Testimony of Professor John C. Coates IV

John F. Cogan, Jr. Professor of Law and Economics

Harvard Law School

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Chairman Brown, Ranking Member Toomey, and members of the Committee, thank you for inviting me to provide written testimony on the index fund voting process. The rise of index fund ownership and its effects on corporate governance are important, as I have written.[1] As I continue to study the phenomenon, I now think of it **not** as a "problem" to be solved, but as a "dilemma" to be managed, to balance economic and practical trade-offs. Any legislative intervention should be cautious and provisional, giving the Securities and Exchange Commission (SEC) the ability to adjust and refine how the law applies over time, as markets respond and evolve.

To state the dilemma: On the one hand, index funds provide huge economic benefits to individual investors, in the form of low cost diversification, which requires keeping regulatory burdens low. On the other hand, their success has so concentrated ownership as to challenge the legitimacy and accountability of customary delegated governance. The rise in popularity of "indexes" also threatens to harm investors through creation and marketing of bespoke and undiversified or otherwise risky "indexed products" that lack the characteristics of conventional indexes. Giving investors ways to better understand and inform advisors about governance decisions and preferences are worthy goals. To avoid degrading index funds' real benefits, any legislative solution should be practical, cost-effective, and carefully designed to avoid unintended consequences, in part by

[1] THE PROBLEM OF TWELVE, COLUMBIA GLOBAL PRESS (forthcoming 2022); The Future of Corporate Governance Part I: The Problem of Twelve (Sep. 20, 2018). Harvard Public Law Working Paper No. 19-07, https://ssrn.com/abstract=3247337; Thirty Years of Evolution in the Roles of Institutional Investors in Corporate Governance (May 2014), in RESEARCH HANDBOOK ON SHAREHOLDER POWER (Jennifer Hill and Randall Thomas, eds., Edward Elgar 2015).

delegating implementation to the SEC. It should enlist rather than try to supplant market forces.

As written, Senate Bill 4241 is not practical or cost-effective, would create significant uncertainty in corporate governance, and would not address the dilemma of indexation. As discussed more below, depending on unpredictable and ever-shifting variation in ownership of public companies, it would variably (a) entrench managers to shareholders' detriment, (b) make it cheaper for hedge fund activists to attack well-run companies, to the detriment of both corporate managers and shareholders more generally, (c) boost the power of proxy advisors, with some risk of harm to individual investors and in any event only shifting and not improving the legitimacy and accountability of corporate governance, and (d) likely result in less long-term investor influence than at present. It would also create bad incentives for funds or pension plans to adapt "closet indexing" strategies to avoid the law's effects (resulting in no benefits and additional costs).

Better would be a package of reforms that are more modest and effectively targeted. Straightforward would be reforms that build on the kinds of self-imposed disclosure and governance processes and rules that index fund advisors have developed on their own, as they have attempted to address the legitimacy dilemma of their success. For example, low-cost quarterly or more frequent reporting is feasible for large funds. Also worth consideration are specified qualitative disclosures about how advisors develop, identify, assess, and take voting positions on new issues as they emerge. It should be possible for fund advisors to obtain information from their investors about how they want indirect

governance powers to be exercised, without attempting to go so far as S. 4241. But the technology challenges and costs of such investor input should not be underestimated, and patient and persistent pressure from the SEC is likely to lead to better outcomes than an attempt to micromanage consultations through legislation.

Conflict of interest restrictions that exist at the fund level could also be imposed at the advisor level. This would help insure that the potential power that large fund advisors obtain from concentrated ownership cannot be leveraged to benefit their other operations or to harm any of their own investors. To insure this step does not create unintended consequences, it should be done by authorizing and directing the SEC to do so, with appropriate adjustments as the SEC may discover are appropriate to protect investors.

Consistent with analysis and recommendations from former University of Virginia School of Law Dean Paul Mahoney and Professor Adriana Robertson,[2] Congress could clarify authority for the SEC to oversee index providers (such as S&P and MSCI), who provide the key input to the index fund product (that is, indexes themselves), and do so with enormous discretion and with light and incidental current oversight. As to fund advisors, Congress could simplify the requirements for or direct the SEC to use authority to provide exemptive regulatory or liability relief necessary to enable large fund advisors to experiment with practical, low-cost ways to obtain governance direction from their investors. Finally, the SEC should also have at least as much authority it currently has to review and approve new funds to also review and approve investment products that use

[2] Advisers by Another Name, 11 Harv. Bus. L. Rev. 311 (2021).

the "index" brand to partly mimic conventional, low-cost diversified index funds, but lack their all-in investor-friendly attributes, while being designed to avoid conventional fund regulation, including collective investment trusts sponsored by banks.

The rest of this written testimony builds on this introduction in three ways: (a) the benefits of index funds are amplified, to underscore how important it is not to unduly degrade them; (b) the problems with the intuitive but ultimately impractical and even harmful concepts in S. 4241 are explained, and (c) some alternatives for improved regulation sketched above are discussed in more detail.

1. The benefits of indexation

Indexation and index funds provide enormous direct and indirect economic benefits to Main Street investors. That is precisely why they own a large and increasing share of US public company stocks (as well as other financial assets). "At year-end 2021, index mutual funds and index ETFs together accounted for 43 percent of assets in long-term funds, up from 21 percent at year-end 2011."[3] They continue to increase their market share.

They continue to succeed because they are a cost-effective way for individual Americans to invest in broadly diversified portfolios, especially for the 99+% who lack the wealth required to hire a full-time and trusted personal financial advisor. They provide better risk-adjusted returns than if such investors tried to invest directly in public company

[3] ICI Factbook 2022, at 29.

stocks, and on average better than through other institutional channels.[4] My first investment – at age 14 if memory serves – was in a Vanguard index fund. I am not a financial advisor, but I will continue to recommend index funds – to my children, for example.

Still, to be clear, I am not one of those finance academics that believes that no one can outperform the market, or that actively managed funds are so incapable of doing that that they should be banned. Many professionals can in fact generate "alpha" for their investment clients – that is, they can select or weight stocks to achieve greater returns than if they simply invested in standard indexes.[5] That is true on a net-of-fee and risk-adjusted basis, at least for certain kinds of financial assets.[6] In the limit, in principle, doing so will become more feasible as indexation increases.

I come to the topic of index funds, then, not a quasi-religious supporter, or a detractor, but as one who sees their social and economic benefits as well as the social and economic challenges they create. Their rise has lowered the all-in costs of investment directly, for their own investors. On an asset-weighted average basis, conventional equity index fund expense ratios are six basis points; by contrast, the median equity mutual fund charges

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[4] Fama, Eugene, and Kenneth French. 2010. Luck versus skill in the cross-section of mutual fund performance. Journal of Finance 65, 1915-1947; Kosowski, Robert, Allan Timmermann, Russ Wermers, and Hal White. 2006. Can mutual fund "stars" really pick stocks? New evidence from a bootstrap analysis. Journal of Finance 61, 2551-2595.

[5] Barras, Laurent, Olivier Scaillet, and Russ Wermers. 2010. False discoveries in mutual fund performance: Measuring luck in estimated alphas. Journal of Finance 65, 179-216 (75.4% of funds have some skill); Berk, Jonathan, and Jules van Binsbergen. 2015. Measuring skill in the mutual fund industry. Journal of Financial Economics 118, 1-20.

[6] See K.J. Martijn Cremers, Jon A. Fulkerson and Timothy B. Riley, Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds, 75 Fin. Anal. J. 1-28 (2019) (surveying studies).

104 basis points, more than 15x higher.[7] Costs of directly investing in equivalent diversified portfolios are vastly higher for individuals.

Index funds also have benefited all investors, through competition. As they have grown their market share, their direct competitors – actively managed funds – have lowered their fees, too, or else exited the market, shifting assets to lower-fee funds, on average.[8] By making it easier to invest, they also induce more investment, which increases liquidity, and lowers the cost of capital for all firms. Their economic benefits, in other words, are general, and benefit the market as a whole.

Index funds not only charge lower fees, they also impose lower opportunity costs on investors. It is vastly simpler for an individual investor to designate and invest in a reputable low-cost index fund than it is to invest directly. That is true even if a retail investor invests in the same underlying securities, and even if they could do so at the same out-of-pocket cost, which they cannot. That is partly because the components of indexes are constantly changing, as companies merge or otherwise drop out of the market, and new ones are added. An individual investing directly would have to be continually engaged in buying new stocks (along with record-keeping, tax reporting and other "back office" activities) to preserve their exposure to the same diversified investments a single index fund provides.

[7] ICI Factbook 2022, at Figure 6.5.
[8] Id. at Figures 6.2 and 6.3.

Oversight of actively managed funds also takes more time than oversight of index funds. Active strategies must evolve with markets, and key members of good active fund portfolio management teams can retire or exit their roles. Individual investors must thus devote more attention to monitoring active funds than index funds. Importantly for present purposes, governance itself – learning when shares need to be voted, learning about the issues or people to be voted upon, and then voting – is time-consuming and expensive. Few individuals will or even could oversee the votes attached to the many thousands of companies whose shares are held by the most successful index funds. Even attempting such a task would approach a full-time job for an individual investor.

Finally, index funds enjoy significant economies of scale, at least if they primarily hold large company liquid stocks. Those economies of scale are part of why they can charge lower fees. They use their large scale to negotiate very low cost service contracts for back-office functions and trading. Not only do these economies contribute to their growth, but they also create greater concentration of ownership and create the "dilemma" sketched in my introduction.

For thinking about legal change, it is important to note that law and regulation contribute to economies of scale, by simplifying the allocation of voting rights associated with assets held by index funds. Fund investors, unlike direct investors, do not vote the shares owned by the fund. Fund advisors do. This follows from basic organizational law, long primarily a task for the states, not the federal government. Because advisors can and have developed voting systems that can accommodate multiple funds within a given fund

complex, the per-vote cost of governance for index funds is lower than for individuals, or smaller funds and smaller complexes.

Given that they achieve all of the foregoing benefits, the most important principle in thinking about how they are regulated is the principle of "first, do no harm." As I will sketch next, the voting system underneath each index fund is more complex than it appears, just as our sleekly designed personal laptops and phones contain intricate systems inside. It would be a mistake to tinker with the insides of our devices without expert help, or to do so quickly, or based on simplified assumptions about how they work. The same is true for corporate governance by index funds.

2. The governance roles of index funds and the likely effects of S. 4241

Index funds – like all mutual funds, pension funds, corporations and trusts – have legal ownership of their investment assets, such as shares. Fund investors own shares **issued by** funds, not shares **owned by** funds. Fund investors do not have the right to direct how the fund votes shares it owns. The fund board has that right, typically delegated under a contract to the fund advisor.

The same is true of investors in a public company. They do not have the right to direct how to vote shares of other companies that it may own. For example, Exxon and Shell have a 50/50 joint venture called Infineum. The shareholders of Exxon do not have a right to vote Infineum shares, even 50% of them. Exxon, the corporation, has that right, a right held by the Exxon board, typically delegated to Exxon officers. In this way, index

funds are treated under state identically to other kinds of legal entities. To break from this tradition, as proposed in S. 4241, would be a significant change – suggesting caution, as such a change is likely to have unintended consequences.

As S.4241 recognizes, fund owners are themselves commonly other legal entities, such as other funds or trusts or retirement plans. Not reflected in the bill, fund owners can also be "omnibus" accounts at brokerage firms, through which still other investors invest in the fund, whose identities are purposefully shielded from fund advisors for competitive reasons. Many fund advisors separately manage "sleeves" or separate accounts that own the same investments as a fund, in a legally separate way, which would be unaffected by legal changes applicable to index funds, yet which are included in the numbers usually quoted (including by me) to show the rise of indexation. Sometimes voting rights of assets held in such separate accounts are retained by the investor, but sometimes they are delegated to the advisor, as with a fund.

If this brief sketch seems complicated, it is in fact a gross simplification of reality. A typical index fund will have some shares owned by (for example) one or more other mutual funds, one or more pension funds, one or more corporations, and one or more separate accounts at an insurance company. Some of the assets of those entities are typically owned in turn by retirement accounts, which are sponsored in turn by (for example) an employer (e.g., a dentist office) for the benefit of current and retired employees. If one were to drill through all of the layers of ownership of a typical large index fund, one would find not simply the thousands of shareholders that directly own fund shares, but thousands more individual beneficiaries, separated by varying degrees of

legal ownership. Tracing the chains of economic ownership up and back down is complex, time-consuming, and error-prone.

Even if a fund were "flat," and simply had a 1,000 individual shareholders, passing through portfolio level votes to its own shareholders would be complex, time-consuming and error-prone. I can assert this with confidence because of our experience with the current portfolio-company-level voting system. When a company like Procter & Gamble seeks a vote from its shareholders, many of those shareholders own shares through brokers. Unlike individuals who own through funds, individuals who own through brokers retain the right to vote. But the process by which P&G seeks proxies from its shareholders, and brokers seek instructions from their clients, is still a work in progress. Only in the current – 2022 – shareholder meeting season is the industry – by which I mean Broadridge (a major proxy services firm), along with corporate transfer agents, the Depository Trust Company, and large broker-dealers – after years of planning – finally testing a pilot system to permit ultimate individual broker clients to "confirm" that their voting instructions were carried out.[9] In the past, many such instructions have been imperfectly followed, at best. The result has sometimes been lengthy and disputed vote contests, where weeks passed before it was clear who won a given vote, and even then without those involved from having any confidence that votes were correctly counted. Put simply, the foundations of the current voting system are not yet secure. Adding more structures on top of a shaky foundation is likely to not achieve what is intended.

[9] See https://cdn.ymaws.com/stai.org/resource/resmgr/industry_info/pilot_announcement_as_of_12..pdf. For background on vote confirmations and other challenges in the basic portfolio-company voting system, see https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-proxy-plumbing.pdf.

Senate Bill 4241 would magnify by many times the challenges of the current voting system. Somewhat simplified, it would require covered index funds to "pass through" votes on non-routine matters to fund shareholders. Because, as noted above, many fund shareholders are themselves funds or other entities, it could require multiple pass-throughs. But even one pass-through to the first layer of shareholders at a major index fund would create enormous practical challenges, along with expense, delay and error. Those costs would be borne by individual investors in index funds. The increased costs would reduce the benefits of index funds, and induce some investors to switch to fund options that are less efficient for them.

Whatever benefits the system would create would be small, because few individuals are likely to use the pass-through rights for most votes. The costs are likely to be far higher, because the sheer number of votes required each year for index funds, which are designed, customarily, to invest in thousands of companies. Simply identifying the choices and voting in thousands of companies' director elections and shareholder resolutions and merger votes would overwhelm a typical individual. I study voting outcomes as part of my job as a researcher and teacher, and even have a taste for it, but I can barely keep up with the aggregate numbers, much less individual votes. The result would be that a tiny fraction of eligible votes would be cast, at what would still be a significant cost (for the fund to communicate times with its investors about the votes, and vice versa). It is tempting to think modern technology would make such communications inexpensive. That would be, in my experience, a mistake. The "back office" details of such communication systems always turn out to be far more complex that simple intuition might suggest. Remember that fund shareholders move in and out of funds

every day, so determining who is entitled to instruct on a given vote is not simple. Voting instruction forms can be imperfectly completed or interpreted or applied. Investors will want confirmations, and will generate further costs as they dial in or electronically attempt to change or undo prior instructions. They will want to complain if they believe their instructions were not completed properly. Any pass-through is not simply a one-time technology fix, but an ongoing workstream requiring many full-time staff to implement. If your intuition is that the cost of such a pass-through is X, I would suggest the actual cost is at least 10X, and could well turn out to be 100X. And to repeat, that cost will generate relatively little actual benefit, because most fund investors will not instruct on thousands of voting choices per year.

This prediction is consistent with individual voter turnout in corporate elections, where individuals have self-consciously chosen to remain direct investors. In such elections, they vote at far lower levels than is true for institutional shareholders. That is true even in contested votes where both sides expend significant sums to encourage shareholders to vote. The predictable passivity of individuals who currently invest through index funds is even greater. After all, they have chosen to use an index fund (rather than investing directly) for reasons, which include cost reduction and minimizing the need to monitor their investments.

To address the possibility that fund investors would not use the pass-through voting rights, the bill would permit funds to engage in "mirror voting."[10] That is, they could

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[10] It also provides a safe-harbor for funds that simply do not vote at all, which has effectively the same result as mirror voting, except that it could mean many companies could fail to achieve a quorum of shareholders voting, as required under varying states laws and corporate charters.

vote uninstructed shares in the same way that other investors vote. I put aside the challenges of fund advisors obtaining information that would permit mirror voting (often, particularly in close contests, many votes are made at the last minute). Even if it could be made practical, mirror voting would effectively magnify the power of a voting instruction given by other investors. These other investors include activist hedge funds, funds that are actively managed but are pursuing a variety of non-representative and non-financial agendas, and funds that follow advice from proxy advisors such as ISS and Glass-Lewis, as well as executives. Mirror voting would effectively shift voting power from index fund advisors to those other shareholders, with hard-to-predict outcomes. While some of those other shareholders are individuals, those individuals (as noted above) vote less frequently than institutional shareholders. So instead of empowering individuals, the bill would magnify the power of other institutions.

I am fairly sure that what would result is not what is intended. In a subset of public companies, the result would be to entrench managers who own enough shares for the boost of the mirror voting of index funds to move them from a non-controlling to a controlling position. For those companies, it would be as if the law had transformed ordinary voting structures into dual class structures, without any shareholder involvement. This would increase agency costs and increase the risk of managers pursuing non-shareholder goals.

In other companies, instead of fund advisor employees voting shares, the shares would effectively be voted mostly at the direction of other agents -- not individuals. To take a simple example to illustrate, suppose votes at a given company were distributed this way on the record date used to determine voting eligibility:

| TYPE OF SHAREHOLDER | OWNERSHIP | MIRROR VOTING | EFFECTIVE, LIKELY VOTE |
|---|---|---|---|
| **MANAGERS** | 1% | 1% | 2% |
| **INDEX FUNDS** | 20% | 0% | 0% |
| **ISS + GL CLIENTS** | 25% | 31% | 40% |
| **HEDGE FUNDS** | 10% | 13% | 17% |
| **INDIVIDUALS** | 28% | 35% | 16% |
| **OTHER FUNDS** | 16% | 19% | 25% |

For this simple stylized example, I use numbers roughly based on data from Innisfree, a proxy solicitor, building on their deep experience analyzing corporate ownership and predicting likely voting outcomes for corporate boards and other clients. Notice that the effect of "mirror voting" or non-voting by index funds (as permitted by S. 4241) is to boost the effective votes of other shareholders. However, because managers often own so few shares, the boost is correspondingly small, so small it does not change the percentage, due to rounding. For clients of ISS and Glass Lewis, the boost is much larger – their likely vote grows from 25% to 31%. Once one takes into account the fact that individual shareholders commonly do not vote, even when aggressively solicited in a voting contest, the effective votes of hedge funds and proxy advisory clients moves to over 50%. Even assuming only 80% of proxy advisory clients side with a hedge fund activist and vote, mirror voting makes a hedge fund victory in a control contest

significantly more likely than if index funds could vote, because index funds (on average) tend to vote more frequently with management. But if the starting position of hedge funds was lower, and managers or other institutions higher, the outcome could well be different, and could even (as noted above) entrench managers (or empower proxy advisor clients). One can vary assumptions in this simple scenario, and produce outcomes that range widely in likely effect on the ability of corporate managers to resist hedge fund activism, social activist resolutions, or other contested votes.

This uncertainty across outcomes is not a minor flaw. The net effect of the pass-through and mirror voting provisions would be to increase significantly the challenges of predicting the outcomes of many corporate votes, casting a shadow over all public companies. Many outcomes would be bad for shareholders as a whole, on average. And the uncertainty involved would induce more activist interventions, management risk-aversion and settlements in which management gives up control to a subset of institutional investors. That would not be good for corporate managers or corporate governance as a whole, and certainly not benefit the individual investors in index funds, on average.

The bill would also create bad incentives for funds to adapt "closet indexing" strategies to avoid the law's effects (resulting in no gains and additional costs), and for investors to avoid index funds to avoid the associated costs. Index funds could avoid the effects of the bill by modifying their approach to over- or under-weight components of an index sufficiently to avoid the application of the law. This is not easily fixed, because it is not a simple task to identify whether a fund's investments have been chosen to track or be derived from an index, or whether their risk and return characteristics happen to be

correlated with an index. On average, by construction, stocks and other investable assets have a "beta" of one – they are correlated with the market as a whole. In a diversified portfolio, many companies' shares move in tandem, even if they are not part of an index. The upshot is that the bill could be avoided, albeit with costs and increased risk for investors. Alternatively, it could be rewritten to cover all funds, but that would magnify its costs for little marginal benefit.

In sum, the bill would generate significant costs – which would be borne by Main Street investors. It would be likely to not generate substantial new individual investor engagement. Instead, it would shift voting power away from economic owners to unpredictable groupings of other shareholders. And it would make the overall voting process more complex, time-consuming, error-prone, and unpredictable. If I to be asked by **anyone** with an interest in our corporate governance system – managers, investors, fund managers, proxy advisors, proxy solicitors, or activists of various kinds – the cost and risk are such that I would advise them that they would be worse off as a result.

3. Alternative suggestions reforms addressing the index fund dilemma

If the rise of indexed funds presents legitimacy and accountability challenges, as it does, and if Senate Bill 4241 would make corporate governance worse, what are alternative suggestions for reform? What would allow individual investors to better understand and inform advisors about governance decisions, without degrading index funds' real benefits?

First, reforms could build on the kinds of self-imposed disclosure and governance tasks that index fund advisors have developed on their own, as they have attempted to confront

the legitimacy dilemma of their own success. For example, low-cost quarterly or more frequent reporting is feasible for large funds. A faster cadence of after-the-fact electronic vote reporting is now cheaper than in the past, and would not impose undue costs on fund investors. The costs of increased frequency of fund reporting would be far lower than the costs of a pass-through system would be, because more frequent reporting of fund votes involve an existing system, the fixed costs of which have already been incurred, and would consist of a presentation of facts funds must already track. A pass-through system would involve new fixed costs in a system that could elicit, process, validate, aggregate, implement, and reporting back about thousands of voting instructions from thousands of investors.

Advisors could also provide better qualitative disclosures about how advisors develop governance understanding and voting positions on new issues as they emerge. Currently, the only time that fund investors learn about a fund advisor's inclinations on a given policy issue – e.g., whether to vote to split the Chair and CEO roles across companies – is after the fact, after votes on resolutions proposing such issues have occurred. Better would be to inform fund investors beforehand, so they would know that a new kind of governance issue has arisen, and that the fund advisor is considering how to respond. Some issues are too company-specific for advance disclosure to be feasible, outside a specific vote, but often issues arise at one company only to become the subject at votes at multiple companies over time. If advisors were to proactively identify "emerging issues" for their own fund shareholders, those shareholders would be better able to respond (such as by selling fund shares, if they wanted, as they can do now) based on how the advisor plans to respond to the issues. Market discipline would be more effective with more

complete advance disclosure about how fund advisors evaluate new policy issues over which they exercise delegated governance authority.

More ambitiously, it should be possible for fund advisors to obtain some information from their investors about how they want their indirect governance powers should be exercised, without attempting to go so far as S. 4241. For example, funds might ask their investors for their views on topics overall, or whether overall a fund advisor should follow the advice of an existing proxy advisor, or a new one that might emerge over time, which might take different positions from existing proxy advisors. Or funds might give their own investors the ability to set overall voting guidelines, as ISS's institutional clients already do. Those views could be aggregated and used by a fund advisor to guide it in making voting decisions for fund shareholders as a whole. While I believe some such system may turn out to be workable, I emphasize that imposing a simplistic requirement to provide such options may not be best for index fund investors as a whole. That is because any such option may only be used by a minor number of fund investors, but the system to permit it would impose costs on all fund investors. Index funds have a "mutual" component of shared costs, after all – that is they are "mutual funds." Individual investors electing to use the system might be charged individually for the costs of such a system, but such separate expense pass-throughs raise complex regulatory questions under current law, and may require exemptive relief from the SEC.

For both cost reasons, and because taking instructions in this way is likely to be quite practically challenging, for reasons sketched above, investors in and advisors to index funds are likely to benefit from pilots and experimentation before finalizing any given method of communicating with or eliciting governance information from fund

shareholders. It would be best to avoid trying to micromanage how it will be done through legislation, and instead provide advisors with flexibility to test whether and which such types of systems would actually be used by investors. Directing the SEC to oversee pilot programs proposed by advisors to accomplish these goals would be a conservative (in the non-political sense) way to pursue such a goal. The SEC could also be given clear authority to provide regulatory relief (from fiduciary duties under the Investment Advisers Act or other legal duties) if needed by advisors to pursue such pilots, conditioned on appropriate public-regarding conditions and investor protections.

Conflict of interest restrictions that exist at the fund level could also be imposed at the advisor level. This would help assure that the potential power that large fund advisors obtain from concentrated ownership cannot be leveraged to benefit their other operations or to harm any of their own investors. So that this step does not create unintended consequences, it should be done by authorizing and directing the SEC to do so, with appropriate adjustments as the SEC may discover are appropriate to protect investors.

As you consider index funds, you should also consider index providers (such as S&P and MSCI), who provide the key input to the index fund product (i.e., indexes). The market for index creation is highly concentrated, and some evidence exists that providers use market power to charge substantial licensing fees.[11] They wield enormous discretion and have light and incidental current oversight. Famous examples of companies like Tesla

[11] Y. An, M. Benetton, and Y. Song, Index Providers: Whales Behind the Scenes of ETFs, Working Paper (Jan. 12, 2022), available at https://www.law.nyu.edu/sites/default/files/Matteo%20Benetton%20Paper%20Final.pdf.

being taken out of the S&P ESG Index are not due to choices by index funds, but by the index sponsor. Increasingly, "indexes" are being created that consist of narrow classes of assets, without meaningful economic diversification. Former Virginia Law Dean Paul Mahoney and Professor Adriana Robertson have argued that the SEC already has authority to regulate index providers as "investment advisers," but Congress could clarify this authority. Doing so could stave off at least some kinds of predictable industry court challenges, and the SEC could be given some direction as to how index providers should be supervised in this respect. Through a public-comment style process, they could be required to take input from individual investors on how to manage and adapt existing indexes over time.

Finally, before imposing costly new regulations on index funds alone, some thought should be given to whether "indexation" is being misused outside the context of the largest index funds. Collective investment trusts sponsored by banks are currently beyond the reach of the securities laws, as are commodity pools investing in index-linked derivatives. It is not clear that giving responsibility for supervising such vehicles to different federal agencies makes sense, as they are functionally much closer to mutual funds than to other types of financial institutions.

More dangerously, many "products" are sold directly or through brokers to investors as index-linked bonds or the like, and are structured not to fall outside the SEC's jurisdiction altogether, but outside of the Investment Company Act of 1940. As a result, they may be marketed as "index-based" without having to comply with the

diversification, conflict-of-interest and custody rules applicable to mutual funds, such as index funds. Many such products are increasingly being built on bespoke, one-off indices, that utterly lack the economic benefits of index funds. The SEC should also have at least as much authority it currently has to review and approve new funds to also review and approve such products, even if they are not formally investment companies.

None of these suggestions will “solve” the “problem” of increased concentration of ownership through index funds. They do have promise, however, of mitigating the legitimacy and accountability dilemma that such concentration creates. Most importantly, if carefully crafted and accompanied by delegation to the SEC, they may achieve benefits without destroying the basis on which such funds have provided enormous economic benefits to Main Street investors.