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ARTICLE

ASSET MANAGERS AS REGULATORS

DOROTHY S. LUND†

The conventional view of regulation is that it exists to constrain corporate activity that harms the public. But amid perceptions of government failure, many now call on corporations to tackle social problems themselves. And in this moment of dissatisfaction with government, powerful asset managers have stepped in to serve as regulators of last resort, adopting rules that bind corporate America on issues of great social importance, including climate change and workplace diversity. This Article describes this dynamic—where shareholders have become regulators—which has been made possible by the rise of institutional shareholding (and index investing in particular) and the contemporaneous growth of shareholder power. As a result, the large diversified asset managers that specialize in index funds (the so-called "Big Three"—Vanguard, State Street, and BlackRock) collectively hold nearly controlling stakes across the public equity market. In addition to intervening in traditional areas of corporate governance, they have adopted sweeping board diversity mandates as well as "ESG" disclosure and carbon emission reduction requirements, and enforced them through their proxy voting policies. And the early consensus is that asset

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managers have been influential in these areas, driving change where other private (and public) efforts failed.

This Article describes these regulatory interventions in detail and concludes that we are witnessing a novel privatization dynamic. It also offers a theory about the incentives that shape it. Asset managers will only supply regulation if it has a positive impact on their profits; therefore, demand from clients—which include not just individuals, but also institutions—will govern the choice of policies and the substance of their rules. And given the breadth of the Big Three's clientele and their interest in avoiding government backlash, their policies are likely to take many interests into account. Nonetheless, serious concerns loom large, including the fact that for-profit asset managers lack democratic accountability and government oversight for their policymaking, with no guarantee that it will further the public interest. To the extent that their policies are shaped by the corporate clients that provide much of the assets they manage, they are unlikely to be as impactful as many perceive. The provision of regulation by asset managers may also take pressure off the government to respond to these issues with policies better calibrated toward advancing social welfare. At bottom, understanding the forces that shape (and potential problems that accompany) this privatization dynamic is of critical importance not just for investors and corporations, but also for the public.

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"We [] see many governments failing to prepare for the future . . . . As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater." — Larry Fink, 2018 BlackRock CEO Letter[1]

"It seems only a matter of time until index mutual funds cross the 50% mark. If that were to happen, the 'Big Three' might own 30% or more of the U.S. stock market—effective control. I do not believe that such concentration would serve the national interest." — Jack Bogle, founder of the Vanguard Group and the creator of the index fund[2]

INTRODUCTION

Our understanding of the corporation's role in society is in flux. Previous generations viewed corporate power with skepticism and saw government as an important bulwark against corporate harm.[3] There has been a shift, however, toward viewing corporations in a more positive light; indeed, corporate America is now thought to be a solution to government dysfunction around issues like inequality and the environment.[4] In addition, the "Big Three" asset manager giants that specialize in index funds[5]—Vanguard, State

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1 Larry Fink, *A Sense of Purpose*, HARV. L. SCH. F. ON CORP. GOV. (Jan. 17, 2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/2BXX-8EG9].

2 John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018, 10:15 AM), https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551 [https://perma.cc/G5BU-RU6M].

3 *See, e.g.*, Waheed Hussain & Jeffrey Moriarty, *Corporations, the Democratic Deficit, and Voting*, 12 GEO. J.L. & PUB. POL'Y 429, 430 (2014) (describing the standard model of institutional responsibilities in a democratic society, in which the state looks out for social welfare and where business corporations have a "subordinate role to play in social life").

4 *See infra* Part II.

5 The Big Three represent three of the five largest asset managers in the world and three of the four largest in the United States. *America's Top 50 Asset Managers by AUM*, ADV RATINGS, https://www.advratings.com/top-us-asset-managers [https://perma.cc/CK4M-UR38]; *World's Top Asset Management Firms*, ADV RATINGS, https://www.advratings.com/top-asset-management-firms [https://perma.cc/523P-CPE6]. Fidelity Investments comes out ahead of State Street on both rankings, and for this reason, some argue that the term should be the "Big Four." *See* Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007, 1008 (2020) (referring to the "Big Four"). Nonetheless, I exclude Fidelity because unlike the others, it specializes in active management, rather than passive management, and thus, is shaped by different incentives. *See* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, & New Financial Risk*, 19 BUS. & POL. 298, 304 (2017) (showing that only 16.9% of Fidelity's assets under management (AUM) is invested in passive funds); Lucian Bebchuk & Scott Hirst, *Specter of the Giant Three*, 99 B.U. L. REV. 721, 729-32 (2019) (describing the concentration of the market for index funds and the dominance of the Big Three).

Street, and BlackRock—have voiced concern over many of these same issues and promised that they will push companies to address them.[6]

This Article provides a lens to evaluate this dramatic shift in the corporate political environment. It theorizes that demand for regulation has outstripped supply, and that asset managers have stepped in to address the shortfall. More specifically, it reveals that the Big Three[7] 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.[8]

This dynamic—where shareholders have become regulators—is a modern one, made possible by the rise of institutional investing, the recent popularity in index funds, and the growth of shareholder power.[9] As a result of the convergence of these forces, the Big Three now hold large[10] (and in the not-

6 *See* Michal Barzuza, Quinn Curtis & David Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1248 (2020) (describing the Big Three's ESG activism).

7 I use the term "the Big Three" to describe three separate asset managers with important differences, including their investors, managers, clients, and stewardship policies. Nonetheless, this Article generally uses this term to refer to them in aggregate because of the way in which they have operated in tandem in regulating portfolio companies. *See infra* Section II.C.

8 Scholars use the term "regulation" to refer to interventions in the private domain that are implemented in the form of rules that are intended to shape the conduct of individuals and firms. *See, e.g.*, Barak Orbach, *What Is Regulation?*, 30 YALE J. REGUL. ONLINE 1, 3, 6 (2012) (discussing the divergent uses of the term regulation and encouraging an expansive definition). Although regulations can vary greatly in their form of mandate and their consequences for noncompliance, they have a common set of attributes: "[a]ll regulatory instruments consist of some rule or rule-like statement having normative force and backed up with some type of consequences." Cary Coglianese, *Regulation's Four Core Components*, REGUL. REV. (Sept. 17, 2012), https://www.theregreview.org/2012/09/17/regulations-four-core-components [https://perma.cc/BA8J-ZUD2]. Although the "regulator" is generally a public entity or government, it need not be. *Id.*; *see also* Julia Black, *Decentring Regulation: Understanding the Role of Regulation & Self-Regulation in a 'Post-Regulatory' World*, 54 CURRENT LEGAL PROBS. 103, 108 (2001) ("[G]overnment does not have a monopoly on the exercise of power and control, rather [it] is fragmented between social actors and between actors and the state.").

9 It is not, however, the first time that shareholders have exerted power and control over corporations, and in so doing, stepped into the shoes of regulators. In particular, in the early 1900s, powerful banks (such as JP Morgan) exerted ample influence over corporate America during a time of little corporate regulation, by, for example, securing seats on corporate boards and influencing the selection of managers. Indeed, during that time period, the Morgan Bank, as it was then known, "had become the nation's de facto central bank." MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 40 (1994). This early example of shareholder control over corporate affairs reveals that this dynamic is politically fragile: in response to public outcry, Congress and the SEC acted to clamp down on these large and powerful institutional shareholders on the grounds that the "terrific concentration of power in [bankers'] hands . . . [was] threatening" and that the bankers represented "a national danger." *Id.* at 33 (alterations in original) (quoting *Stock Exchange Practices: Hearings Before the Senate Comm. on Banking & Currency*, 73d Cong. 6 (1st Sess. 1934) (statement of Ferdinand Pecora, Counsel to S. Comm. on Banking & Currency).

10 *See infra* Section I.B.

so-distant future, controlling[11]) stakes across the public market,[12] which gives them ample influence over companies and their management. Although they have historically taken a passive approach to governance, since 2017, the Big Three have launched policymaking initiatives in two areas of great social importance: improving board gender diversity and reducing climate risk.[13] As for the first, the Big Three mandated that companies improve the diversity of their boards, and some even specified a quota. The asset managers then enforced these mandates by voting against directors at noncompliant companies—a powerful motivator.[14] As a result, their policies led companies to take action where other measures had fallen short: empirical research suggests that the Big Three's mandates caused companies to add 2.5 times as many women directors in 2019, as compared to 2016.[15]

The Big Three have likewise urged companies to reduce carbon emissions and improve their disclosure of environmental, social, and governance (ESG) information.[16] By 2020, soft encouragement in the form of "engagement" evolved into an aggressive voting policy when BlackRock announced it would require companies to disclose ESG information and operational plans in compliance with the Paris Agreement and committed to voting against directors that failed to make sufficient progress in doing so.[17] Vanguard and State Street quickly followed suit.[18] As with board gender diversity, these climate policies appear to have influenced corporate conduct. One empirical study determined that there is a strong negative association between Big Three ownership and subsequent carbon omissions.[19] Companies have also increased climate disclosures since the Big Three began to focus on it, and many credit the Big Three's mandates as being a substantial motivator.[20]

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11 Bebchuk & Hirst, *supra* note 5, at 724; Bogle, *supra* note 2.

12 Private companies and some smaller public companies are less likely to count the Big Three as major shareholders. *See* Dorothy S. Lund, *In Search of Good Corporate Governance*, 131 YALE L.J.F. 854, 861 (2022) [hereinafter Lund, *In Search of Good Governance*] (discussing the gap between big and small public companies with respect to Big Three ownership).

13 *See infra* Section II.B.

14 *See infra* Section II.B (describing board diversity quotas imposed by some of the Big Three).

15 Todd A. Gormley, Vishal K. Gupta, David A. Matsa, Sandra C. Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* 3 (Eur. Corp. Governance Inst., Finance Working Paper No. 714/2020, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3724653 [https://perma.cc/K3C5-8QKK].

16 Barzuza et al., *supra* note 6, at 1272-75 (discussing the Big Three's climate change advocacy).

17 Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, BLACKROCK (2020), https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter [https://perma.cc/C8HA-LJJK].

18 *See infra* subsection II.B.2 (detailing the Big Three's positions on climate change-related corporate governance policies).

19 José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 142 J. FIN. ECON. 674, 675 (2021).

20 *See infra* note 196 and accompanying text.

Therefore, in light of their size and "universal ownership"—the fact that they hold stakes in nearly every company in the public market[21]—the Big Three have been able to assume regulatory functions that typically reside in the hands of large government agencies like the Environmental Protection Agency or Securities & Exchange Commission (SEC).[22] Like those public bodies, the Big Three adopt marketwide standards governing firm conduct, assess compliance with those standards, and then penalize violations with their voting power.[23] Although their enforcement relies on different tools—not the power to tax or fine, but instead, to subject management to possible job loss or reputational penalties—it is no less coercive.[24] In this way, the Big Three have supplied rules where public bodies have failed to move quickly (or at all).

And as this discussion reveals, there is much that is puzzling about this dynamic. From starting principles, the concentration of power in the hands of three private for-profit companies that lack democratic legitimacy and electoral accountability is seriously concerning.[25] And yet, their chosen rules seem relatively benign, and indeed, offer benefits. For these reasons, commentators are divided on whether the rise of asset manager regulation is a benefit or curse.[26]

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21 *See* Jan Fichtner & Eelke M. Heemskerk, *The New Permanent Universal Owners*, 49 ECON. & SOC'Y 493, 502 (2020) ("By early 2019, BlackRock held ownership in well over 10,000 listed corporations around the world. Vanguard even held positions in over 10,500 companies. State Street is smaller and held ownership in approximately 6,000 firms.").

22 For a discussion of how institutional investors act as a constraint on management misbehavior, and as such, operate as a substitute for investor protection law, see Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings*, 13 J. LEGAL ANALYSIS 672, 673 (2021).

23 *See* Section II.B.

24 Indeed, unlike most government penalties, universal shareholder penalties target top management and subject them to potential job loss, which is a powerful deterrent. *See infra* notes 252–255 (discussing the efficacy of no-votes against corporate directors as an enforcement mechanism).

25 *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harv. Pub. L. Working Paper No. 19-07, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 [https://perma.cc/9SH6-52SC] (noting that the rise of index investing raises legitimacy and accountability issues and poses a "political challenge to corporate law").

26 *Compare id.* (raising concerns about the rise of indexing and democratic legitimacy), *with* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1410 (2020) (describing how the Big Three's ESG activism reduces social risk), Barzuza et al., *supra* note 6, at 1260-61 (describing the benefits of Big Three stewardship), *and* Jeffrey N. Gordon, *Systematic Stewardship* 36 (Eur. Corp. Governance Inst., Colum. L. & Econ. Working Paper No. 640, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814 [https://perma.cc/3VZP-CTS5] (providing a roadmap for universal owner stewardship that would reduce systematic risk created by climate change).

This Article provides a framework to evaluate this regulatory dynamic and these outcomes. Specifically, I theorize that market mechanisms constrain the exercise of power by the Big Three: because they are profit-maximizing asset managers, they must secure broad consensus from their clients when adopting rules.[27] Indeed, Section III posits that in the areas that they have been the most proactive, the Big Three are responding to a demand for rules from these clients—and their institutional clients in particular.

More broadly, this framework suggests that the issue of whether and how asset manager agency costs undermine the interests of beneficial owners is more complex than many recognize. The literature has generally assumed that there is only a single intermediary standing between beneficial owners and portfolio companies, as occurs when an individual chooses to invest in an index fund managed by BlackRock.[28] But instead, as my analysis reveals, intermediation is often more complex. Indeed, many beneficial owners have two layers of intermediaries exercising influence over their investments and the use of their governance rights (I call this "double intermediation"). Consider, for example, a state employee who makes monetary contributions into a public pension fund during their career. That public pension fund is fiduciary-bound to manage the employee's investment prudently, and as such, may choose to invest in an index fund managed by State Street, in exchange for a fee. Consider, too, a corporate employee whose employer selects a menu of funds offered by State Street for that employee's 401(k) contributions. In these examples, the employee's governance rights would be exercised by State Street,[29] but that fact obscures the reality that the beneficial owner employee is subject to two layers of intermediation (and accompanying agency cost issues), rather than one.

It is likely, therefore, that double intermediation will affect the Big Three's policy initiatives. In particular, the Big Three's interventions will be shaped by their desire to satisfy their institutional clients—the corporations and public pensions in the above examples—as well as those individuals that invest in their funds directly. In addition to ensuring support from these

27 When conducting research for this Article during the fall of 2021, I interviewed several high-level stewardship officials from the Big Three to better understand their stewardship policies, practices, and goals. In one of those confidential interviews, a stewardship official emphasized that managing relationships with clients was an important consideration when developing ESG policies.

28 *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013) (describing agency costs created by an ownership structure consisting of three parties: portfolio companies, fund managers, and beneficial owners); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 100 (2017) (describing conflicts between fund managers and beneficial owners).

29 In some cases, large pension fund clients contract for the right to exercise the votes according to their own policies. *See infra* note 169.

clients (or at least, avoiding client alienation), the Big Three's interventions will be calculated to maximize support from the government,[30] which is an institutional client as well as a regulator of the Big Three's activities.[31] This separate limit suggests that the Big Three's regulatory interventions will take the public interest into account to some degree: if they were to veer too far afield, they would likely face public and regulatory backlash.[32] But my theory also suggests an important limitation. In particular, the Big Three will never adopt socially beneficial policies that lack broad support from their clients, and particularly the corporate clients that supply a large percentage of their assets under management (AUM). Relatedly, the need to ensure client approval indicates that the Big Three are likely to mandate only tepid changes in corporate behavior, and that their rules will not bring about the sweeping changes that may be necessary to address pressing social problems.

My theory is therefore distinct from others that attempt to explain the Big Three's puzzling interventions in environmental and social areas, and an analysis of their policies suggests it is a better fit. In particular, scholars have argued that the Big Three's activism is motivated by a desire to market the asset managers' funds to millennial investors, who will become important sources of wealth in the coming years.[33] Although this explanation is partially correct, it is incomplete. The majority of the Big Three's revenue comes from institutions—and corporate and public pension plans in particular—rather

30 Note that the government includes not just the federal government, but also individual state governments, which have increasingly used their influence as clients to advance their political interests. *See, e.g.*, Andrew Freedman, *BlackRock, UBS and 348 ESG Funds "Banned" in Texas*, AXIOS (Aug. 25, 2022), https://www.axios.com/2022/08/25/texas-bans-blackrock-ubs-esg-backlash [https://perma.cc/4LKZ-9PVZ].

31 Each of the Big Three are subject to extensive regulation of their investment activities by the SEC, the DOL, the Board of Governors of the Federal Reserve Bank, FINRA, the CFTC, and more. BlackRock, Inc., Annual Report (Form 10-K) (Feb. 28, 2007), https://www.sec.gov/Archives/edgar/data/1364742/000119312508041884/d10k.htm [https://perma.cc/T3AG-52BH].

32 *See* Jeff Schwartz, *'Public' Mutual Funds*, *in* THE CAMBRIDGE HANDBOOK OF INVESTOR PROTECTION (Arthur Laby ed., forthcoming 2022) (manuscript at 4) (on file with Univ. of Utah College of Law) [hereinafter, Schwartz, *'Public' Mutual Funds*] ("[M]utual funds, . . . are keenly aware that the public is watching them. This drives them to participate in corporate governance just enough to ward off public opprobrium and potential regulation."). Of course, political pressure will not necessarily result in outcomes that further the public interest. For a recent example, see *infra* note 115. *See* Jeff Schwartz, *Stewardship Theater*, 100 WASH. U. L. REV. (forthcoming 2022) (manuscript at 4) [hereinafter Schwartz, *Stewardship Theater*] (describing the problems associated with politically motivated asset manager stewardship). My point is only that the Big Three are necessarily attuned to their public image due to the risk of regulatory backlash, which operates as a further constraint on their policies.

33 *See* Barzuza et al., *supra* note 6, at 1250 (arguing that ESG activism by the Big Three is motivated by demand from millennial investors).

than individuals.[34] Therefore, the Big Three's interventions must be calibrated to generate support from those clients, too. Again, this insight helps us evaluate and even predict the substance of the Big Three's regulatory policies, and in particular, suggests that they are unlikely to go as far as millennial investors would like. For example, although millennials welcome board diversity, they would likely prefer more sweeping rules than the limited requirements (one or two women directors, rather than parity) adopted by the Big Three. In addition, other workplace issues—including preventing sexual harassment and reforming healthcare—continually rank higher in surveys of millennial priorities, and yet, the Big Three have not used their heft to address these issues.[35]

My theory also differs from those advanced by Madison Condon and Jeffrey Gordon, who argue that the Big Three address climate change and social risk in order to increase the value of their funds' portfolios. In brief, Condon suggests that diversified investor activism on climate change is motivated by a desire to induce firms to internalize intra-portfolio externalities that harm the market and thus, the diversified investor's portfolio.[36] Relatedly, Gordon theorizes that highly diversified asset managers should take steps to reduce portfolio-wide systematic risk that would reduce risk-adjusted returns, such as by tackling climate change and improving social stability.[37] The normative thrust of these theories is that interventions by the Big Three are desirable and should even be encouraged.[38] Nonetheless, I am skeptical that reducing portfolio-wide risk is the primary

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[34] *See, e.g.*, BlackRock, Inc., Annual Report (Form 10-K), at 3-6 (Feb. 28, 2020), *reprinted in* BLACKROCK, INC., 2020 ANNUAL REPORT [hereinafter BlackRock, 2020 Annual Report], https://www.blackrock.com/corporate/literature/annual-report/blackrock-2020-annual-report.pdf [https://perma.cc/LT9K-7AZU] (explaining that most of BlackRock's revenue comes from management fees (as a percentage of AUM), and that the majority of AUM are held by institutions, not individual clients). Interestingly, the asset manager that has devoted the greatest amount of effort to targeting individual investors is Vanguard, which, as Section III reveals, has been the least proactive of the Big Three in adopting and enforcing ESG policies. This fact suggests that individual investor rational apathy may overwhelm millennial preferences, and that a stronger source of demand for ESG policies comes from pension fund and corporate clients.

[35] *See generally* THE MILLENNIAL IMPACT PROJECT, UNDERSTANDING HOW MILLENNIALS ENGAGE WITH CAUSES AND SOCIAL ISSUES (2019), http://www.themillennialimpact.com/sites/default/files/images/2018/MIR-10-Years-Looking-Back.pdf [https://perma.cc/YE8Q-R6KN] (surveying the importance of various social issues to millennials).

[36] *See generally* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020) (discussing how diversified investors should be rationally motivated to internalize intra-portfolio externalities).

[37] Gordon, *supra* note 26, at 3.

[38] *But see* John C. Coffee, *The Coming Shift in Shareholder Activism: From "Firm Specific" to "Systematic Risk" Proxy Campaigns (and How to Enable Them)*, 16 BROOK. J. CORP. FINANCE & COM. L. 45, 50 (2021) (discussing how undiversified investors may lose out under a portfolio primacy strategy).

driver of the Big Three's interventions. In particular, if internalizing externalities or reducing systematic risk was the goal, there are more direct ways of achieving it. For example, the Big Three could take a more aggressive stance toward disclosing and restricting corporate money in politics, which compromises regulatory efforts to regulate risk and externalities.[39] Instead, the Big Three generally vote against shareholder proposals aimed at limiting corporate influence in the political process.[40] Again, this is likely because investor activism on corporate political spending has not been broadly embraced by their clients (and corporate America in particular), in contrast to policies aiming to reduce carbon emissions and improve board diversity.[41]

Beyond the inconsistency between these theories and the Big Three's chosen policies, the fact remains that large diversified asset managers are not well equipped to push companies to internalize externalities or reduce systematic risk.[42] The Big Three are forced, due to their business models, to seek governance solutions that can be implemented at scale and enforced cheaply.[43] Reducing systematic risk caused by climate change, however, is a

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39 *See* Leo E. Strine, Jr., *Corporate Power Ratchet: The Courts' Role in Eroding 'We The People's' Ability to Constrain Our Corporate Creations*, 51 HARV. C.R.-C.L. L. REV. 423, 432 (2016) (describing how corporate political spending diminishes the ability of citizens to constrain harmful corporate activity and reduces the ability of Congress and executive agencies to implement social welfare regulation).

40 Strine, *supra* note 5, at 1019.

41 As another example, consider that the Big Three could have pushed companies to implement mandatory employee COVID-19 vaccination or mask mandates during the pandemic, which would have reduced market-wide risk. *See, e.g.*, Vanessa Rémy, Nathalie Largeron, Sibilia Quilici & Stuart Carroll, *The Economic Value of Vaccination: Why Prevention is Wealth*, 3 J. MKT. ACCESS & HEALTH POL'Y (Aug. 12, 2015), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4802701/pdf/JMAHP-3-29284.pdf [https://perma.cc/2GWG-8ZWS] (elaborating on the economic benefits of immunization). The fact that they have not suggests that the risk of client blowback is a more forceful driver of their behavior than principled risk reduction. For further discussion of the general public controversy surrounding Covid-19 vaccine mandates, see Alexandra Kelley, *Half of U.S. Employees Support Vaccine Mandates in These Industries: Poll*, THE HILL (Aug. 26, 2021), https://thehill.com/changing-america/well-being/prevention-cures/569627-half-of-us-employees-support-vaccine-mandates-in [https://perma.cc/ZVR8-WKDT], which found that "50[%] of surveyed adults reported feeling in favor of vaccination requirements and another 52[%] supported requiring employees working in public office spaces to wear face masks."

42 As BlackRock's former Chief Investment Officer (CIO) for Sustainable Investing put it, "[T]he investment process is a bizarre place to try to create social impact in the first place. Investment professionals are like competitive athletes: They're trained to chase yield and profits." 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/P3NF-36G5]; *see also infra* notes 234–236 and accompanying text (discussing the limits of the Big Three's stewardship activity).

43 *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 516-17 (2018) [hereinafter Lund, *The Case Against Passive Shareholder Voting*] (observing that the Big Three have adopted low cost and one-size-fits-all policies and procedures with regards to proxy voting to manage their fiduciary responsibilities); Gilson & Gordon, *supra* note 28, at 867 (observing that the

complicated and highly contested project, and one that is unlikely to lend itself to a low-cost approach.[44] A simpler explanation is that the Big Three believe that playing a regulatory role will satisfy existing and prospective clients, as well as the United States government. For this reason, the Big Three will be willing to intervene only in the face of strong client demand and market consensus supporting their policies. Although this distinction is subtle, it is important, as it suggests that client tastes will dictate policies, rather than the principled consideration of systematic risks or externalities. It further indicates that this regulatory dynamic offers fewer societal benefits than these alternative theories suggest.

In addition to elucidating the forces that shape the Big Three's policymaking, this Article's key observation—that this activity is a form of privatized regulation—leads to many important implications. It reveals that unlike simple marketing campaigns, these initiatives have broad ramifications not just for corporate America, but also for our system of democracy.[45] More specifically, the Big Three's entry into the market for regulation represents the expansion of privatization dynamics that have shaped policymaking and legal scholarship since the 1980s.[46] However, this is the first time that regulatory functions have been performed by mutual fund blockholders.[47]

Big Three's business model of serving as large intermediaries limits their ability to engage proactively in corporate governance).

44 In addition, because the Big Three are "exclusively exposed to 'producer welfare' . . . [and] significantly overexposed to richer economies[,]" they are likely to discount the global cost of climate change. Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. (forthcoming 2023) (manuscript at 43), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3912977 [https://perma.cc/4R8E-ZZG7].

45 *See* Coates, *supra* note 25, at 2 (describing the rise of index investing as posing a "legitimacy and accountability issue of the first order").

46 In particular, this Article is related to the "New Governance" paradigm in legal scholarship, which seeks to understand how power and responsibility are allocated among public and private regulators interacting in the real world. *See* Orly Lobel, *The Renew Deal: The Fall of Regulation & the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 344 (2004) ("Governance signifies the range of activities, functions, and exercise of control by both public and private actors in the promotion of social, political, and economic ends."); *see also* Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 L. & SOC'Y REV. 691, 726 (2003) (discussing the impact of private regulation on "intractable policy problems"); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 549 (2000) (proposing that our understanding of regulation should take into account the actions of both public and private actors).

47 Note that divestment campaigns could serve as another form of regulation by shareholders, with a different penalty: selling shares of a noncompliant company. Although divestment campaigns have been waged for years, historically they have not been influential because the targeted company is not affected unless a substantial number of shareholders exit. *See, e.g.*, Alex Gorman, *Exit vs. Voice: A Comparison of Divestment and Shareholder Engagement*, 72 N.Y.U. ANN. SURV. AM. L. 113, 131-32 (2017) (describing how divestment efforts have had little impact on corporate behavior). Nonetheless, there is some evidence that divestment campaigns are beginning to affect the oil and gas industry. *See, e.g.*, Rianna Gargiulo, *Letter: Divestment Campaigns Alter the Way Fossil Fuel Groups*

And given that these powerful asset managers are here to stay, the time is ripe to contemplate how this dynamic affects society.

On the one hand, there are reasons to embrace it. If government regulation caused companies to internalize harmful externalities, there would be no need for the Big Three to intervene; in the absence of such regulation, however, we might welcome intervention from private actors.[48] Not only that, shareholder regulation may be subject to fewer pathologies than regulation by public bodies, and it also bypasses international coordination issues (Section III.B discusses these benefits in greater detail).

On the other hand, the provision of regulation by a handful of for-profit asset managers, acting in response to demand from their clients, is concerning. The governance officials and executives at the Big Three who make the rules lack democratic accountability for their actions,[49] and there is little oversight or transparency surrounding their policies and how they are formulated, unlike other private regulators that impact the broader market.[50]

Moreover, there is no guarantee that asset manager regulation will further the public interest. Investors make up the wealthier half of America,[51] and corporations likely embrace rules regulating their conduct for strategic reasons; in particular, out of a desire to forestall or co-opt future government regulation.[52] For these reasons, the reforms wrought by asset managers are unlikely to lead to far-reaching changes in corporate behavior.

In addition, public pensions—another important source of demand for asset manager regulatory policies—are susceptible to political pressure, and therefore may use their influence over asset manager policies to achieve ends they could not achieve through normal political channels.[53] Consider as an example how state legislatures in Texas and Maine have used their influence

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Behave, FIN. TIMES (Mar. 19, 2021), https://www.ft.com/content/aae8b12f-6336-4f0a-a565-ea51edc36647 [https://perma.cc/VNU3-W5DH] (noting that divestment has negatively impacted the share prices of oil and gas companies).

48 *See infra* Section III.B.

49 *See* Coates, *supra* note 25, at 2 ("The prospect of twelve people even potentially controlling most of the economy poses a legitimacy and accountability issue of the first order . . . ."). Although I echo many of John Coates's concerns, my analysis suggests that market mechanisms will operate as an indirect constraint on the use of their power. *See infra* Section II.A.

50 *See infra* Section III.C.

51 *See* Lynn A. Stout & Sergio Gramitto, *Corporate Governance as Privately-Ordered Public Policy: A Proposal*, 41 SEATTLE U. L. REV. 551, 552-53 (2018) ("In particular, the economic benefits of equity ownership are highly concentrated today among older, whiter, and wealthier investors.").

52 *Id.*

53 *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) (describing how public pension funds are subject to political pressures).

over the state's pension investments to send messages about the propriety of investing in oil and gas companies.[54]

Perhaps most important, there is the risk that the provision of private regulation will take pressure off of the government to respond to these important issues. As BlackRock's former CIO for Sustainable Investing has commented, BlackRock's foray into sustainable investing represents a "deadly distraction" "that delayed overdue governmental reforms . . . ."[55]

As this discussion reveals, difficult normative questions loom on the horizon. Traditional economic concepts suggest that shareholder "owners" should have the ability to influence companies, including by pushing them to be operated consistent with their values.[56] Nonetheless, allowing three for-profit asset managers that lack electoral accountability to set regulatory policies for the United States economy is dangerous for our democracy. This Article begins the difficult task of weighing these normative tradeoffs, a task that will only become more important in the coming years as the Big Three continue to wield greater power.

In the meantime, that the observation that the Big Three are performing regulatory functions leads to tentative conclusions of relevance for policymakers, including that greater governmental oversight of the Big Three's regulatory interventions may be warranted. In particular, governmental oversight could help ensure that the public has information about how their regulatory policies are made and why, and in so doing, better reconcile the public interest and the interests of the Big Three's management and their clients.

This Article proceeds as follows: Part I describes several pathologies that shape the modern regulatory environment and charts the rise of the Big Three and shareholder power. Part II introduces my theory about the incentives that shape asset manager regulation and supports it with a detailed analysis of two areas in which the Big Three have played a regulatory role: improving board diversity and reducing climate risk. As additional support for my theory, I consider areas in which the Big Three have not been proactive. Part III considers the implications of my analysis by comparing this regulatory dynamic to other forms of privatized regulation. It concludes that the Big

[54] *See State Regulation of ESG Investment Decision-making by Public Retirement Plans: An Updated Survey*, ROPES & GRAY (Aug. 9, 2022), https://www.ropesgray.com/en/newsroom/alerts/2022/August/Navigating-State-Regulation-of-ESG-Investments-by-Investment-Managers [https://perma.cc/VMW9-RGKL] (examining the influence of state legislation in 2021, which "adopted contradictory ESG policies for state pension fund investments").

[55] Fancy, *supra* note 42.

[56] *See* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, J.L. FIN. & ACCT. 247, 270 (2017) ("[S]hareholder welfare and market value are not the same, and [] companies should maximize the former and not the latter.").

Three's regulatory activity represents something new, and then discusses both the advantages and reasons for concern.

I. BACKGROUND

This Part describes the modern regulatory environment and two of its primary pathologies: regulatory capture and ossification. It then describes the forces that have empowered asset managers to play a regulatory role.

A. *The Modern Public Regulatory Environment*

In a perfect world, government regulation would correct market failures and advance public welfare. However, the traditional levers of the regulatory state—formal and informal rulemaking, in addition to rule enforcement—have come under stress in modern times. Various pathologies have led to the reality that even laws with strong popular support fail to pass or get serious consideration.[57] Regulatory capture and ossification, as well as pushes for deregulation, have weakened the regulatory infrastructure in the United States. This is not to say that the regulatory state is dead, only that it is, in the words of Michael Livermore, "awfully stagnant."[58]

Much has been written about these pathologies, so I only briefly describe two of them: regulatory capture and ossification. Regulatory capture occurs when a regulated industry influences the regulator so that they serve the industry's interests, rather than the interests of the public.[59] The basic problem is that regulators are humans capable of being influenced, but not every group has an equal opportunity to influence them.[60] In particular, well-

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57 *See* Tim Wu, *The Oppression of the Supermajority*, N.Y. TIMES (Mar. 5, 2019), https://www.nytimes.com/2019/03/05/opinion/oppression-majority.html [https://perma.cc/X9N7-EM64] ("The defining political fact of our time is not polarization. It's the inability of even large bipartisan majorities to get what they want . . . .").

58 *See* Michael A. Livermore, *Reviving Environmental Protection: Preference-Directed Regulation and Regulatory Ossification*, 25 VA. ENV'T L.J. 311, 313 (2007) ("The major environmental statutes were passed three decades ago. The role of OSHA in regulating the American workplace is slowly dissolving. The rulemaking process drags on in endless litigation and political fighting. Even regulatory reform measures have stalled.").

59 *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3 (1971) (discussing how industries seek to obtain regulation for their benefit); *see also* Pamela J. Clouser McCann, Douglas M. Spencer & Abby K. Wood, *Measuring State Capture*, 2021 WIS. L. REV. 1141, 1145 (2021) (describing a related theory of "state capture," which is when an industry directs the policies of government actors in a way that benefits the industry and not the public).

60 LUIGI ZINGALES, PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT 126 (Daniel Carpenter & David A. Moss eds., Cambridge Univ. Press 2014).

funded and organized groups (generally referred to as "interest groups"[61]) have a better shot at "capturing" officials and bending them to their interests.[62] Although the extent of industry capture varies by agency and by industry, empirical evidence generally supports the view that industry groups are able to influence regulation in their favor.[63]

Second, legislative and regulatory ossification can compromise government lawmaking.[64] As a result of procedural hurdles, it can take government bodies years to promulgate regulations, even those with substantial public welfare benefits.[65] Even after rules are promulgated, they are often challenged and given a "hard look" by courts that may lead to invalidation.[66] By contrast, a deregulatory agenda can be implemented rather quickly. To take a recent example, in 2017, former President Trump directed agencies to remove two regulations for every one regulation issued, which led to a "sharp reduction in the issuance of new regulations, as well as [the] . . . removal of some existing regulations."[67]

These are not the only symptoms of dysfunction in the modern regulatory environment; for example, administrative agencies sometimes fail to implement rules when directed to do so, and Congress often lacks the tools or will to push agencies to act.[68] But capture and ossification are important reasons why the regulatory state has failed to supply regulation that has garnered substantial popular support, and why many have begun to look to

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61 Maria Rosa Borges, *Regulation and Regulatory Capture*, WORLD ACAD. OF ARTS. & SCI. 1, 6-7 (2017), https://www.worldacademy.org/files/colloquium_2017/papers/Regulation_regulatory_capture_M.Borges.pdf [https://perma.cc/3WE3-5N5J].

62 *Id.* at 6 (citing MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION; PUBLIC GOODS AND THE THEORY OF GROUPS (Harv. Univ. Press, 1965)).

63 *See infra* note 127 (discussing empirical support for the regulatory capture model). Although capture is generally thought to be a legislative pathology, administrative agencies can also be subject to "information capture." *See* Wendy E. Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L.J. 1321, 1325 (2010) ("In the regulatory context, information capture refers to the excessive use of information and related information costs as a means of gaining control over regulatory decisionmaking in informal rulemakings.").

64 Not everyone views ossification as a pathology, however. *See, e.g.*, Aaron L. Nielson, *Optimal Ossification*, 86 GEO. WASH. L. REV. 1209, 1211 (2018) ("[D]elay . . . sometimes has proregulatory benefits.").

65 Sidney A. Shapiro & Richard W. Murphy, *Arbitrariness Review Made Reasonable: Structural and Conceptual Reform of the "Hard Look"*, 92 NOTRE DAME L. REV. 331, 333 (2016); *see also* Nielson, *supra* note 64, at 1214-15 (describing how the rulemaking process has become ossified).

66 Nielson, *supra* note 64, at 1216-17.

67 Susan Dudley, *A Brief History of Regulation and Deregulation*, REGUL. REV. (Mar. 11, 2019), https://www.theregreview.org/2019/03/11/dudley-brief-history-regulation-deregulation [https://perma.cc/RTQ3-SNJL]; Jonathan S. Masur & Eric A. Posner, *Chevronizing Around Cost Benefit Analysis*, 70 DUKE L.J. 1109, 1110 (2021) ("The Trump administration launched the most significant effort to deregulate the economy since the Reagan administration.").

68 Hannah J. Wiseman, *Delegation and Dysfunction*, 35 YALE J. ON REGUL. 233, 237 (2018).

the private sector for solutions.[69] In particular, asset managers have become a frequent target for regulatory solutions because of their growing power and ability to influence companies,[70] which the next Section discusses in detail.

B. *The Growth of the Big Three and Shareholder Power*

As the public regulatory infrastructure has become stagnant, shareholders have witnessed an expansion of their rights and powers. In particular, over the past few decades, stock exchanges, proxy advisors, investor advocacy groups, and even stock indices have put pressure on companies to increase shareholder rights, such as by unifying boards, implementing proxy access, and moving to majority voting for director elections, to name a few examples.[71]

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69 Cassie Phillips, Jonathan Gilligan, Stephen Harper, Jackie Roberts & Michael P. Vandenbergh, Dialogue, *Beyond Politics: The Private Governance Response to Climate Change*, 48 ENV'T L. REP. NEWS & ANALYSIS 11049, 11052 (2018). Private governance can address a multitude of issues. *See, e.g.*, Agni Kalfagianni, *Addressing the Global Sustainability Challenge: The Potential and Pitfalls of Private Governance from the Perspective of Human Capabilities*, 122 J. BUS. ETHICS 307, 307 (2014) ("[Private governance] address[es] profound global environmental and socio-economic (i.e., sustainability) challenges ranging from forest deforestation, fisheries depletion, climate change, to labor and human rights concerns."); *see also* Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 133 (2013) ("These new private environmental governance activities play the standard-setting, implementation, monitoring, enforcement, and adjudication roles traditionally played by public regulatory regimes.").

70 *See, e.g.*, Mark Lebovitch & Jacob Spaid, *In Corporations We Trust: Ongoing Deregulation and Government Protections*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 6, 2019), https://corpgov.law.harvard.edu/2019/02/06/in-corporations-we-trust-ongoing-deregulation-and-government-protections [https://perma.cc/PP4V-ZAG7] (commenting that when faced with a presidential administration committed to deregulation, institutional investors are "the last line of defense"); Leo E. Strine, Jr., *The Role of Institutional Investor Regulation in Restoring a Fair, Sustainable Economy*, THE COLUM. BLUE SKY BLOG (Oct. 27, 2020), https://clsbluesky.law.columbia.edu/2020/10/27/the-central-role-of-institutional-investor-regulation-in-restoring-a-fair-and-sustainable-american-economy [https://perma.cc/C5YJ-UYPR] (calling on institutional investors to tackle environmental issues and promote the fair treatment of workers); *see also* Leo E. Strine, Jr., Toward Fair and Sustainable Capitalism 1, 15 (Aug. 13, 2020) (working paper), https://rooseveltinstitute.org/wp-content/uploads/2020/08/RI_TowardFairandSustainableCapitalism_WorkingPaper_202008.pdf [https://perma.cc/LSN2-SKSG] (arguing that institutional investor fiduciary duties include the consideration of their beneficiaries' interests and objectives).

71 *See* Kobi Kastiel & Yaron Nili, *The Corporate Governance Gap*, 131 YALE L.J. 782, 794 (2022) ("Regulators, investors, proxy advisors, and stock exchanges have all developed a growing interest in both observing and actively shaping corporate governance. As a result, over the last two decades, shareholders have obtained increasing power and influence over their companies' affairs . . . ."); Dorothy Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2569-77 (2022) (discussing the rise in shareholder rights and powers).

The growth of institutional investors—a group that includes public pension funds, mutual funds, and hedge funds[72]—in the United States is an important contributory factor in this evolution. As of 2017, institutional investors held 65% of U.S. equities (up from 6.1% in 1950),[73] and 80% of the equity of S&P 500 companies.[74] This astronomical growth has several causes: the regulation of retirement savings,[75] special tax treatment for mutual funds,[76] and of particular relevance to this Article, the development (and eventual investor embrace) of new financial products, including index funds.[77]

Index funds are a type of mutual fund that seek to track the performance of a market index as closely as possible,[78] offering investors the opportunity to secure broad diversification and low fees.[79] (By contrast, actively managed mutual funds or "active funds" seek to outperform their baseline index.)[80] Vanguard launched the first index fund in 1974, but these funds did not become popular until the early 2000s.[81] In the last decade, index funds have exploded. For example, index funds make up more than 34% of the assets invested in mutual funds, up from only 4% in 1995.[82] This growth has benefitted three asset managers in particular—the so-called Big Three mutual fund complexes, which specialize in passive management and collectively comprise 81% of the index fund market.[83] Between 2009 to 2018, 82% of asset inflows to active and passive mutual funds alike went to the Big Three.[84] As a result, the Big Three have garnered massive stakes across the public market. By 2017, the Big Three collectively managed approximately 20.5% of equity

72 Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW & GOVERNANCE 363, 365 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2015).

73 Bebchuk & Hirst, *supra* note 5, at 725-26.

74 *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017, 1:00 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/R38E-F4FC].

75 Gilson & Gordon, *supra* note 28, at 878-82.

76 Coates, *supra* note 25, at 8 n.17.

77 *Id.* at 9-10.

78 Adriana Z. Robertson, The (Mis)Uses of the S&P 500, at 4 (Dec. 5, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205235 [https://perma.cc/E5TZ-X7HV].

79 *Index Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-4 [https://perma.cc/JU4C-JVCS].

80 *Cf.* Adriana Z. Robertson, *Passive in Name Only*, 36 YALE J. ON REGUL. 795, 802 (2019) ("[T]he fund manager [of an actively managed fund] is empowered to buy or sell assets at any time based on an overall investment strategy . . . .").

81 Coates, *supra* note 25, at 10-11; Lund, *In Search of Good Governance*, *supra* note 12, at 860.

82 Bebchuk & Hirst, *supra* note 5, at 727.

83 *See id.* at 732 (discussing the concentration of the index fund industry); Bogle, *supra* note 2.

84 Bebchuk & Hirst, *supra* note 5, at 732-33.

in the S&P 500[85] and 16.5% of the Russell 3000 index.[86] Not only that, BlackRock and Vanguard together held 5% positions in nearly every S&P 500 company, and in more than two-thirds of Russell 3000 companies.[87] For this reason, they have been dubbed universal owners—or shareholders "invested indefinitely in thousands of firms."[88] And scholars predict that this growth will continue, giving the Big Three controlling (or nearly controlling) stakes across the public market in the not-so-distant future.[89]

In sum, within a decade, the Big Three have become the most important shareholders in the marketplace. And their heft translates to substantial governance power. For example, one study reveals that the Big Three together have the power to cast a majority vote on 49.1% of environmental proposals at Fortune 250 companies (Vanguard and BlackRock alone have sufficient voting control to determine majority support for 35% of such proposals).[90] For governance proposals, the extent of their influence is even greater.[91]

And yet, the issue of *how* the Big Three exercise their governance power has been subject to heated debate. Some commentators (myself included) suggest that the Big Three lack incentives to adequately monitor and engage with portfolio companies.[92] Because their indexing strategy entails broad diversification, each of the Big Three holds positions in thousands of companies, with hundreds of thousands of voting obligations each year.[93] To

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85 *Id.* at 733.

86 *Id.* at 735.

87 *Id.*

88 *See* Fichtner & Heemskerk, *supra* note 21, at 495.

89 Bebchuk & Hirst, *supra* note 5, at 741.

90 Caleb N. Griffin, *Margins: Estimating the Influence of The Big Three on Shareholder Proposals*, 73 SMU L. REV. 409, 423 (2020). This is because many shareholders do not exercise their votes.

91 *See id.* at 438 (finding that the Big Three have sufficient voting control for majority support on almost 60% of governance proposals).

92 Lund, *The Case Against Passive Shareholder Voting*, *supra* note 43, at 495-96; Bebchuk & Hirst, *supra* note 5, at 741. *But see* 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, 31-32, 71 (2019) (calling recent criticism of passive investors and their incentives "incomplete" and "deficient"); Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1776 (2020) ("[C]riticisms [of index funds] rest on a flawed understanding of the current corporate governance landscape and of the nature of institutional investing.").

93 *See* Fichtner & Heemskerk, *supra* note 21, at 502 ("By early 2019, BlackRock held ownership in well over 10,000 listed corporations around the world. Vanguard even held positions in over 10,500 companies. State Street is smaller and held ownership in approximately 6,000 firms."); VANGUARD, INVESTMENT STEWARDSHIP 2020 ANNUAL REPORT 44 (2020), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2020_investment_stewardship_annual_report.pdf [https://perma.cc/KU78-D9PR] ("Vanguard funds cast over 168,000 individual votes in 2020."); BlackRock, 2020 Annual Report, *supra* note 34, at 4 (touting that Blackrock voted 160,769 proposals in 2020); Press Release, State St. Glob. Advisors, State Street Global Advisors Publishes 2020 Proxy Season Review (Oct. 5, 2020), https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/policies-

manage these obligations as inexpensively as possible, each asset manager centralizes its governance activities within a single "stewardship" group.[94] These groups generally promulgate stewardship guidelines ex ante that detail the institution's approach to engagement and voting.[95] The Big Three also communicate with companies in the form of public letters, setting forth engagement and voting priorities ahead of each proxy season.[96] And although the Big Three, like all mutual funds, are required to disclose how they voted their proxies each year,[97] they are not required to disclose how they formulate their policies or how they engage with companies. In sum, much of their governance activity (and what motivates it) is unobserved.

II. ASSET MANAGERS AS REGULATORS

The previous Part described the modern capital market landscape featuring powerful "universal owner" asset managers. As this Part describes in detail, these asset managers have begun to tackle issues traditionally addressed by governmental bodies, including board diversity and climate change risk. In each of these areas, the Big Three have adopted market-wide rules, assessed compliance, and taken enforcement action. First, I describe the incentives that shape this regulatory activity, theorizing that the Big Three seek to maximize a weighted utility function that takes into account the preferences of their clients, subject to a separate constraint of avoiding governmental backlash. Next, I describe the Big Three's regulatory initiatives and how they support my theory about their incentives. I also discuss counterexamples—areas in which the Big Three have not been particularly proactive—as further support for my theory.

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and-reports/2020_investment_stewardship_annual_report.pdf [https://perma.cc/6ZRY-XN47] ("During the 2020 proxy season, State Street Global Advisors' asset stewardship team had comprehensive engagements with 409 companies and voted on 113,595 proposals across 70 countries on behalf of clients.").

94 *Investment Stewardship*, VANGUARD, https://about.vanguard.com/investment-stewardship [https://perma.cc/KPL8-UMHT]; *Investment Stewardship*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship#about-us [https://perma.cc/PKZ9-LMUX]; *Asset Stewardship*, STATE ST. GLOBAL ADVISORS, https://www.ssga.com/us/en/intermediary/ic/capabilities/esg/asset-stewardship [https://perma.cc/A483-L53P].

95 See note 94 for examples of each of the Big Three's guidelines.

96 *See, e.g.*, Fink, *supra* note 17 (noting BlackRock's focus on sustainability and emphasizing the importance of accountability to investors); Larry Fink, *Larry Fink's 2021 Letter to CEOs*, BLACKROCK (2021), https://www.blackrock.com/corporate/investor-relations/2021-larry-fink-ceo-letter [https://perma.cc/UH7K-4CGA] ("This is why I write to you each year, seeking to highlight issues that are pivotal to creating durable value—issues such as *capital management*, *long-term strategy*, *purpose*, and *climate change*.").

97 Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 17 C.F.R. §§ 239, 249, 270.30b1-4 & 274.129 (2003).

A. *Theory and Incentives*

Before describing the regulatory policies that the Big Three have adopted, I consider the forces of supply and demand that shape them.[98] To understand the motivations of asset manager suppliers of regulation, it is necessary to understand how these institutions earn profits, because profit is likely the driving motivation for this activity. (Later on, I will discuss the possibility that they are driven by other considerations, including the personal preferences of the individuals who make the rules). The vast majority of the Big Three's revenue comes from investment management fees from investors, set at a fixed percentage of AUM.[99] Therefore, the institution can increase profit by raising fees—a tenuous proposition given that fees have precipitously declined contemporaneous with the rise of indexing[100]—or increasing the amount of AUM.[101]

An asset manager has a few different ways to increase AUM beyond slashing fees. Mutual funds compete on the basis of cost-adjusted relative performance, and so demonstrating that the asset manager's funds have outperformed rivals over time would likely generate new clients.[102] But this method is largely unavailable to the asset managers that specialize in index funds, which promise to track a market index as closely as possible, rather than outperform it.

98 *Cf.* Stigler, *supra* note 59 (characterizing the market for regulation and the forces of supply and demand that govern it).

99 *See, e.g.*, Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1177 (2019) (noting that investment management fees make up 88% of BlackRock's quarterly revenue); Nathan Reiff, *How BlackRock Makes Money*, INVESTOPEDIA (Mar. 18, 2022), https://www.investopedia.com/articles/markets/012616/how-blackrock-makes-money.asp [https://perma.cc/ET6X-AK47] (showing that nearly 80% of revenue comes from investment management fees). Other sources of revenue include securities lending fees and income from client services. *See, e.g.*, Edwin Hu, Joshua Mitts & Haley Sylvester, *The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff* 7 (Colum. L. & Econ., Working Paper No. 647, 2020) (noting that BlackRock keeps a portion of the fees collected when lending their client's securities).

100 *See* Evie Liu, *Investing Gets Cheaper as Fund Fees Continue to Fall*, BARRON'S (June 9, 2020), https://www.barrons.com/articles/mutual-fund-fees-etf-passive-investing-financial-advice-morningstar-51591719173 [https://perma.cc/P8AX-TU6T] (noting that fund fees have decreased from 0.87% in 1999 to 0.45% in 2019); David C. Brown & Shaun William Davies, Closet Indexing: The Cost of Falling Asset Management Fees 1 n.1 (Oct. 31, 2014) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517701 [https://perma.cc/F46X-P3X3] (describing how expense ratios for actively managed and index funds have fallen since 2000).

101 Note that the Big Three could also increase revenue by moving existing investors into products with higher management fees, including actively managed funds or ESG funds. Indeed, this incentive may provide another source of pressure to adopt ESG policies that the institution's clients desire.

102 *See* Jonathan B. Berk & Richard Green, *Mutual Fund Flows and Performance in Rational Markets*, 122 J. POL. ECON. 1269, 1270 (2004) ("Nevertheless, mutual fund investors chase performance. Flows into and out of mutual funds are strongly related to lagged measures of excess returns . . . .").

For asset managers specializing in index funds, therefore, there are two alternative means of increasing AUM, with differing ease of accomplishment. As for the first "challenging" method, the asset manager could invest in stewardship that would increase the value of the companies in the portfolio. This need not entail costly firm-specific interventions; indeed, as Jeffrey Gordon and others have explored, the broadly diversified asset managers that specialize in index funds could seek to set marketwide governance standards that would increase the value of the companies in the portfolio on average.[103] As an example, if a large diversified investor's stewardship and standard-setting reduced systematic risk created by climate change or financial instability, risk-adjusted returns would improve.[104]

The intuitive appeal of this explanation obscures the complexity of this project. Recall that mutual funds compete on the basis of cost-adjusted relative performance.[105] This strategy means that index funds will rationally avoid high-cost governance activity, as well as interventions that benefit rivals. However, there are few market-wide interventions that an index fund can undertake cheaply. In particular, removing systematic risk from the portfolio, whether caused by climate change or social risk, is likely to be a costly endeavor.[106]

This leaves us with the comparatively "easy" method—creating relationships that lead to asset inflows or avoid outflows[107]—which more likely motivates the Big Three's regulatory activity. Simply put, I theorize that the Big Three adopt the regulatory policies that the bulk of their clients (and potential clients) demand, because doing so is likely to increase their AUM. This explanation for the Big Three's regulatory activity is related to the marketing explanation that has been advanced by Michal Barzuza, David Webber, and Quinn Curtis,[108] but it has a key difference: rather than simply marketing to a subset of millennial investors,[109] the Big Three adopt regulatory policies that maximize support from *all* of their clients, as well as potential clients.

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103 Gordon, *supra* note 26; Kahan & Rock, *supra* note 92, at 1807-08 (stating that the Big Three have superior information relative active fund managers when voting on market-wide governance standards); Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentive to Be Engaged 33 (Feb. 2021) (unpublished manuscript) (on file at Dartmouth University), https://faculty.tuck.dartmouth.edu/images/uploads/faculty/jonathan-lewellen/Institutional_incentives.pdf [https://perma.cc/6QHU-CVZS].

104 Gordon, *supra* note 26, at 3; Condon, *supra* note 36, at 5-6.

105 Gilson & Gordon, *supra* note 28, at 889-90.

106 *See infra* notes 208–215 and accompanying text.

107 As one representative of the Big Three explained, their ESG policies helped them differentiate their products in an arena of increasingly low fees, enabling them to sell their products to more people, for more money. *See supra* note 27.

108 Barzuza et al., *supra* note 6, at 1248.

109 *Id.*

Who are those clients? The biggest source of assets, and therefore revenue, is pension plans. BlackRock is the only public company of the Big Three and is therefore subject to detailed reporting requirements that give us a sense of its client base, which is somewhat representative of the general breakdown for the others.[110] Specifically, the majority of BlackRock's AUM (66%) is in the form of pension plan assets that are managed on behalf of corporations, governments, and unions (another 16% of AUM comes in the form of sub-advisory services for corporate clients).[111] Individual investors make up only 11% of AUM; assets from other entities like insurance companies, endowments, and "official institutions" make up the rest.[112]

As this description indicates, the issue of whether and how intermediary agency costs undermine the interests of beneficial owners is more complex than many realize. Beneficial owners sometimes invest directly with asset managers, and a robust literature considers the agency cost issues that arise from that single layer of intermediation.[113] But more often, the investment choice is mediated by another institution—a public pension or the beneficial owner's employer.[114] This reality of double intermediation means that there is not one, but two layers of intermediaries (and corresponding agency cost issues) involved in the choice of how to invest and exercise governance rights. And to the extent that asset managers rely on these institutions for profit, the asset manager's policies will be influenced by them.

110 Representatives of the Big Three confirmed this in conversations, see *supra* note 27, although Vanguard has made a point of differentiating itself from BlackRock and State Street by targeting individual investors, rather than institutions. This difference may explain why Vanguard's regulatory positions are generally the most tentative, as institutional clients like pension funds and corporations are best positioned to voice their policy preferences and for the reasons described in Section II.B, have strong incentives to demand that certain policies be adopted.

111 BlackRock, 2020 Annual Report, *supra* note 34, at 6.

112 *Id.*

113 *See* Bebchuk et al., *supra* note 28, at 108 (noting that the rise of index investment involves intermediation).

114 *See generally* BLACKROCK, IT'S ALL ABOUT CHOICE (2022), https://www.blackrock.com/corporate/literature/publication/its-all-about-choice.pdf [https://perma.cc/DB9Q-D9KX] (describing how $2.3 trillion of BlackRock's index equity AUM comes from institutional clients—pension funds, insurance companies, and corporations—investing in separately managed or pooled accounts).

Figure 1: Classical View of Intermediary Agency Costs

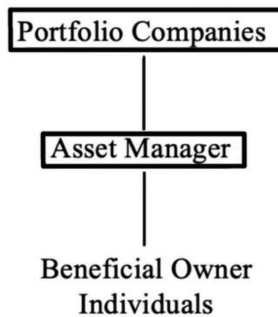
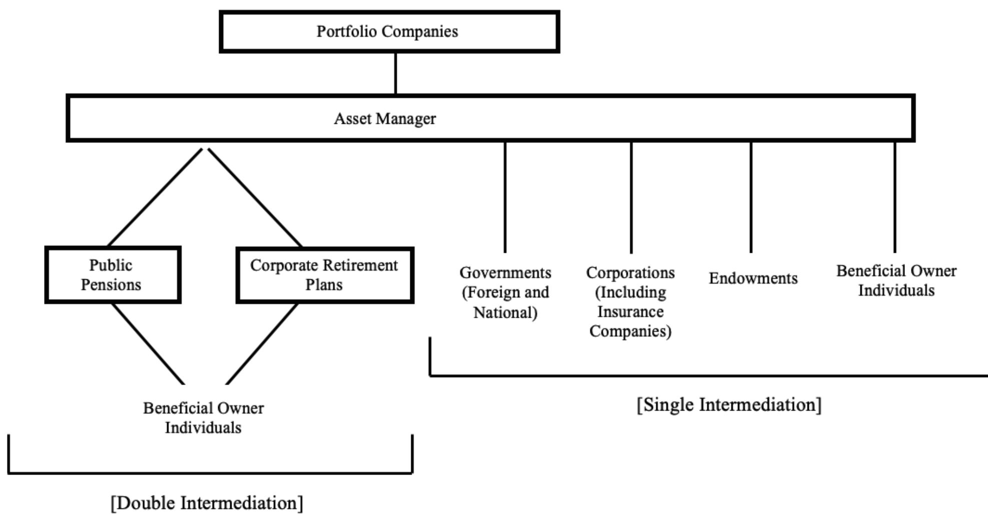


Figure 2: Single vs. Double Intermediation



Consequently, BlackRock aims to appease (and at the very least, not alienate) a diverse set of clients when adopting regulatory policies: corporate management that chooses the asset manager for the company's 401(k) accounts, public pension funds, individual investors, and even the United States government. Indeed, the latter group is important for another reason: as Jeff Schwartz observes, the Big Three's governance policies may affect their own regulatory landscape.[115] If, for example, an asset manager used its power

115 *See* Schwartz, *'Public' Mutual Funds*, *supra* note 32, at 28 ("[A]n important implication of publicness theory is that private institutions in the public eye will foresee regulatory efforts and take steps to ward them off"); *see also* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2037 (2019) ("[T]he

to advance a narrow set of interests at the expense of the public at large, it might face legislative backlash.[116] For this reason, support from the government operates as an additional and separate constraint on the asset manager's regulatory activities, and suggests that the Big Three will take pains to advance (or appear to advance) the public interest.

Although I theorize that asset managers will supply regulatory products in response to client demand, another possibility exists: it is possible that the individuals who develop governance policies will use that authority to advance their own private interests.[117] But my theory suggests that there are limits on the extent to which personal preferences that are not broadly shared with the asset manager's clients will dictate policies. Importantly, asset managers will be wary of adopting policies that most clients oppose, for fear of alienating them.[118] Imagine, for example, that BlackRock adopted a controversial position on the Israel-Palestine conflict, one that was not broadly shared by its clients, and in fact, even caused some of its corporate and public pension fund clients to face backlash from consumers and employees. These clients could immediately take steps to end the relationship with BlackRock and choose another financial advisor that better matched their preferences.[119] In addition, those clients could threaten to lobby the asset

growing power of the Big Three means that a nondeferential approach would likely encounter significant resistance from corporate managers, which would create a substantial risk of regulatory backlash."). Consider how the state of Texas directed the state comptroller to collect the name of financial companies that boycott fossil fuels and consider barring them from the state's pension funds. In the wake of this decision, BlackRock clarified that it did not boycott energy companies. *See* Ross Kerber, *Facing Texas Pushback, BlackRock Says it Backs Fossil Fuels*, REUTERS (Feb. 17, 2022), https://www.reuters.com/markets/us/facing-texas-pushback-blackrock-says-it-backs-fossil-fuels-2022-02-17 [https://perma.cc/3BXN-LY38] ("'We will continue to invest in and support fossil fuel companies, including Texas fossil fuel companies,' . . . [says] Dalia Blass, BlackRock's head of external affairs . . . .").

116 *See* Bebchuk & Hirst, *supra* note 115, at 2067 (providing historical examples of instances where financial interests faced public backlash that led to regulatory constraints); *see also* Mark J. Roe, Essay, *Backlash*, 98 COLUM. L. REV. 217, 219 (1998) (discussing how political backlash affects economic decisionmaking); Mark J. Roe & Roy Shapira, *The Power of Narrative in Corporate Lawmaking*, 11 HARV. BUS. L. REV. 233, 240-41 (2021) ("[C]orporate interests lacking a public interest narrative for their proposed laws can, and often do, face backlash in the media and the polity.").

117 Coates, *supra* note 25, at 2.

118 Indeed, certain institutional clients may secure voting commitments from asset managers as a condition of managing their money, meaning that the asset manager will be contractually obligated to vote the client's shares according to the client's preferences. BLACKROCK, *supra* note 114, at 4.

119 The risk of client backlash is heightened by the prevalence of no-cause termination clauses in asset management agreements. *See, e.g.*, *Amendment to Investment Management Agreement*, N.Y. FED. RSRV. 7 (Dec. 15, 2021), https://www.newyorkfed.org/medialibrary/media/markets/special_facilities/ima-blackrock-fma [https://perma.cc/6GQ4-2KLS] (including a provision that the Federal Reserve may terminate its agreement with BlackRock "at any time for any reason"). In the past, companies have used this power

manager's own regulators and seek limits on its power.[120] Individual investors that become alienated by the fund's policies could also theoretically switch to a different asset manager.[121] However, it is more likely that these considerations will influence the choice of where they invest in the first place. That is not to say that private preferences will not shape policies—it is possible that they will determine which policies are chosen out of many that clients support—but it is unlikely that an asset manager would advance policies that lack broad support from clients.[122]

In sum, I theorize that like the market for government regulation, the supply-side of the market for asset manager regulation is substantially influenced by demand from paying constituents. In the government regulatory context, this reality is known as the "regulatory capture" model.[123] An early proponent of this theory is George Stigler, who makes the provocative argument that regulation is a product produced in a market, and that is often purchased by businesses, which hold important advantages relative to society at large.[124] Drawing heavily on Mancur Olson,[125] Stigler emphasized the challenges of collective decisionmaking, including the rational apathy of voters to become informed and express their preferences by voting.[126] As a result, industries can usually influence their regulatory

to send messages. For example, in 1990, Armstrong World Industries, a strong supporter of a Pennsylvania anti-takeover law "switched its $180 million employee savings plan to Fidelity from Vanguard after Fidelity withdrew its opposition to the new law." Lund, *The Case Against Passive Shareholder Voting*, *supra* note 43, at 513 n.99 (citing Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 602 (1990)). More recently, the Texas Comptroller stated that BlackRock would no longer be allowed to do business with the state due to its boycotting of energy companies. Freedman, *supra* note 30.

120 Relatedly, the fear of public scrutiny and government backlash limits the extent to which the Big Three will issue policies that are blatantly self-serving (for example, by mandating that all public companies invest employee 401(k) assets in index funds).

121 The literature generally suggests that fund choices are sticky for individuals, but that movement is possible. *See generally* Clemens Sialm, Laura T. Starks & Hanjiang Zhang, *Defined Contribution Pension Plans: Sticky or Discerning Money?*, 70 J. FIN. 805 (2015) (surveying fund choice literature).

122 Indeed, since the Big Three have begun to play a regulatory role, their AUM have steadily increased. Bebchuk & Hirst, *supra* note 115, at 2053-54.

123 *See* Christopher Carrigan & Cary Coglianese, *George J. Stigler, "The Theory of Economic Regulation"*, *in* THE OXFORD HANDBOOK OF CLASSICS IN PUBLIC POLICY AND ADMINISTRATION 287, 287 (Steven J. Balla, Martin Lodge & Edward C. Page eds., 2015) (discussing how Stigler's work has become associated with the phrase "regulatory capture" despite never using the term in his writing).

124 *See* Stigler, *supra* note 59, at 12 (arguing that industry is able to "pay" for political power using "votes and resources" in order to advance its regulatory preferences).

125 *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION; PUBLIC GOODS AND THE THEORY OF GROUPS (Harv. Univ. Press, 1965) (developing a theory of collective action problems in regulation).

126 *See* Stigler, *supra* note 59, at 11-13 (noting the high information costs associated with collective decisionmaking).

environment by going to the political party who functions as the "seller" and paying with "votes and resources."[127]

In the market for regulation by asset managers, corporations and other institutions should also play an outsized role, as they provide a large fraction of the assets that institutional shareholders manage and also exhibit organizational and communicative advantages relative to diffuse individual investors.[128] In particular, institutions can be expected to have easier access to the Big Three's governance group than individual investors and to face comparatively lower coordination costs.[129] And as the next Section discusses, corporations and public pensions have strong incentives to push for their preferred policies.[130]

Nonetheless, there are also reasons to think that this regulatory process will result in less influence by concentrated interest groups than the government context. In the market for government regulation, interest group dynamics dominate because the regulators that govern the particular industry may be particularly dependent on the interest group for campaign contributions and other resources, and are likely to be subject to intense lobbying.[131] The presence of a revolving door between industry and

127 *Id.* at 12. Despite lacking institutional richness, the regulatory capture model has found empirical support in a number of settings. *See, e.g.*, Randall S. Kroszner & Philip E. Strahan, *What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions*, 114 Q.J. ECON. 1437, 1463 (1999) (finding that the private interest approach provides the most compelling explanation for bank branching deregulation in the 1970s and '80s).

128 One of the Big Three representatives that I spoke to also mentioned that governance is a repeat game and that keeping productive relationships with companies was an important goal for asset managers. *See supra* note 27.

129 For example, institutions often work together to pursue common stewardship agendas via investor associations, such as the Council of Institutional Investors and the Investor Stewardship Group. *See* Lund & Pollman, *supra* note 71, at 2591 ("Influential investors exert pressure not only on their own but also in coordination with other investors via associations.").

130 *See infra* notes 166–172 and accompanying text. However, the Big Three are unlikely to disregard individual preferences entirely for several reasons. As discussed, were individual investors to become alienated by an asset manger's policies, they could choose a different institution for future investments. To the extent that individual investors exert pressure on institutional clients like corporations and public pensions, the Big Three will also be forced to consider their interests. In sum, my main point is not that individual preferences are likely to be disregarded, but that they are unlikely to be the primary catalyst for action.

131 *See, e.g.*, Matthew H. Goldberg, Jennifer R. Marlon, Xinran Wang, Sander van der Linden & Anthony Leiserowitz, *Oil and Gas Companies Invest in Legislators that Vote Against the Environment*, 117 PROC. FROM THE NAT'L ACAD. OF SCI. FOR THE U.S. 5111, 5112 (Mar. 10, 2020), https://www.pnas.org/content/pnas/117/10/5111.full.pdf [https://perma.cc/5Z57-CWTC] ("[O]il and gas companies seem to provide financial rewards to members of Congress after they have voted against legislation to protect the environment."); Lee Drutman, *How Corporate Lobbyists Conquered American Democracy*, THE ATL. (Apr. 20, 2015), https://www.theatlantic.com/business/archive/2015/04/how-corporate-lobbyists-conquered-american-democracy/390822 [https://perma.cc/DXW7-B8CT] ("The evolution of business lobbying

government exacerbates these concerns—regulators find lucrative jobs within the affected industry when they leave their government positions, and industry employees regularly go on to lead government agencies.[132]

In the asset manager regulatory context, interest group dynamics—i.e., policies being dictated by a vocal minority of institutions or individuals, at the expense of everyone else—are unlikely to dominate. There are two main reasons why. First, when an asset manager adopts regulatory policies, its clients are less capable of influence. In the public sphere, there is no limit on the ability of a company or industry advocacy group to reward a legislator with contributions to super PACs (political action committees) that support candidates.[133] By contrast, a client of the asset manager has fewer opportunities to dole out rewards or impose punishment. Consider a hypothetical decision by BlackRock to adopt a regulatory policy that would increase costs for the oil and gas companies in the portfolio. Those companies may threaten to withdraw their assets and choose a different financial advisor, but that threat will be unlikely to dissuade the asset manager if the policy secures broad support from the rest of the portfolio, which includes thousands of clients.[134] Of course, those oil and gas companies could also threaten to

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from a sparse reactive force into a ubiquitous and increasingly proactive one is among the most important transformations in American politics over the last [forty] years.").

132 Scholars have provided evidence supporting the revolving door theory of capture. *See, e.g.*, Haris Tabakovic & Thomas G. Wollmann, *From Revolving Doors to Regulatory Capture? Evidence from Patent Examiners* 3-4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24638, 2018) (finding that patent examiners that moved to industry granted more patents prior to their move than their peers, especially as compared to companies that went on to hire them); Jess Cornaggia, Kimberly J. Cornaggia & Han Xia, *Revolving Doors on Wall Street*, 120 J. FIN. ECON. 400, 401 (2016) (finding that credit analysts inflate ratings of the firms they went on to work for); Ben Lourie, *The Revolving Door of Sell-Side Analysts*, 94 ACCT. REV. 249, 250 (2019) (finding that equity analysts bias their reports in favor of the firms they go on to work for). *But see* Ed deHaan, Simi Kedia, Kevin Koh & Shivaram Rajgopal, *The Revolving Door and the SEC's Enforcement Outcomes: Initial Evidence from Civil Litigation*, 60 J. ACCT. & ECON. 65, 67 (2015) (finding evidence that SEC lawyers that went on to work for law firms were generally more aggressive in enforcement while working at the SEC).

133 Studies show that affected industry groups spend heavily to influence regulation in their favor. *See, e.g.*, Oliver J. Wouters, *Lobbying Expenditures and Campaign Contributions by the Pharmaceutical and Health Product Industry in the United States, 1999-2018*, 180 JAMA INTERNAL MED. 688, 689 (2020) (finding substantial lobbying and campaign expenditures by the pharmaceutical industry).

134 Of course, if a large enough group of clients are opposed to a policy, that could be enough to induce the asset manager to change course or adopt a new policy. Consider BlackRock's response to ESG pushback from states that threatened to ban asset managers that boycott energy companies from managing their state pensions. *See* Freedman, *supra* note 30 (discussing how the Texas comptroller banned BlackRock from managing the state's pension accounts); *see also* Andrew Ross Sorkin, Vivian Giang, Stephen Gandel, Bernhard Warner, Michael J. de la Merced, Lauren Hirsch & Ephrat Livni, *BlackRock Seeks to Defend Its Reputation Over E.S.G. Fight*, N.Y. TIMES (Sept. 8, 2022), https://www.nytimes.com/2022/09/08/business/dealbook/blackrock-texas-defend-reputation-esg-fight.html [https://perma.cc/Z3EA-GSY8]. This opposition from a large group of vocal clients to BlackRock's ESG policies has seemingly influenced the asset managers policies. *See*

lobby the asset manager's regulators and seek unfavorable policies as punishment.[135] But companies and industry groups generally focus their attention on legislators and committees that are responsible for regulating that company or industry;[136] as such, they may not have as much sway when targeting the SEC and other financial regulators. Therefore, the oil and gas companies are unlikely to have sufficient power to dissuade BlackRock from adopting the policy.

There is a second reason why interest group dynamics are less likely to manifest in this context—there is unlikely to be the same revolving door between members of the affected industry and the asset manager regulator. Recall that the government employees charged with oversight and regulation of a particular industry may be drawn from companies within that industry, or be hoping for lucrative jobs within it afterwards, which can affect the policies that they adopt.[137] By contrast, the people that form an asset manager's governance group are experts in corporate governance, drawn from backgrounds in investing and finance.[138] Therefore, the revolving door form of capture is unlikely to exist when the asset manager adopts policies outside of those issue areas.

Rob Davies & Josephine Moulds, *Green Credentials of World's Largest Investor Questioned Over Oil Industry Emails*, GUARDIAN (Mar. 9, 2022, 5:28 PM) https://www.theguardian.com/environment/2022/mar/09/blackrock-privately-soothes-oil-industry-fears-over-its-new-green-credentials [https://perma.cc/CGT4-5GA8]. This example reveals that asset managers are sensitive to client interests, and that if a large enough group threaten to withdraw, this opposition can influence policies and enforcement.

135 For example, after a proxy season in which the Big Three supported several high-profile shareholder proposals, the National Association of Manufacturers created a lobbying group to work against the expansion of shareholder rights. *See* Nell Minow, *The Main Street Investors Coalition in an Industry-Funded Effort to Cut Off Shareholder Oversight*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 14, 2018), https://corpgov.law.harvard.edu/2018/06/14/the-main-street-investors-coalition-is-an-industry-funded-effort-to-cut-off-shareholder-oversight [https://perma.cc/DS7K-MDTL] (describing how the National Association of Manufacturers created the Main Street Investors Coalition to oppose the expansion of shareholder rights).

136 *See* Leo E. Strine, Jr., *Corporate Power Ratchet: The Court's Role in Eroding "We the People's" Ability to Constrain Our Corporate Creations*, 51 HARV. C.-R.-C.L. L. REV. 423, 441 (2016) (arguing that because only stockholders have power over corporate management, managers will participate in the political process only to the extent that doing so results in the election of candidates favorable to corporate interests); *see also* Hussain & Moriarty, *supra* note 3, at 432 (noting that corporations engage in lobbying and campaign finance in order to achieve certain regulatory outcomes); Goldberg et al., *supra* note 131, at 5111 (finding that members of Congress vote against environmental policies where large oil and gas companies have invested in them).

137 For a survey on the revolving door theory of regulatory capture, see *supra* note 132 and accompanying text.

138 *See, e.g.*, *Michelle Edkins, Managing Director Biography*, BLACKROCK, https://www.blackrock.com/us/individual/biographies/michelle-edkins [https://perma.cc/K4V5-D8WQ]; *Benjamin Colton, Global Head of Asset Stewardship Biography*, STATE ST. GLOB. ADVISORS, *https://www.ssga.com/us/en/intermediary/ic/bio/343610* [https://perma.cc/U37G-QEMM].

In sum, I theorize that asset manager regulators will not have much of an incentive to cater to the demands of a small group of vocal clients. Instead, they will seek to adopt policies that secure broad support from clients (and institutional clients in particular), as well as the institution's own regulators. In the next Section, I describe how the regulatory steps taken by the Big Three are consistent with this theory.

B. *Regulation by Asset Managers*

This Section takes a close look at two areas of regulatory focus for the Big Three: averting climate change and improving board diversity. And as the following subsections reveal, the Big Three's interventions feature core regulatory attributes: the creation of a rule binding a regulatory target, a command that the target adopt means or achieve ends, and the enforcement of rules with penalties.[139] Although the tools at hand differ from those used by a public regulatory body, the Big Three's size gives them substantial influence. The subsections that follow describe these regulatory initiatives in detail and discuss how they are consistent with my theory that the Big Three supply rules based on client demand. As further evidence, I conclude by highlighting areas in which the Big Three have not been proactive.

1. Board Diversity

Improving board gender diversity has been a major area of regulatory focus for the Big Three. Their intervention came after efforts by private and public actors failed to prompt much change. For example, in 2011, two public pension funds, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), set up the Diverse Director Data Source, which they hoped would make it easier for companies to find underrepresented individuals for director seats.[140] Around the same time, politicians and regulators—including then-SEC Commissioner Luis Aguilar—urged companies to adopt policies that would increase workplace diversity at the board level and beyond.[141]

[139] Coglianese, *supra* note 8.

[140] *See* Press Release, Correcting & Replacing CalSTRS, CalSTRS, CalPERS, Announce Diverse Director DataSource (3D) – A Resource to Identify Corporate Director Candidates (Apr. 5, 2011), https://www.businesswire.com/news/home/20110405006168/en [https://perma.cc/8R55-D4Q4] (announcing the launch of the Diverse Director Datasource (3D)).

[141] *See* Tyler Winters & Madhuri Jacobs-Sharma, *Gender Diversity on Corporate Boards: The Competing Perspectives in the U.S. and the EU* 13-14 (Comp. Corp. Governance & Fin. Reg., Select Seminar Paper, 2016), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1012&context=fisch_2016 [https://perma.cc/32Z9-SQYX] (describing politicians and regulators' efforts to promote gender diversity).

California even passed a voluntary quota for women on corporate boards in 2013.[142] That same year, the SEC amended regulation S-K "to require corporations with a diversity policy to disclose how the policy is implemented and how the nominating committee 'assesses the effectiveness of its policy.'"[143]

But ultimately, these efforts had little effect. Despite making up half of the U.S. workforce and holding 30% of management positions,[144] in 2015, women made up only 20% of corporate directors of S&P 500 companies[145]—a number that had remained fairly static for years.[146] In 2016, a survey of U.S. directors revealed that gender diversity was not on the agenda for many corporate boards.[147] In fact, one public company director was quoted in 2016 as saying: "Gender diversity has never been a stated or implicit goal at any of the boards I have served on."[148]

This changed in 2017 when State Street became the first of the Big Three to make board diversity a focus. Memorably, the asset manager launched an aggressive voting campaign at the same time it launched its Fearless Girl marketing campaign, which resulted in the placement of a statue of a defiant

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142 The voluntary quota specified that

> within the three-year period from January 2014 to December 2016, every publicly held corporation in California with nine or more director seats [should] have a minimum of three women on its board, every publicly held corporation in California with five to eight director seats [should] have a minimum of two women on its board, and every publicly held corporation in California with fewer than five director seats [should] have a minimum of one woman on its board . . . .

S. Con. Res. 62, 2013-2014 Gen. Assemb., Reg. Sess. (Cal. 2013).

143 Enkelena Gjuka, *Corporate America, It's Time to Increase Gender Diversity in Boardrooms*, JURIST (Nov. 11, 2013, 8:34 AM), https://www.jurist.org/commentary/2013/11/enkelena-gjuka-womens-rights [https://perma.cc/M3YQ-FKUR].

144 Magarethe Wiersema & Marie Louise Mors, *What Board Directors Really Think of Gender Quotas*, HARV. BUS. REV. (Nov. 14, 2016), https://hbr.org/2016/11/what-board-directors-really-think-of-gender-quotas [https://perma.cc/H46W-U93G].

145 SPENCER STUART, 2020 U.S. SPENCER STUART BOARD INDEX 3 (2020), https://www.spencerstuart.com/-/media/2020/december/ssbi2020/2020_us_spencer_stuart_board_index.pdf [https://perma.cc/H9WN-SQQC].

146 Between 2011 and 2016, the percentage of women directors of S&P 500 companies only increased approximately 1% per year. SPENCER STUART, 2016 SPENCER STUART BOARD INDEX 8 (2016), https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/spencer-stuart-us-board-index-2016.pdf [https://perma.cc/HAS7-3JYC]. California's voluntary quota also failed to move the needle for companies that were subject to it. *See* John Woolfolk, *California Becomes First State to Require a Woman on Corporate Boards*, MERCURY NEWS, https://www.mercurynews.com/2018/09/30/california-becomes-first-state-to-require-a-woman-on-corporate-boards [https://perma.cc/D4HW-EV8N] (Oct. 1, 2018, 8:12 AM) ("An 'aspirational' resolution [written] in 2013 urging corporate boards to voluntarily add women 'fell on deaf ears,' with the percentage of women on corporate boards barely inching up from 15.5 percent in 2013 to 16 percent five years later.").

147 *See* Wiersema & Mors, *supra* note 144 ("[I]ncreasing gender diversity is not even on the agenda for many directors.").

148 *Id.*

young girl facing the Charging Bull on Wall Street.[149] As part of that campaign, State Street announced that it would vote against the chair of the nominating committee at boards that lacked diversity and failed to take adequate steps to improve it.[150] Within five months of announcing this policy, State Street had voted against nominating directors at 400 portfolio companies that lacked women directors and had not convinced State Street they were making sufficient progress in improving board diversity.[151] And just over one year following the policy change, over 300 companies added women to their board.[152]

Shortly thereafter, BlackRock and Vanguard joined State Street in pressuring companies to improve their board diversity. In July 2017, BlackRock announced that it planned to focus on gender diversity by, among other tactics, voting against directors of nondiverse boards,[153] and in its proxy voting guidelines posted in February 2018, BlackRock stated that it "normally expect[s] to see at least two women directors on every board."[154] The asset manager also sent letters to portfolio companies with fewer than two woman directors, asking them to disclose their approach to board diversity.[155] In August 2017, Vanguard's CEO announced in an open letter that it would consider whether companies were making meaningful progress on gender

149 *See* Barzuza et al., *supra* note 6, at 1266 (describing the origin of the Wall Street's "Fearless Girl" statue).

150 Joann S. Lublin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J. (Mar. 7, 2017), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863 [https://perma.cc/3DPB-6WS8].

151 Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J. (July 25, 2017), https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490 [https://perma.cc/L9Y3-3SVP*]*. Between March 2018 and February 2019, State Street voted against another 421 directors of companies with all-male boards. Gormley et al., *supra* note 15, at 8.

152 Press Release, State St. Glob. Advisors, State Street Global Advisors Reports Fearless Girl's Impact: More than 300 Companies Have Added Female Directors (Sept. 27, 2018) [hereinafter Fearless Girl's Impact Press Release], https://www.businesswire.com/news/home/20180927005518/en/State-Street-Global-Advisors-Reports-Fearless-Girl%E2%80%99s-Impact-More-than-300-Companies-Have-Added-Female-Directors [https://perma.cc/W83H-C778].

153 Trevor Hunnicutt, *BlackRock Supports Effort to Boost Number of Women Board Members*, REUTERS (July 13, 2017), https://www.reuters.com/article/us-blackrock-women/blackrock-supports-effort-to-boost-number-of-women-board-members-idUSKBN19Z09C [https://perma.cc/RT9C-X988].

154 Sarah Krouse, *BlackRock: Companies Should Have At Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018, 2:06 PM), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407 [https://perma.cc/S6NF-HDVN].

155 Gormley et al., *supra* note 15, at 9.

diversity when voting for directors.[156] Around that same time, State Street went even further. It announced that in 2020, it would withhold votes from the entire nominating committee—not just the chair—if a board did not have any woman members and had not engaged in a successful dialogue with the asset manager about its efforts to improve.[157]

These policies made an impact. From 2017 to 2020, the number of S&P 1500 firms lacking a woman director dropped from 179 to 30, and by 2020, no S&P 500 company had an all-male board.[158] Empirical research estimates that the "Big Three's campaigns led firms to add 2.5 times as many female directors in 2019 as they had in 2016 . . . ."[159] In addition, during the time in which they instituted these campaigns, a one-standard-deviation increase in ownership by the Big Three was associated with a 76%increase in woman directors and reduced the chance that a company would have zero woman directors by almost 20%.[160]

In catalyzing change, the Big Three's interventions moved beyond the asset manager's traditional tools of advising and encouragement in the form of public statements and open letters, and into the regulatory realm. Specifically, the Big Three adopted "rules" (ranging from vague mandates to improve diversity or enhance disclosure to concrete quotas—e.g., "at least two women directors"), and enforced them with consequences (votes against directors).[161] Although the Big Three lack the coercive powers of a government body—i.e., the power to tax, fine, and imprison—their ample governance power was a potent source of influence over portfolio companies.

Their interventions also appear to have brought about action by others. Most prominently, in 2018, after State Street's Fearless Girl campaign, California made a voluntary board gender diversity quota binding. Specifically, the state adopted S.B. 826, which requires any publicly traded

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156 Open Letter from William McNabb III, Chairman & CEO, Vanguard, to Dirs. of Public Companies Worldwide 2 (Aug. 31, 2017), https://www.vanguard.ca/documents/literature/ceo-governance-letter.pdf [https://perma.cc/XS64-Y9F2].

157 Fearless Girl's Impact Press Release, *supra* note 152.

158 Mary Brooke Billings, April Klein & Yanting Crystal Shi, *Investors' Response to the #MeToo Movement: Does Corporate Culture Matter?*, 27 REV. ACCT. STUD. 897, 898 (2020).

159 Gormley et al., *supra* note 15, at 3. Interestingly, this study also sheds light on the mechanism for change—the campaigns pushed companies to expand management's networks to identify diverse candidates and place less emphasis on candidates' executive experience. *See id.* at 28 ("We find that firms with higher Big Three ownership hired women with less executive experience after 2016 than they had previously.").

160 *Id.* at 13-14.

161 *Id.* at 8-9. Votes against directors have continued. *See* Rebecca Sherratt, *Board Diversity Deliberations*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 17, 2021), https://corpgov.law.harvard.edu/2021/08/17/board-diversity-deliberations [https://perma.cc/AS8H-9B3P] (describing instances of asset managers voting against board directors who have failed to sufficiently promote diversity).

company with a principal office in California to include at least one woman on their board by the end of 2019, and two or more by 2021.[162] Companies that fail to comply face financial penalties—$100,000 for a first violation and $300,000 for any others.[163] This law, therefore, resembles the mandates imposed by State Street and BlackRock, but is less potent in many respects. In particular, for most public companies, the prospect of a no-vote from shareholders that make up nearly 20% of a company's shareholder base is likely to be a greater threat than a $100,000 penalty.[164] Not only that, but the law has also been subject to serious legal challenges.[165]

162 Patrick McGreevy, *Gov. Jerry Brown Signs Bill Requiring California Corporate Boards to Include Women*, L.A. TIMES (Sept. 30, 2018, 4:00 PM), https://www.latimes.com/politics/la-pol-ca-governor-women-corporate-boards-20180930-story.html [https://perma.cc/J92T-A5PT].

163 *Id.*

164 Indeed, the negative public relations attention that would accompany these no-votes would itself likely be more damaging than the fine. *See* John Armour, Colin Mayer & Andrea Polo, *Regulatory Sanctions and Damage in Financial Markets*, 52 J. FIN. & QUANT. ANALYSIS 1429, 1439-40 (2017) (finding that the reputational loss associated with U.K. regulators' negative public announcements was approximately nine times greater than the fines and compensation paid by the targeted firms).

165 In particular, the quota has been struck down as unconstitutional by a Los Angeles Superior Court judge. The Secretary of State plans to appeal that decision. Cydney Posner, *California To Appeal Decision Striking Down Board Gender Diversity Statute*, COOLEY PUBCO (May 23, 2022), https://cooleypubco.com/2022/05/23/appeal-board-gender-diversity-statute [https://perma.cc/C42A-Y3EY]; *see also* Robin Nunn, Joseph E. Floren & Susan D. Resley, *Report: California Sees Significant Increase in Female Directors After SB 826, But More Needed*, LEXOLOGY (Oct. 27, 2020), https://www.lexology.com/library/detail.aspx?g=6f5d19b8-dab7-4c6a-9df2-3497efa7a24f [https://perma.cc/4BYL-4MXT]. For a discussion of potential legal challenges, see Lisa M. Fairfax, *All on Board? Board Diversity Trends Reflect Signs of Promise and Concern*, 87 GEO. WASH. L. REV. 1031 (2019) and Joe Grundfest, *Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California's SB 826* (Rock Ctr. for Corp. Governance at Stan. Univ., Working Paper No. 232, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3248791 [https://perma.cc/8KSQ-3P65]. Note that California has since adopted a second board quota, this time targeting racial and ethnic diversity. Michael Volkov, *California Mandates Increased Diversity on Corporate Boards*, J.D. SUPRA (Dec. 17, 2020), https://www.jdsupra.com/legalnews/california-mandates-increased-diversity-18235 [https://perma.cc/4TDM-ZS48]. BlackRock adopted voting policies aimed at increasing the racial and ethnic diversity of portfolio company boards shortly thereafter. Saijel Kishan, *BlackRock to Push Companies on Racial Diversity in 2021*, BLOOMBERG (Dec. 10, 2020), https://www.bloomberg.com/news/articles/2020-12-10/blackrock-plans-to-push-companies-on-racial-diversity-in-2021 [https://perma.cc/9G38-EQ4V]. Within a year of this announcement, the Nasdaq stock exchange announced that it too was tackling the issue of board diversity by adopting a rule that would require listed companies to disclose diversity statistics and, if they lack at least two diverse directors, to explain why. *See* NASDAQ, NASDAQ'S BOARD DIVERSITY RULE: WHAT NASDAQ-LISTED COMPANIES SHOULD KNOW 1-2 (2022), https://listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf [https://perma.cc/D4WZ-454H].

In sum, the Big Three's policies were powerful drivers of change when other efforts had failed.[166] And I theorize that the Big Three adopted these regulatory policies because the vast majority of their clients embraced and even demanded them. In some ways, therefore, my theory resembles the marketing explanation advanced by Michal Barzuza, Quinn Curtis, and David Webber, who posit that that the Big Three advance social agendas to attract assets from millennial investors.[167] But this explanation is only part of the story: as discussed, individual investors make up only a small portion of the Big Three's AUM, and millennial investors are only a portion of those assets.[168] Therefore, the Big Three likely produced board diversity mandates because such mandates thread the needle between the goals of a diverse set of clients: not just individual investors, but also public pension funds[169] and even corporate America.[170]

Why might corporate management broadly support rules advancing board diversity, which can lead to search costs and cultural changes that management has historically resisted? One possibility is that some companies had been forced to improve board diversity after being targeted by activist

166 One of the representatives from the Big Three explained that in the absence of regulation, they felt that it was their opportunity and obligation to move to adopt rules and discipline laggards. *See supra* note 27.

167 Barzuza et al., *supra* note 6, at 1251.

168 *See supra* notes 33–35 (discussing the makeup of the Big Three's investors and the limits of individual investor influence).

169 Although I theorize that the Big Three seek to maximize the utility of all their clients, this example suggests that public pensions may have outsized influence relative to their share of assets. There are a few reasons why this may be the case, including that public pensions may insist that their outside investment advisors follow their voting policies as a condition of investing. And if public pension funds can secure outsized influence in the market for asset manager regulation, there is the risk that these funds, which are often run by political appointees, may seek to use their influence as a back door to achieve ends they cannot achieve through normal political channels. *See* Romano, *supra* note 53, at 796 (describing how public pension funds are subject to political pressures).

170 Another way of conceptualizing this dynamic is that it represents the influence of elite political opinion on asset managers. Elites—including corporate leaders and pension fund managers—tend to form homogenous political viewpoints. *See* Litsa Nicolaou-Smokoviti & Burt Baldwin, *Hierarchies, Attitudes, and Gender*, *in* GENDERING ELITES: ECONOMIC AND POLITICAL LEADERSHIP IN 27 INDUSTRIALISED SOCIETIES 207, 212 (Mino Vianello & Gwen Moore eds., 2000) (finding evidence that the higher you go in corporate management hierarchy, the higher the degree of attitudinal homogeneity); *see also* Harold R. Kerbo & L. Richard Della Fave, *The Empirical Side of the Power Elite Debate: An Assessment and Critique of Recent Research*, 20 SOCIOLOGICAL Q. 5, 14-15 (1979) (describing the phenomenon of "elite unity"). Accordingly, elite demand for rules is shaped by these political views. In turn, asset managers, by publicly advertising their congruence with these political views, likely influence public opinion on these issues. *Cf.* James N. Druckman, Erik Peterson & Rune Slothuus, *How Elite Partisan Polarization Affects Public Opinion Formation*, 107 AM. POL. SCI. REV. 57, 74-75 (2013) (finding that the strength and polarization of elite positions significantly influences broader public sentiment). This process generates a feedback loop by which investors approve of and even seek out mutual funds that espouse these same political preferences.

investors, consumers, and employees.[171] In addition, many others have begun to understand that the writing is on the wall. In other words, once it became clear that the market was moving in the direction of greater board diversity (and that regulators were considering action in this space), companies may have realized that it was in their advantage to comply and then ensure that competitors incurred the same transition costs.[172] Not only that, these companies might have predicted that asset manager regulation might stave off more intrusive standards developed by government regulators.

As this discussion reveals, understanding the incentives that shape these policies reveals something about their substance. In particular, the policies that corporate America supports are likely to be different than those that millennial investors or government regulators would choose. Notably, the Big Three did not adopt bold policies such as mandating that half the board be composed of women (which would better approximate the workforce). Instead, they offered tepid policies with fewer requirements than the quota eventually adopted by the state of California. Why? This modest regulatory agenda was the most likely to be embraced by a broad swath of their clients.

This theory is also more plausible than an alternative theory advanced by Jeffrey Gordon—that diversified institutional shareholders have an incentive to adopt social policies that will increase the value of the portfolio as a whole.[173] Although I believe that portfolio value may be a byproduct of these

171 *See, e.g.*, Hannah Murphy, *Women Represent 40% of Facebook Board After Two New Additions*, FIN. TIMES (Mar. 9, 2020), https://www.ft.com/content/d33a692c-624a-11ea-a6cd-df28cc3c6a68 [https://perma.cc/HBY3-L9LY] (describing how Facebook improved its board diversity after being criticized for a lack of diversity); Kori Hale, *Amazon Delivers a Turnaround in Board Diversity Approach*, FORBES (May 16, 2018, 8:23 PM), https://www.forbes.com/sites/korihale/2018/05/16/amazon-delivers-a-turnaround-in-board-diversity-approach/?sh=5028a07e26e6 [https://perma.cc/A4G2-E9MC] (describing how Amazon signed on to a board diversity policy after initially opposing a similar, employee-supported proposal and facing employee and shareholder backlash); Khristopher J. Brooks, *Starbucks Chair Says Lack of Boardroom Diversity Is "Corporate Suicide"*, CBS NEWS (Apr. 22, 2021, 3:11 PM), https://www.cbsnews.com/news/starbucks-hobson-diversity-suicide-bowdoin-boardroom [https://perma.cc/9392-GDLH] (observing that nearly half of the Starbucks board is composed of people of color, and reporting that the chairwoman called lack of board diversity at other companies "corporate suicide").

172 As support for this proposition, consider that the two most influential industry groups, the Business Roundtable and the U.S. Chamber of Commerce, have both adopted policies urging companies to increase board diversity. *See Business Leaders Add Boardroom Diversity to Best Practices List*, BUS. ROUNDTABLE, https://www.businessroundtable.org/archive/media/news-releases/business-leaders-add-boardroom-diversity-best-practices-list [https://perma.cc/DYS3-NJ6M]; *see also USCC & NACD Board Diversity Accelerator Initiative*, U.S. CHAMBER OF COM., https://www.uschamber.com/program/strategic-alliances-and-outreach/uscc-nacd-board-diversity-accelerator-initiative [https://perma.cc/UQ4J-FTUM] (discussing a Chamber of Commerce initiative to increase opportunities for minority business executives).

173 Gordon, *supra* note 26, at 4.

diversity policies, it is unlikely to be the main driver for action.[174] Although empirical evidence generally suggests that increased board diversity creates shareholder value, it is not conclusive.[175] By contrast, there are other ESG initiatives that have as strong, if not stronger, links to value creation for diversified and undiversified investors, but that have not garnered broad consensus among the business community: for example, seeking improved conditions for workers,[176] reducing outsized executive compensation,[177] and improving community relations.[178] In other words, my theory provides an

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174 *See* Jill E. Fisch & Steven Davidoff Solomon, Centros*, California's "Women on Boards" Statute and the Scope of Regulatory Competition*, 20 EUR. BUS. ORG. L. REV. 493, 509 (2019) (suggesting that the main driver behind diversity policy change, and SB 826 specifically, is directed at "the promotion of societal value").

175 *See* James A. Fanto, Lawrence M. Solan & John M. Darley, *Justifying Board Diversity*, 89 N.C. L. REV. 901, 917-18 (2011) (arguing that the need to justify board diversity in terms of shareholder value is problematic because there is no strong empirical evidence providing that increased board diversity results in increased value); Alex Edmans, *No, Board Diversity Does Not Mean Higher Profits*, TELEGRAPH (Aug. 20, 2021), https://www.telegraph.co.uk/business/2021/08/20/no-boardroom-diversity-does-not-mean-higher-profits [https://perma.cc/LYR3-N379] (arguing that the empirical evidence that board diversity leads to higher profit is actually much weaker than generally recognized); *see also* Felix von Meyerinck, Alexandra Niessen-Ruenzi, Markus Schmid & Steven Davidoff Solomon, *As California Goes, So Goes the Nation? Board Gender Quotas and Shareholders' Distaste of Government Interventions* 3 (Eur. Corp. Governance Inst., Working Paper No. 785/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303798 [https://perma.cc/W92R-A5L6] (documenting large negative announcement returns for companies subject to California's board gender quota). Indeed, one of the Big Three stewardship representatives that I spoke to admitted the evidence that board diversity improves shareholder value was debatable. *See supra* note 27.

176 *See* Alex Edmans, Darcy Pu & Chendi Zhang, *Employee Satisfaction, Labor Market Flexibility, and Stock Returns Around the World* 5 (Eur. Corp. Governance Inst. Working Paper No. 433/2014, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2461003 [https://perma.cc/EF2Z-9W8B] (finding that employee satisfaction is associated with future profitability, especially in flexible labor markets); Emma Seppälä & Kim Cameron, *Proof That Positive Work Cultures Are More Productive*, HARV. BUS. REV. (Dec. 1, 2015), https://hbr.org/2015/12/proof-that-positive-work-cultures-are-more-productive [https://perma.cc/PJ7A-35NH] (discussing research showing that positive work culture leads to higher profit due to increased productivity); HARV. BUS. REV. ANALYTIC SERVS., THE IMPACT OF EMPLOYEE ENGAGEMENT ON PERFORMANCE 1, 4 (2013), https://hbr.org/resources/pdfs/comm/achievers/hbr_achievers_report_sep13.pdf [https://perma.cc/G5L4-JCTE] (describing how employees that are more engaged perform at higher levels); Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621, 624–34 (2011) (finding that companies rated as best to work for outperform industry benchmarks); Alex Edmans, *The Link Between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility*, ACAD. MGMT. PERSP., Nov. 2012, at 1, 12–16 (2012) (describing how corporate social responsibility is linked to a positive firm value due to increased employee satisfaction).

177 *See generally* Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence*, *in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 383 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017).

178 *See, e.g.*, Amy J. Hillman & Gerald D. Keim, *Shareholder Value, Stakeholder Management, and Social Issues: What's the Bottom Line?*, 22 STRATEGIC MGMT. J. 125, 135 (2001) (finding that if a corporation invests in community relations activities that are directly tied to its primary

explanation for why the Big Three select certain regulatory areas among many that could drive portfolio-wide value: client demand.

The observation that client demand will dictate policymaking also reveals that the Big Three's activism may push companies to advance purposes other than shareholder wealth maximization, in contrast to theories that suggest that the Big Three's ESG activity is designed to maximize portfolio value. Under traditional economic concepts, this represents an agency cost of intermediation,[179] but at first blush, the social welfare implications are ambiguous. If, for instance, client demand pushes the Big Three to adopt policies that strongly advance public welfare (for example, by improving board diversity), the costs to shareholders may be outweighed by the benefits to others. Even so, questions remain about whether the stewardship groups at the Big Three are well-positioned to evaluate these tradeoffs.

2. Climate Risk

The Big Three have also adopted rules that push portfolio companies to address climate change by reducing carbon emissions and enhancing disclosures related to their environmental impact. As with board diversity, the Big Three were not the first private actors to take action in this space. For example, in 2015, the pension fund CalPERs began to focus on climate change after assessing the carbon impact of their portfolio companies.[180] By 2018, CalPERs had rallied other investors to launch Climate Action 100+, a group of asset managers that pledged to influence the largest carbon emitters in their portfolio.[181]

Although the Big Three had discussed the investment risks created by climate change for years,[182] they waited until 2020 to commit to using their

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stakeholders, its investments may benefit not only its stakeholders but may also result in increased shareholder wealth); Jeroen Derwall, Nadja Guenster, Rob Bauer & Kees Koedijk, *The Eco-Efficiency Premium Puzzle*, FIN. ANALYSTS J., Mar./Apr. 2005, at 51, 52-53 (suggesting that environmental responsibility may increase company profits); Kuldeep Singh & Madhvendra Misra, *Linking Corporate Social Responsibility (CSR) and Organizational Performance: The Moderating Effect of Corporate Reputation*, 27 EUR. RSCH. ON MGMT. & BUS. ECON. 1, 5-8 (2021) (finding that corporate responsibility can increase company performance).

179 *Cf.* Bebchuk et al., *supra* note 28, at 108 (describing agency problems associated with investment intermediaries).

180 *See Climate Change*, CALPERS, https://www.calpers.ca.gov/page/investments/sustainable-investments-program/climate-change [https://perma.cc/E5ZD-AUKU] (choose "Engagement" tab) (describing the origins of the Climate Action 100+ initiative).

181 *See* CLIMATE ACTION 100+, https://www.climateaction100.org [https://perma.cc/6P3R-MGMY] ("Global Investors Driving Business Transition . . . .").

182 BlackRock and State Street had issued reports discussing the risks to asset managers from climate change in 2015, but did not discuss taking steps to force portfolio companies to address them. *See* STATE ST. GLOB. ADVISORS, STATE STREET 2015 CORPORATE RESPONSIBILITY REPORT 49 (2015),

governance heft to address this issue. Specifically, BlackRock CEO Larry Fink dedicated his 2020 CEO letter to climate issues, stating that BlackRock was asking portfolio companies to

> (1) publish a disclosure in line with industry-specific [Sustainability Accounting Standards Board] guidelines by year-end . . . and (2) disclose climate-related risks in line with the [Task Force on Climate-related Financial Disclosures's] recommendations . . . . This should include your plan for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is fully realized . . . .[183]

The letter then informed portfolio company CEOs (in bold type): "[W]e will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[184]

In sum, in this letter, BlackRock issued important regulatory mandates. The asset manager specified three different forms of disclosure that portfolio companies would need to comply with: how they contribute to climate change, how climate change could affect their business, and operational plans in compliance with Paris Agreement goals. Importantly, BlackRock also specified the standards for such disclosure, picking winners in an increasingly crowded space. The asset manager then committed to enforcing these requirements through its voting practices.[185]

State Street and Vanguard followed suit shortly thereafter. In 2020, State Street (along with BlackRock) joined Climate Action 100+, and each of the Big Three joined the Net Zero Asset Managers initiative, which binds asset managers to supporting the goal of net zero greenhouse gas emissions by 2050

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https://www.statestreet.com/content/dam/statestreet/documents/values/StateStreet_2015_CR_Report.pdf [https://perma.cc/P8DM-SVF4] ("While climate change isn't a major risk to our operations right now, we identified certain risks and mitigation strategies primarily involving strategic and reputational risk."); *see also* BLACKROCK INV. INST., THE PRICE OF CLIMATE CHANGE: GLOBAL WARMING'S IMPACT ON PORTFOLIOS 2 (Oct. 2015), http://blueandgreentomorrow.com/wp-content/uploads/2015/11/The-Price-of-Climate-Change-BlackRock.pdf [https://perma.cc/R5P3-3LHH] (noting that climate change risk is an investment issue). By contrast, Vanguard first mentioned climate change risks in 2018. Vanguard, *ESG, SRI, and Impact Investing, A Primer for Decision-Making*, NEW CAPITAL (Aug. 15, 2018), https://www.newcapitalmgmt.com/news/esg-sri-impact-investing [https://perma.cc/334V-VRN4].

183 Fink, *supra* note 17.

184 *Id.*

185 Lest portfolio companies think that its positions were temporary, BlackRock subsequently recommitted to enforcing these precepts. *See* Letter from BlackRock Global Exec. Comm. to BlackRock Clients, https://www.blackrock.com/corporate/investor-relations/2021-blackrock-client-letter [https://perma.cc/D68A-HW76] ("Asking companies to disclose a business plan aligned with the goal of limiting global warming to well below 2ºC, consistent with achieving net zero global greenhouse gas emissions by 2050 . . . .").

or sooner.[186] As part of this goal, each asset manager promised to use their engagement and voting practices to promote emissions reductions by portfolio companies.[187] In addition, State Street published a letter in 2020 stating that it would incorporate a firm's R-Factor (or performance of the company's business and governance across various ESG issues, based on the SASB framework for disclosure) into its voting decisions.[188] In turn, Vanguard emphasized climate disclosure and emissions reduction in 2020, albeit less forcefully than State Street and BlackRock. In its investment stewardship annual report, the asset manager stated: "Where climate change is a material risk, Vanguard encourages companies to set and disclose targets that align with [Paris Agreement] goals, and to both assess and communicate their progress."[189]

Although studies of the Big Three's voting policies suggest that many of their early climate commitments were empty rhetoric, 2020 marked a turning point.[190] During the 2020 proxy season, BlackRock supported a record number of climate-related shareholder proposals—297 (or 35%), compared to 155 (or 17%) the previous year.[191] The asset manager also voted against the election of 255 directors because of concerns about their company's performance on climate issues, up from 55 the previous year.[192] State Street likewise supported its commitments through voting: in 2020, the asset

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186 Mark Segal, *State Street Global Advisors Joins Net Zero Asset Managers Initiative*, ESG TODAY (Apr. 21, 2021), https://www.esgtoday.com/state-street-global-advisors-joins-net-zero-asset-managers-initiative [https://perma.cc/4Y7X-944D]; *see also BlackRock Joins Climate Action 100+ to Ensure Largest Corporate Emitters Act on Climate Crisis*, CLIMATE ACTION 100+ (Jan. 9, 2020), https://www.climateaction100.org/news/blackrock-joins-climate-action-100-to-ensure-largest-corporate-emitters-act-on-climate-crisis [https://perma.cc/BVS9-TFQN].

187 Segal, *supra* note 186.

188 Letter from Cyrus Taraporevala, President and CEO, State St. Glob. Advisors, to Board Members (Jan. 28, 2020), https://www.ssga.com/library-content/pdfs/insights/CEOs-letter-on-SSGA-2020-proxy-voting-agenda.pdf [https://perma.cc/2FQG-SBXF].

189 VANGUARD, *supra* note 93, at 11.

190 *See* Caleb N. Griffin, *Environmental and Social Voting at the Big Three*, THE CLS BLUE SKY BLOG (June 16, 2020), https://clsbluesky.law.columbia.edu/2020/06/16/environmental-and-social-voting-at-the-big-three [https://perma.cc/6MD5-DXEA] (discussing the Big Three's low support for ESG shareholder proposals before 2020); Eric Rosenbaum, *Activists Thought BlackRock, Vanguard Found Religion on Climate Change. Not Anymore*, CNBC (Oct. 16, 2019, 8:50 AM), https://www.cnbc.com/2019/10/13/blackrock-vanguard-found-religion-on-climate-doubts-are-growing.html [https://perma.cc/GRP4-7HEP] (describing BlackRock and Vanguard's voting records on climate shareholder proposals).

191 Cydney Posner, *BlackRock Flexes Its Muscles During the 2020-21 Proxy Period*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 16, 2021), https://corpgov.law.harvard.edu/2021/08/16/blackrock-flexes-its-muscles-during-the-2020-21-proxy-period [https://perma.cc/6CPG-ZDHW]; *see also* BLACKROCK, PURSUING LONG-TERM VALUE FOR OUR CLIENTS, BLACKROCK INVESTMENT STEWARDSHIP 16 (2020), https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf [https://perma.cc/6KA5-HVQ9] (discussing BlackRock's commitment to climate change).

192 Posner, *supra* note 191.

manager stated that it voted against entire boards at companies that were "laggards" in terms of their R-Factor score, and also supported a record number of shareholder proposals that asked companies to report on the risks of climate change to their business and disclose their plan to address these risks.[193] In addition, Vanguard supported a number of shareholder proposals related to climate disclosure in the 2020 proxy season.[194] As a result of this increased support from the world's largest asset managers, climate-related shareholder proposals received greater shareholder backing than ever before: the average support level for climate proposals during the 2020 proxy season was 31.6% (up from 24.1%), and four proposals received majority support (none did in 2019).[195]

There is also evidence suggesting that these efforts have been effective at encouraging portfolio companies to improve disclosures and reduce emissions. One empirical study found that the Big Three generally target the highest emitting companies in their portfolio for engagements, and there is a strong negative association between Big Three ownership and subsequent carbon omissions.[196] Companies have also increased climate disclosure during the time period that the Big Three have focused their efforts on promoting it.[197] Of course, the Big Three were not alone in pushing for disclosure, but many companies credit the asset managers' mandates as a substantial reason for their compliance.[198]

193 Press Release, State St. Glob. Advisors, *supra* note 93.

194 VANGUARD, *supra* note 93, at 14-19.

195 Matteo Tonello, *2021 Proxy Season Preview and Shareholder Voting Trends (2017-2020)*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2021), https://corpgov.law.harvard.edu/2021/02/11/2021-proxy-season-preview-and-shareholder-voting-trends-2017-2020 [https://perma.cc/F7Q8-X2N9].

196 Azar et al., *supra* note 19, at 675. Note, however, that this evidence does not establish causation.

197 *See* Marc S. Gerber, Caroline S. Kim & Jeongu Gim, *Enhancing Disclosure Controls and Procedures Relating to Voluntary Environmental and Social Disclosures*, SKADDEN (June 29, 2021), https://www.skadden.com/insights/publications/2021/06/enhancing-disclosure-controls-and-procedures [https://perma.cc/W38B-FJEY] ("The percentage of S&P 500 companies publishing sustainability or corporate social responsibility (CSR) reports that address E&S matters continues to grow, reaching 90% in 2019. Similarly, one study found that, in 2020, 98% of the top 100 companies by revenue in the United States reported on their sustainability efforts.").

198 *See* Catherine M. Clarkin, Melissa Sawyer & Joshua L. Levin, *The Rise of Standardized ESG Disclosure Frameworks in the United States*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 22, 2020), https://corpgov.law.harvard.edu/2020/06/22/the-rise-of-standardized-esg-disclosure-frameworks-in-the-united-states [https://perma.cc/Y4PQ-U33Q] ("[P]ublic companies are facing mounting pressure from investors—including [from] influential institutional investors such as BlackRock, Vanguard and State Street, which have indicated in public statements in the past year that they are in support of companies making ESG disclosures . . . ."); *see also* Coffee, *supra* note 38, at 68 (describing voluntary ESG disclosures as being driven in the U.S. by pressure from large institutional investors).

As with the previous example, these policies—mandating progress on climate issues, assessing results, and penalizing noncompliance—constitute regulatory action. And these policies brought about change where other measures fell short. Indeed, the Big Three appear to have taken action in the climate space *because of* a public regulatory shortfall. Early on, Fink referred to "government[] failing" when discussing BlackRock's ESG governance policies.[199] Later, in his 2020 CEO letter, Fink discussed how BlackRock would seek to enforce compliance with the Paris Climate Agreement, even after former President Trump withdrew from it.[200] In addition, the Big Three's effort to promote disclosure and mandate uniform ESG reporting pursuant to the Task Force on Climate-Related Financial Disclosures and SASB metrics comes as the SEC grapples with this issue.[201] Although the agency has proposed climate disclosure rules,[202] there are many roadblocks ahead, including threatened legal challenges.[203] As a result, action by private actors may continue to be necessary. As Fink stated in his 2021 letter: "Because better sustainability disclosures are in companies' as well as investors' own interests, I urge companies to move quickly to issue them rather than waiting for regulators to impose them."[204] He also made clear that his expectation extended beyond the public companies in which BlackRock is

199 *See* Fink, *supra* note 1 (stating that due to government failure to prepare for the future, private companies need to fill the gap).

200 *See* Fink, *supra* note 17; *see also* Rebecca Hersher, *U.S. Officially Leaving Paris Climate Agreement*, NAT'L PUB. RADIO (Nov. 3, 2020), https://www.npr.org/2020/11/03/930312701/u-s-officially-leaving-paris-climate-agreement [https://perma.cc/4UYL-ZAQJ] (reporting that the United States was leaving the Paris Climate Agreement under former President Trump). This example showcases some of the ramifications for democracy wrought by this novel regulatory dynamic. Fink—the CEO of a for-profit asset manager—essentially overrode the authority of the government official who was constitutionally charged to make these decisions.

201 In 2010, the SEC approved a directive explaining that issuers may have climate reporting obligations under the existing materiality framework but did not provide any framework to guide them. Comm'n Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release Nos. 33-9106, 34-61469, 35 Fed. Reg. 62,290 (Feb. 8, 2010), https://www.sec.gov/rules/interp/2010/33-9106.pdf [https://perma.cc/7TBB-VC9D]. This absence of a framework "empower[ed] market forces to shape the disclosure process . . . ." Julian Nyarko & Eric Talley, *Corporate Climate: A Machine Learning Assessment of Climate Risk Disclosures*, UNIV. OF OXFORD, FAC. OF L. (Sept. 13, 2021), https://www.law.ox.ac.uk/business-law-blog/blog/2021/09/corporate-climate-machine-learning-assessment-climate-risk [https://perma.cc/3LMJ-MRKC].

202 *See* Press Release, U.S. Sec. & Exc. Comm'n, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/XXC4-KBRV] (proposing climate disclosure rules).

203 *See, e.g.*, John Gardella, *SEC Greenhouse Gas Rule – Legal Challenges Ahead*, NAT'L L. REV. (Apr. 6, 2022), https://www.natlawreview.com/article/sec-greenhouse-gas-rule-legal-challenges-ahead [https://perma.cc/5H6S-38TS] (describing possible legal challenges to the proposed SEC climate disclosure rules).

204 Fink, *supra* note 17.

a major investor: "If we want these disclosures to be truly effective—if we want to see true societal change—they should be embraced by large private companies as well."[205]

Why did the Big Three take the lead in mandating corporate disclosure of climate risk? The asset managers claim that these regulatory policies minimize investment risk, and researchers have offered related explanations, contending that such action reduces portfolio-wide externalities or systematic risk.[206] Although these benefits may be a byproduct of their actions, they are unlikely to be the primary drivers because the Big Three are not well-equipped to tackle portfolio-wide externalities or systematic risk created by climate change. The Big Three are forced, due to their business models, to adopt governance solutions that can be implemented at scale and enforced cheaply.[207] Reducing systematic risk caused by climate change, however, is a complicated and highly contested project, and one that is unlikely to lend itself to a low-cost approach. Instead, there would presumably be substantial variation from company to company, requiring firm-specific research and an understanding of how the company's operations contribute to climate change, as well as the path forward that would reduce it. Some of the Big Three's policies may be designed to ferret out this information for more sophisticated parties, who can then bring shareholder proposals or even proxy contests to put pressure on the worst offenders, but even then, it is costly for the governance team to determine whether to support management or the shareholder activist.[208] In addition, because the "green" shareholder activist

205 *Id.* As this example shows, the Big Three's regulatory policies also seek to influence private companies, although they tend to hold smaller stakes in such companies and are therefore likely to be less influential.

206 *See generally* Gordon, *supra* note 26; Condon, *supra* note 36.

207 Gordon, *supra* note 26.

208 Consider the recent proxy fight by Engine 1 at Exxon Mobil as an example. In this fight, Engine 1, a small upstart green activist fund (which had never before waged a proxy contest), successfully seated three directors at Exxon Mobil despite holding only .02% of its shares. Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021) https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html [https://perma.cc/5PYS-7L2V]. This example represents the "green" version of the dynamic described by Ronald Gilson and Jeffrey Gordon, where sophisticated and informed investors tee up proposals for large and "rationally reticent" mutual fund blockholders to support (or not). Gilson & Gordon, *supra* note 28, at 897. However, this example also shows the challenges that the Big Three face when deciding to support a green activist or management. Engine 1 submitted an eighty-two-page presentation containing its arguments, and yet commentators noted that its plans for the company lacked much in the way of substance, as well as experience. *See* Katherine Dunn & Sophie Mellor, *ExxonMobil Faces Historic Loss in Proxy Shareholder Battle Over Future of Its Board*, FORTUNE (May 26, 2021, 12:57 PM), https://fortune.com/2021/05/26/exxonmobil-agm-landmark-vote-shareholders [https://perma.cc/5EDF-F95X] ("Many onlookers, however, reacted to the plan with skepticism, noting a lack of concrete detail in the initial announcement."). In contrast, Exxon was "blanketing its shareholders with letters defending its performance." Steven Mufson, *The Fight For the Soul—and the Future—of ExxonMobil*, WASH. POST (May 22, 2021, 7:00 AM)

should anticipate that the target company's share price will fall in the wake of the campaign, such campaigns are unlikely to attract sophisticated parties to lead them.[209]

The more likely explanation for policies mandating ESG disclosure and targeting high carbon emitters is that these policies maximize support from the Big Three's clients.[210] Recall that the pension fund CalPERS—a client with nearly $400 billion in AUM[211]—sought greater environmental action by asset managers for years before the Big Three became involved. In addition, as other researchers have explored, individual investors are increasingly seeking out funds that promise environmental activism.[212] Even the United

https://www.washingtonpost.com/climate-environment/2021/05/21/exxon-faces-shareholder-revolt-over-climate-change [https://perma.cc/PP5U-HBC9]. The Big Three were forced to choose between supporting lackluster management and believing its pledges to improve on climate and other issues or supporting an activist that was green in more ways than one. Even assuming that the Big Three's only objective was enhanced welfare for Exxon shareholders, the decision would have been a challenging one. *See* Hemang Desai, Shiva Rajgopal & Sorabh Tomar, *Is an Activist Hedge Fund's Climate-Linked Coup of Exxon's Board Simply a Case of 'Greenwashing'?*, MARKETWATCH (June 8, 2021, 1:54 PM), https://www.marketwatch.com/story/is-an-activist-hedge-funds-climate-linked-coup-of-exxons-board-simply-a-case-of-greenwashing-11623103432?mod=article_inline [https://perma.cc/33JA-7BHN] (describing the difficult decision for shareholders given Exxon's poor performance and the lack of specificity in Engine 1's plans). But it is a far more difficult task to predict which course of action, supporting management or the activist, would better reduce risk-adjusted portfolio returns, especially for an institution that is generally cost-constrained and limited in the amount of time and resources it can devote to any given proposal. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 43, at 854 (discussing the incentive limitations of index funds); *see also* Bebchuk & Hirst, *supr*a note 115, at 721 (discussing the incentive limitations of index fund portfolio managers).

209 *See* Coffee, *supra* note 38, at 7 (contending that diversified investors should be reluctant to lead systematic risk proxy campaigns). Corporate fiduciaries will also be disinclined to implement proposals that require the targeted firm's stock price to take a hit. *See* Marcel Kahan & Edward Rock, *Systematic Stewardship with Tradeoffs* 3 (N.Y. Univ. Sch. of L., Working Paper, Paper No. 22-01, 2021) (discussing the limited extent to which universal owners will be willing to push a firm to sacrifice profit to reduce externalities).

210 Note that the voting records of the Big Three are also in conflict with a systematic stewardship theory. *See* Marie Brière, Sébastien Pouget & Loredana Ureche-Rangau, Do Universal Owners Vote to Curb Negative Corporate Externalities? An Empirical Analysis of Shareholder Meetings 3 (Oct. 1, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3403465 [https://perma.cc/WN68-DVTW] (showing that universal owners' support for issues related to externalities is lower than that of rival funds).

211 CALPERS, INVESTMENT & PENSION FUNDING: FACTS AT A GLANCE FOR FISCAL YEAR 2019-20 1 (2021), https://www.calpers.ca.gov/docs/forms-publications/facts-investment-pension-funding.pdf [https://perma.cc/7SVX-QPBM].

212 *See* Barzuza et al., *supra* note 6, at 1250 (describing how individual investors, and millennial investors in particular, are seeking out investment vehicles that are consistent with their values). Indeed, BlackRock and Vanguard were each targeted by their own shareholders that submitted proposals asking them to tackle climate issues in 2020. Attracta Mooney, *Biggest Asset Managers Attacked Over Role in Climate Change*, FIN. TIMES (Jan. 11, 2020), https://www.ft.com/content/8aade207-09bc-41a7-9f0a-24417882f1bc [https://perma.cc/6NDW-8RSB].

States government under the Biden administration has pressured banks to mitigate the financial risks created by climate change,[213] which indicates that this important client (and source of regulatory constraint of the Big Three's activities) would likely welcome the Big Three's regulatory action.[214]

What about the Big Three's corporate clients? At first blush, one might suppose that corporate America would oppose mandates requiring them to engage in costly disclosure or take steps to curtail their emissions. But a closer look suggests that these mandates are calibrated to generate support from the broader business community, too. Regarding emissions, the Business Roundtable issued a statement in 2020 supporting the goals of the Paris Climate Agreement, and business leaders have subsequently urged the Biden administration to push companies to curtail emissions.[215] There are a few reasons why the business community might broadly support limits on emissions, especially when they are enacted by asset managers.[216] In particular, carbon emissions are heavily concentrated in the market: as CalPERs has explained, "out of the 10,000+ companies within our portfolio, only 80 companies were found responsible for 50 percent of the portfolio's [greenhouse gas] emissions."[217] In other words, only a handful of companies would be affected by (and therefore, strongly oppose) a policy that targets the highest emitters in the Big Three's portfolios.[218] For the rest of the portfolio, reducing emissions might not hurt, and could even save them money over

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213 Pete Schroeder, *Fed Privately Presses Big Banks on Risks from Climate Change*, REUTERS (May 13, 2021, 7:00 AM), https://www.reuters.com/business/sustainable-business/exclusive-fed-privately-presses-big-banks-risks-climate-change-2021-05-12 [https://perma.cc/YHZ4-WTU9].

214 *Id.* Foreign governments that also constitute clients of the Big Three have been pushing private actors to take action to reduce climate risk for years. *See Sustainable Finance*, EUR. COMM'N, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en [https://perma.cc/TQR2-Z5LK] ("The EU is examining how to make sustainability considerations an integral part of its financial policy in order to support the European green deal . . . .").

215 *See* BUS. ROUNDTABLE, ADDRESSING CLIMATE CHANGE: PRINCIPLES AND POLICIES, https://s3.amazonaws.com/brt.org/Business-RoundtableAddressingClimateChangeReport.September2020.pdf [https://perma.cc/S9A4-C47D]; *see also* Lisa Friedman, *Executives Call for Deep Emissions Cuts to Combat Climate Change*, N.Y. TIMES (Apr. 19, 2021), https://www.nytimes.com/2021/04/13/climate/business-executives-climate-change.html [https://perma.cc/43HW-GDY5] (reporting that more than 300 businesses have pushed for reduced carbon emission targets).

216 In particular, asset manager regulation may enable industries to secure rules that solve collective action problems or a prisoner's dilemma, without the same liability concerns associated with government regulation.

217 *Climate Change*, CALPERS, https://www.calpers.ca.gov/page/investments/sustainable-investments-program/climate-change [https://perma.cc/E5ZD-AUKU] (Apr. 14, 2022).

218 *See* Azar et al., *supra* note 19, at 675 (showing that the Big Three target the highest emitters in their portfolio for engagements). As will be discussed, even those high emitting companies might support regulation by asset managers if that regulation was likely to prevent more intrusive government regulation.

time (for example, improving the energy efficiency of buildings generally pays for itself in a matter of years).[219]

Of course, the same is not true of ESG disclosure—as Fink made clear, BlackRock's expectation is that all public and private firms will comply with their mandate, and disclosure is costly and exposes firms to legal risks. Why might corporate America broadly support these efforts? There are a few possibilities. First, as with board diversity, companies increasingly face pressure to disclose their environmental practices from consumers, regulators, employees, and shareholders.[220] Therefore, firms that have been pushed to disclose ESG information might prefer a blanket rule that requires rivals to also invest in costly disclosure that subjects them to scrutiny and risk.[221] A second and related reason is that mandated disclosure, like other forms of regulation, can serve as a barrier to entry: large and profitable companies can afford to invest in costly disclosure more easily than small ones, and so those companies will favor policies that harm smaller entrants.[222]

A third and final reason why corporate America might broadly support ESG disclosure regulation by institutional shareholders is that it is preferable to regulation by the government. If asset managers demand ESG disclosure and the market broadly complies, the risk of government intervention may be reduced.[223] As then-SEC General Counsel John Coates explained, a

219 *See, e.g.*, *Leading Companies Cut Supply Chain Emissions, Save Money*, UNITED NATIONS FRAMEWORK CONVENTION ON CLIMATE CHANGE (Jan. 29, 2018), https://unfccc.int/news/leading-companies-cut-supply-chain-emissions-save-money [https://perma.cc/43CZ-GCHK] (demonstrating that emissions cuts can save money).

220 *See* Kristin Broughton & Mark Maurer, *Companies Could Face Pressure to Disclose More ESG Data*, WALL ST. J. (Dec. 6, 2020), https://www.wsj.com/articles/companies-could-face-pressure-to-disclose-more-esg-data-11607263201 [https://perma.cc/EH5S-AXR3] (discussing the pressure that companies face not only from shareholders, but also from employees, regulators, and even the Biden administration).

221 For a political economy discussion of how mandatory securities disclosure laws have survived, see generally Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

222 *See* Leora Klapper, Luc Laeven & Raghuram Rajan, *Entry Regulation as a Barrier to Entrepreneurship* 3-4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 10380, 2004), https://www.nber.org/system/files/working_papers/w10380/w10380.pdf [https://perma.cc/VY5N-8CKR] (finding that costly regulations hamper the creation of new firms in Europe and force new entrants to be larger); *see also* Lloyd Dixon, Susan M. Gates, Kanika Kapur, Seth A. Seabury & Eric Talley, *The Impact of Regulation and Litigation on Small Business and Entrepreneurship: An Overview* 1–2 (RAND Inst. for Civ. Just., Working Paper No. WR-317-ICJ, 2006), https://www.rand.org/content/dam/rand/pubs/working_papers/2006/RAND_WR317.pdf [https://perma.cc/P8YF-W8T9] ("[T]he cost of complying with a particular regulation may be roughly comparable for smaller and larger firms, thus placing a disproportionate burden on the smaller firm.").

223 *See* Neil Bradley, *U.S. Chamber of Commerce Comment Letter on the Shareholder Political Transparency Act & Workforce Investment Disclosure Act*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 1, 2020), https://corpgov.law.harvard.edu/2020/03/01/u-s-chamber-of-commerce-comment-

primary reason for mandatory ESG disclosure is the lack of "consistent, comparable, and reliable ESG information available upon which to make informed investment and voting decisions."[224] This statement suggests that if the SEC thought the market was moving to standardize disclosure on its own, the rationale for regulatory intervention would be weakened. In fact, in a comment letter to the agency regarding a proposed ESG disclosure rule, the Chamber of Commerce—the largest business organization in the U.S.—argued that the existing voluntary approach was working quite well.[225]

Even if the government was to intervene in this space, which appears inevitable at this point, companies may believe that those rules may be influenced or even coopted by the approach taken by private actors.[226] Indeed, in its comment letter to the SEC regarding ESG disclosure, the Business Roundtable, another influential business association, requested that companies that have been producing ESG information pursuant to the Big Three's mandate be permitted to stay the course.[227] And there are reasons to

letter-on-the-shareholder-political-transparency-act-workforce-investment-disclosure-act [https://perma.cc/F75M-FRLS] (stating that voluntary disclosure would be the preferred approach over specific line-item disclosures through government regulation); *see also* Bebchuk & Hirst, *supra* note 115, at 2037 (arguing that the Big Three's governance activism seeks to forestall regulatory activity into their governance efforts). This can also be a goal of self-regulation. *See* John W. Maxwell, Thomas P. Lyon & Steven C. Hackett, *Self-Regulation and Social Welfare: The Political Economy of Corporate Environmentalism*, 43 J.L. ECON. 583, 587 (2000) (discussing how the threat of government regulation encourages self-regulation).

224 John Coates, *ESG Disclosure—Keeping Pace with Developments Affecting Investors, Companies, and the Capital Markets*, SEC. EXCH. COMM'N (Mar. 11, 2021), https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121 [https://perma.cc/FX95-L7UV].

225 Specifically, the Executive Vice President for the Center for Capital Markets Competitiveness at the Chamber of Commerce stated that:

> The Chamber recognizes the increased interest in disclosure related to ESG information . . . . The number of companies that voluntarily publish annual sustainability reports has grown significantly, reflected in the fact that more than 90% of S&P 500 Index companies publish such reports, over a four-fold increase in the past decade.

Letter from Tom Quaadman, Exec. Vice President, Ctr. for Capital Mkts. Competitiveness, to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (June 11, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8907271-244249.pdf [https://perma.cc/7LXZ-4R3A]. However, many contend that the current voluntary framework is "not useful for investors or other decision-makers." BLOOMBERG, IMPACT REPORT UPDATE 2015, at 2 (2015), https://data.bloomberglp.com/sustainability/sites/6/2016/04/16_0404_Impact_Report.pdf [https://perma.cc/9WEZ-NWMX].

226 *See* John T. Scholz & Cheng-Lung Wang, *Cooptation or Transformation? Local Policy Networks and Federal Regulatory Enforcement*, 50 AM. J. POL. SCI. 81, 81 (2006) ("[D]ecentralized processes [can] create autonomous policy networks that can resist central guidance . . . and coopt authoritative institutions of governance . . . ." (citations omitted)).

227 Letter from Business Roundtable to Hon. Gary Gensler, Chair of U.S. Sec. & Exch. Comm'n (June 11, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8906771-244124.pdf [https://perma.cc/7J6H-HS6M].

believe that the approach taken by the Big Three—enforcing disclosure under the SASB standards—is a lighter touch than might otherwise be required. Regarding the alternative set of Global Reporting Initiative (GRI) standards that are prevalent in other countries, the founder of SASB explained, "[w]e consider ourselves the floor and GRI more of the ceiling. In other words, we're *the minimum set of things that are highly material* and would be recognized as such by the SEC . . . ."[228]

As with board diversity, the Big Three's policies on climate change appear to be shaped by client demand, and this insight tells us something about the policies' substance. In addition, this example showcases pitfalls with the asset manager regulatory dynamic, including that government policy may be coopted or preempted. I will return to this possibility in the next Part.

3. Counterexamples

The previous subsections discussed the Big Three's regulatory efforts in two discrete areas: averting climate change and improving board diversity. They theorized that these regulatory policies are designed to maximize support from existing and prospective clients, rather than minimize externalities or systematic risk across the portfolio. In this subsection, I discuss areas in which the Big Three have not adopted regulatory policies as further support for my theory.

One important area of abstention is the regulation of corporate political spending. A primary motivation for corporate political spending and lobbying is rent-seeking—i.e., using assets to seek regulatory transfers, rather than putting them to productive uses.[229] As just one example, over the past few decades, oil and gas companies have spent substantial sums influencing regulators and undermining environmental regulation that would force those companies to internalize externalities that harm society.[230] This reality should

228 Kathleen Hertz Rupley, Darrell Brown & Scott Marshall, *Evolution of Corporate Reporting: From Stand-Alone Corporate Social Responsibility Reporting to Integrated Reporting*, 29 RSCH. ACCT. REGUL. 172, 173 (2017) (emphasis added) (quoting Jean Rogers, Founder & Exec. Dir. of SASB).

229 *See* Richard L. Hasen, *Lobbying, Rent-Seeking, and the Constitution*, 64 STAN. L. REV. 191, 229-31 (2012); *see also* JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY 32 (2012) (explaining the concept of rent seeking and its inefficiencies); John Coates, *Corporate Speech and the First Amendment: History, Data, and Implications*, 30 CONST. COMMENT. 223, 224 (2015) (arguing that half of First Amendment challenges benefit business corporations and trade groups, which use these lawsuits as a form of rent seeking to advance their self-interest at the expense of shareholders, consumers, and employees). For a nuanced discussion of how corporations participate in the political process, see generally Jill Fisch, *How Do Corporations Play Politics?: The Fedex Story*, 58 VAND. L. REV. 1495 (2005).

230 *See, e.g.*, Chris McGreal, *How a Powerful US Lobby Group Helps Big Oil to Block Climate Action*, GUARDIAN (July 19, 2021, 6:00 AM), https://www.theguardian.com/environment/2021/jul/19/big-oil-climate-crisis-lobby-group-api

be a first-order concern to any asset manager that is seeking to minimize externalities and reduce systematic risk created by climate change. Put somewhat differently, if the Big Three were calibrating their governance efforts to best reduce the risk of climate change, we would expect them to not just urge companies to reduce emissions, but also to push them to disclose and even restrict corporate political expenditures aimed at thwarting public regulatory action in the climate space.

But this is not what we see. As Leo Strine, the former Chief Justice of the Delaware Supreme Court, has explained, the Big Three "have opted for a policy of total deference to management" on political spending issues.[231] In general, the Big Three rarely support shareholder proposals that urge management to disclose corporate political spending, a particularly tepid approach taken by shareholders that seek limits on corporate political activity.[232] In 2018, Vanguard did not support a single political spending disclosure proposal, while BlackRock supported 4.1%.[233] In the 2020 proxy season, BlackRock and Vanguard supported zero out of forty-eight

[https://perma.cc/Z5GW-HNWF] (providing a history and general overview of the American Petroleum Institute (API) and its lobbying efforts to stall or weaken legislation); Niall McCarthy, *Oil & Gas Giants Spend Millions Lobbying to Block Climate Change Policies*, FORBES (Mar. 25, 2019), https://www.forbes.com/sites/niallmccarthy/2019/03/25/oil-and-gas-giants-spend-millions-lobbying-to-block-climate-change-policies-infographic/?sh=29bd350f7c4f [https://perma.cc/3BHW-JLBN] (describing oil companies' large lobbying expenditures meant to stymie environmental regulation); Timothy Puko & Ted Mann, *Washington's Oil Lobby Pivoted on Climate Change—and Made No One Happy*, WALL ST. J. (July 28, 2021, 10:54 AM), https://www.wsj.com/articles/api-oil-gas-lobby-reckoning-climate-change-11627484072 [https://perma.cc/X42X-6ABJ] ("[API] helped scuttle . . . the last ambitious attempt by Congress to limit greenhouse gas emissions by levying a cost on emissions."); Phoebe Keane, *How the Oil Industry Made Us Doubt Climate Change*, BBC NEWS (Sept. 20, 2020), www.bbc.com/news/stories-53640382 [https://perma.cc/A4DT-WX5D] (recounting the API's "campaign of deception" that partially rewrote the public narrative of climate change); Robert J. Brulle, *Institutionalizing Delay: Foundation Funding and the Creation of U.S. Climate Change Counter-Movement Organizations*, 122 CLIMATIC CHANGE 681, 684 (2014) (using IRS data to analyze the mobilization of financial resources by members of the climate change counter-movement). For a more recent example, see Jeff Brady, *Exxon Lobbyist Caught on Video Talking About Undermining Biden's Climate Push*, NAT'L PUB. RADIO (July 1, 2021, 11:37 AM), https://www.npr.org/2021/07/01/1012138741/exxon-lobbyist-caught-on-video-talks-about-undermining-bidens-climate-push [https://perma.cc/9TWX-CD55].

231 Strine, *supra* note 5, at 1019.

232 *See* CTR. FOR POL. ACCOUNTABILITY, CONFLICTED CONSEQUENCES 2 (2020), https://politicalaccountability.net/hifi/files/Conflicted-Consequences.pdf [https://perma.cc/P2H5-9S3C] (describing disclosure as the "minimum" companies should do); Dorothy S. Lund & Leo Strine, Jr., *Corporate Political Spending is Bad Business*, HARV. BUS. REV., Jan.-Feb. 2022, at 130, 136-37, https://hbr.org/2022/01/corporate-political-spending-is-bad-business [https://perma.cc/WA7A-WFVZ] (proposing steps companies can take to reign in corporate political spending).

233 *See* James McRitchie, *Support for Corporate Political Disclosure Surges*, CORP. GOVERNANCE (Nov. 29, 2018), https://www.corpgov.net/2018/11/support-for-corporate-political-disclosure-surges [https://perma.cc/5GDD-S282] (summarizing BlackRock's expressed support as compared to that of Vanguard). By contrast, State Street supported 39% of proposals—far less than other institutional investors, but well above BlackRock and Vanguard. *Id.*

proposals.[234] These positions were in marked contrast to the positions of other asset managers, which have generally increased their support for these proposals over the years.[235]

These policies and outcomes suggest that the Big Three act in response to client demand, and not out of principled concern about externalities or systematic risk. Because ESG disclosure and compliance with the Paris Agreement have strong support within the business community, and corporate political spending disclosure does not,[236] the Big Three have adopted regulatory policies on the former, rather than the latter. Their positions on corporate political spending also suggest another concern: the Big Three appear to enjoy exercising regulatory heft as a result of government dysfunction. Rather than using their power to alleviate rent-seeking by industry (which they also engage in),[237] they choose to maintain the status quo, which positions them to attract new clients and satisfy existing ones. Part III discusses this issue in greater detail.

Corporate political spending is not the only area in which the Big Three have failed to be proactive. For example, a concern for systematic risk and financial instability would suggest that the Big Three would be interested in adopting regulatory policies governing executive compensation.[238] It is well

234 *See* MAJORITY ACTION, EQUITY IN THE BOARDROOM: HOW ASSET MANAGER VOTING SHAPED CORPORATE ACTION ON RACIAL JUSTICE IN 2020 5 (2020), https://static1.squarespace.com/static/5d4df99c531b6d0001b48264/t/5fd841b950dc481b789a127e/1608008149955/MA_SEIU_EquityintheBoardroom2020.pdf [https://perma.cc/CL9L-A4WM] ("In 2020, 48 resolutions to improve corporate policy influence disclosures received more than 20% shareholder support across the S&P 500. BlackRock and Vanguard voted against every single one. At least 19 of these resolutions would have received majority support had BlackRock and/or Vanguard voted in favor."). In addition, BlackRock engaged with only two companies—Cintas (a company that manufactures products for businesses) and Origin (an energy company)—on their political support and spending activities. BLACKROCK, OUR 2021 STEWARDSHIP EXPECTATIONS 16-17 (2021), https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf [https://perma.cc/65H6-K4S4].

235 *See* Press Release, Ctr. for Pol. Accountability, 2020 Proxy Season Analysis Report 1, 6 (Dec. 23, 2020), https://politicalaccountability.net/hifi/files/2020-Proxy-Vote-Analysis-Report-CPA.pdf [https://perma.cc/7HBS-T8SF] (showing an overall increase in support for corporate political disclosure proposals by large asset managers in 2020).

236 *See, e.g.*, Letter from U.S. Chamber of Com. to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Jan. 4, 2013), https://www.sec.gov/comments/4-637/4637-1198.pdf [https://perma.cc/M66P-KMHU] (opposing an SEC rule that would have mandated corporate political spending disclosure).

237 *See* Hazel Bradford, *Public Funds Press BlackRock on Political Spending*, PENSIONS & INVS. (Jan. 26, 2021), https://www.pionline.com/governance/public-funds-press-blackrock-political-spending [https://perma.cc/ZFV9-4L6B] (discussing how public pension funds have called on BlackRock to reform its own corporate political spending practices and match the higher standards that BlackRock sets for other companies).

238 *See* Gordon, *supra* note 26, at 10 (arguing that asset managers concerned about systematic risk should be interested in mitigating it by focusing on executive compensation practices).

understood that executive compensation can incentivize risk taking;[239] for example, studies have linked banker pay packages at Bear Stearns and Lehman Brothers and the risky conduct that led to the 2008 financial crisis.[240] And yet, shareholders (including the Big Three) generally support executive pay packages when they are brought to a shareholder vote.[241] For example, in the 2021 proxy season, support levels for say-on-pay proposals averaged 93%, with only 3% of proposals failing to pass.[242] Even those few proposals that failed nonetheless garnered support from some of the Big Three.[243] Not only that, the Big Three's votes against executive pay appear to be driven by factors other than risk. For example, neither Vanguard nor State Street once mention incentives for risk taking in their proxy voting guidelines regarding executive compensation.[244]

The Big Three's voting record on golden parachutes is similarly inconsistent with a systematic risk reduction story. As Jeffrey Gordon has

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239 *See, e.g.*, Jin-Chuan Duan & Jason Wei, *Executive Stock Options and Incentive Effects Due to Systematic Risk*, 29 J. BANKING & FIN. 1185, 1207 (2005) ("For non-indexed stock options, CEOs always have an incentive to increase the systematic risk."); Chris Armstrong, Allison Nicoletti & Frank Zhou, *Executive Stock Options and Systemic Risk*, 146 J. FIN. ECON. 256, 274 (2022) ("[Bank executives' contractual incentives] cause[] managers to alter their lending, investing, and financing activities during economic expansions, resulting in greater systemic risk during economic contractions.").

240 Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE. J. ON REGUL. 257, 275 (2010) (describing how the executive compensation structure at Bear Stearns and Lehman Brothers created incentives for excessive risk taking).

241 *See* Davidson Health, Daniele Macciocchi, Roni Michaely & Matthew C. Ringgenberg, *Do Index Funds Monitor?*, 35 REV. FIN. STUD. 91, 96 (2021) (finding that increased index fund ownership is associated with worse executive pay performance sensitivity).

242 Marc Trevino, Jeanette Bander & June Hu, *2021 Proxy Season Review: Say on Pay Votes and Equity Compensation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 8, 2021), https://corpgov.law.harvard.edu/2021/09/08/2021-proxy-season-review-say-on-pay-votes-and-equity-compensation [https://perma.cc/AE4D-JUV6].

243 Rajeev Kumar, *How the Top 10 Investors Voted on Failed Say-on-Pay Proposals*, GEORGESON, https://www.georgeson.com/us/top-10-investors-votes-at-failed-say-on-pay-proposals [https://perma.cc/YPQ5-K9WW].

244 STATE ST. GLOB. ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES (Mar. 2022), https://www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guidelines-us-canada.pdf [https://perma.cc/982M-GQ99]; VANGUARD, INVESTMENT STEWARDSHIP 2021 ANNUAL REPORT (2021), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf [https://perma.cc/9BGH-EVRD]. BlackRock mentions the moral hazard created by executive pay packages only once in a four-page report summarizing its approach. *See* BLACKROCK, INVESTMENT STEWARDSHIP'S APPROACH TO EXECUTIVE COMPENSATION 2 (2020), https://www.blackrock.com/corporate/literature/publication/blk-commentary-our-approach-to-executive-compensation.pdf [https://perma.cc/73L2-FZWH] ("[W]e expect compensation committees to ensure that incentive plans do not incentivize excessive risk taking beyond the company's determined risk appetite and that rewards are reasonable in light of returns to shareholders.").

recognized, golden parachutes can "induce an inefficiently high level of mergers and acquisitions activity, which in turn imposes extra social stability risk through layoffs that produce 'synergy gains.'"[245] Despite these risks, BlackRock and Vanguard supported more than 90% of golden parachute proposals brought by management in the 2017 proxy season.[246]

Again, the Big Three's passive stance in an area that is strongly linked to systematic risk and social instability suggests that those concerns are not the primary driver for their regulatory activities. Instead, their policies appear to be shaped by client preferences. And additional examples abound. Consider how the Big Three did not take any position on employee mask mandates or vaccination policies during the Covid-19 pandemic, both of which would have strongly reduced market-wide risk.[247] The controversial nature of these policies, however, suggests that they are not a good candidate for regulatory intervention. Consider too, that the Big Three sometimes vote to support corporate inversions that allow companies to escape U.S. taxes and regulatory oversight.[248] Again, a principled concern about externalities and systematic risk would likely encourage them to take a different stance. That is not to say that any of these examples serves as conclusive proof about their motivations; indeed, each outcome could be motivated by different considerations. But the fact remains that my theory explains both what the Big Three do and what they fail to do, in contrast to others that have been offered.

C. *Why Regulation?*

The previous subsections described two regulatory areas that the Big Three have tackled, and several that they have neglected. These examples suggest that the Big Three act in response to client demand for regulatory policies in a way that maximizes client support for their activities. Fear of government scrutiny operates as a separate constraint and suggests that the Big Three will pursue policies that advance (or appear to advance) the public interest.

This Section explains why this activity can be considered "regulatory." As mentioned, the Big Three's marketwide interventions squarely fit within leading definitions of regulatory action. Although regulations can vary greatly

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245 Gordon, *supra* note 26, at 10-11.

246 Nick Dawson, *Poisoned Chalice? An Analysis of Investor Voting on Golden Parachutes*, HARV. L. SCH. F. ON CORP. GOVERNANCE, at tbl. 1 (Apr. 6, 2017), https://corpgov.law.harvard.edu/2017/04/06/poisoned-chalice-an-analysis-of-investor-voting-on-golden-parachutes [https://perma.cc/8FKH-JQBX]. The Big Three also generally support stock buybacks and M&A activity that are associated with short-term gains to shareholders. *See* Fichtner & Heemskerk, *supra* note 21, at 506-07.

247 *See generally* Rémy et al., *supra* note 41.

248 *See infra* note 295.

in their form of mandate and the consequence for non-compliance, they all share a set of common attributes: "All regulatory instruments consist of some rule or rule-like statement . . . backed up with some type of consequences."[249]

As this discussion reveals, an important component of regulation is that the normative force of the command be enforced with penalties. George Stigler memorably referred to this as "coercive power"—the fundamental asset that is in play when the government regulates.[250] When the regulator is an asset manager, the consequence for noncompliance is not a fine or tax, but instead, the risk of an adverse voting outcome, such as opposing a director's election or supporting a shareholder proposal. At first blush, these consequences seem far from coercive. Shareholder proposals rarely pass, and even when they do, they are nonbinding.[251] Not only that, directors are not required to step down when they fail to be reelected.[252]

In reality, though, no-votes come with consequences, and job loss in particular; research shows that votes against a director's re-election are significantly associated with a director's departure within the coming year.[253] Those no-votes can also result in spillover effects—for example, the director will be less likely to secure board positions at other companies.[254] Regarding shareholder proposals, strong levels of shareholder support force the company to, at the very least, take seriously the activist's position.[255] This reality is compounded by the voting positions of proxy advisors: for example, Institutional Shareholder Services (ISS) has committed to recommending

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249 Coglianese, *supra* note 8. Note that regulators need not be government entities. *Id.*; Rory Van Loo, *The New Gatekeepers: Private Firms as Public Enforcers*, 106 VA. L. REV. 467, 496-522 (2020) (describing how companies are enlisted to play a regulatory role); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 551-63 (2000) (describing the pervasiveness of private regulation in the modern regulatory environment); *see also* Black, *supra* note 8, at 104-05 (explaining the concept of decentered regulation, in which the government does not play a central role).

250 Stigler, *supra* note 59, at 6.

251 Doron Levit & Nadya Malenko, *Nonbinding Voting for Shareholder Proposals*, 66 J. FIN. 1579, 1579 (2011).

252 *See* Bo Becker & Guhan Subramanian, *Improving Director Elections*, 3 HARV. BUS. L. REV. 1, 13-14 (2013) (studying director elections and finding that many directors who fail to receive a majority of the votes cast in an election actually leave their boards).

253 Reena Aggarwal, Sandeep Dahiya & Nagpurnanand R. Prabhala, *The Power of Shareholder Votes: Evidence from Uncontested Director Elections*, 133 J. FIN. ECON. 134, 135 (2019).

254 *Id.* Even if directors with low levels of shareholder support remain on the board, they are often forced to leave prominent committees. *Id.* at 136.

255 *See* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 389 (2007) (showing that directors often implement demands by shareholders when proposals pass with majority support); Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 69 (2010) ("[W]e . . . find that the likelihood of implementation of [majority vote] proposals . . . is a function of the degree of shareholder pressure, as measured by the percentage of votes in favor of the proposal and the influence of the shareholders submitting and supporting the proposal.").

votes against directors based on their lack of "responsiveness" to shareholder proposals that receive majority support.[256] In sum, the risk of losing the Big Three's support provides ample coercive power.

In addition to their ability to impose penalties, the breadth of their influence over the market allows these asset managers to assume regulatory authority that is typically in the hands of large government agencies like the Environmental Protection Agency or the SEC. Like those government bodies, the Big Three adopt broad standards governing firm conduct, make judgments about compliance, and then bring enforcement actions using their voting power. But unlike those agencies, the scope of their rules is potentially unlimited—asset managers can adopt rules involving any subject matter and that target firms in any industry. Not only that, there are no procedural hurdles for the creation of rules, nor is there any opportunity for judicial review. In other words, the Big Three's regulatory power exceeds that of the typical government agency, despite a near total lack of oversight.

Before discussing these implications in detail, there is more to say about the Big Three's conduct as regulators. Although their policies on board diversity and climate were ultimately sweeping in their breadth and influence, they were not radical in terms of their timing or content. Regarding their content, the Big Three's policies have been tepid: by 2020, most people believed that a board should have at least one woman director and that companies have a role to play in averting climate change. The Big Three did not take bold positions on these issues, for example, by mandating that corporate boards be as diverse as their workforce. Instead, their modest policies were designed not to alienate clients. They were also designed to be consistent with the business model of these largely indexed asset managers. Specifically, the Big Three adopted marketwide standards that were either easily verifiable ("at least two female directors") or designed to ferret information to boost the activism of more engaged investors. That way, the Big Three, like resource-constrained enforcement agencies, have been better able to maximize their impact.

Relatedly, the Big Three were also late movers for both initiatives, waiting until general consensus among the public—and more importantly, their client base—evolved to embrace them before they acted. Interestingly, in both instances, one asset manager became a first mover, and the others followed shortly thereafter. This pattern suggests that once one institution has adopted

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256 INSTITUTIONAL S'HOLDER SERVS. (ISS), BOARD RESPONSE TO MAJORITY-SUPPORTED SHAREHOLDER PROPOSALS (US) 1, https://www.issgovernance.com/file/files/2014ISSDraftPolicyUSBoardResponsetoMajoritySupportedShareholderProposals.pdf [https://perma.cc/J9WM-EBWG]. Beyond these direct consequences, directors and management worry about alienating their largest investors out of the fear that they may become inclined to support activist investors.

a policy with broad client support, the costs of failing to adopt a similar policy are substantial. In particular, the risk of client loss to a rival asset manager looms large.

But this pattern also raises the question of what induces an asset manager to become a first mover and how the regulatory policies come to be. Although there is very little transparency surrounding their choice of policies, it appears that the Big Three take tentative steps before adopting rules. For example, regarding climate change, each of the Big Three issued public letters outlining the risks for companies and their expectations for improvement nearly six years prior to adopting rules.[257] Not only that, the more stringent mandates summarized in Fink's 2020 and 2021 CEO letters were preceded by soft engagements with companies on these issues for several years.[258] In other words, the Big Three spend years formulating and examining policies before adopting rules, testing out client and government reactions.

Of course, a necessary precondition for their action is government inaction. Regarding climate change, public regulatory inaction left space for regulatory action by others. Likewise, in the case of board diversity, slow and piecemeal action by states and private actors left opportunities for asset managers to become regulators. And given the Big Three's growing size and power and the continued demand for greater business regulation, this is unlikely to be the Big Three's only foray into a regulatory role.

III. IMPLICATIONS

This Part explores the implications of this private regulatory dynamic. It first compares asset manager regulation to other sources of private regulation and concludes that we are witnessing something new. It then sets forth the benefits and costs, beginning the difficult task of weighing the normative tradeoffs created by this regulatory dynamic.

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257 *See supra* note 182.

258 *See generally* BLACKROCK, 2019 INVESTMENT STEWARDSHIP ANNUAL REPORT (2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf [https://perma.cc/DPV5-SFWS] (presenting various case studies regarding BlackRock's engagement and stewardship efforts on environmental issues); BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP 2018 ANNUAL REPORT (Aug. 30, 2018), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf [https://perma.cc/VT6U-QK6H] (noting BlackRock's engagement on environmental issues). This observation leads to an additional implication: we can predict the Big Three's future areas of regulatory focus by looking at their soft engagements.

A. *What's Going on Here?: A Novel Privatization Dynamic*

Broadly, the Big Three's regulatory actions represent an example of "decentered" regulation—regulation that is produced privately, rather than by the government.[259] In this way, the dynamic represents a continuation of one that began in the 1980s, when the state's role as regulator began to diminish and "privately promulgated voluntary regimes . . . emerged in its place."[260] And although the intellectual support for privatization has receded somewhat in modern times,[261] it remains an important part of the policymaker's toolkit.[262] In the typical privatization dynamic, there is a shift in the production of goods and services from the public to private sector.[263] That shift can be deliberate, or it can be "demand-driven," which occurs when private actors emerge to provide services (like healthcare or education) that the government is not supplying.[264]

In addition to the ceding of government services to private entities, the 80s and 90s also brought about the increased acceptance of privatized *regulation*, where "a single member of a group of private entities makes or enforces rules that apply to the rest of that collective group."[265] Private regulators include industry associations (for example, the American Petroleum Institute, a private standard setting organization that adopts and enforces rules for the oil and gas industry[266]) and professional societies

259 Black, *supra* note 8, at 104-05.

260 Joel Bakan, *The Invisible Hand of Law: Private Regulation and the Rule of Law*, 48 CORNELL INT'L L.J. 279, 280 (2015); *see also* Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 676 (2010) (describing various schemes of "co-regulation" between public and private forces).

261 For an example of a recent critique of privatization, see Bakan, *supra* note 260.

262 *See, e.g.*, Brian Alexander, *Privatization Is Changing America's Relationship With Its Physical Stuff*, THE ATL. (July 12, 2017), https://www.theatlantic.com/business/archive/2017/07/infrastructure-private-public-partnerships/533256 [https://perma.cc/EU8F-K4LP] (describing the use of private vendors to complete infrastructure projects).

263 Paul Starr, *The Meaning of Privatization*, 6 YALE L. & POL'Y REV. 6, 14 (1988).

264 *Id.* at 15 (describing the difference between demand-driven and policy-driven privatization).

265 Saule T. Omarova, *Wall Street as a Community of Fate*, 159 U. PA. L. REV. 411, 426 (2011); *see also* Tim Büthe, *Private Regulation in the Global Economy: A (P)Review*, 12 BUS. & POLS. 1, 1 n.1 (2010) ("Private regulation in a broad sense entails private actors playing a major role [] at one or more stages beyond implementation or compliance . . . .").

266 *Standards*, AM. PETROLEUM INST., https://www.api.org/products-and-services/standards [https://perma.cc/R9DU-DDQ6].

(including those of lawyers and doctors).[267] They also include credit ratings agencies and other groups that supply important information for a fee.[268]

Certain providers of private regulation can further be categorized as "self-regulatory organizations." Self-regulation has many forms and definitions, but essentially, it represents "a regime of collective rule-making" "whereby an industry-level . . . organization sets rules and standards governing the behavior of the members of that industry and monitors and enforces compliance with the rules."[269] Sometimes the government is involved in oversight of the self-regulatory organization, but not always.[270] Ultimately, the difference between a self-regulatory organization and a private regulator is the degree to which the regulated party opts into the regime.[271]

As the previous Part made clear, the Big Three's regulatory activity is distinct from self-regulation because the affected companies have not agreed to be bound by their rules. Instead, the Big Three more closely resemble other private providers of rules, like credit rating agencies. Credit rating agencies perform a market regulatory function inadvertently: their goal is not to set standards for compliance, but given the consequences companies face when their debt is downgraded, their activity ultimately has that effect.[272] For this reason, credit rating agencies are subject to government oversight: for example, the Credit Rating Agency Reform Act of 2006 allowed the SEC to regulate their business practices, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated that credit ratings agencies disclose their methodologies.[273] By contrast, aside from the SEC

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267 *See* Mark S. Frankel, *Professional Codes: Why, How, & With What Impact?*, 8 J. BUS. ETHICS 109, 113–14 (1989) (discussing private self-regulation in professional societies); Lesley K. McAllister, *Harnessing Private Regulation*, 3 MICH. J. ENV'T & ADMIN. L. 291, 300–01 (2014) (describing longstanding private regulation by professional societies that have been active since the early twentieth century); Harold I. Abramson, *A Fifth Branch of Government: The Private Regulators & Their Constitutionality*, 16 HASTINGS CONST. L.Q. 165, 169 (1989) (describing the relationship between government regulators and professional licensing boards).

268 *See* Colin Scott, *Private Regulation of the Public Sector: A Neglected Facet of Contemporary Governance*, 29 J.L. & SOC'Y 56, 58 (2002) ("An example of a regime which has the effect but not the object of regulating is the activities of credit rating agencies in assessing the appropriate rating for sovereign credit.").

269 Omarova, *supra* note 265, at 426 (internal quotation marks omitted) (citing Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 L. & POL'Y 363, 364 (1997)).

270 *See* Abramson, *supra* note 267, at 169-73 (discussing various relationships between self-regulatory organizations and government in the provision of regulation).

271 Black, *supra* note 8, at 116 ("[I]t is that regulation is voluntarily initiated . . . and that the jurisdiction of any enforcer is voluntarily submitted to, which is the hallmark of 'pure' self-regulation.").

272 Scott, *supra* note 268, at 58.

273 *Credit Rating Agencies*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml [https://perma.cc/TSE5-AYFH]. For critical perspectives on these reforms, see generally John C. Coffee, *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS.

requirements that asset managers disclose how they vote investor proxies and act in their investors' interests,[274] there is no regulation or oversight of the Big Three's regulatory activities.[275] This difference is particularly striking when we recall the scope of their influence: the Big Three, as universal shareholder regulators, can make rules that bind the public market on a wide variety of issues, from corporate governance to climate change and beyond.

As this discussion indicates, although the Big Three's regulatory role has elements in common with other private regulatory regimes, it is ultimately something new. In particular, this is the first time that asset managers have emulated large public regulatory bodies by issuing broad rules and enforcing them with meaningful penalties. As the first Part made clear, this dynamic is possible not only because of the growth of the Big Three and the concentration of the mutual fund market, but also because of the increase in the rights and powers of shareholders. Accordingly, this activity represents a novel demand-driven privatization dynamic, in which powerful asset managers use their governance power to issue and enforce regulatory mandates in response to client demand. The next two Sections begin the project of evaluating the advantages and concerns posed by this dynamic.

B. *Advantages*

Optimism about this asset manager regulatory dynamic usually stems from disillusionment with public regulation. As Part I discussed, the modern regulatory environment is dysfunctional, which has led many to advocate for private actors to step in and push companies to internalize externalities that harm the public.[276] Indeed, with the knowledge that government is not always able or willing to move quickly to address pressing problems, many celebrate the Big Three's involvement and influence, which as the previous Part explored, has driven real change. Nonetheless, asset manager regulation is subject to important limits and deficiencies, which the next Section will describe in detail. As such, it should not be viewed as a substitute for

L. REV. 231 (2011); Frank Partnoy, *What's (Still) Wrong with Credit Ratings Agencies*, 92 WASH. L. REV. 1407 (2017); Aline Darbelly & Frank Partnoy, *Credit Ratings Agencies and Regulatory Reform* (U. of San Diego Sch. of L., Legal Studies Research Paper No. 12-083, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2042111 [https://perma.cc/S79H-QTVZ]. Important self-regulatory organizations are also subject to government oversight. Omarova, *supra* note 265, at 417.

274 *Final Rule: Disclosure of Proxy Voting Polices and Proxy Voting Records by Registered Management Investment Companies*, U.S. SEC. & EXCH. COMM'N (Apr. 14, 2003), https://www.sec.gov/rules/final/33-8188.htm [https://perma.cc/U26S-D58S].

275 See *infra* Section III.B for a discussion of how regulation of their other activities may operate as an indirect constraint on the policies that the Big Three adopt.

276 *See supra* Part II.

government regulation; at best, asset manager regulation could be harnessed to respond to deficiencies in public regulation, but not replace it.

With that in mind, this form of private regulation has some appealing features. As discussed in Part II, asset manager regulation is less likely to be subject to interest group dynamics than public regulation.[277] Instead, given the breadth of the Big Three's clientele, the policies that the Big Three generate are likely to be supported by a broad swath of individuals, companies, and governments.[278] Asset manager regulation also has practical benefits, including that it is less likely to be hamstrung by legal roadblocks that thwart the public regulatory process. Consider the California board diversity quota discussed in Part II. That law has been threatened by litigation arguing that it violates the Equal Protection Clause of the Fourteenth Amendment, as well as the internal affairs doctrine.[279] Some academic commentators predict that it will be struck down, and as a result, some companies have ignored it.[280] By contrast, the board diversity rules adopted by private market actors are not required to follow the same procedural hurdles. Of course, this advantage is also a liability: our constitutional democracy sets up protections for basic rights that governments cannot touch, and yet asset manager regulation is not equally bound by these important limitations.

Nonetheless, to the extent that these private rules are beneficial, they may be more effective in inducing compliance than those issued by public bodies. One reason is that asset manager penalties threaten the jobs of top management. Compare such penalties to agency fines that are borne by the entity, rather than culpable individuals, and that have been likened to mere "parking tickets" rather than meaningful deterrents.[281] Not only that, asset

277 *See supra* Section I.A.

278 This is not to say that this process is a democratic one by any means, or that these policies will further the public interest, as discussed in greater detail in subsection III.B.1.

279 Cydney Posner, *New Challenge to California Board Diversity Laws*, COOLEY PUBCO (July 19, 2021), https://cooleypubco.com/2021/07/19/new-challenge-california-board-diversity-laws [https://perma.cc/YX3A-79AM]. A California Superior Court judge struck down the law because it violated the state's Constitution; the state is appealing the decision. Alisah Haridasani Gupta, *Another California Board Diversity Law Was Struck Down*, N.Y. TIMES (May 19, 2022), https://www.nytimes.com/2022/05/19/business/california-board-diversity-women.html [https://perma.cc/N5WF-PW8T].

280 *See* Grundfest, *supra* note 165, at 6-7 (explaining how and why the California law will fail to have its intended effect); Casey Leins, *Report: Some California Corporations Ignore Law Requiring Females on Boards*, U.S. NEWS (Mar. 4, 2020), https://www.usnews.com/news/best-states/articles/2020-03-04/many-california-corporations-refuse-to-follow-gender-diversity-law-report-finds [https://perma.cc/3CGA-EATF].

281 *See* Dorothy S. Lund & Natasha Sarin, *Corporate Crime and Punishment: An Empirical Study*, 100 TEX. L. REV. 285, 291-92 (2021) (finding evidence supporting the view that agency fines borne by large firms represent "parking tickets" rather than meaningful deterrents).

manager enforcers may be better positioned to rein in bad behavior than government bodies, which issue rules that are often subject to arbitrage.[282] In particular, government bodies are bound to enforce only the rules they adopt, and if regulated parties discover a way to technically comply while violating the spirit of the rule, the government agency will have little recourse. By contrast, the Big Three can take a contextual approach to enforcement, penalizing activity that violates the spirit of their broad mandates.[283]

In addition, asset manager regulation can bypass global coordination issues that hinder the implementation of full-scale regulatory solutions.[284] For example, averting climate change will depend on successful cooperation between nations to abate carbon emissions—a difficult task.[285] By contrast, asset manager regulation does not depend on intergovernmental cooperation; instead, each of the Big Three can influence global emitters unilaterally, and require them to adhere to emissions standards that are more stringent than those of their home country.[286] Indeed, the global reach of their rules is a large advantage: BlackRock, for example, has investments in over a hundred

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282 *See* Victor Fleisher, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230 (2011) ("[R]egulatory arbitrage [is] the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment."); *see also* Jordan M. Barry, *On Regulatory Arbitrage*, 89 TEX. L. REV. 69, 73 (2010) ("[R]egulatory arbitrage is a phenomenon that follows from having regulations that fail to take economic reality into account.").

283 Of course, there are also limits to their enforcement: given their resource constraints, the Big Three need to rely on others whenever compliance is not easily verifiable.

284 Fabrizio Cafaggi & Andrea Renda, *Public and Private Regulation: Mapping the Labyrinth* 28 (CEPS, Working Document No. 370, 2012), https://www.files.ethz.ch/isn/153645/WD370%20Renda%20Public%20and%20Private%20Regulation.pdf [https://perma.cc/J4MA-BGQL] ("Private regulation is emerging as a viable solution for a number of problems faced by contemporary societies, and can be superior to traditional command and control regulation due to informational asymmetries, superior coordination, the need for transnational cooperation and standardization, and also the superior flexibility and adaptability of de-ossified, privately implemented, designed and enforced rules.").

285 *See* Alon Brav & J.B. Heaton, *Brown Assets for the Prudent Investor*, 12 HARV. BUS. L. REV. ONLINE 3-4 (2021) ("While an unpopular thing to say, the possibility that the world will fail to contain climate change is not remote.").

286 Because foreign governments also comprise important clients, the Big Three's rules may impose foreign policies on United States companies. For example, European countries had adopted board diversity policies well before U.S. states took action. *Compare* Aagoth Storvik, *Women on Boards—Experience from the Norwegian Quota Reform*, CESIFO DICE REP., Jan. 2011, at 35, https://www.ifo.de/DocDL/dicereport111-rm2.pdf [https://perma.cc/842T-EU43] ("The Norwegian Parliament in December 2003 passed a new regulation that required at least 40 percent of each gender on company boards."), *with* Michael Hatcher & Weldon Latham, *States are Leading the Charge to Corporate Boards: Diversify!*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 12, 2020), https://corpgov.law.harvard.edu/2020/05/12/states-are-leading-the-charge-to-corporate-boards-diversify [https://perma.cc/BCH6-892F] ("In September 2018, California Governor Gavin Newsom signed a Bill mandating gender diversity on the boards of directors of publicly traded corporations . . . .").

different markets[287], meaning that its rules can tackle global problems that individual countries have struggled to address. Nonetheless, a large ownership position is necessary for the asset manager to make an impact, and so private companies or companies with a controlling shareholder[288] will be insulated from the reach of their rules. This reality provides a reminder that complementary government action is necessary in order to fully address global problems.

Regarding multinational companies, the Big Three's regulatory efforts can be impactful for another reason: they can be responsive to the problem of companies evading regulation by incorporating in other jurisdictions.[289] Consider the rise of international tax havens that have lured major U.S. companies—including Medtronic and Burger King[290]—to invert their structure to escape U.S. corporate taxes.[291] In addition, companies regularly offshore factories to avoid costly wage and safety regulations.[292] Corporations' ability to escape regulation by moving their activity overseas not only undermines the reach of rules, it also leads to a regulatory race to the bottom by jurisdictions competing to lure corporations.[293] By contrast, multinational companies cannot escape asset manager regulation by incorporating in new jurisdictions. For example, Medtronic's three largest shareholders are BlackRock, Vanguard, and State Street, which together own nearly 20% of the company's outstanding equity.[294] Therefore, Medtronic will

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287 *Global Impact*, BLACKROCK, https://www.blackrock.com/corporate/about-us/global-impact [https://perma.cc/88ZU-LFVB] (Mar. 31, 2015) (showing assets managed for clients in 100 countries).

288 *Cf.* Dhammika Dharmapala & Vikramaditya Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities* 33-34 (Eur. Corp. Governance Inst., Working Paper No. 603/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3904316 [https://perma.cc/4VRC-TYJF] (arguing that firms with controlling shareholders are less likely to act in ways that minimize cross-firm externalities).

289 Bakan, *supra* note 260, at 282-83 (highlighting the benefit of private regulation where globalization makes it easier for corporations to "elude domestic legal systems").

290 Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 809, 814 (2015).

291 *Id.* at 814.

292 THE WHITE HOUSE, BUILDING RESILIENT SUPPLY CHAINS, REVITALIZING AMERICAN MANUFACTURING, AND FOSTERING BROAD-BASED GROWTH 8 (June 2021) ("[T]he United States has taken certain features of global markets—especially the fear that companies and capital will flee to wherever wages, taxes and regulations are lowest—as inevitable.").

293 *Cf.* Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341, 2343 (1996) ("The 'race-to-the-bottom' rationale for federal environmental regulation posits that states, in an effort to induce geographically mobile firms to locate within their jurisdictions, will offer them suboptimally lax environmental standards so as to benefit from additional jobs and tax revenues.").

294 *Medtronic PLC*, CNN BUS. (Sept. 9, 2022), https://money.cnn.com/quote/shareholders/shareholders.html?symb=MDT&subView=institutional [https://perma.cc/T7LX-76HZ].

not be able to escape the reach of the Big Three's regulatory agenda, despite being incorporated in Ireland.[295] Instead, as the next subsection discusses, they would have to take the company private or spin off pieces to avoid the Big Three's regulatory reach—burdensome changes with large economic consequences.

A final benefit of asset manager regulation is one that is shared by all private regulatory regimes: it may be more flexible and responsive than government regulation.[296] Because asset managers try to avoid alienating their clients when adopting rules, they often promulgate them over years, with tailoring based on client feedback and third-party expert advice.[297] By contrast, government regulation often requires political compromise that may undermine the efficacy of rules and can allow political interests to surpass technocratic experience. For these reasons, the asset manager regulatory process may lead to better rules than public regulation, especially because the former set of rules can be more easily changed.[298] However, the features of the asset manager regulatory landscape that render it most flexible and fast-moving—the lack of government oversight, as well as democratic accountability—are also cause for concern, as will be discussed in the next Section.

C. *Concerns*

Although there are reasons to welcome the emergence of asset manager regulation, serious concerns loom. Indeed, as this Section discusses, the ceding of power from government to a small number of private actors that

295 *Tracking Tax Runaways*, BLOOMBERG (Mar. 1, 2017), https://www.bloomberg.com/graphics/tax-inversion-tracker [https://perma.cc/5767-4K4D] (showing Medtronic's move from Minnesota to Ireland). However, the fact that these asset managers often vote in favor of inversions suggests again that their interventions need not further the public or even the government's interests. *See* Steven Davidoff Solomon, *Regulators Unbundle Some Attractions of Mergers*, N.Y. TIMES (Nov. 3, 2015), https://www.nytimes.com/2015/11/04/business/dealbook/regulators-unbundle-some-attractions-of-mergers.html [https://perma.cc/5GST-BCMY] (describing shareholder voting requirements for inversions).

296 Omarova, *supra* note 265, at 422 ("[S]elf-regulation is often said to be considerably more flexible and context-driven, as private entities participating in regulated market activities can respond better and more quickly to changes in market conditions.").

297 Each of the representatives from the Big Three that I spoke to emphasized the need to have clear evidence and data about the efficacy of their proposed policies before they are adopted, to assuage any client backlash. *See supra* note 27.

298 For a discussion of the barriers to changing existing regulation, see generally Cary Coglianese, Natasha Sarin, & Stuart Shapiro, *The Deregulation Deception* (U. Pa. L. Sch., Pub. L. & Legal Theory Rsch. Paper No. 20-44, 2021), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3231&context=faculty_scholarship [https://perma.cc/4X5U-L2GS].

lack democratic legitimacy or political accountability can result in severe democratic harm.[299]

Recall that the policies adopted by the Big Three are those that their clients embrace, which means those policies will not necessarily further the public interest. Even though nearly half of U.S. households invest in mutual funds,[300] the other half does not and therefore lacks any means of influencing asset manager regulatory policy. In addition, investors are wealthier than non-investors, which means that these policies are likely to be shaped by the preferences of the wealthier half of the United States.[301] Not only that, assuming that there are many initiatives that clients support, the choice between policies will be made not by elected officials, but by the wealthy individuals that manage the Big Three.

As a result of these realities, the Big Three's policies are not guaranteed to further overall social welfare. As Part III described, the Big Three's policies are tepid, and are likely embraced by their clients for strategic reasons. In addition, the Big Three are unlikely to adopt socially beneficial regulations that their clients oppose. Recall that the Big Three have failed to take a stand on the disclosure of corporate political spending and other deregulatory business agendas. Limiting the influence of business in politics would likely benefit society,[302] but because most companies oppose such limits, the Big Three will not adopt them. What is to stop the Big Three from adopting a

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299 *See, e.g.*, CHIARA CORDELLI, THE PRIVATIZED STATE 6 (2020) (characterizing privatization as a transformation of how a government is constituted, which presents "moral and political" problems).

300 Statista Rsch. Dep't, *Share of Households Owning Mutual Funds in the United States from 1980 to 2020*, STATISTA (June 28, 2022), https://www.statista.com/statistics/246224/mutual-funds-owned-by-american-households [https://perma.cc/P6FJ-6PF6].

301 Indeed, most of that ownership in mutual funds is concentrated in the top 10% of households by wealth. *See* Michael Simkovic, Natural-Person Shareholder Voting 18 (Aug. 2022) (unpublished manuscript) (on file with author) ("Although pension holdings are less concentrated than direct holdings, even accounting for pensions, beneficial ownership outside of the top 10 percent remains negligible.").

302 *See generally* John Craig & David Madland, *How Campaign Contributions and Lobbying Can Lead to Inefficient Economic Policy*, CTR. FOR ECON. PROGRESS (May 2, 2014), https://www.americanprogress.org/issues/economy/reports/2014/05/02/88917/how-campaign-contributions-and-lobbying-can-lead-to-inefficient-economic-policy [https://perma.cc/X322-ERN9] (highlighting various case studies in which corporate lobbying leads to inefficient policies); Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSPS. ON POL. 564, 576 (2014) ("Furthermore, the preferences of economic elites (as measured by our proxy, the preferences of 'affluent' citizens) have far more independent impact upon policy change than the preferences of average citizens do."). Polling evidence further suggests that a majority of Americans support limiting the influence of business in politics. U. OF MD., SCH. OF PUB. POL'Y, PROGRAM FOR PUB. CONSULTATION, AMERICANS EVALUATE CAMPAIGN FINANCE REFORM 1 (May 2018), https://www.documentcloud.org/documents/4455238-campaignfinancereport.html [https://perma.cc/5CM5-X6BM].

rule solidifying this stance, making clear that they will vote against any shareholder proposal that seeks greater transparency around corporate political spending? Indeed, not very long ago, this was BlackRock's position—in its 2019 proxy voting guidelines, the asset manager stated that it "believe[s] that it is not the role of shareholders to suggest or approve corporate political activities; therefore [it] generally do[es] not support proposals requesting a shareholder vote on political activities or expenditures."[303]

Ultimately, BlackRock shifted this stance toward a more moderate one after facing pressure from academics and unfavorable press.[304] And that shift reveals that the Big Three are ultimately responsive to public pressure, in addition to client pressure.[305] Indeed, public sentiment may inform client attitudes, and it certainly informs regulatory reactions.[306] If the Big Three adopted controversial rules that alienated the public, the resulting outcry could fuel momentum for regulatory bodies to clamp down on their power.

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303 Strine, *supra* note 5, at 1019.

304 *See, e.g.*, *id.* at 1022-26 (collecting criticism of the Big Three's lax approach to corporate political spending); Erin Arvedlund, *Vanguard, BlackRock Lag State Street on Some Proxy Votes Seeking Political Donation Disclosures: New Study*, PHILA. INQUIRER (Jan. 18, 2021), https://www.inquirer.com/business/wall-street-vanguard-blackrock-fidelity-center-political-accountability-donations-congress-20210118.html [https://perma.cc/4BST-N332] (highlighting BlackRock's position as a laggard with regards to proxy voting on political donation disclosures).

305 To take another example of how fear of regulatory scrutiny affects asset manager conduct, consider the efforts that the Big Three made to dissuade regulators from thinking that their governance influence could lead to anticompetitive behavior. This concern was raised by academics following the publication of academic research suggesting that the presence of investors with large stakes across competing firms in concentrated industries led to higher consumer prices. *See, e.g.*, José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1544 (2018) (finding that institutional investor cross-ownership correlates with higher ticket prices in the airline industry). In response, several commentators contended that cross-holders should be subject to additional scrutiny or regulation, and regulators opened inquiries. *See* Eric A. Posner, Fiona M. Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 669–70 (2017) (proposing that antitrust enforcement agencies enforce the Clayton Act against institutional investors with large cross holdings unless those institutions limit their stake to 1% of the industry or commit to passivity); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1301 (2016). Out of fear of regulatory reprisal, the Big Three took great pains to demonstrate that their policies and influence were not leading to anticompetitive conduct. *See, e.g.*, *Public Policy: Common Ownership*, BLACKROCK, https://www.blackrock.com/corporate/insights/public-policy/common-ownership [https://perma.cc/8SF6-NPWK] (providing data to rebut the "common ownership" and anticompetitive conduct theory).

306 *See* Schwartz, *Stewardship Theater*, *supra* note 32, at 34-35, 37-38 (arguing that mutual fund activities are constrained by fears of public retribution).

Already, the accumulation of power among so few investors has led to alarm[307] as well as calls for reform, ranging from breaking up the Big Three,[308] taking steps to diffuse their voting power,[309] or requiring them to limit their holdings.[310] With so many eyes on them, the Big Three have become more sensitive to how the public perceives their activities.[311] That is not to say that their policies will necessarily further the public interest, only that they are unlikely to take visible steps to harm it. However, this check on the exercise of anti-social power ultimately depends on internal power dynamics within the institutions. If, for example, BlackRock CEO Larry Fink was sufficiently entrenched that he could decide on policies unilaterally, he would not be bound to consider how his clients or even the public would perceive his actions.

This threat of unchecked power is compounded by the oligopolistic nature of the market. As discussed, the market for index funds is very concentrated, with over 80% of mutual fund inflows going to the Big Three.[312] There are many causes of this concentration, including economies of scale and scope that allow the largest players to charge the lowest fees, but the fact remains that it would be very difficult for an entrant to break in and disturb the Big Three's lock on the market. As a result, this regulatory dynamic is unlikely to

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307 *See, e.g.*, Coates, *supra* note 25, at 2 ("The prospect of twelve people even potentially controlling most of the economy poses a legitimacy and accountability issue of the first order—one might even call it a small 'c' constitutional challenge."); Bogle, *supra* note 2 (describing his concern that index fund ownership concentration is reaching a critical level that will no longer "serve the national interest").

308 *See, e.g.*, Zohar Goshen & Doron Levit, *Common Ownership and the Decline of the American Worker* 49-58 (Eur. Corp. Governance Inst., Working Paper No. 584/2021, 2021) (proposing breaking up large institutional investors).

309 *See, e.g.*, Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, 16 BROOK. J. CORP FIN. & COM. L. 71, 90-92 (2021) (advocating for "pass-through voting" for mutual funds); Caleb Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954, 983 (2020) (proposing diluting index fund votes by altering their weight); Lund, *The Case Against Passive Shareholder Voting*, *supra* note 43, at 528-31 (proposing that index funds be prohibited from voting or be required to pass through votes); Sean Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 990 (2020) (proposing that mutual fund voting on certain issues should be restricted); Dick Weil, *Passive Investors, Don't Vote*, WALL ST. J. (Mar 8, 2018, 6:44 PM), https://www.wsj.com/articles/passive-investors-dont-vote-1520552657 [https://perma.cc/22FT-MJMY] (arguing that passive fund managers should not vote).

310 Posner et al., *supra* note 305, at 670.

311 In an interview, a representative from the Big Three explained that the more that large asset managers are being scrutinized for market impact, the more important it is for them to be seen as doing something good for the world. *See supra* note 27.

312 Bebchuk & Hirst, *supra* note 5, at 732; *see also* Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It* 9 (Am. Econ. Liberties Project, Working Paper Series on Corp. Power No. 8, 2020), https://www.economicliberties.us/wp-content/uploads/2020/11/Working-Paper-Series-on-Corporate-Power_8_FINAL.pdf [https://perma.cc/9DJK-KFTB] ("Eighty-two percent of all assets flowing into all investment funds—both active and 'passive'—over the last decade have gone to the Big Three.").

be checked or influenced by outside competitive pressures, although competition between each of the Big Three may affect the policies that are chosen.[313]

The lack of transparency and oversight into the process by which asset manager rules are made and enforced further exacerbates fears about unchecked power.[314] Although the SEC requires mutual funds to disclose their proxy votes,[315] the Big Three are not required to provide the rationale for their voting policies or their votes. In contrast, most other powerful private regulators in the United States operate with some governmental oversight of their rules and rulemaking authority, and offer detailed explanations when policies are adopted or changed.[316] Although the Big Three make their voting policies public and proffer explanations for certain key votes, we lack information about how and why their voting policies are promulgated. The lack of information not only leaves investors and the public guessing, but also dampens a core feature of democracy: the public deliberative process.[317]

A related concern is that the people at the Big Three who make the rules are salaried employees with backgrounds in investing and corporate governance. For this reason, they lack expertise in regulatory policy that seasoned public officials bring to the table. In addition, these governance groups are extremely resource constrained.[318] These realities affect the form

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313 For a discussion of the benefits of regulatory competition, see generally Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

314 See Table 1 of the Appendix for a stark representation of the lack of legal obligations and procedural hurdles that asset managers face when adopting rules, as compared to public and quasi-public entities.

315 *Final Rule: Disclosure of Proxy Voting Polices and Proxy Voting Records by Registered Management Investment Companies*, *supra* note 274.

316 *See, e.g.*, *SEC Approves New Nasdaq Board Diversity Rules*, GIBSON DUNN (Aug. 12, 2021), https://www.gibsondunn.com/sec-approves-new-nasdaq-board-diversity-rules [https://perma.cc/VHR3-9KEA] (describing NASDAQ listing rules aiming to enhance board diversity); *see also* Omarova, *supra* note 265, at 417 (describing how the securities industry is regulated by many self-regulatory organizations, including stock exchanges and the Financial Industry Regulatory Authority (FINRA), which are overseen by the SEC); Stavros Gadinis & Howell Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1245 (2007) ("In . . . the United States and Canada [], the regulatory powers of stock exchanges extend over most issues, but are exercised under close supervision by government agencies.").

317 *See* Joshua Cohen, *Deliberation and Democratic Legitimacy*, *in* DEBATES IN CONTEMPORARY POLITICAL PHILOSOPHY: AN ANTHOLOGY 342, 345 (Derek Matravers & Jon Pike eds., 2003) ("The notion of a deliberative democracy is rooted in the intuitive ideal of a democratic association in which the justification of the terms and conditions of association proceeds through public argument and reasoning among equal citizens.").

318 *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 43, at 516 ("Given the number of companies the engagement teams are charged with overseeing, simply voting the shares . . . is an enormous task. It would not be possible for teams of that size to . . . thoughtfully vote proxies . . . ."). Although government agencies are also resource constrained, the Big Three devote

and efficacy of their rules (among other things, their rules must apply in a blanket fashion to very different firms and compliance must be easy to verify) and suggest that mistakes could be made. For example, Alon Brav and J.B. Heaton argue that the Big Three's positions on carbon emissions abatement pose national security concerns.[319] If the Big Three push United States companies to decarbonize before the world is ready, those companies could find themselves dependent on resources from foreign countries.[320]

The risks that come from a lack of political experience are compounded by the opaque nature of asset manager regulation. Government regulation must abide by cumbersome processes and judicial review, but those requirements lead to greater transparency and provide an opportunity for affected parties to weigh in. By contrast, asset managers can adopt broad mandates without an opportunity for notice and comment, nor any judicial review of their rules or enforcement actions.[321] Not only that, asset manager policymakers lack electoral accountability for their actions.[322] This lack of accountability has some advantages—as discussed, their rules may be less likely to be influenced by political winds than those adopted by elected officials—but it again raises concerns about how asset manager rules are adopted and the groups they are intended to benefit. In addition, there are deeper issues that accompany the delegation of broad rulemaking authority to private actors that lack electoral authorization and accountability from all affected groups.[323] In the public regulatory context, when rules are made that affect stakeholders, those groups are (at least in theory) able to influence whether the rulemaker remains in power.

And yet, the democratic process is not free of these issues either—interest groups can capture the political process, and elected officials might not ever

far fewer staff and resources to stewardship than the typical administrative agency. *Compare* Bebchuk & Hirst, *supra* note 115, at 2076-77 (estimating that in 2017, the annual stewardship budget of each of the Big Three was between five million to fifteen million dollars, employing between eleven and thirty-three stewardship team members) *with* U.S. SEC. EXCHANGE COMM'N, FISCAL YEAR 2023 CONGRESSIONAL BUDGET JUSTIFICATION 16 (Mar. 25, 2022), https://www.sec.gov/files/FY%202023%20Congressional%20Budget%20Justification%20Annual%20Performance%20Plan_FINAL.pdf [https://perma.cc/S654-JACT] (showing a requested budget of $96,171,000, including 239 positions and 222 full-time equivalents, for the SEC Division of Investment Management in Fiscal Year 2023).

319 Brav & Heaton, *supra* note 285, at 7, 22.

320 *Id.* at 22.

321 *See infra* Table 1 (describing the legal obligations and procedural hurdles that bind asset managers, as compared to stock exchanges and the EPA).

322 *C.f.* Hussain & Moriarty, *supra* note 3, at 432-34 (describing scholarly articles which argue that a "democratic deficit" is created when private actors take on state functions because the course of public life is shaped by actors that are not accountable to the public).

323 For an analogous problem, consider self-appointed representatives in government and the attendant issues of democratic legitimacy. *See generally* Laura Montanaro, *The Democratic Legitimacy of Self-Appointed Representatives*, 74 J. POL. 1094 (2012).

face consequences for their choices.[324] But there is also reason to think that the Big Three have exacerbated, rather than improved, the political dynamics that keep them in power. In particular, if the Big Three were to push the government to take steps to limit the influence of corporate spending in politics, and to regulate business to respond to the risk of climate change or improve workplace diversity, there would be less of a need for them to intervene to adopt rules. The fact that they have not done so suggests that they may benefit from playing the role of regulator of last resort. In particular, such regulatory activity allows the asset manager to differentiate its products from competitors.[325] And given that index funds have few ways to do this beyond slashing fees (which cuts into the asset manager's profits), maintaining an aspect of the business that allows for product differentiation may be very appealing indeed.[326]

Even without deliberate effort by the Big Three to amplify government dysfunction, there is the real risk that their policymaking will take the onus off of government to provide solutions better calibrated toward advancing public welfare. Indeed, co-opting regulation is often a goal of self-regulatory regimes and a likely reason why corporate America supports asset manager regulation.[327] Therefore, the Big Three's efforts may be undermining progress on the issues they claim to be addressing. Indeed, BlackRock's former CIO for sustainable investing described the company's green policies as a "deadly distraction" capable of "delay[ing] overdue government reforms."[328]

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324 For example, partisan gerrymandering undermines electoral accountability. *See generally* Alex Tausanovitch & Danielle Root, *How Partisan Gerrymandering Limits Voting Rights*, CTR. FOR AM. PROGRESS (July 8, 2020), https://dataspace.princeton.edu/bitstream/88435/dsp015d86p329p/1/GerrymanderVotingRights-brief.pdf [https://perma.cc/E9GH-BFN4]. Not only that, elected officials that delegate rules to agency officials may escape electoral consequences for their actions. *See* Adam Hill, *Does Delegation Undermine Accountability? Experimental Evidence on the Relationship Between Blame Shifting and Control*, 12 J. EMPIRICAL LEGAL STUD. 311, 312 (2015) ("[P]rincipals can delegate a blameworthy decision to a powerless intermediary and . . . evade responsibility.").

325 *See supra* note 118.

326 As one representative of the Big Three explained, their ESG policies helped them differentiate their products in an arena of increasingly low fees, enabling them to sell their products to more people for more money. *See supra* note 27; *see also* Barzuza et al., *supra* note 6, at 1304 (explaining how index funds are reaching a natural limit with competition on price, which incentivizes them to differentiate their products through approaches unrelated to pricing).

327 *See supra* Part III.

328 Fancy, *supra* note 42; *see also* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 96 (2020) (arguing that the perception of stakeholder governance can chill the government from adopting stakeholder-oriented reforms). The opposite is also possible—that "internal reforms [such as asset manager regulation] could reshape the way that corporations use their formidable political capital . . . making external reforms more likely." Aneil Kovvali, *Stark Choices for Corporate Reform*, 123 COLUM. L. REV. (forthcoming 2023) (manuscript at 5, 34-42), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4067505 [https://perma.cc/5VQW-G99Q]. Indeed, the Big Three's policies on board diversity and ESG

This prospect of regulatory co-opting is problematic for several reasons. For one, as the examples in Part III reveal, the Big Three are unlikely to adopt policies that are particularly controversial or that will alienate their clients, which also means that they are unlikely to go as far as needed to respond to global problems. Not only that, there are major limits on the Big Three's regulatory reach: their penalties are unlikely to affect a private company or company with a controlling shareholder, to take two examples.[329] In addition, public companies can escape the reach of their rules by going private or divesting high externality assets. Consider, for example, how BP met its climate targets by selling its Alaska oilfields to Hilcorp, a small private company that "has made a name buying oil and gas assets no one else wants."[330] For these reasons, asset manager regulation should not be viewed as a substitute for government action.

CONCLUSION

This Article describes a novel privatization dynamic, where asset managers have responded to government inaction in areas of great public importance by regulating corporate conduct themselves. Like the market for regulation by public bodies, asset managers produce regulation in response to financial incentives, and particularly, demand from their clients. The breadth of their clientele suggests that their regulatory policies will advance the interests of a large set of individuals and institutions; nonetheless, because client interests are not equivalent to the interests of the public, there is no guarantee that asset manager regulation will advance social welfare. Moreover, asset manager regulators operate with little accountability for and oversight of their actions. To the extent that the provision of asset manager regulation takes pressure off of the government to adopt rules, we should be especially wary. At bottom, understanding the forces that shape (and potential problems that accompany) this novel privatization dynamic is of critical importance not just for investors and corporations, but also the public.

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disclosure were followed by public regulation addressing the same issues, suggesting that the Big Three's interventions did not prevent the government from acting.

329 *See, e.g.*, Paul Mahoney & Julia Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840, 856 (2021) ("When it comes to carbon production and use and climate-sensitive assets, an S&P 500 index fund does not own the market . . . ."); Dharmapala & Khanna, *supra* note 288, at 26-27 (revealing how the presence of a controlling shareholder limits the influence of universal owner stewardship).

330 Rachel Adams-Heard, *What Happens When an Oil Giant Walks Away*, BLOOMBERG (Apr. 14, 2021), https://www.bloomberg.com/graphics/2021-tracking-carbon-emissions-BP-hilcorp [https://perma.cc/QYF5-UE3S].

APPENDIX

Table 1: Asset Manager Regulation, Compared to That of Stock Exchanges (Quasi-Public) & the EPA (Public)

	Asset Managers	Stock Exchanges	EPA
Form of Mandate	Achieve (easily verifiable) ends	Achieve (easily verifiable) ends	Achieve ends, restrictions on certain activities, market-oriented policy instruments
Legal Obligations	Fiduciary duty to act in investors' interests	Extensive SEC regulation of rules and exchange operations	Comply with federal law (Clean Air Act, etc.)
Procedural Hurdles	None	File rules with the SEC for approval	Must comply with the Administrative Procedure Act, survive Office of Information & Regulatory Affairs review (benefits in excess of costs), judicial review if challenged
Oversight of Rules	None	Day-to-day oversight from the SEC	Administrator appointed by the President, budget determined by Congress, judicial review of regulations
Target	Portfolio companies (i.e., tens of thousands of companies, across all industries, in hundreds of markets)	Listed companies, broker-dealers that trade on exchange	Business sectors that pollute

	Asset Managers	**Stock Exchanges**	**EPA**
Subject Matter	Unlimited	Corporate governance, fair trading, disclosure	Regulate pollutants and contaminants, subsidize environmental practices
Penalties	Votes against directors, votes in favor of shareholder proposals	Fines, delisting	Civil and criminal penalties (fines, jail, injunctive relief, restitution) sought in administrative action or formal lawsuit
Oversight of Enforcement	Votes must be disclosed	Day-to-day oversight from the SEC	Judicial review