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What Boards Can Expect From the 'Big Three'

Agenda Week
By Jennifer Williams-Alvarez
Friday, June 28, 2019

For all the hue and cry over shareholder dominance and vigorous shareholder engagement, it appears the largest investors — **Vanguard**, **BlackRock** and **State Street Global Advisors** — may actually be more deferential to company management in practice than previously believed.

Two recent academic studies co-authored by notable **Harvard** Law School professor **Lucian Bebchuk** provide evidence suggesting that, despite the large ownership stakes held by the so-called "Big Three," the largest investors aren't wielding their might in the form of say-on-pay votes, engagement with boards about director nominations, involvement in securities class action lawsuits, and governance reform efforts. Instead, for all their dominance, the largest investors may be incentivized to defer to companies' management teams, the papers posit.

Even while it may seem convenient to be unencumbered by various large investors with differing concerns, Bebchuk tells *Agenda,* the findings present a troubling reality for company stakeholders, including directors. "Less accountability can lead to worse incentives and performance," he writes in an e-mail. "Thus, excessive deference and sub-optimal stewardship can impose significant costs on public company shareholders and the economy."

Yet not all are convinced that companies should expect these three to yield to the wishes of corporate management and boards.

Karla Bos, director of corporate governance consulting at **Aon**, for one, says it's unlikely that those who have engaged with these investors would find them to be excessively deferential.

It may be that they are not regularly wading into matters like director elections, she admits, but she believes they are taking a stance on a few governance issues, such as diversity in the boardroom and overboarding. "I think they're taking a more measured approach, which is reasonable given the significance of every vote they make."

Too Much Deference?

Bebchuk and co-author **Scott Hirst**, associate professor of law at **Boston University** School of Law, assert in one of the two papers that the Big Three have several reasons to be deferential to corporate management.

One "especially strong factor" inducing the trio to be deferential to management is the potential for backlash from companies in response to non-deferential positions, the authors suggest in the paper, slated for publication later this year. For instance, if the largest investors took an

“interventional strategy” in which fund managers pressured companies to link executive compensation more closely to performance or for underperforming CEOs to be forced out, company executives would likely strike back.

The paper notes that such an interventional strategy would give company managers “strong incentives to resist it and mobilize against the Big Three,” the authors write. “Because managers control the massive resources of Main Street companies, they are a formidable foe in the political arena,” the paper suggests, meaning company leaders could attempt to curtail the power of these three with legal constraints.

The paper also highlights the deferential nature of votes from and actions taken by the Big Three. They voted against pay for companies in the S&P 500 in only an average of 3.2% of cases over a six-year period beginning in 2012, for instance. Additionally, the index fund managers rarely get involved, formally or through informal engagement, in director nominations (where there is a 5% or more stake, zero Schedule 13D filings were made to Russell 3000 companies from 2008 to 2017) and do not take advantage of shareholder proposals (zero submitted by any of the three in the same period and to companies in the same index), the findings show.

Nor do the Big Three take the lead in securities class action cases based on a review of a 10-year period beginning in 2008, which the authors note as an important investor tool for deterring misconduct within companies.

In the second and more recent paper, *The Specter of the Giant Three,* the authors build on the idea that BlackRock, State Street and Vanguard are immensely powerful, expanding the research to show that they may well cast as much as 40% of the votes in S&P 500 companies within two decades. Looking to the past to predict future growth, the authors suggest the Big Three may become the “Giant Three,” a scenario that would mean “three investment managers would largely dominate shareholder voting in practically all significant U.S. companies that do not have a controlling shareholder.”

“If the Big Three were to grow into the Giant Three, these deference incentives would operate to weaken beneficial constraints on corporate managers,” the authors write.

Boards are often given the message that now is a time of heightened pressure from investors, Bebchuk tells *Agenda.* “Our analysis and empirical evidence [indicate] that, nonetheless, shareholder oversight and intervention are weaker than would be desirable,” he writes in an e-mail. And the trouble is, he adds, that “excessive deference on the part of key institutional investors is likely to have an impact on the decisions of incumbent directors and to weaken the checks on such decisions.”

Vanguard, in a statement from a spokesperson, stressed the importance of engagement over votes cast.

In an e-mail, the spokesperson noted that shareholder meeting votes are “just one part of the process,” adding that the firm “regularly” engages with portfolio companies to advocate for the long-term interests of its shareholders. “Our engagements with portfolio companies enable us to

provide constructive input to board and management teams and advocate on shareholders' behalf," the statement reads.

"These activities, even more so than voting, can effect meaningful changes that generate long-term value for all shareholders," it says.

Neither BlackRock nor State Street responded to requests for comment.

A Measured Approach

Aon's Bos agrees that the three largest investors are indeed more deferential than others — "I would not call them activists," she says — but adds that, rather than second-guessing all decisions made by corporate directors and executives, it "makes sense" to be more calculated when deciding which issues to take a stance on.

Furthermore, Bos doesn't believe companies and board members "should take comfort or relax" because of any perceived lack of pushback from these three.

For one, investors' views on what they see as critical governance matters are constantly progressing, and as that occurs, new issues may be taken up by any one or all of them, she says. What's more, Bos's opinion is that other investors take cues from policies put forth by the trio and that they may be willing to ratchet up the pressure on particular issues.

Plus, boards should be pleased to have Vanguard, BlackRock and State Street among top investors, Bos says. It creates a "limited universe" of policies for companies and boards to consider. That said, she notes that directors still need to voice specific concerns and ask questions about voting policies when engaging with these investors.

Take Vanguard's recent update to proxy voting guidelines that, as of this proxy season, it would generally vote against what it defines as overboarded directors, says Bos, a former director of investment proxy research at **Fidelity**. "I think companies were surprised," she says of the announcement, adding that the takeaway is that companies, when engaging with investors, need to be direct in asking where they can expect votes against various proposals.

"In my experience, it was all too easy for companies to come in and talk about what they were doing but never ask the hard questions. It's harder to say, 'OK, where should I improve? What would you recommend?'" she says. "This is all the more important with the large index funds, because they have large positions and you may have less opportunity to influence votes."