supermajority* voting provisions, which are commonplace, or to ordinary voting situations in which the Delaware default rule applies.

There are a plethora of conceivable voting rules, and the large publicly traded companies cataloged in the Manhattan Institute's Proxy Monitor database are divided roughly evenly in how they treat voting abstentions. The last thing we would want in this reform legislation is to blunt efforts by *actual* activist investors taking large stock positions in researched companies and trying to change corporate behavior to unlock latent value limited by existing management agency costs, but the INDEX Act could inadvertently do so, even though that is obviously not its intended design.

The House Model

The discussion draft bill circulated by the House Financial Services staff in July 2023 varies from the INDEX Act in certain material respects:

- The House draft, unlike the INDEX Act, would apply to *all* passively managed funds, not merely those holding at least a 1% voting interest in a given company.

- Rather than requiring passive fund managers to seek out voting guidance from beneficial owners, or else abstain except in circumstances triggering "mirror voting," the House draft permits passive managers one of three voting options: (1) vote according to beneficial owners' directions; (2) vote with corporate boards' recommendations; or (3) abstain from voting.

- The House draft varies from the INDEX Act in how it defines what constitutes a "routine matter" exempt from the proposed legislation's voting rules.

Analysis: More Flexible but More Protective of Management

In giving asset managers more flexibility rather than requiring that such managers seek out beneficial owners' directions, the House draft would certainly empower asset managers to sidestep some of the logistical difficulties inherent in the INDEX Act's rule. The House draft applies commonly to all passive funds—rather than exempting smaller funds from the general rule and effectively ordering larger funds to apply the INDEX Act rules in some, but not necessarily all, fund holdings, given the 1% ownership threshold.

The discussion draft also avoids at least some of the issues that would arise from the INDEX Act's "vote according to directions, or abstain" mandate. Fund managers would be allowed *either* to abstain *or* to vote with management—and presumably, they might vary their response depending on bylaw voting rules and the subject being voted on.

There are problems with the discussion draft's approach, too. On the one hand, the House draft allows large fund managers to continue to put a "thumb on the scale" in casting their ballots, at least in situations in which an abstention is not functionally identical to a vote with management. In this regard, the draft blunts somewhat the intended purpose of the INDEX Act, which is partly to disempower large asset managers overseeing passively managed funds from exerting such a large influence over corporations across the economy.

On the other hand, the House discussion draft reflexively pushes passive funds to abstain from voting or to vote with management—but never against management. It creates some of the same obstacles to positive shareholder activism, such as hedge-fund activism designed to mitigate agency costs, restructure corporate ownership, or otherwise drive value. While corporate boards and managers might welcome being further insulated from such market pressures, that cannot be the objective of new legislation if it is designed to enhance market efficiency and capital formation. (The INDEX Act's mirror-voting mechanism, for all its complexity and limitations, actually would insulate management less than the House draft, at least for those situations in which it is triggered.)

Recommendation: An Alternative Reform Proposal

That there are unsatisfactory trade-offs with the two proposals does not mean that Congress should abandon its salutary efforts to ameliorate the very real problem of increasing shareholder voting control by passive index funds definitionally untethered from any valuation of corporate assets themselves. In lieu of the two proposals offered to date, the model legislation below does something functionally similar but substantively simpler—namely, remove passive index funds' shares from shareholder voting calculations altogether.

Precisely because passive index funds are simply tracking market indexes, the voting rights attached to their shares are necessarily attenuated from actual fund management and performance, just as they are separated from the passive index funds' buy-and-sell decisions themselves. Thus, the right decision rule for those shares—if they are held in passive index funds—is to *abstain* from voting altogether, coupled with a vote-counting rule that acts as if those shares *do not exist*.

This approach is fully consistent with the INDEX Act's mirror-voting mechanism, which essentially says that if you are in a passive fund, and vote according to this mechanism, you just vote the same as the market average. That rule makes sense: just as the passive index fund is managed to mirror the market, so should its shares be voted to mirror those of other shareholders.

One approach to the passive index fund voting problem would be, simply, to replicate the INDEX Act's mirror-voting provisions for all shareholder votes. The model legislation proposed here seeks to achieve a similar purpose with a different mechanism, which may be more feasible to execute and add more clarity to fiduciary duties. This mechanism is also potentially more respectful of state-law corporate-bylaw variations, empowering existing shareholders with respect to voting rules and allowing shareholders to reconsider these voting rules over time, in the event of unintended consequences.

The approach prescribed here would operate through two mechanisms acting in parallel:

1. Require passive index funds to abstain from all shareholder votes.

2. Empower existing shareholders, prior to this shift's effective date, to modify corporate bylaws' treatment of abstention votes for passive index investors.

This approach requires amendments not only to the Investment Company Act of 1940 but also to the Securities Exchange Act of 1934, presented here as two separate (but necessarily linked) models.

The Investment Company Act governs asset managers' fiduciary duties and would now make clear that such duty, for passively managed index funds, is to abstain. (The model language largely tracks that presented in the INDEX Act and House discussion draft.)

The Securities Exchange Act governs the corporate proxy process and would now require publicly traded companies to put before existing shareholders a vote on how exactly to consider passive index funds' votes. (The model language taps into the previously designed and exercised incorporation of shareholder voting on executive compensation advisory voting in the Dodd-Frank Act of 2010.) Given the broad thrust of institutional asset managers' preferences, we can expect that existing institutional shareholders would *not* select voting rules entrenching managers from shareholder activism—thus avoiding the problem of insulating incumbent boards and managers. But by allowing some variation in voting rules and allowing for such rules to be modified over time, the proposed mechanism avoids locking in an inefficient voting design and allows for modification if unintended consequences were to arise.

Model Policy 1: Amend the Investment Advisers Act of 1940

A BILL

To amend the Investment Advisers Act of 1940 with respect to proxy voting of passively managed funds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PROXY VOTING OF PASSIVELY MANAGED FUNDS.

(a) In General.—The Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) is amended by inserting after section 208 (15 U.S.C. 80b–8) the following:

"SEC. 208A. PROXY VOTING OF PASSIVELY MANAGED FUNDS.

"(a) Investment Adviser Proxy Voting.—

"In General.—An investment adviser that holds authority to vote a proxy solicited by an issuer pursuant to section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) in connection with any vote of covered securities held by a passively managed fund shall abstain from voting.

"(b) Safe Harbor.—With respect to a matter that is not a routine matter, in the case of a vote described in subsection (a)(1), an investment adviser shall not be liable to any person under any law or regulation of the United States, any constitution, law, or regulation of any State or political subdivision thereof, or under any contract or other legally enforceable agreement (including any arbitration agreement), for any of the following:

"(1) Not soliciting voting instructing from any person under subsection (a)(1) with respect to such vote.

"(2) Voting in accordance with the voting instructions of an issuer pursuant to subparagraph (B) of such subsection.

"(3) Abstaining from voting in accordance with subparagraph (C) of such subsection.

"(c) Definitions.—In this section:

"(1) Covered Security.—The term 'covered security'—

"(A) means a voting security, as that term is defined in section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)), in which a qualified fund is invested; and

"(B) does not include any voting security (as defined in subparagraph (A)) of an issuer registered with the Commission as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8).

"(2) Passively Managed Fund.—The term 'passively managed fund' means a qualified 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 index fund; or

"(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 fund.

"(3) Qualified Fund.—The term 'qualified fund' means—

"(A) an investment company, as that term is defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3);

"(B) a private fund;

"(C) an eligible deferred compensation plan, as that term is defined in section 457(b) of the Internal Revenue Code of 1986;

"(D) a trust, plan, account, or other entity described in section 3(c)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(11));

"(E) a plan maintained by an employer described in clause (i), (ii), or (iii) of section 403(b)(1)(A) of the Internal Revenue Code of 1986 to provide annuity contracts described in section 403(b) of such Code;

"(F) a common trust fund, or similar fund, maintained by a bank;

"(G) any fund established under section 8438(b)(1) of title 5, United States Code; or

"(H) any separate managed account of a client of an investment adviser.

"(4) Registrant.—The term 'registrant' means an issuer of covered securities."

(b) Effective Date.—The amendment made by this section shall take effect on the first August 1 that occurs after the date that is 2 years after the date of enactment of this Act.

Model Policy 2: Amend the Securities Exchange Act of 1934

A BILL

To amend the Securities Exchange Act of 1934 to empower shareholders to determine the treatment of passive index fund voting abstentions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 14 (15 U.S.C. 78n–2) the following:

"SEC. 14C. TREATMENT OF PASSIVE INDEX FUND VOTING ABSTENTIONS.

"(a) Separate Resolution Required.—

"(1) In General.—Not less frequently than once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require tallies of shareholder voting shall include a separate resolution subject to shareholder vote to determine whether voting abstentions by passively managed funds, as defined under Section 206A of the Investment Advisers Act, codified at 15 U.S.C. ___, be excluded altogether from required shareholder voting thresholds as specified under state corporate law or corporate articles of incorporation or bylaws, including but not limited to supermajority voting thresholds and matters requiring the approval of a majority of the outstanding securities of the registrant entitled to vote on the matter.

"(2) Variation in Voting Treatment Allowed.—The Commission may allow corporate issuers to propose separate resolutions for different categories of vote for shareholder consideration under this section, to the extent permissible under state law.

"(3) Effective Date.—The proxy or consent or authorization for the first annual or other meeting of the shareholders occurring after the end of the 6-month period beginning on the date of enactment of this section shall include the resolution or resolutions described in paragraphs (1) and (2).

"(b) Rule of Construction.—The shareholder vote referred to in subsection (a) may not be construed—

"(1) to create or imply any change to the fiduciary duties of such issuer or board of directors;

"(2) to create or imply any additional fiduciary duties for such issuer or board of directors; or

"(3) to override state corporate law voting requirements to the extent inconsistent with this statute, except as otherwise required under paragraph 14C(a)(1) of this statute."

Appendix A

S. 4241: The Index Act of 2022

A BILL

To amend the Investment Advisers Act of 1940 to require investment advisers for passively managed funds to arrange for pass-through voting of proxies for certain securities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the INvestor Democracy is EXpected Act or the INDEX Act.

SECTION 2. PROXY VOTING OF PASSIVELY MANAGED FUNDS.

(a) In General.—The Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) is amended by inserting after section 208 (15 U.S.C. 80b–8) the following:

SECTION 208A. REQUIREMENT WITH RESPECT TO PROXY VOTING OF PASSIVELY MANAGED FUNDS.

(a) Definitions.—In this section—

(1) the term "covered security"—

(A) means a voting security, as that term is defined in section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)), in which a qualified fund is invested; and

(B) does not include any voting security (as defined in subparagraph (A)) of an issuer registered with the Commission as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8);

(2) the term "passively managed fund" means a qualified 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;

(3) the term "qualified fund" means—

(A) an investment company, as that term is defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3);

(B) a private fund;

(C) an eligible deferred compensation plan, as that term is defined in section 457(b) of the Internal Revenue Code of 1986;

(D) an entity described in section 3(c)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(11));

(E) a plan maintained by an employer described in clause (i), (ii), or (iii) of section 403(b)(1)(A) of the Internal Revenue Code of 1986 to provide annuity contracts described in section 403(b) of such Code;

(F) a common trust fund, or similar fund, maintained by a bank;

(G) any fund established under section 8438(b)(1) of title 5, United States Code; or

(H) any separate managed account of a client of an investment adviser;

(4) the term "registrant" means an issuer of covered securities;

(5) the term "routine matter" does not include—

(A) a proposal that is not submitted to a holder of covered securities by means of a proxy statement comparable with that described in section 240.14a–101 of title 17, Code of Federal Regulations, or any successor regulation;

(B) a proposal that is—

(i) the subject of a counter-solicitation; or

(ii) part of a proposal made by a person other than the applicable registrant;

(C) a proposal that relates to a merger or consolidation, except when, with respect to a registrant—

(i) the proposal is to merge with a wholly owned subsidiary of the registrant; and

(ii) holders of covered securities issued by the registrant that dissent to the proposal do not have rights of appraisal;

(D) a proposal that relates to the sale, lease, or exchange of all, or substantially all, of the property and assets of a registrant;

(E) an election for directors (or comparable positions); or

(F) any other matter determined by the Commission or an exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) to be not routine; and

(6) the term "voting person" means a person that provides voting instructions under subsection (b) or (c).

(b) Requirement.—

(1) In General.—Subject to subsection (g), if an investment adviser holds authority to vote a proxy solicited pursuant to section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) in connection with any vote of covered securities held by a passively managed fund, and the voting authority held by that investment adviser with respect to those covered securities (when combined with the voting authority of other persons controlled by, or under common control with, that investment adviser) is more than 1 percent of the voting authority of the outstanding securities of the registrant subject to the vote, the investment adviser shall vote proportionate amounts of those covered securities in accordance with the voting instructions of—

(A) in the case of a passively managed fund that issues securities, persons holding securities in the passively managed fund, such that, solely for the purposes of that vote, the percentage of securities held by such a person shall be deemed to be the percentage of the covered securities beneficially owned by that person; and

(B) in all cases other than a case described in subparagraph (A), persons holding economic interests in the passively managed fund, such that, solely for purposes of that vote, the percentage of economic interests held by such a person shall be deemed to be the percentage of the covered securities beneficially owned by that person.

(2) Prohibition.—If paragraph (1) applies with respect to any vote of covered securities and the investment adviser to which that paragraph applies does not receiving voting instructions from all persons described in subparagraphs (A) and (B) of that paragraph, the investment adviser may not vote the proportion of the shares of the covered securities for which the investment adviser does not receive voting instructions.

(c) Passively Managed Fund as Security Holder of Another Passively Managed Fund.—If a passively managed fund (referred to in this subsection as the holding fund) holds securities of another passively managed fund (referred to in this subsection as the held fund), and there is a vote with respect to covered securities held by the held fund, the investment adviser of the holding fund shall obtain voting instructions from persons holding securities in the holding fund, or to persons holding economic interests in the holding fund, as applicable, with respect to that vote in the manner described in subsection (b).

(d) Prohibitions.—

(1) Reimbursement.—No person may seek reimbursement from a registrant, or require any expenses incurred to be paid by a registrant, with respect to the obligations imposed under this section.

(2) Partial compliance.—An investment adviser may not solicit voting instructions from some, but not all, voting persons under subsection (b)(1) or (c), as applicable.

(e) Exceptions.—

(1) Voting on Routine Matters.—Notwithstanding subsections (b)(1), (b)(2), and (d)(2), if an investment adviser chooses not to solicit voting instructions with respect to a vote described in subsection (b)(1) or (c), or, as of the date that is 10 days before such a vote, the investment adviser has not received voting instructions from a person described in subparagraph (A) or (B) of subsection (b)(1) or subsection (c), as applicable, the investment adviser may vote the covered securities for which the investment adviser has not received voting instructions with respect to a routine matter.

(2) Mirror-Voting Exception for Matters Requiring Approval of a Majority of Outstanding Securities.—Notwithstanding subsections (b)(1), (b)(2), and (d)(2), if a matter to be considered at a meeting of a registrant requires the approval of a majority of the outstanding securities of the registrant entitled to vote on the matter, an investment adviser to which any such provision applies may, with respect to any covered securities for which voting instructions have not been received, as of the date that is 10 days before that vote, vote the uninstructed covered securities in a manner that is proportionate to the votes submitted on the matter by all other security holders of the registrant.

(f) Dissemination of Information.—

(1) In General.—Any investment adviser subject to the requirements of subsection (b) or (c) shall, with respect to the dissemination of information and other materials to a voting person, comply with the following requirements, unless the voting person affirmatively declines to receive that information and other materials:

(A) Provide to the voting person—

(i) a proxy statement, other proxy soliciting material, or an information statement;

(ii) an annual report from the applicable registrant;

(iii) a form of voting instruction to return to the investment adviser; and

(iv) any control or identification number that the voting person needs to return to the investment adviser the voting instruction provided under subparagraph (B).

(B) Provide the voting person with not less than 5 business days after the date on which the voting person receives the materials provided under paragraph (1) to return those materials to the investment adviser.

(2) Electronic Delivery.—All, or any portion, of the materials that an investment adviser is required to provide under paragraph (1)(A) may be provided electronically, including an internet web site address provided by the applicable registrant or a third party.

(3) Option for Investment Advisers.—An investment adviser may provide recommendations to voting persons with the material provided under paragraph (1)(A), or after providing the material under that paragraph, if the investment adviser permits voting recommendations to be provided to voting persons by third parties on a nondiscriminatory basis and on a wide range of views.

(4) Satisfaction of Requirements by Passively Managed Fund.—With respect to any requirement applicable to an investment adviser under this subsection, the requirement may be satisfied by the applicable passively managed fund, which may cover any expenses, direct or indirect, incurred in carrying out that requirement.

(g) Safe Harbor and Rule of Construction Regarding Duties.—An investment adviser—

(1) with respect to a matter that is not a routine matter, may choose not to solicit voting instructions from any person under subsection (b)(1) or (c), subject to subsections (d)(2) and (e); and

(2) if the investment adviser chooses not to solicit voting instructions under subparagraph (A), shall not be considered to be in violation of any duty under any Federal or State law for failing to vote the applicable securities.

(b) Effective date.—Section 208A of the Investment Advisers Act of 1940, as added by subsection (a), shall take effect on the first August 1 that occurs after the date that is 2 years after the date of enactment of this Act.

SEC. 3. VOTING INSTRUCTIONS FROM CUSTOMERS.

Section 14(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(b)(1)) is amended by inserting "voting instruction," after "consent."

Appendix B

House Committee on Financial Services, Discussion Bill, 2023

A BILL

To amend the Investment Advisers Act of 1940 with respect to proxy voting of passively managed funds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PROXY VOTING OF PASSIVELY MANAGED FUNDS.

(a) In General.—The Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) is amended by inserting after section 208 (15 U.S.C. 80b–8) the following:

"SEC. 208A. PROXY VOTING OF PASSIVELY MANAGED FUNDS.

"(a) Investment Adviser Proxy Voting.—

"(1) In General.—An investment adviser that holds authority to vote a proxy solicited by an issuer pursuant to section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) in connection with any vote of covered securities held by a passively managed fund shall—

"(A) vote in accordance with the instructions of the beneficial owner of such covered securities;

"(B) vote in accordance with the voting instructions of such issuer; or

"(C) abstain from voting.

"(2) Exception.—Paragraph (1) shall not apply with respect to a vote on a routine matter.

"(b) Safe Harbor.—With respect to a matter that is not a routine matter, in the case of a vote described in subsection (a)(1), an investment adviser shall not be liable to any person under any law or regulation of the United States, any constitution, law, or regulation of any State or political subdivision thereof, or under any contract or other legally enforceable agreement (including any arbitration agreement), for any of the following:

"(1) Not soliciting voting instructing from any person under subsection (a)(1) with respect to such vote.

"(2) Voting in accordance with the voting instructions of an issuer pursuant to subparagraph (B) of such subsection.

"(3) Abstaining from voting in accordance with subparagraph (C) of such subsection.

"(c) Definitions.—In this section:

"(1) Covered Security.—The term 'covered security'—

"(A) means a voting security, as that term is defined in section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)), in which a qualified fund is invested; and

"(B) does not include any voting security (as defined in subparagraph (A)) of an issuer registered with the Commission as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8).

"(2) Passively Managed Fund.—The term 'passively managed fund' means a qualified 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 index fund; or

"(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 fund.

"(3) Qualified Fund.—The term 'qualified fund' means—

"(A) an investment company, as that term is defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3);

"(B) a private fund;

"(C) an eligible deferred compensation plan, as that term is defined in section 457(b) of the Internal Revenue Code of 1986;

"(D) a trust, plan, account, or other entity described in section 3(c)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(11));

"(E) a plan maintained by an employer described in clause (i), (ii), or (iii) of section 403(b)(1)(A) of the Internal Revenue Code of 1986 to provide annuity contracts described in section 403(b) of such Code;

"(F) a common trust fund, or similar fund, maintained by a bank;

"(G) any fund established under section 8438(b)(1) of title 5, United States Code; or

"(H) any separate managed account of a client of an investment adviser.

"(4) Registrant.—The term 'registrant' means an issuer of covered securities.

"(5) Routine Matter.—The term 'routine matter'—

"(A) includes a proposal that relates to—

"(i) an election with respect to the board of directors of the registrant;

"(ii) the compensation of management or the board of directors of the registrant;

"(iii) the selection of auditors;

"(iv) material conflicts;

"(v) declassification; or

"(vi) transactions that would transform the structure of the registrant, including—

"(I) a merger or consolidation;

"(II) the sale, lease, or exchange of all, or substantially all, of the property and assets of a registrant; and

"(B) does not include—

"(i) a proposal that is not submitted to a holder of covered securities by means of a proxy statement comparable with that described in section 240.14a–101 of title 17, Code of Federal Regulations, or any successor regulation;

"(ii) a proposal that is—

"(I) the subject of a counter-solicitation; or

"(II) part of a proposal made by a person other than the applicable registrant;

"(iii) any other matter determined by the Commission or an exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) to be not routine."

(b) Effective Date.—The amendment made by this section shall take effect on the first August 1 that occurs after the date that is 2 years after the date of enactment of this Act.

Endnotes

1 Investment Company Institute, "2023 Fact Book," p. 23, fig. 2.6.

2 Ibid., p. 48.

3 Steve Johnson, "Passive Fund Ownership of U.S. Stocks Overtakes Active for First Time," *Financial Times*, June 6, 2022.

4 Investment Company Institute, "2023 Fact Book," p. 23, fig. 2.6.

5 Alexander Chinco and Marco Sammon, "The Passive Ownership Share Is Double What You Think It Is," Dec. 16, 2023.

6 Investment Company Institute, "2023 Fact Book," p. 27, fig. 2.10.

7 Theo Andrew, "Vanguard Lags BlackRock and State Street in Support of ESG Issues," *EFT Stream* (blog), June 15, 2023.

8 Ibid.

9 Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo "Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk," *Business and Politics* 19, no. 2 (2017): 298–326. Although the analysis of Big Three ownership by Fichtner, Heemskerk, and Garcia-Bernardo dates from 2017, evidence suggests that this ownership pattern has only increased since then. A recent paper by professors Lucian Bebchuk and Scott Hirst finds that the median percentage ownership by the Big Three in S&P 500 companies grew from 19.5% in 2017 to 21.9% by the end of 2021. Lucian A. Bebchuk and Scott Hirst, "Big Three Power, and Why it Matters," *Boston University Law Review* 102 (2022).

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18 Silla Brush and Alex Wittenberg, "BlackRock Assets Hit Record $10 Trillion, Powered by ETFs," Bloomberg, Jan. 14, 2022.

19 Wursthorn, "Tidal Wave of ESG Funds Brings Profit to Wall Street."

20 Larry Fink, "2022 Letter to CEOs: The Power of Capitalism," BlackRock, 2022.

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22 James R. Copland and Margaret M. O'Keefe, "Climate-Change Proposals Break Through," Proxy Monitor Finding 1, 2017.

23 Danielle Wiener-Bronner, "Why a Defiant Girl Is Staring Down the Wall Street Bull," CNN, Mar. 7, 2017.

24 Abe M. Friedman and Robert McCormick, "BlackRock's 2017–2018 Engagement Priorities," Harvard Law School Forum on Corporate Governance, Mar. 17, 2017.

25 Larry Fink, "A Sense of Purpose," Harvard Law School Forum on Corporate Governance, Jan. 17, 2018.

26 James R. Copland, "The Business Roundtable's Statement Isn't Revolutionary. It's a Truism," *Washington Post*, Aug. 22, 2019.

27 Shareholder primacy—the notion that corporate managers have a near-exclusive fiduciary obligation to shareholders rather than other corporate "stakeholders"—is deeply rooted in American law. It traces at least as far back as *Dodge v. Ford Motor Company*, in which the Michigan Supreme Court ruled that Henry Ford had a fiduciary duty to manage Ford Motor Company for the benefit of shareholders rather than employees or the broader community: 170 N.W. 668. (Mich. 1919).

In the academic literature, Adolf Berle and Gardiner Means were early defenders of the primacy of shareholders' interests in governing corporate managers' fiduciary duties; see Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933). Shareholder primacy was buttressed by later law and economics articles; see, e.g., Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review* 62, no. 5 (1972): 777–95; Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): 305–60.

Notwithstanding the more modern push for "corporate social responsibility"—cf. Christopher D. Stone, *Where the Law Ends: The Social Control of Corporate Behavior* (New York: Harper & Row, 1975); Ralph Nader, Mark J. Green, and Joel Seligman, *Taming the Giant Corporation* (New York: Norton, 1976); but see David L. Engel, "An Approach to Corporate Social Responsibility," *Stanford Law Review* 32, no. 1 (November 1979)—the legal duties of corporate managers have remained essentially shareholder-focused. See also Elizabeth Warren, "Companies Shouldn't Be Accountable Only to Shareholders," *Wall Street Journal*, Aug. 15, 2018; James R. Copland, "Senator Warren's Bizarro Corporate Governance," *Economics21* (blog), Aug. 16, 2018.

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29 Ibid.

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34 See, e.g., James R. Copland, "Another Shareholder Proposal? McDonald's Deserves a Break Today," *Wall Street Journal*, July 7, 2017; idem, "Getting the Politics Out of Proxy Season," *Wall Street Journal*, Apr. 23, 2015.

35 Stephen R. Soukup, *The Dictatorship of Woke Capital: How Political Correctness Captured Big Business* (New York: Encounter, 2021).

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39 See Boardroom Accountability Project.

40 Ross Kerber, "Florida Pulls $2 Bln from BlackRock in Largest Anti-ESG Divestment," Reuters, Dec. 1, 2022.

41 Fred Lucas, "21 State AGs Warn Top Asset Management Firms About Woke Investing," *Daily Signal*, Mar. 31, 2023.

42 See press release, "Sullivan Introduces INDEX Act to Empower Investors and Neutralize Wall Street's Biggest Investment Firms," May 13, 2022; press release, "Huizenga, Luetkemeyer Introduce INDEX Act to Empower Retail Investors, Increase Transparency," July 27, 2022.

43 INDEX Act, S. 4241, 117th Cong. (2022).

44 See "Hearing Entitled: Protecting Investor Interests: Examining Environmental and Social Policy in Financial Regulation," U.S. House Committee on Financial Services, July 12, 2023.

45 See, e.g., James R. Copland, "Statement to the House Committee on Financial Services," U.S. House Committee on Financial Services, July 12, 2023.

46 Discussion draft, H.R.___, 118th Cong. (July 6, 2023).

47 See Kenneth R. French, "Presidential Address: The Cost of Active Investing," *Journal of Finance* 63, no. 4 (August 2008): 1537, 1561 (concluding that a passive investor from 1980 to 2006 would have beaten an active investor by 67 basis points per year).

48 See, e.g., Alan D. Crane and Kevin Crotty, "Passive Versus Active Fund Performance," *Journal of Financial and Quantitative Analysis* 53, no. 1 (February 2018): 33–64.

49 Bernard S. Sharfman, "Looking at the 'Big Three' Investment Advisers Through the Lens of Agency," *Oxford Business Law Blog*, Feb. 18, 2022.

50 "Investment Stewardship Annual Report: January 1–December 31, 2022," BlackRock (2022), p. 39; Dhruv Aggarwal, Lubomir P. Litov, and Shivaram Rajgopal, "Big Three (Dis) Engagements," Norwestern Law and Econ Research Paper No. 23–17, Northwestern Public Law Research Paper No. 25–53 (Dec. 5, 2023).

51 See, e.g., Lucian A. Bebchuk, Alon Brav, and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism," National Bureau of Economic Research, working paper 21227 (June 2015); Robin M. Greenwood and Michael Schor, "Investor Activism and Takeovers," *Journal of Financial Economics* 92 (2008): 362, 374; April Klein and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors," *Journal of Finance* 64, no. 1 (February 2009): 187, 213, 217–18; Alon Brav et al., "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance* 63, no. 4 (August 2008): 1729, 1732; Christopher P. Clifford, "Value Creation or Destruction? Hedge Funds as Shareholder Activists," *Journal of Corporate Finance* 14, no. 4 (2008): 323–24.

52 Paul Rose and Bernard S. Sharfman, "Shareholder Activism as a Corrective Mechanism in Corporate Governance," *Brigham Young University Law Review* 2014, no. 5 (2014).

53 See, e.g., James R. Copland, *The Unelected: How an Unaccountable Elite Is Governing America* (New York: Encounter, 2020), introduction, chap. 13.

54 INDEX, S. 4241, 117th Cong. § 2 (2022).

55 15 U.S.C. § 80b–1 et seq.

56 Ibid.

57 For a discussion of these laws' history and evolution, see Securities and Exchange Commission, "Protecting Investors: A Half Century of Investment Company Regulation," May 1992.

58 S. 4241 (2022), § 2(a), at § 208A(a)(2).

59 Ibid., § 208A(b)(1).

60 Ibid., § 208A(e)(1).

61 Ibid., § 208A(a)(5).

62 Such investors might prefer institutional vehicles rather than investing directly in securities because of capital constraints (they may lack adequate resources to build a truly diversified portfolio of individual securities or may lack economies of scale necessary to execute a trading strategy efficiently); or they may have a broad belief about market valuations but otherwise lack capacity to execute their strategy individually.

63 See James R. Copland, Testimony Before the House Committee on Financial Services, July 13, 2023.

64 Securities Exchange Act Release No. 3638 (Jan. 3, 1945), 11 Fed. Reg. 10,995 (1946).

65 Division of Corporation Finance, Securities and Exchange Commission, "Shareholder Proposals: Staff Legal Bulletin No. 14L (CF)," CF Staff Legal Bulletin, Nov. 3, 2021.

66 See n. 27 for further explanation.

67 Yale Law professor Henry Hansmann explains in his seminal book *The Ownership of Enterprise*, which empirically analyzes alternative forms of enterprise ownership:

> Most fundamentally, political representation evidently performs poorly, relative to markets, where there is any significant conflict of interest among the participants. Or at least this seems to be the obvious conclusion to be drawn from the fact that, although there are hundreds of thousands of firms in the economy, and although these firms exhibit a diverse variety of ownership structures, including a surprisingly large number of firms in which ownership is not in the hands of investors, in virtually all cases the group of individuals to whom ownership is given is extremely homogeneous in its interests. It is extraordinarily rare to find a firm in which control is shared among individuals who have stakes in the enterprise that are at all dissimilar.

Henry Hansmann, *The Ownership of Enterprise* (Cambridge, MA: Belknap Press of Harvard University Press, 1996), 288. The high costs of aggregating votes along heterogeneous interests is self-evident to any observer of real-world electoral republics, as well as to anyone remotely familiar with the public-choice literature. See Kenneth K. Arrow, *Social Choice and Individual Values* (New York: Wiley, 1963) (articulating Arrow's Impossibility Theorem, which holds that, given certain fairness criteria, voters facing three or more ranked alternatives cannot convert their preferences into a consistent, community-wide ranked order of preferences).

68 See Copland, "Getting the Politics Out of Proxy Season."

69 See, e.g., Shivaram Rajgopal, "Is the INDEX Act Workable?" *Forbes*, July 6, 2023.

70 See James R. Copland, "How Everyday Investors May Soon Vote Away ESG," *New York Post*, Sept. 16, 2023.

71 See James R. Copland, "Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs," Apr. 2, 2019; see also idem, David F. Larcker, and Brian Tayan, "Proxy Advisory Firms: Empirical Evidence and the Case for Reform," Manhattan Institute, 2018.

72 James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "A Report on Corporate Governance and Shareholder Activism," Proxy Monitor, Fall 2012. Note that in general, the proxy advisors have been more likely to recommend voting with progressive activists than even the Big Three asset managers. The German stock exchange Deutsche Börse, which owns ISS, is part of the United Nations' Sustainable Stock Exchanges Initiative, committed to

environmental and social issues and "sustainable" investing. Similarly, Peloton Capital, which owns Glass Lewis, is a signatory of the UN Principles of Responsible Investment, committed to incorporating environmental and social concerns into investment decision-making.

73 See Tracie Woidtke, "Public Pension Fund Activism and Firm Value," Manhattan Institute Legal Policy Report no. 20 (September 2015).

74 See, e.g., Bebchuk, Brav, and Jiang, "The Long-Term Effects of Hedge Fund Activism."

75 For a variety of reasons, most large publicly traded companies in the U.S. are incorporated in Delaware. This phenomenon has long been the subject of academic debate. Cf. William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware," *Yale Law Journal* 83, no. 4 (March 1974): 663, 705 (lamenting a "race to the bottom" in U.S. corporate law), with Ralph K. Winter Jr., "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6, no. 2 (June 1977): 251 (arguing that, *contra* Cary, the federal structure of corporate law creates a "race to the top"); Winter, "The 'Race for the Top' Revisited: A Comment on Eisenberg," *Columbia Law Review* 89, no. 7 (1989): 1526. See also Roberta Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle," *Journal of Law, Economics, and Organization* 1, no. 2 (Fall 1985): 225 (finding the "race to the top" hypothesis more supported than the "race to the bottom" hypothesis in empirical testing).

76 Del. Gen. Corp. L. Title 8 § 216.

77 Ibid. at 216(4).