ARTICLE

# A HARD LOOK AT PORTFOLIO-FOCUSED STEWARDSHIP

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*Financially motivated diversified investors want to maximize the overall value of their portfolio and are not independently concerned with the performance of any given portfolio firm. A growing number of scholars have concluded that index fund managers should therefore engage in stewardship designed to force portfolio firms to internalize the costs their activities impose on other portfolio firms ("portfolio-focused stewardship"). This seemingly provides a financial justification for SEC-mandated disclosure on ESG topics—ESG disclosures concerning how a firm's activities affect the broader economy might help index fund managers identify and, through stewardship, force the internalization of intraportfolio externalities, leading to increases in risk-adjusted portfolio value. This Article critically examines whether, and under what circumstances, financially motivated diversified investors would want their index fund managers to engage in portfolio-focused stewardship, paying careful attention to the real-world frictions that cast doubt on the likelihood that portfolio-focused stewardship would lead to net gains in risk-adjusted*

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*portfolio value as well as the alternative tools available to diversified investors for addressing intraportfolio externalities. The analysis has important implications for contemporary debates over SEC-mandated ESG disclosure as well as index fund managers' fiduciary responsibilities.*

I. Introduction....314
II. Portfolio-Focused Stewardship Gains Academic Adherents....326
III. Is Portfolio-Focused Stewardship Likely to Increase Portfolio Value?....331
A. Real World Friction #1: Managerial Agency Costs 333
B. Real World Friction #2: Intermediary Agency Costs 340
C. Real World Friction #3: Imperfect Information..355
1. Command-and-Control Regulation....363
2. Disclosure Regulation....368
D. Real World Friction #4: Market Dynamism....371
IV. Evaluating the Big Three's Efforts....373
A. Statements of Corporate Purpose....374
B. Gender Quotas for Corporate Boards....376
C. Emissions Reductions....376
D. Disclosure Initiatives....381
V. Available Alternatives....383
VI. Conclusion: Implications for Modern Debates....387

## I. INTRODUCTION

The United States Securities & Exchange Commission ("SEC") recently finalized a controversial set of new disclosure mandates related to climate change,[1] and pressure is on for

[1] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 89 Fed. Reg. 21668 (Mar. 28, 2024) (to be codified at 17 CFR §§ 210, 229, 230, 232, 239, 249); The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (Apr. 11, 2022). The SEC's climate disclosure proposal garnered thousands

the SEC to adopt additional "ESG"[2] disclosure mandates.[3] The SEC's climate disclosure mandates have already prompted numerous challenges, in both courts of law and public opinion, and the same can be expected if the SEC imposes additional "ESG" disclosure requirements.[4] This makes the

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of comment letters expressing a broad array of divergent views. *See, e.g.*, Lawrence A. Cunningham, *What the Volume and Diversity of Comment Letters to the SEC Say About its Climate Proposal*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 3, 2022), https://corpgov.law.harvard.edu/2022/07/03/__trashed-4/ [https://perma.cc/VE6B-UP9N] (observing that "only a handful of the thousands of SEC rule proposals have garnered anywhere near the level of comment letters as this one, and few with the diversity of views"); Cynthia A. Williams & Robert G. Eccles, *Review of Comments on SEC Climate Rulemaking*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 23, 2022), https://corpgov.law.harvard.edu/2022/11/23/review-of-comments-on-sec-climate-rulemaking/ [https://perma.cc/Q28W-SDZX] (providing an overview of the positions taken in the comment letters submitted).

2 The acronym "ESG" is used as shorthand for a broad array of "environmental," "social," and "governance" topics affecting businesses, including climate change, human capital management, supply chain management, human rights, cybersecurity, diversity and inclusion, corporate tax policy, corporate political spending, executive compensation practices, and more. Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821, 1822 (2021). Sometimes the equally broad terms "sustainability" and "non-financial disclosure" are used synonymously to refer to this collection of topics. For a discussion of the origin of the term ESG, see Elizabeth Pollman, *The Making and Meaning of ESG* (Univ. of Pa. Carey L. Sch. Inst. for L. & Econ., Research Paper No. 22-23, 2022), https://ssrn.com/abstract=4219857 [https://perma.cc/47JP-X7EM].

3 *See, e.g.*, Marcel Kahan & Edward Rock, *The Emergence of Welfarist Corporate Governance* 15 J. LEGAL ANALYSIS 122 (2023) (describing numerous recent requests for disclosure rulemaking on social topics).

4 *See* Zoya Mirza & Lamar Johnson, *SEC Battles Climate Disclosure Rule Legal Challenges*, ESG DIVE (Mar. 27, 2024), https://www.esgdive.com/news/SEC-climate-disclosure-rule-legal-challenges-tracker-roundup-analysis/711313/ [https://perma.cc/X6AP-PTHH] (summarizing ongoing litigation challenging the SEC's final climate disclosure rule); Andrew Ramonas, *SEC Freezes Climate Rules After Challengers Pushed for Pause*, Bloomberg L. (Apr. 4, 2024), https://news.bloomberglaw.com/esg/sec-freezes-climate-rules-after-challengers-pushed-for-pause [on file with the Columbia Business Law Review] (noting that the SEC temporarily stayed implementation of the final rule in response to legal pressure).

rationale for their adoption of vital importance. While socially motivated investment has skyrocketed in popularity in recent years,[5] ESG disclosure advocates—which include many of the largest traditional asset managers—are often careful to cast their demands as in the interests of purely *financially* motivated investors,[6] and the SEC has explicitly justified its climate-related disclosure mandates in terms of their financial rather than social significance to investors.[7] Some allege that

[5] *See* Tamara Kostova, *Beyond Returns: The Rise Of Values-Aligned Investing*, FORBES (May 26, 2023), https://www.forbes.com/sites/forbesbusinesscouncil/2023/05/26/beyond-returns-the-rise-of-values-aligned-investing [https://perma.cc/83KK-S74S] (discussing this trend); INV. CO. INST., INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE INVESTMENT COMPANY INDUSTRY 31–33 (2023), https://www.ici.org/system/files/2023-05/2023-factbook.pdf [https://perma.cc/VQ5T-BJVU] (providing data on the rise of funds that engage in sustainable investing strategies).

[6] *See* Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840, 843 ("Institutional investors who have joined environmental and social activists in supporting mandatory ESG disclosures argue that the disclosures will help them generate superior returns—that ESG investing is about 'value, not values.'") (quoting Letter from Cyrus Taraporevala, President & CEO, State St. Glob. Advisors, to Bd. Members (Jan. 28, 2020)). For useful attempts to clarify the distinction between financially motivated ESG investing and ESG investing driven by broader concerns, see Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 397 (2020) (referring "to ESG investing motivated by providing a benefit to a third party or otherwise for moral or ethical reasons as *collateral benefits ESG*, and ESG investing to improve risk adjusted returns as *risk-return ESG*"); Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 211–13 (2018) (drawing a distinction between "concessionary" ESG investing, which tolerates sacrificing some financial return to achieve ESG goals, and "non-concessionary" ESG investing, which carries an expectation of a full risk-adjusted market-rate financial return).

[7] *See, e.g.*, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21335–36 (April 11, 2022) (stating that "[i]nvestors need information about climate-related risks—and it is squarely within the Commission's authority to require such disclosure . . . —because climate-related risks have present *financial* consequences that investors in public companies consider in making investment and

this is subterfuge, that in fact those calling for SEC-mandated ESG disclosures are motivated by a desire to promote other policy objectives, or perhaps to advance their own personal financial interests rather than those of investors.[8] This Article does not take a position on this heated, and increasingly partisan, question.[9] Instead, it attempts something more

voting decisions" and disclaiming any objective "to address climate-related issues more generally" (emphasis added)).

[8] *See* Mahoney & Mahoney, *supra* note 6, at 843–44 (calling the financial value argument in favor of ESG disclosure mandates "cheap talk" and noting that there are "good reasons to believe that [asset managers'] purpose [in supporting such mandates] is in part to pursue public policy goals outside the normal political process"); *see also* Elon Musk (@elonmusk), X (formerly Twitter) (May 18, 2022, 11:09 AM), https://twitter.com/elonmusk/status/1526958110023245829 ("ESG is a scam. It has been weaponized by phony social justice warriors."); Press Release, James Comer, Chairman, House Committee on Oversight and Accountability, Comer: ESG is Just Window Dressing for Liberal Activism and Far-left Ideology (May 10, 2023), https://oversight.house.gov/release/comer-esg-is-just-window-dressing-for-liberal-activism-and-far-left-ideology%EF%BF%BC/ [https://perma.cc/6PJG-FABY] (stating that Representative James Comer (R-Ky.) asserted at a Congressional hearing on ESG that "[t]he ESG agenda prioritizes leftist ideology over the growth of retirees' investments"); Written Testimony of Steven T. Marshall Alabama Attorney General Before the United States House of Representatives Committee on Oversight and Accountability, ESG Part I: An Examination of Environmental, Social and Governance Practices with Attorneys General (May 10, 2023), https://oversight.house.gov/wp-content/uploads/2023/05/Marshall-written-testimony.pdf [https://perma.cc/P34P-FVEV] ("An unelected cabal of global elites are using ESG, a woke economic strategy, to hijack our capitalist system, coerce corporations, and threaten the hard-earned dollars of working Americans. ESG must be stopped."); *see also* Rose, *supra* note 2, at 1823 ("ESG proponents . . . include members of an emerging corps of people and institutions who profit from the movement, including corporate sustainability officers, providers of ESG ratings and indices, accounting firms that offer ESG-related services, and managers of specialized ESG-investment vehicles.").

[9] Clara Hudson, *BlackRock's Shifts in Governance Leave ESG Foes Hungry for More*, BLOOMBERG L. (July 21, 2023), https://news.bloomberglaw.com/esg/blackrock-changes-set-up-anti-esg-forces-to-seek-next-targets [on file with the Columbia Business Law Review] ("Republicans say ESG pushes progressive policies that don't prioritize financial metrics for shareholders. Democrats, meanwhile, have countered that investors want

constructive by subjecting the *financial* case for SEC-imposed ESG disclosure mandates to much-needed analytical rigor.

Financial arguments in favor of SEC-imposed ESG disclosure mandates come in at least three different permutations, only the last of which is examined in this Article. The first is traditional—that ESG information would be important to a financially-motivated investor or prospective investor in the disclosing firm because the information is likely to significantly impact the disclosing firm's future expected cash flows.[10] To call this argument traditional does not, of course, answer whether it is convincing in application. Its strength as a justification for mandatory ESG disclosure will depend on, *inter alia*, the specific piece of ESG information at issue and the plausibility of the contention that such information is likely to be valuation relevant.[11]

The second argument is more novel. ESG information might be thought of in terms of its relation not only to firms' future expected cash flows but also in relation to firms' contribution to, or sensitivity to, systematic risk in the economy, in which case disclosure might improve the market's understanding of the level of, and specific firms' sensitivity to,

ESG information because it's good for the performance of their investments.").

[10] *See e.g.*, George S. Georgiev, *The Market-Essential Role of Corporate Climate Disclosure*, 56 U.C. DAVIS L. REV. 2105, 2124–29 (2023) (defending certain aspects of the SEC's climate disclosure proposal on this basis).

[11] As I have explained elsewhere, not even the most ardent ESG disclosure advocate would contend that *all* ESG information is financially important to companies—certain ESG topics may impact corporations' cash flows in a material way, whereas other ESG topics may not, and variations will exist amongst industries and amongst corporations within industries. *See* Rose, *supra* note 2, at 1833–34. Moreover, even if information on a specific ESG topic is plausibly valuation-relevant, mandatory disclosure is not necessarily justified. *See id.* at 1834 (explaining that the SEC does not mandate disclosure of information simply because it is material to firms' financial performance: "[t]he decision to create a duty to disclose requires a weighing of, inter alia, the cost to companies of producing the information and the magnitude of the benefit to investors of the information's production").

systematic risk.[12] If such disclosures revealed that systematic risk was higher or lower than previously understood, investors could better optimize their portfolios across asset classes; and if investor understanding of particular firms' sensitivity to systematic risk became more accurate by virtue of the disclosure, investors could construct portfolios that better match their risk preferences.[13] Whether the SEC should be in the business of mandating disclosures designed to promote more accurate pricing of systematic risk is an interesting question that warrants further thought. While the benefits of this sort of disclosure are easy to articulate, so too are the costs, particularly as it concerns placing meaningful boundaries on the SEC's authority.[14]

The third argument, which is the focus of this Article, builds on a theory that has become popularized recently in

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[12] *See, e.g.*, Madison Condon, *Market Myopia's Climate Bubble*, 2022 UTAH L. REV. 63 (arguing that climate risk is systematic in nature, in the sense that it cannot be diversified away, and that it is underpriced by the market); The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21446 (Apr. 11, 2022) (discussing how climate change is a form of systematic risk and how disclosure can help investors appreciate this and adjust their portfolios to decrease vulnerability to sudden losses).

[13] *See* ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS, Part II (13th ed. 2024) (providing an introduction to portfolio theory).

[14] Establishing that the market is underpricing a systematic risk to the economy, and that mandatory disclosure of related information is likely to correct the distortion, would be incredibly difficult to do with any degree of certainty. Indeed, establishing that something even *is* a systematic risk is fraught with uncertainty. *See, e.g.*, John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, 2021 COLUM. BUS. L. REV. 602, 620–21 (observing that "[s]keptics may doubt that [ESG] disclosures [focused on racial diversity and inclusiveness] relate at all to systematic risk disclosure," but positing that "over the long run, these disclosures arguably relate to the potential viability of our corporate system" because if that system "cannot offer inclusiveness and promote diversity, it may subject itself to a political risk that capitalism . . . will be politically challenged . . ."). If the SEC were given broad deference by the courts when invoking this rationale for disclosure, it could have the practical effect of broadly expanding the scope of the SEC's authority.

both academic literature and in asset manager discourse.[15] The theory, which has been referred to as "portfolio primacy theory," proceeds from a clearly correct premise: financially motivated diversified investors want to maximize the risk-adjusted value of their portfolio as a whole and are not independently concerned with the performance of any given portfolio firm. In familiar economic terms, this means that such investors would, all else equal, want their portfolio firms to internalize the costs their activities impose on other portfolio firms, leading those firms to conduct business in a way that leads to Kaldor-Hicks efficient outcomes at the portfolio level. From this solid premise about the desired *end* of financially motivated diversified investors, portfolio primacy theory makes a contestable claim about the *means* by which such investors would wish to pursue it—namely, that they would want to use their influence as investors over portfolio firm managers to cause those managers to pursue portfolio value maximization, even at the expense of firm value maximization. Because the vast majority of diversified investors are passive investors in index funds, this translates into a claim that financially motivated diversified investors would want their index fund managers to wield their funds' influence in this way. I refer to this as "portfolio-focused stewardship."[16]

15 *See, e.g.*, Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. 511, 514 (2023) (explaining the theory and noting that "[it] has received increasing support among public institutions, market players, and environmental activists"); Coffee, Jr., *supra* note 14, at 646 (noting that the theory "has excited scholars").

16 The dramatic growth of indexed mutual and exchange traded funds in recent years is what makes the notion that public companies could successfully be pushed to subordinate firm-value maximization to portfolio-value maximization plausible. *See generally* Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. Rev. 721 (2019) (providing empirical evidence of this growth). Management of the index fund sector is dominated by BlackRock, Inc. (Blackrock), State Street Global Advisors (State Street), and the Vanguard Group (Vanguard), collectively known as the "Big Three." *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033 n.2 (2019) (describing the origins of the term). The Big Three collectively direct the votes of roughly 25% of the shares in all S&P500 companies, and it has been estimated that the average proportion

The idea that financially motivated diversified investors would want their index fund managers to engage in portfolio-focused stewardship might justify a more expansive set of SEC disclosure mandates than would be called for if such investors preferred their fund managers to focus more narrowly on issues affecting individual firm value. For example, ESG disclosures about how a firm's activities affect the broader economy might help index fund managers identify and, through stewardship, force the internalization of intraportfolio externalities. Such externalities would include, but are potentially much broader than, a portfolio firm's contributions to unpriced systematic risk, distinguishing this argument from the second. There is another, more fundamental, distinction between this and the second argument: whereas the second assumes that investors will use the enhanced disclosures to inform their *investment* decisions, the third posits that index fund managers may use the enhanced disclosures to inform their *stewardship* decisions.[17] It is the effect of portfolio-focused stewardship on the behavior of firms that may cause the risk-adjusted value of the portfolio as a whole to increase, not just the impact of the information on trading decisions that improve share price accuracy. Indeed, portfolio primacy theory presumes diversified investors whose portfolios are fixed and thus for whom "exit" is not an option.

This Article interrogates the logic of portfolio-focused stewardship, with direct implications for the debate over ESG disclosure mandates. It considers the issue from the perspective of a rational, financially motivated diversified investor—not

of shares in S&P500 companies voted by the Big Three could reach as much as 40% within two decades. *See* Bebchuk & Hirst, *The Specter of the Giant Three*, *supra*, at 737–40. Big Three voting power raises important questions beyond the capacity of the Big Three to use that power to achieve portfolio-level financial gains—questions related to democratic legitimacy as well as the potential anti-competitive effects of common ownership. While incredibly important, those concerns are beyond the scope of this Article. *See infra* notes 61 & 158–160 and accompanying text (discussing these concerns).

[17] The term "stewardship" refers to the influence that fund managers can exert over their portfolio firms through monitoring, engagement, and voting. *See* Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2044–46 (discussing these forms of stewardship).

because real investors are always rational and care single-mindedly about financial returns, but because this is the type of investor whose interests portfolio-focused stewardship (and SEC disclosure mandates in support thereof) is purported to advance.[18] The Article posits that such an investor would logically prefer the path of portfolio-focused stewardship as a way to limit intraportfolio externalities and thus enhance risk-adjusted portfolio value only if two conditions are satisfied. *First*, the benefits of that path must be expected to exceed the costs—that is, net of fees and other costs, it must be expected that such stewardship will in fact lead to an increase in risk-adjusted portfolio value. *Second*, the expected net benefits of such stewardship must exceed the expected net benefits of pursuing alternative methods available to diversified investors for causing portfolio firms to internalize intraportfolio externalities (unless the alternative(s) and the stewardship together would be expected to produce more net benefits than the alternative(s) alone).

As explored herein, four frictions render dubious an assumption that portfolio-focused stewardship would lead to an increase in risk-adjusted portfolio value. They are: (1)

[18] No human investor is single-mindedly focused on financial returns; individuals have broader concerns based on their social, political, and religious commitments. But whereas one can assume that all (or almost all) investors have an interest in increasing their risk-adjusted financial returns, one cannot assume homogeneity with respect to investors' non-financial concerns. *See* Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1009 (2020) (similarly explaining that the norm of shareholder wealth maximization "is often posited or assumed not because it is the highest and best thing for real-life shareholders but because it is the most that can be assumed about shareholders as a class," operating as "a kind of lowest common denominator solution to their inability to coalesce around other objectives"). Hence, federal securities regulation has traditionally focused on the disclosure needs of a fictionalized financially driven "reasonable investor," and managers of traditional index funds are understood to owe their fiduciary duties to such an investor. *See* Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77, 88–92 (2017) (discussing other attributes of the "reasonable investor"); Schanzenbach & Sitkoff, *supra* note 6 at 399–422 (discussing the fiduciary duties of asset managers).

managerial agency costs; (2) intermediary agency costs; (3) imperfect information; and (4) market dynamism. Several recent scholarly works address one or more of these frictions.[19] One contribution of this Article is to bring the insights of these works together within a comprehensive analytical framework focused on the ultimate question: under what circumstances, if any, would financially motivated diversified investors wish their asset managers to engage in portfolio-focused stewardship? Another contribution is to surface insights developed in the law and economics and public choice literature relevant to government lawmaking designed to curb negative externalities. This rich body of scholarship sheds considerable light on the relative capacity of index fund managers to step into a comparable private lawmaking role and prove effective, but it has gone largely ignored in discussions of portfolio primacy theory.[20] A further contribution is to lay out, in consideration of the second condition, the alternative means available to diversified investors for reducing intraportfolio externalities—such as direct advocacy for legal change and interventions to

[19] *See, e.g.*, Tallarita, *supra* note 15; Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. 77 (2023); Bernard S. Sharfman, *Opportunism in the Shareholder Voting and Engagement of the "Big Three" Investment Advisers to Index Funds*, 48 J. CORP. L. 463 (2023); Jill Fisch & Jeff Schwartz, *Corporate Democracy and the Intermediary Voting Dilemma*, 102 TEX. L. REV. 1, 31 (2023); Jeffrey Schwartz, *Stewardship Theater*, 100 WASH. U. L. REV. 393 (2022); Marcel Kahan & Edward B. Rock, *Systemic Stewardship with Tradeoffs*, 48 J. CORP. L. 497 (2021); David H. Webber, Michal Barzuza & Quinn Curtis, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020); Griffith, *supra* note 18; John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019).

[20] One notable exception is Professor Dorothy Lund's recent article *Asset Managers as Regulators*, which among other things analyzes the relative vulnerability of asset managers and public lawmakers to regulatory capture. Lund, *supra* note 19, at 101–05. *Asset Managers as Regulators* also discusses other advantages and limitations of asset manager regulation as compared to public lawmaking (*see id.* at 133–44), but unlike this Article does not explore the relative capacity of asset managers to employ various legal instruments for forcing the internalization of externalities. *See infra* Section III.C.

reduce corporate influence in politics—and assess their relative attractiveness.

The analysis produces a set of criteria for evaluating specific stewardship interventions, and it leads to some general conclusions about the types of portfolio-focused stewardship interventions that rational, financially motivated diversified investors would—and would not—be likely to support. The analysis suggests that these investors would *not* generally support portfolio-focused stewardship interventions by index fund managers designed to directly regulate portfolio companies' externalizing activities ("command and control regulation"), but that under certain conditions they *might* support stewardship interventions that force portfolio companies to disclose information about intraportfolio externalities ("disclosure regulation"). Importantly, the analysis suggests that disclosure regulation would not be supported because it would assist index fund managers in crafting future command-and-control style portfolio-focused stewardship interventions, but rather because it might prod *other* actors (including, e.g., non-index investors, consumers, labor and environmental organizations, regulators, and legislators) to take actions that would lead portfolio firms to internalize their intraportfolio externalities.

The narrow band of portfolio-focused stewardship interventions that this Article suggests financially motivated diversified investors might rationally support has important implications. For example, it should assist index fund managers seeking to understand their fiduciary duties to fund investors, a topic that is currently under Congressional scrutiny.[21] In short: index fund managers should *not* view themselves as possessing broad license to wield their influence over portfolio firms in a manner that purports to prioritize portfolio over firm value.

[21] *See* Press Release, Bill Huizenga, Chairman, House Financial Services Subcommittee on Oversight and Investigations, Huizenga Opens Inquiry into How Asset Managers Fulfill Their Fiduciary Responsibility, (July 18, 2023), https://huizenga.house.gov/news/documentsingle.aspx?DocumentID=402668 [https://perma.cc/43VW-XEH5].

The Article's analysis also has significant implications for the contemporary debate over SEC-imposed ESG disclosure mandates. The idea that disclosure of ESG information—if made more consistent and credible through SEC mandates—would assist index fund managers in future portfolio-focused stewardship efforts seems consistent with the materiality standard set forth by the Supreme Court in *TSC Industries, Inc. v. Northway Inc.*[22] That case provides that information is material if there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[23] But, as just noted, the analysis herein suggests that financially motivated diversified investors would not rationally want their index fund managers to use the information in this way. Instead, they would view the information as potentially valuable only insofar as it might catalyze *other* actors to take actions that would result in portfolio firms' internalization of intraportoflio externalities. To the extent such mandates were expected to catalyze more informed trading by financially-motivated non-index investors, portfolio primacy theory would add nothing to the first two financial arguments for SEC-imposed ESG disclosure mandates discussed above. The upshot is that portfolio primacy theory potentially provides an independent financial justification for SEC-imposed ESG disclosure mandates only if the SEC may mandate disclosures designed for consumption by audiences *other than* financially motivated investors (assuming those audiences are expected to respond in ways that may lead to an increase in the risk-adjusted value of a diversified portfolio). This is a novel and expansive understanding of the SEC's regulatory authority, one many—including the Court of Appeals for the D.C. Circuit—are likely to reject.

The remainder of this Article proceeds as follows. Part II discusses the recent embrace of portfolio-focused stewardship by legal academics and lays out the idea's premises. Part III interrogates whether, and under what circumstances, financially motivated diversified investors might rationally expect

[22] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).
[23] *Id.* at 449.

portfolio-focused stewardship to lead to net gains in risk-adjusted portfolio value. It develops criteria for evaluating whether specific stewardship interventions are of the sort that rational, financially motivated diversified investors might endorse, criteria that are then applied in Part IV to evaluate the recent stewardship efforts of the "Big Three" asset managers.[24] Part V turns to discuss alternative approaches available to such investors for forcing the internalization of intraportfolio externalities, commenting on their relative attractiveness. The Article concludes by remarking on the implications of the analysis for current debates over SEC-mandated ESG disclosures and the scope of index fund managers' fiduciary duties. The conclusion also highlights implications of the analysis for recent proposals that index fund managers pass their funds' voting rights through to fund investors.

## II. PORTFOLIO-FOCUSED STEWARDSHIP GAINS ACADEMIC ADHERENTS

For decades before "ESG" was a household term, commentators hotly debated the purpose of a corporation. Should boards and managers run corporations to maximize firm value for the benefit of shareholders, or in service of broader social interests?[25] Proponents of "corporate social responsibility" or "CSR" advocated for the latter, but their position has traditionally been considered an outside view: the firm-value-maximization perspective is firmly embedded both in Delaware law and management culture, and market-oriented corporate law scholars tend to find it normatively appealing.[26] The rise

[24] Bebchuk & Hirst, *supra* note 16.

[25] For one of the early, foundational manifestations of this debate, see Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); and Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932). *See also* A. A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP L. 33, 36–39 (1991) (tracing the history of this debate).

[26] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) (observing that "as a

of "ESG" has rekindled this old debate, but in a muddied way. Some view "ESG" as simply a repackaging of "CSR," a carrying forward of the same position under a new acronym.[27] Others view "ESG" as not only different from "CSR," but as fully consistent with a firm-value-maximization view of corporate purpose—corporations do well by paying heed to "ESG" issues.[28]

A third perspective has also emerged, one that touts "ESG" not as a substitute for CSR nor as a means for achieving firm value maximization, but rather as a means for diversified investors to maximize *portfolio* value. Diversified investors can actualize on this potential, the argument goes, through the portfolio-focused stewardship efforts of their increasingly powerful asset managers, who can use their clout to force portfolio firms to internalize the costs their activities impose on one another, leading to more portfolio-level efficient behavior and increased risk-adjusted portfolio-level returns. Because it is based on the financial incentives of diversified investors, rather than on more amorphous notions of the "social good," this perspective seems less radical than the CSR perspective, and,

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consequence of both logic and experience, there is convergence on a consensus that the best means to [pursue] aggregate social welfare[] is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests"); William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and* The Modern Corporation, 34 J. CORP. L. 99, 100 (2008) (observing that "shareholder primacy prevails today as the dominant view," and describing "advocates of corporate social responsibility (CSR) as a rearguard").

[27] *See* Pollman, *supra* note 2, at 24–25 (discussing this perspective).

[28] This view, sometimes called "enlightened shareholder value," has become more difficult to defend as the war in Ukraine, consumer backlash to corporate social initiatives, and rising interest rates have made the potential cost to firms of "ESG" initiatives more readily apparent than they were just a few short years ago. *See* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 97 (2020) (using the term "enlightened shareholder value" to describe the view that "corporate leaders should take into account stakeholder interests as a means to maximize shareholder value").

as discussed below, it has recently captured the imagination of a growing cohort of corporate and securities law scholars.[29]

Madison Condon's article *Externalities and the Common Owner*, published in 2020, sparked recent interest by legal academics in portfolio-focused stewardship.[30] In that article, Professor Condon made a positive claim to explain institutional investor interest in climate-related stewardship—*viz.*, that "institutional investors' climate activism is motivated by their desire to mitigate climate change risks and damages to their economy-mirroring portfolios."[31] She argued that portfolio value maximization, not share value maximization, best explains institutional investor interventions with portfolio companies to achieve emission reductions, and detailed what those interventions have looked like.[32] While subsequent works have cited her article to support normative arguments in favor of institutional investors engaging in this sort of stewardship activity, Professor Condon was careful not to reach normative conclusions herself, identifying several reasons why "common ownership internalization of negative externalities" might not be socially desirable.[33]

[29] Enthusiasm for portfolio-focused stewardship extends beyond the ivory tower. Organizations like the Shareholder Commons provide tools to asset managers to help them ensure that portfolio firms "prioritize their systemic impacts over individual company profit in order to protect portfolio values." *See System Stewardship Theory*, S'HOLDER COMMONS, https://theshareholdercommons.com/resources-page/#tsc-and-system-stewardship [https://perma.cc/R79N-GVF7].

[30] Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020). For some earlier contributions by scholars in other disciplines, see the articles discussed *infra* at note 42, as well as James Hawley & Andrew Williams, *The Emergence of Universal Owners: Some Implications of Institutional Equity Ownership*, 43 CHALLENGE 43 (2000).

[31] Condon, *Externalities and the Common Owner*, *supra* note 30, at 6.

[32] *Id.* at 12, 19–26.

[33] *Id.* at 65. *But see* Condon, *Market Myopia's Climate Bubble*, *supra* note 12, at 125 (explaining that "large institutional shareholders should have a particular interest in how climate constitutes a systematic risk to their portfolios, as these unhedgeable risks cannot be diversified away," and stating that they therefore "should" integrate climate risks into their stewardship efforts, including potentially by "taking a portfolio perspective and

John Coffee embraced the idea of portfolio-focused stewardship without the same level of hesitancy in his 2021 article *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*.[34] In that article, Professor Coffee observed that we may be "moving from a system of corporate governance that is premised on a 'shareholder primacy model' to a system that is premised on a 'portfolio primacy model,'" where "our largest institutions [] knowingly accept, and even cause, losses at some firms in their portfolio if they expect that those losses will be outweighed by correlative gains at other portfolio firms."[35] "[A] possibility has arisen," he writes, "that institutional activism may curb externalities and lead to a better (and not just more profitable) society" and that SEC disclosure mandates in service of portfolio-focused stewardship efforts could help "bring about significant social change."[36] In a subsequent article titled *The Coming Shift in Shareholder Activism: From 'Firm-Specific' To 'Systematic Risk' Proxy Campaigns (and How to Enable Them)*, he similarly asserts that "[i]f some companies are imposing negative externalities on the market [as a whole], it would be both rational and feasible for large index investors to seek to curb such conduct (at least when the gains from such efforts are expected to exceed the losses to the companies imposing such externalities)."[37] He proceeds to discuss how such behavior can be encouraged, by identifying ways to stimulate proxy campaigns with such aims.

Jeffrey Gordon has similarly argued that because a "diversified investment vehicle internalizes many of the externalities that firms may create," "the portfolio managers have

seeking direct mitigation of climate risk itself through pressuring companies to reduce their emissions").

[34] Coffee, Jr., *supra note 14.* Coffee does note in passing that this phenomenon may work to the detriment of undiversified retail investors, prompt political backlash, and lead to anticompetitive effects.

[35] *Id.* at 604–05.

[36] *Id.* at 650.

[37] John C. Coffee, Jr., *The Coming Shift in Shareholder Activism: From "Firm-Specific" to "Systematic Risk" Proxy Campaigns (and How to Enable Them)*, 16 BROOK. J. CORP. FIN. & COM. L. 45, 50 (2021).

incentives to exercise corporate governance rights to mitigate them."[38] His 2022 article *Systematic Stewardship* advocates for a portfolio-focused stewardship approach, albeit one that "focuses not on increasing expected returns across the portfolio but on reducing systematic risk and, in this way, improving risk-adjusted portfolio returns."[39] Professor Gordon views such interventions as compatible with asset manager incentives because, if successful, they "will reduce the likelihood of events that could abruptly shrink portfolio values and thus reduce manager profits."[40] Such interventions, he believes, are best targeted at a subset of systematic risk, namely *systemic* risks like climate change risk, financial stability risk, and what he calls "social stability risk," as the avoidance or mitigation of such risks would have a bigger impact on risk-adjusted portfolio returns than the avoidance or mitigation of non-systemic systematic risks. He identifies several forms these interventions might take, including the endorsement of shareholder proposals that call for "a modification in business conduct."[41]

[38] Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627, 633 (2022).

[39] *Id.* at 646–47.

[40] *Id.* at 647–48. In earlier work with John Armour, Professor Gordon dismissed the potential for index fund managers to effectively address systemic risks through firm-level (as opposed to political) channels, due to their poor incentives. John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 60–61 (2014).

[41] Gordon, *Systematic Stewardship*, *supra* note 38, at 660. Professors Luca Enriques & Alessandro Romano also endorse portfolio-focused stewardship, but only vis-à-vis certain "central" firms that play a large role in generating system-wide externalities; they believe firm-value maximizing shareholders should have greater influence than portfolio-value maximizing shareholders in other firms. *See generally* Luca Enriques & Alessandro Romano, *Rewiring Corporate Law for an Interconnected World*, 64 ARIZ. L. REV. 51 (2022); *see also* Armour & Gordon, *supra* note 40 (generally endorsing the share value maximization norm but arguing that it should be relaxed in systemically important financial firms).

## III. IS PORTFOLIO-FOCUSED STEWARDSHIP LIKELY TO INCREASE PORTFOLIO VALUE?

To assert that rational, financially motivated diversified investors want to maximize the value of their portfolios and are not independently concerned with the performance of any individual portfolio firm is tautological. The hard question is whether such investors would view portfolio-focused stewardship as a desirable way to *pursue* portfolio value maximization. Under certain strict assumptions, they clearly would—namely, if portfolio firm managers did exactly what diversified investors' asset managers asked them to do, those asset managers only asked portfolio firm managers to do what is portfolio value maximizing, and the whole endeavor were costless and the market static. Early economic proofs that diversified investors would prefer firm managers to manage with the aim of maximizing portfolio rather than firm value, cited by both Coffee and Condon in the articles discussed above, are explicitly qualified by assumptions this strict.[42]

[42] Professor Coffee asserts that the "idea that common ownership will lead rational investors in a common portfolio to seek to minimize externalities" probably originates in a 1996 article by economists Robert Hansen and John Lott. Coffee, Jr., *supra* note 14, at 646 n.122 (citing Robert Hansen & John Lott, *Externalities and Corporate Objectives in a World with Diversified/Shareholders/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43 (1996)). He also cites to a paper by economist Roger H. Gordon, first published by the National Bureau of Economic Research in 1990. *Id.* (citing Roger H. Gordon, *Do Publicly Traded Corporations Act in the Public Interest?* (Nat'l Bureau of Econ. Research, Working Paper No. 3303, 1990)). Madison Condon also cites to these two articles as support for the proposition that "[i]f a subset of firms in a portfolio impose costs on the broader portfolio through the generation of negative externalities, a portfolio-wide owner should be motivated to curtail those externalities at the source." Condon, *supra* note 30, at 6 n.19. Both of the referenced papers offer mathematical models to prove, *inter alia*, that common owners would prefer firm managers to pursue portfolio value maximization over share value maximization. Both of the models are highly stylized. One key assumption is that firm managers always act in the interests of common owners (assuming the latter have voting control)—*viz.*, that there are no managerial agency costs. *See, e.g.*, Hansen & Lott, *supra*, at 45 ("[W]e will assume that firms are, in all cases, run by managers who act entirely in the interest of owners—that is, we ignore any agency problem between managers and owners."); Gordon,

In the real world, of course, these assumptions are all false. Asset managers are not perfect agents to diversified investors, nor are portfolio firm managers. Asset managers cannot

*supra*, at 5 ("I assume that the firm follows the preferences of the median shareholder, and ignore any possible agency problems."). The authors also concede that, even under this assumption, their models work only if the market for corporate control is hindered, and diversified shareholders are prohibited from *un*diversifying. *See, e.g.,* Gordon, *supra*, at 5 ("I assume that there are sufficiently many shareholders with the same preferences as that of the median shareholder that no single shareholder is in a position to change the firm's behavior through changing his portfolio choices."); *cf*. *id.* at 11 (relaxing this assumption). This is because "if shareholders are successful in maximizing portfolio value rather than firm value, corporate profits will decline," creating "an incentive to become undiversified and acquire a controlling interest in the company, change its policies, and reap the gains of increased profits." Hansen & Lott, *supra*, at 54. Hansen and Lott offer some potential solutions to this problematic aspect of their model, including if "citizens of a country have delegated investment decisions to large investment institutions such as pension funds" that hold most of an economy's firms, coupled with "restrictions that keep any one fund from being undiversified," or, alternatively, *outright government ownership of the economy*. *Id.* at 55–56. In suggesting these fixes, Hansen and Lott assume that the envisioned institutions or government overseers would act in the best interests of common owners—that is, that intermediary agency costs are nonexistent. Of course, if all investors were permanently diversified, stock price signals would no longer exist. Hansen and Lott do not address this, perhaps because if one assumes that firm managers and portfolio managers are perfect agents of common owners (both perfectly loyal and perfectly competent), it does not matter. Roger Gordon, too, ignores the potential for agency costs at the intermediary level. Finally, both articles acknowledge that their models prove not only that firm managers, faithful to common owners and under the other stated assumptions, would have efficiency-increasing incentives to take account of negative intraportfolio externalities, but also that they would have efficiency-reducing incentives to behave anticompetitively. *See, e.g.*, Gordon, *supra*, at 22 (explaining that if firms were to take spillovers into account, "then collusion among existing firms would become much easier since firms would not focus on how market shares are divided among the firms in the industry"). For an early economic model showing that firms, acting in the interest of their shareholders, tend to act collusively when their shareholders have diversified portfolios, see Julio Rotemberg, *Financial Transaction Costs and Industrial Performance* (Mass. Inst. of Tech. Alfred P. Sloan Sch. of Mgmt., 1984) https://dspace.mit.edu/bitstream/handle/1721.1/47993/financialtransac00rote.pdf [https://perma.cc/XWQ9-KEGD].

costlessly adopt and enforce internalization policies, and imperfect information may lead them to make mistakes. Finally, the market is dynamic and may react in ways that undermine any potential portfolio-value enhancing effects of portfolio-focused stewardship. Given these frictions, a rational, financially-motivated diversified investor would doubt whether portfolio-focused stewardship interventions would lead to net gains in risk-adjusted portfolio value, and even worry that they could lead to portfolio losses. This, combined with the alternative paths available to diversified investors for dealing with intraportfolio externalities, discussed in Part V, may lead them to conclude that the best way to maximize portfolio value is to place extensive limits on portfolio-focused stewardship, or perhaps to eschew it altogether.

This Part elaborates on these frictions, which it groups under the headings (1) managerial agency costs; (2) intermediary agency costs; (3) imperfect information; and (4) market dynamism. First, it explains how the need to constrain managerial agency costs places important limitations on the types of portfolio-focused stewardship interventions that index fund investors would want their fund managers to pursue. Second, it discusses intermediary agency costs, explaining how the conflicts of interest that exist between index fund managers and index fund investors place additional limitations on the types of portfolio-focused stewardship interventions that index fund investors would view as desirable. Third, it discusses informational barriers to the crafting of effective internalization policies, drawing on a rich body of public law scholarship focused on regulatory techniques for dealing with negative externalities. The discussion highlights the problems asset managers will face if they seek to serve as private regulators of their portfolio firms, including problems of legitimacy. Finally, this Part comments on the transient nature of any gains that might be achieved through portfolio-focused stewardship given the existence of a competitive marketplace.

## A. Real World Friction #1: Managerial Agency Costs

Left to their own devices, managers of public companies may place their own interests above those of investors. They

may divert firm value to themselves, act less prudently in their management of the enterprise than they would in the conduct of their own affairs, and avoid risks that investors would want them to take.[43] These "agency costs" reduce firm value,[44] and when multiplied across a broad portfolio can substantially reduce its overall value. It is therefore rational for diversified investors to take steps to prevent these losses, if the steps cost less than the expected savings. Direct monitoring of firm managers is one option, but information deficits and collective action problems make it uneconomical for diversified investors to directly police firm managers' behavior on a systematic basis.[45] While the largest index funds own enough shares in their portfolio companies to make some investment in direct monitoring rational, lingering information deficits and collective action problems, as well as the intermediary agency costs discussed in the next part, mean that index fund managers cannot be relied upon to systematically monitor the behavior of portfolio firm managers either.

Luckily, a variety of other, more cost effective, techniques exist for constraining managerial agency costs. One of the most powerful is incentive-alignment through compensation structures tied to firm value.[46] Such structures push managers to focus on the task of increasing firm value without the need for continual investor oversight of management decisions.[47] Other important techniques, such as fiduciary duties

[43] Amanda M. Rose, *Cutting Class Action Agency Costs: Lessons from the Public Company*, 54 U.C. DAVIS L. REV. 337, 350–52 (2020).

[44] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

[45] Rose, *supra* note 43, at 350.

[46] *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives–It's Not How Much You Pay, But How*, HARV. BUS. REV. May–June 1990 (discussing this technique).

[47] Stock-option based compensation can also help to align firm managers' risk preferences with those of diversified shareholders. *See* David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 453 (2000) (explaining that stock options "increase an executive's appetite for risk, an effect that diversified

owed to the firm's residual claimants (coupled with a judicial assumption that such claimants want to maximize firm value), the market for corporate control, and hedge fund activism, serve a similar function.[48] To be sure, these techniques also create incentives for managers to externalize costs onto other firms, and onto society more broadly, so as to increase firm value at others' expense.[49] Social and ethical norms will constrain such behavior, but only to an extent. Corporate law scholars have traditionally treated this as a problem best managed by substantive laws external to corporate law, which should—within their relevant subject matter area—force firms to internalize the externalities they produce.[50] But external laws, along with social and ethical norms, may fail to force the internalization of all firm externalities—hence the problem that portfolio-focused stewardship is designed to solve (albeit on behalf of diversified investors, not society at large[51]).

Excitement over the fact that diversified investors self-internalize many public company externalities sometimes leads to a forgetfulness about managerial agency costs. But if it were not for managerial agency costs and the techniques that have been adopted to mitigate them, laws designed to prevent firms from imposing uncompensated costs on other portfolio

shareholders value because they are otherwise more risk-tolerant than undiversified managers").

48 For an overview of the techniques used to constrain agency costs in U.S. public companies, see Rose, *supra* note 43, at 363–80.

49 Armour & Gordon, *supra* note 40, at 37.

50 This, at least, has been the dominant view since shareholderism overtook managerialism as the dominant corporate governance ideology. *See* Kahan & Rock, *supra* note 3 (charting this history).

51 It is important not to conflate the idea of portfolio primacy with stakeholder primacy. As Professor Coffee has explained, the latter "has been supported by many commentators who want boards and managers to balance the interests of other stakeholders in the corporation with those of shareholders," but a "focus on maximizing the value of the portfolio is quite different from a focus on sustainability or wealth transfers to stakeholders (even though the two perspectives may overlap)." Coffee, Jr., *supra* note 14, at 604 n.2. *Cf.* Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REGUL. 499 (2020) (critiquing the tendency to treat investors as a proxy for broader society).

firms would be unnecessary, as would portfolio-focused stewardship efforts to supplement those laws. Managers would simply do what diversified investors want—*i.e.*, act to maximize portfolio value—without the need for prodding by lawyers, regulators, or asset managers.[52] Investors obviously cannot trust firm managers to behave so virtuously. Nothing about the trend of investor diversification has changed the nature of firm managers; if left to their own devices, they are as likely to act selfishly or carelessly as they ever were.[53] And not even the strongest proponents of portfolio primacy theory suggest that assets managers for diversified investors can now be counted on to directly monitor managerial performance in any systematic way. There therefore remains a need to tie managerial fortunes to firm-specific performance.[54] Two important points follow from this as it concerns portfolio-focused stewardship.

*First*, rational, financially motivated diversified investors would not favor portfolio-focused stewardship interventions that generally reduce firm managers' sensitivity to firm value in the hope that managers will use the breathing room to

[52] When portfolio companies sue one another, they create intraportfolio externalities; if managerial agency costs did not exist, financially motivated diversified investors would want to prohibit such lawsuits. *See* Hansen & Lott, *supra* note 42, at 47 (explaining that because damage awards would be mere pocket-shifting, "diversified owners would [only be] concerned about the 'leakage' going to lawyers (who are not part of publicly owned firms)"). In work that pre-dates the recent academic interest in portfolio primacy theory, Professor Richard Squire and I explained that in a world *with* managerial agency costs, intraportfolio litigation is (under certain circumstances at least) consistent with the pursuit of portfolio value maximization, because it attributes portfolio-level costs to the firms of responsible corporate managers, making it easier for diversified shareholders to evaluate and motivate their agents. *See generally* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. L. REV. 1679 (2011).

[53] This is true even if the insider-shareholder dynamic has become more collaborative than competitive in recent years. *See* Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEXAS L. REV. 863 (2020).

[54] Tying executive compensation to portfolio performance is not a viable alternative way to motivate portfolio firm managers to work hard and selflessly, given that they have little capacity to influence overall portfolio value.

prioritize portfolio over firm value. This includes interventions that would insulate firm managers from the market for corporate control or hedge fund activism, as well as those that would weaken the link between executive compensation and firm performance.[55] While interventions that generally reduce firm managers' sensitivity to firm value would mitigate incentives managers have to exploit gaps in the law to externalize costs onto other portfolio firms, they would also erode managers' incentives to work hard and honestly to increase firm value, thus risking more profound losses to portfolio value.[56]

*Second*, and following from that, to be effective portfolio-focused stewardship interventions need to be crafted with the firm-focused incentives corporate managers face in mind. Given these incentives, vague portfolio-focused stewardship policies that leave discretion in the hands of firm managers

[55] Financially motivated diversified investors would always prefer more targeted interventions, meeting the criteria discussed *infra*, to address intraportfolio externalities over a general relaxation of firm-focused incentives coupled with a hope that firm managers will respond in ways that align with their preferences (as opposed to the managers' own). Such targeted interventions could involve changes to compensation structure—for example, bonus payments for meeting verifiable emissions-reduction targets, or tilting executive pay at systemically important financial firms toward restricted stock rather than options as a way to calibrate incentives toward risk taking—although targeted interventions may be undesirable for other reasons discussed *infra*.

[56] This is not to suggest that financially motivated diversified investors cannot disagree about the best way to calibrate firm managers' sensitivity to firm value. For example, commentators have debated the optimal holding periods for stock-based compensation. *See, e.g.*, Lucian Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010); Sanjai Bhagat & Roberta Romano, *Reforming Financial Executives' Compensation for the Long Term*, *in* RESEARCH HANDBOOK ON EXECUTIVE PAY (Randall Thomas & Jennifer Hill eds., 2014). But even if financially motivated diversified investors might favor adjustments to incentive compensation or other governance structures to mitigate perceived managerial "short termism" or other deficiencies in particular structures' design, this is fully consistent with a commitment to tethering managerial incentives to individual firm value. *See* Mark J. Roe, *Social Costs from Stock-Market-Driven Corporate Short-Termism?*, *in* MISSING THE TARGET (2022) 52, 56 (explaining the distinction between corporate short-termism and corporate externalities).

are unlikely to be effective, as are interventions that call on managers to take actions that cannot effectively be monitored. To be successful, portfolio-focused stewardship policies need to be specific regarding the actions or outcomes demanded of firm managers, and asset managers need to be capable of observing and judging compliance.[57]

This requirement of specificity and enforceability introduces distinct complications, however. In their article *Systemic Stewardship with Tradeoffs*, Professors Marcel Kahan and Edward Rock describe the "deep architecture" of corporate law that operates to focus firm managers on firm value, including legally enforceable fiduciary duties.[58] They warn that firm managers who acquiesce to asset manager demands to take specific actions that involve a sacrifice of firm value for the benefit of a broader portfolio expose themselves to potential liability. How big a risk this presents can be debated,[59] but there is at least some universe of potential portfolio-focused stewardship interventions that firm managers might reject due to litigation risk, and the more specific—and hence potentially effective—the policy being pushed, the more pushback due to litigation risk can be expected. Moreover, to the extent that managerial acquiescence to a portfolio-focused stewardship intervention does produce litigation risk, it is a cost that diversified investors will ultimately bear, at least partially, reducing any portfolio level gains the intervention is expected to produce. Again, the more specific and hence potentially effective the intervention, the higher these offsetting costs. (Notably, corporate law cuts through this Gordian Knot vis-à-vis *legal* obligations imposed on the corporation by interpreting fiduciary duties to require legal obedience.[60])

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[57] *See* Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, 48 J. CORP. L. 37, 66–68 (2022) (making a similar point regarding ESG performance metrics).

[58] Kahan & Rock, *supra* note 19, at 508–09.

[59] *See* Coffee, Jr., *supra* note 37, at 65–67; Jeffrey N. Gordon, *Systematic Stewardship: It's Up to the Shareholders—A Response to Profs. Kahan and Rock*, 48 J. CORP. L. 26 (2023).

[60] *See, e.g.*, Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2018 (2019) (explaining that state corporate law

The requirement of specificity and enforceability also interacts in problematic ways with the other frictions discussed *infra*. For example, the more specific and enforceable the portfolio-focused stewardship intervention, the more personally costly asset managers will view the intervention because it will make it harder for them to deflect rising antitrust concerns about their common ownership positions.[61] To the extent that they manage other funds with different portfolios, heightened specificity also increases risks to their business model and, if they vote as a fund family, their fiduciary liability risk.[62] For these reasons, intermediary agency costs may discourage asset managers from designing effective interventions. The dynamic nature of the market might also hobble effective interventions because firms that acquiesce to specific firm value-reducing initiatives may find themselves more

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imposes fiduciary duties on directors "that prohibit them from acting with the intention of violating the law").

[61] The "common ownership hypothesis, which suggests that when large investors own shares in many firms within the same industry, those firms have an incentive to soften competition by producing fewer units, raising prices, reducing investment, innovating less, or limiting entry into new markets," MATTHEW BACKUS, CHRISTOPHER CONLON & MICHAEL SINKINSON, THE COMMON OWNERSHIP HYPOTHESIS: THEORY AND EVIDENCE 1 (2019), https://www.brookings.edu/wp-content/uploads/2019/02/ES_20190205_Common-Ownership.pdf [https://perma.cc/543A-KRKR], has in recent years captured the attention of not only antitrust scholars, *see generally id.* (surveying the growing empirical literature on this topic), but also of media and politicians. Rose, *supra* note 2, at 1824 n.12. Prominent legal scholars and economists have suggested policy responses in light of these concerns—reforms that would significantly and detrimentally impact the fortunes of the Big Three. *See, e.g.*, Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026 (2018); Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017). For broader concerns regarding the concentration of power in the hands of the leaders of index fund managers, see John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Harvard Pub. L. Working Paper No. 19-07, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 [https://perma.cc/35UC-CWD5].

[62] *See infra* note 99 and accompanying text.

exposed to a takeover or activist hedge fund campaign.[63] The cost of deflecting such campaigns would be borne by diversified investors and thus would erode the benefits of the intervention, and if such campaigns were successful those benefits would prove short-lived. Firm managers might also take preemptory actions in response to these threats—such as by going private or selling assets—that could erase the benefits (and even result in losses) to risk-adjusted portfolio value.

## B. Real World Friction #2: Intermediary Agency Costs

Like portfolio firm managers vis-à-vis their firm and its shareholders, an index fund manager is an agent who may prioritize its own interests over those of the fund it manages and the fund's investors. But index fund managers are immune from many of the techniques used to mitigate managerial agency costs at portfolio companies[64]: index fund managers' pay is not strongly linked to performance,[65] nor are index fund managers subject to the pressures of the market for

[63] *See infra* Section III.D.

[64] John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1283 (1991) (explaining that traditional mechanisms of corporate accountability are not generally available to constrain institutional intermediaries).

[65] Index fund managers earn fees calculated as a percentage of assets under management ("AUM"). They can therefore increase their fee income by increasing AUM, either by selling more shares in the fund or by taking steps that cause portfolio companies to increase their value. The first technique does not inure to the benefit of fund investors (unless it allows the fund to realize economies of scale that lower per share costs); the second does, but because fees are extremely low the incentive for index fund managers to engage in such efforts is very weak. *See* Coates, *supra* note 61, at 15 ("[I]t would take large increases in shareholder value at a given portfolio company for an action by an index provider to result in significant gains to that provider's fee income."). The Investment Advisers Act prohibits stronger forms of incentive compensation, with narrow exceptions that are not utilized by index fund managers. *See* 15 U.S.C. § 80b-5; 17 C.F.R. §§ 275.205-1 to -3.

corporate control or hedge fund activism.[66] They stand little chance of being fired or successfully sued.[67]

The way fund managers' incentives deviate from the funds they manage has been well chronicled.[68] To oversimplify[69]: index fund managers bear the full cost of their stewardship

[66] Mutual fund shares are priced based on the net asset value ("NAV") of the fund's holdings and are thus are not sensitive to fund manager performance. *See, e.g.*, John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 89 (2010). Fund outflows can, however, discipline managers by shrinking AUM and hence management fees.

[67] *See generally id.* (arguing that fund investors' exit right almost completely eliminates any incentive to use voting or litigation to discipline fund managers); *see also* Fisch & Schwartz, *supra* note 19, at 30 (observing that mutual fund managers' fiduciary duty to fund investors "at this point is toothless": "To our knowledge, there has not been a successful claim that institutional investors have [breached their duty] when voting shares in their portfolio companies").

[68] I provide only a brief summary here. For more detailed examinations, see Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16.

[69] Not all index fund managers are identical, and differences in their clientele and ownership structure (among other things) will influence the nature and severity of the conflicts of interest they face. *See generally* Dorothy Lund & Adriana Robertson, Giant Asset Managers, the Big Three, and Index Investing (USC Gould Sch. of L. Ctr. for L. & Soc. Sci., Research Paper Series No. 23-13, 2023), https://ssrn.com/abstract=4406204 [https://perma.cc/WAK5-RWER]. Among the "Big Three," for example, Vanguard is uniquely owned by its funds, rather than by a separate set of investors (by contrast, Blackrock is publicly traded, as is State Street's parent company). *Id.* at 12. Therefore, the interests of Vanguard's owners and its funds are better aligned. While nothing causal can be established, it is interesting to note that among the Big Three, Vanguard has reportedly been the *least* supportive of ESG initiatives. *See* Hannah Zhang, *Stop Lumping the 'Big Three' Asset Managers Together, Academics Say*, INSTITUTIONAL INV. (June 26, 2023), https://www.institutionalinvestor.com/article/2btxellkcqh4xzqlt8c1s/corner-office/stop-lumping-the-big-three-asset-managers-together-academics-say [https://perma.cc/RU28-8NEY] ("According to Lindsey Stewart, director of investment stewardship research on Morningstar's global manager research team, in the trailing 24 months ending March 31, BlackRock and State Street Global Advisors supported twice as many key ESG resolutions as Vanguard did.").

efforts but typically stand to capture only a small fraction of the benefit;[70] competitive pressures push index fund managers to keep costs low and create few incentives to engage in stewardship; [71] fund managers may privately benefit from friendly relations with portfolio firm managers (who can direct corporate 401(k) business their way)[72] and may face conflicts of interests due to their management of other funds with different portfolios.[73] As just alluded to, they also risk incurring private costs if they attempt to wield significant influence over portfolio companies—not just antitrust scrutiny,[74] but also special burdens that corporate and securities laws impose on those who exercise control.[75] In addition, index fund managers are themselves firms, giving rise to the possibility that their personnel may act in ways that do not align with the interests of the fund manager or the managed fund and its investors.

If index fund managers were only tasked with maintaining an index-mirroring portfolio, the risk of residual agency costs would be very low: a fund manager's job would be easy and there would be almost no discretion to abuse. But index fund managers are expected to vote their funds' shares.[76] When indexing began growing in popularity, a hope emerged that this

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[70] Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2052–56.

[71] *See* Schwartz, *supra* note 19, at 417–18 ("For index funds, there is no hope for competitive advantage through stewardship" because they "own the same firms in the same proportion as other index funds [and thus] cannot outcompete other index funds by improving the performance of their portfolio firms.").

[72] Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2062–65.

[73] *See, e.g.*, Morley, *supra* note 19 (exploring such conflicts); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019) (same).

[74] *See supra* note 61.

[75] *See, e.g.*, Kahan & Rock, *supra* note 19, at 517–19; Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2065–66.

[76] *See* Griffith, *supra* note 18, at 992 (discussing the delegation of mutual fund voting authority to fund managers).

reconcentration of share ownership and voting power might lead to greater monitoring of public company managers and a reduction in managerial agency costs. When patterns of passivity and deference to management emerged instead, many blamed the misaligned incentives of fund managers discussed above.[77] This led the SEC in 2003 to adopt rules requiring asset managers to "adopt and implement policies and procedures for voting proxies in the best interest of clients."[78] The SEC also emphasized that asset managers have a fiduciary duty to vote shares in the best interest of fund shareholders and implemented annual fund voting disclosure requirements.[79] Asset managers initially attempted to satisfy these obligations by soliciting voting advice from proxy advisory firms, and when proxy advisory firms began drawing regulatory scrutiny they augmented their in-house stewardship teams.[80] But the incentive and capacity of index funds to vote intelligently on the thousands of matters put up for a vote at their portfolio companies each year remains doubtful.[81]

Some view the SEC's efforts to induce voting by index fund managers as fundamentally misguided. Professor Dorothy Lund, for example, has taken the view that index fund managers' incentives to engage in informed voting are *so* poor that index funds should be stripped of their voting rights altogether, or alternatively that index fund votes on non-routine matters should pass through to fund shareholders rather than be exercised by fund managers.[82] She warns that index fund managers are "likely to adhere to low-cost voting strategies,

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77 *See generally* Rose, *supra* note 43, at 355–58.

78 Proxy Voting by Investment Advisors, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003).

79 Schwartz, *supra* note 19, at 422. The Department of Labor had earlier "made clear that advisers to private pension plans owe a fiduciary duty to vote shares in portfolio firms in the best interests of pension fund participants." Fisch & Schwartz, *supra* note 19, at 14 & n.57.

80 Schwartz, *supra* note 19, at 422–23.

81 *See* Sharfman, *supra* note 19 at 472–73 (explaining that BlackRock casts tens of thousands of votes each year at almost all of the approximately 4,000 U.S. public companies despite having a global stewardship team of 45 people, only 21 of whom are based in the United States).

82 Lund, *supra* note 68, at 528–31.

such as following a proxy advisor's recommendation or voting 'yes' to any shareholder proposal that meets pre-defined qualifications," leading to the "proliferation of an unthinking, one-size-fits-all approach to governance [that] will make many companies worse off."[83] She further warns that uninformed voting by index fund managers may determine the outcome, or contours, of hedge fund activism, undermining its effectiveness as a constraint on managerial agency costs.[84]

Other scholars recognize index fund managers' problematic incentives, but nevertheless see some limited potential for those managers to help monitor portfolio firms and hence constrain managerial agency costs. For example, Professor Bernard Black has observed that because "many process and structural issues arise in similar form at many companies," becoming informed with respect to how to vote on such issues may therefore be rational for fund managers because economies of scale can be achieved by supporting implementation of preferred policies across the portfolio.[85] In the wake of the

[83] *Id.* at 495.

[84] *Id.* at 520–23.

[85] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 822 (1992); *see also* Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1776 (2020) (agreeing that index fund advisers are not well positioned to identify company-specific performance problems, but arguing that their incentives to vote intelligently on the small number of votes per year that are potentially consequential, to develop proper guidelines for voting on market-wide governance standards, and to engage on company-specific governance deficiencies are superior to most other institutional investors); Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. ILL. L. REV. 223 (using network theory to argue that asset managers have better motivations to become informed about portfolio companies than standard accounts predict); 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, 32 (2019) (arguing that index fund managers, especially the largest, have incentives to engage in stewardship in order to compete with managers of active funds, while conceding that they may face suboptimal incentives to do so); *cf*. Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2058–59 (critiquing Fisch et al.'s argument); J.B. Heaton, *Where the Fisch, Hamdani, and Davidoff Solomon Theory of Passive Investors Goes Awry*, CLS BLUE SKY BLOG

SEC's 2003 reforms, institutional investors did begin voting systematically in favor of corporate governance reforms thought to reduce managerial agency costs, such as the destaggering of boards and the elimination of plurality voting rules for director elections.[86] Whether these represent thoughtful interventions or examples of the unthinking, one-size-fits all approach that Professor Lund warns of is a matter of debate.[87] Empirical evidence on their value to investors is inconclusive.[88]

Professors Ronald Gilson and Jeffrey Gordon also point to a symbiotic relationship that may exist between mutual fund managers and activists hedge funds. Whereas the former do not have sufficient incentives to identify firm specific performance issues and advocate for change, the latter do given, *inter alia*, the more concentrated positions they take in portfolio firms and the compensation structure which motivates their managers. Mutual fund managers, their argument proceeds, may have sufficient incentives to vote intelligently on the

(July 25, 2018), https://clsbluesky.law.columbia.edu/2018/07/25/where-the-fisch-hamdani-and-davidoff-solomon-theory-of-passive-investors-goes-awry/ [https://perma.cc/643G-DL6A]. Professors Lucian Bebchuk and Scott Hirst critique index fund managers for being too passive in corporate governance and propose a variety of reforms meant to improve fund managers' efforts at policing managerial agency costs, such as mandated investments in stewardship and enhanced disclosure about engagement efforts with portfolio firms. *See generally* Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16.

86 *See* Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2102 (discussing Big Three support for shareholder proposals calling for governance changes).

87 *See, e.g.*, Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 892 (2007) (warning of the ill effects of pressuring public companies "to adopt a homogenized set of governance rules which may be ill-suited to the companies' respective situations"); K.J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422, 424 (2017) (observing that the "heterogeneous relation of board structure with performance . . . indicates that a one-size-fits-all view of board structure is not supported by the data").

88 *See* Fisch & Schwartz, *supra* note 19, at 21 & n.105 (discussing this evidence).

matters teed up by activists, even if they lack adequate incentives to develop and pursue the interventions on their own.[89]

What does all of this mean for portfolio-focused stewardship? At the outset, it challenges advocates to explain why index fund managers would incur costs to achieve intraportfolio internalization of externalities, given their perverse incentives for passivity and managerial deference. Notably, judging whether certain corporate governance features are likely (at least on average) to increase firm value, or whether an activist hedge fund's plan for a particular company is better than the plan of the firm's managers, will typically be far easier than crafting or judging internalization policies that will govern an index fund's entire portfolio, the complexities of which are discussed in Section III.C. Moreover, the stakes to portfolio value of getting those answers wrong would seem to be far less than with respect to portfolio-focused stewardship interventions that induce portfolio-wide changes in operational business practice. Yet even with respect to these traditional efforts, index funds have staunch critics. Why then should we expect them to take up the mantle of portfolio-focused stewardship and, more importantly, do it well?

Professors Gordon and Coffee partially address this question. Professor Gordon, for example, acknowledges that index fund managers' incentives generally bias them toward passivity but argues that some portfolio-focused stewardship interventions could be "incentive compatible" because of their expected impact on risk-adjusted portfolio value.[90] In other words, some interventions may be expected to increase the index fund manager's compensation by increasing the value of assets under management *enough* to make the costs of pursuing the intervention rational.[91] He also points out that just as the work of activist hedge funds lowers the cost to index fund managers of firm-focused stewardship interventions, so too can the work of ESG activists when it comes to portfolio-

[89] 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, 896–902 (2013).

[90] Gordon, *supra* note 38, at 647–48.

[91] *See supra* note 65.

focused stewardship interventions.[92] Professor Coffee also points to investor coalitions as a way for index fund managers to overcome collective action problems.[93]

The foregoing logic is sound, but how often in practice will the increase in compensation expected by virtue of a stewardship intervention's impact on portfolio value outweigh the private costs fund managers would incur to pursue it? There are reasons to doubt that ESG activists will be as helpful in producing useful information for index fund managers confronted with a decision on a portfolio-focused stewardship matter as activist hedge funds are with respect to decisions on firm specific performance issues. Socially motivated ESG activists can be expected to advocate for stewardship policies that advance their vision of what is in the social interest, but what (in the activist's view) is in the social interest may conflict with what is portfolio-value maximizing.[94] ESG activists seeking to court index fund support will portray their preferred interventions as portfolio-value maximizing, but index fund managers faithful to the notion of portfolio-value maximization would place little stock in their representations. Activist hedge funds, by contrast, take actions that they hope will increase a targeted firm's value, something that is naturally aligned with the interests of financially motivated diversified investors. To be sure, activist hedge funds have been accused of advocating for changes that destroy long-term firm value in pursuit of short-term price effects,[95] but it should be far easier for index fund managers to assess whether a hedge fund's strategy is likely to produce lasting positive effects on firm value than it is to determine the effects of a portfolio-focused stewardship

[92] Gordon, *supra* note 38, at 660.

[93] Coffee, Jr., *supra* note 37, at 62–63; *see also* Gordon, *supra* note 38, at 665.

[94] *See, e.g.*, Tallarita, *supra* note 15, at 537 (cataloguing how index funds—which are heavily weighted toward American public companies—internalize only a small fraction of climate externalities and are likely to prefer climate mitigation strategies that are privately efficient for large companies over those that are socially efficient).

[95] *See, e.g.*, Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1873 (2017).

intervention on portfolio value.[96] Moreover, index fund managers' willingness to turn to investor coalitions for help may be inhibited by concerns about antitrust scrutiny. Indeed, in the wake of such scrutiny, Vanguard recently withdrew from the Net Zero Asset Managers initiative.[97]

It is also the case that index fund managers simultaneously manage other portfolios, often voting as a fund family.[98] As Professors Kahan and Rock have observed, "a business model that prioritized the interests of index fund investors over other funds would likely doom those other funds, as competitors would offer competing products that pledged loyalty to fund investors."[99] This represents an additional private cost to index fund managers of pursuing portfolio-focused stewardship, further biasing them toward passivity.

Finally, interventions that would have the sort of significant impact on portfolio value that Gordon and Coffee envision, if crafted poorly, could also significantly damage portfolio value, and even introduce new systematic risks. Consider, for example, what more aggressive interventions regarding fossil fuels might have meant for global stability in the wake

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[96] *See infra* Section III.C (discussing the information needed to evaluate such effects).

[97] Mark Segal, *Republican AGs Warn Asset Managers that ESG Investing Risks Fiduciary, Antitrust Violations*, ESG TODAY (Apr. 3, 2023), https://www.esgtoday.com/republican-ags-warn-asset-managers-that-esg-investing-risks-fiduciary-antitrust-violations [https://perma.cc/9JSH-ZPJU] (reporting on these developments); *see also* Amelia Miazad, *From Zero-Sum to Net-Zero Antitrust*, 56 U.C. DAVIS L. REV. 2067 (2023) (describing the recent antitrust scrutiny and arguing that antitrust law should accommodate investor alliances focused on reducing systematic risks to the economy).

[98] *See* Ann Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017).

[99] Kahan & Rock, *supra* note 19, at 521; *see also* Tallarita, *supra* note 15, at 565 (explaining that if "the Big Three overtly pressured energy companies to engage in value-decreasing strategies for the benefit of other companies, it is very likely that investors in their energy-focused funds would flee (and perhaps even take legal action)," and observing that mutual funds shareholders' strong exit rights and the desire of investment managers to attract new investors force fund managers to pay careful attention to conflict-of-interest issues).

of Russia's invasion of the Ukraine. Professors Gordon and Coffee seem to assume that asset managers will always get their portfolio-focused stewardship interventions right, but asset managers would rationally recognize that they might not and discount the potential benefits accordingly.

But even if Professors Gordon and Coffee are correct that some set of portfolio-value enhancing stewardship interventions exist in the real world that are compatible with fund managers' incentives, it is also the case that portfolio-value *decreasing* stewardship interventions may exist that are *likewise* compatible with fund managers' incentives—because they produce more private benefits than they decrease management fees. This is a point that is too often missed in discussions of portfolio-focused stewardship.[100] The attenuated relationship between index fund manager compensation and portfolio value means not only that expected portfolio gains must be sufficiently significant to motivate index fund managers to incur private costs to achieve them, it also means that expected portfolio *losses* must be sufficiently significant to motivate index fund managers to forego using their funds' governance powers when doing so would allow them to reap private benefits. A variety of selfish incentives have been identified that might lead index fund managers to engage in stewardship related to ESG matters under a false banner of increasing risk-adjusted portfolio value.

For example, embracing the ESG movement may help index fund managers curry political favor, enabling them to fend off greater regulation of the industry at a time when the Big

[100] *But see* Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?*, 12 HARV. BUS. L. REV. ONLINE art. 1, 2021, at 8 (2021) (observing that "an index fund operator will benefit from engaging in activism that sacrifices 1% of aggregate portfolio company value but attracts 2% more in managed assets"); Sharfman, *supra* note 19, at 488 (explaining that "an expected small positive movement in market share will, in terms of AUM, overwhelm any expected loss in the value of an index fund or family of funds," and providing a numeric example); *cf.* C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392, 1429–34 (2020) (explaining how index fund managers may benefit from a decline in aggregate portfolio value due to differential fees charged to different funds).

Three face intense political scrutiny over their perceived outsized influence on capital and product markets.[101] Professor Jeff Schwartz posits that this is the most likely motivation for index fund voting.[102] He argues that if index fund managers found stewardship profitable, they would have participated in it since the industry's inception rather than avoiding it until the SEC intervened through rulemaking.[103] He also points out that if index fund managers viewed stewardship as a way to improve portfolio returns, they would involve fund-level finance professionals in the process, whereas in reality they delegate the task to centralized (and woefully understaffed) compliance-oriented teams.[104] In Professor Schwartz's view, it is no coincidence that "[a]fter consistently voting down ES proposals, the large asset managers pivoted to supporting such measures in the same year the U.S. presidency switched

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[101] *See supra* note 61; *see also* David McLaughlin & Annie Massa, *The Hidden Dangers of the Great Index Fund Takeover*, BLOOMBERG (Jan. 9, 2020), https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover [on file with the Columbia Business Law Review] (observing that the Big Three are "potentially the most powerful force over a huge swath of America Inc." and that "[a]larm bells have begun to go off with some regulators, as well as with an ideologically diverse array of academics and activists"); Matt Egan, *BlackRock and the $15 Trillion Fund Industry Should Be Broken up, Antimonopoly Group Says*, CNN BUS. (Nov. 24, 2020), https://www.cnn.com/2020/11/24/business/blackrock-vanguard-state-street-biden/index.html [https://perma.cc/24AH-X9FF] (reporting that "[c]ritics say [the Big Three] have become too powerful and that the Biden administration and Congress need to rein them in").

[102] Schwartz, *supra* note 19, at 398.

[103] *Id.* at 424.

[104] *Id.* at 425. For how mutual fund advisors approach their voting responsibilities across fund families, as well as the conflicts of interest fund advisers face in casting votes, see generally Griffith & Lund, *supra* note 73; Lipton, *supra* note 98. For empirical evidence "that the Big Three devote an economically negligible fraction of their fee income to stewardship and that their stewardship staffing levels enable only limited and cursory stewardship for the vast majority of their portfolio companies," see Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2033, 2075–84. *Cf.* Fisch et al., *supra* note 85, at 50 (responding to those who have criticized the limited size of index fund managers' governance staffs).

parties from the Trump to the Biden administration."[105] "The abrupt shift in large assets managers' voting parallels the abrupt shift in government policy" on topics such as climate change; politics, he asserts, "is the only plausible explanation."[106] If Professor Schwartz is correct, voting by index fund managers may injure the very diversified investors it is meant to help by forestalling new regulations designed to protect them, and may also negatively affect the functioning of the economy more broadly by introducing an indirect form of state capitalism (albeit one unconstrained by democratic electoral accountability or constitutional limits).[107]

Another self-serving motive that could explain index fund managers' positions on ESG matters is a desire to court millennial investors to their funds, not only to their index funds but also to a milieu of higher-fee ESG-themed funds that they offer. Professors Michal Barzuza, Quinn Curtis, and David Webber have advanced this argument, pointing out that millennials, who will soon accumulate significant assets, place a premium on social issues in their economic lives.[108]

Professor Lund offers an alternative marketing-based theory for index fund managers' interventions on ESG topics. She theorizes that, subject to a constraint of avoiding government

[105] Schwartz, *supra* note 19, at 442.

[106] *Id.* at 443. Schwartz's hypothesis that the Big Three's embrace of ESG has been driven by political expediency is consistent with the Big Three's apparent backpedaling on those commitments in the wake of recent threats by Republican lawmakers. *See infra* note 194 and accompanying text.

[107] *See infra* notes 158–160 and accompanying text. Professor Schwartz recommends requiring asset managers to vote in line with their fund investors' polled preferences as an antidote to this concern. "For instance," he explains, "investors could be asked about whether they support diversity efforts and climate transparency efforts at portfolio firms. The asset manager would then be required to proportionally reflect investor preferences at each company where activism or shareholder proposals that implicate these issues arise." Schwartz, *supra* note 19 at 451. Professor Schwartz rejects a pure form of pass-through voting, where fund investors would instruct the asset managers on how to vote their percentage share ownership with respect to each matter at each portfolio company, due to rational apathy concerns. *Id.* For more on pass-through voting, see notes 16 & 160.

[108] Barzuza, et al., *supra* note 19, at 1304–06.

backlash, the Big Three take ESG positions that will satisfy the bulk of their clients and potential clients, because doing so is likely to increase fund inflows and in turn assets under management and their compensation.[109] Because "client tastes will dictate policies, rather than the principled consideration of systematic risk or externalities," she posits that the Big Three's efforts will reflect the views of the corporate managers who control 401(k) plans as well as the officials who control government and union pension funds, given that such funds constitute the bulk of the Big Three's assets. She acknowledges that this will tend to privilege elitist views and explains why those who control public pension funds are likely to have an outsized voice.[110]

It is also possible that the positions taken by the Big Three are driven by the personal preferences of those who run them. Blackrock's positions could have more to do with Larry Fink's sociopolitical commitments, or those of Blackrock's stewardship team, than an assessment of portfolio value. In the literature on managerial agency costs at public companies, the psychological benefits of empire building are well understood.[111] Serving, along with leaders at Vanguard and State Street, as controllers of funds constituting the largest voting bloc in nearly 90% of S&P 500 companies represents an empire beyond the wildest dreams of any public company CEO.[112] Using the power that comes along with that position offers commensurate private benefits.[113]

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[109] Lund, *supra* note 19.

[110] *Id.* at 110 n.170.

[111] *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 903–07 (2005) (discussing firm managers' incentives to engage in empire building and observing that some scholars view it as the most significant agency problem that large public companies face).

[112] Schwartz, *Stewardship Theater*, *supra* note 15, at 406 (explaining that the ownership stakes of Vanguard, BlackRock, and State Street "is enough to make them, collectively, the largest shareholders in 88% of S&P 500 companies").

[113] *See* Coates, *supra* note 61, at 18–19 (discussing the non-wealth power and other private benefits the leaders of large index providers may obtain through use of their funds' voting power).

I cannot answer which of the foregoing motives, if any, drives index fund managers to engage in stewardship on ESG topics. Multiple motivations could be at play, and their influence could be subconscious. Indeed, when the outcome of a decision is ambiguous, the self-serving bias is likely to cause fund management personnel to view decisions that are privately beneficial, to themselves or the fund manager, as having a beneficial impact on the portfolio they manage. And in some cases, of course, what is privately beneficial to a fund manager or its personnel may also be beneficial to the portfolio.[114] My point is simply that given the selfish motives that *could* drive index fund managers to engage in stewardship that is destructive of portfolio value, financially motivated diversified investors would rationally discount the touted benefits of portfolio-focused stewardship interventions. As discussed below, some generalities can be stated about the sorts of characteristics that would trigger heightened skepticism—and hence a steeper discount.

*First*, as explained in the last part, interventions which impose vague, discretionary policies on portfolio firms, or policies that are difficult to monitor compliance with, are unlikely to work given the firm-focused incentives portfolio firm managers face. If index fund managers push such policies, there is strong reason to suspect that they are driven not by a desire to increase portfolio value but rather by improper motives—such as a selfish desire to benefit in the eyes of various constituencies (e.g., politicians, millennials, other clients) from the false appearance that they are taking meaningful action to address ESG issues, when in fact they are accomplishing little. Or perhaps the virtue signaling is psychologically rewarding to those who run the fund manager, or those same constituencies. Notably, portfolio firm managers are unlikely to resist such toothless policies and may in fact benefit from them; such policies are therefore also consistent with index fund managers' pro-manager bias, presenting another reason for skepticism. With respect to firm-focused stewardship,

[114] *See* Kahan & Rock, *supra* note 85, at 1800 (observing that reputational incentives of index fund managers may sometimes be aligned with the interests of fundholders, and sometimes not).

Professors Bebchuk and Hirst view managerial deference as a reason to expect Big Three passivity—pushing effective governance reforms or policing for performance could lead corporate managers to instigate a backlash leading to regulatory break-up of the Big Three or other draconian interventions that affect their profitability.[115] Interventions touted as portfolio-focused stewardship, by contrast, can be advantageous to portfolio firm managers, if the interventions allow them to cast themselves in a better public light without actually changing their behavior, or better yet if they operate to give firm managers breathing room from market discipline.[116]

*Second*, interventions which operate by generally eroding managerial sensitivity to firm value are suspect for similar reasons and would therefore also be viewed disapprovingly by financially motivated diversified investors. As discussed in the last part, such interventions are likely to decrease portfolio value by increasing managerial agency costs more than they decrease intraportfolio externalities, and because they benefit portfolio firm managers are likely motivated by fund managers' pro-manager bias.[117]

*Third*, financially motivated diversified investors would also discount interventions that align with the self-interest of fund managers or their personnel (beyond their self-interest in increased management fees resulting from effective portfolio-focused stewardship policies) when the benefits of those interventions are difficult to verify. This would be the case, for example, if the relationship between the portfolio firm behavior sought to be modified and risk-adjusted portfolio value is

[115] *See* Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2069–70.

[116] *See id.* at 2070 (noting "that Martin Lipton, who has long been associated with support for takeover defenses and other pro-management positions, has favorably described the increasing influence of index funds"); Mark J. Roe & Roy Shapira, *The Power of the Narrative in Corporate Lawmaking*, 11 HARV. BUS. L. REV. 233, 263 (2021) (discussing how narratives can "condition[] lawmakers to accord executives more autonomy from stock markets," while flattering "executives' self-image by allowing them to view themselves not as pursuing their self-interest but as heroically overcoming the shortsightedness of financial markets for the good of all").

[117] *See supra* note 115.

opaque. It would also be the case if the relationship between the behavior sought to be modified and risk-adjusted portfolio value is clear, but the effect of the specific intervention on portfolio value is not.

*Fourth* is a related but distinct observation. As discussed in the next part, identifying the right policy intervention to address an externality-producing behavior can be a complex endeavor, and sometimes the cure can be worse than the proverbial disease. The more complicated it is to determine whether an intervention will do more good than harm to the portfolio, the more costly an informed determination is to reach. Given index fund managers' strong incentives to keep costs low, portfolio-focused stewardship interventions that purport to solve very difficult externality problems should be looked at skeptically.

### C. Real World Friction #3: Imperfect Information

Proponents of portfolio primacy theory suggest that asset managers have not only the incentive (at least under certain circumstances) to adopt and enforce portfolio-wide policies designed to increase risk-adjusted portfolio value, but also the *capacity* to do so effectively. As Professor Lund has observed, adopting portfolio-wide policies in an effort to cause firms to internalize intraportfolio externalities is a lawmaking-like activity.[118] It involves declaring and enforcing policies that govern within the jurisdictional boundaries of the portfolio. Indeed, portfolio-focused stewardship is potentially warranted only in situations where law, as augmented by social and ethical norms, does not already cause firms to internalize the externalities they impose on other firms in the economy.[119]

This is notable because much has been written in the law and economics tradition about negative externalities and how

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[118] *See* Lund, *supra* note 19 at 80 (observing that "the Big Three are providing a form of privatized regulation—a body of standards and mandates that is more stringent than existing law, enforced with penalties, and applied across the market").

[119] Professors Fisch and Schwartz analogize fund managers to legislators in a representative democracy. *See* Fisch & Schwartz, *supra* note 19, at 9, 61.

the law can best intervene to address them; indeed, forcing the internalization of negative externalities is one of the most well-accepted grounds for government intervention in the market.[120] This literature teaches that the proper approach lawmakers should take to an externality-producing behavior turns in part on whether the behavior should be sanctioned—*i.e.*, deterred unconditionally—or instead regulated or priced. Behavior warranting sanction should be outlawed altogether, backed up by punishments that make it economically irrational to engage in; lawmakers should approach other types of behaviors with the goal of encouraging firms to engage in them only in socially efficient ways and amounts.[121] This can be attempted by using a well-recognized array of instruments, each with its own unique advantages and pitfalls.[122]

[120] *See* Bryan Caplan, *Externalities*, CONCISE ENCYCLOPEDIA OF ECONOMICS (2023) https://www.econlib.org/library/Enc/Externalities.html [https://perma.cc/NC7H-9GMR] ("Externalities are probably the argument for government intervention that economists most respect."); Maureen L. Cropper & Wallace E. Oates, *Environmental Economics: A Survey*, 30 J. ECON. LIT. 675, 678 (observing that the "literature on [the theory of externalities] is enormous"). I will focus here on negative externalities, as that is the focus of the portfolio primacy theory literature. But if an index fund manager would want to suppress the overproduction of negative externalities in order to increase portfolio value, it should also want to address the *under*production of positive externalities for the same reason. It has been theorized that asset managers may be incentivized to support good governance in part because it produces positive externalities that are captured at the portfolio level. *See* Viral V. Acharya & Paolo F. Volpin, *Corporate Governance Externalities*, 14 REV. OF FIN. 1 (2010); He Jie, Huang Jiekun & Zhao Shan, *Internalizing Governance Externalities: The Role of Institutional Cross-Ownership*, 134 J. FIN ECON. 400 (2019).

[121] The law and economics literature would treat behavior that should be deterred unconditionally as criminal. For an overview of the economic rationale for the civil-criminal divide, see Amanda M. Rose, *Public Enforcement: Civil versus Criminal*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 946 (2018).

[122] The law and economics literature on instrument choice is vast. For field-level overviews, see STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW (2004); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (8th Ed. 2011). For an environmentally focused overview, including an analysis of private governance analogues, see Sarah E. Light & Eric W. Orts,

One dimension along which these legal instruments vary is temporal. Some operate by imposing liability *ex post*, after harms occur, whereas others operate *ex ante*, before harms occur. Which is more desirable will depend on several factors, including how knowledgeable the lawmaker is about the harmfulness of the particular activity relative to the parties that engage in it, the effectiveness and feasibility of imposing *ex post* sanctions under the circumstances, and relative administrative costs.[123] Designing an *ex post* liability regime involves numerous sub-choices that will affect its efficacy in forcing the internalization of externalities—for example, whether to impose strict or standards-based liability,[124] how to calculate damages,[125] and the contours of enforcement procedure.[126]

With respect to *ex ante* instruments, lawmakers have an array to choose from. One type is command-and-control style regulation. As the term is used here, command-and-control style regulation attempts to prescriptively dictate how (or at what levels) an externality-generating activity will be conducted.[127] It is best contrasted with the so-called Pigouvian

*Parallels in Public and Private Environmental Governance*, 5 MICH. J. ENV'T & ADMIN. L. 1 (2015).

[123] Shavell, *supra* note 122, at 575–78; *see also* Richard A. Posner, *Regulation (Agencies) Versus Litigation (Courts): An Analytical Framework*, in REGULATION VERSUS LITIGATION: PERSPECTIVES FROM ECONOMICS AND LAW 11 (Daniel P. Kessler ed., 2011); Posner, *supra* note 122, at 852–56.

[124] For the classic treatment of this choice, see Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980). For a succinct overview of the tradeoffs, see Kyle D. Logue, *Coordinating Sanctions in Torts*, 6 CARDOZO L. REV. 2313, 2321–23 (2010).

[125] For discussions of optimal damages, *see, e.g.,* Logue, *supra* note 124 at 2324; A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880 (1979).

[126] *See* Amanda M. Rose, *The Multi-Enforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2192–97 (2010) (discussing how procedural choices, as well as the choice of enforcer, can affect the efficiency of a deterrence regime).

[127] The prescription could be enforced either through punishment for noncompliance or reward for compliance; any difference between the effect of these two approaches is not relevant for purposes of the discussion here.

tax, another *ex ante* instrument.[128] Whereas command-and-control style regulation requires the lawmaker to decide what specific steps a firm must take to align its externality-generating activity with social welfare—something that requires an analysis of both costs and benefits—Pigouvian taxes require only that the lawmaker estimate the cost of the harm the externality produces and charge it back to externality-producing firms based on their output levels, thus causing firms to incorporate social cost into their internal profit function. Because Pigouvian taxes generally require less knowledge on the part of lawmakers to craft, they are thought to be less error prone than command-and-control style regulations and are generally preferred by economists.[129] Pigouvian taxes may be

[128] The name derives from economist Arthur Pigou and his classic work ECONOMICS OF WELFARE (1932).

[129] In an article advocating for greater use of Pigouvian taxes, Professors Masur and Posner provide an example to illustrate this point:

> Other forms of regulation are inferior to the Pigouvian tax. Consider command-and-control regulation, in which a regulator forces a firm to take a particular action, such as installing a pollution-reducing scrubber. Under this form of regulation, the regulator may conduct a cost-benefit analysis to determine whether the benefit of alleviating the pollution for the firm's neighbors is greater or less than the cost to the firm of having to install the scrubbers or take other precautions. If scrubbers pass a cost-benefit analysis, then the regulator orders the firm to install them. If they do not pass, the regulator allows the firm to continue its activity unabated. A perfectly conducted cost-benefit analysis should produce results as efficient as a Pigouvian tax, but in a world of administrative costs, command-and-control regulation will be inferior. The reason is that in order to determine the correct command-and-control rule, the regulator must know both the cost and benefit of the activities. In contrast, the regulator only needs to know the cost of the activity to determine the correct Pigouvian tax. It is not necessary to know the benefit. Thus, as long as regulators make errors (as they unavoidably do), a Pigouvian tax is superior to command-and-control regulation.

Jonathan S. Masur & Eric A. Posner, *Toward A Pigouvian State*, 164 U. PA. L. REV. 93, 95 (2015) (internal footnotes omitted). *See also id.* at 96 (observing that it "would be an understatement to say that economists endorse Pigouvian taxes over command-and-control regulation" and noting that "Pigouvian taxes are constantly advocated by economists who seek to influence public policy"); Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L. REV. 1673, 1676 (2015) (noting the "academic

inferior to command-and-control style regulation when harms are non-linear, however,[130] and may prove ineffective when the marginal social cost of an externality-generating activity is non-uniform across firms.[131] Other *ex ante* instruments that can help solve externality problems include the assignment of property rights[132] as well as disclosure regulation designed to promote Coasean bargaining solutions.[133]

What does this mean for portfolio-focused stewardship? *First*, it is plausible that index fund managers could effectively enforce a prohibition on a discrete portfolio firm activity that should be deterred unconditionally—imagine the production of an irredeemably noxious chemical. While a shareholder proposal could not be used for this purpose, given that shareholders lack authority under Delaware corporate law to dictate substantive managerial decisions,[134] index fund managers could make known their intention to vote against directors who fail to cause their firm to cease producing the chemical.[135] Compliance would be relatively easy for index fund managers

exuberance" for Pigouvian taxes); Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1, 14 (2002) ("Economists traditionally have favored the use of corrective taxes to reduce harmful externalities because taxes leave control decisions in the hands of individual firms, which have better knowledge of their own control costs than does the state.").

[130] Fleischer, *supra* note 129, at 1686 n. 63–69 and accompanying text; *cf*. Kaplow & Shavell, *supra* note 129 (arguing against this view).

[131] *See generally* Fleischer, *supra* note 129.

[132] *See, e.g.*, Harold Demsetz, *Towards a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967); Robert J. Smith, *Resolving the Tragedy of the Commons by Creating Private Property Rights in Wildlife*, 1 CATO J. 439 (1981).

[133] *See, e.g.*, David W. Case, *Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective*, 76 U. COLO. L. REV. 379, 423 (2005). Hybrid use of various instruments is also possible. Cap-and-trade systems in environmental law, for example, combine command-and-control style regulation (the cap) with the assignment of property rights (the allocation of rights to trade emissions permits).

[134] CA, Inc. v. AFSCME Emples. Pension Plan, 953 A.2d 227, 232 (Del. 2008).

[135] For the ways that fund managers can influence portfolio firm managers, see Fisch & Schwartz, *supra* note 19, at 10–12.

to monitor. The rub is that dictating production choices across their broad portfolios would place index fund managers on an antitrust collision course, making these sorts of stewardship interventions highly unlikely. More fundamentally, it is hard to think of activities that warrant sanctions that are not *already* illegal. The reality is that most legal externality-generating activities by firms today are of the type that should be regulated or priced, rather than sanctioned. The production of greenhouse gases clearly falls in this category, given our present need for fossil fuels to meet society's energy demands. Thus, the theoretical capacity of index fund managers to effectively sanction portfolio firm conduct is of little practical importance.

*Second*, with respect to externality-producing behaviors that do not warrant sanctions, an index fund manager's toolkit is much more limited than a public lawmaker's toolkit. An *ex-post* liability regime is not a viable option for index fund managers: they are ill-equipped to stand in the shoes of courts to determine whether a portfolio company should be held liable for imposing costs on another, and they lack any practical ability to force liable firms to pay monetary fines tethered to the cost of the intraportfolio externalities a firm's activity has produced. However, as Professor Squire and I have previously argued, a desire to deter intraportfolio harms may justify index fund managers' support for traditional litigation between portfolio firms using the extant judicial system.[136] Moreover, if the traditional litigation system is failing in some material

[136] *See generally supra* note 52; *see also* Rose & Squire, *supra* note 52, at 1697 (explaining that "diversified shareholders effectively delegate to the court system the responsibility for authorizing compensatory payments among portfolio firms, thereby correcting the distortions in those firms' financial data caused by intraportfolio injuries," and that while they ultimately bear the costs of this system, those costs "may be outweighed by the informational benefits of the lawsuit, which could cause financial data about each portfolio firm to better reflect the contribution of that firm's managers to overall portfolio wealth," making it more likely that managers will "make decisions that maximize portfolio value, including by investing in measures to prevent subordinates from engaging in conduct that is not cost-justified from the perspective of diversified shareholders").

way, it might justify their advocacy in support of litigation reform efforts.[137]

Index fund managers' *ex ante* instrument options are also much more restricted than those of public lawmakers. Unlike Congress, index fund managers cannot impose a Pigouvian tax on portfolio firms. They could attempt something analogous by requiring that the pay of portfolio firm executives be tethered to an adjusted measure of firm financial performance—one that charged back to the firm the cost of the intraportfolio externalities the firm generated. The best candidate would be a charge based on the costs the firm's carbon emissions impose on other portfolio firms.[138] But calibrating the appropriate charge would be immensely challenging,[139] as would determining how to select and adjust the baseline of firm financial performance.[140] Additionally, a "significant challenge" in the design of a carbon tax "is the design of a system for ensuring that the rate changes over time as new information becomes available about the costs and benefits of reducing emissions."[141] It seems unreasonable to expect that cost-conscious index fund managers would invest in this

137 *See infra* Part V (discussing alternatives to portfolio-focused stewardship for addressing intraportfolio externalities).

138 *See* Fleischer, *supra* note 129 (arguing that Pigouvian taxes are likely to be the optimal regulatory instrument only when the harm to be internalized is properly analogized to global pollution and does not vary significantly based on the source, or the variation in marginal social cost is easily observed and categorized).

139 Calibrating this tax would be much more difficult than calibrating a true carbon tax tied to the cost firms' carbon emissions impose on society generally, itself no walk in the park. *See* Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENV'T L. REV. 499, 511 (2009) (discussing the challenges in calibrating a carbon tax). This is because it would require calculating the tenuous impact of portfolio firms' emissions on risk-adjusted portfolio value. *See* Tallarita, *supra* note 15, at 517 (questioning the ability of the Big Three's climate stewardship to actually impact climate change given that "[p]ublicly traded companies, the target of index fund stewardship, represent only a subset of the global economy").

140 This would not be required if public lawmakers imposed a carbon tax on firms directly and introduces additional room for error.

141 Metcalf & Weisbach, *supra* note 139, at 501.

endeavor, particularly given that dictating executive pay so specifically would raise their risk of facing antitrust liability and being considered "controllers" for purposes of the corporate and securities laws.[142]

Index fund managers also lack the capacity to assign formal property rights as a way to deal with intraportfolio externalities. As with any attempt to mimic Pigouvian taxes through executive pay, devising a way to mimic a property rights regime within the portfolio would be immensely complicated, and overseeing such a scheme would require index fund managers to assert a level of control that would leave them legally vulnerable. Thus, even if theoretically possible, it is not plausible that they would pursue this approach.[143]

That leaves just two instruments that index fund managers might plausibly utilize in an effort to cause portfolio firms to internalize their intraportfolio externalities: (1) command-and-control style regulation (i.e., demands that portfolio firms adjust their business practices in specified ways[144]) and (2) disclosure regulation. Each is briefly discussed below.

[142] *See supra* note 75. It is telling that companies incorporating ESG metrics into executive pay packages have taken a very different approach; rather than mimicking a Pigouvian approach, they set a (typically vague) ESG-linked command-and-control style performance target and then adjust the executive's annual cash bonus based on the board's assessment of whether it has been met. *See* Bebchuk & Tallarita, *supra* note 57 (providing an empirical analysis of ESG metrics in executive pay and warning that the ESG compensation trend "poses the danger of creating vague, opaque, and easy-to-manipulate compensation components, which self-interested CEOs can exploit to inflate their payoffs, with little or no accountability for actual performance").

[143] A portfolio firm could, however, assign property rights within the firm as a means of achieving compliance with command-and-control style edicts handed down by index fund managers. *Cf.* Light & Orts, *supra* note 122, at 30–32 (explaining a private governance form of the property approach to environmental regulation that involves allocating internal property rights to business units within a single firm). They could likewise impose Pigouvian taxes on units within the firm with the same aim. *See id.* at 34–35 (discussing how Disney and Microsoft have adopted internal carbon fees to support efforts to achieve their goal of carbon neutrality).

[144] Some scholars treat regulations that tell firms what they must accomplish but leave them to decide how best to do so as a distinct instrument

### 1. Command-and-Control Regulation

In the instrument choice literature, command-and control style regulation has been heavily criticized, particularly in comparison to Pigouvian taxes.[145] The most fundamental critique concerns the tremendous amount of information lawmakers must acquire and process in order to craft command-and-control style regulations that are even nominally efficient.[146] Expert agencies are generally relied upon to conduct

(sometimes called "performance-based standards"). *See* Jon D. Hanson & Kyle D. Logue, *The Costs of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 107 YALE L.J. 1163, 1273–74 (1998) (taking this approach and limiting use of the term "command-and-control" to rules that impose specific requirements on regulated firms, such as a rule requiring a polluter to adopt a particular type of pollution-reducing technology). This article treats such performance-based standards as a species of command-and-control style regulation. *See id.* at 1267 (noting that the informational needs of regulators in both contexts are the same).

145 *See, e.g.*, Rena I. Steinzor, *Reinventing Environmental Regulation: The Dangerous Journey from Command to Self-Control*, 22 HARV. ENV'T L. REV. 103, 103 & n.1 (1998) (citing academic and popular works critiquing command-and-control regulation as economically inefficient and observing that these critiques "have gained widespread acceptance among participants in the policymaking process"); Howard Latin, *Ideal Versus Real Regulatory Efficiency: Implementation of Uniform Standards and "Fine-Tuning" Regulatory Reform*, 37 STAN. L. REV. 1267, 1268 (1985) ("[P]rominent legal scholars such as Bruce Ackerman, Steven Breyer, and Richard Stewart have concluded that command-and-control regulation is inefficient and should be replaced by more flexible strategies."); Bruce A. Ackerman & Richard B. Stewart, *Comment: Reforming Environmental Law*, 37 STAN. L. REV. 1333, 1341–51 (1985) (critiquing command-and-control regulation and advocating for greater use of market mechanisms).

146 *See, e.g.*, *supra* note 129; Kyle D. Logue, *In Praise of (Some) Ex Post Regulation: A Response to Professor Galle*, 69 VAND. L. REV. EN BANC 97, 103, 105 (2016) (discussing the "enormous informational burden" crafting command-and-control style regulations imposes on the regulator, while recognizing that even though "command-and-control regulation is difficult to implement effectively and requires a great deal of information on the part of the regulator," "there are plenty of situations in which specific regulatory mandates, despite the difficulty of getting them right, may be optimal"); Hanson & Logue, *supra* note 144, at 1264–1265 (discussing the massive amount of information regulators would need to craft command-and-control style regulations designed to address smoking externalities). There is significant literature debating the relative merits of command-and-control

the intensive information gathering and analysis needed to draw the lines correctly. But, as the public choice literature has emphasized,[147] the process of crafting command-and-control style regulations is subject to predictable pathologies which can lead to inefficient rules that stifle innovation[148] and suppress competition.[149] Various safeguards exist that help to

style regulations versus Pigouvian taxes as instruments for dealing with environmental externalities; as noted above, most economists view Pigouvian taxes as superior. In an article defending command-and-control style regulations, Professors Cole and Grossman observe that this literature tends to conflate nominal and relative efficiency. They explain that the nominal efficiency of a regulatory regime is determined by comparing its social costs and benefits; the regime is nominally efficient if it produces benefits in excess of its costs. And it remains nominally efficient even if it turns out to be less efficient than (or relatively inefficient compared to) some real or imagined alternative regulatory regime. Daniel H. Cole & Peter Z. Grossman, *When Is Command-And-Control Efficient? Institutions, Technology, and the Comparative Efficiency of Alternative Regulatory Regimes for Environmental Protection*, 1999 WIS. L. REV. 887, 893 (1999). *See also* Latin, *supra* note 145, at 1272 (warning that "intemperate academic criticisms of command-and-control standards combined with support of unrealistic 'fine-tuning' strategies may lend an aura of intellectual credibility to political initiatives designed to achieve less regulation, not better regulation"). While the efficiency of command-and-control style portfolio focused stewardship interventions relative to (realistically attainable) political alternatives is relevant to whether financially motivated diversified investors would support them (*see infra* Part V), the present discussion is focused on nominal efficiency.

[147] For a general introduction to the public choice literature, see DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

[148] *See generally* Richard B. Stewart, *Regulation, Innovation, and Administrative Law: A Conceptual Framework,* 69 CALIF. L. REV. 1256, 1264 (1981). This critique has less force when the regulation sets a performance standard. *See* David M. Driesen, *Does Emissions Trading Encourage Innovation?*, 33 ENV'T L. REP. 10094 (2003) (drawing this distinction).

[149] For arguments along this line directed at environmental regulation, see Nathaniel O. Keohane, Richard L. Revesz & Robert N. Stavins, *The Choice of Regulatory Instruments in Environmental Policy*, 22 HARV. ENV'T L. REV. 313, 348–50 (1998) (explaining "why private firms (and their trade associations) may have a strong preference for command-and-control standards, which may create rents, and especially for considerably more stringent command-and-control standards for new pollution sources, which create barriers to entry"); Todd J. Zywicki, *Environmental Externalities and*

protect against this, and to promote efficient lawmaking more generally. These include oversight of administrative agencies by democratically accountable bodies, requirements that agencies engage in notice-and-comment rulemaking, and the specter of judicial review. But, the efficacy of these safeguards is hotly contested.

Regardless of one's views on the capacity of the administrative state to craft efficient command-and-control style regulations, there are good reasons for one to take concerns about the informational burden this sort of regulation places on lawmakers more seriously in the context of portfolio-focused stewardship. Index fund managers have nothing akin the expertise of the administrative state at their disposal to assist them in gathering and analyzing the information needed to judge whether a command-and-control style stewardship intervention is likely to increase risk-adjusted portfolio value.[150] This means they would have to develop or hire the requisite expertise if they wanted to make intelligent decisions—something that cuts against their financial incentives to keep costs low.[151] As already discussed, the assistance that ESG activists

*Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. 845, 911 (1999) (arguing that "[l]arge, politically connected corporations and industries" use command-and-control style environmental regulation "as a method to impose costs on and create barriers to entry for new, smaller businesses").

150 *See, e.g.*, Lund, *supra* note 19, at 141 (observing that "the people at the Big Three who make the rules are salaried employees with backgrounds in investing and corporate governance," and thus "lack expertise in regulatory policy that seasoned public officials bring to the table"); *see also* Enriques & Romano, *supra* note 41, at 18 ("estimating interfirm spillovers can be a very complex endeavor, especially for institutional investors that hold stakes in thousands of corporations").

151 *See supra* note 71 and accompanying text; *see also* Lund, *supra* note 19, at 141–42 & n. 318 ("[T]he Big Three devote far fewer staff and resources to stewardship than the typical administrative agency."). The Big Three rarely even provide comments on SEC proposed rules that will impact portfolio value, or chime in as amicus curiae in significant litigation. Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2095–2112; *but see* Fisch, et al., *supra* note 85, at 54–55 (presenting data that the authors contend demonstrate index fund managers' active

and investor coalitions might offer is limited in important ways.[152]

Moreover, index fund managers who cut corners or allow self-interest to infect their decisions face far less accountability than government actors.[153] Index fund shareholders lack meaningful voting rights.[154] The policies index fund managers adopt are not subject to anything resembling notice-and-comment rulemaking. Judicial review is weak—while index fund managers technically owe fiduciary duties to the funds they manage, they face essentially no liability risk for their stewardship decisions.[155] Index fund investors do have the capacity to discipline a fund manager who engages in value-destroying stewardship activities by switching to a fund with a different advisor, thereby reducing the fund manager's compensation by lowering the value of its assets under management. But index fund investors are rationally apathetic and cannot be expected to pay attention to stewardship.[156] Moreover, command-and-control style portfolio stewardship

engagement in policy discussions related to investor voice as well as issues beyond corporate governance).

152 *See supra* notes 94–97 and accompanying text.

153 *See, e.g.*, Lund, *supra* note 19, at 129 ("[T]he Big Three's regulatory power exceeds that of the typical government agency, despite a near total lack of oversight.").

154 *See* Morley & Curtis, *supra* note 66, at 92–93, 106–08.

155 *See supra* note 67.

156 *See, e.g.*, Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2073 ("[M]ost investors are unlikely to have sufficient expertise or resources to evaluate the many stewardship decisions made by index fund managers."). Even if index fund investors did pay attention to stewardship, switching can be costly. Company 401(k) plans usually do not offer employees multiple competing funds of the same type to choose from. Moreover, if the Big Three take the same position on stewardship interventions, fund investors may have no funds they can flee to without sacrificing the lower fees that the Big Three can offer due to their economies of scale. *See id.* at 2130 ("There is . . . no market mechanism that rewards index fund managers for good judgement about stewardship for their portfolio companies."); Fisch & Schwartz, *supra* note 19, at 26, 41 (noting "many fund managers appear to be herding on ESG issues" and observing that, "[a]lthough a handful of anti-ESG funds are now available, they are new, small, and higher cost than broad-based index funds").

interventions may take place entirely outside of public view, or may be intentionally obfuscated by index fund managers, making monitoring by even interested parties difficult.[157] Theoretically, command-and-control style regulation can be more easily corrected when implemented by index fund managers than it can be when implemented by government: in the unlikely event fund managers are willing to acknowledge they have made a mistake, it is simpler to change course. But even then, if the initial intervention required that portfolio companies make substantial investments or alter their business operations, the ease of *ex post* revision may be of little value.

Unlike public lawmakers, asset managers also do not face constitutional limitations on their authority. They can therefore impose regulations on large sectors of the economy that government could not, such as gender or racial quotas that would violate the Equal Protection Clause if adopted by government, and restrictions on corporate speech that if adopted by government would violate the First Amendment. The issues raised by this, like the issues raised by the potential for asset managers to promote anticompetitive behavior,[158] are not strictly relevant to the preferences of our hypothesized diversified investor concerned purely with financial returns.[159] But they are certainly relevant to a broader public policy discussion regarding the power of the Big Three. Even if portfolio-focused stewardship were good for financially motivated diversified investors, it may still be something society would not want to permit or encourage.[160]

[157] *See* Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 16, at 2123–26 (advocating for reforms that would increase transparency surrounding engagement by the Big Three with portfolio companies); Kahan & Rock, *supra* note 19, at 534 (explaining index fund managers' incentives to cloak portfolio-focused stewardship interventions in the language of firm value maximization).

[158] *See supra* note 61.

[159] *See supra* note 18 and accompanying text.

[160] Professor Sean Griffith has observed that when a determination as to whether a portfolio-focused stewardship intervention will create more benefit than cost must be made based on incomplete information about the proposed intervention's ultimate effects on portfolio value, the decision can be viewed as coming down to tradeoffs between competing values. Griffith,

### 2. Disclosure Regulation

While its use by index fund managers is beset by the same accountability problems as command-and-control style regulation, disclosure regulation may be a relatively more attractive instrument from the perspective of financially motivated diversified investors because it is less expensive to comply with, is more flexible, and presents less risk of distortion than prescriptive regulatory commands.[161] But just because

*supra* note 18, at 1019. He argues that individual fund investors are better suited to make these tradeoffs relative to fund managers and argues more generally that index fund managers should be stripped of discretionary voting power with respect to environmental and social proposals. In the event fund investors failed to provide instructions on how to vote, he would require fund managers to vote the non-instructed shares in line with the recommendations of portfolio firm managers. Professors Fisch and Schwartz express similar concern over fund managers making values-based voting decisions that may not reflect the ideological preferences of fund investors. Fisch & Schwartz, *supra* note 19, at 26 ("How one views the impact of environmental and social proposals on firm performance is largely a function of values and political leanings, not finance. Because support for such measures is based on contested values, not just financial analysis, fund managers cannot, at the same time, ignore beneficiary views and claim to faithfully represent them."); *id.* at 27 ("It is undemocratic to rely on unelected, largely unaccountable, financial institutions to set public policy without any input from the public."). Their proposed solution is to not to strip fund managers of voting power, but rather to require fund managers to solicit input from fund investors on their voting preferences and to incorporate the feedback received into the fund managers' stewardship decisions.

[161] *See, e.g.*, Cass R. Sunstein, *Informational Regulation and Informational Standing: Akins and Beyond*, 147 U. PA. L. REV. 613, 626 (1999) (observing that it "is increasingly recognized that information is often a far less expensive and more efficient strategy than command-and-control, which consists of rigid mandates about regulatory ends (a certain percentage reduction in sulfur dioxide, for example), regulatory means (a technological mandate for cars, for example), or both," and noting its comparative flexibility); Michael Vandenbergh, *From Smokestack to SUV: The Individual as Regulated Entity in the New Era of Environmental Law*, 57 VAND. L. REV. 515, 530–31 (2004) (explaining that information disclosure may be less expensive for regulators and regulated entities, and more flexible and efficient, than command and control requirements); George Loewenstein, Cass R. Sunstein & Russell Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV. ECON. 391, 392 (2014) (explaining that "[an] important advantage of disclosure requirements, as opposed to harder forms of

disclosure regulation may be less costly than command-and-control style regulation does not mean that it is costless, or effective.

As for costs, information disclosure can in fact be quite expensive—particularly given the liability risk that U.S. public companies face for disclosure missteps.[162] To evaluate the likely effectiveness of disclosure regulation as a portfolio-focused stewardship technique requires clarity as to the mechanism through which the mandated disclosure is supposed to lead portfolio firms to internalize their intraportfolio externalities. After all, disclosure regulation alone does not magically internalize externalities; its success as a regulatory technique requires that the disclosures produced by it catalyze (or that portfolio firms *anticipate* that they will catalyze) action by others that, in turn, cause portfolio firms to take account of the external effects of their behavior.[163] This requires that the disclosure mandates target relevant information, that firms credibly comply with those mandates, and—importantly—that the disclosures trigger the desired response by those who are meant to consume them.[164] The last requirement is

regulation, is their flexibility and respect for the operation of markets" and observing that "[r]egulatory mandates are blunt swords; they tend to neglect heterogeneity and may have serious unintended adverse effects").

[162] Actual costs will vary significantly depending on the nature of the disclosure mandates. *C.f.* Rose, *supra* note 2, at 1834 (discussing factors that affect the cost of SEC disclosure mandates).

[163] *See, e.g.*, Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1108-1113 (2007) (discussing how disclosure regulation works and its benefits). Disclosers may sometimes adjust their behavior more than disclosee's reactions to the information would rationally warrant, in an example of what has been referred to in the behavioral economics literature as the "Telltale Heart Effect." *See, e.g.*, Loewenstein, et al., *supra* note 161, at 403-404 (describing this phenomenon); *see also* Stephanie Bornstein, *The Enforcement Value of Disclosure*, 72 DUKE L.J. 1771 (2023) (discussing how disclosure regulation can operate as a "nudge" on the discloser).

[164] Dalley, *supra* note 163, at 1113-19 (discussing limitations of disclosure regulation, including "the ability of individuals to process information" as well as "the way information affects individuals' behavior"); David Weil, Elena Fagotto, Archon Fung & Mary Graham, *The Effectiveness of Regulatory Disclosure Policies*, 25 J. POL'Y ANALYSIS AND MGMT. 155, 157 (2006)

perhaps the biggest wildcard, given that cognitive biases make predicting human behavior fraught, and even if a disclosure audience responds rationally to information it may not have the power to change firm behavior.[165] Scholars who have studied disclosure regulation have concluded that the "conditions for effectiveness are quite demanding and therefore not easily met."[166]

With respect to disclosure-style portfolio-focused stewardship interventions, one could imagine three potential groups whose behavior the disclosures could be meant to influence. In the first category are market actors who might adjust their market behavior by virtue of the disclosures in a way that forces companies to take account of the external costs of their actions. This could include consumers, suppliers, as well as *non*-index investors and their fund managers. These actors could modify their market behavior based on their own digestion of the disclosures or based on their reaction to others' responses to those disclosures, such as campaigns organized by various advocacy groups, media coverage, etc.[167] In the second category are government actors who may be catalyzed to

(explaining that "[w]hether and how new information is used to further public objectives depends upon its incorporation into complex chains of comprehension, action, and response"); Sunstein, *supra* note 161, at 627 (noting that even when disclosure mandates "are not prohibitively expensive, they may be ineffectual and thus have low benefits; they may even be counterproductive").

165 Dalley, *supra* note 164, at 1130; *see generally* Loewenstein, et al., *supra* note 161, at 398-404 (cataloguing the biases that can render disclosure regulation ineffective and even counterproductive).

166 Weil et al., *supra* note 164, at 175; *see also* Loewenstein et al., *supra* note 161, at 413 (explaining that "[p]sychological factors severely complicate the standard arguments for the efficacy of disclosure requirements" and concluding that "disclosure requirements appear to have been less effective in changing recipient behavior than their proponents seem to assume").

167 *Cf.* Michael P. Vanderburgh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 137–38 (2013) (explaining how environmental goals can be advanced through private preferences "expressed in purchasing, lending, investing, and supply chain contracting decisions, not just at the ballot box or through lobbying public officials"). For an extensive discussion of the ways that non-investor audiences may use corporate disclosures to affect corporate behavior, see Lipton, *supra* note 51, at 511–19.

adopt new regulations (or better enforce existing ones) in light of the disclosures.[168] Third are the index fund managers themselves, who might use the information to help them craft new command-and-control style policies (or better enforce existing ones).

Note that the interests of the actors in each of these categories clearly deviate from the interests of financially motivated diversified investors. There is no guarantee that their reactions (or anticipated reactions)—even if entirely rational—will result in an increase in risk-adjusted portfolio value net of compliance costs, and it is possible that the net result could be a *reduction* in risk-adjusted portfolio value.[169]

## D. Real World Friction #4: Market Dynamism

In addition to assuming away managerial agency costs, intermediary agency costs, and information deficits, early economic proofs that firms owned by diversified investors would seek to maximize portfolio rather than firm value made one additional key assumption: a static marketplace.[170] This assumption is critical, because if diversified investors "are successful in maximizing portfolio value rather than firm value, corporate profits will decline."[171] In a dynamic market, this would create an incentive for an investor "to become undiversified and acquire a controlling interest in the company, change its policies, and reap the gains of increased profits."[172] Declining profits would also create incentives for activist hedge funds to team up with non-indexed (or differently-

[168] *But see* OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014) (warning that disclosure regulation is often politically expedient to adopt as a compromise against more effective alternatives).

[169] *Cf*. Hans B. Christensen, Luzi Hail & Christian Leuz, *Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review*, 26 REV. ACCT. STUD. 1176 (2021) (warning that mandatory disclosure regimes can have negative unintended consequences and outlining the potential effects on firm behavior of mandatory ESG disclosure mandates).

[170] *See supra* note 42 and accompanying text.

[171] Hansen & Lott, *supra* note 42, at 54.

[172] *Id.*

indexed) institutional investors to force such changes.[173] This reality means that any positive effects of portfolio-focused stewardship on portfolio value may prove fleeting. As previously discussed, a financially motivated diversified investor would not favor insulating firm managers from market discipline as a solution to this problem, because doing so would exacerbate managerial agency costs.[174]

Moreover, even if firm managers were insulated from the market for corporate control and hedge fund activism, if they prioritize portfolio over firm value they may cede market share to firm-value maximizing firms outside the portfolio. Non-portfolio firms might increase their production of an externality in response, leading to offsetting harms to portfolio value. After all, there is no magic bubble that limits the exposure of portfolio firms to only the externalities produced by other firms in the same portfolio. The portfolio primacy literature sometimes glosses over this by assuming that diversified investors own the entire global economy, but they do not: most are invested in only a subset of U.S. public companies—there are no true "universal owners."[175]

In *Systemic Stewardship with Tradeoffs*, Professors Kahan and Rock detail how competitive responses in the marketplace can detract from the potential for portfolio-focused stewardship interventions to increase risk-adjusted portfolio value.[176]

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[173] *See generally* Gilson & Gordon, *supra* note 89.

[174] *See supra* Section III.A.

[175] Kahan & Rock, *supra* note 19, at 504. It is also the case that some portfolio firms will be immune from index fund managers' portfolio-focused stewardship efforts because they have controlling shareholders or significant blockholders; these firms' competitive responses might also offset anticipated portfolio gains. *See* Tallarita, *supra* note 15, at 517 (observing that even among publicly traded companies, the target of index fund stewardship, "most companies have a controlling shareholder or an influential blockholder who can frustrate stewardship initiatives"); Dhammika Dharmapala & Vikramaditya S. Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities* 1, (Eur. Corp. Governance Inst., Working paper No. 603/2021, 2021) ("[T]he widespread prevalence of controlled firms with undiversified controlling shareholders constitutes a significant obstacle to the internalization of cross-firm externalities.").

[176] Kahan & Rock, *supra* note 19, at 505-08.

They provide examples to illustrate how such responses "can, depending on the circumstances, eliminate or greatly reduce any benefits" from such interventions, leaving diversified investors "with a portfolio loss rather than the gain they had hoped to reap."[177] Professors Fisch and Schwartz similarly warn that because the impact of fund managers' efforts to address environmental externalities "is limited to the companies in which their funds invest," "pollution producing activities can migrate offshore or to private companies rather than disappear," with the result that "public investors continue to bear the costs of the pollution but do not share in the benefits."[178]

Market dynamism thus further complicates the task of predicting the effects a portfolio-focused stewardship intervention will have on risk-adjusted portfolio value, whether that intervention takes the form of a command-and-control style regulation or disclosure regulation.

## IV. EVALUATING THE BIG THREE'S EFFORTS

There are several points to take away from Part III's discussion of the real-world frictions that affect portfolio-focused stewardship. To wit:

- Interventions which operate by generally eroding managerial sensitivity to firm value will likely do more harm to portfolio value (by increasing managerial agency costs) than good (by reducing intraportfolio externalities).
- Interventions which impose vague, discretionary policies on portfolio firms, or policies that are otherwise difficult to monitor compliance with, are unlikely to work given the firm-focused incentives portfolio firm managers face.
- Index fund managers may find stewardship interventions that decrease risk-adjusted portfolio value compatible with their private incentives. If a motive other than increasing risk-adjusted portfolio value (and in turn management fees) could explain a purported

[177] *Id.* at 8.

[178] Fisch & Schwartz, *supra* note 19, at 28.

portfolio-focused stewardship intervention, and the impact of the intervention on risk-adjusted portfolio value is difficult to verify, financially motivated diversified investors would question its worth. Verification of the intervention's value might be difficult because (a) the relationship between the portfolio firm behavior sought to be modified and risk-adjusted portfolio value is opaque, or (b) the effect of the specific intervention on portfolio value is hard to predict.

- Relative to public lawmakers, index fund managers have far fewer instruments they can use to force the internalization of externalities—being practically limited to command-and control style regulation and disclosure regulation—and they face far less accountability for their policies.
- Crafting efficient command-and-control style regulation is very information intensive, and the efficiency of disclosure regulation will depend on how others (with different incentives than financially motivated diversified investors) react to it, which can be difficult to predict.
- Judging the likely effect of any type of stewardship intervention on portfolio value is complicated by the dynamic nature of the marketplace, as portfolio gains can be erased through changes in ownership or competitive responses by other firms.

With these points in mind, let us turn to evaluate some of the Big Three's recent stewardship interventions that might be characterized as "portfolio focused." Would rational, financially motivated diversified investors expect these interventions to lead to a net increase in risk-adjusted portfolio value through the forced internalization of intraportfolio externalities?

## A. Statements of Corporate Purpose

Starting in 2018, Blackrock began asking the CEOs of its funds' portfolio firms to express their firm's "corporate purpose," while emphasizing that a corporation's purpose should be to "benefit all of [its] stakeholders, including shareholders,

employees, customers, and the communities in which [it] operate[s]."[179] In 2019, 181 CEOs of America's largest public companies signed a letter put out by the Business Roundtable stating that the purpose of a corporation is to serve all stakeholders, not merely to maximize shareholders' firm-specific returns.[180] The statement contained vague commitments by the signatories, such as to: "meet[] or exceed[] customer expectations"; compensate employees "fairly" and provide them with "important benefits"; foster "diversity and inclusion"; and "embrac[e] sustainable practices."[181] Many public companies have followed up with firm-specific statements of corporate purpose, which tend to be equally vague. For example, Coca-Cola's corporate purpose is "[t]o refresh the world and make a difference,"[182] and Nike's is "to unite the world through sport to create a healthy planet, active communities, and an equal playing field for all."[183]

Because such vague commitments do not meaningfully limit managerial discretion, they cannot be expected to cause portfolio firm managers to ignore their strong firm-focused incentives and act to prioritize portfolio over firm value.[184] Thus, financially motivated diversified investors would not

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[179] Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/4X6T-3UYU]; *see also* Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose and Profits*, BLACKROCK (2019), https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter [https://perma.cc/XU66-TEPD].

[180] BUSINESS ROUNDTABLE, STATEMENT ON THE PURPOSE OF A CORPORATION (Aug. 19, 2019), https://system.businessroundtable.org/app/uploads/sites/5/2023/02/WSJ_BRT_POC_Ad.pdf [https://perma.cc/YLM3-KF6A].

[181] *Id.*

[182] *Does The Coca-Cola Company Strive to Operate Its Business Responsibly?*, THE COCA-COLA CO., https://www.coca-cola.com/us/en/about-us/faq/does-the-coca-cola-company-strive-to-operate-its-business-respon [https://perma.cc/5EBN-E5UG].

[183] *Nike*, THE ALUMNI SOC'Y, https://thealumnisociety.com/partners/nike [https://perma.cc/J46C-XKWX].

[184] *See supra* Section III.A.

view Blackrock's intervention on corporate purpose as effective portfolio-focused stewardship.

## B. Gender Quotas for Corporate Boards

The Big Three have each threatened to vote against directors of portfolio companies that fail to increase female representation on the board.[185] Unlike requests for statements of corporate purpose, this type of intervention imposes specific and easily enforceable obligations on portfolio companies. Moreover, the intervention does not generally undermine firm-focused managerial incentives. But financially motivated diversified investors would nevertheless doubt that it would lead to a net increase in risk-adjusted portfolio value, because there are obvious self-serving marketing reasons why the Big Three might want to champion the policy,[186] and the link between gender representation on corporate boards and portfolio value is not well established.[187]

## C. Emissions Reductions

What about the Big Three's demands that portfolio companies cut greenhouse gas emissions? First off, it is not clear that the Big Three are committed to making such demands. They have recently taken pains to say that they do not require

[185] Barzuza et al., *supra* note 19, at 1265–69 (detailing the Big Three's efforts at increasing female representation on the boards of portfolio firms).

[186] *Id.* (arguing that marketing incentives best explain the Big Three's efforts to promote diversity).

[187] *See* Order Approving Proposed Rule Changes Related to Board Diversity and To Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service, 86 Fed. Reg. 44424, 44432 (Aug. 6, 2021) (noting that studies on the "effects of board diversity are generally inconclusive"); *see* Fried, *supra* note 100, at 1 (reviewing empirical evidence and finding that increasing board diversity may reduce investor returns, but positing that doing so could nevertheless be in asset managers' selfish interest by helping them attract socially minded millennial investors and pensions funds, leading to increased AUM and hence management fees); Sharfman, *supra* note 19, at 480-87 (arguing that a business case cannot be made for gender diversity mandates and attributing the Big Three's support therefore to a millennial marketing strategy).

portfolio companies to meet specific climate targets or otherwise tell them what to do to address climate change; in other words, they have expressly disavowed that they are engaged in command-and-control style regulation.[188] Earlier statements suggested that they expected commitments from portfolio firms related to emissions and were willing to punish firms that did not make adequate progress toward reductions[189]—a threat some believe they followed through on in 2021, when they supported Engine No. 1's proxy campaign to replace three directors at ExxonMobil.[190] Some have critiqued this seeming change in position, demanding the Big Three "recommit" to command-and-control style climate interventions.[191]

What might explain this apparent retrenchment? One possibility is that the Big Three now recognize that prescriptive stewardship interventions are dangerous because their

188 *See* Larry Fink, *Larry Fink's 2023 Annual Chairman's Letter to Investors*, BLACKROCK (2023), https://www.blackrock.com/corporate/investor-relations/larry-fink-annual-chairmans-letter [https://perma.cc/9L6D-E9PW] ("It is not the role of an asset manager like BlackRock to engineer a particular outcome in the economy, and we don't know the ultimate path and timing of the transition. . . . As minority shareholders, it's not our place to be telling companies what to do . . . it is for governments to make policy and enact legislation, and not for companies, including asset managers, to be the environmental police. . . . Transition toward lower carbon emissions will reflect the regulatory and legislative choices governments make to balance the need for secure, reliable and affordable energy with orderly decarbonization.").

189 *See, e.g.*, Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, BLACKROCK (2020), https://www.blackrock.com/americas-offshore/en/larry-fink-ceo-letter [https://perma.cc/3VTD-2V69].

190 It is possible, of course, that Big Three support for Engine No. 1's proxy campaign was driven not by climate concerns but rather by more traditional concerns about firm performance.

191 *See, e.g.*, Angel Au-Yeung, *BlackRock Takes Heat From New York City Over Climate Stance*, WALL ST. J. (Sept. 22, 2022), https://www.wsj.com/articles/blackrock-takes-heat-from-new-york-city-over-climate-stance-11663864059 [on file with the Columbia Business Law Review] (quoting the New York City Comptroller as writing that "BlackRock now abdicates responsibility for driving net zero alignment on its own portfolio by saying that it does not ask companies to set specific targets").

stewardship teams do not possess the necessary information or expertise to determine whether they will have a positive effect on risk-adjusted portfolio value. This realization may have been helped along by Russia's invasion of the Ukraine, which increased the salience of dangers associated with too quickly abandoning domestic fossil fuel production,[192] or by cogent academic arguments as to the uncertain likelihood that the Big Three's efforts could actually affect the trajectory of climate change.[193] Another possibility is that the Big Three's private cost-benefit calculation has shifted in ways that make such interventions no longer attractive. Whereas environmental activism may have previously paid political dividends by muting common ownership criticism from the Left, recent pushback by Republicans in Congress and by officials in conservative states has now made it a political and financial liability for the Big Three.[194] It is also the case that the potential to profit from such activism by attracting millennial

[192] *Cf.* Alon Brav & J.B. Heaton, *Brown Assets for the Prudent Investor*, 12 HARV. BUS. L. REV. ONLINE, art. 2, 2021, at 7 (noting the "national security and economic security implications of ceding fossil fuel production to foreign adversaries").

[193] *See generally* Tallarita, *supra* note 15.

[194] *See, e.g.*, Fisch & Schwartz, *supra* note 19, at 29 (describing the recent "political backlash" and divestment threats by red states and suggesting that this pressure may have caused Blackrock "to reevaluate its ESG stance"); Saijel Kishan & Jeff Green, *Onetime Trump Appointee Helps Spark Sweeping ESG Backlash*, BLOOMBERG (Nov. 20, 2022), https://www.bloomberg.com/news/articles/2022-11-20/onetime-trump-appointee-helps-spark-sweeping-esg-backlash [on file with the Columbia Business Law Review] (describing the "ESG backlash" against BlackRock and other asset managers). In addition to disclaiming placing environmental demands of portfolio firms, Blackrock has reportedly lessened its support for environmental and social proposals recently. *See* Brook Masters, *BlackRock Pulls Back Support for Climate and Social Resolutions*, FIN. TIMES (July 26, 2022), https://www.ft.com/content/48084b34-888a-48ff-8ff3-226f4e87af30 [https://perma.cc/RAY2-3JBY]. As noted *supra*, Vanguard also recently quit the Net Zero Asset Managers initiative. *See supra* note 97 and accompanying text; Ross Kerber & Noor Zainab Hussain, *Vanguard Quits Net Zero Climate Effort, Citing Need for Independence*, REUTERS (Dec. 7, 2022), https://www.reuters.com/business/sustainable-business/vanguard-quits-net-zero-climate-alliance-2022-12-07/ [on file with the Columbia Business Law Review].

investment has decreased, as the popularity of ESG products has waned.[195]

Whatever the cause, financially motivated diversified investors would likely support the Big Three's recent turn against prescriptive climate interventions. While such investors would recognize that portfolio firms contribute to climate change, and that climate change poses risks to a diversified portfolio, the impact particular climate interventions would have on risk-adjusted portfolio value is very difficult to determine. As Professor Tallarita has explained, such interventions could impose costs on portfolio firms without actually achieving any reduction in portfolio risk, given that some of the largest contributors to climate change are firms outside the portfolio.[196] Moreover, the market could react in ways that mute the impact of the intervention—for example, portfolio firms could go private or sell dirty assets to firms outside the portfolio, or non-portfolio firms could gain greater market share, leading to potentially *worse* climate outcomes and *greater* portfolio risk.[197] It is also hard to anticipate the possible unintended consequences of such interventions on technological innovation, domestic energy security and geopolitical stability—consequences that could negatively impact risk-adjusted portfolio value. In addition, such interventions could alter political dynamics in ways that reduce the likelihood of government action that would more effectively address climate change.[198] Given fund managers' incentives to keep

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[195] Lauren Foster, *U.S. ESG Funds Suffer Worst Quarterly Outflows in More Than 5 Years*, BARRON'S (Jan. 27, 2022) https://www.barrons.com/articles/us-esg-sustainable-funds-outflows-51674767507 [on file with the Columbia Business Law Review].

[196] Tallarita, *supra* note 15, at 517-18.

[197] *See infra* Section III.D.

[198] *See, e.g.*, Tariq Fancy, *Blackrock Hired Me to Make Sustainable Investing Mainstream. Now I Realize It's a Deadly Distraction From the Climate-change Threat*, GLOBE & MAIL (Mar. 30, 2021), https://www.theglobeandmail.com/business/commentary/article-sustainable-investing-is-a-deadly-distraction-from-actually-averting [https://perma.cc/G9BR-D97H ] (asserting that government action required to effectively address climate change "is still being held up by the illusion promoted by many global business leaders that the free market will somehow correct itself and the climate

costs low and their lack of both expertise and accountability, financially motivated diversified investors are unlikely to trust them with such a difficult calculus.

Similar points could be made about most command-and-control style interventions. Importantly, when the expected impact of a command-and-control style intervention on portfolio value *is* easy to determine, its adoption via government channels should be both feasible and, for reasons discussed in the next section, preferable. Thus, financially motivated diversified investors—whose rational apathy precludes case-by-case monitoring of stewardship interventions—would likely categorically prefer index fund managers to avoid command-and-control style portfolio-focused stewardship interventions. Notably, Blackrock appears to share this view. Larry Fink's recent statement that it is not the role of an asset manager "to engineer a particular outcome in the economy" or to "tell[] companies what to do" has implications beyond climate—it expresses disapproval of command-and-control style stewardship interventions on any topic.[199]

crisis without government action"); Tallarita, *supra* note 15, at 567 (warning that "portfolio primacy's flawed promise of an internalization mechanism might become a political argument to justify weaker support for painful but necessary regulation" to address climate change); *cf*. Kahan & Rock, *supra* note 19, at 539 (suggesting that imposing regulatory costs on portfolio firms through stewardship might serve as a catalyst for political change); Vandenbergh, *supra* note 167, at 186–87 (warning against assuming that private governance efforts will detract from, rather than promote, the likelihood of additional regulation); Aneil Kovvali, *Stark Choices for Corporate Reform*, 123 COLUM. L. REV. 693 (2023) (presenting theoretical arguments in opposition to the claim that corporate governance measure to promote stakeholder interests will impede stakeholder-oriented governmental reforms). There is a growing empirical literature testing this contention. *See* Kovvali, *supra*, at 734 n.180 (collecting studies); Hajin Kim, Joshua Macey & Kristen Underhill, Does ESG Crowd Out Support for Government Regulation? (Univ. of Chi. Coase-Sandor Inst. for Law & Econ. Rsch. Paper No. 983, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4521781 [https://perma.cc/J64W-NLD4].

[199] *See supra* note 188.

## D. Disclosure Initiatives

What about disclosure regulation? Index fund managers have been active in pursuing this sort of intervention in recent years on a range of topics. For example, Blackrock, State Street and Vanguard have all demanded that portfolio firms publish disclosures in line with both the industry-specific guidelines promulgated by the Sustainability Accounting Standards Board ("SASB") and the recommendations of the Task Force on Climate-Related Financial Disclosures ("TCFD").[200] They have also demanded information related to companies' diversity, equity and inclusion ("DEI") efforts, as well a variety of other topics spanning from human capital management to human rights.[201]

Portfolio-focused stewardship interventions that take the form of disclosure regulation are specific and enforceable, and they do not directly undermine firm managers' sensitivity to firm value. Such interventions are also less likely to land index fund managers in the crosshairs of regulators or ruffle the feathers of investors in the fund's other portfolios, so they have fewer disincentives to pursue this type of intervention relative to command-and-control style interventions. This

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[200] Rose, *supra* note 2, at 1854–55.

[201] *See, e.g.*, Eric Knox, Sehrish Siddiqui & David Venturella, *The Big Three Remain Big on ESG, DEI – 2021 Proxy Season in Review*, CORPORATE COMPLIANCE INSIGHTS (Sep. 14, 2021), https://www.corporatecomplianceinsights.com/year-in-review-big-three-voting-trends/ [https://perma.cc/9ZU9-42CB] (reporting on State Street's "expectations" that portfolio companies will provide "enhanced disclosure regarding the role of diversity in human capital management practices, diversity-related goals, measures of diversity (including EEO-1 report data), board-level diversity and board oversight over diversity and inclusion"); STATE STREET GLOBAL ADVISORS, STEWARDSHIP ACTIVITY REPORT Q42022 (2022) reporting that State Street voted against certain directors at Moderna, Inc. after the company failed to acquiesce to requests to publish its EEO-1 report and SASB-aligned disclosures, and that it has communicated with Walt Disney Company regarding "opportunities for Disney to enhance its human rights-related disclosures"); STATE STREET GLOBAL ADVISORS, ASSET STEWARDSHIP: GUIDANCE ON DISCLOSURE EXPECTATIONS FOR EFFECTIVE CLIMATE TRANSITION PLANS (2023) (providing "portfolio companies with clarity on our expectations for effective climate transition plan disclosure").

does not mean that disclosure regulation will only be pursued when index fund managers perceive that it will increase risk-adjusted portfolio value, however, given that index fund managers may have selfish motives for pushing disclosure regulation. For example, doing so may allow index fund managers to create an appearance that they are doing something, which may produce benefits for them regardless of whether it improves (or even harms) portfolio value. The disclosures may also subsidize their management of ESG-themed financial products.

Financially motivated diversified investors would therefore likely expect such interventions to increase portfolio value only if there was a clear link between the topic of the disclosure regulation and portfolio value.[202] If such a link exits, they would also consider how likely it is that that the disclosures would lead to improvements in risk-adjusted portfolio value. As already discussed, the impact of disclosure regulation on portfolio value can be difficult to predict. In the portfolio-focused stewardship context, the hope of disclosure regulation is that it will cause certain actors to react in ways that will force portfolio companies to internalize their intraportfolio externalities, leading to net increases in risk-adjusted portfolio value. But it can fail to do that and may even have the opposite effect by triggering reactions that *reduce* risk-adjusted portfolio value.

Recall that potentially affected actors fall into three groups: (1) market actors, such as consumers, suppliers, and non-index investors and their fund managers, who may adjust their market behavior by virtue of the disclosures in a way that forces companies to take account of the external costs of their actions; (2) government actors who may be catalyzed to adopt new regulations (or better enforce existing ones) in light of the disclosures; and (3) index fund managers, who may use the information to help them craft new command-and-control style portfolio-focused stewardship policies (or better enforce

[202] *See supra* note 187. This test is far more likely to be met with respect to the Big Three's demands for climate-change related disclosures than with respect to their demands on various disclosure topics that fall under the "S" in "ESG."

existing ones). It seems unlikely that financially motivated diversified investors would want their index fund managers to promulgate command-and-control style interventions even with the help of additional disclosures, and as just explained the Big Three have seemingly disavowed any intention to do so.[203] Thus, we can eliminate the third group from our analysis and conclude that financially motivated diversified investors might support portfolio-focused stewardship interventions that take the form of disclosure regulation, but only if the disclosure topic bears a clear relationship to portfolio value *and* it seems likely that the disclosures will prod either (1) market or (2) government actors to take steps that have the effect of causing portfolio firms to internalize their intraportfolio externalities, leading to increases in risk-adjusted portfolio value net of compliance costs.

A full analysis of whether the myriad disclosure demands the Big Three have placed on their portfolio companies in recent years pass this test would take us far beyond the scope of this Article. Suffice it to say that many probably would not. With respect to some, reasonable minds might disagree.

## V. AVAILABLE ALTERNATIVES

The foregoing suggests that rational, financially motivated diversified investors would discount the benefits of a portfolio-focused stewardship intervention touted by asset managers, to varying degrees depending on the intervention's characteristics. They would also consider the alternatives available to them for achieving the internalization of intraportfolio externalities. If those alternatives were expected to lead to a greater net increase in risk-adjusted portfolio value if pursued alone, financially motivated diversified investors would rationally prefer them.

Alternatives include direct advocacy by diversified investors for government actors to address intraportfolio externalities through legal change, as well as delegated advocacy for

[203] *See infra* Section IV.C.

the same by asset managers.[204] Just as financially motivated diversified investors would likely not support command-and-control style portfolio-focused stewardship interventions, they would likely not want index fund managers to advocate for specific regulatory solutions. But they might support advocacy by index fund managers designed to raise awareness of problems that negatively impact portfolio value and to encourage legislative or administrative attention be paid to those problems. Indeed, this approach could complement disclosure regulation imposed by asset managers with the goal of prodding government action.

Advocating for legal change may be preferable to portfolio focused stewardship because, as explained above, government lawmakers have a broader array of instruments available to them, often have expertise that index fund managers lack, and are subject to a much greater degree of accountability that serves as a constraint on opportunism. Moreover, laws avoid the Gordian Knot that portfolio focused stewardship interventions face because complying with laws is consistent with firm managers' fiduciary duties. To be sure, laws should be designed to maximize social welfare, not risk-adjusted portfolio value, and the two are not the same. But given the foregoing advantages, legal interventions may nevertheless result in greater increases in risk-adjusted portfolio value than portfolio-focused stewardship interventions.

What if pathologies were expected to preclude effective government action? If that were the case, then obviously advocating for government action would not be an attractive alternative to portfolio-focused stewardship as a way to deal with intraportfolio externalities. But the absence of a viable government alternative would not make portfolio focused stewardship interventions that are unlikely to increase risk-adjusted portfolio value suddenly attractive to financially motivated diversified investors. As discussed above, most command-and-control style portfolio-focused stewardship interventions would not be trusted to have a positive effect on

[204] *Cf*. Armour and Gordon, *supra* note 40, at 61 (remarking that "there may be grounds for institutional investors to influence governance in systemic firms through political, rather than firm-level, channels").

portfolio value. Those that would are the sort that would produce clear portfolio payoffs with little risk, and thus would likely garner broad bipartisan support if a government alternative was pursued.[205] Moreover, disclosure regulation by index fund managers will often fail to effectively address intraportfolio externalities. Therefore, a more promising approach to the issue of government failure might be to try to correct the underlying pathologies that interfere with effective government action.

Index fund managers could be viewed as having a role to play in this endeavor, although it is debatable whether financially motivated diversified investors would want them to. Specifically, index fund managers could use fund influence over portfolio firm managers to disable the latter from using corporate resources to fight legal changes that might operate to force the internalization of intraportfolio harms. While this might be thought of as an example of a command-and-control style portfolio-focused stewardship intervention, it is distinguishable in one critical respect: it leaves the crafting of the internalization solution to the public lawmaking process. They could, more softly, demand *disclosure* about corporate political spending and lobbying efforts. This could be viewed as disclosure regulation of the sort discussed above, but again it is slightly different. When disclosure regulation was explained *supra*, the assumption was that the disclosed information would directly prod actions that would in turn force the internalization of intraportfolio externalities. Here, the chain is more attenuated: the information would be designed to prod—through market actors' response (or anticipated response) to the disclosures—a reduction in corporate political spending and lobbying efforts, which *in turn* could make government intervention to address the externality more likely. Whether financially motivated diversified investors would

[205] Moreover, it must be remembered that index fund managers are unlikely to push command-and-control style regulations of any sort, given the numerous incentives they face to remain passive, and the Big Three have recently declared that they view doing so as inconsistent with the proper role of an asset manager.

rationally support these sorts of interventions is contestable for at least two reasons.

First, there may be uncertainty regarding the premise that corporate political spending or corporate lobbying have led to a government failure that in turn has negatively impacted risk-adjusted portfolio value. Arguments of government failure must be analyzed rigorously because what one views as government dysfunction another may view as government working by design. Whenever political roadblocks are hit that stall a government response to an externality-generating behavior, it may be the result of rent-seeking behavior by special interests, or it may reflect genuine disagreements about the correct intervention operating against a government design meant to stall lawmaking in such a situation.

Second, and relatedly, corporate lobbying as well as corporate political spending can be both good and bad from the perspective of financially motivated diversified investors. Such activities would be viewed negatively if they stymied the crafting of laws that would cause portfolio firms to internalize intraportfolio externalities. But such activities would be viewed positively if the efforts prevented the passage of laws that are bad for the portfolio. Corporate lobbying, for example, can help reduce regulatory misunderstandings about what companies are actually doing and the effect regulatory interventions would have on their operations and the economy more broadly; it can also counteract the influence of other special interest groups. Whether reducing corporate influence in politics is desirable from the perspective of a financially motivated diversified investor thus turns on a complicated balancing of likely effects, including whether other groups with knowledge about corporate realities could be relied upon to educate policymakers when other special interest groups overreach.

Notably, the Big Three have *not* been strong supporters of efforts to constrain corporate political spending or corporate lobbying.[206] This could reflect their view that limiting

[206] Lund, *supra* note 19, at 86 ("[T]he Big Three generally vote against shareholder proposals aimed at limiting corporate influence in the political process."); Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of*

corporate voice in politics would not in fact increase risk-adjusted portfolio value, perhaps because it would do more harm to the lawmaking process than good, or perhaps because it is not the source of the government gridlock. Alternatively, it could be explained by intermediary agency costs: the impact of such efforts on portfolio value may not be significant enough to index fund managers' compensation to warrant the undertaking. Figuring out whether the effort would actually benefit the portfolio would be difficult and hence costly. Moreover, supporting efforts to reduce corporate influence in politics could alienate portfolio firm managers, jeopardizing 401(k) business, and risks triggering political backlash. The Big Three may also wish to preserve their own ability to engage in lobbying and political spending. Professor Lund offers another possibility. She writes that "the Big Three appear to enjoy exercising regulatory heft as a result of government dysfunction," noting that "[r]ather than using their power to alleviate rent-seeking by industry (which they also engage in), they choose to maintain the status quo, which positions them well to attract new clients and satisfy existing ones."[207]

## VI. CONCLUSION: IMPLICATIONS FOR MODERN DEBATES

This Article's critical examination of portfolio-focused stewardship sheds light on several contemporary debates. Most directly, it offers guidance on how index fund managers' fiduciary duties should be understood in relation to stewardship—a timely contribution, given that Congress is currently investigating whether the Big Three's ESG-related stewardship efforts conform with their fiduciary responsibilities.[208] The analysis suggests that the financially motivated diversified investors to whom index fund managers owe their duties

*Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007, 1019 (2020) (asserting that the Big Three "have opted for a policy of total deference to management" on political spending issues).

207 Lund, *supra* note 19, at 125.

208 *See supra* note 21.

would likely support only a narrow band of portfolio-focused stewardship interventions. Index fund managers should therefore not be viewed as possessing broad license to wield their influence over portfolio firms in a manner that purports to prioritize portfolio over firm value. In particular, the analysis suggests that index fund managers should generally avoid command-and-control style portfolio-focused stewardship interventions and should carefully consider the likely effect of disclosure-based interventions on portfolio value.

The Article's analysis also has significant implications for the contemporary debate over SEC-mandated ESG disclosure. It demonstrates that financially motivated diversified investors would likely limit their support of portfolio-focused stewardship to interventions that take the form of disclosure regulation (if they support portfolio-focused stewardship interventions at all). One threshold question this raises for SEC-imposed ESG disclosure mandates is why/whether financially motivated diversified investors would support those mandates, given the ability of their index fund managers to directly impose disclosure regulation on portfolio firms through portfolio-focused stewardship efforts. The answer that ESG disclosure advocates would likely offer is that SEC disclosure mandates provide a comparability and credibility that cannot be achieved through the private efforts of index fund managers. Reasonable minds might differ on how convincing such a response is. The SASB and TCFD disclosure frameworks that the Big Three have pushed on portfolio companies are specifically meant to foster comparability, and index fund managers could insist that portfolio firms include SASB and TCFD disclosures in SEC filings. Moreover, codifying disclosure in SEC regulations undermines one of the main benefits of a privatized regulatory approach—flexibility to change and adjust over time at low cost.[209]

But a more fundamental question is lurking. The benefits of comparability and credibility, while often cited as a reason favoring mandatory as opposed to voluntary disclosure, are

[209] For an argument that the SEC should make its climate-related disclosure mandates optional, *see* Scott Hirst, *Saving Climate Disclosure*, 28 STAN. J.L. BUS. & FIN. 91 (2023).

not a sufficient basis for SEC disclosure mandates. The disclosures that SEC mandates would standardize, and whose credibility they would enhance, must be of the sort that the SEC has the authority to compel. The foregoing analysis suggests that *if* financially motivated diversified investors were to support portfolio-focused disclosure regulation, the goal would *not* be to provide index fund managers with the information they need to craft more prescriptive portfolio-focused stewardship interventions in the future. In other words, they would not consider the information, to use the materiality test set forth in *TSC Industries, Inc. v. Northway Inc.*, "important in deciding how to vote."[210] Rather, the goal of the disclosure regulation would be to prod *other* market actors or, alternatively, government actors (e.g., Congress or the EPA), to take steps that have the effect of forcing portfolio companies to internalize the costs their actions impose on other portfolio firms. Should the SEC view disclosure designed for this purpose as within its mandate? Should the courts condone such a view? While ultimately serving the interests of diversified investors, such disclosures would be directly aimed at *different* audiences, including non-financially motivated investors and various non-investor groups like consumers, labor unions, regulators and legislators. This represents a significant departure from the traditional use of SEC disclosure mandates to assist investors in making investment and voting decisions.[211] Accepting it could lead to a broad expansion of the scope of the agency's authority.

Finally, this Article's analysis helps to contextualize calls for index funds to adopt pass-through voting regimes. Many recent proposals recommend that index funds' beneficial

[210] TSC Indus. v. Northway, 426 U.S. 438, 440 (1976).

[211] *Cf.* Kahan & Rock, *supra* note 3, at 122 (stating that the SEC's mandate "does not include supplying product information to consumer [sic] or work-related information to employees"). As noted in the introduction, if the disclosures were aimed at influencing the behavior of *financially motivated* non-index investors, portfolio primacy theory would add nothing to the other two financial arguments that have been advanced in favor of SEC-mandated ESG disclosure—namely, that mandated ESG disclosure may be warranted to the extent that it helps investors better estimate firms' future expected cash flows or their systematic risk exposure.

owners, rather than their fund managers, be given the right to vote fund shares in proportion to their beneficial ownership; legislation has been proposed that would require this[212]; and the Big Three have begun some experimentation with the idea.[213] The clout of the Big Three—their ability to impose policies that could potentially have portfolio-wide effects—stems from their ability to collectively direct the votes of the shares owned by the index funds they manage. If voting rights instead passed through to the funds' beneficial owners, it could eliminate the potential for portfolio-focused stewardship. The analysis herein suggests that hamstringing portfolio-focused stewardship would likely be perceived by financially motivated diversified investors as a benefit, rather than a cost, of pass-through voting. But, depending on how it is designed, pass-through voting could also diminish the ability of index fund managers to police portfolio firms for managerial agency costs. Whether, or under what circumstances, financially motivated diversified investors would support pass-through voting given this tradeoff is an important topic for future research.

[212] *See supra* notes 107 & 160; *see also* Investor Democracy Act, S.4241, 117th Cong. 2d Sess. (2022).

[213] *See, e.g.*, Larry Fink, *Letter to Blackrock Clients and Corporate CEOs: The Transformative Power of Choice in Proxy Voting*, BLACKROCK (Nov. 3, 2022), https://www.blackrock.com/corporate/about-us/investment-stewardship/blackrock-voting-choice/proxy-voting-power-of-choice [https://perma.cc/99HR-HLLL]; Ross Kerber, *State Street to Offer Proxy Voting Choices to Retail Investors*, REUTERS (May 22, 2023), https://www.reuters.com/business/finance/state-street-offer-proxy-voting-choices-retail-investors-2023-05-22/ [on file with the Columbia Business Law Review]; *Empowering Everyday Investors Through Proxy Voting Choice*, VANGUARD (Feb. 1, 2023), https://investor.vanguard.com/investor-resources-education/article/empowering-everyday-investors-through-proxy-voting-choice [https://perma.cc/PT88-R48Y].