

# From exit to control: Structural power under asset manager capitalism

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## **Abstract**

The rise of asset manager capitalism has transformed the structural power of finance vis-à-vis the non-financial sector in ways not captured by the Hirschmanian triad of exit, voice, and loyalty. The established view of structural power as based on financial actors' capacity to (threaten) exit has been undermined by a dramatic decline of exit options, documented here for the United States. This decline has been compensated by a reunification of share ownership and control in the hands of large asset managers. The question is, (how) do the latter wield this power? The available data does not support the forceful stewardship hypothesis, according to which diversified asset managers should steer corporate behavior towards environmental and social sustainability. In order to explain this divergence from universal owner theory, this paper argues that corporate governance is the least important arena for asset managers, who also compete in the market for asset management services and who lobby for macroeconomic and regulatory policies. Organizational hypocrisy is how asset managers navigate the complex politics of actually existing asset manager capitalism.

**Keywords:** Corporate governance, finance capital, shareholder primacy, universal ownership, index funds, greenwashing

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## Introduction

The structural power of finance is conventionally thought of as a function of its ability to threaten to exit firms, sectors, or entire countries. The exit-based enforcement of shareholder primacy in corporate governance, dreamt up by agency theorists, became reality with the rise of “impatient” institutional investors in the 1990s (Harmes, 1998). Since then, however, the economic conditions for exit-based structural power have eroded – companies have become less dependent on external financing and when financiers’ exit options are diminished. This paper argues, first, that the primary mechanism underpinning the structural power of finance has changed. Rather than through financing and exit, structural power increasingly operates through the large equity stakes held by asset managers, to the point where share ownership and control are becoming re-united. At the same time – and this is my second argument – their unexpected dominance in the field of corporate governance has become a political liability for the largest asset managers. In order to theorize the power of asset managers vis-à-vis portfolio companies, and to understand why they have been reluctant to wield it, we need to look beyond corporate governance and take seriously the broader politics of asset manager capitalism. As the financing function of the financial system has been superseded by the asset management function, power has shifted from banks to institutional capital pools. The latter category has steadily expanded and today includes asset owners, such as insurers, pension funds, and sovereign wealth funds, as well as asset management companies. Supported by a broader “wealth defence industry” (Winters, 2017) of lawyers and accountants (Ajdacic et al., 2020; Hoang, 2022; Pistor, 2019; Seabrooke & Wigan, 2022), these asset managers constantly reorganize economic activity with the goal of increasing financial returns. This reorganization takes different forms in different segments of the economy. Outside the realm of publicly listed corporations, alternative asset managers have pushed financialization by making ever new areas of economic activity accessible for financial investment. Venture capital firms groom startup companies (Cooiman, 2021), while private equity firms turn companies (Benquet & Bourgeron, 2021a; Eaton, 2020), housing (Christophers, 2021a, 2021b), infrastructure (Gabor, 2021), and even farm land (Ouma, 2020) into asset classes accessible to institutional capital pools. In this world

of private capital, private equity firms purposely forfeit the exit option in exchange for full ownership rights, so that their structural power is clearly based on control.

The case of publicly listed companies is theoretically more interesting. Here, the power of the Big-Three asset managers – BlackRock, Vanguard, and State Street – is no longer “hidden” (Fichtner et al., 2017). Indeed, asset manager capitalism constitutes a distinct corporate governance regime, characterized by a historically unique combination of diversification and near-control (Braun, 2021). At the same time, the sources of asset managers’ power and the degree to which they wield it have been hotly debated among economists, legal scholars, and political economists (Azar et al., 2018; Bebchuk et al., 2017; Condon, 2021a; Fichtner & Heemskerk, 2020). While the promise of the shareholder primacy regime was efficiency, achieved via the combination of exit and voice, the promise of asset manager capitalism is sustainability, made necessary by (involuntary) loyalty: Universal owners should internalize negative externalities arising from the conduct of their portfolio companies, and use their structural power to enforce socially and environmentally sustainable corporate behaviors (Condon, 2020). Although the Big Three have all embraced the rhetoric of universal ownership (Chaffee, 2021, pp. 1298–1299), they have clearly failed to deliver on the promise of sustainability – payouts to shareholders have risen to all-time highs, market structures have become increasingly monopolistic, and fossil fuel production and greenhouse gas emissions have continued unabated (Auvray et al., 2021; Palladino & Lazonick, 2021; Philippon, 2019). Do we need to conclude that asset managers lack structural power?

This paper argues that while asset managers have potential structural power in abundance, they wield it sparingly, and according to a political calculus. This calculus is not captured by the notion, still dominant in the legal and management literatures, of corporate governance as a field neatly organized around agency conflicts between managers and shareholders. While such a field existed at one point (G. F. Davis & Thompson, 1994; Fligstein, 2016), the rise of asset manager capitalism has fundamentally transformed the political economy of corporate governance.

For asset managers, corporate governance is only one of three battle grounds – the others being the market for asset management services and, crucially, politics. When they exercise “voice”, they address not only the portfolio company’s management but also

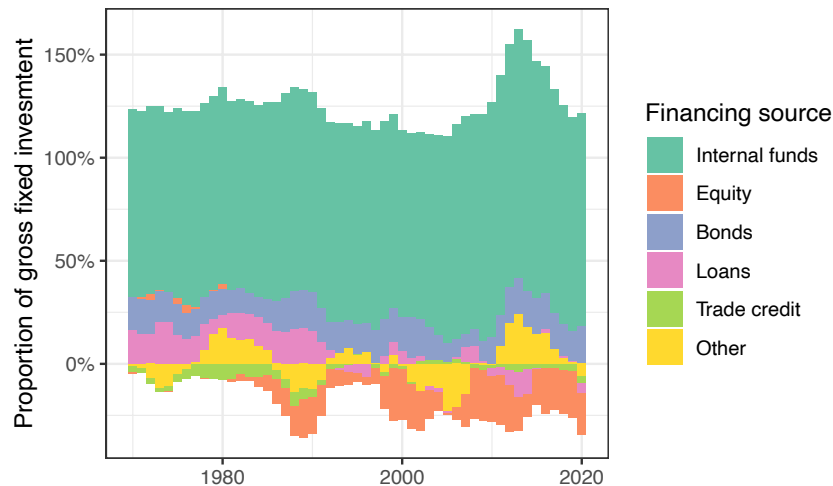
(prospective) clients, regulators, and politicians and their voters. In principle, Hirschman’s original conception, which contrasted exit, an economic form of action, to the “messy” concept of voice, which referred to “political action par excellence”, could be applied to this multi-audience situation (Hirschman, 1970, p. 16). However, asset managers’ position is so deeply conflicted that a more robust concept is needed. Tried and tested for the case of “corporate social responsibility” (Lim & Tsutsui, 2012), the concept of “organizational hypocrisy” captures behaviors characterized by systematic divergence between organizations’ talk, decisions, and actions (Brunsson, 1989). Organizational hypocrisy has been at the heart of the *politics of actually existing asset manager capitalism*, understood here as the art of (not) wielding structural power in ways that mediate between the goals of achieving satisfactory returns, maximizing assets under management, and minimizing political and regulatory risk. This perspective offers a reasonably parsimonious explanation of the controversy over environmental, social, and governance (ESG) investing, greenwashing, and “woke capital” – arguably the central political conflict within asset manager capitalism to date.

The argument will be developed based on the case of the United States, home to the lion’s share of the global asset management industry (Haberly & Wójcik, 2022; Oatley & Petrova, 2020). Simply put, the scope conditions of the argument track the expanding footprint of the largest US asset managers in other advanced economies. The paper proceeds as follows. Sections one and two document the decline of exit and the rise of control, respectively. Section three reconstructs the rise of asset manager capitalism as a corporate governance regime. Section four examines the extent to which asset managers wield their potential structural power, and the role of organizational hypocrisy in their quest to maximize assets under management and to minimize political and regulatory risk. The final section concludes.

## 1. The end of exit

Presenting data from the U.S. financial accounts, this section shows that the non-financial corporate sector has, in the aggregate, become financially self-sufficient. The upshot is that in such a world, the exit-based theory of the structural power of finance loses much of its appeal.<sup>1</sup>

**Figure 1:** Financing of gross fixed investment, US non-financial corporations, 1970-2020



Data: Federal Reserve, US Financial Accounts.

Note: Author's calculations based on Corbett and Jenkins (1997) and van Treeck (2009). Sums do not add up to 100% due to the approximate nature of both the method and the underlying data.

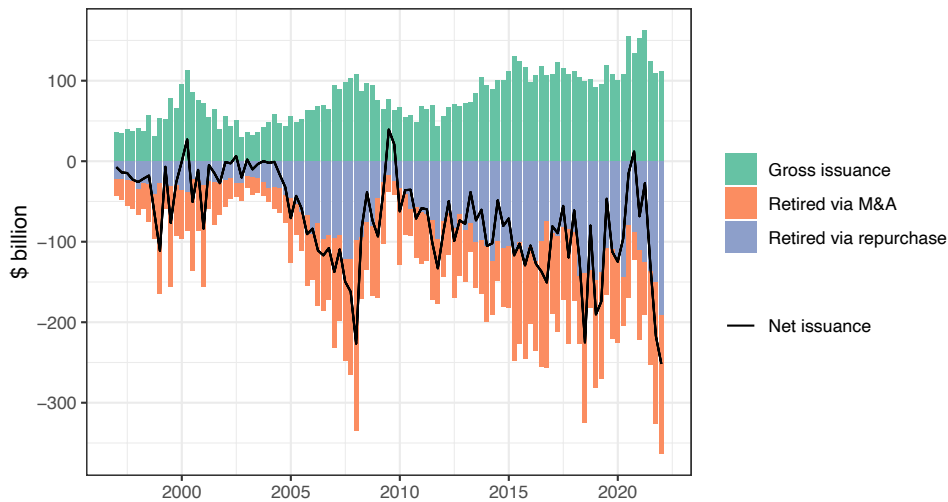
The most direct way of measuring the non-financial corporate sector's dependence on finance is look at the extent to which capital formation is financed by external funds. Figure 1 shows results obtained by using the methodology proposed by Corbett and Jenkins (1997) and van Treeck (2009). It shows, first, that the vast majority of corporate investment is financed from internal funds, that is, retained profits. Second, the stock market's contribution to the net financing of corporations turned negative in the 1980s, meaning it has helped ferret capital *out* of the corporate sector, at the expense of workers and of investment (L. E. Davis, 2018; Mason, 2015; Palladino, 2020). Third, and most remarkably, even traditional loans have made a negative contribution since 1990.<sup>2</sup>

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<sup>1</sup> Emerging market economies do, of course, remain vulnerable to capital flight (Bonizzi et al., 2020).

<sup>2</sup> This flow data is compatible with high corporate debt, a stock measure; see Baines and Hager (2021).

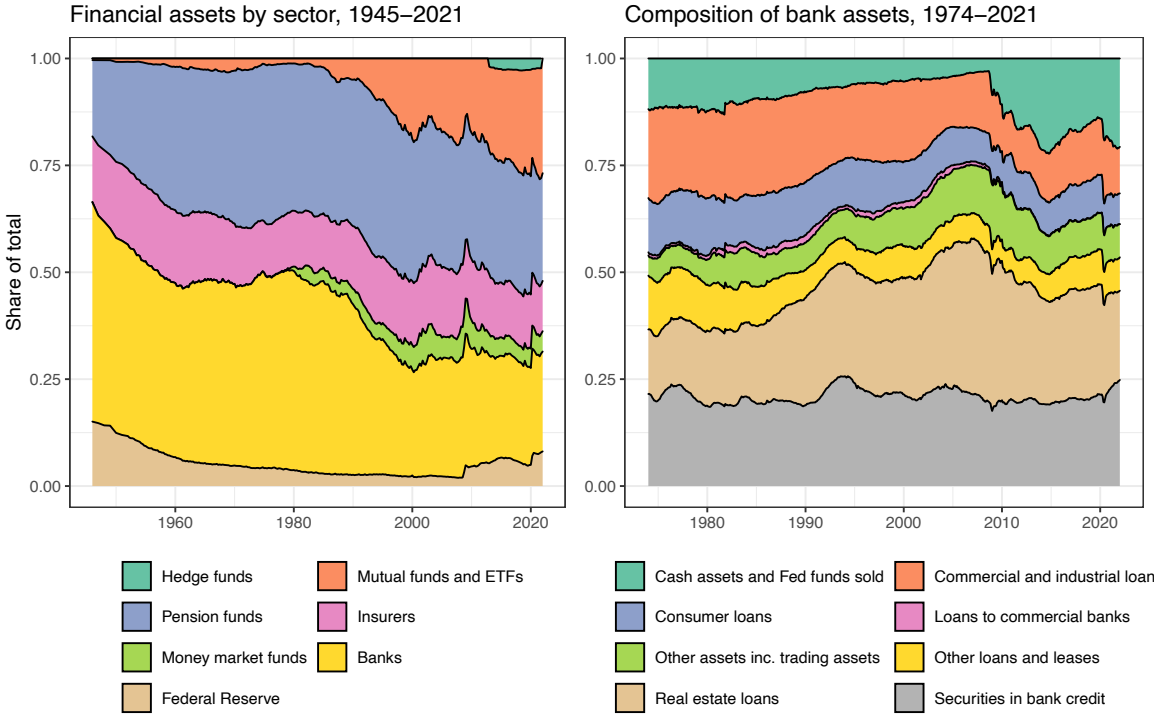
**Figure 2:** Net corporate equity issuance, United States, 1996-2021



Data: Federal Reserve, US Financial Accounts.

We can drill down further into the equity and loan categories. Figure 2 shows why net issuance of corporate equity in the US has been negative since 1996. Although gross issuance has followed an upward trend, that growth has – until the beginning of the Covid-19 pandemic – been eclipsed by the retiring of shares via stock buybacks and mergers and acquisitions. Lending to non-financial corporations has also turned negative. Since the category “loans” also includes government loans and loans from non-bank financial institutions, shedding light on *bank* lending to non-financial corporations requires data on commercial bank assets, displayed in Figure 3. The first panel shows the declining importance of banks, whose share of total financial asset holdings has declined from 50% in 1945 to 25% today. The second panel shows that commercial and industrial loans (orange) have seen the largest decline in total bank assets, whereas real estate loans (light brown) have seen the largest increase. At the same time, loans to non-depository financial institutions, such as private equity and hedge funds (not shown in Figure 3), have more than doubled in absolute terms since 2015, fueling leverage in the global shadow banking system (Bezemer, 2014; Thiemann, 2018). This “debt shift” from business lending to mortgage lending and intra-finance lending has been documented for a large number of countries (Bezemer et al., 2020; Jordà et al., 2016).

**Figure 3:** The declining relative size and changing asset composition of US banks



Data: Federal Reserve, US Financial Accounts. Right-hand panel: H8, Table 2.

Note: Bank data includes US branches and agencies of foreign banks.

Given these developments, how have wealth owners fared? Other things equal, the corporate sector’s declining demand for financing should put downward pressure on corporate bond and equity yields. However, things have not remained equal, and the “plunder” has, if anything, escalated (Brenner, 2020). The best measure of rentier power – Piketty’s (2014)  $r - g$ , the gap between the rate of return on capital ( $r$ ) and the rate of economic growth ( $g$ ) – has proven remarkably resilient. Indeed, the data collected by Jordà et al. (2019) on real returns on wealth indicate a larger  $r-g$  gap for the four decades since 1980 than during any comparable period since the late 19<sup>th</sup> century. This data points to the enduring structural power of finance. Are we, therefore, in a Wile E. Coyote moment, in which the structural power of finance holds up while its institutional underpinnings have already crumbled? Or has there been a change in the mechanism through which this power operates?

## 2. Finance capital is back: Structural power and institutional capital pools

The ability of capitalists to hold back investment or to permanently move capital elsewhere is the subject of a large literature on the structural power of business (Block, 1977; Culpepper, 2015; Fairfield, 2015; Lindblom, 1977). The literature on the structural power of *finance* is more explicitly focused on exit, the threat of which became much more potent with global financial liberalization (Strange, 1988). Political economists have studied financiers' ability to (threaten to) withdraw credit or portfolio investment from firms, sectors, or entire countries, both in the Global South (Dafe, 2019; Naqvi, 2019; Roos, 2019) and in the Global North (Bell & Hindmoor, 2015; Culpepper & Reinke, 2014; Woll, 2014). Subject to certain scope conditions – such as issue salience, regulatory capacity, and intra-finance disunity (James & Quaglia, 2019; Kalaitzake, 2020; Massoc, 2020, 2021) – exit-based structural power allows financial actors to “influence the policy choices of corporate and sovereign borrowers” (Harmes, 1998, p. 99).<sup>3</sup>

In recent decades, however, the growth of institutional capital pools has strengthened the *control-based* power of finance. The structural part of this argument draws on Rudolf Hilferding's analysis of early 20<sup>th</sup> century “finance capital”, the relevance of which for early 21<sup>st</sup>-century financialization has long been emphasized by Marxist scholars (Chesnais, 2016; Maher & Aquanno, 2022; Windolf, 2005). Taking his cue from Marx and anticipating the arguments of Braudel and Arrighi, Hilferding viewed finance capital as the outcome of an extended period of capitalist accumulation, during which a “steadily increasing proportion of capital in industry does not belong to the industrialists who employ it” but instead belongs to the banking sector, which in turn “is forced to keep an increasing share of its funds engaged in industry.” This “capital in money form which is ... transformed into industrial capital” is what Hilferding called finance capital (Hilferding, 1985, p. 283). The hallmarks of finance capitalism were the dominance of the financial sector – as opposed to states, families or individuals – among the creditors and shareholders of corporations; and the high degree of control the financial sector exercised in corporate governance.

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<sup>3</sup> For an approach to the structural power of banks that emphasizes financial actors' ability to use leverage (that is, debt) in order to acquire more assets, see Sgambati (2019) and Knafo (2022).

Hilferding saw in finance not just a source of financing but also a means of (re-)organizing industry. Capitalists whose profits exceeded what they could, or wished to, re-invest deposited their money with the banking system, thus causing them to increase their lending, as well as their purchases of debt and equity securities. Thus acquiring “a permanent interest” in corporations, banks faced the problem of *control* – corporations now had to be “closely watched ... and so far as possible controlled by the bank in order to make the latter’s profitable financial transaction secure” (Hilferding, 1985, p. 120). Although historians of corporate governance regimes around 1900 tend to reach more nuanced conclusions about the power of “Morgan’s men” (DeLong, 1991; Fohlin, 2007; O’Sullivan, 2016), Hilferding’s point stands that both in the US and in Germany, banks’ role in corporate governance was geared towards minimizing competition, maximizing profits, and thus the ability of corporations to service their debts and pay out dividends. This control-based understanding of the power of finance capital was largely forgotten in the political economy literature, but it lived on in the sociology of the corporate elite and in the French regulation school. The former focused on the power of corporate managers and the network of interlocking directorates, especially in the United States. While scholars debated the relative influence of the corporate versus the financial communities, a consensus emerged that an “inner circle” existed whose power was rooted *not primarily in ownership* but in a dense and stable interlock network (Herman, 1981; Mintz & Schwartz, 1985; Useem, 1984). Hilferding’s ideas also informed the French regulation school. Taking his cue from Baran and Sweezy, Michel Aglietta diagnosed a strong tendency towards “capital concentration” for US capitalism. Finance capital constitutes “the ultimate mode of capital centralization” that took “concrete form in financial groups” whose economic importance consisted in their ability to foster “the cohesion of finance capital” – that is, to act as aggregators and coordinators of the interests of wealth owners (Aglietta, 1979, pp. 253, 266). More recently, however, Hilferding has seen a revival. The best attempts to theorize the post-2008 institutional configuration have revolved around the concept of the “new finance capital” (G. F. Davis, 2008; Maher & Aquanno, 2022).

Hilferding’s analysis is key to understanding how the current financial configuration is linked to the structural dynamics of capitalism. At the level of agency, however, there is

an important discontinuity. Who are the agents of finance capital? When Aglietta asked this question based on data for 1968, he found that banks still dominated the financial landscape. Since then, however, banks have been joined, and then increasingly overshadowed, by what Aglietta called institutions of “contractual saving”, and what this paper refers to as “institutional capital pools.” This diverse group comprises asset owners – pension funds, insurers, endowments, sovereign wealth funds, and the family offices of the super-rich – and their asset managers.<sup>4</sup> Funded pension systems have been the most important driver of the rise of institutional capital pools, and the chief source of growth for asset management companies (Braun, 2022; Scharfstein, 2018). Asset managers are intermediaries who invest other people’s money for a fee. Just like pension funds pool the savings of many households, asset managers pool the capital of many institutional investors (as well as households). The asset management sector comprises mutual funds and exchange-traded funds, as well as less regulated and more leveraged institutions, namely hedge funds, private equity funds, and venture capital funds. The sector has seen exceptional growth over the past half century. Since the global financial crisis, most large banks have moved into asset management, as have many insurers. On the list of the world’s top-10 asset managers, BlackRock and Vanguard are closely followed by the asset management arms of Goldman Sachs, Allianz, and the like.

A comprehensive discussion of the control- and diversification-based theory of structural financial-sector power would need to consider all major asset classes, including listed and unlisted corporate equity, corporate, household, and government debt, as well as real estate. The remainder of this paper focuses on listed equity, and thus on corporate governance.

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<sup>4</sup> The former group comprises both not-for-profit institutions (such as pension or sovereign wealth funds) and for-profit financial business, notably insurers. Institutional asset owners differ by legal form, social purpose, asset-liability structure, and regulatory regime (Deeg & Hardie, 2016). See McCarthy et al. (2016) on pension funds, Kohl and van der Heide (forthc.) on insurers, Chambers et al. (2020) on university endowments, and Babic et al. (2020) on sovereign wealth funds.

### 3. The rise of control

The theoretical, legal, and practical edifice of corporate governance was erected on a foundation defined by the “Berle-Means-Jensen-Meckling ontology” (Braun, 2021, p. 271). According to this ontology, shareholdings in the United States were dispersed among atomistic, weak shareholders (the Berle-Means component) who were, nevertheless, the only stakeholders with a long-term interest in the economic performance of the corporation, whose governance they therefore ought to dominate (the Jensen-Meckling component). The main power resource of these individually weak shareholders was their ability to exit by selling their shares, thereby pushing down the share price and exposing corporate managers to the dangers of the market for corporate control.<sup>5</sup> This ontology has also underpinned the comparative political economy literature, which equated institutional investors in liberal market economies with “impatient” capital, in contrast to the “patient” capital provided by banks and other strategic blockholders in coordinated market economies (Gourevitch & Shinn, 2005; Hall & Soskice, 2001).

The Berle-Means-Jensen-Meckling ontology does not, however, map onto the new landscape of asset manager capitalism. Table 1 presents a stylized overview of the evolution of U.S. corporate equity ownership and corporate governance since 1900. Each of the four columns represents a distinct corporate governance regime, classified according to four criteria. The hallmarks of finance capitalism were a high concentration of share ownership, substantial control exercised by shareholders, poorly diversified portfolios, and therefore a strong shareholder interest in the performance of individual firms. This regime gave way under the early-20<sup>th</sup>-century diffusion of share ownership, which brought about the separation of ownership and control and ushered in managerialism. Driven by the growth of institutional capital pools, the post-World War II decades then brought a “Great Re-concentration” of shareholdings, weakening shareholders’ exit options while strengthening their control. Today, the United States is no longer the dispersed ownership society that scholars across disciplines and across

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<sup>5</sup> For a paradigmatic formulation of the “strong managers, weak owners” view of U.S. corporate governance, see Roe (1994). For an early and prescient discussion of re-unification of ownership and control in the hands of institutional investors, see Hawley and Williams (2000, p. 43).

generations – from Berle and Means, to Jensen and Meckling, to Hall and Soskice – took for granted. This section traces the emergence of the historically unprecedented control-and-diversification configuration, focusing on the regime shifts from managerialism to shareholder primacy, and from shareholder primacy to asset manager capitalism.

**Table 1:** Hallmarks of shareholder power under four corporate governance regimes

| Main shareholders                | <b>Robber barons</b>      | <b>Households</b>    | <b>Pension funds</b>       | <b>Asset managers</b>                |
|----------------------------------|---------------------------|----------------------|----------------------------|--------------------------------------|
| Concentration of ownership       | High                      | Low                  | Medium                     | High                                 |
| <b>Power</b> of shareholders     | Strong: control           | Weak: exit           | Medium: exit and voice     | Strong: Approaching control, no exit |
| Portfolio <b>diversification</b> | Low                       | Low                  | Medium                     | High (indexed)                       |
| Interest in firms                | High                      | High                 | Medium                     | Low                                  |
| <b>Corp gov regime</b>           | <b>Finance capitalism</b> | <b>Managerialism</b> | <b>Shareholder primacy</b> | <b>Asset manager capitalism</b>      |

Source: B. Braun, ‘Asset manager capitalism as a corporate governance regime.’

### *Shareholder primacy: Exit plus voice*

Among the drivers of the transition from managerialism to the shareholder primacy regime, the rise of the law and economics movement and the growth of institutional investors stand out.<sup>6</sup> Law and economics took the corporate governance field by storm via the idea of a “market for corporate control”, which redefined the economic function of capital markets (Manne, 1965). Manne’s idea underpinned Jensen and Meckling’s agency theory of the corporation, which revolved around the idea of a conflict of interest between weak outsiders (shareholders) and strong insiders (managers) and therefore the need, justified on efficiency grounds, to strengthen the rights of shareholders vis-à-vis managers. By the end of the 1970s, agency theory had reduced the complex political question of how to organize the corporate system to protecting outside shareholders against “expropriation” by insiders (La Porta et al., 2000, p. 4). Although the law and

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<sup>6</sup> The fracturing of the corporate elite was, arguably, both a cause and a symptom of the financialization of corporate governance (Mizruchi, 2013).

economics movement paved the ideological ground for the shareholder primacy regime (Jung & Dobbin, 2015; Lazonick & O’Sullivan, 2000; Robé, 2012), it could hardly have succeeded had it not been for the rise of institutional capital pools.

Two developments related to institutional capital pools tipped the balance in favor of shareholders – the takeover wave led by private equity firms, and the rise of pension funds pushing for governance reforms. The 1980s saw the emergence and rapid growth of private equity firms (Appelbaum & Batt, 2014). Specializing in leveraged buyouts of listed firms, these “corporate raiders” systematically dismantled the conglomerates managerialism had built (Fligstein, 1990; Useem, 1993). From a structural power perspective, the significance of the creation of a market for corporate control was that it weaponized the exit option. While shareholders had always had the option to sell their holdings in a corporation, managers did not need to worry too much about the resulting downward pressure on the share price. The emergence of institutional capital pools with a business model centered on hostile takeovers and asset stripping fundamentally changed the managerial calculus regarding the price of their company’s stock.

The rise of buyout firms coincided with an explosion in the growth of pension funds, whose direct holdings of total corporate equity (listed and unlisted) reached an all-time high of 27 percent in 1985 (Braun, 2021, p. 276). What made U.S. institutional investors such a revolutionary force was their unique “capacity to unite liquidity and control” (Coffee, 1991, pp. 1284–1285; see Table 1 above). Public pension funds’ equity stakes – approaching but rarely exceeding one percent – were small enough to make exit a credible threat and, at the same time, large enough for their voice to carry weight within the newly shareholder-friendly corporate governance system (G. F. Davis, 2008). Indeed, public pension funds emerged as the driving force of the corporate governance reforms of the 1990s and early 2000s, successfully campaigning against poison pills, and for independent directors, de-staggered boards, and proxy voting (Webber, 2018, pp. 45–78). At the same time, these funds, despite holding diversified portfolios, were generally still active stock pickers and traders. An asset-weighted turnover rate of between 60 and 80 percent in the early 1980s certainly justified their reputation, in the comparative political economy literature, as “impatient” investors (Ippolito & Turner, 1987, p. 19).

By the mid-2000s, the “revolt of the owners” was over (Useem, 1993). Not only in the United States and the UK, but across many advanced economies, CEO remuneration was now tied to stock market performance (Linsi et al., 2021), minority shareholder rights were highly protected (Katelouzou & Siems, 2015), and private equity and hedge funds enforced the rules of the game via the (newly) liberalized market for corporate control (Callaghan, 2018; Goyer, 2011). Such was the success of the owners’ revolt that two legal scholars declared the “end of history for corporate law”(Hansmann & Kraakman, 2001, p. 468). Their declaration could hardly have been timed more poorly.

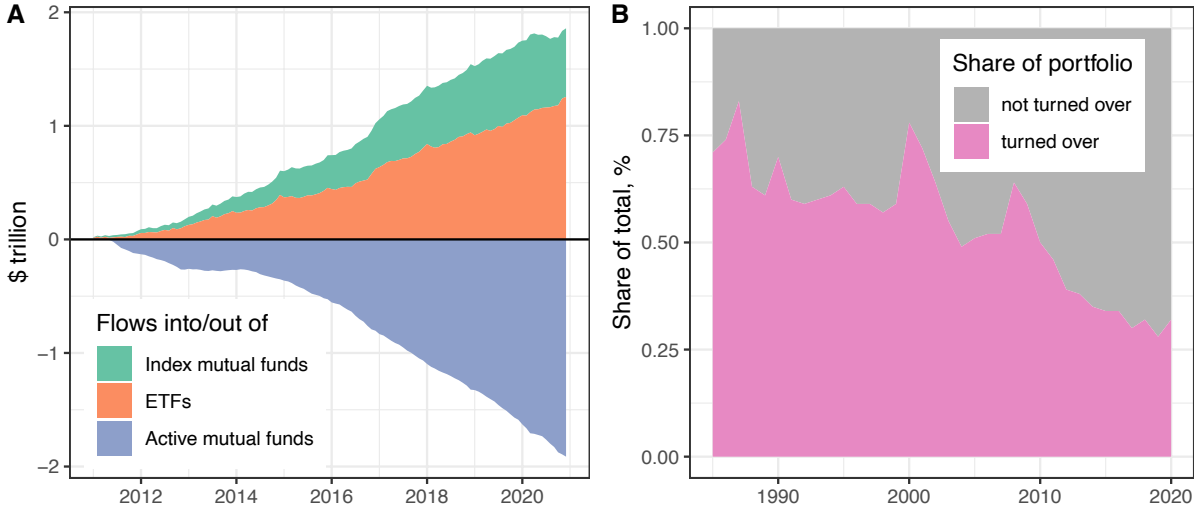
*Asset manager capitalism: De-facto control plus diversification*

Whereas pension funds pool the retirement assets of households, asset managers pool assets of both households *and* institutional investors. This makes them very large. The resulting shift in the U.S. stock ownership structure from dispersed to concentrated was not anticipated and caught most corporate governance scholars by surprise. In 2009, the very first sentence of an article published by leading finance scholars in a leading finance journal still described dispersed ownership in the United States as “[o]ne of the best established stylized facts about corporate ownership” (Franks et al., 2009, p. 4009). At that point, however, BlackRock’s *average* equity stake in S&P 500 companies had already surpassed 5 percent.

The implications of this Great Re-concentration for the structural power of finance are not straightforward. Consider, first, the question of exit. In their quest for scale, large asset managers have essentially relinquished the option to exit individual investments (Condon, 2020; Fichtner & Heemskerk, 2020; Jahnke, 2019). This is a consequence, first, of the size of their stakes in individual companies, which even in a liquid market cannot be sold without causing a major drop in the share price. Indeed, as shown in Figure 4, Panel B, the turnover rate in mutual fund equity portfolios has continuously declined over the past four decades, from around 70 percent in the late 1980s to around 30 percent in recent years. Second, the loss of exit is a feature of the index-tracking investment strategies pursued by the majority of funds offered by the Big-Three asset managers. Figure 4, Panel A, shows that investors have re-allocated almost \$2 trillion from actively managed domestic mutual funds to index-tracking equity funds over the past decade.

These data points should be seen in the context of the evidence, cited above, of the declining dependence of the corporate sector on outside financing. In addition to corporations borrowing less from banks and capital markets, they also have less to fear from the trading of their outstanding equity liabilities on the stock market. Exit-based theories would predict the structural power of large asset managers to be weakened by this decline of exit options.<sup>7</sup>

**Figure 4:** Indicators of declining exit-options for U.S. domestic equity funds



Data: Investment Company Institute Factbook 2021.

Note: Panel A: Showing domestic equity funds. Mutual fund data include net new cash flow and reinvested dividends; ETF data for net share issuance include reinvested dividends. Panel B shows asset-weighted averages for mutual equity funds.

However, exit was, and is, a relatively weak mechanism to enforce shareholder power. Where there’s a seller, there’s also always a buyer. Unless the volume of shares sold is large, the impact on the share price is small. Even the combination of exit and voice – the hallmark of the shareholder primacy regime – was often insufficient for even large institutional shareholders to prevail in conflicts with corporate management.<sup>8</sup> Today, however, managers of S&P 500 companies face a highly concentrated ownership

<sup>7</sup> Falling portfolio turnover rates coexists with the rise of high-frequency trading and other quantitative trading strategies. However, these appear to have relatively little impact on corporate governance.

<sup>8</sup> Roe recounts an instructive episode in 1990, in which “two of General Motor’s largest institutional shareholders” were rebuffed by GM’s management, which “could get away with that rebuff because each [shareholder] owned less than 1 percent of GM’s stock” (Roe, 1994, p. xiii).

landscape in which the joint holdings of BlackRock and Vanguard often approach 20 percent – a common threshold to identify controlling shareholders (Aminadav & Papaioannou, 2020). Thus, although the largest shareholders have lost the option to exit individual portfolio companies, they have gained a considerable degree of *control*.

At the same time, today’s dominant shareholders are *fully diversified* holders of the market portfolio. Pension funds, in order to achieve reasonably high diversification, could only hold relatively small stakes in individual companies, which limited the effectiveness of their voice in corporate governance. The explosive growth of asset managers eliminated this temporary bottleneck. Large institutional capital pools (pension funds) could now pool their investments in even larger institutional capital pools (asset managers). Contrary to the previous dynamic, pension funds’ quest for diversification now actively contributes to the strengthening of shareholder control, exercised by asset managers. As a result, for the first time, shareholder control and full shareholder diversification have ceased to be mutually exclusive.

The combination of control *and* full diversification is what marks asset manager capitalism as a distinct corporate governance regime (see Table 1). At the same time, however, it is an accidental feature. Rather than the outcome of BlackRock and Vanguard seeking control over portfolio firms, the size of their shareholdings is a by-product of their success in the market for index-tracking equity investment funds. If there was a way for them to manage 10 trillion dollars each *without* holding a 5 to 10 percent stake in almost every major company, they would, presumably, gladly do so. Alas, winning in the market for asset management services is to be the world’s largest shareholder, and thus to be in a politically highly exposed position. My analysis of the politics of actually existing asset manager capitalism rests on this premise: Rather than a corporate governance asset, control-based power represents a political liability.

#### **4. Organized hypocrisy, or: The art of not wielding structural power**

The behavior of fully diversified “universal owners” should differ from that of non-diversified shareholders (Hawley & Williams, 2000; Monks & Minow, 1995). Specifically, instead of pushing individual corporations to do whatever it takes to maximize profits, fully diversified shareholders should act as “forceful stewards” (Fichtner & Heemskerk,

2020, p. 509) to internalize negative external effects from the conduct of individual portfolio companies. The theoretical and legal case for diversified asset managers to wield their structural power so as to minimize negative externalities at the portfolio level is compelling (Condon, 2020). Following the invention of environmental, social, and governance (ESG) investing in 2004, the discourse and practice of ESG increasingly defined the rules of the universal-ownership game (Pollman, 2022). Asset managers embraced the ESG rhetoric, presenting themselves as quintessential long-term shareholders (Chaffee, 2021; Jahnke, 2019). They supported establishing so-called stewardship codes in dozens of countries, which spell out the implications of ESG for shareholder engagement (Katelouzou & Puchniak, 2022). For a decade, Larry Fink, the CEO of BlackRock, has made a point of sending an annual letter to all CEOs of BlackRock’s portfolio companies in which he extols the virtues of “long-term thinking”, “sustainability”, and “corporate purpose.” At the time of this writing, however, it is clear that asset managers have systematically engaged in “greenwashing” – the misrepresentation of investment products as more environmentally sustainable than they are, while refraining from enforcing ESG principles at their portfolio companies (Condon, 2021a, 2021b). This gap between corporate governance rhetoric and corporate governance outcomes indicates a striking pattern of “organizational hypocrisy”, understood as the ability “to talk in a way that satisfies one demand, to decide in a way that satisfies another, and to supply products in a way that satisfies a third” (Brunsson, 1989, p. 27). Unlike the concept of voice, the concept of organized hypocrisy captures the complex politics of actually asset manager capitalism – talk so as to minimize regulatory risk; decide so as to maximize assets under management; and offer funds that satisfy investors’ demand for ESG products.

### *The broken promise of universal ownership*

The case for analyzing asset managers’ role in corporate governance through the lens of organizational hypocrisy rests on a critique of the Berle-Means-Jensen-Meckling ontology, and in particular its concept of ownership (Braun, 2021). Berle and Means (1932, p. 119) defined ownership as “having interests in an enterprise”. The entire edifice of agency theory hinges on the assumption that shareholders have more skin in the game

than either managers or workers (Fama & Jensen, 1983, p. 301). Yet precisely this assumption has become very difficult to defend. That U.S. corporate law does not assign ownership rights to shareholders has been known for some time (Stout, 2012). However, as agency relationships have proliferated, even *share* ownership has fragmented along the investment chain (Gilson & Gordon, 2013). Asset managers, who hold shares and control the associated voting rights, have a fiduciary duty to asset owners (e.g., pension funds), who have a fiduciary duty to the individual savers who are the ultimate beneficiaries of this investment chain. In other words, the separation of ownership and control has been joined by the “separation of ownership from ownership” (Strine Jr, 2007, p. 7). At the same time, asset managers are profit- and shareholder-oriented corporations themselves. For their business model, corporate governance is a second-order variable that matters only to the extent that it impacts assets under management, fee income, and costs. Here, too, for-profit asset managers are fundamentally different from not-for-profit asset owners, such as pension funds. Asset managers have much more to lose from actions – such as casting their proxy votes against management – that could cause the latter to retaliate by shifting corporate retirement plan assets to competing asset managers (Bebchuk et al., 2017).

It is therefore not surprising that the empirical evidence provides scarce support for the forceful stewardship hypothesis. Baines and Hager, who focus on the proxy voting record of the Big-Three asset managers at the shareholder meetings of a group of 55 fossil fuel, mining and cement companies, have found that the Big Three “seldom defy management in supporting shareholder resolutions aimed at improving environmental governance” and that “the voting behavior of their ESG funds ... is almost identical to that of their non-ESG funds” (Baines & Hager, 2022, p. 3). Similarly, a study of 146 shareholder resolutions related to environmental and social issues, from the 2021 proxy season, has shown that the world’s six largest asset managers are more likely than almost all their peers to vote against those resolutions (ShareAction, 2021). All six supported fewer resolutions than recommended by the two leading proxy advisory firms, ISS and Glass Lewis. For a significant number of resolutions, the lack of support from the largest asset managers proved decisive. While 30 out 146 resolutions passed, 18 more resolutions would have passed had one or more of the Big Three voted yes. In other words, the voting

power that comes with large shareholdings effectively makes BlackRock, Vanguard, and State Street the decisive swing vote on controversial shareholder resolutions. To date, they have used that power to shield corporations from the environmental and social demands tabled by activist shareholders. The counterargument that large asset managers do not depend on voting because their size allows them to engage with portfolio companies behind closed doors is also invalidated by the data, which shows that index funds are *less* likely than other funds to engage with portfolio firms (Heath et al., 2021). For corporate governance to reflect the logic of universal ownership, asset managers would have to enforce it, which the available evidence suggests they are unable, or unwilling, to do. The same is not true for the logic of “common ownership”, which is largely self-enforcing. Here, the question is whether the same small group of asset managers holding significant stakes in all competing firms in a given sector is associated with anti-competitive behavior by portfolio firms (Elhauge, 2016). Common ownership can be understood as the evil twin of universal ownership (Azar, 2020). Whereas the latter postulates the internalization of negative environmental or social externalities at the level of the entire portfolio, the former postulates, for the sectoral level, the internalization of the negative externality competition exerts on profits. The agenda-setting studies in this field have found evidence that when competing firms in the same sector – notably, airlines and banks – have the same dominant shareholders, anti-competitive collusion becomes more likely (Azar et al., 2018, 2021). The hypothesized causal mechanisms range from shareholder passivity, to large shareholders payouts reducing investment and thus product market competition, to shareholders actively discouraging price competition.

The question of a causal relationship between common ownership and oligopolistic pricing notwithstanding, the common ownership argument provides a better explanation of recent trends in corporate governance than the universal ownership argument. The rise of asset manager capitalism has coincided with a steep increase in payouts to shareholders. Figure 2, which is based on data for all listed U.S. corporations, shows that average quarterly stock buybacks doubled from \$51 billion during 2000-2010 to \$106 billion during 2011-2021. Similarly, between 2010 and 2020, both the average quarterly spending of S&P 500 companies on buybacks and the ratio of buyback spending to net

income roughly doubled (Palladino & Lazonick, 2021, pp. 19–21). A similar pattern can be observed for executive remuneration, which almost doubled between 2000 and 2014 in the United States, while more than tripling in the UK, where pay increases with the size of shareholdings by US asset managers (Linsi et al., 2021, p. 5).

In light of the institutional realities of asset manager capitalism, how should these observed outcomes be assessed? Unlike pension funds under the shareholder primacy regime, BlackRock and Vanguard do have the power to enforce far-reaching changes at their portfolio companies. However, they have made no attempt whatsoever to orchestrate a rapid decarbonization of the economy. Following the revival of fossil fuel production in the wake of Russia’s invasion of Ukraine, the largest asset managers stated explicitly that decarbonization, be it through divestment or engagement, was not their primary goal. Thus, Vanguard announced its intention to continue investing in fossil fuel industries because climate change was “only one factor in an investment decision” (Flood, 2022). BlackRock announced that it considered many climate-related shareholder proposals made for the 2022 proxy season overly “prescriptive” and “[not] consistent with our clients’ long-term financial interests”, signaling that it was going to vote against them (BlackRock, 2022a). Given these asset managers’ longstanding strategies of organizational hypocrisy – talking ESG while opposing climate-related shareholder proposals – what motivated this re-alignment of rhetoric and action?

*Maximizing assets under management, minimizing political risk*

As is all politics, the politics of asset manager capitalism is driven by interests. On the revenue side, asset managers’ overriding interest is in maximizing their fee revenue, and thus their assets under management. For this, returns matter, but only indirectly, and to the extent that they cause asset owners to move their money to or from competitors. Instead, the variable of the greatest interest to (conventional) asset managers are *aggregate* asset prices. This is because the fees they charge are calculated as a percentage of the current value of a client’s assets. Across a large asset manager’s portfolio of funds, the impact of individual fund performance on the growth of assets under management is far less than the impact of aggregate asset price developments.

Although forceful stewardship across the entire portfolio would, in theory, be a means to ensure high aggregate asset prices, a cheaper and simpler strategy exists: macroeconomic policies that sustain high asset prices. BlackRock’s preference for such policies is illustrated by its strategic and persistent lobbying for expansionary monetary policy (Braun, 2021, p. 291). The actor with the greatest power over the asset management sector’s profitability is the Federal Reserve, whose monetary policy decisions are the single most important driver of global asset prices (Rey, 2015). For instance, in 2020, when the Fed’s unexpected resumption of financial asset purchases sparked a stock market rally, net inflows of new money into the asset management sector contributed only \$5 billion towards the sector’s gross revenue increase, whereas the aggregate rise in asset prices contributed \$29 billion (McKinsey, 2021).

On the cost side, the single most important risk for the Big-Three asset managers is regulatory risk. This holds for financial firms generally, but the Big Three are walking a particularly tricky tightrope walk. Nowhere has this been more obvious than in the United States, where regulatory actions against asset managers are, at this point, as likely to originate from the left as from the right. Progressive Democrats criticize the Big Three for their complicity in perpetuating the distributional outcomes of the shareholder value regime and for not wielding their potential power in the service of a rapid decarbonization. Republicans, meanwhile, have rekindled their own brand of anti-finance politics under the banner “woke capital” (Fan, 2019). Senator Ted Cruz’ recent comment that “every time you fill up your tank, you can thank Larry [Fink] for the massive and inappropriate ESG pressure” is representative of what has become a concerted Republican campaign against large asset managers (Mangan, 2022).

Thus caught between a rock and a hard place, it appears that asset managers seek to perform as much environmental and social stewardship as necessary to appease progressives, while saying and doing as little as possible that could be weaponized by the ascendant anti-finance wing within the Republican party.<sup>9</sup> Larry Fink’s (2022) most

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<sup>9</sup> Both in the United States and in the UK, the political right has allied itself with the alternative asset management sector, especially with “private” capital, while directing its critiques of finance against banks and large, diversified asset managers (Benquet & Bourgeron, 2021b; Cooper, 2022).

recent annual letter to CEOs, in which he explained that the “stakeholder capitalism” BlackRock had been advocating was neither “a social or ideological agenda” nor “woke”, illustrates the contortions required by this tightrope walk. Fink has since doubled down, saying that he did not “want to be the environmental police” (Brush & Massa, 2022). Beyond rhetoric, smoking gun evidence that BlackRock’s proxy voting is driven by political rather than by universal-owner considerations can be found in the regional variation in its voting behavior: Since 2017, BlackRock has voted *in favour* of environmental and social shareholder proposals 87 percent of the time in ESG-friendly Europe, while voting *against* such proposals 84 percent of the time in North America (Willis & Baldock, 2022, p. 10). In an evident attempt to further reduce its footprint in proxy voting, BlackRock, in late 2021, announced a pilot project to allow institutional investors in the U.S. and the UK the option to decide themselves how their proxy votes should be cast by BlackRock (Bradford, 2021). It has since expanded the program, dubbed “Voting Choice” (BlackRock, 2022b).

BlackRock’s pro-management stance in U.S. proxy voting and its move towards re-delegating proxy voting to institutional clients could not, however, prevent political backlash from the right. In May 2022, Dan Sullivan, a Republican Senator from Alaska, together with ten co-sponsors, introduced the Investor Democracy is Expected, or INDEX Act. Under the bill, index-tracking asset managers holding more than one percent of a listed company’s shares would be required to vote shares according to each individual investor’s instructions (Croce, 2022). Practical problems with implementation notwithstanding, such a rule would radically curtail the proxy voting power of the Big Three.

## **Conclusion**

The declining dependence of non-financial corporations on outside financing and the growth of institutional capital pools have reduced the capacity of financial actors to sell their shareholdings in individual firms. As a result, exit is no longer the main mechanism underpinning the structural power of finance in general, and of shareholders in particular. Instead, control has largely replaced exit as the primary mechanism underpinning the structural power of finance vis-à-vis non-financial firms. The question is if, and how, the

new financial capitalists wield this potential power. Based on ample evidence that the largest asset managers have not used their power to enforce environmental and social corporate governance principles, the forceful stewardship hypothesis must be rejected. In order to understand why they have been so reluctant to wield their control-based power, we need to look beyond corporate governance and take seriously that the primary determinants of asset manager profits are not corporate governance outcomes but success in the competition for asset management services, as well as macroeconomic and regulatory policy. In order to navigate the treacherous politics of asset manager capitalism, these firms resort to strategies of organizational hypocrisy.

The discussion points towards three promising avenues for future research on the structural power of finance. The first concerns the renewed debate about how to democratize share ownership and corporate governance (Block, 2014; Buller & Lawrence, *forthc.*; McCarthy, 2019; Palladino, 2021). Here, a firm grasp of the historical uniqueness of asset manager capitalism can help make the case that the ideological defense of the shareholder primacy is bankrupt even on its own terms. With the fragmentation of what the law-and-economics tradition called “ownership”, and the breakdown of the Berle-Means-Jensen-Meckling ontology, the structural power wielded by asset managers appears to rest on shaky ideological ground.

The second use case concerns research on the political economy of inequality. The rate of return on capital is determined by technology as well as by government policies on labor markets, taxation and financial regulation. Whereas in the past the distribution of power between capital and labor may have sufficed to explain policy outcomes in those areas, the growth and financialization of household wealth have complicated the picture (Adkins et al., 2020; Pagliari et al., 2020; Pfeffer & Waitkus, 2021). Today, even middle-class households have a stake in the rate of return on capital, and thus “great expectations” of governments to protect their wealth (Chwioroth & Walter, 2019). In this context, studying the mechanisms through which financial firms wield structural power in order to defend the claims of wealth owners against competing claims promises to shed new light on the sociology and political economy of inequality.

Finally, more research is needed on what asset managers want. Whereas the corporate governance preferences of asset managers are the subject of a burgeoning field, their

preferences for *macroeconomic* governance are poorly understood. There are good reasons to assume that here, too, dramatic change is underfoot. Simply put, banks – the core of the late-20<sup>th</sup> century “deflationary bloc” (Feygin, 2021) – benefits from stable growth rates and positive real interest rates, regardless of whether interest income derives mainly from business lending or from mortgage and consumer lending (Posen, 1995). By contrast, asset managers’ overriding preference is macroeconomic policies that sustain high asset prices, notably an expansionary monetary policy stance. Whereas banks are certified monetary policy hawks, asset managers appear to be doves.

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