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The Contribution of Index Funds to the Corporate Governance of Listed Stock Corporations

Index funds invest their customers' capital in securities included in an index. If the securities are stocks, the index funds also gain influence on the respective stock corporation through voting rights. But how do they use this influence? Do they contribute to corporate governance? And are their contributions beneficial or do they need to be regulated? In the U.S., an academic debate has emerged on these questions in recent years. Given the popularity of index funds, it is relevant for Germany, too. However, the characteristics of the German corporate governance system must be taken into account.

It has been argued that index funds have poor monitoring incentives due to the low fees they collect and the highly diversified portfolio they manage. In addition, they did not draw monitoring incentives from the competition with other index funds, because they could free ride on the monitoring investments made as they have an identical portfolio. This incentive structure might not only lead to little respect for the peculiarities of different portfolio companies but might also harm the interests of the index funds' customers to maximize portfolio value.

This work shows instead that index funds have fundamental incentives to contribute to corporate governance. Their fees are a percentage of the assets under management and are therefore increased by enhanced values of portfolio companies. Even if these fees are low and index funds manage highly diversified portfolios, they still profit from value increasing steps applicable to a number of issuers, as long as the steps are cheap to implement through index fund influence. Index funds demand such steps from issuers in their public voting policies. An examination of the policies of four influential index fund providers shows that they develop specific demands on issues affecting a large number of portfolio companies and threaten to use their voting rights against management if they deviate from demands. Moreover, by having their portfolio composition tied to an index, index funds cannot terminate their investments at any time. The only way to achieve value enhancements then is to participate in corporate governance. This constellation also makes their investment horizon indefinitely long. Due to the low fees collected, index funds do not have the funds to approach all portfolio companies in order to bring about long-term changes. However, an examination of index fund providers' own reports on their contributions to corporate governance shows that they conduct so-called engagements with a small fraction of the portfolio companies to secure long-term growth when necessary. On these occasions they exchange views on issues such as the composition of the

supervisory board or the initiatives of other shareholders. The fact that index funds cannot address the peculiarities of each portfolio company in this process does not do any harm. If the unspecific contributions of an index fund (e.g. the intention to vote against an activist proposal) threaten to harm a portfolio company, index funds, in cooperation with management and other shareholders, have both the opportunity and the incentives to adjust the planned contribution.

Because index funds act as shareholders in corporate governance, the correct standard of review for their conduct is corporate law. A comparison between the corporate law of Germany and Delaware shows that shareholders are free to decide whether and how to participate in corporate governance. Therefore, criticism of index funds contributions is not warranted. As they exercise their voting rights in a lot of portfolio companies based on voting guidelines, aiming to establish value-enhancing standards, and sometimes engage with management, index funds meet their obligations under corporate law. In the same way they fulfill their duties towards customers.

On the other hand, incentives by index funds to impair the competition between competing portfolio companies to increase general portfolio value might cause problems. Although German law currently sufficiently prevents such actions, it will be necessary to observe future developments on this field. Furthermore, in attempting to further reduce the costs of corporate governance contributions, index funds coordinate their voting in centralized departments. In order to avoid the resulting conflicts of interest, sec. 134 par. 1 no. 5 and sec. 134 par. 2 Aktiengesetz should be interpreted broadly: index funds (and others falling under the rule) must expressly indicate centralized voting departments and must report on the exercise of voting rights, even if only potential conflicts of interest arose. Such potential conflicts of interests exist, if voting rights were exercised uniformly, although the voting rights stem from different types of funds, whose investment strategies are fundamentally different towards the portfolio company the department voted in.

To conclude, index funds remain under scrutiny in view of these problems and must be held to act in the interests of their customers. Apart from that, no regulation is required for the time being. Index funds provide diversification for a large number of investors and contribute to create long-term value in portfolio companies, and therefore play an important role in global capital markets.