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The Role of Passive Investors in Corporate Governance and Socially Responsible Investing: Evidence from Shareholder Proposals

Lukai Yang [1,*], Xinhui Huang [2] and Xiaochuan Song [3]

[1] Division of International Banking and Finance Studies, A.R. Sanchez, Jr. School of Business, Texas A&M International University, 5201 University Boulevard, Laredo, TX 78041, USA
[2] Maine Business School, University of Maine, 5723 DP Corbett Business Building, Orono, ME 04469, USA; xinhui.huang@maine.edu
[3] Department of Management, Marketing, and Information Systems, College of Business Administration, Texas A&M University-Kingsville, 1115 N. University Blvd., Kingsville, TX 78363, USA; xiaochuan.song@tamuk.edu
* Correspondence: lukai.yang@tamiu.edu

Abstract: We study whether the substantial rise in passive ownership reshapes activist shareholders' behavior in sponsoring shareholder proposals, which shareholders use to address issues they believe are crucial for the sustainable growth of a company. Our findings reveal a positive impact of passive investors on the initiation of governance, socially responsible investing (SRI), and an aggregate of both proposals. Interestingly, we show that managerial ability and board co-option potentially moderate their link. In the subsequent analysis, we note a constructive influence of passive investors on post-initiation outcomes, evidenced by an increase in withdrawal and voting percentage of proposals corresponding to heightened levels of passive ownership. These findings suggest that passive investors foster communication between activists and management and endorse the case even when it progresses to the voting stage. More importantly, the market values these proposals positively as reflected in higher observed buy-and-hold returns. Finally, our results are robust to instrumental variable analysis using Russell reconstitution as an exogenous shock. Taken together, our study offers broad implications that passive investors can indirectly engage in promoting sustainable practices by encouraging activist investors to sponsor governance and socially responsible proposals, a collaborative approach where shareholders contribute to sustainability efforts.

Keywords: passive investors; shareholder proposals; governance; SRI

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1. Introduction

The role of passive investors has become progressively more crucial in financial markets. Unlike active investors who frequently buy and sell securities, passive investors, also known as passive index funds, seek to replicate the returns of a particular market index or benchmark [1]. However, growing evidence suggests that passive investors exhibit "active" behaviors [2,3]. Indeed, passive fund managers have made statements suggesting that they are not content with sitting on the sidelines but instead intend to have a say in how the firm is managed. For example, Bloomberg Intelligence has pointed out that around August 2018, passively managed funds overtook active ones, and they now constitute approximately 54% of the market share, primarily driven by the growth of funds tracking the S&P 500 and other indexes [4]. Among the important facets that these fund managers aim to engage companies in, sustainability is one of the crucial issues that they repeatedly highlight. Examples include iShares MSCI KLD 400 Social ETF by BlackRock, the first SRI ETF. Despite the fact that passive investors may dedicate themselves to enhancing portfolio firms' corporate governance and social responsibilities [5,6], it remains debatable how effective they are in fulfilling these fiduciary duties. Although we strive to unveil the

subtle yet impactful role of passive investors, an important metric, shareholder proposal, has drawn our attention. Proposals can provide a unique perspective into the indirect but discernible influence passive investors exert on corporate decisions and accountability. Therefore, in this paper, we seek to delve deeper into how passive investors are involved in governance and socially responsible issues by examining various aspects of shareholder proposals, including the initiation of proposals, proposal withdrawals, voting outcomes, and long-term value implications. This extensive analysis can offer valuable insights into the impact passive investors have on corporate sustainable practices and consequences.

Using a sample of shareholder proposals in US firms from 2007 to 2018, we find that passive ownership is positively associated with socially responsible investing (SRI), governance, or both types of proposals. These findings indicate that the presence of passive investors increases activists' inclination to participate in relatively less costly forms of activism. In the subsequent round of moderation analysis, our evidence shows that a co-opted board strengthens the positive impact of passive ownership on proposal initiations, but managerial ability diminishes the passive investor's impact. These phenomena are attributable to the extent to which their governance or monitoring is reinforced or undermined under varying circumstances. Next, an important question to consider is whether passive investors play a role in negotiations between proposal sponsors and companies, which is closely linked to the withdrawal of proposals [7–9]. Our findings demonstrate a positive correlation between passive ownership and the withdrawal of proposals, indicating that they facilitate successful communications. We also find that even when the discussion was unsuccessful and ultimately progressed to a vote during the annual meeting, passive investors continue to be positively associated with the vote-for percentage of proposals, indicating their support on these matters. Additionally, we observe that passive investors' endorsement carries positive value implications as they are shown to be correlated with enhanced buy-and-hold stock returns the year following the annual meeting date when the proposals were presented, aligning with their ongoing pursuit of long-term value creation goals.

To tackle possible endogeneity problems and ensure the causal effect of our baseline results, we follow recent research [2,3,10–14] and impose a two-stage least squares (2SLS) methodology using inclusion in the Russell 2000 index as our instrumental variable. The underlying concept is that the annual reconstitution of the Russell indexes results in passive ownership being significantly higher for top-ranked stocks in Russell 2000 compared with those of bottom-tier Russell 1000 stocks, though these two groups of stocks are otherwise similar [15]. Our results remain robust after the adoption of the instrumental variable, further confirming the validity of our findings.

Our paper contributes to ongoing studies that focus on shareholder activism [16–23]. The extant literature has primarily focused on activist investors' involvement in shareholder activism, such as pension fund activism [17,24–27] and hedge fund activism [28–32]. However, despite the growing importance of passive investors, research on their direct or indirect engagement in shareholder activism remains scant. Our paper extends to this stream of the literature by offering novel evidence that passive investors are notably associated with the initiation of proposals as well as facilitating negotiations between activists and the company.

Our paper also adds to emerging research on the governance effects of passive investors [33,34]. The remarkable rise in the volume of assets under management by these institutions has sparked debates about the role of passive investors in the economy [1,35,36]. Although recent scholarly work has raised doubt about their positive roles, a vast majority of extant studies have highlighted the favorable influence of these investors on corporate governance [12,37,38]. More importantly, recent research indicates that passive investors have significant monitoring incentives for broad-ranging issues like sustainability or diversity [39], where they can leverage their monitoring on a large scale without obtaining firm-specific information [2,40]. We contribute to this important debate by uncovering the pivotal fact that passive investors may not directly engage in conventional forms of

activism or monitoring activities but can still exert a considerable influence on the actions of other shareholders. This presents a distinct mechanism through which the proliferation of passive ownership is impacting managerial oversight.

Lastly, this paper provides important implications and extensions to Corporate Social Responsibility (CSR) and Environmental, Social, and Governance (ESG) literature [41–50]. A substantial body of research has explored the impact of CSR/ESG on many firm aspects, such as corporate governance [51], firm performance and valuation [52–54], intensity of investments [55], and reputation [56]. Another strand of study, more related to our research question, examines the factors contributing to corporate sustainable behaviors [57–61]. Our analysis expands on the existing literature on socially responsible investing by revealing that passive investors play a crucial role in the increase of SRI-related proposals, and this rise also improves firm value.

We organize our paper as follows. Section 2 presents the hypothesis development. Section 3 describes our data sources and empirical specifications. Section 4 details the main findings and Section 5 concludes the paper.

2. Hypothesis Development

2.1. Background on Passive Investors

It is broadly recognized that passively managed funds have become an integral component of the U.S. equity market [1,3,62,63]. It has become the most important advancement in contemporary capital markets, holding a substantial portion of corporate America [62]. Extant studies argue that they are not merely managing funds 'passively' but instead are motivated to have a significant impact on corporate monitoring [2,13,35,40]. For example, Gormley et al. [40] show that the Big Three (e.g., BlackRock, State Street Global Advisors, and Vanguard, known as the largest passive index fund managers) initiated gender diversity campaigns and pressured firms to appoint more female directors. This implies their intervention to urge companies to adopt centralized corporate governance strategies that are easy to monitor at scale. All the aforementioned evidence spurs our interest in analyzing whether passive investors, though behind the scenes, can exercise their governance role by strengthening or reshaping other shareholders' choice of voice—shareholder proposals.

2.2. Shareholder Proposals

Shareholder proposals are key mechanisms that allow investors to effectively convey their opinions on the governance and operation of firms [64]. The scope of proposals covers an extensive range of topics, touching upon various matters such as ESG and executive compensation. Our focus on shareholder proposals stems from the following rationales. Shareholders have increased their intervention through communication and negotiation with managers, proxy contests, and shareholder proposals, among which shareholder proposals are relatively easier to initiate [9,23]. It is commonly regarded as low-cost activism because the cost of initiating proposals is quite modest, and they do not require a large equity stake in the company [9]. Shareholder proposals allow individual or institutional investors to easily put forth specific issues for consideration at a company's annual meeting. Furthermore, proposals offer a direct channel for shareholders to promote awareness about specific issues (e.g., sustainable investment) and advocate for responsible corporate behaviors [65,66]. They are shown to be an effective instrument for sponsors to monitor companies [67]. In addition, the subsequent proposal resolution, withdrawal, or voting offers tangible and measurable outcomes to assess the effectiveness of the initial actions [68]. These unique characteristics are crucial to gaining a better understanding of the dynamics and allow us to evaluate the influence of passive investors empirically and systematically on corporate governance and socially responsible investing practices.

2.3. The Link between Passive Ownership and Shareholder Proposal

It is unclear, however, whether passive investors will facilitate the initiation of proposals, including governance- and SRI-related proposals. On the one hand, index investors seek

to replicate a well-diversified market index, lacking the motivation to gather firm-specific information. Knowing these details is typically essential for enhanced firm monitoring. Furthermore, scholars have found no strongly persuasive evidence of shareholder proposals (irrespective of governance or SRI proposals) being associated with share value increases [17,25,31,69], a factor that shareholders place considerable importance on [1]. Under these circumstances, passive investors perhaps are unsupportive or neutral to the activists' agenda in sponsoring proposals.

On the other hand, given that shareholder proposals can be a useful tool for generic monitoring as pointed out by Renneboog and Szilagyi [23], passive investors might be most likely to use their voting rights associated with their large ownership stakes to not only pressure firms but also provide confidence to other shareholders to sponsor proposals. In particular, the largest index investors (e.g., BlackRock, State Street, and Vanguard) consistently outline in their proxy voting guidelines over the past decade that, when a portfolio company fails to adequately consider the interests of its key stakeholders or address their concerns, they may support shareholder proposals related to these topics or vote against relevant directors. Furthermore, in contrast to the lack of evidence regarding the connection between proposal and firm value, Renneboog and Szilagyi [23] instead show that regardless of the proposal objectives, shareholder proposals are associated with share price increases for the firm being targeted. In conjunction with this, Buchanan et al. [70] provide evidence that shareholder proposals (any type) are associated with a positive impact on firm performance. If the arguments discussed above hold, passive investors may lend support to activists to sponsor more proposals to align with their ultimate goal of value creation.

Based on the above discussion, whether passive investors will encourage more shareholder proposals remains an empirical question. Therefore, we present our hypothesis as follows:

H1a: *Passive ownership is positively associated with the initiation of shareholder proposals, including governance- and SRI-related proposals.*

H1b: *Passive ownership exhibits an inverse relationship with or is indifferent to the initiation of shareholder proposals.*

2.4. The Potential Moderating Role of Managerial Ability on Passive-Shareholder Proposal Link

Cui and Leung [71] and Andreou et al. [72] suggest that exceptional managerial ability can enhance a firm's operational performance and stock returns. Additionally, the existing literature highlights that higher managerial competence at the top management level improves firms' information transparency [73], potentially alleviating concerns about information asymmetry among investors. More relevant to our study, Yan and Yang [74] show that highly skilled managers who are proficient in negotiation and management could collaborate effectively to reach agreements with hedge fund activists. The above arguments collectively provide supporting evidence that competent managers can not only address concerns shareholders or activists may have regarding firm performance or other aspects of firms but also enhance communications with activists. This is anticipated to counterbalance the positive influence of passive investors in encouraging activists to initiate more proposals. Accordingly, we propose:

H2: *Managerial ability mitigates the positive impact of passive ownership on shareholder proposals.*

2.5. The Possible Moderating Role of the Co-Opted Board

Coles et al. [75] argue that a co-opted board can signify the CEO's sway over the firm's board. Such heightened CEO power can compromise the board's capability to effectively monitor the company, which is observed in the Cassell et al. [76] study. Other scholars also indicate that a co-opted board can adversely affect firms' sound information

ecosystem, leading to an increase in real earnings management [77], augmented profits in insider trading [78], and heightened earnings linked to misconduct [79]. These findings imply that co-opted boards may exacerbate information asymmetry problems and escalate governance-related issues [79]. Reflecting this in our specific situation, board co-option may strengthen the positive influence of passive ownership on activists as passive owners could become more concerned about corporate governance due to board co-option, possibly fostering shareholder activism. Consequently, we hypothesize:

H3: *Board co-option amplifies the positive association between passive ownership and shareholder proposals.*

3. Data, Summary Statistics, and Empirical Frameworks

3.1. Passive Ownership

We computed passive ownership using mutual fund holdings from the Thomson Reuters (TR hereafter) S12 dataset. We followed Appel et al. [2] and Appel et al. [3] to categorize passive funds if their name contained an index-identifiable string or if the CRSP Mutual Fund data classified them as such. We then calculated the proportion of passive ownership relative to each stock's market capitalization at the end of each quarter. Our sample spans the period from 2007 to 2018.

3.2. Shareholder Proposals

Shareholder proposal information was obtained from the Institutional Shareholder Services (ISS) data file. These data collect shareholder proposals submitted to companies within the S&P 1500 index. The dataset also provides information on proposal resolution types, categorizing it as either socially responsible investing (SRI) or governance (GOV).

3.3. Firm-Level Variables

We calculated the total market capitalization for each stock using the Center for Research in Security Prices (CRSP) monthly dataset. Other control variables, including ROA, Leverage, and PPE were obtained from Compustat. Managerial ability measurement and board co-option information were obtained from Demerjian et al. [80] and Coles et al. [75], respectively.

3.4. Russell 1000/2000 Index Reconstitution

We obtained Russell 1000 and Russell 2000 compositions from FTSE Russell. The Russell 1000 index comprises the first 1000 largest market-capitalized companies and the Russell 2000 includes firms ranking from the 1001st to the 3000th largest in market capitalization. Russell employs its proprietary float-adjusted market cap method to rank U.S. stocks within respective indexes. All related variable definitions and their sources are reported in Table 1.

3.5. Descriptive Statistics

Table 2 shows our sample summary statistics. On average, there are a total of 0.345 proposals initiated every firm-year. In other words, roughly one in every three firms has a proposal initiated by activists every year. Among all proposals, 37.35% (0.127/0.34) are SRI-related and 62.65% (0.208/0.34) are governance-related proposals. For the average observation in our sample, the passive ownership is approximately 10.5%. As is also indicated in this table, the vote-for percentage of proposals is approximately 33% and the probability of withdrawing a proposal is 17%.

Table 1. Variable definitions.

Variable	Description
Band	An indicator of whether the company's end-of-May market capitalization is adequately near the Rusell 1000/2000 cutoff such that the firm will remain in the same index. Source: CRSP and FTSE Russell
Board Co-option	Percentage of directors that are appointed following the hiring of the CEO (Coles et al. [75]). Source: https://sites.temple.edu/lnaveen/data/, accessed on 5 November 2023
Indicator for Any Proposal	An indicator that equals one if there were one or more proposals sponsored in a firm-year. Source: ISS
Indicator for GOV Proposal	An indicator that equals one if there were one or more governance-related proposals sponsored in a firm-year. Source: ISS
Indicator for SRI Proposal	An indicator that equals one if there were one or more SRI proposals sponsored in a firm-year. Source: ISS
Indicator for Withdrawn	An indicator of if there is any proposal being withdrawn in a firm-year. Source: ISS
Leverage	Measured as the ratio of debt in current liabilities plus long-term debt to total assets. Source: Compustat
Ln(Mktcap)	The logarithm of total market cap. Source: CRSP
Ln(Floatmc)	The logarithm of float-adjusted market cap. Source: FTSE Russell
Managerial Ability	Top management team's managerial ability (Demerjian et al. [80]). Source: https://peterdemerjian.weebly.com/managerialability.html, accessed on 5 November 2023
Passive%	Percent of passive ownership. Source: Thomson Reuters and CRSP
R2000	An indicator of if the company is included in the Russell 2000. Source: FTSE Russell
ROA	The ratio of net income to total assets. Source: Compustat
PPE	Sum (property, plant, and equipment) scaled by total assets. Source: Compustat
Total Proposal Total SRI Proposal Total GOV Proposal	The total number of shareholder proposals in a firm-year. Source: ISS The total number of socially responsible investing proposals in a firm-year. Source: ISS The total number of governance proposals in a firm-year. Source: ISS
Total Withdrawn	The total number of proposals withdrawn in a firm-year. Source: ISS
Vote-for%	The voting percentage that is in support of the proposal. Source: ISS

Note: This table reports definitions and sources of all key variables.

Table 2. Summary statistics.

Variables	N	Mean	SD	P25	Median	P75
Total Proposal	29,230	0.340	1.116	0	0	0
Total SRI Proposal	29,230	0.127	0.547	0	0	0
Total GOV Proposal	29,230	0.208	0.735	0	0	0
Indicator for Any Proposal	29,230	0.163	0.369	0	0	0
Indicator for SRI Proposal	29,230	0.080	0.272	0	0	0
Indicator for GOV Proposal	29,230	0.123	0.329	0	0	0
Passive%	29,065	0.105	0.056	0.067	0.096	0.134
Ln(Mktcap)	29,230	21.115	1.594	19.869	20.918	22.105
Total Withdrawn	29,230	0.083	0.347	0	0	0
Indicator for Withdrawn	29,230	0.169	0.375	0	0	0
Vote-for%	5516	33.164	22.900	13.300	31.300	45.400
ROA	29,230	0.087	0.183	0.037	0.103	0.159
Leverage	29,230	0.227	0.230	0.040	0.183	0.344
PPE	29,230	0.223	0.243	0.036	0.126	0.332
Managerial Ability	21,218	0.004	0.152	−0.087	−0.035	0.049
Board Co-option	12,910	0.466	0.307	0.2	0.444	0.714

Note: This table shows the descriptive statistics of key variables. Variable definitions and sources are reported in Table 1.

3.6. Empirical Framework

We begin our estimation with an ordinary least square (OLS) regression to assess the influence of passive ownership. Specifically, the model employed in our analysis is as follows:

$$Y_{it+1} = \alpha + \beta Passive\%_{it} + \sum_{n=1}^{2} \theta n\big(Ln(Mktcap)\big)^n + \mu_1 ROA_{it} + \mu_2 Leverage_{it} + \mu_3 PPE_{it} + \delta_{it} + \varepsilon_{it} \quad (1)$$

where Y_{it+1} is the outcome variable (e.g., Total Proposal, Total SRI Proposal, Total Withdrawn, etc.). Passive% is the passive ownership and Mktcap is the market capitalization of firm i in year t. Firm-level control variables include ROA, Leverage, and PPE. Additionally, we include firm-fixed effects to take firms' time-invariant attributes into consideration and year-fixed effects to address the secular trends affecting all firms (δ_{it}).

4. Results

In this section, we present our regression estimations of the impact of passive investors on shareholder proposal initiations, proposal withdrawals, voting outcomes, and buy-and-hold stock returns. We also explore the possible influence of two mediators, managerial ability and board co-option, on the correlation between passive and shareholder proposal initiations.

4.1. Baseline Results

4.1.1. The Impact of Passive Ownership on Shareholder Proposals

We begin our analysis with whether passive investors affect the total number of proposals sponsored (Total Proposals, Total SRI Proposal, and Total GOV Proposals) and the likelihood of initiating shareholder proposals (Indicator for Any Proposal, Indicator for SRI Proposal, and Indicator for GOV Proposal. We report our baseline estimates in Table 3. We find that, across all the measurements of proposal initiations, the influence of passive investors is positive and statistically significant. For example, in column 1, a one-standard-deviation increase in passive ownership is associated with an increase in the total number of proposals by 13.8% relative to its sample mean ($0.839 \times 0.056/0.340$). Similarly, a one-standard-deviation increase in passive ownership increases the likelihood of initiating a proposal by 9.1% relative to its sample average ($0.264 \times 0.056/0.163$) (Table 3, column 4). It is worth noting that the positive impact of passive ownership persists when we examine SRI (columns 2 and 5) and governance (columns 3 and 6) proposals individually. Collectively, our baseline findings provide supporting evidence that an increase in passive ownership positively influences activists to sponsor more proposals and, at a minimum, heightens firms' awareness of the SRI or governance matters outlined in these proposals.

4.1.2. The Moderating Role of Managerial Ability

Given that the established positive impact of passive investors on shareholder proposals is rather robust, the subsequent analysis explores, from the management perspective, the potential moderating role of managerial ability in shaping the dynamics of this relationship. In this analysis, we employ a modified version of Equation (1) to empirically investigate the aforementioned perspectives:

$$Y_{it+1} = \alpha + \beta Passive\%_{it} * \text{ Managerial Ability} + \sum_{n=1}^{2} \theta n\big(Ln(Mktcap)\big)^n + \mu_1 ROA_{it} + \mu_2 Leverage_{it} + \mu_3 PPE_{it} + \delta_{it} + \varepsilon_{it}, \quad (2)$$

where Y_{it+1} represents the measurements of shareholder proposals, and the remaining variables match those specified in Equation (1). We report our estimation results in Table 4. Indeed, our results confirm this assertion. The coefficient of the interaction Passive%*Managerial Ability is negative, further confirming the attenuated effect of managerial ability.

Table 3. Passive investors and shareholder proposals.

	(1)	(2)	(3)	(4)	(5)	(6)
	Total Proposal	**Total SRI Proposal**	**Total GOV Proposal**	**Indicator for Any Proposal**	**Indicator for SRI Proposal**	**Indicator for GOV Proposal**
Passive%	0.839 ***	0.406 ***	0.458 ***	0.264 ***	0.119 **	0.153 **
	(4.61)	(4.19)	(3.33)	(3.25)	(2.13)	(2.04)
Ln(Mktcap)	−0.849 ***	−0.408 **	−0.229	−0.404 ***	−0.208 ***	−0.318 ***
	(−2.60)	(−2.29)	(−1.21)	(−6.55)	(−3.58)	(−5.45)
Ln(Mktcap)^2	0.023 ***	0.011 **	0.007	0.011 ***	0.006 ***	0.008 ***
	(2.80)	(2.41)	(1.49)	(6.96)	(3.83)	(5.81)
ROA	−0.108 **	−0.017	−0.097 **	−0.042 **	−0.025 ***	−0.044 **
	(−2.34)	(−1.01)	(−2.47)	(−2.28)	(−2.68)	(−2.42)
Leverage	0.102 **	−0.003	0.097 ***	0.042 **	−0.008	0.037 **
	(2.24)	(−0.15)	(2.66)	(2.43)	(−0.74)	(2.31)
PPE	0.228	0.150 *	0.080	0.075 *	0.094 ***	0.037
	(1.59)	(1.88)	(0.88)	(1.72)	(2.71)	(0.89)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
N	29,230	29,230	29,230	29,230	29,230	29,230
R-sq	0.710	0.600	0.620	0.555	0.484	0.517

Note: This table reports estimates of the impact of passive ownership on shareholder proposals. Columns 1–3 show the regressions when outcome variables are in total numbers and columns 4–6 represent analysis using indicators. All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

Table 4. The moderating role of managerial ability.

	(1)	(2)	(3)
	Total Proposal	**Total SRI Proposal**	**Total GOV Proposal**
Passive%	0.740 ***	0.404 ***	0.369 **
	(3.43)	(3.27)	(2.34)
Managerial Ability	0.413 **	0.253 **	0.220 *
	(2.30)	(2.17)	(1.85)
Passive%*Managerial Ability	−4.384 ***	−2.696 ***	−2.387 **
	(−2.72)	(−2.69)	(−2.25)
Ln(Mktcap)	−1.032 **	−0.520 **	−0.330
	(−2.47)	(−2.25)	(−1.41)
Ln(Mktcap)^2	0.027 ***	0.013 **	0.010
	(2.63)	(2.35)	(1.63)
ROA	−0.163 **	−0.026	−0.138 **
	(−2.26)	(−0.77)	(−2.53)
Leverage	0.060	−0.013	0.060
	(1.12)	(−0.48)	(1.38)
PPE	0.203	0.105	0.104
	(1.17)	(1.10)	(0.99)
Year FE	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
N	21,218	21,218	21,218
R-squared	0.713	0.609	0.618

Note: This table reports estimates of the moderating effect of managerial ability on the passive–proposal link. Columns 1–3 show the analysis results when outcome variables are the total number of proposals, total SRI-related proposals, and total governance-related proposals. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

4.1.3. Does Board Co-Option Matter

Besides managerial aspects, another critical and influencing factor that should not be overlooked is board co-option. Co-opted board members are those who were appointed after the CEO took office, which indicates that they are likely to align their loyalties

with the CEO who facilitated their appointment. Such a connection may reshape the boardroom decision-making process. Given the potential impacts of board composition on many aspects of firms, board co-option emerges as a significant factor affecting corporate governance. To test the influence of the co-opted board, we again adopt a modified version of Equation (1), similar to Equation (2):

$$Y_{it+1} = \alpha + \beta Passive\%_{it} * \text{Board Co-option} + \sum_{n=1}^{2} \theta n\left(Ln(Mktcap)\right)^n + \mu_1 ROA_{it} + \mu_2 Leverage_{it} + \mu_3 PPE_{it} + \delta_{it} + \varepsilon_{it} \quad (3)$$

where Y_{it+1} represents the outcome measures, and the other variables are specified in Equation (1). Table 5 confirms our conjecture that the co-opted board reinforces the positive link between Passive% and proposals.

Table 5. The moderating role of the co-opted board.

	(1)	(2)	(3)
	Total Proposal	**Total SRI Proposal**	**Total GOV Proposal**
Passive%	1.168 *	1.126 ***	0.485
	(1.79)	(2.67)	(1.14)
Board Co-option	−0.351 **	−0.027	−0.317 ***
	(−2.57)	(−0.35)	(−3.46)
Passive%*Board Co-option	2.196 **	0.300	1.808 ***
	(2.58)	(0.64)	(3.17)
Ln(Mktcap)	−0.707	−0.510	0.176
	(−0.88)	(−1.13)	(0.42)
$Ln(Mktcap)^2$	0.021	0.014	−0.001
	(1.09)	(1.26)	(−0.10)
ROA	−0.529 **	−0.156	−0.422 **
	(−2.17)	(−1.38)	(−2.33)
Leverage	0.101	−0.086	0.164
	(0.72)	(−1.30)	(1.44)
PPE	0.228	0.185	0.019
	(0.57)	(0.82)	(0.08)
Year FE	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
N	12,910	12,910	12,910
R-squared	0.713	0.604	0.626

Note: This table reports regression estimations of board co-option as the moderating factor. Columns 1–3 show the analysis results when the dependent variables are the total number of proposals, total SRI-related proposals, and total governance-related proposals. All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

4.2. Passive Ownership and Shareholder Proposal Withdrawals

Next, we direct our attention to an important consequent stage of shareholder proposals—proposal withdrawals. Proposal withdrawal is often considered an important indicator of activism success because the sponsor has likely negotiated a satisfactory resolution with the management [81]. Furthermore, in Amendments to Rules on Shareholder Proposals, the SEC writes that "*A proposal may also influence management even if it is not put to a shareholder vote. We understand that in some instances management has made concessions to shareholders in return for the withdrawal of a proposal*" (File No. S7–25–97). Therefore, given that institutional investors endorse activists to sponsor shareholder proposals, it is plausible that they also contribute to facilitating negotiations between activists and managers. Table 6 presents our results, where the withdrawal metrics consist of the total number of proposals withdrawn and an indicator for one or more proposals withdrawn in a specific firm-year. We again observe that passive is positively associated with both measures of proposal withdrawals. The magnitude is also considerable as a one-standard-deviation increase in Passive% is associated with a 14.03% increase in the total number of withdrawals relative

to its sample mean (Table 6, column 1). These findings demonstrate the constructive role passive investors play in promoting negotiations.

Table 6. Passive and proposal withdrawals.

	(1)	(2)
	Total Withdrawn	**Indicator for Withdrawn**
Passive%	0.208 ***	0.276 ***
	(3.05)	(3.40)
Ln(Mktcap)	−0.360 ***	−0.436 ***
	(−3.60)	(−6.79)
Ln(Mktcap)^2	0.009 ***	0.012 ***
	(3.76)	(7.16)
ROA	−0.003	−0.039 **
	(−0.23)	(−2.10)
Leverage	0.024 *	0.057 ***
	(1.67)	(3.15)
PPE	0.053	0.086 **
	(1.27)	(1.97)
Year FE	Yes	Yes
Firm FE	Yes	Yes
N	29,230	29,230
R-sq	0.337	0.555

Note: This table shows the estimates of the impact of passive ownership on proposal withdrawals. Dependent variables are the total number of proposals that were withdrawn (Total Withdrawn) and an indicator for one or more proposals being withdrawn in a firm-year (Indicator for Withdrawn). All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

4.3. The Impact of Passive Investors on Voting Outcomes

Proffitt and Spicer [81] emphasize that, in addition to proposal withdrawals, voting serves as another sign of success as it propels the issue to a heightened level of awareness. Table 7 presents our regression estimations. Across all three vote-for measures, the estimated coefficients are statistically significant at a 1% level. These favorable voting outcomes of all types of proposals in the presence of passive investors align with their commitment to governance and ESG-related matters, along with their pledge to intervene if they do not witness firms making progress.

Table 7. Passive ownership and voting outcomes.

	(1)	(2)	(3)
	Vote-for% (SRI)	**Vote-for% (GOV)**	**Vote-for% (All)**
Passive%	11.566 ***	5.546 **	7.442 ***
	(5.77)	(2.26)	(3.45)
Ln(Mktcap)	31.161 ***	23.186 ***	19.147 ***
	(2.83)	(3.40)	(2.77)
Ln(Mktcap)^2	−0.684 ***	−0.581 ***	−0.492 ***
	(−2.89)	(−3.99)	(−3.30)
ROA	−6.597	8.557	−0.345
	(−1.29)	(1.50)	(−0.08)
Leverage	−5.166 **	−8.523 **	−8.221 ***
	(−2.34)	(−2.37)	(−3.54)
PPE	6.303 ***	−2.031	−3.553 *
	(2.87)	(−0.83)	(−1.66)
Year FE	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
N	1886	3630	5516
R-sq	0.186	0.122	0.129

Note: This table shows estimates of voting outcomes based on proposal types (SRI, GOV, or both). All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

4.4. Long-Term Value Implication

Finally, our focus revolves around assessing the implications for firm value. We analyze how passive ownership is associated with 12-month buy-and-hold abnormal returns (BHAR) following the annual meeting date at which a proposal was presented. The BHAR is computed as the difference between the compounded monthly returns and the CRSP equal-weighted market returns (benchmark). We report the results in Table 8. Our findings indicate that the market perceives the involvement of passive investors in the initiation of proposals favorably.

Table 8. Passive and BHAR.

	(1)	(2)	(3)
	BHAR (All Proposal)	**BHAR (SRI Proposal)**	**BHAR (GOV Proposal)**
Passive%	0.576 **	0.617 **	0.611 **
	(2.46)	(1.98)	(2.22)
Ln(Mktcap)	0.046	0.281 ***	−0.031
	(0.58)	(2.59)	(−0.32)
$Ln(Mktcap)^2$	−0.001	−0.006 **	0.001
	(−0.52)	(−2.54)	(0.37)
ROA	−0.169 *	−0.174 **	−0.148
	(−1.93)	(−2.02)	(−1.27)
Leverage	0.019	0.041	0.003
	(0.58)	(1.17)	(0.07)
PPE	−0.021	−0.021	−0.019
	(−0.94)	(−0.71)	(−0.69)
Year FE	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
N	9810	3708	6102
R-sq	0.030	0.039	0.028

Note: This table shows the association between passive ownership and 12-month buy-and-hold abnormal returns after the annual meeting date at which the proposal was presented to the board. Abnormal returns are computed as the difference between compounded monthly returns and CRSP equal-weighted market returns. All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

4.5. Robustness Check

To further ensure the causal inference of our baseline results, in this section, we perform instrumental variable analysis as our robustness check. Indeed, the correlation between passive ownership and shareholder proposals faces endogeneity challenges as it is possible that a firm's ownership structure and proposal initiations can be simultaneously influenced by unobservable firm attributes. Failure to account for these factors can introduce biases that confound causal inference. We follow previous studies [3,14] and adopt the annual Russell index reconstitution as an exogenous shock to the ownership structure of firms. A large discontinuity in the Russell index weights (See Figure A1) drives a substantive shift in passive ownership independent of firm attributes or policies, allowing for an exploration of the measurable impact of passive ownership on sponsoring shareholder proposals.

It is noteworthy that Russell has adopted a new approach for reconstructing its indices since 2007. The determination of index assignment involves a comparison of two ratios: firstly, the firm's market cap in relation to the cumulative market cap of the Russell 3000E index (the largest 4000 stocks); and secondly, the ratio of the 1000th largest stock to Russell 3000E aggregated market cap. The stock is categorized as not switching indexes if the discrepancy between these two ratios falls below 2.5%. Following this new methodology, the stock remains in the existing index unless there is a substantial alteration in its market capitalization. Russell denotes this as 'banded' because the stocks' market cap must deviate

far enough from the previous year to warrant a switch. Therefore, our two-stage least squares (2SLS) model follows the stages below:

$$\text{1st stage}: \ \text{Passive\%}_{it} = \eta + \lambda \text{R2000}_{it} + \sum_{n=1}^{N} \theta n \left(\text{Ln}(\text{Mktcap})\right)^n + \sigma \text{Ln}(\text{float}_{it}) + \phi_1 \text{band}_{it} + \phi_2 R2000_{it\text{-}1} + \phi_3 (\text{band}_{it} * R2000_{it\text{-}1}) + \delta_t + \varepsilon_{it} \quad (4)$$

$$\text{2nd stage}: \ Y_{it+1} = \alpha + \beta \ \hat{\text{Passive\%}}_{it} + \sum_{n=1}^{N} \theta n \left(\text{Ln}(\text{Mktcap})\right)^n + \gamma \text{Ln}(\text{float}_{it}) + \mu_1 \text{band}_{it} + \mu_2 R2000_{it\text{-}1} + \mu_3 (\text{band}_{it} * R2000_{it\text{-}1}) + \delta_t + \varepsilon_{it} \quad (5)$$

where R2000 is an indicator for inclusion in the Russell 2000 index and Float is the float-adjusted market cap when assigning the portfolio weight for each stock during the end-of-June reconstitution. Band is an indicator for the firm not switching indexes and being 'banded'.

Table 9 shows our results. We find in the first stage regression (column 1) that inclusion in Russell 2000 is positively associated with passive ownership, confirming the credibility of the instrumental variable. In an unreported analysis, the F-statistics are greater than 10, suggesting the presence of a strong instrument. We also find that Passive% is positively correlated with all proposal measurements, affirming the robustness of our analysis.

Table 9. Instrumental variable analysis.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Passive%	**Total Proposal**	**Total SRI Proposal**	**Total GOV Proposal**	**Indicator for Any Proposal**	**Indicator for SRI Proposal**	**Indicator for GOV Proposal**
$R2000_{it}$	0.034 ***						
	(14.33)						
Passive%		2.428 ***	0.938 **	1.436 ***	1.494 ***	0.636 *	1.161 ***
		(3.38)	(2.36)	(2.71)	(2.79)	(1.83)	(2.66)
Polynomial order	2	2	2	2	2	2	2
Band	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Ln(Floatmc)	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	9660	9660	9660	9660	9660	9660	9660
R-sq	0.312	0.039	0.017	0.026	0.043	0.020	0.027

This table shows instrumental variable analysis. The instrumental variable analysis sample consists of the top 500 firms in the Russell 2000 index and the bottom 500 firms in the Russell 1000 index. All variables are defined in Table 1. The t-values are in parentheses. The symbols *, **, and *** correspond to 10%, 5%, and 1% significance levels, respectively.

5. Conclusions

Despite the argument that passive investors might lack the motivation to monitor portfolio firms, we provide compelling evidence that they have a significant influence on shareholder activism in the form of shareholder proposals. This underscores the evolving role of passive investors beyond merely holding stakes. The positive effect of passive investors suggests a shift in their traditional strategy to a more proactive engagement in governance matters. Our results of higher proposal withdrawal rate and greater vote-for percentage also indicate that passive investors facilitate the 'voice' of fellow shareholders, promote negotiations between proposal proponents and the companies, and raise awareness for governance and socially responsible investing through supportive proposal voting. Most importantly, passive investors are associated with long-lasting market performance following the annual meeting when proposals are put forth. Our analysis is consistent with evidence presented by previous scholars that passive investors lessen the need for high-cost activism by employing low-cost strategies to improve corporate governance [3].

In light of various agency conflicts that may arise between managers and shareholders, it is imperative to delve into the impact of the growing trend toward passively managed

funds in the U.S. stock market on shareholders' ability to discipline managers. Our findings offer broad implications that rather than a formal alliance, the impact of passive investors on fellow shareholders sponsoring proposals can be tacit. In particular, passive investors have exhibited robust support for governance practices that align with the long-term valuation of the firm. Altogether, our findings suggest that passive investors reinforce the endeavors of activists pursuing similar objectives.

To extend the scope of this research, several promising areas are worth exploring. Considering market dynamics and investor preferences across nations, comparative and comprehensive assessments of passive investors' role in shaping corporate governance and sustainable practices in global markets merit further investigation. In addition, it is intriguing to examine the spillover effects of socially responsible initiatives in the context of heightened passive ownership, such as whether the positive effects can lead to improvements in other sustainable aspects. Venturing deeper into these dimensions will facilitate understanding of passive investors' influence on sustainability and governance.

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Appendix A

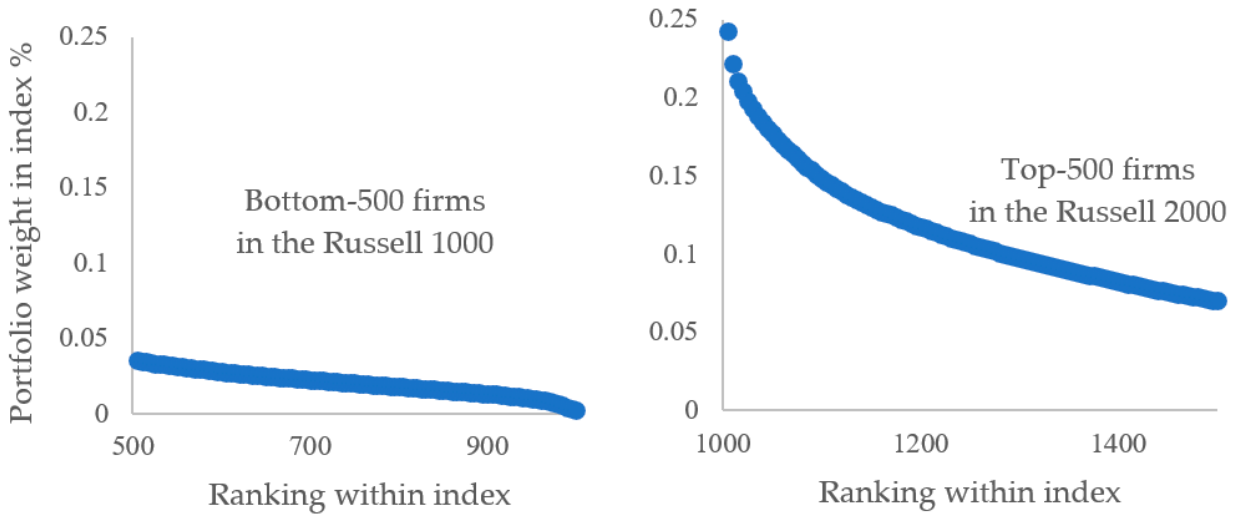

Figure A1. Mean portfolio weights by within index ranking. Note: This figure plots the mean portfolio weights of the bottom 500 firms in the Russell 1000 (**left**) and the top 500 firms in the Russell 2000 index (**right**) for the years 2007 to 2018 with a bin of 10 stocks.

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