Prepared Statement
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Executive Summary

In recent decades, a few asset management firms have accumulated major ownership shares of virtually every large corporation in the economy. This development has had significant implications for the distribution of economic power in the United States.

Economic power is the power of individuals or organizations to determine how our economy functions. Today, economic power is concentrated in three types of entities: individual technology behemoths such as Amazon and Facebook; large private equity firms, which individually own more than two hundred companies; and giant asset management firms such as BlackRock, Vanguard, and State Street (also known as the Big Three), which I focus on here.

Under state law, corporations are governed by their shareholders, who elect the board of directors and vote directly on certain issues. The Big Three control more than $20 trillion in assets, largely in mutual funds and exchange-traded funds (ETFs) that they manage on behalf of households and institutions. Many of these funds buy stock in corporations. Because these funds hold legal title to the stock, their managers generally have the power to vote the stock in corporate elections —even though the true economic owners are the investors in the funds.

The Big Three currently cast 25 percent of all votes cast in director elections for large corporations. This gives them significant influence over corporate directors and executives. The Big Three have been criticized for misusing this power in at least four different ways: (1) failing to adequately oversee corporations; (2) forcing a political agenda on companies; (3) blocking shareholder efforts to make corporations address environmental, social, and governance (ESG) issues; and (4) facilitating collusion among large players in the same industry.

The fundamental question, however, is not how these companies should use their power, but whether they should have it in the first place. In essence, economic power has been concentrated in the hands of the people who are best at administering and marketing low-cost index funds. Instead of shareholder capitalism, we have financial intermediary capitalism. Is this how we want our economy to be managed?

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What Is Economic Power?

The economy is the sum total of our productive activities and the mechanisms by which the things that we produce are distributed. Ordinary people primarily interact with the economy as consumers of goods and services and as workers in the labor market. Businesses interact with the economy as buyers and sellers of goods and services. Economic power is simply the power of different people or organizations to determine how things are produced and distributed: what products are made, where they are made, how they are made, how they are sold, and so on.

The United States has a largely capitalist economic system, in which economic decision-making is widely distributed. In such a system, economic power is mainly held by big corporations. Of course, the United States has an important small business sector. However, small businesses compete on a playing field that is largely determined by large corporations. For example, it is possible to create an innovative, profitable business selling small electronic accessories—but only if you can successfully market and sell your products on Amazon.

How Are Corporations Controlled?

Corporations do not think for themselves—at least not yet. So the question of who holds economic power boils to the question of who controls large corporations. The governance of corporations is primarily a question of state corporate law. Most large corporations are incorporated in Delaware, but the basic rules are common to all states.

In principle, American corporations are governed by their shareholders. The primary justification for this system is that it is the shareholders who are directly affected by the economic fortunes of the corporation: shareholders are (indirectly) benefited by higher profits and harmed by lower profits. Lower profits also harm creditors and employees, among other stakeholders. In theory, however, because shareholders are the "residual" claimants on the corporation—the ones who get whatever is left over after all the debts are paid—they have the incentive to maximize the value of the corporation, and therefore they should decide what it does.

Things do not have to be this way. In a large German corporation, for example, workers have the right to select up to half of the members of the supervisory board. American shareholder primacy has been criticized for leading corporations to focus solely on maximizing profits, without concern for employees, customers, local communities, or the environment. At present, I simply want to note that it is widely believed in the American business community that corporations are and should be governed by their shareholders.

If a corporation has a majority shareholder, that person can make all the decisions for the corporation, or can hire a CEO who will follow their instructions. Most large corporations, however, do not have a majority shareholder. For them, shareholder governance works like this:

- Shareholders vote directly on a small number of fundamental decisions, such as whether to merge the corporation into another entity, and on advisory resolutions. Shareholders also vote to elect members of the board of directors.

- The board directly makes certain important decisions, such as whether to pay dividends. The board also hires and oversees the chief executive officer.
- The CEO makes ordinary operational decisions along with the rest of the management team, which is hired by and responsible to the CEO.

As a result, even when there is no majority shareholder, shareholders can influence corporate directors and executives in three ways:

- By voting out directors or by voting against management on other issues
- By expressing their views to directors and executives, with the implicit threat of voting against them
- By selling their stock, which can reduce the stock price

It is possible for a single minority shareholder to effectively control a corporation. For example, if one person owns 30 percent of a corporation's stock and no one else owns more than 2 percent, the person with a 30 percent stake is likely to be able to win any vote, especially given that many investors do not bother to vote their shares.

Even when there is no controlling shareholder, corporate executives tend to be very attentive to the wishes of significant shareholders. They are concerned that major shareholders will sell their stock, lowering the share price; vote against the current board of directors; or support an activist hedge fund seeking to change the corporation's strategy or management.

Congress has recognized the significant influence that minority shareholders can have over a corporation. Section 13(d) of the Securities Exchange Act requires entities or groups holding more than 5 percent of the stock of a corporation to disclose their ownership publicly, in order to alert investors to potential changes in control. Section 16 of the Securities Exchange Act classifies as insiders not only directors and officers but also holders of 10 percent of the stock of a corporation. Such insiders must report transactions in the corporation's stock and are barred from making profits on certain short-term price swings, on the grounds that they may be benefiting from their close relationship with the corporation.

Who Controls Corporations?

If a single person owns a controlling block of stock in a corporation, they control the corporation. A few people wield considerable economic power because of their personal control of important companies, such as Jeff Bezos and Mark Zuckerberg, as did John D. Rockefeller in the nineteenth century. However, most large corporations are not controlled by a single person.

A Little Bit of History

To simplify greatly, the United States economy has seen three general models of corporate governance in the past century. From roughly the 1930s to the 1970s, the ownership of large corporations was divided up among many individual shareholders, each with inconsequential ownership shares. In this model, described by scholars Adolf Berle and Gardiner Means, dispersed shareholders with small stakes have little incentive to even try to govern the corporation, leaving economic power in the hands of directors and executives.

The second half of the twentieth century saw the consolidation of assets among large institutional investors such as pension funds, mutual funds, hedge funds, and university endowments. Institutional investors amassed significant stakes in specific large corporations and began putting pressure on directors and executives to focus more closely on the stock price as the best measure of shareholder value. Corporate managers largely complied, in part because of a shift to compensation packages based on stock options, and in part because those who failed to increase their stock price were vulnerable to takeover in a merger wave that began in the 1980s. In this model, a corporation's decision-making is significantly influenced by a small number of institutional investors with large stakes in that corporation.

The past decade has seen the development of a new model of corporate control and hence a new allocation of economic power. A few asset management firms—led by BlackRock, Vanguard, and State Street—have amassed significant ownership stakes in *virtually every large corporation*, which means that almost all corporations have the same major shareholders. Their influence over these corporations potentially gives them a breadth of economic power probably unrivaled since the age of J. P. Morgan at the beginning of the twentieth century.

This is not to say that these asset management firms are the only locus of economic power in today's economy. Amazon, for example, has tremendous power over the retail sector, shipping, publishing, and web services infrastructure, to name a few. Large private equity firms such as Blackstone, Carlyle, and KKR can each control more than 200 companies directly. Here, however, I want to focus on the specific issues presented by large asset management firms with concentrated stock ownership across the entire corporate sector.

Corporate Control Today

BlackRock, Vanguard, and State Street—sometimes known as the Big Three—have amassed their ownership positions largely because of a shift from actively-managed funds to index funds. Most individuals and institutions invest in stocks via mutual funds or exchange-traded funds (ETFs). In an actively-managed fund, the fund manager attempts to beat the market by betting on individual stocks or industry sectors. In an index fund, the fund manager simply buys every stock in an index (such as the S&P 500), ensuring that the fund will do exactly as well as the market.

Since index funds were introduced in the early 1970s, their share of total fund investments and of the total stock market has been increasing at an accelerating rate. In 2019, the amount of money in U.S. stock index funds exceeded the amount in actively-managed U.S. stock funds for the first time.[2] The rise of index funds has generally been *good* for investors because (a) most actively-managed funds do worse than the market in most years, so index funds provide better returns on average, and (b) index funds have much lower costs because they are simple to administer. BlackRock, Vanguard, and State Street are by far the three largest managers of stock index funds, with a combined 90 percent market share.[3] This high concentration results from natural economies of scale in asset management and in index funds in particular: the larger the fund, the smaller its operating expenses are as a percentage of fund assets, which means lower fees for investors. From 2009 to 2018, the Big Three captured more than 80 percent of all net asset flows (inflows minus outflows) into *all* mutual funds and ETFs.[4]

The Big Three offer actively-managed funds as well. At the end of 2021, BlackRock was the largest asset manager in the world, with more than $10 trillion in assets, while Vanguard had more than $8 trillion and State Street more than $4 trillion.[5] More to the point, however, is their ownership share in large corporations. Although the money in a mutual fund or ETF is contributed by outside investors, the fund itself has legal title to the shares it holds and therefore the right to vote those shares (absent a side agreement with the investors). As of 2019, BlackRock's median ownership stake of S&P 500 corporations was 7.4 percent; that is, BlackRock owned more than 7.4 percent of half of the companies in the index and less than 7.4 percent of the other half. Vanguard's and State Street's median ownership percentages were 9.5 percent and 4.5 percent, respectively. In 2017, the Big Three together cast more than one-quarter of all votes in director elections for S&P 500 companies.[6] In aggregate, their median ownership stake in S&P 500 companies in 2019 was more than three times as large as in 2000.[7]

Consequences

What is novel about this situation is that the Big Three own significant shares of not just some corporations, but virtually all large corporations. Traditionally, a large investor would have a major ownership stake in a relatively limited number of companies and would therefore have a vested interest in their success. Because the Big Three own similar proportions of every large corporation, they have different incentives.

Different commentators have made at least four major critiques of how the Big Three use their

[2] Dawn Lim, "Index Funds Are the New Kings of Wall Street," *Wall Street Journal*, Sept. 18, 2019.
[3] Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo, "Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk," *Business and Politics* 19 (2017): 298–326, 304. Close to half of my family's liquid assets are invested in index funds, and most of those are managed by BlackRock or Vanguard.
[4] Lucian Bebchuk and Scott Hirst, "The Specter of the Giant Three,"*Boston University Law Review* 99 (2019): 721–41, 732.
[5] BlackRock Q4 2021 Earnings Release, Jan. 14, 2022; "Vanguard at a Glance: Facts and Figures," https://corporate.vanguard.com/content/corporatesite/us/en/corp/who-we-are/sets-us-apart/facts-and-figures.html ($8.0 trillion as of Sept. 30, 2021); State Street Q4 2021 Earnings Release, Jan. 19, 2022;
[6] Bebchuk and Hirst, "The Specter of the Giant Three," 736.
[7] Lucian Bebchuk and Scott Hirst, "The Power of the Big Three, and Why It Matters" (working paper), Feb. 21, 2021, http://www.law.harvard.edu/faculty/bebchuk/The_Power_of_the_Big_Three_and_Why_It_Matters.pdf, 9.

economic power. All four critiques cannot be valid in the same context at the same time—at times the Big Three have been criticized for doing one thing and for doing its opposite—but all four could be valid to differing degrees in different contexts.

(In addition to these four critiques of the economic power of the Big Three, there is also evidence that excessive concentration in the asset management industry can create risks to financial stability.[8] That is a separate topic that I will not pursue here.)

1. Failure to Govern

The Big Three may pay too little attention to corporate governance issues, allowing corporate managers to ignore the interests of their shareholders.[9] A large proportion of their assets are held in index funds, and index funds do not compete based on returns (because all funds tracking the same index have virtually the same returns), so the fund management companies have little incentive to oversee the companies they invest in. Because index funds compete on cost, there is a disincentive to invest in corporate governance. As of 2016, the Big Three together employed only about fifty people dedicated to governance issues.[10] In addition, asset management firms may defer to corporate managers because they earn revenues from managing the assets in those corporations' retirement plans. Indeed, the Big Three vote according to the recommendations of the board of directors more than 90 percent of the time; they are even more likely to vote with management against proposals initiated by outside shareholders.[11]

2. Forcing Political Views on Corporations

In recent years, the Big Three have become sensitive to this criticism, and they now insist that they take their corporate governance responsibilities seriously. Vanguard founder John Bogle claimed, "we are the invisible hand of the marketplace,"[12] and BlackRock CEO Larry Fink regularly exhorts corporate executives to take climate change more seriously.[13] All three companies advertise their oversight efforts loudly, particularly their attention to environmental, social, and governance (ESG) issues. As a result, some observers argue that the Big Three are using their power to advance the political agendas of their CEOs instead of focusing on

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[8] Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, and John Sedunov, "The Granular Nature of Large Institutional Investors," *Management Science* 67, no. 11 (Nov. 2021): 6629–59; Kenechukwu Anadu, Mathias Kruttli, Patrick McCabe, and Emilio Osambela, "The Shift from Active to Passive Investing: Risks to Financial Stability?" Federal Reserve Bank of Boston Working Paper SRA 18-04, last revised May 15, 2020.

[9] See Lucian Bebchuk and Scott Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy," *Columbia Law Review* 119, no. 8 (Dec. 2019): 2029–2145.

[10] Sarah Krouse, David Benoit, and Tom McGinty, "Meet the New Power Brokers: Passive Investors," *Wall Street Journal*, Oct. 24, 2016.

[11] Fichtner et al., "Hidden Power of the Big Three?" 317–18.

[12] Krouse et al., "Meet the New Power Brokers."

[13] Dawn Lim, ""Larry Fink Wants to Save the World (and Make Money Doing It),"*Wall Street Journal*, Jan. 6, 2022.

maximizing shareholder value.[14]

3. Blocking Progress on ESG Issues

At the same time, other people criticize the Big Three for *not* using their economic power to improve society, in particular for opposing ESG-related proposals. Of the top 25 asset management firms in 2019, BlackRock, Vanguard, and State Street were among the most likely to vote against shareholder proposals addressing climate risks, political and lobbying activities by fossil fuel companies, and governance reforms at fossil fuel companies. All three voted for management-recommended directors of fossil fuel companies at least 99 percent of the time.[15] (BlackRock increased its support for climate-related proposals in 2021, but still rarely votes against directors.[16]) BlackRock and Vanguard also vote overwhelmingly against proposals that require corporations to disclose their political spending activities.[17]

Obviously critiques 2 and 3 cannot both be valid in the same context, but they demonstrate the influence of these asset management companies.

4. Anti-Competitive Behavior

The Big Three may facilitate tacit collusion among large corporations in the same industry. The Big Three own stock in all of the large companies in any industry, and they could use their influence to encourage collusive policies that increase the aggregate profits of those companies but harm customers and employees. Economic studies have found that common ownership of nominal competitors by asset management firms produces higher prices in both the airline and retail banking industries.[18] While there is no smoking-gun evidence of asset management firms encouraging price-fixing, corporate executives are certainly aware of the interests of their major shareholders and could adopt anti-competitive policies to make those shareholders happy.

The Special Case of BlackRock

BlackRock has also accumulated additional power through its interactions with the federal government. BlackRock is so important a player in the securities markets that it has been hired by the Federal Reserve to implement several of its programs. During the 2008 financial crisis,

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[14] Senator Pat Toomey and Senator Ron Johnson, Letter to David. A. Jones, Acting Chairman, Federal Retirement Thrift Investment Board, June 30, 2021.

[15] *Climate in the Board Room: How Asset Manager Voting Shaped Corporate Climate Action in 2019*, Majority Action, 12, 18–21.

[16] *Climate in the Board Room: How Asset Manager Voting Shaped Corporate Climate Action in 2021*, Majority Action, 4–5.

[17] 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,” *Washington University Law Review* 97, no. 4 (2020): 1007–45, 1019–20.

[18] José Azar, Martin C. Schmalz, and Isabel Tecu, “Anticompetitive Effects of Common Ownership,” *Journal of Finance* 73,no. 4 (Aug. 2018): 1513–65; José Azar, Sahil Raina, and Martin Schmalz, “Ultimate Ownership and Bank Competition,” *Financial Management*, June 15, 2021, https://onlinelibrary.wiley.com/doi/10.1111/fima.12368.

BlackRock was selected to manage mortgage assets previously held by Bear Stearns and AIG. During the initial phase of the COVID-19 pandemic in March 2020, BlackRock was hired to execute the Federal Reserve's purchases of mortgage-backed securities and corporate bonds and ETFs, which put BlackRock in the position of buying its own ETFs for the Federal Reserve's account.[19] BlackRock executives have frequent contacts with senior government officials in both Republican and Democratic administrations.[20] Larry Fink was widely considered a serious contender to become treasury secretary if Hillary Clinton won the 2016 presidential election. The firm's political influence no doubt contributes to its economic power.

The Accidental Oligopoly

The best argument for American shareholder capitalism—in which shareholders govern the corporations that shape our economy—is that the owners of a company should get to decide what it does. The system may not be ideal, but the underlying justification is that the people whose money is at risk get to call the shots.

This is no longer the case. The people increasingly calling the shots in the American economy are a handful of executives of a handful of asset management firms who are playing with enormous amounts of other people's money that they accumulated by being very good at administering, marketing, and selling index funds. Instead of shareholder governance, we have financial intermediary governance. These intermediaries gained economic power because of a massive swing in investor sentiment away from actively-managed funds and toward index funds. Their executives are highly capable businesspeople, but they are increasingly becoming the unelected stewards of the American economy. (People buy index funds and ETFs from a given asset manager either because they have no other choice in their retirement plan or because of cost—not because they like how that asset manager votes its shares.) In the words of law professor John Coates, "A small number of unelected agents, operating largely behind closed doors, are increasingly important to the lives of millions who barely know of the existence much less the identity or inclinations of those agents."[21]

Take the example of climate change. Some people think that asset managers should not take a position on climate issues. Others think that they should actively push corporations to reduce their carbon footprints. But the more fundamental question is: Why do the CEOs of the Big Three, assisted by a few dozen analysts, have the swing vote on crucial questions that affect our economy and society? Do we want corporate America's attitude to climate change to depend on whether three people happen to be Republicans or Democrats? This is obviously not a

[19] Jeanna Smialek, "Top U.S. Officials Consulted with BlackRock as Markets Melted Down," *New York Times*, June 24, 2021; Victoria Guida, "Massive Bailout Leaves Wall Street Giant Exposed to Fire from All Sides," *Politico*, June 7, 2020.
[20] Smialek, "Top U.S. Officials Consulted with BlackRock as Markets Melted Down."
[21] John C. Coates, "The Future of Corporate Governance Part I: The Problem of Twelve," Harvard Public Law Working Paper No. 19-07, Sept. 20, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337.

democratic system. But it is not really a capitalist system, either. Corporate control is in the hands not of the people whose money is at stake—the investors in mutual funds and ETFs—but of the executives who manage the companies that manage those mutual funds and ETFs.

We are not yet at the point where Larry Fink can dictate terms to any corporation in the S&P 500, but the CEO of almost every large corporation has to listen to Larry Fink and take his views seriously. This problem is not going to solve itself. Each year, the Big Three's aggregate ownership share of the typical S&P 500 company grows by about one percentage point.[22] This trend is unlikely to change anytime soon because the shift to index funds is actually *good* for investors as individuals. I hope that Republicans and Democrats can agree that this increasing concentration of economic power by a few asset management firms is not good for our economy or our country, even if we may disagree on what to do about it.

[22] Bebchuk and Hirst, "The Power of the Big Three, and Why It Matters," 9.