ESG and Asset Manager Capitalism

1. Introduction

In 2021, Engine No. 1, a small activist hedge fund, led a charge to install three new ESG-focused directors at the oil and gas giant ExxonMobil. These new directors aimed to improve the company's strategic planning concerning the "existential" risks to its business model posed by climate change and the energy transition. They have overseen big changes at Exxon, including substantially reducing new capital investment in fossil fuel projects, pushing the company instead to use its record profits to both return capital to shareholders and boost investment in low carbon energy projects.[1] This represents a much-needed change in behavior at what might be the least climate conscious of the oil majors. Though it is too early to tell whether this proxy fight will have a lasting effect on Exxon's emissions profile, it constitutes an important proof of concept for the idea that corporate behavior can be pushed in a more pro-social direction through activism in the capital markets.

Engine No. 1 did not accomplish this alone: it had the backing of several institutional investors. The largest and most important of these was Blackrock. Eventually, it also gained the support of Vanguard and State Street. Together, these are known as the "big three" asset managers. They are the largest shareholders in most publicly traded companies in America.[2] Together, they own more than 20% of the average S&P 500 company, and are usually among the largest shareholders in public companies. The rise of these three huge asset managers has been fueled by the passive investing revolution—itself driven by academic research showing that the diversification and low cost of passive investing achieve superior risk-adjusted returns compared to actively managed portfolios. The big three do not themselves own such large stakes; rather, they manage the investments of millions of individuals and institutions, and as such, exercise the voting rights associated with the shares they manage. The sheer amount of assets they manage implies that the big three have immense power in the world of corporate governance. What's more, the passive revolution is not yet complete, as the assets under management of the big three are projected to continue to grow in the coming decades, as the passive revolution continues.[3]

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[1] Jacobs (2022). "Signs of Change at ExxonMobil a Year after Hedge Fund Proxy Fight." *Financial Times*.
[2] Though the passive revolution and the power of asset managers is a global phenomenon, I will largely focus on the U.S. context for the purpose of this paper.
[3] Bebchuk and Hirst (2019).

The normative implications of this concentration of the voting rights of America's public companies are the subject of this paper. Many have seen this concentration as an important opportunity to improve the social responsibility of business. For instance, in a 2018 letter to American CEO's, Larry Fink, chairman and CEO of Blackrock, instructed managers that "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[4] Yet, others, mainly on the political right, see this as a problematic trend, calling the whole idea "woke capitalism" and threatening to regulate or withdraw state monies from managers who use ESG criteria and "discriminate" against fossil fuel companies. Though these criticisms from the right are largely off-base, there are some significant reasons to be concerned about the large and growing influence of asset managers.

Here is how the paper proceeds. In section two, I will examine the economic driver behind the size and power of the big three: the passive investing revolution. I will discuss several respects in which this revolution has fundamentally changed capital markets, most notably by making a large share of investors *universal owners*. In the third section, I argue for my central analytical conjecture: asset managers exercise *quasi-political power*. They use their influence to shape the rules of the game in public capital markets in order to implement social and environmental policies that have traditionally been the exclusive purview of states. "Asset manager capitalism" is a recent term coined to refer to the contemporary system of corporate governance that succeeded the Berle and Means corporation with its dispersed ownership;[5] the argument of this section is that asset manager capitalism is also a new political-economic regime. In the fourth section I defend my central normative claim: asset manager capitalism is an untenable and illegitimate political-economic arrangement, for at least two reasons. First, the power of asset managers is not checked by any institutional constraints, and is not rendered legitimate by any democratic process. More fundamental than this procedural critique is an argument that the interests of asset managers could not be aligned with the public interest. I conclude by discussing several proposals to reform asset manager capitalism.

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[4] Fink (2018)

[5] Braun (2021).

2. Background: Passive Investing and the Rise of Asset Managers

The index fund is the most important financial innovation since the joint stock corporation. Since its introduction in the 1970s, it has fundamentally transformed the way that investors interact with capital markets. Before its popularization, investors either had to pick stocks themselves or pay an expensive professional to do so on their behalf. Now many people invest in the stock market at practically no cost, and are able to consistently achieve the market's return. The passive revolution has created immense value for ordinary investors, as it has democratized access to capital markets. The share of assets under passive management has consistently grown over time: one recent estimate suggests that around one third of equity assets are passively managed,[6] and this share will continue to grow over the coming decades.[7] Despite their huge importance, the effects of the introduction and wide adoption of index funds are not yet well understood.

Index funds are based on academic research first conducted in the 1950s and 1960s by Harry Markowitz (1952), William Sharpe (1964) and Eugene Fama (1965), (1970), among others. This early work had two important conclusions. First, rational investors seek to maximize the risk-adjusted rate of return of their entire portfolios, and all ways of doing this involve holding the market portfolio—the portfolio that holds all publicly traded securities in proportion to their market capitalization. Second, it is impossible to consistently beat the risk-adjusted return of the market portfolio through active management, because capital markets are *efficient*—the prices of capital assets incorporate all publicly available information about their expected future returns. These claims imply that the then prevailing practice of hiring a professional manager to pick stocks, and paying them large fees to do so, is inferior to purchasing a broad cross-section of the market at low cost. It took a long time for financial professionals to act on these academic results, but eventually Jack Bogle founded Vanguard in 1975, the first firm to provide index funds at scale.[8] This inaugurated the passive revolution, which would gradually bring about profound changes to capital markets over the next 50 years.

There are limits, though, to how far the passive revolution can proceed. Suppose that the passive share continued to rise and eventually reached 100%. Then, the economy would be

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[6] Chinco and Sammon (2023).
[7] Bebchuk and Hirst (2019), Coates (2018).
[8] Wigglesworth (2021) contains a well-documented account of how these academic results were transmitted.

completely centrally planned—capital allocation would occur not on the basis of prices in a capital market, but rather, on the basis of decisions made by asset managers and corporate executives who would then play the role of central planners. If every individual did what was individually rational according to financial theory—buying index funds to take advantage of market efficiency—then markets would cease to be efficient. Passive investors free-ride off of the price discovery activities of active investors, but if everyone did this, then capital markets would cease to function. This is the Grossman-Stiglitz paradox.[9] Increasing the share of capital held by index funds reduces the share of active managers who incorporate information into prices. So far, though, the steady rise in the passive share has not led to a measurable decrease in market efficiency.[10] Eventually, an equilibrium might be reached in which the passive share cannot grow any further, because the returns to active investing would exceed those of passive investing if it becomes easier to incorporate new information into prices. We do not know where the passive-active equilibrium lies, or indeed, whether it is a static or dynamic equilibrium.

The investor in an index fund is a *universal owner*:[11] they own every company in the index in proportion to its size. It is crucial to understand how the incentives of universal owners differ from those of concentrated owners. Suppose that Una and Constance buy stocks in the home improvement industry. Una buys both Lowe's and Home Depot stock but Constance only buys Home Depot. Una is indifferent as to whether Lowe's or Home Depot earns the profits in the home improvement industry; indeed, she is averse to competition between the two if that would result in a reduction in the sum of their profits. By contrast, Constance only wants Home Depot to make a profit, even if this means aggressively competing against Lowe's for market share. Universal owners want to maximize the level of profits in the entire economy, because they own all of the firms in the entire economy. As such, universal owners do not want firms to compete with each other if that reduces the level of profits of any publicly traded companies. By contrast, concentrated owners want to maximize the profits made by the firms that they own, but don't care about industry- or economy-wide profits. Both simply want to maximize profits, but due to their different holdings, do so in different ways.

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[9] Grossman and Stiglitz (1980).
[10] Coles et al. (2022).
[11] For an analysis and history of this concept, see Quigley (2019) "Universal Ownership in the Anthropocene."

For precisely this reason, universal ownership has raised anti-trust concerns among economists and legal scholars.[12] Empirical research has found anti-competitive effects in product prices in the banking and airline industries that reflect concentrated ownership by large asset managers.[13] Universal ownership led to higher prices and lower output in these industries, imposing costs on consumers. These costs will likely become detectable in other industries and grow in magnitude as the passive revolution proceeds, since firms will have a greater proportion of common owners. This research program is still new, and is quickly building on promising early results and a strong theoretical foundation. Asset managers may view it as a threat, evinced by the fact that Blackrock released a strongly worded whitepaper which attempted to debunk some of the findings.[14]

There is an upside of universal ownership, though. Universal owners have an incentive to mitigate risks facing the economy as a whole, because these are risks to aggregate profits. Universal owners are incentivized to ensure that there is a stable business and regulatory environment in which all firms can operate. Most importantly, universal owners are incentivized to mitigate systemic risks to the economy, such as climate change and war. Universal owners are not sensitive to idiosyncratic risks, insofar as one firm's idiosyncratic risk is another firm's opportunity. Concentrated owners have the opposite set of incentives. Negative externalities produced by firms are irrelevant from the financial perspective of concentrated owners, but universal owners internalize externalities caused by one firm that adversely affect other firms. This is the primary reason why the large asset managers have become interested in ESG standards.[15] Promoting these standards in the companies they own is consistent with—indeed, it is required by—the fiduciary obligations that the asset managers owe to their clients, and this is *because* the clients are universal owners. Climate change and environmental degradation, the adverse effect of businesses on social institutions and social capital, and poor corporate governance are among the most important threats to sustainable profitability in the economy as a whole. The fact that asset managers represent universal owners, along with the fact that those owners usually have a long time horizon, explains why asset managers focus most on these

[12] Morton and Hovenkamp (2018), Posner et al. (2017), Azar (2020), Boller and Morton (2020).
[13] See Azar et al. (2018) and Azar et al. (2019), respectively.
[14] Novick et al. (2017).
[15] Condon (2020).

issues.[16] A core component of my normative analysis in the fourth section rests on a structural limitation of this upside: universal owners only have an incentive to mitigate externalities and risks facing other publicly traded businesses, not those that face society as a whole.

The phenomenon of universal ownership also raises an important normative question for fiduciary theories of managerial obligation (e.g., Friedman 1970). According to such theories, managers have the sole obligation to act in the best financial interest of their shareholders. But the notion of the "financial interest" of the shareholders is ill-defined at best. The financial interest of those shareholders who are universal owners will be best advanced when firms adopt less competitive strategies, and the financial interests of those shareholders who are concentrated owners will be best advanced when firms adopt more competitive strategies. *Which* shareholder financial interests should firms prioritize? Similarly, investors have financial interests other than the total return on their investment. According to modern portfolio theory, one of these is decreasing the volatility of the investment. Another is decreasing the correlation between the stock price and the entire stock market. Investors also have different time preferences and discount rates. The fact that owners of any public company have heterogenous risk and time preferences means that there is no such thing as *the* financial interests of the shareholders. Hence, the recommendations of shareholder theories in business ethics are, in an important sense, indeterminate.

Now that I have explained the economic fundamentals driving the passive revolution and the characteristics of universal ownership, I can explain how passive capital ownership has been institutionalized. As index funds have grown in popularity, the asset management industry has become concentrated in the hands of a few key players, because there are economies of scale in providing index funds. Asset managers are responsible for "stewarding" the capital that they manage. In principle, this can be done either by exit or voice, but since passive investments merely track an index, managers cannot sell shares of companies that are being mismanaged. Instead, their only mechanism for influence is exercising the voting rights of the shares they manage. But since part of the appeal of passive investing is its low costs, the big three cannot thoroughly investigate every issue at every shareholder meeting for the thousands of companies

[16] See Fisch et al. (2019) for a similar analysis.

they own. Rather, they have general guidelines about how they vote on issues.[17] They also rely on proxy voting advisory services. The market for these consulting services is a duopoly controlled by Glass Lewis and Institutional Shareholder Services. Since asset managers often defer to their advice, the proxy advisors are an important locus of coordination. Asset managers also tend to default to supporting management when conflicts arise.[18] Finally, they also rely on the providers of the indices that their funds track, including the relatively new field of ESG rating. Proxy advisors and index providers are thus two additional loci of unaccountable power in corporate governance.[19]

Since the big three manage so many assets, they are no doubt the most important voice in corporate governance today; they have the ability to influence the behavior of almost all publicly traded companies. There are several mechanisms through which they exercise influence. The most transparent, and least important, of these is by voting at shareholder meetings. Occasionally there will be a confrontational and contested meeting, like Exxon's in 2021. But the real power of asset managers lies in the shadow of the votes they control. First, when an asset manager votes against executives at one company, this sends a signal to executives at other companies. The fact that Exxon's management had to go through a public, expensive and nasty proxy battle shows other executives what they must do to avoid this at their companies.[20] Second, asset managers exercise power when they "engage" with companies.[21] Engagements take the form of informal contacts between the asset manager and the company in question, in which the asset manager provides feedback and details any changes that they would like to see. These requests are not binding, but have force because if management does not fulfill the requests, the asset manager may litigate the issue more publicly at the next shareholder meeting. These engagements are opaque, even to scholars working in corporate law and corporate governance. There is no dataset

[17] See Coates (2018) for a discussion. Vanguard "2022 Investment Stewardship Annual Report" and Blackrock "BIS 2022 Annual Report."
[18] Stewart (2023).
[19] See Wigglesworth (2021; 251-264, 288-290).
[20] Importantly, the government's power to influence corporate activity is sometimes indirect in a similar way. For instance, antitrust litigation, even if it fails, sends a signal to markets: Nylen and Davis (2023) "US Antitrust Enforcers Are Chilling Big Mergers" *Bloomberg.*
[21] Vanguard conducted almost 2,000 such engagements in 2022. Vanguard "2022 investment Stewardship Annual Report." Blackrock conducted almost 4,000. Blackrock "Investment Stewardship Annual Report."

of engagements available, so we cannot quantitatively study their effects.[22] Finally, recent evidence has shown that management compensation packages—which are, of course, designed and implemented by the board of directors, who asset managers have a large say in selecting—promote the interests of universal owners. Anton et al. (2022) found that where universal ownership is more prevalent, "the sensitivity of top managers' wealth to their firm's performance is weaker." They then build a model to show how this incentive transmits down the management structure of the firm to influence pricing decisions in an anti-competitive way. The final mechanism, which plays a central role in the anti-trust literature, is influence by omission. Omissions can play a causal role, as philosophers who study the topic have long recognized. The idea is that merely by failing to push managers to compete more aggressively, as a concentrated owner would, managers get an important signal. What's more, managers know who owns their companies, and what their ultimate economic interests are, and they know which strategies to adopt to best advance those interests. There don't need to be any smoke-filled rooms in which asset managers and executives all collude to raise prices in order for the effect of widespread universal ownership to be higher prices. The effect can come about through a decentralized mechanism whereby owners fail to push their portfolio companies to compete and managers know who their owners are and why they fail to incentivize competition.

I have just identified several ways that asset managers can influence the behavior of corporations whose shares they own. Now I must discuss two mechanisms through which asset managers can impact the real economy by influencing how capital is allocated. Asset managers offer ESG-branded financial products, which purport to have a positive social impact through investing and avoid certain risk factors. The promise of these funds is that they will raise the cost of capital for low-ESG firms, making their behavior more expensive, and hence reducing its prevalence. ESG investors are willing to accept a lower return in order to avoid ESG risk factors, and, perhaps, because they derive consumption value from the thought that they are doing something good with their investments. Asset managers offer them because the ESG branding allows them to charge higher fees compared to index funds. Just as asset managers can use their voice in company engagements and proxy voting, they can also partially divest from some

[22] Vanguard disclosed in its 2022 stewardship report a list of companies it engaged with and the general area of the engagement, but not the specific concern or request. Blackrock did not disclose a list of companies it engaged with or why in its 2022 stewardship report, it only reported high level statistics about its activities.

companies by excluding them from popular ESG funds. This gives executives an incentive to improve the ESG performance of their companies.

Second, exercising voice is often a disguised form of partial exit. The relationship between asset managers and big oil in the last few years illustrates this point quite well. Asset managers have used their voice to get big oil to reduce its environmental impact, which, in practice, required the oil majors to sell off their dirtiest and oldest assets. But when these assets were sold, they did not disappear from *the world*, only from the *balance sheets* of the largest oil corporations. Rather, privately held oil companies like Hilcorp Energy purchased these assets (at a discount, and often with preferential financing supplied by the previous owners) and continued to operate them through the rest of their useful lives.[23] This illustrates how voice can be disguised exit: by having a corporation change its strategy and sell some assets, asset managers exit from certain parts of the corporation. It is to such cases that critics of ESG from the left turn when making the point that ESG is inefficacious. It does not matter if a polluting asset is no longer visible and scrutable to public markets and the institutions that control them, so long as it still operates and pollutes as a privately held asset. From the perspective of actually combatting climate change, accounting changes are no changes at all. This critique is partly right. But as long as an accounting change changes the cost of capital and hence the cost of operating the asset, it will have some effect in the aggregate.

3. Asset Managers Have Quasi-Political Power

Recent scholarship in corporate governance has argued that the passive revolution has ushered in a new corporate governance regime: asset manager capitalism.[24] I identified some of the main features of the asset manager corporate governance regime above. The aim of this section is to show that asset manager capitalism is not merely a new corporate governance regime, but rather a new political-economic regime, since asset managers exercise quasi-political power.

The first step is to answer a conceptual question: what is it to exercise political power? One natural answer is that entities have political power when they *perform public functions*, or

[23] Morenne (2023) "Houston Oilman Confounded Climate Activists" *Wall Street Journal*
[24] Braun (2021), Braun (2022), Archer (2023), Voss (manuscript). Though they do not use the term, Lund and Pollman's (2021) notion of the "corporate governance machine" is similar in spirit.

use their influence to *promote causes that are intrinsically political*, or "engage in activities that significantly affect issues of common concern."[25] The standard account in the literature on corporations and politics construes political power roughly along these lines.[26] This literature largely focuses on an international context, in which corporations are both important players in global governance and exercise great powers over people's lives in developing countries where they make foreign direct investments, without any accountability to those people. This view is also inherent in the critique of asset managers from the political right: those on the right think that asset managers have political power because they use their influence to promote "woke" causes. I will discuss this further in the next section.

This account of the political power of corporations cannot be right; it is, at the least, much broader than the phenomenon I am interested in. Taking a stand on a political issue or being able to affect issues of common concern does not give an entity political power. The simplest reason for this is that what counts as a political issue and what is within the scope of politics is essentially contested in a democracy: there is no fixed set of activities that are "public functions" that can either be performed by the state or by private actors. What counts as a public function should itself be determined democratically. There is no set of ends such that, if a corporation advances one of those ends, it is exercising political power. Corporations adopt policies that offend the social or political sensibilities of one segment of society or another all of the time, but they do not *exercise political power* in so doing.

Rather, we should think of asset managers as possessing and wielding quasi-political power because they have substantial influence over the rules of the game in the commercial sphere. What it is to have political power is to be able to influence the rules that everyone must live by. The commercial sphere is a significant part of life, and publicly traded companies constitute a significant part of that sphere. Asset managers have quasi-political power because they can influence the rules of the game in this significant segment of the commercial sphere. I call their powers "quasi-political" rather than simply "political" because asset managers only possess some of the powers to shape the rules of the game typically possessed by Westphalian states. For instance, they do not have a monopoly over the use of force in a geographic territory. They can impose financial costs on non-compliance, but they cannot throw you in jail for non-

[25] Hussain and Moriarty (2018).
[26] Hussain and Moriarty (2014), Scherer and Palazzo (2007).

compliance. Likewise, their nature limits their jurisdictional scope: they can only (directly) exercise power over public companies. The government can regulate both public and private companies. However, there are some respects in which their power is more robust than that of states. Their reach extends further than that of states: their influence is global, because they are diversified across the entire global economy. Dorothy Lund (2023, 129), who also encourages us to think of asset managers as having the ability to regulate public companies, identifies several more respects in which their power is more robust than that of states:

> "Like those government bodies [the EPA and SEC], 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."

Lund also points out (2023, 134-135) that though executives often view government fines as simply a cost of doing business, they cannot do this for asset manager regulations, since asset managers have the power to slash their pay or fire them. Overall, we should think of asset managers as having quasi-political power because they partially set the terms on which firms can interact with public capital markets, and they can influence the behavior of almost all public companies. I will now discuss two forms this influence takes: regulation and taxation.

To understand why asset managers should be seen as regulators, consider an argument by analogy. Return to the example that started this paper. Thanks to Blackrock and other asset managers, Exxon was forced to return some of its profits to shareholders and invest more in its low carbon solutions business, rather than roll those profits back into new oil and gas capital investment as management wished. But on the very same day, Shell was forced by a Dutch court to take similar actions.[27] And in other contexts, the executive branch exercises regulatory control over fossil fuel companies through a variety of tools: restricting rights to drill on public land, limiting emissions through environmental agencies, forcing environmental review before new projects are approved, etc.

[27] McCormick et al. (2021) "Climate activists hail breakthrough victories over Exxon and Shell" *Financial Times*.

Similar examples can be found for social policies as well. Companies are often under pressure to improve their diversity. In different political economic systems, this manifests in different ways. Beginning in 2005, Norway legally required that 40% of the directors of public companies be women. More recently the EU has followed suit: a new European parliament law requires the same of large companies throughout the EU, going into full effect in 2026.[28] Across the Atlantic, however, the federal government has issued no such requirements. Nonetheless, asset managers and other players in the capital markets have instituted similar regulations. Goldman Sachs will not take a company public unless it has at least two "diverse" directors.[29] The NASDAQ exchange is instituting a similar requirement on its listed companies.[30] And, of course, Blackrock pushes its portfolio companies to have at least two women directors.[31] Other social issues, like access to abortion and gun rights, have been the proposed subjects of regulation.[32] Companies are being regulated on both sides of the Atlantic, but only in Europe is the state doing the regulating.

It is clear that *the same thing* here is being brought about by different institutional arrangements: corporations are being constrained in order to promote environmental or social goals. In the one case, corporate decisions are shaped by the capital markets—in particular, by the agents of universal owners. In the other case, corporate decisions are shaped in the traditional way by the state. In both cases, the behavior of companies is constrained by regulation. I cannot see a difference analytically between the cases where the government forbids firms from offering shares to the public unless they comply with condition X, and the situation in which powerful institutionalized gatekeepers for the capital markets forbid firms from offering shares to the public unless they comply with condition X. In both cases, the rules of the game for participation in public equity markets require complying with condition X. Of course, not any constraint posed by capital markets on firm behavior is relevantly similar to regulation. Compare the previous board diversity cases with a case where all companies spontaneously appointed at least two diverse directors, simply as a matter of course. This is not a situation in which a regulation is implemented on my view, even if, for example, the reason many companies have at least two

[28] Reuters (2022) "In wider diversity push, Norway proposes 40% gender quota for large unlisted firms."
[29] Goldman Sachs (2023).
[30] Nasdaq (2023).
[31] Krouse (2018a) "BlackRock: Companies Should Have at Least Two Female Directors" *WSJ*.
[32] Au-Yeung (2022) "Wall Street Gets Forced into the Abortion Debate" *WSJ* and Krouse (2018b) "BlackRock, a Shareholder in Gun Makers, Ramps Up Pressure on Gun Industry" *WSJ*.

diverse directors is to avoid public shaming. Spontaneous orders created by social norms are not regulations even if they produce the same outcomes as institutionalized requirements. Compare: the rules of the game require shaking hands with a new acquaintance when meeting in formal settings. No person or institution made this rule; since it is a spontaneous order created by a social norm, we all shape this rule together. Nor does any decision by the owners of a company count as regulating that company's behavior. If Exxon was a closely held company and its owners decided to do exactly what the asset managers did in 2021, this would not count as regulation, since the decision would not shape the rules of the game in the capital markets. If a closely held ownership group took these actions, then the motivation would be to maximize the profits of Exxon, rather than to force Exxon to play its part in the scheme that would maximize the profits across the entire economy in the long run, the objective of universal owners.[33] The reality is that if Exxon were closely held then the owners likely would not have pushed for the changes we saw in 2021.

Now we can turn to an (admittedly speculative) argument that asset managers have fiscal powers. There is strong theoretical reason to expect good ESG scores to go hand in hand with low capital costs: ESG investors require a lower return because (1) ESG investments have less exposure to certain risks and (2) ESG investors derive consumption value from the fact that their investments make a positive social impact (or at least avoid negative ones), so they can be compensated with slightly lower risk-adjusted returns. There is some empirical evidence suggesting that a higher ESG score can reduce a firm's cost of capital.[34] There is also empirical evidence to suggest that firms alter their behavior to improve their ESG scores, by placing exactly two women on their boards of directors, for instance.[35] The determinants of firm-level ESG performance are still highly uncertain, but it is at least plausible to suspect that one driver of ESG performance is the motivation to secure inclusion in ESG-focused financial products, especially ETF's, which secures lower capital costs. All things being equal, if the cost of capital for a firm doing some activity is higher, then the economy will contain less of that activity because it is more costly. ESG is at least a meaningful, and probably an increasingly important, determinant of capital allocation.

[33] Thanks to Santiago Mejia for urging me to clarify this point.
[34] This has been documented in a number of industries and countries. Pellegrini et al. (2019), Chen et al. (2023), Brounen et al. (2021), Yilmaz (2022).
[35] Chang et al. (2019). See also Cornaggia and Cornaggia (2023).

A sharper way to put this is that ratings agencies and large asset managers can levy taxes on firms that partake in undesirable behavior, by increasing their cost of capital. Of course, the asset managers and ratings agencies cannot collect this tax themselves; rather, they directly pass it on as subsidies to firms that partake in desirable behavior in the form of a lower cost of capital for more desirable firms. Of course, the state also has the power to levy taxes on disfavored industries and deliver subsidies to favored ones. The recent wave of climate-focused industrial policy undertaken by the Biden administration illustrates this power in full force. My point here is that both the state and asset managers have the power to levy taxes and deliver subsidies, though to different degrees. Importantly, the ESG ratings of different underwriters have little correlation with each other, so it is to some extent arbitrary whether a company is "high ESG" or "low ESG."[36] This arbitrariness grounds the last important feature of my argument. Here are two hypotheses about ESG: (1) demand for it is market driven (2) demand for it is artificially created by asset managers. Both hypotheses are true; the question is which factor is more important. The low correlation among ESG ratings suggests that ESG demand is not market driven—investors don't know what they want *ex ante*, but only form a preference for it once it has ESG branding. If the second mechanism dominates the first, as I suspect, then we should see ESG as a manifestation of the quasi-political power of asset managers,[37] rather than as a spontaneous order created by investor demand. This is something our normative assessment of ESG will depend on, given my argument above.

I have just argued that asset managers have quasi-political power. This means that they have the power to shape the rules of the game in the commercial sphere in a way that mirrors the regulatory, and perhaps, the fiscal powers of governments. In other words, since they are universal owners, they can influence who has access to public markets, and on what terms—they can constrain the behavior of capital market participants in both systematic and arbitrary ways. And they can use their power to shape the distribution of resources. Two things should be noted about the nature of this power. First, an entity can possess power even if it does not exercise that power to its fullest extent. Asset managers, I believe, have an additional unexercised capacity to shape capital markets and real economic activity that they do not exercise: they are not pushing

[36] Berg et al. (2022), Dimson et al. (2020).
[37] And, perhaps, a manifestation of the pricing power asset managers have because of the concentration in the industry.

the envelope as much as possible. Second, the power of asset managers is likely to continue to expand as the passive share continues to grow. Thus, even if the examples above don't concern you because they operate on a small scale or in a circumscribed domain, the specter of what is likely coming in the near to medium term should be very concerning.

Even though this theoretical treatment of asset management capitalism as a political economic regime is by no means comprehensive, its main features should now be clear. To conclude this discussion, it is worth situating the rise of asset managers within broader changes to the political economy in the last few decades. Since about the time that index funds were invented in the mid 1970s, the power of states over the organization of economic activity has been decreasing. "Neoliberalism" is a popular term given to designate this trend. Over this time, many sectors have been deregulated, international barriers to trade have been reduced, and states have sold off public assets. Because states now have less influence over the organization of economic activity, they are not as well positioned to provide some public goods, such as accelerating the energy transition or implementing good social policy. Simply because asset managers are so large, well-diversified and have a long-term outlook, they have the ability and the incentive to step in to provide some of the public goods that the state will not or cannot provide. In general, when an institution is sufficiently large and powerful, that institution will find it beneficial to provide public goods to a society, because the private cost of providing public goods will be smaller than the private benefit of the public goods to the institution's constituents. This is why the state—the largest institution in society—traditionally provides public goods. But, weakened by neoliberalism and suffering from institutional gridlock, the state's ability to provide public goods has been curtailed. Thus, there is an incentive for other large institutions to provide these goods. Over just the period when the state's economic power has atrophied, we have seen the rise of institutions that are sufficiently powerful and incentivized to provide some of these public goods. Asset manager capitalism is a set of institutional arrangements that naturally accompanies other recent changes in the political economy, perhaps one that evinces institutional complementarities.

Unfortunately, however, the interests of universal owners are not perfectly aligned with the public interest, which sets a limit on how pro-socially they can act. This fact creates some fatal normative flaws with asset manager capitalism as a political economic regime, and it is to these flaws that we now turn.

4. The Normative Deficiencies of Asset Manager Capitalism

There are two normative elements of asset manager capitalism that form the basis of my critique. The first is a procedural complaint: the quasi-political power of asset managers is not democratically accountable, and hence, is illegitimate. The second is a substantive complaint: though there is some overlap between the interests of universal owners and the public interest, the incentives of asset managers are fundamentally misaligned with the public interest, so they will be unable to consistently promote the public interest. Therefore, asset manager capitalism could not be a system of economic governance that appropriately represented everyone's interests, and accordingly, the policies made by asset managers will not be acceptable to all, or even most, members of society.

Outcomes and the processes that brought about those outcomes both matter morally. I will argue below that asset manager capitalism will bring about some bad outcomes that have not yet been properly anticipated. But there is no denying that asset managers have brought about some good outcomes. When regulation is necessary, regulation supplied by asset managers is better than no regulation at all. Necessary measures like driving the decarbonization of the economy and implementing just social policies seem impossible to accomplish through the polarized and slow-moving political process. If taxing carbon and subsidizing clean energy is not supplied by the government to the socially optimal degree, then additional taxation and subsidies by the concentrated owners of capital can result in a better outcome than would otherwise obtain.

But if these outcomes are brought about in a problematic way, their goodness is somewhat impaired. A core tenant of democratic political theory is that the rules of the game, what Rawls called the basic structure of society, should be responsive to the interests of everyone in society. When states shape the rules of the game in the commercial sphere, those rules are legitimate when and because the state is democratically accountable. Liberal democrats add that rules meant to protect peoples' interests from the tyranny of the majority are necessary too. This justifies judicial institutions and judicial review which constrain how the government exercises power. Our question is thus: is the ability of asset managers to shape the rules of the game in a substantial segment of the commercial sphere subject to the kind of accountability that would render the resulting rules legitimate?

The analysis will proceed in the form of a dilemma. Regulation by asset managers can either be conceived of and implemented by staff members on the stewardship teams of the asset managers (as in the status quo) or the voting rights can be passed through to the ultimate beneficial owners (as in several recent reform proposals). The former option lacks legitimacy because the only authority the staff of the asset managers have derives from their technical expertise. The latter option lacks legitimacy because, given the background facts about wealth inequality, the wealthy would have an outsized say in policy making. The former option is technocracy and the latter is plutocracy. It seems that no way of doing social and environmental policy through the capital markets can claim the legitimacy that policy created by the state enjoys. This is why we should be concerned about social and environmental policy made by non-state institutions like asset managers.

Technocracy is the status quo in the industry. It is up to just a few employees and executives at asset management companies to determine how portfolio companies are regulated. Each of the big three has a relatively small stewardship team that conducts engagements and determines how the shares will be voted. Of course, there are other parts of the ecosystem that facilitate this regulation, like the ESG raters, the index providers and the two proxy advisors, but even once this is taken into account, it is the work of just a few hundred people that ultimately determines how the shares managed by the big three are voted. And the decision-making authority lies in even fewer hands: with only the top executives at the big asset managers. This is what legal scholar John Coates calls *the problem of twelve*: "[it is likely that] in the near future roughly twelve individuals will have practical power over the majority of U.S. public companies."[38] The executives at asset management companies, the workers on their stewardship teams, the ESG raters and proxy advisors are highly competent professionals who are likely to have the relevant expertise about how to best design and implement any regulation. They know, for instance, that Exxon's new oil and gas developments are those that are most likely to be stranded assets in the near future because they are the furthest up on the industry's cost curve, which is one reason why the big asset managers vetoed proposed new capital expenditures in 2021. This technocratic competence makes these individuals analogous to career bureaucrats at the SEC, CFPB, EPA and other regulatory agencies.

Despite their technocratic competence, the crucial problem is that none of these people were either elected to their positions, or appointed to their positions by someone who was elected. Contrast the large asset managers with the federal reserve—a technocratic body with even more power than the asset managers—whose governors are appointed by the president and confirmed by the senate. Stewardship teams and executives at the big three have the power to implement labor, environmental, diversity and other policies and influence behavior across most of corporate America. Regulatory agencies also have such power, but that power is rendered legitimate by the fact that its exercise is subject to democratic accountability. One might think that the technocrats at asset managers could act

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[38] Coates (2018).

in the public's best interest, even if they are not formally constrained by mechanisms of democratic accountability. But this hope is illusory. Citizens should not have to count on the good graces of asset managers and hope that they will promote the public interest. More fundamentally, I will show below that asset managers could not simultaneously promote the public interest and satisfy their fiduciary obligations to their clients to maximize their returns.

Before we get to this argument, however, it will be instructive to contrast the foregoing democratic critique of asset managers with those made recently by right-wing critics of ESG. Vivek Ramaswamy, a former corporate governance activist running for president on an anti-ESG platform, primarily criticizes asset managers for promoting what he regards as a "woke agenda." But his more sober criticisms of the idea emphasize its anti-democratic character.[39] In his previous career as a booster of anti-ESG financial products and corporate governance activism, Ramaswamy articulated a serious criticism in a letter to the CEO of Chevron.[40] In that letter, Ramaswamy criticized the exercise of regulatory power by businesses instead of government:

> "Chevron appears to have responded [to pressure from large shareholders] by issuing a new press release announcing a "net zero aspiration" and set specific targets for reducing carbon intensity, including its Scope 3 emissions. Chevron released an updated "climate change resilience" report, which says Chevron "support[s] the global net zero ambitions of the Paris Agreement." Addressing climate change may be an important societal objective, but deciding whether and how to address this challenge is the duty of publicly elected officials, not Chevron. Congress had its chance to ratify the Paris Agreement and chose not to. It is not Chevron's job to ratify it instead."

Ramaswamy continues by questioning the justifiability of the actions taken by large asset managers. Throughout the letter he uses the term "shareholder" in scare-quotes when referring large asset managers, alleging that these firms, through using their proxy votes to pursue ESG objectives, are violating their fiduciary obligations:

> "We understand that you are in a challenging position when Chevron's top "shareholders" mandate your board to adopt a course of action that you believe is not in the best interests of Chevron's shareholders. But here is the reality: your purported "shareholders" are not the actual owners of your company…There is strong reason to believe that these large asset managers are not voting with their clients' best interests in mind. Indeed, nineteen state

[39] Unusually for a book by a presidential candidate, his book *Woke Inc.* contains a measured and thoughtful criticism of asset managers.
[40] Strive (2022) "Our letter to Chevron."

> Attorneys General have explicitly accused BlackRock of as much. Last month, they sent a letter alleging that the company "use[s] the hard-earned money of our states' citizens to circumvent the best possible return on investment." It further accused BlackRock of violating the law by "commit[ing] to accelerate net zero emissions across all of its assets, regardless of client wishes.""

The rhetoric of democratic legitimacy, somewhat ironically given the recent history of the party, features prominently in other recent Republican criticism of ESG. For instance, in a 2023 regulatory filing, seventeen Republican attorneys general aimed to block Blackrock from imposing ESG standards on utility companies. The attorney general of Indiana said of the investment management company: "These elitists are trying to impose restrictions on energy companies and utilities that would never win approval at the ballot box."[41]

Republicans don't like the fact that asset managers push ESG objectives, many of which are similar to policies that Democrats favor. They think that because these objectives have content that they regard as political in nature, asset managers usurp democratic authority by using their influence to promote them. And using their influence to promote a political objective must violate the fiduciary obligations asset managers have to their clients. But this does not follow. Indeed, as I argued, promoting ESG objectives is precisely what is required by their fiduciary obligations *because* the clients are universal owners, and ESG objectives mitigate systemic risk—the only type of risk universal owners are sensitive to. But this fact is compatible with the claim, which I also argued for, that exercising their influence in this way constitutes *quasi-political power* and thus lacks democratic legitimacy. The problem is not that asset managers use their clients' money to push for a "woke agenda" rather than the best return available, in violation of their fiduciary obligations, because their leaders have a preference for progressive policies. Rather, the problem is that in advancing the interests of their clients using ESG objectives, something they are required by fiduciary obligations to do given that their clients are universal owners, asset managers must exercise quasi-political power to shape the rules of the game in capital markets. The problem is that the institutions of asset manager capitalism undermine democratic institutions, not that leaders of asset managers violate their fiduciary obligations to undemocratically realize their own political preferences.

I argued above that the normative problem with asset managers is that they have the power to influence the rules of the game *without the right kind of accountability*. What, then, constitutes the

[41] Neukam (2023) "Republican states move to block giant asset manager's ESG push for utility companies" *The Hill.*

right kind of accountability? Let's consider one idea. Matt Levine, a respected and non-partisan finance columnist at *Bloomberg*, has a "maximalist theory of ESG" that is worth quoting at length:

> "There is a government of the U.S., consisting of a president and Congress and so forth, chosen through more-or-less democratic processes, and it makes big collective decisions for society. There is another government, in the world, consisting of a handful of gigantic institutional asset managers—BlackRock, Vanguard, Fidelity, etc.—who own (on behalf of their customers) most of the stocks of most of the public companies, and can, in some loose sense, tell those companies how to behave. They are not chosen democratically, exactly, but they are *representative*; millions of people give their money to those institutions and trust them to make decisions for them."[42]

This suggests a way to ameliorate the democratic concerns. Even though the technocratic decisions of large asset managers lack democratic legitimacy, at least they are subject to some form of accountability. These institutions are fiduciaries that are the agents of millions of different principals. Perhaps the agency relationship here can provide the kind of accountability that would render legitimate the power of asset managers. But this brings us to the second horn of the technocracy-plutocracy dilemma.

There are two mechanisms by which their clients can hold the large asset managers accountable: exit and voice. If someone does not like the proxy voting and engagement record of their asset manager, then they can take their savings elsewhere and select a different asset manager more closely aligned with their values. Merely by allowing their money to be managed by State Street, Vanguard or Blackrock, investors endorse the regulatory actions taken by the big three and thereby render these actions legitimate. Many liberal political philosophers since Hobbes and Locke have found this argument compelling in the case of the state: continuing to remain as a part of a polity expresses one's tacit consent to the government that governs the polity. Perhaps this point should apply to organizations more generally.[43] Indeed, several Republican-led state governments divested from Blackrock in 2022 and 2023—because Blackrock "boycotts" the fossil fuel companies active in those states—though the effect on its balance sheet has been quite small. The exit channel seems to be what Levine has in mind: the big three are accountable because millions of investors could choose to exit if they were dissatisfied. One complication of this proposal is that investors, especially index fund investors who value the low complexity and monitoring costs that passive

[42] Levine (2020) "The Government Wants ESG out of Pensions" *Bloomberg*, emphasis original.
[43] The argument would seem to have more force in the case of non-state organizations, since the costs of exit from such institutions are far lower than the costs of exit from the state.

investing provides, are rationally ignorant of and apathetic about how their shares are voted: they care about their returns but not about the technicalities of corporate governance. And since the asset management industry itself is so concentrated, investors have limited exit options.

By contrast, investors could exercise voice in how the asset managers vote their shares. Instead of unelected and unaccountable stewardship teams at the big three, why not allow the beneficial owners of the managed assets to exercise the voting rights of their shares themselves? There have been a number of proposals along these lines in the corporate governance and corporate law literatures.[44] Vanguard is piloting such a program. The program would allow a fund's owners to participate in proxy voting contests "proportionate to their ownership in that fund."[45] Blackrock has a similar program, but only one that allows institutional clients to exercise the voting rights associated with their shares.[46] Some Republican senators, in 2022, introduced a bill to return the franchise to investors themselves from their asset managers.[47] A complication of this proposal, again, is that even when ordinary investors can vote their shares, they rarely do, because they know they have a miniscule chance of influencing the outcome. But if investors themselves possess the voting rights that are associated with their shares, then the problem of rendering legitimate the actions of asset managers would seem to be resolved, since investors themselves would have the power to vote for those regulatory actions.

But regardless of whether the regulatory decisions of asset managers are constrained by investor exit or investor voice, they will not be rendered *democratically legitimate*. Asset managers' accountability to their investors is not the kind of accountability that could render legitimate their shaping the rules of the game in a large part of the commercial sphere. This is simply because, on either proposal, people with no assets get no say in how the rules are shaped, and people with more assets get more of a say. This conforms with the principle of "one share, one vote" in corporate governance. This principle dates to the origin of joint stock companies, and seems to best respect the property rights that investors have in their assets. But when corporate governance expands its scope to include making social and environmental policy as it has done in recent years, this principle is no longer appropriate because it gives an outsized share of influence over policy to the wealthy.

In a capitalist democracy, each dollar gets one vote and each person gets one vote, but the passive revolution and the rise of asset managers has shifted the balance of power: the votes of

[44] Griffin (2020, 991-996), Coates (2018), etc.
[45] Vanguard (2023) "Empowering everyday investors through proxy voting choice"
[46] Blackrock also claims to be "committed to a future where every investor can participate in shareholder voting." Blackrock (2023) "Empowering investors through BlackRock Voting Choice."
[47] Au-Yeung (2022).

dollars get more weight than they did before. In other words, in a democracy, policy responds to the preferences of the median voter, and in a plutocracy, policy responds to the preferences of the holder of the median asset. In a world where more of our social and environmental policy is being made by capital market institutions, the balance of power shifts from the median voter to the median dollar. Given the facts about the unequal distribution of wealth in the contemporary United States, that means that policy will reflect the preferences of wealthier, whiter and older people than it would if policy were made exclusively by a democratic process.

We can see this very point by revisiting the incentives of universal owners. Universal owners receive the aggregate return on capital, and hence, they seek to maximize the aggregate return on capital. As I noted above, this has some good effects—externalities like environmental pollution are internalized by universal ownership—and some bad effects—universal ownership causes firms to be less competitive. The interests of universal owners hence partially overlap with the public interest; for instance, it is not in the public interest for environmental resources to be depleted. But this overlap in interests is *only* partial. This is because there are three claimants for the surplus generated by economic activity: labor, capital and consumers.[48] The first two claimants produce everything that gets produced and the third claimant consumes everything that gets produced. Universal owners, *qua* universal owners, have as their ultimate goal to maximize the sustainable return on their investment, which decomposes into two factors: (1) maximizing the size of the economy and (2) maximizing the share of economic surplus they receive, which requires minimizing the share of the economic surplus received by consumers and laborers. It has been extensively documented, in the empirical and theoretical research I reviewed above, that the rising power of universal owners and the asset managers who represent them has resulted in welfare losses for consumers. Theory also predicts that the share of economic surplus that laborers receive will decrease because of universal ownership; Braun (2021, 22) points out that the logic of asset manager capitalism "should be expected to push the economy towards the lowest sustainable labor share." Indeed, labor's share of GDP has seen a secular decline during precisely the same period that universal ownership has risen.[49] And a growing body of empirical research is beginning to uncover a causal link between universal ownership and the level of real wages.[50] One study estimates that about a quarter of the secular decline in the labor share is due to universal ownership.[51]

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[48] For the purpose of this analysis, I consider natural resources as a constituent of capital, since most natural resources are privately owned.
[49] Elsby et al. (2013).
[50] Goshen and Levitt (2022), Azar et al. (2021).
[51] Falato et al. (2022)

This way of putting things reveals a new way to look at what index funds are: *index funds are a capital union.* When capital is held in concentrated form, different segments of capital have some common interests and some competing interests. Both Lowes's owners and Home Depot's owners want people to live in larger homes that need more repairs. But they have competing interests in capturing more of the market for themselves. Universal ownership reconciles the competing interests of different segments of capital, allowing the segments of capital to attend only to their shared interests. In just the same way that a labor union aims to reconcile the competing interests of different laborers in order to allow them to focus on their common interest in capturing more of the social product that would otherwise go to capital and consumers, capital unions reconcile the competing interests of different segments of capital in order to allow them to focus on their common interest in capturing more of the social product that would otherwise go to labor and consumers. The question of whether we should allow index funds to continue to grow, or even have them at all, is the question of whether we should permit capital to unionize.[52][53]

Asset managers, as the bosses who run the capital union, look to maximize returns across their entire portfolio. This has some pro-social side-effects, as we noted above. But a severe anti-social side-effect is that the bosses aim to capture more of the social product from labor and consumers. The thing that *makes* this effect anti-social is the fact of pronounced wealth inequality. The three roles that make claims on the social product can be overlapping identities of a single person: many people are at once capitalists, laborers and consumers. If capital were equally distributed, then an increase in the capital share would benefit everyone equally. But in reality, the interests of capital are much more highly concentrated than the interests of labor and the interests of consumers. Almost all of the capital is held by a very small segment of society.[54] Almost half of people have no capital at all. Everyone is a consumer and almost everyone is, was or will be a laborer. Since the interests of capital are realized by a small minority of natural persons, and the interests of labor and consumers are realized by most members of society, the interests of universal owners and the asset managers who represent them are in fundamental misalignment with the public interest. Simply put, one of the interests of universal owners is to increase wealth inequality.

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[52] Perhaps a fair proposal would be to cap the passive at the share of capital at the unionized share of the labor force.

[53] It turns out that unionizing capital is easier than unionizing labor, because the highest consistently achievable risk-adjusted returns are only had in the capital union; active managers, in aggregate, can't gain by free-riding off of the union activities like laborers who aren't part of the union do. Indeed, it is the participants in the capital union who free-ride off of the non-participants.

[54] For members of this segment, their interests *qua* capital owner swamp their interests *qua* consumer and their interests *qua* laborer. Such individuals would thus benefit on net from higher prices, lower wages and higher profits, though everyone else would be harmed.

My ultimate conclusion here is that there is no problem *in principle* with making social and environmental policy through the capital markets and corporate governance. Power to shape the rules of the game in a significant sphere of social activity, like the commercial sphere, can be concentrated in institutions other than the state, so long as those institutions are subject to the right kind of accountability. Nor, I should add, have I argued that wealth inequality is problematic as such. But given high and rising wealth inequality, and the fact that wealth ownership is correlated with other socially important identity categories like age and race, the fact that asset managers are accountable to the owners of capital is not the kind of accountability that could render their quasi-political powers legitimate. Were wealth more equally distributed in society, as in the ideal of a property-owning democracy, the fluidity of economic and political power would be, to the extent that wealth is more equally distributed, less problematic. Perhaps ironically, political democracy is not as important in a property-owning democracy since power in the commercial sphere is roughly equally distributed.

In conclusion, I showed in this section that the quasi-political power of asset managers is not legitimate. Everyone should have an equal say about setting the rules of the game in the commercial sphere. Given the fact of wealth inequality and the lack of democratic accountability of asset managers, the only way this can be done is through democratic state institutions. And given that the interests of universal owners are only partially aligned with the public interest, asset managers cannot consistently promote the public interest and satisfy their fiduciary duties. We may be moving toward a future where the wealthy have even more influence over the rules of the game in the commercial sphere as the power of asset managers continues to grow. It is thus imperative to consider what changes can be made to reform asset manager capitalism.

5. Approaches to Institutional Reform

I argued above that large asset managers exercise quasi-political power, and that this power is not democratically legitimate. There are thus two ways forward: we can democratize the asset managers, or we can strip them of their powers. There are promising versions of each option. Any proposal for reform should be considered in the context of an overall cost-benefit analysis of the practice of passive investing. We should keep in mind the immense benefits that index funds have provided for ordinary investors, in addition to the public goods and public bads delivered by asset managers. Democracy is important, but it is not the only thing that is important. We should count the lack of democratic accountability as one item on the cost side of the ledger. But it could be that we should do nothing because the benefits swamp the costs. The ideal institutional reform would preserve as many of the benefits as possible while mitigating the harms caused by asset managers.

The first avenue for reform is democratizing the asset managers. The most straightforward way to do this would be to nationalize the asset management industry, or at least that part of it which manages index funds. This proposal is not ideal—it would give the government immense control over most public companies which would likely lead to undesirable corporatism.

One reform, mentioned above, purports to democratize asset managers by passing through the voting rights to the ultimate beneficial owners. This solves Coates's problem of twelve—it would no longer be the case that a small clique has power over nearly all public companies—but it would not solve the democratic problem: it merely transfers the power from a small technocratic elite to a somewhat larger plutocratic elite. Some versions of this proposal are better than others though. For instance, allowing pension funds and other managers of public wealth like the sovereign wealth funds of democracies to cast their own votes in corporate elections would both (1) take power away from the asset managers and (2) give it to a representative and democratically accountable organization. A pass-through voting scheme, however, should not allow entities that are not democratically accountable to receive voting privileges.

Some more modest changes to the status quo should be considered as well. The asset managers respond to pressure by activist groups, are held accountable in the court of public opinion, and are ultimately constrained by their large institutional clients, many of which represent the interests of ordinary people. The prevailing regime for holding asset managers accountable is a patchwork of industry norms and a damaged, but still somewhat functional, public sphere and court of public opinion. Three concrete changes would improve the prevailing patchwork regime. First, there should be a strong norm that asset managers managing public wealth should play an agenda setting role in corporate governance. Second, all parties that have influence over asset managers should push them to invest in solving some of the problems that make the state dysfunctional. Many companies engage in rent seeking and donate large sums to political campaigns, and a select few companies profit from activities that damage our democratic institutions. From the perspective of a universal owner, this ought to look both short-sighted and like a zero- or negative-sum activity—it is not part of the set of activities that will maximize profits in the entire economy in the long run. A minimal first step would be for asset managers to require companies to disclose their political, lobbying and PR expenditures. Eventually, they could require companies to refrain from spending money to influence the political process across the board. Asset managers could start to use their power to protect democratic institutions from corporate predation, and this would mitigate the democratic complaints I raised in the last section. Finally, no matter what reforms are adopted, more transparency is needed from asset managers: the SEC should require them to disclose all of their "engagements" with their portfolio companies. Such disclosure would strengthen the ability of activists, scholars and the public to know how asset managers exercise their influence and to hold asset managers accountable. Thus, there are ways to improve the prevailing patchwork regime, even if no large-scale change is adopted.

But we should also consider larger changes, ones that involve legally unbundling the voting rights associated with the shares of universal owners from the economic rights of the shares, thus stripping asset managers of their power. This change would be justifiable. Many companies have dual class shares that concentrate most voting power in the hands of just a few, or just one, person, so that other investors have only economic rights but no control rights. Facebook is one such company: Mark Zuckerberg holds a small percentage of the economic rights but a majority of the voting rights. If it is permissible to unbundle control from economic rights in order to concentrate the control rights in the hands of one person or a small clique, then it is also permissible to unbundle economic and control rights for the purposes of distributing control rights more equally. Investors in Facebook have done just fine despite the fact that they don't have voting rights, and investors in index funds would do just fine if we socialized the voting rights of universal, passive owners.

Thus, the question is: who should exercise the voting rights now exercised by asset managers? There are three salient options. One is simple disenfranchisement: just forbid universal owners from voting. This would have the effect of proportionally redistributing those rights to all of the other shareholders. This approach has a clear justification: universal owners free-ride off of the price discovery activities of other investors. So, it would be justifiable for other investors to receive some compensation from index investors for this service, and a redistribution of the voting rights would be one way to satisfy this demand.

This approach is not entirely satisfying, though, since calls to democratize corporations in general have been sounding ever more clearly in recent years.[55] Two further proposals would answer such calls. The voting rights could be redistributed to other stakeholders of the corporation, in particular, its employees, as in the Continental co-determination model. Other stakeholders arguably have an informational advantage vis-à-vis universal owners concerning the workings of the firm. Letting them control the voting rights of universal owners would give them a non-trivial say in corporate governance that is much deserved and seems to work well in other institutional contexts.

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[55] E.g., Anderson (2017).

Finally, the voting rights of universal owners could be socialized subject to direct democracy or lottocracy.[56] Here is the idea: each natural person who owns any shares in a corporation would have an equal chance to be chosen to vote the shares of the passive owners. Or perhaps a small committee of around five people could be chosen by this process. They could be selected anew each year, or hold staggered multi-year terms. Most American adults participate in the stock market, so a large segment of society would be represented. And the barriers for participation for those who currently do not own stocks would be quite low. If someone opens an online brokerage account and invests a trivial sum in a total market index fund, then they would have an equal chance of being selected. The people selected by this lottery would be brought to the annual shareholder meeting and given a modest stipend for their work.

This proposal solves a lot of problems. (1) An institutional arrangement of this kind would reinvigorate annual shareholder meetings and, indeed, would turn them into one of society's leading fora for democratic deliberation. (2) The proposal is consistent with the principle of one share, one vote. All it does is introduce of new rule for how the shares of the firm's most disinterested owners are to be voted. (3) Like the current regime, there would still be a small group with the power to exercise a huge portion of the voting rights, but under this proposal the group (a) would not be the same across different companies, (b) would not be the same year to year, and (c) would be selected by a procedure that gives everyone an equal opportunity to participate. (4) Corporate governance is arguably the ideal test case for a lottocracy, because it brings out the most epistemically advantageous features of lottocracies. People are rationally ignorant about politics because they have such a small chance of changing the outcome in elections. These problems are compounded in corporate elections, since investors are both rationally ignorant and rationally apathetic about matters of corporate governance, since they care much more about the economic characteristics of their investments. This is why retail investor turnout at elections is quite low, and this is why any pass-through voting regime would fail. Indeed, the only reason many institutions turn out is because this is a legal requirement of fiduciary obligation. However, the idea that a small group selected by lottery to vote some 25% of the shares currently controlled by asset managers suffers from none of these problems. With this concentration, the vote of the lottocratically selected representatives has a good chance of determining the outcome. Representatives will understand the powers this gives them and think carefully about how they exercise them, unlike someone who casts one vote among millions.

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[56] Guerrero (2014) presents the canonical recent defense of political lottocracy, though the idea has emerged many times in the history of Western thought, all the way back to ancient Greece, in which the system of government was largely lottocratic.

(5) Finally, this proposal would ensure that corporate social responsibility measures are actually reflective of the role that ordinary people want corporations to play in society.

To my knowledge, incorporating lottocracy into the system of corporate governance has never before been proposed, so the details of this possible institutional arrangement at least merit further study.[57] The other proposals I mentioned, of course, do as well. The need for this further study is pressing. I think it is more likely than not that our corporate governance regime will see a major reform in the next decade, since it is simply not politically sustainable to have a large locus of unaccountable power over a substantial segment of the economy. I tentatively favor disenfranchising the asset managers and socializing the voting rights, since this is unlikely to adversely affect the economic interests of universal owners. It is, however, likely to bring corporations under greater democratic accountability and control, which may ultimately improve their social responsibility more than control by asset managers ever could.

[57] Simkovic's (2022) proposal to give natural persons "bonus" votes in corporate elections comes the closest.

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