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Recommended Citation

Michael E. Murphy, *Pension Plans and the Prospects of Corporate Self-Regulation*, 5 DePaul Bus. & Com. L.J. 503 (2007)

Available at: <https://via.library.depaul.edu/bclj/vol5/iss3/5>

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Pension Plans and the Prospects of Corporate Self-Regulation

Michael E. Murphy*

I. INTRODUCTION

The concept of corporate self-regulation, embedded in the New Deal legislation that forms the foundation of securities law,¹ is unlikely to draw criticism in principle from any quarter. For corporate reformers, it carries the scent of industrial democracy; for the business community, it promises greater freedom from government interference; and for legal scholars familiar with regulatory jurisprudence, it represents a response to the complexity of modern society that may advance the objectives of prescriptive law while lightening the burden of external controls.² But there is no agreed path to the El Dorado of corporate self-regulation or even any assurance that it can be found. When New Deal legislation failed to prevent the scandals of the 1990s, the response of Congress was to spurn the elusive alternative of corporate self-regulation and to impose a stronger set of external controls in the form of the Sarbanes-Oxley Act.

In this article, I will explore how the institutional environment of pension funds raises obstacles to the goal of corporate self-regulation. The question is prompted by the size of corporate stock ownership by pension funds, the unique issues affecting this category of institutional investor, and the uncertain promise of a shareholder-based system of corporate self-regulation. Pension funds now hold approximately 24

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1. See LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 35-47 (5TH ED. 2004). In an excellent overview of securities law, the authors note that a "major theme" of the Securities Exchange Act of 1934 is "self-regulation under the general aegis of the SEC." *Id.* at 34. The self-regulating organizations created by the 1934 Act include the national securities exchanges and the National Association of Securities Dealers, Inc. In addition, the required filings of annual and quarterly reports, as well as the prescribed disclosures in proxy solicitation, have a self-regulatory effect in that they provide information needed for market forces or the procedures of corporate governance to provide needed corrections in corporate policies.

2. This theory was advanced most notably by Gunther Teubner, *Substantive and Reflexive Elements in Modern Law*, 17 *LAW & SOC'Y REV.* 239 (1975).

percent of the total U.S. equity market³ and 29 percent of the equity in the 1000 largest corporations.⁴ Roughly 40 percent of these equity investments are found in public pension funds for state, local and federal employees, and the balance in various forms of private pension funds, including the rapidly growing sector of 401(k) plans.⁵

Private pension plans, with certain exceptions, are covered by the Employee Retirement Income Security Act of 1974 (ERISA), which poses fiduciary issues relating only to this category of institutional investors. These issues are a major focus of this article and are discussed in three distinct contexts. ERISA and parallel provisions of state law also give rise to issues of redundant regulation, discussed in a separate section, because they apply to plans that are subject to overlapping provisions of securities law. Other anomalies peculiar to the pension field are found in legislation relating to federal and union plans.

Although the notion of pension fund activism has stirred populist expectations,⁶ the pension funds actively engaged in corporate monitoring are in fact a minority of a minority composed of some large public pension funds, a portion of the small group of Taft-Hartley funds, and a single unique institution, TIAA-CREF. In general, pension funds exhibit the pattern of shareholder passivity displayed by other institutional investors. The considerable body of literature analyzing this phenomenon uniformly recognizes that it is linked to dis-

3. See THE CONFERENCE BOARD, THE 2005 INSTITUTIONAL INVESTMENT REPORT 28-29 (2005); SECURITIES INDUSTRY ASSOCIATION, SECURITY INDUSTRY FACT BOOK 69 (2005). The Conference Board offers a well recognized source of data, but the 2005 report does not include federal plans or provide a breakdown of the category of private insured pension plans. The figure of 24 percent is based on The Conference Board data for state and local funds and private trustee plans (9.7 percent and 12.7 percent, respectively), plus .6 percent for federal plans and an estimated of 1 percent for TIAA-CREF, the largest pension plan provider, which belongs in the category of pension funds (rather than insured plans) for the purpose of this article. The figure for federal funds is taken from Securities Industry Association's Fact Book; the estimate for TIAA-CREF assumes that half of its \$380 billion assets are in equities, a figure representative of pensions as a whole, and assumes an equity market of 18 trillion. See TIAA-CREF, Annual Reports & Financial Statements, at www.tiaa-cref.org/about/governance/corporate/topics/annual_reports.html.

4. The institutional ownership of the top 1,000 U.S. corporations was 69.4 percent in 2004. THE CONFERENCE BOARD, *supra* note 3, at 36. The portion held by pension funds is calculated in the manner described *infra* note 3.

5. See SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, at 69 (equity holdings of state and local funds and federal funds) and *infra* pp. 27 and 46 (breakdown of private pension plan holdings).

6. MARJORIE KELLY, THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY 182 (2001); THOMAS GEOGHEGAN, WHICH SIDE ARE YOU ON? 242-246 (1991) (critiquing the idea); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1539 n.64 (collecting sources).

persed ownership and high investment turnover, which reduce the shareholder incentive to engage in corporate monitoring. However, the phenomenon is specifically American in origin — the same degree of shareholder passivity is not found in the United Kingdom and is entirely absent in other countries. The institutional environment clearly must be considered for a full understanding of shareholder passivity, though scholars differ in their assessment of its importance.⁷ This article offers a contribution to existing literature by giving pension funds the detailed attention that their unique regulatory context demands.

The first section introduces the statutory requirements of diversification, which are often linked to shareholder passivity, and discusses the benefits of applying these requirements in light of modern portfolio theory and broader concepts of fiduciary responsibility. This subject leads directly to issues of redundant securities regulation. I turn next to the issue of fiduciary structure in a section on employer-directed pension plans and find a compelling model for reform in the British Pension Act 1995. The succeeding section on union plans notes historical anomalies of the Taft-Hartley Act, but generally leads to the same considerations affecting other employer-directed plans. The strange case of the Federal Employees Savings Plan deserves a separate comment. Lastly, I discuss the fiduciary structure of 401(k) plans, which is increasingly becoming the dominant form of pension plan. Considerations of corporate governance are of distinctly secondary policy importance here, but passivity in corporate monitoring may be viewed as one adverse consequence, among others, of a dysfunctional system.

Pension funds today operate in what might generously be described as a weak self-regulatory system of shareholder monitoring. Although shareholders must approve extraordinary measures such as mergers, and large institutional investors can sometimes successfully target particularly vulnerable managements or promote widely accepted corporate governance reforms, the self-regulatory impulses generated by shareholders are still sporadic and marginal in effect. In the last section of this essay, I consider whether pension fund reforms suggested by my earlier discussion can be regarded as a step toward a more ro-

7. Several studies in the late 1980s and early 1990s explored the institutional causes of shareholder passivity. See, e.g., Alfred E. Conrad, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1994). Roe has recently studied the question in an international context. MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, POLITICAL CONTEXT, CORPORATE IMPACT* (2003).

bust system of corporate self-regulation that might offer an alternative to the sort of external controls exemplified by the Sarbanes-Oxley Act. I discuss the requirements of self-regulation in management theory, the potential value of a pension fund voice in corporate governance, and the need for multiple approaches and institutional innovations to create a more effective system of shareholder-based corporate self-regulation. I leave open the question of whether a stronger self-regulatory regime can in fact evolve through a process of incremental reform.

It will become clear the pension funds are by no means the key to corporate self-regulation – but then there is no one key. I offer the article in the hope that the close examination of this subject will open windows to larger issues and suggest modifications in the regulatory environment of pension funds that could gain importance in combination with other reforms.

II. INSTITUTIONAL CONSTRAINTS ON CORPORATE MONITORING

A. *The Diversification Rule of ERISA*

An unusual triumph of the reforming impulse in American politics, the Employee Retirement Income Security Act of 1974 created a comprehensive system of federal regulation of private pensions. The legislation was motivated chiefly by concern about unfunded plans and unvested pension benefits. As remedies, Congress imposed mandatory vesting and minimum funding rules, and created an insurance system for defined benefit plans by establishing the Pension Benefit Guaranty Corporation.⁸ The complex legislation, however, contained extensive provisions lying outside the main legislative purposes. Two such provisions have an important impact on the role of pension plans in corporate governance: the structure of fiduciary responsibility and the diversification rule. The fiduciary structure of pension plans presents a story of unintended consequences that we will take up later. The diversification rule similarly provides the context for later sections, but it also has a direct, and problematic, connection with the phenomenon of shareholder passivity. Diversification implies dispersed share ownership that reduces the incentive for corporate monitoring of individual companies. For this reason, some distinguished scholars stressed the connection between

8. Excellent accounts of the political history and legislative purpose of ERISA can be found in: JAMES A. WOOTEN, *THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY* (2004) and JACOB S. HACKER, *THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE SOCIAL BENEFITS IN THE UNITED STATES* 145-153 (2002).

the diversification rule and shareholder passivity.⁹ But I will argue that the most vital issues concern interpretation of the diversification rule. If properly construed, the rule is compatible with a regime of enhanced corporate monitoring.

The diversification rule appears in section 404 of ERISA, a provision that has been aptly described as embodying “a carefully tailored law of trusts, including the familiar requirements of undivided loyalty to beneficiaries, the prudent man rule, the rule requiring diversification of investments and the requirement that fiduciaries comply with the provisions of plan documents to the extent that they are not inconsistent with the Act.”¹⁰ The statutory language requires a fiduciary to “discharge his duties with respect to a plan . . . by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”¹¹ Other provisions exempt employer securities from the diversification rule¹² and establish different (and decidedly lax) requirements for employee-directed plans.¹³

The relevant legislative history indicates that Congress intended to federalize the existing law of trust by adopting Section 404.¹⁴ This interpretation of legislative intent carries the implication that the statute can properly be applied in light of evolving principles of trust law. ERISA was in fact enacted at a time when a revolution in financial theory, known as modern portfolio theory, was gaining general acceptance among investment professionals. The American Law Institute saw fit to issue the Third Restatement of Trust only about twenty years after the publication of Second Restatement so as to incorporate the new financial principles.¹⁵

9. See ROE, *supra* note 7, at 38; Black, *supra* note 7, at 553-556; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1355-1357 (1991).

10. *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978).

11. 29 U.S.C. § 1104 (a)(1)(C) (2007).

12. ERISA § 407(a)(2) provides that a plan may not acquire holdings of employer securities exceeding 10% of the assets of the plan, but sections 407(b)(1) and (d)(3) allow plans to avoid this limitation by authorizing investment in employer securities subject to certain restrictions. See 29 U.S.C. § 1107(a)(2), (b)(1) and (d)(3) (2007).

13. See discussion *infra* pp. 52-55.

14. See H.R. REP. NO. 93-1280 (1974) reprinted in 1974 U.S.C.C.A.N. 5084; Daniel Fischell & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1108 n.15; *Varity Corp v. Howe*, 516 U.S. 489, 496 (1996).

15. Restatement (Third) of Trusts was written in 1990 and published in 1992; Restatement (Second) of Trusts was issued in 1958-1959. The tendency of courts and legislatures to lag behind investment professions in accepting modern portfolio theory is discussed in Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987);

Modern portfolio theory adds precision and analytical clarity to the time-honored rule of diversification.¹⁶ It proceeds from the premise that individual stocks in a portfolio are subject to risks that are negatively correlated, that is, an event that will cause the rise in the price of one stock will tend to depress the price of another. For example, high oil prices may be good for oil companies but bad for airlines. The object of diversification is to minimize risks that are specific to a particular company, or perhaps a segment of an industry. From the perspective of modern portfolio theory, firm-specific risk represents an impermissible speculation that can be offset, or eliminated, by combining stocks subject to distinct risks without reducing the average expected return. A skillfully diversified portfolio is still subject to market-wide risks caused by vicissitudes of the economy, but these market risks can be set at a desired level by investing in different categories of assets with different risks and probable returns. Thus, the investment of a segment of a portfolio in cash or treasury bonds will lower portfolio risk as well as the expected return.

The analysis of modern portfolio theory strongly supports the principle that diversification is a mandatory practice of prudent investing. Moreover, where past volatility of securities is known, the theory provides a method to precisely calculate the probable benefits of diversification. It turns out that most of the benefit in reducing firm-specific risks can be achieved with relatively few stocks. According to a leading text, “the improvement is slight when the number of securities is increased beyond, say 20 or 30.”¹⁷

A Seventh Circuit decision contains dicta approving modern portfolio theory¹⁸ and a Fifth Circuit decision recognizes the principle of combining negatively correlated risks,¹⁹ but most case law on point has concerned the peculiar problems of small pension funds. Weiss

Edward C. Halback, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP. PROB. & TR. J. 407, 412-413 (1992).

16. For introductions to modern portfolio theory, see JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (American College of Trust and Estate Counsel Foundation, 1991); RICHARD A. BREALEY & STEWART C. MYERS, THE PRINCIPLES OF CORPORATE FINANCE 148-166 (5th Ed. 1996); HARVEY E. BINES AND STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION ch.7 (2d ed. 2004).

17. BREALEY & MYERS, *supra* note 16, at 154.

18. Leigh v. Engle, 858 F.2d 361, 368 (7th Cir. 1988) (acknowledging that its “discussion is greatly simplified” and refers to a standard text on financial theory as providing a “more technical explanation.”)

19. Laborers Nat. Pension v. N. Trust Quantitative Advisors, 173 F.3d 313, 321 (5th Cir. 1999) (holding that investment in interest-only mortgage-backed securities “was reasonably designed as part of the Fund’s portfolio to further the purposes of diversification as a hedge against possible interest rate hikes and consequent declines in values of fixed income securities”).

and Sgaraglino express concern that the judicial difficulty in applying the diversification rule to small plans has generated confusion as to the basic principles applying to all plans,²⁰ but the precedents that they discuss²¹ should probably be viewed only as pointing to the need to develop distinct principles governing small plans.²²

The Commission on Uniform Laws has followed the Third Restatement of Trusts in embracing modern portfolio theory. The comment to Section 3 of the Uniform Prudent Investor Act, adopted in 44 states and the District of Columbia, pointedly endorses modern portfolio theory and cites the pertinent provisions of the Third Restatement.²³ The Uniform Management of Public Employees Retirement Systems Act, so far adopted in only two states, similarly directs the trustee to consider “the role that each investment . . . plays within the overall portfolio of the retirement program,” and the comment offers a brief explanation of modern portfolio theory with references to more detailed sources.²⁴

Most importantly, five years after the enactment of ERISA, the Department of Labor formulated a statement of the fiduciary’s investment duties that adopts a total portfolio approach to prudent

20. See Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers* 1996 Wis. L. REV. 1175, 1186 (1996) (noting that the courts have broadly construed the statutory “unless” clause requiring diversification, *i.e.* unless “under the circumstances it is clearly prudent not to do so”).

21. The following cases have found prudent departures from the diversification rule: *Etter v. J. Pease Constr. Co.*, 963 F.2d 1005 (7th Cir. 1992) (profit sharing plan for 6 employees, with assets of \$127,993, invested 88% of its assets in one real estate venture); *Reich v. King*, 867 F. Supp. 341, 344 (D. Md. 1994) (profit sharing plan of plumbing contractor, with assets of \$5 million, invested 70% of assets in financially conservative residential real estate mortgages primarily in one county); *Lanka v. O’Higgins*, 810 F. Supp. 379, 385 (N.D.N.Y. 1992) (“pension and profit sharing plan” for office of two dentists with assets of \$387,203 invested 98% of portfolio in three stocks); *Jones v. O’Higgins*, 11 Employee Benefit Cases (BNA) 1660 (defined benefit and target benefit plans for medical office employees, with assets of \$836,335, invested 90% of fund in three stocks); *Metzler v. Graham*, 112 F.3d 207, 208 (5th Cir. 1997) (defined-contribution plan with 123 participants and \$2,740,735 in assets invested 63% of assets in a single tract of land).

22. For statistical purposes, the Department of Labor categorizes plans with fewer than 100 participants as small plans. See EMPLOYEE BENEFITS SECURITY ADMINISTRATION, DEPT. OF LABOR, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2001 FORM 5500 ANNUAL REPORTS (2006). But for the purposes of applying the diversification rule, the size of the plan can best be measured by total assets. The decisions cited *infra* note 21 excuse fiduciaries from diversification in plans with \$5 million or less in assets. With respect to the principles governing small plans, it should be noted such plans have the option of investing in a larger diversified pool of investments through a mutual fund, bank collective trust or an insurance company pooled separate account. The Department of Labor applies a look-through approach in analyzing the diversity of such investments. See JAYNE E. ZANGLEIN & SUSAN STABILE, *ERISA LITIGATION* 745 (2d ed. 2005). For discussions of the diversification dilemmas of small plans, see BINES & THEL, *supra* note 16, at 406, 456; RESTATEMENT (THIRD) OF TRUSTS, § 227, cmt. h.

23. UNIF. PRUDENT INVESTORS ACT § 3 cmt., 7B U.L.A. 29-30 (2006).

24. UNIF. MGMT. PUB. EMPLOYEES RET. SYS. ACT §8, 7A U.L.A. pt. III, 63 (2006).

investing that is consistent with modern portfolio theory. The regulation issued in 1979 directs the fiduciary to consider whether a “particular investment” is calculated “to further the purposes of the plan. Taking into consideration the risk of loss and the opportunity for gain . . . associated with the investment.”²⁵ The history of this cautious statement makes clear that it was intended to sanction reliance on modern financial principles by authorizing the fiduciary to consider aggregate risks and expected returns of a portfolio.²⁶

The relative flexibility allowed by modern portfolio theory contrasts with the practices of diversification prevailing in employer-directed pension plans. In general, the concentration of institutional stock ownership in individual companies has grown more slowly than the institutional investors’ share in the U.S. equity market,²⁷ and the ownership stakes of pension funds have tended to be especially low. A 2004 survey of the top 25 institutional investors of the 25 largest corporations revealed that only 2 or 3 pension funds typically rank among the top 25 institutional investors and, with one exception, they placed below the top 10 in the size of their stock holding. TIAA-CREF was the only fund consistently included in the list of top investors. CalPERS and other public pension funds – if they made the top 25 – ordinarily held no more than 0.5 percent of total stock of the corporation.²⁸

The disinclination of investment managers to take advantage of the flexibility allowed by modern portfolio theory may be due in part to uncertainty as to interpretation of the law, but it undoubtedly also owes something to the practice of index investing. In 2004, the 200 largest defined benefit plans devoted 23.5 percent of their portfolio to indexed equities.²⁹ An index fund imposes practical constraints on the fund manager’s ability to engage in informed proxy voting. Since the fund contains a cross-section of the entire market, the fiduciary’s options are limited to a perfunctory response recurring issues or delegation of proxy voting responsibility to an advisory service. The practice of index investing is compatible with modern portfolio theory because of the cost advantages it offers. As stated in the Third Restatement of Trusts, passive investing through an index fund is a “practical invest-

25. 29 C.F.R. § 2550.404a-1(b)(2)(i) (2007).

26. See BINES & THEL, *supra* note 16, at 377-384.

27. Franklin R. Edwards & R. Glenn Hubbard, *The Growth of Institutional Stock Ownership: a Promise Unfulfilled*, in CORPORATE GOVERNANCE AT THE CROSSROADS 347, 350 (Donald H. Chew & Stuart L. Gillan eds., 2005).

28. THE CONFERENCE BOARD, *supra* note 3, at 38-50.

29. THE CONFERENCE BOARD, *supra* note 3, at 32.

ment alternative,” which “offers the pricing security and economies of buying in essentially efficient markets.”³⁰

Where diversification exceeds the dictates of modern portfolio theory and lacks the cost justification of index investing, it can be in some tension with the pension fiduciary’s duty to engage in informed proxy voting. The larger the portfolio the more difficult it will be to monitor particular securities. The Department of Labor has repeatedly affirmed the fiduciary’s duty to monitor proxy voting issues, without addressing the interface between this duty and the diversification rule. The landmark Avon letter affirmed that “the fiduciary act of managing plan assets” included the voting of proxies to shares of corporate stock.³¹ Six years later, the Department issued a more comprehensive and nuanced statement in Interpretative Bulletin 94-2, which again described the fiduciary’s responsibilities as including the voting of proxies for corporate stock. In a qualified approval of shareholder activism, the Department stated that “activities intended to monitor or influence the management of corporations” are consistent with a fiduciary’s duty under ERISA where the fiduciary has a “reasonable expectation” that “such monitoring . . . is likely to enhance the value of the plan’s investment in the corporation, after taking into account the costs involved.”³²

In short, there are points of tension between the duty to monitor, the diversification rule, and cost considerations involved in index investing and the process of monitoring itself. One may make a few safe observations in this poorly explored area. First, the option of delegating proxy voting responsibility to an advisory service is not necessarily an inferior one.³³ Proxy voting services may allow fund managers to delegate even the most complex proxy voting programs. The efficiency and quality of the services may reflect the fund manager’s demand for effective corporate monitoring and willingness to incur associated costs. Secondly, since the bulk of the benefit of diversification is conferred by relatively few stocks, pension fund managers can tailor a portfolio to their capacity to directly engage in meaningful

30. RESTATEMENT (THIRD) OF TRUSTS, § 227, cmt. h, at 28-29.

31. Avon Prods., Inc., DOL Op. Ltr., [1987-1989 Transfer Binder] Pens. Plan Guide (CCH) ¶ 23,747W at 25,163 (Feb. 23, 1988).

32. DOL Interpretative Bulletin 94-2 is codified as 29 C.F.R. § 2509.94-2.

33. The largest proxy voting service is Institutional Investors Service, which has over 400 clients and considerable influence in the marketplace, at www.issproxy.com. It has a number of active competitors, e.g., JMR Financial, at www.jmr-financial.com/pvs.htm; Voting Agency Service (a recently formed co-venture of Investor Responsibility Research Center and Glass, Lewis & Co); Proxy Governance, Inc., at www.proxygovernance.com; and EC Proxy Voting Services, Inc., at www.ecproxyvoting.com.

monitoring without sacrificing the benefits of diversification.³⁴ As the benefits of diversification approach zero, the value of monitoring represents a potential benefit that may be balanced against transaction costs and other considerations. Thirdly, it is unrealistic to analyze monitoring as an isolated activity of a single pension fund manager or proxy voting service; it will normally involve elements of reciprocity among similarly situated institutional investors. Monitoring can potentially gain efficiency and effectiveness through concerted action by pension funds that will spread the costs among individual funds and lend the influence of a larger group to the individual exercise of shareholder rights.³⁵

Excessive diversification and perfunctory proxy voting may indeed exist, but it is wrong to blame these phenomena on the diversification rule. If the statute is construed in light of evolving standards of prudent investing – as the legislative history appears to permit – the diversification rule can accommodate the opportunities and flexibility of modern portfolio theory. Excessive diversification, where it is encountered, may stem more from a cultural predilection of fund managers toward unnecessary caution.³⁶ According to a former general counsel of CalPERS, “pension plan trustees continue to welcome diversification and derive comfort from strategies that are widely accepted and relatively risk free.”³⁷ The Department of Labor can counter such unproductive caution by clearly affirming modern portfolio theory and reconciling the duty (or option) of monitoring with the practice of diversification. The 1979 regulation was an important step in this direction, but there is still a need to more explicitly endorse modern portfolio theory and to recognize the propriety of portfolio management practices intended to achieve more effective corporate monitoring, including moderate diversification and reliance on professional proxy voting advisers.

B. *Redundant Regulation*

Institutional shareholders, it has been argued, are “hobbled by a complex web of legal rules” that make it “expensive, and legally

34. Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor and Index Fund Through Relational Investing*, 20 J. CORP. L. 413, 445-447 (1995); BINES & THEL, *supra* note 16, at 456 n.398.

35. See discussion *infra* p. 22 and note 106.

36. See WILLIAM N. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* 194-201 (1992) (an anthropological study of pension managers).

37. Koppes & Reilly, *supra* note 34, at 445. Richard Koppes is a former general counsel of CalPERS.

risky” for them to play an active role in corporate governance.³⁸ But the normative question of whether specific measures of deregulation should be undertaken involves a more specific question: are particular institutional investors otherwise adequately regulated in the public interest? The answer for pension funds, regulated under ERISA or state law, may not apply for hedge funds, which are exempt from most provisions of the Investment Company Act.³⁹ The diversification rules of ERISA and state law⁴⁰ in fact present the unique phenomenon of redundant regulation because they effectively prevent employer-sponsored plans, in both the private and public sphere, from engaging in activities that a series of legal restrictions are also intended to curb. I will examine four conspicuous areas of such redundant regulation.

1. Section 13(d) of the Exchange Act

Section 13(d) is one of several amendments to the Exchange Act of 1934, known collectively as the Williams Act, enacted in 1968 in response to concerns about the increasing use of cash tender offers in hostile contests for corporate control.⁴¹ At that time, cash tender offers fell outside the reach of federal securities law while proxy contests were regulated by Section 14 of the Exchange Act of 1934 and exchange offers of securities were subject to the registration requirements of the Securities Act of 1933.⁴² As explained by Senator Kuchel, a co-sponsor of the legislation, the new disclosure rules of Section 13(d) were intended to prevent a “corporate raider” from acting “under a cloak of secrecy while obtaining the shareholders needed to put him on the road to a successful capture of the company.”⁴³

As amended in 1970, Section 13(d) requires takeover bidders to file with the SEC a prescribed statement, within 10 days of acquiring the

38. Black, *supra* note 7, at 523. Other seminal articles advancing this thesis include Conrad, *supra* note 7; Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). For a collection of articles bearing on this controversy, see generally, Thomas W. Briggs, *Shareholder Activism and Insurgency under New Proxy Rules*, 50 BUS. LAW. 99, 100-101 (1994).

39. SHARTSIS, FRIESE, LLP, U.S. REGULATION OF HEDGE FUNDS 87 (2005).

40. The retirement systems of 34 states use a variation of the prudent investor standard of ERISA section 404(a)(1). Other states use a prudent person standard that requires a similar practice of diversification. See CYNTHIA L. MOORE, PROTECTING RETIREES' MONEY 4-5 (National Council on Teacher Retirement, 5th ed. 2005). For asset allocation practices, see CHARACTERISTICS OF 100 LARGE PUBLIC PENSION PLANS 58-59 (National Education Association, 2002).

41. The legislative history is reviewed in Comment, *Section 13(d) and Disclosure of Corporate Equity Ownership*, 119 U. PA. L. REV. 853 (1971).

42. See *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 22 (1976).

43. 113 CONG. REC. 857-858, *quoted in* *Piper*, 430 U.S. at 28.

beneficial interest of 5 percent of any class of a corporation's equity securities, which discloses the bidder's identity, the source of its funds, the amount of its stock holdings, and any plans to change the business or corporate structure.⁴⁴ The purpose of the statute was "to alert the market place to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."⁴⁵ Filings are only moderately burdensome but they invite litigation because a hostile management can allege failure to make full disclosure.⁴⁶ A failure to file or disclose subjects an investor to a range of remedies, including disgorgement of profits.⁴⁷

To close a possible loophole in the disclosure requirements, Section 13(d)(3) provides that, when two or more persons act as a group "for the purpose of acquiring, holding, or disposing of securities of an issuer," the group shall be deemed a "person" for the purpose of the filing requirements of 13(d).⁴⁸ The Senate and House reports explain: "This provision would prevent a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns more than . . . [5] percent of a class of securities at the time they agreed to act in concert. . . ."⁴⁹

On its face, this group action provision should not affect pension funds because they virtually never act as a group in buying or selling securities and have no reason to incur the sacrifice of liquidity that such collective decision-making would entail,⁵⁰ but the SEC has interpreted the provision to embrace coordinated *voting* of securities. The regulations under Section 13(d) define a group as including persons who "agree to act together for the purpose of acquiring, holding, *voting* or disposing of equity securities of an issuer."⁵¹ Other regulatory provisions serve to expand and fortify this concept of a voting group. A beneficial interest in a security coming within the 5 percent rule is very broadly defined to include *inter alia* the power to direct the voting of the security.⁵² The required disclosures include any intention to

44. 15 U.S.C. § 78m(d)(1) (2007); 17 C.F.R. § 240.13d-1 (2007).

45. GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971).

46. See Black, *supra* note 7, at 543.

47. See Briggs, *supra* note 38, at 120-121.

48. 15 U.S.C. § 78m(d)(3) (2007).

49. Wellman v. Dickerson, 682 F.2d 355, 366 (2d Cir. 1982) (*quoting* S. REP. No 90-550, at 8 (1967); H.R. REP. No. 90-1711, at 8-9 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2818).

50. See John C. Coffee, Jr., *The SEC and the Institutional Investor: a Half-Time Report*, 15 CARDOZO L. REV. 837, 877 (1994)

51. 17 C.F.R. § 240.13d-5(b)(1).

52. 17 C.F.R. § 240.13d-3 (2007).

seek a “change in the present board of directors or management of the issuer.”⁵³ An effort to influence management of the corporation by close monitoring skirts the broad definition of an intention to change control of the corporation.⁵⁴ Adding to the over-breadth, the courts have held that an agreement coming within the group provision of Section 13(d) may be oral and informal and may be proved by circumstantial evidence. Whether the requisite agreement exists is a question of fact.⁵⁵

The effect of this process of regulatory drift is to deter pension funds from agreeing to vote together even on procedural matters, such as confidential voting, which have nothing to do with contests for corporate control.⁵⁶ A fund manager, who receives communications on proxy voting matters from another fund, will incur the risk of litigation by suggesting a joint course of action or by offering to co-sponsor a shareholder resolution. Any arrangement to share costs of proxy solicitation will be evidence of the existence of a voting group.⁵⁷

Pension funds subject to diversification requirements pose no threat of secret combinations of power with predatory objectives to seize corporate control.⁵⁸ Indeed, as small concessions to reality, the SEC regulations allow employee benefit plans to make simplified filings and provide an exemption for private offerings. Unfortunately, the simplified filings are still burdensome and still invite litigation.⁵⁹ Moreover, to secure this largely meaningless concession, pension funds must disclaim any interest in influencing policies of management – in effect, the funds must promise shareholder passivity.⁶⁰ Whether or not the legislative purpose of Section 13(d) supports the

53. 17 C.F.R. § 240.13d-101 (2007), Instructions, Item 4(d).

54. 17 C.F.R. § 240.12b-2 (2007) provides: “The term ‘control’ . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” This definition is made applicable to Schedule 13D filings by 17 C.F.R. § 240-12b-1 (2007). See Schedule D, Item 4(g) and (j). The relationship between these regulations is explained in *Gen. Aircraft Corp. v. Lampert*, 556 F.2d 90, 96 (1st Cir. 1977).

55. See *Hallwood Realty Partners v. Gotham Partners*, 286 F.3d 613, 617 (2d Cir. 2002); *SEC v. Savoy Indus.*, 587 F.2d 1149, 1162-1163 (D.C. Cir. 1978); *Schaffer v. C.C. Inv., LDC*, 2002-2003 Fed. Sec. L. Rep. (CCH), ¶ 92248 (S.D.N.Y. 2002); *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F. Supp. 825 (N.D. Ill. 1978).

56. *Coffee*, *supra* note 50, at 879-880; *Black*, *supra* note 7, at 544.

57. *Coffee*, *supra* note 50, at 880.

58. See *John C. Coffee*, *SEC Over-regulation of Proxy Contests*, N.Y.L.J. 7 (Jan. 31, 1991).

59. 17 C.F.R. §§ 240.13d-1(b)(1)(ii) and (iii) and (2) (2007). Pension funds can file a short-form statement on form 13G within 45 days after the end of a calendar year but still must notify all beneficiaries of 13(d) filings filed in a year. Employee benefit plans also enjoy a limited exemption in purchasing stock in a private offering. 17 C.F.R. § 240.13d-5(b)(2) (2007).

60. The simplified filing requirements apply only on condition that the institutional investor acquired securities without “the effect or changing or influencing the control of the issuer, nor in

group-voting rule in other contexts, the rule should not apply to pension funds that are prevented by other regulations from engaging in hostile contests for control. Public pension funds and private funds subject to the diversification requirements of ERISA section 404(a)(1)(c)⁶¹ should enjoy an unqualified exemption from the application of 13(d) to group voting activities.⁶²

2. Section 16(b) of the Exchange Act

Section 16(b) of the Exchange Act is intended to protect shareholders from short-swing speculation by corporate insiders with advance information of matters affecting the market value of stock.⁶³ It imposes a drastic no-fault remedy on the trading in stock by the beneficial owner of more than 10 percent of the class of any equity security *or* by a director or officer of the issuer. Any profit realized by such a person from the sale and purchase of the security within any period of less than six months “inures to” and is recoverable by the corporation, thereby giving the corporation an incentive to bring suit.⁶⁴ Shareholders may also sue under Section 16(b), and the courts have awarded attorney’s fees generously to encourage enforcement.⁶⁵ The plaintiff does not need to prove actual possession or misuse of insider information or any fraudulent intent; rather, the statute applies mechanically to impose liability within its narrowly drawn limits.⁶⁶

Pension funds with legally mandated diversification practices and a relatively long-term investment horizon might seem to be far out of range of Section 16(b), but the SEC regulations import into enforcement of Section 16(b) the definition of beneficial ownership used under Section 13(d). By defining beneficial ownership to embrace any indirect arrangement to control voting, the regulations raise the specter of Section 16(b) sanctions for concerted voting among a group

connection with or as a participant in any transaction having such purpose or effect. . . .” 17 C.F.R. § 240.13d-1(b)(1)(i) (2007). *See Coffee, supra* note 50, at 877.

61. 29 U.S.C. § 1002(3) (2007); 29 U.S.C. § 1104(a)(1)(C) (2007).

62. The exemption should be precisely limited to employee pension benefit plans that are subject to the diversification requirements of section 404(a)(1)(C) of ERISA. *See* 29 U.S.C. § 1002(3) (2007) and 29 U.S.C. § 1104(a)(1)(C) (2007). The SEC regulations loosely refer to “employee benefit plans.” This imprecise term includes plans that are either of little importance or that would allow troubling use of employer stock.

63. 15 U.S.C. § 78p(b) (2007).

64. *See generally* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING ch. 15 (1996).

65. *Id.* at 999 n.12.

66. *See* 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2343-2349 (3d ed. 2000).

of funds.⁶⁷ The regulations do provide an exemption for employee benefit plans, but, as in the case of Section 13(d) regulations, it is available only if a fund has no intention of influencing the control of the corporation.⁶⁸ In view of the profit incentive to bring suit under Section 16(d), an arrangement for concerted proxy voting among pension funds would invite challenge not only under Section 13(d) but also Section 16(b).⁶⁹

A separate litigation risk arises from a judicial gloss on the term “director” enunciated by *Feder v. Martin Marietta Corp.*⁷⁰ The president and CEO of Martin Marietta Corporation, George Bunker, served on the board of Sperry Rand Corporation after receiving the approval of his own board of directors.⁷¹ During his tenure on the board, Martin Marietta bought and sold stock in Sperry Rand within the six-month period of Section 16(b).⁷² A shareholder brought suit against Martin Marietta itself to recover insider profits on the theory that the corporation had deputized Bunker to serve on the Sperry Rand board on its behalf.⁷³ Citing dicta in earlier cases,⁷⁴ the court upheld the deputization theory and found that the theory was proved on the facts of the case.⁷⁵

The *Feder* decision can be read narrowly as saying that Martin Marietta came within the statutory definition of a director, i.e. “any director of a corporation or any person performing *similar functions* with respect to any organization.”⁷⁶ Indeed, the Supreme Court has cited the decision as holding only that a corporation may perform “the functions” of a director.⁷⁷ But the language in *Feder* suggests an alter-

67. See 17 C.F.R. § 240.16a-1(a) (2007) (incorporating by reference the definition of beneficial owner under section 13(d)) and 17 C.F.R. § 240.13d-3(a) (2007) (“a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; . . .”).

68. See 17 C.F.R. § 140.16a-1(a)(1) (2007) (shares must not be acquired with “the purpose or effect of changing or influencing control of the issuer”).

69. See Black, *supra* note 7, at 546; Coffee, *supra* note 58, at 7.

70. 406 F.2d 260 (2d Cir 1969).

71. *Id.* at 264-65.

72. *Id.* at 263.

73. *Id.* at 266.

74. *Rattner v. Lehman*, 193 F.2d 56, 567 (2d Cir. 1952) (concurring opinion Learned Hand, J. “I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director of the board, the other partners would not be liable.”); *Blau v. Lehman*, 368 U.S. 403, 408-410 (1960) (while refusing to reverse a lower court decision finding no deputization, the court acknowledged that a partnership could still be a director and “function through a deputy” for purposes of section 16(b)).

75. *Feder*, 406 F.2d at 266

76. 15 U.S.C. § 78c(7) (2007).

77. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 n.4 (1971).

native interpretation: a corporation, or other legal entity, will incur liability for short-swing profits if it places an officer on the board of the issuer for the purpose of conveying information about the issuer. This theory of liability, premised on a “listening director,” has been criticized as lacking statutory support and importing the mechanical rules of Section 16(b) into an area more appropriately governed by Rule 10(b)-5.⁷⁸ But the SEC has recognized the deputization theory in principle while leaving it to a “case-by-case determination.”⁷⁹ The deputization theory continues to figure in litigation and has the potential of ensnaring a pension fund that is instrumental in placing a director on the board of a corporation.⁸⁰

3. Hart-Scott-Rodino Antitrust Improvements Act

An odd twist to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 adds another obstacle to the possibility of pension funds having a representative on a corporate board. The Act, codified as Section 7A of the Clayton Act,⁸¹ requires that the Federal Trade Commission and the anti-trust division of the Department of Justice be given a premerger notification 15 or 30 days in advance of the purchase of the target company’s stock. The purpose of the notice is to give the antitrust enforcement agencies time to study the acquisition before it is consummated. The length of the waiting period depends on the nature of the acquisition and may be extended if the agencies request further information. A failure to give the notice or comply with the waiting period subjects the acquiring corporation to civil penalties and equitable relief.⁸²

The Act has complex threshold provisions, but, in general, it applies to stock purchases that cause the purchaser’s holdings to exceed \$50 million – a level that affects only the largest holdings of the largest

78. Carroll L. Wagner, *Deputization and Section 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151 (1968-1969); 5 LOSS & SELIGMAN, *supra* note 66, at ch. 6E, 2402-2403; 17 C.F.R. § 240.10b-5 (2007); Coffee, *supra* note 50, at 895-897.

79. See Exchange Act – Insiders, Exchange Act Release No. 26333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84343, 89602 (Dec. 2, 1988). See also 5 LOSS & SELIGMAN, *supra* note 66, at 2402-2403.

80. Colan v. Cutler-Hammer, Inc., 812 F.2d 357, 364 n.9 (7th Cir. 1987); Dreiling v. Am. Ex. Travel Related Serv., 351 F. Supp.2d 1077, 1083 (W.D. Wash. 2004); *In re Enron Corp. Sec., Derivative and ERISA Lit.*, 258 F. Supp.2d 576, 645 (S.D. Tex. 2003); Lowey v. Howmet Corp., 424 F.Supp. 461(S.D.N.D. 1977).

81. 15 U.S.C. § 18a(a) (2007).

82. See M. Howard Morse, *Mergers and Acquisitions: Antitrust Limitations on Conduct Before Closing*, 57 BUS. LAW 1463, 1464-1475; William J. Baer, *Reflections on Twenty Years of Merger Enforcement under the Hart-Scott-Rodino Act*, 65 ANTITRUST L. J. 825 (1997); 5 LOSS & SELIGMAN, *supra* note 66, at 2139-2140.

pension funds.⁸³ Institutional investors enjoy an exemption for purchases made in the ordinary course of business and “solely for the purpose of investment.”⁸⁴ The difficulty lies in the regulatory definition of the latter phrase. The FTC’s regulations provide that a purchaser acquires a security “solely for purposes of investment” only if it “has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer.”⁸⁵ Thus, a pension fund or other institution will forfeit the exemption if it later seeks to place a representative on the board of directors.⁸⁶

The propriety of pension funds seeking representation on the board of directors presents serious issues, but there is no statutory basis to require a large fund pursuing this objective to comply with a procedure intended to give the FTC and Department of Justice time to study mergers and acquisitions. The exemption applying to purchases “solely for the purpose of investment” clearly should be construed to include all stock purchases by public pension funds and private pension funds subject to the diversification requirements of ERISA.

4. Proxy Rules

Section 14(a) of the Exchange Act authorizes the SEC to prescribe rules, “in the public interest or for the protection of investors,” for the solicitation of “a proxy, consent, authorization or information statement in respect of” a registered security.⁸⁷ Under this authority, the SEC has issued rules that require any proxy solicitation of a shareholder to be accompanied by a proxy statement, filed with the SEC at least ten days previously, which meets certain detailed requirements.⁸⁸ The proxy solicitation process is notoriously costly,⁸⁹ and the definition of a solicitation that was adopted in 1956⁹⁰ is so broad as to turn

83. See MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA* 31 (1996).

84. 15 U.S.C. § 18a(c)(9) (2007); 16 C.F.R. § 802.64(b)(3) (2007).

85. 16 C.F.R. § 801.1(i)(1) (2007).

86. See STEPHEN M. AXINN ET AL., *ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTI-TRUST IMPROVEMENTS ACT* § 6.15(3), at 6-108 (2005).

87. 15 U.S.C. § 78n(a) (2007). Section 14(a) (codified as 15 U.S.C. § 78n(a)) provides:

It shall be unlawful for any person . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to 78l of this title.

88. 15 U.S.C. § 78n(a) (2007); 17 C.F.R. §§ 240.14a-3(a), 14a-6 (2007); 5 LOSS & SELIGMAN, *supra* note 66, at 1955-1979.

89. 5 LOSS & SELIGMAN, *supra* note 66, at ch. 6.C., 1912-1927 (2006 Supp. 763).

90. A solicitation embraces any “communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.” 17

almost any discussion of management performance with other shareholders, management or third-party sources of information into a regulated proxy solicitation.⁹¹

The SEC has not changed the 1956 definition of a solicitation, but, in response to complaints that the rules restrict useful exchanges of information,⁹² it adopted in 1992 a complex set of reforms that somewhat mitigate its impact.⁹³ The revised regulations retain a previous exemption applying “where the total number of persons solicited is not more than ten.”⁹⁴ They also ease certain administrative burdens and filing deadlines and modify the definition of solicitation to exclude public announcements by investors of how they intend to vote.⁹⁵ Most important, the revised Rule 14a-2(b) provides a qualified exemption for solicitations by a person who does not seek “either on its own or another’s behalf, the power to act as a proxy for a security holder.”⁹⁶ In other words, shareholders can communicate freely with each other, without first filing a proxy statement, if they do not seek proxy authority. However, if a shareholder claiming this exemption has \$5 million worth of stock, the shareholder is still required to file promptly *after* the exempt shareholder communication all written materials transmitted to other shareholders, along with a notice of exempt solicitation.⁹⁷ A shareholder’s election to employ this exemption is irrevocable; if the shareholder invokes the exemption and later

C.F.R. § 240.14a-1(l)(1) (2007). The language of the definition draws from language of Learned Hand in *SEC v. Okin*, 132 F.2d 784, 789 (2d Cir. 1943), who posed the question whether the SEC’s power “extends to any other writings which are part of a continuous plan ending in solicitation and which prepare the way for its success.”

91. See Final Rules, Exchange Act Release 31326 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85051, at 83,356 (“... literal breadth [of definition of solicitation] potentially turned almost every expression of opinion. . . into a regulated proxy solicitation”) and 83,357 (commentators stated that the scope of definition under the proxy rules has a “chilling effect on attempts to participate in corporate governance process by expressing their views.”) (Oct. 16, 1992).

92. See Proposed Rules, Exchange Act Release 29315 [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84811, at 81844 (June 17, 1991) (CalPERS and others “manifest a strong concern that the Commission’s proxy filing and disclosure requirements function to restrict unduly security-holder communications not only with one another, but also with the issuer’s management and board of directors as well as third-party sources of proxy voting information unaffiliated with any person participating in a particular solicitation.”)

93. See Final Rules, *supra* note 91. For a summary and history of the 1992 reforms, see Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. LAW 327 (1993).

94. 17 C.F.R. § 240.14a-2(b)(2) (2007).

95. 17 C.F.R. § 240.14a-1(l)(2)(iv) (2007).

96. 17 C.F.R. § 240.14a-2(b)(1) (2007).

97. 17 C.F.R. § 240.14a-6(g) (2007).

decides to seek a proxy, the exemption becomes retroactively unavailable and earlier communications are in violation of the proxy rules.⁹⁸

The 1992 reforms were cautious measures that appear to have brought no fundamental change in corporate governance relationships.⁹⁹ The SEC's caution may well have been appropriate in deregulating the activities of aggressive speculators, such as hedge and risk arbitrage funds,¹⁰⁰ but the revised rules lack any apparent justification as applied to pension funds subject to the diversification requirements of ERISA and state law. Concerted action is the only way these funds can achieve a voice in corporate governance commensurate to their share ownership. With small stakes in individual companies and a long-term investment outlook, they are effectively precluded from engaging in manipulative schemes and have no record of doing so.¹⁰¹ But the rules still encumber these funds by limiting concerted action to certain defined paths: communications following an irrevocable decision not to seek proxies, contacts with no more than ten shareholders, and association activities removed from the exercise of proxy voting.¹⁰² The rules call for circumspection, reduce options for cooperative action, and may trigger onerous filing requirements.

In the case of diversified pension funds, the pertinent question is not whether the restrictions of the proxy rules are excessive, but rather why they exist at all. What is the justification under the statutory standard, "in the public interest or for the protection of investors?" The rules currently contain exemptions (or qualified exemptions) for harmless communications, *i.e.*, fewer than ten contacts and communications that do not seek proxy voting authority.¹⁰³ If one accepts the premise that the pooling of knowledge and resources among diversified funds is a highly desirable phenomenon, an exemption tailored for diversified pension funds also belongs in the proxy rules.

98. Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 12 (1993).

99. See Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J. L. ECON. & ORG. 233 (2000).

100. See Briggs, *supra* note 38, at 101-102, 147-148.

101. The same logic would apply to endowment funds and church plans. It is worth noting that [endowment funds] and church plans are treated in parity with pension plans in 17 C.F.R. § 240.13d-1(b)(1)(ii) (2007). Endowment funds accounted for 1.9 percent of total U.S. equity market in 2003. THE CONFERENCE BOARD, *supra* note 3, at 29.

102. Most notably the Council of Institutional Investors. See <http://www.cii.org>.

103. See 17 C.F.R. § 240.14a-2(b)(2) (2007) (fewer than ten shareholder contacts) and 17 C.F.R. § 240.14a-6(g) (2007) (shareholders with less than \$5 million in stock).

5. Deregulation and its Consequences

The long accumulation of laws relating to securities and corporate control at both federal and state levels gives rise to other litigation hazards for pension funds seeking closer involvement in corporate governance,¹⁰⁴ but these additional regulatory restrictions are either relatively remote or do not fall easily into the category of redundant regulation. The four restrictions we have examined are significant and share a common element of regulatory perversity: they lack any reasonable justification in legislative purpose or public policy as applied to diversified pension funds. They should all be eliminated.

Nevertheless, it is important to bear in mind the limited effects of this program of deregulation. In the case private employer-directed pension plans, the effect is likely to be small. Some jointly trustee union funds have already achieved a degree of coordination by adherence to the proxy voting policies of the AFL-CIO.¹⁰⁵ Outside the union sphere, the passivity of employer-directed plans has deep roots in conflicts of interest that we will examine in the next section. The principal effect would be to enable public pension funds to more effectively pool resources in corporate governance activities, but public pension funds have shown a somewhat modest proclivity to engage in the opportunities for concerted action that are now allowed of them.¹⁰⁶ Deregulation can be expected only to open opportunities for further institutional innovations and reforms that might lead to more active corporate monitoring.

C. Conflicts of Interest

By legislative inadvertence, ERISA produced an administrative system for private employer-directed pension plans that is characterized by pervasive conflict of interest checked by fiduciary duties. This paradoxical system resulted from Congress' intent "to spread a broad

104. See Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 Wis. L. REV. 1071, 1096-1102.

105. See discussion *infra* Part II.C. and note 191.

106. Coffee maintains that public pension fund managers are politically motivated to seek individual credit rather than collective solutions. See John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1977-79 (1997)). But there is some evidence to the contrary. See Ronald B. Davis, *The Enron Pension Jigsaw: Assembling Accountable Corporate Governance by Fiduciaries*, 36 U. BRIT. COLUM. L. REV. 541, 573 (2003) (sharing of information among Canadian pension funds); JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* 173 (2000) (statement of Colorado pension fund executive); Joann S. Lublin & Sara Calian, *Activist Pension Funds in Trans-Atlantic Alliance*, WALL ST. J., Nov. 23, 1998, at A4 (cooperation between CalPERS and Hermes Pension Management Ltd., Britain's largest pension fund manager) and the participation of sixty-nine public pension funds in the Council of Institutional Investors. See www.ici.org, *supra* note 102.

protective net of fiduciary responsibility” over the administration of pension plans,¹⁰⁷ while leaving the actual administrative structure unregulated and under management control. We will examine first the fiduciary structure and then explore the problem of conflicts of interest that pertain to proxy voting.

ERISA establishes both a formal fiduciary structure and a functional test of fiduciary duties.¹⁰⁸ The formal structure begins with a “named fiduciary” designated in the written plan document – a concept unprecedented in trust law.¹⁰⁹ The statute leaves the choice of the named fiduciary up to the employer without imposing qualifications or other requirements of any kind. The named fiduciary may be a committee of corporate officers, which meets on an *ad hoc* basis to deal with pension matters,¹¹⁰ a committee of directors,¹¹¹ or even the corporation itself.¹¹² Second, ERISA requires that all assets of the pension plan other than insurance contracts and certain plans must be held in trust.¹¹³ The named fiduciary is not a trustee but may have authority to appoint and direct the actions of a trustee if the plan so provides. The trustee is ordinarily a bank or insurance company, although the statute again imposes no requirements as such, and the plan sponsor may choose a corporate officer to serve as an in-house trustee.¹¹⁴ Finally, the named fiduciary is authorized to appoint an investment manager to manage the assets of the plan. In this case, the

107. Dist. 65, *UAW v. Harper & Row, Publishers, Inc.*, 670 F. Supp. 550, 555 (S.D.N.Y. 1978).

108. See *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 262 (1993) (ERISA defines fiduciary “in functional terms of control and authority over the plan”); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 543 (S.D. Tex. 2003) (states the two tests of fiduciary responsibility under ERISA).

109. 29 U.S.C. § 1102(a) (2007); Patricia Wick Hatamyar, *See No Evil? The Role of the Directed Trustee under ERISA*, 64 TENN. L. REV. 1, 29 (1996).

110. See, e.g., *Pension Benefit Guar. Corp. v. Ross*, 733 F. Supp. 1005, 1006 (M.D.N.C. 1990).

111. See ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 157-58 (3d ed. 2004). Monks asserts that that “trustees of private pension funds spend little time fulfilling their duties” because the duties are “considered ancillary to their main corporate responsibilities.” ROBERT A.G. MONKS, *THE EMPEROR’S NIGHTINGALE: RESTORING THE INTEGRITY OF THE CORPORATION IN THE AGE OF SHAREHOLDER ACTIVISM* 147 (1998). According to another source, the average chief financial officer in the United States spends about three percent of her time managing her company’s retirement accounts. Nikolay A. Ouzounov, *Keeping Employees’ Trust: The Rocky Road Ahead for Pension Plan Trustees*, 37 J. MARSHALL L. REV. 903, 903 (2004).

112. See 29 C.F.R. § 2509.75-5, at FR-3 (2007).

113. 29 U.S.C. § 1103(a), (b) (2007).

114. See Hatamyar, *supra* note 109, at 8 n.46; see also Gregory S. Alexander, *Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 111, 125 (1993) (“Some firms exacerbate pension ownership passivity by keeping all of these fiduciary positions at home, appointing in-house trustees, named fiduciaries, and investment managers.”). The case law abounds in examples of banks acting as trustees. See, e.g., *In re Am. Continental/Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1458 (D. Ariz. 1992).

statute imposes the statutory requirement that the investment manager must be a registered investment adviser, bank, or insurance company.¹¹⁵

Overlying this formal scheme is a functional definition of a fiduciary as a person who has “any discretionary authority or discretionary responsibility” in the administration of the plan.¹¹⁶ As a leading text observes, the definition is broad “enough to include nearly everyone having a measurable influence in fashioning or carrying out an investment program for a covered employee benefit plan.”¹¹⁷ Thus, a corporate officer’s power to appoint or remove a trustee or investment manager has been held to imply a duty to monitor the actions of the trustee or manager.¹¹⁸ Further expanding the reach of the functional test, ERISA casts a net of co-fiduciary liability on corporate officers with pension plan responsibilities who fail to prevent or to remedy a breach of duty by other fiduciaries.¹¹⁹

The broad and ill-defined group of corporate officers charged with fiduciary duties toward the pension plan is inevitably placed in a position of dual loyalty to the pension beneficiaries and the corporate employer. ERISA does not preclude such a position of dual loyalties,¹²⁰ but in fact expressly provides that a person may serve as a fiduciary “in addition to being an officer, employee, agent, or other representative” of the plan sponsor.¹²¹ A Second Circuit decision cautioned that a company officer should resign as pension trustee during a hostile takeover attempt,¹²² but pension fiduciaries are still routinely charged

115. 29 U.S.C. § 1002(38) (2007).

116. 29 U.S.C. § 1002(21) (2007).

117. BINES & THEL, *supra* note 16, at 61. The volume of litigation over fiduciary status of particular defendants attests to the practical importance of the functional test of fiduciary responsibility. See Susan P. Serota, *Overview of ERISA Fiduciary Law*, in ERISA FIDUCIARY LAW 10-11 (Susan Serota ed., 1995).

118. *Henry v. Champlain Enters.*, 288 F. Supp. 2d 202, 232 (N.D.N.Y. 2003); *Keach v. U.S. Trust Co.*, 234 F. Supp. 2d 872 (C.D. Ill. 2003).

119. 29 U.S.C. § 1105(a) (2007).

120. See *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000) (“Under ERISA . . . a fiduciary may have financial interests adverse to beneficiaries.”); *Scardelletti v. Bobo*, 897 F. Supp. 913, 918 (D. Md. 1995); *Dist. 65, UAW v. Harper & Row, Publishers, Inc.*, 670 F. Supp. at 557 (“Although ‘dual loyalty’ and a potentiality of conflict of interest exist when an employer also acts as an administrator or trustee of a pension plan, ERISA does not preclude an employer from serving as a plan administrator.”); *Musto v. Am. Gen. Corp.*, 615 F. Supp. 1483, 1501 (M.D. Tenn. 1985) (“Unlike the common law prohibition against dual loyalties, Congress permits the fiduciary of benefit plans to assume multiple obligations.”); Mark A. Vogel, *Named Fiduciaries*, in ERISA FIDUCIARY LAW, *supra* note 117, at 214-15.

121. 29 U.S.C. § 1108(c)(3) (2007).

122. *Donovan v. Bierwirth*, 680 F.2d 263, 271-272 (2d Cir. 1982); see also *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 250 (S.D.N.Y. 1986).

with deciding matters relating to pension benefits that will affect corporate cash flow, tax liability, and investment opportunities.¹²³

ERISA addresses the problem of dual loyalties of pension administrators by imposing on them a fiduciary duty to act in the interests of participants and beneficiaries.¹²⁴ As formulated by Section 404, “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and – (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.”¹²⁵ Complementing this provision, Section 406 describes a series of prohibited transactions involving dealings between a plan and related employers, unions, service providers, and fiduciaries.¹²⁶

The unintended consequence of the structure of fiduciary responsibility is to place the voting of proxies in pension funds under the control of management, which has an almost unfailing propensity to

123. On the use of pension plans for purposes of corporate finance, see TERESA GHILARDUCCI, *LABOR'S CAPITAL: THE ECONOMICS AND POLITICS OF PRIVATE PENSIONS*, 85-110 (1992); Teresa Ghilarducci, *Small Benefits, Big Pension Funds, and How Governance Reforms Can Close the Gap*, in *WORKING CAPITAL, THE POWER OF LABOR'S PENSIONS* 158 (Archon Fung, et al eds., 2001). The courts have allowed corporate fiduciaries to engage in investments that incidentally benefit the corporation or the fiduciaries themselves if the investments serve the beneficiaries interest. *Donovan v. Bierwirth*, 680 F.2d. at 271; but see *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984) (investment in pension fund for corporate benefit, though profitable, violated fiduciary duty). Most decisions in this field, however, are decided by applying a distinction between actions in administering the plan, which are subject to a fiduciary duty, and actions lying within the corporation's capacity as settlor of the pension trust to which no fiduciary responsibility attaches. See *Dewitt v. Penn-Del Directory Corp.*, 106 F.3d 514, 520 (3d Cir. 1997); *Nazay v. Miller*, 949 F.2d 1323, 1329 (3d Cir. 1991); *Stout v. Bethlehem Steel Corp.*, 957 F. Supp. 673, 693 (E.D. Pa. 1997); *United Rubber, Cork, Linoleum & Plastic Workers v. Perelli Armstrong Tire Corp.*, 873 F. Supp. 1093, 1101 (M.D. Tenn. 1994); *Amato v. W. Union Int'l, Inc.*, 773 F.2d 1402, 1416-17 (2d Cir. 1985). Corporate actions as settlor include plan amendments (see *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438, 443-46 (1999); *Lockheed Corp. v. Spink*, 517 U.S. 882, 889-91 (1996); *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 78 (1994)), changes in the level of funding (see *Johnson v. Georgia-Pacific Corp.*, 19 F.3d 1184, 1188 (7th Cir. 1994); *Siskind v. Sperry Ret. Program, Unisys*, 47 F.3d 498, 505 (2d Cir. 1995) (“an employer must have latitude in the sound management of its business to determine the benefits it will guarantee”) and plan terminations (see *Payank v. HMW Indus.*, 883 F.2d 221, 224-25 (3d Cir. 1989).

124. *Schaefer v. Ark. Med. Soc'y*, 853 F.2d 1487, 1492 (8th Cir. 1988) (“When a fiduciary has dual loyalties . . . the prudent person standard requires that he make a careful and impartial investigation of all investment decisions”); *Donovan v. Bierwirth*, 538 F. Supp. 463, 468 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (“Having provided for an unorthodox departure from the common law rule against dual loyalties, Congress provided two statutory safeguards to protect plan participants and beneficiaries,” *i.e.*, 29 U.S.C. §§ 1104(a), 1106 (2007)).

125. 29 U.S.C. § 1104(a)(1)(A) (2007).

126. 29 U.S.C. §§ 1002(14), 1106 (2007).

support management recommendations in other corporations.¹²⁷ Useem explains:

[C]orporate executives quickly close ranks when it comes to national policies or shareholder power. This is due to both higher principles and pragmatic politics. Top managements still share the traditional belief that they, not shareholders, should run their companies. They know, in any case, that allowing their pension funds to vote against the managements of other firms is to invite retaliation the next time their own enterprise is under shareholder challenge. Companies constantly compete with other companies for customers, but they seem constitutionally incapable of challenging one another on governance.¹²⁸

The system-wide effect is to subtract the equity securities in employer-directed pension funds – approximately six percent of the total U.S. equity market – from any meaningful role in monitoring corporate management.¹²⁹

Corporate dominance of proxy voting is not affected by the appointment of an outside investment manager. Many corporations keep the task of proxy voting in-house, while delegating other investment functions to an outside manager; and nearly all corporations give their investment managers proxy voting instructions and attempt some monitoring.¹³⁰ Even if the monitoring is lax, the professional managers have a compelling incentive to conform to their clients' preferences so as to secure and expand their business relationships.

127. For observations on management dominance of proxy voting by pension plans, see Black, *supra* note 7, at 596-98 (1990); MONKS & MINOW, *supra* note 111, at 157; MONKS & MINOW, *supra* note 111, at 147, 153; Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 77 (1993) ("Few managers want their pension more active in the corporate governance of other companies than they would want their stockholders to be active in their firm."). There are two systematic studies on point: O'BARR & CONLEY, *supra* note 36, at 194-201 (O'Barr and Conley use the methods of anthropology in studying the community of investment managers) and John Pound, *Proxy Contests and Efficiency of Shareholder Oversight*, 20 J. OF FIN. ECON. 237, 242-44, 260 (1988) (a statistical study supports hypothesis of conflict of interest in proxy voting).

128. USEEM, *supra* note 83.

129. This figure excludes 401(k) plans and other employee-directed plans, which are discussed *infra* Part II.F. The Conference Board data indicates that 12.7 percent of equity holdings are in private trustee plans. Employer-directed plans ordinarily consist of defined benefit plans, which account for 46 percent of the assets of this category. THE CONFERENCE BOARD, *supra* note 3, at 29, 31.

130. Monks and Minow report, "A recent trend, endorsed by the Business Roundtable, is for plan sponsors to leave other aspects of the fund management outside, but to take the proxy voting in house." MONKS & MINOW, *supra* note 111, at 157. See PATRICK J. DAVEY, *VOTING PENSION FUND PROXIES*, 6, 12-18 (The Conference Board, 1991) (surveys conducted by the Conference Board revealed that in-house voting increased from 8 percent to 28 percent from 1988 to 1994 in the wake of the Avon letter). See *infra* note 31.

The Department of Labor actually imposes on corporate officers serving as pension fiduciaries a *duty* to monitor the proxy voting of investment managers where voting authority is delegated.¹³¹ Interpretative bulletin 94-2 begins with the premise that where a named fiduciary delegates the power to manage pension assets to an investment manager, the delegation may include responsibility to vote proxies on corporate stock in the pension fund.¹³² The fiduciary may then require the investment manager to comply with a statement of policy that sets forth “guidelines on the voting of proxies on shares of stock for which the investment manager is responsible.”¹³³ The fiduciary’s responsibility to monitor the performance of the investment manager includes an obligation to “periodically monitor the activities of the investment manager with respect to . . . actions taken by the investment manager with regard to proxy voting decisions.”¹³⁴

For its part, the SEC requires that the investment managers be amenable to instructions by their corporate principals on proxy voting.¹³⁵ The SEC regulation on proxy voting by investment advisers, issued under the Investment Advisers Act of 1940, states three principles that in most applications are beyond criticism:¹³⁶ 1) Registered investment advisers must adopt written policies and procedures intended to assure that client interests are served in proxy voting, including procedures to deal with conflicts of interests between a client and other clients, 2) they must disclose to clients how they may obtain information about how their proxies are voted, and 3) they must convey to clients their proxy voting policies and procedures. The regulation, however, does not address the conflict of interest between corporate management and pension fund beneficiaries in proxy voting. In fact, the regulation actually aggravates these conflicts of interest by exposing investment managers to corporate pressure during proxy contests. In principle, a client should have ready access to information about proxy voting, but as applied to fiduciaries with dual loyalties, this otherwise sound principle serves to re-enforce patterns of management domination of proxy voting.

131. Dept. of Labor, Interpretative Bulletin 94-2, *codified at* 29 C.F.R. § 2509.94-2 (2007). See also Avon letter, *supra* note 31.

132. 29 C.F.R. § 2509.94-2, 343 (2007).

133. *Id.* at 344.

134. 29 C.F.R. § 2509.94-2 (2007). The ruling is cited favorably in *Cal. Ironworkers Field Pension v. Loomis-Sayles*, 259 F.3d 1036, 1042 (9th Cir. 2001).

135. Investment Adviser’s Act Release 2106 (Jan. 31, 2003), *codified in* 17 C.F.R. 275.206(4)-6 (2007).

136. See THOMAS P. LEMKE & GERALD T. LINS, *REGULATION OF INVESTMENT ADVISERS* 254-59 (2006); CLIFFORD E. KIRSCH, *INVESTMENT ADVISER REGULATION: A STEP-BY-STEP GUIDE TO COMPLIANCE AND THE LAW* 11-2 to 11-10 (1996).

The passivity of corporate pension funds in proxy voting represents only a small subset of the problems raised by the system of dual loyalties of pension administrators under ERISA. Beneficiaries are in fact very unlikely to be concerned with proxy voting, which has only a system-wide importance. Of immediate importance to them will be decisions affecting the actual provision of benefits. A revealing series of cases concerned the termination of defined benefit plans in the 1980s. The termination rules required that the pension plan purchase annuities from insurers to fund vested benefits but provided that any assets remaining after purchase of the annuities would revert back to the corporation.¹³⁷ A low premium for annuities, of course, increased the reversion of assets to the corporation. One executive who chose a low bid of a failing insurance company over the bid of other financially sound insurers was later called to testify before a Congressional committee. After recounting his testimony, Stein concludes,

The lesson we should draw from this story, which was replayed in several hundred major plan terminations . . . is that some fiduciaries, including some who are stewarding the affairs of plans of major corporations, will discharge their obligations to achieve benefits for themselves unless they believe their actions will be closely scrutinized.¹³⁸

The consequences of conflicts of interest in proxy voting by employer-sponsored pension plans could be curbed somewhat by changes in the existing regulatory scheme. Corporate management could be barred from keeping proxy voting in-house while delegating other investment functions to an investment manager – an arrangement calculated to assure management domination of proxy voting¹³⁹ – and the practice of maintaining in-house trustees could be prohibited by requiring the appointment of unrelated firms to provide this service. Investment managers could be shielded from day-to-day pressure from management in proxy voting by precluding consideration of client requests for information until sixty days after close of voting.¹⁴⁰ Finally, with the widespread use of electronic proxy voting software, it would be entirely feasible to require investment advisers

137. See *Bussian v. RJR Nabisco*, 223 F.3d 286, 295 (5th Cir. 2000).

138. Norman Stein, *ERISA & the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 71, 105-07 (1993).

139. See Black, *supra* note 7, at 598 (“The third alternative – delegating investment power and retaining voting power – is potentially the most conflict-ridden.”); Coffee, *supra* note 9, at 1357 (1991) (“The decision of a pension fund to delegate investment discretion, while retaining or reclaiming voting discretion, is inherently questionable”).

140. The SEC disclosure rules for mutual funds now require disclosure of proxy voting no earlier than two or three months after shareholder meetings. See discussion *infra* Sec. II.F.2 and note 238.

to post their proxy voting record on their website, thereby subjecting them to some countervailing pressures from beneficiaries and prospective customers.¹⁴¹

These minor reforms might temper but would not eliminate conflicts of interest in proxy voting by employer-sponsored plans.¹⁴² The business interests of trustees and investment managers would still give them an incentive to anticipate the desires of management in proxy voting. Moreover, to the extent that these proposals might enhance the autonomy of investment managers, they are subject to a serious objection: they would tend to shift the locus of proxy voting responsibility from corporate management to other business entities equally lacking in accountability and subject to other kinds of conflicts of interest.¹⁴³

There can be only one adequate solution to the problem of dual loyalties in employer-directed pension plans: it is to establish an administrative structure with guarantees of independence. The United Kingdom chose this course in the Pension Act 1995, a comprehensive reform of private pensions that was extensively amended nine years later in the Pension Act 2004. These pension acts can be regarded as the British counterparts to ERISA adopted more than twenty years later.¹⁴⁴ They require private pension plans to be administered by a board of trustees, with statutorily defined responsibilities,¹⁴⁵ which must retain an independent auditor and actuary unrelated to the sponsoring company. An agency called the Pensions Regulator processes complaints from the auditor and actuary, as well as from individual trustees and beneficiaries, and is authorized to conduct investigations, remove trustees for “serious or persistent” breach of duty, and ap-

141. Personal communication of John Harrington, principal of Harrington Investments, Inc., an investment adviser, on October 17, 2006. A recent study of the GAO calls broadly for greater transparency of plan fiduciaries and appears to be directed at investment advisers. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PENSION PLANS: ADDITIONAL TRANSPARENCY AND OTHER ACTIONS NEEDED IN CONNECTION WITH PROXY VOTING 28-30 (Aug. 2004).

142. The reforms would require legislation. Dept. of Labor, Interpretative Bulletin 94-2 is a reasonable application of the fiduciary duties created by ERISA sections 402 and 403 (29 U.S.C. §§1102, 1103 (2007)), and Investment Advisor Release 2106 properly applies section 206 of the Investment Advisers Act. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95 (1963).

143. See ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION, CAPITAL MARKETS, CORPORATE CONTROL, AND ECONOMIC PERFORMANCE 125, fig. 6.1 (2006) (“Who Owns Asset Managers?”).

144. The Pension Act 1995 is reprinted in 33 Halsbury’s Statutes (4th ed.) at 851 et seq. The Pension Act 2004 may be found on the website of the Office of Public Sector Information. See <http://www.opsi.gov.uk/ACTS/acts2004/20040035.htm>. See generally, George Walker, *United Kingdom Pensions Law Reform*, 64 BROOK. L. REV. 871 (1998).

145. Pension Act 1995 §§ 18A-36.

point replacement trustees.¹⁴⁶ The agency requires pension boards to adopt procedures to assure the appointment of qualified members and to provide for their continuing education; among other services, it offers training programs for trustees, including online courses of instruction.¹⁴⁷

One third of the trustees on the pension board (or at least 2 members) must be nominated by members of the pension plan.¹⁴⁸ Each pension board is charged with putting in place procedures for selecting the member-nominated trustees, which may be tailored to the needs of a particular company. In July 2006, the Pension Regulator issued a draft Code of Practice offering guidance on appropriate methods of choosing member-nominated trustees. Adopting a principle-based approach, the Code requires nominating and selection procedures affording proportionality, fairness and transparency; and it outlines alternative methods of selection that may meet these criteria. The member-nominated trustees may be trade union representatives, but only if the employer agrees. The board of trustees must review its selection procedures every three to five years, and, as in other pension matters, members may report improprieties to the Pension Regulator.¹⁴⁹

The importance of an independent board of pension trustees extends beyond proxy voting; it would directly serve the interests of beneficiaries by remedying conflicts of interest in the administration of pension benefits. Management also would have something to gain in a reform modeled after the British legislation. By confining fiduciary liability to a board of trustees with clearly identified duties, management would be freed of the threat of litigation presented by the vague functional theories of fiduciary responsibility under ERISA. In addition, management would gain a strong argument for reducing the ad-

146. Pension Act 1995 § 3.

147. See The Pension Regulator, Code of Practice 7, Trustee Knowledge and Understanding, available at www.pensionsregulator.gov.uk/pdf/CodeTKuFinal.pdf

148. Pension Act 1995 § 16; Pension Act 2004, § 241; Occupational Pension Schemes (Member-nominated Trustees and Directors) Regulations 2006, available at Office of Public Sector Information website, <http://www.opsi.gov.uk/si/si2006/20060714.htm>. Australia also has a regulated system of pension boards with employee representation. See Greg Burner, *Private Pensions Supervisory Methods in Australia*, in *SUPERVISING PRIVATE PENSIONS*, OECD Private Pensions Series, No. 6 (2004). Canadian provinces, with the exception of Quebec, allow employers to administer pension funds despite the kind of conflicts of interest that occur under ERISA. See Eileen E. Gillese, *Pension Plans and the Law of Trusts*, 75 *CANADIAN BAR REV.* 221, 229 (1996).

149. Pensions Regulator, Draft Code of Practice No. 8 Member-nominated trustees and directors – putting in place and implementing arrangements. See <http://www.thepensionsregulator.gov.uk/codesOfPractice/mnt.index.aspx>

ministrative burdens now weighing on pension plans, including some of the onerous reporting requirements. By introducing a framework of self-regulation, the British model would offer assurances of integrity in pension plan administration that would justify easing external controls.

D. *Union Plans*

A distrust of unions, embedded in an outdated law, is linked to another seldom discussed anomaly of considerable social importance: most union pension funds are under the exclusive control of corporate management. Union influence is limited to jointly trusteeed plans, with equal representation of management and unions authorized by Section 302(c) of the Labor Management Relations Act of 1947 (commonly known as the Taft-Hartley Act).¹⁵⁰ These Taft-Hartley funds, with few exceptions, consist of multi-employer plans providing benefits to numerous bargaining units within a particular industry. According to the most recent available data, the assets of jointly trusteeed funds include an estimated \$180 billion in corporate equities.¹⁵¹ All other collectively bargained plans, with roughly \$400 billion in corporate equities,¹⁵² are administered by management in the same manner as other employer-sponsored plans.

The Taft-Hartley Act was a conservative reaction to the growth of union power in the 1940s, which was enacted shortly after a crippling coal strike of the United Mine Workers led by their autocratic leader, John L. Lewis.¹⁵³ Initially, Lewis pressed for a stipulated employer

150. 29 U.S.C. § 186(c)(5) (2007).

151. This estimate is based on funded assets of \$307 billion in 2003 as reported by PENSION BENEFIT GUARANTY CORPORATION, PENSION INSURANCE DATA BOOK 2005, at 92, tbl. M-9, available at <http://www.pbgc.gov/docs/2005databook.pdf>. Following a GAO report, it assumes that fifty-five percent of the assets consist of equity holdings. See GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS, MULTIEMPLOYER PLANS FACE SHORT- AND LONG- TERM CHALLENGES 10 (Mar. 2004).

152. The starting point in this estimate is the Department of Labor's compilation of Form 5500 reports, which show total assets of collectively bargained plans to be \$1,117 billion. Unfortunately the figure overstates the assets of these plans to an undeterminable degree because some collectively bargained plans cover non-bargaining units. See EMPLOYEE BENEFITS SECURITY ADMINISTRATION, *supra* note 22, at 7 tbl. A6. The estimate of roughly \$400 billion rests on the assumption that the assets of non-bargaining units included in this Department of Labor's figure are in the range of ten to fifteen percent of the total. I deduct the funded assets of multi-employer plans, as reported to the Pension Benefit Guaranty Corporation, from eighty-five to ninety percent of the reported total assets of collectively bargained plans and assume that 60 percent of assets are invested in equities, following a GAO estimate. See PENSION BENEFIT GUARANTY CORPORATION, *supra* note 151, at 92, tbl. M-9, and GENERAL ACCOUNTING OFFICE, *supra* note 151, at 10.

153. For a brief history of the pension provision, see Stephen Fogdall, *Exclusive Union Control of Pension Funds: Taft-Hartley's Ill-Considered Prohibition*, 4 U. PA. J. LAB. & EMP. L. 215,

payment per ton of coal to a welfare fund controlled by the union. Although he settled for a jointly trustee fund, the demand raised the specter of unchecked union power over a serious accumulation of capital. Speaking on Section 305(c), Senator Taft explained,

The occasion of the amendment was the demand made by the United Mine Workers of America that a tax of 10 cents a ton be levied on all coal mined, and that the tax so levied be paid into a general welfare fund to be administered by the union for practically any purpose the union considered to come within the term 'welfare.'¹⁵⁴

Such a fund, he claimed, would in effect become "a war chest, if you please, for the union."¹⁵⁵ Senator Byrd warned that similar demands were on the agenda of other unions. If the unions got their way, "it would mean a complete destruction of the private enterprise system in the U.S."¹⁵⁶

As enacted, Section 302 broadly prohibits any employer from paying "money or other thing of value" to any labor organization or to "any representative of any of his employees."¹⁵⁷ Employer contributions to union-administered pension plans are included in this prohibition, but subdivision (c)(5) makes an exception for payments to a trust fund established for the purpose of paying pensions or other specified benefits, provided "employees and employers are equally represented in the administration of such fund, together with such neutral persons as the representatives of the employers and the representatives of employees may agree upon."¹⁵⁸

Today, the concerns that led to the enactment of Section 305 belong to history. Union membership in the private sector has declined from a peak of over thirty percent in the mid-1950s to less than nine percent.¹⁵⁹ Approximately thirty percent of the assets of collectively bargained pension funds are invested in mutual funds and other institutional investments under defined contribution plans.¹⁶⁰ There is scant possibility of using the funds as a "union war chest." The bal-

222-24 (2001); JEREMY RIFKIN & RANDY BARBER, *THE NORTH WILL RISE AGAIN, PENSIONS, POLITICS AND POWER IN THE 1980s* 98-103 (1978); ROE, *supra* note 7, at 128-29.

154. LEGISLATIVE HISTORY OF THE LABOR MANAGEMENT RELATIONS ACT 1947, at 1310-11, printed for Subcomm. on Labor of the Comm. on Labor and Public Welfare, U.S. Senate (Jan. 1974).

155. *Id.* at 1311.

156. As cited in ROE, *supra* note 7, at 128-29.

157. 29 U.S.C. § 186(a)(2007)

158. 29 U.S.C. § 186(c)(5)(B)(2007).

159. See GENERAL ACCOUNTING OFFICE, *supra* note 151, at 4; Gary N. Chaison & Joseph B. Rose, *The Macrodeterminants of Union Growth and Decline*, in *THE STATE OF THE UNIONS*, at 4 fig.1 (George Strauss, et al. eds., 1991).

160. See EMPLOYEE BENEFITS SECURITY ADMINISTRATION, *supra* note 22, at 7, tbl. A6.

ance of the assets fund-defined benefit plans that have been subject to multiple layers of regulation under ERISA, including fiduciary standards and prohibited transaction provisions,¹⁶¹ elaborate disclosure and reporting requirements,¹⁶² and minimum funding rules that have grown increasingly complex and rigid with successive legislation.¹⁶³

The multiemployer plans allowed by the Taft-Hartley Act have established a solid record that belies any claim that unions are unable to work with management in their beneficiaries' interest. The plans are ordinarily negotiated between a union and an employers' association on a national or regional basis and are particularly well suited to industries, such as construction, with many small employers and a mobile workforce.¹⁶⁴ They offer employees the advantage of portable pension benefits within the trade and allow employers to rely on an efficient central administration of pension benefits.¹⁶⁵ The boards of trustees, which administer the plans, typically operate as separate entities with their own plan administrator or a contract administrator.¹⁶⁶ The fragmented constituencies of the boards can operate as a check on negligence or abuse; if a union, or a particular employer is out of line, other trustees are in a position to impose necessary discipline.¹⁶⁷

161. ERISA §§ 404, 406, *codified at* 29 U.S.C. §§ 1104, 1106 (2007).

162. The agencies are the Department of Labor, the Pension Benefit Guaranty Corporation, and the Internal Revenue Service. See generally Sharon E. Kazaras, *Reporting and Disclosure Requirements for Plans Covered by ERISA*, in ERISA: A COMPREHENSIVE GUIDE 2-1 (Paul J. Schneider & Barbara W. Freedman eds., 2d ed. 2003).

163. Jeffrey S. Myers, *Minimum Funding Requirements*, in ERISA: A COMPREHENSIVE GUIDE, *supra* note 162, at 5-1.

164. NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS, A BASIC GUIDE TO MULTIEMPLOYER PLANS 3-5, 13-14 (2005); *Reforming and Strengthening Defined Benefit Plans: Examining the Health of the Multiemployer Pension System: Hearing Before the Subcomm. on Education and the Workforce*, 108th Cong. 38-40 (2004) (statement of Randy G. DeFrehn, executive director of NCCMP).

165. NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS, *supra* note 164, at 4; *Funding Rules for Multiemployer Defined Benefit Plans in H.R. 2830, The "Pension Protection Act of 2005": Hearing Before the Subcomm. on Select Rev. Measures*, 109th Cong. 36-37 (2005) (statement of Judith Mazo, The Segal Company).

166. Paul J. Ondrasik, Jr. & Donald A. Walters, *Utilizing Professional Advisors in Fulfilling Fiduciary Responsibility*, in TRUSTEES HANDBOOK, A PRACTICAL GUIDE TO LABOR-MANAGEMENT EMPLOYEE BENEFIT PLANS 122, 128 (Marc Gertner ed., 6th ed. 2006).

167. Schwab and Thomas write that "the joint union-management control of the trustees" is, "[t]he most important check on investment abuses . . . at least in theory," but "[d]espite the balanced board membership, unions have tended to dominate these jointly managed funds." Stewart J. Schwab & Randall Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1076-1077 (1998). This generalization appears somewhat overly broad in light of the record of proxy voting, which reflects the choices of jointly chosen investment managers. See discussion *infra* p. 41 and note 191. The responsibilities of management trustees are by no means *pro forma* in nature. See TRUSTEE'S HANDBOOK, *supra* note 166, *passim*; NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS, *supra* note 164, at 11-12. Management faces liability for unfunded vested benefits as a penalty for poor

A team of researchers have provided an illuminating study of the Central Pension Fund serving the International Union of Operating Engineers. In this exemplary pension fund, they found that the employer and union representatives on the board of trustees were professionally removed from collective bargaining and reached decisions by a process of consensus, relying heavily on retained actuaries, accountants and attorneys.¹⁶⁸

The assets of multiemployer plans grew at an annual average rate of 11.7 percent from 1980 to 2000, exceeding the average 10.5 percent rate of single-employer plan assets even though they typically adopted a more conservative asset allocation than corporate defined-benefit plans.¹⁶⁹ The conservative investment policy has stood them well in adverse times;¹⁷⁰ the Taft-Hartley plans have an extraordinarily low rate of failure. From 1980 to 2004, the Pension Benefit Guarantee Corporation provided assistance to only 33 multiemployer plans as compared to 296 single-employer plans.¹⁷¹ Five years ago, corporate plans sank into a deep crisis caused by low interest rates and a stock market decline. Taft-Hartley plans are also in difficulty, but, in the words of a GAO study, "the plans are not experiencing anywhere near the magnitude of the problems that have recently afflicted the single-employer plans."¹⁷² In 2003, 87 percent of multi-employer plans had fully funded vested benefits while only 25 percent of single employer plans were fully funded.¹⁷³

management of the fund. See Paul J. Schneider, *Withdrawal Liability under the Multiemployer Pension Plan Amendments Act*, in ERISA: A COMPREHENSIVE GUIDE, *supra* note 162, at 11-1.

168. See TERESA GHILARDUCCI ET AL., PORTABLE PENSION PLANS FOR CASUAL LABOR MARKETS: LESSONS FROM THE OPERATING ENGINEERS' CENTRAL PENSION FUND 177-180 (1995). Many Taft-Hartley trusts, however, do not achieve this degree of independence. The conflict of interest affecting union trustees with collective bargaining obligations persists in many plans and has been repeatedly recognized in judicial decisions. See David W. Silverman, *Trustees and Bargaining Parties*, in TRUSTEE'S HANDBOOK, *supra* note 166, at 50.

169. GENERAL ACCOUNTING OFFICE, *supra* note 151, at 9. Taft-Hartley funds have typically invested 50 to 55 percent of their assets in corporate equities. See Statement of DeFrehn, *supra* note 164, at 41; GHILARDUCCI, *supra* note 123, at 47-48.

170. See Alicia H. Munnell, *Who Should Manage the Assets of Collectively Bargained Pension Plans?*, NEW ENG. ECON. REV., July/Aug. 1983, at 28 (finding Taft-Hartley plans in prior ten years "have performed very much like the universe as a whole"). But due to their conservative asset allocations, the investment returns of Taft-Hartley funds have lagged somewhat below single-employer funds during periods of rapidly rising stock prices. GHILARDUCCI, *supra* note 123, at 142; *Legislative Hearings on H.R. 2664: Hearings before the Subcomm. on Labor-Management Relations of the Comm. on Education and Labor*, 101st Cong. 41-43 (1990), printed in H.R. REP. NO. 101-89 (1990).

171. GENERAL ACCOUNTING OFFICE, *supra* note 151, at 18.

172. *Id.* at 26.

173. NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS, *supra* note 164, at 9.

One of the unforeseen consequences of the Taft-Hartley Act has been to bar the emergence of cooperative or non profit retirement benefit providers with links to labor organizations. A union-owned insurance company, Union Labor Life Insurance Company (now Ullico, Inc) does exist and represents one possible model. Reflecting the vision of Samuel Gompers, Ullico was founded in 1925 a year after his death. It operates as a privately held corporation with stock generally restricted to unions and is governed by a board of directors composed of union leaders. Today it provides group life insurance to 800,000 union members as well as other insurance and investment products, but it has been left knocking at the door of the retirement plan market. It offers certain consulting services and pooled investment trusts as investment options for Taft-Hartley plans,¹⁷⁴ but, unlike other insurance companies, it is not able to offer variable annuities as a 401(k) option or to enter the large market for tax-deferred annuities for non-profit organizations and public school teachers authorized by Internal Revenue Code Section 403(b).¹⁷⁵

An alternative model is suggested by TIAA-CREF. A nonprofit annuity provider, Teachers Insurance and Annuity Association, joined with a newly organized affiliate, College Retirement Equities Fund, to market retirement plans, with voluntary participation, to employees in private educational and research institutions. Such packaged plans offered to multiple employers remain outside the sphere of ERISA regulation.¹⁷⁶ The corporate governance structure of TIAA-CREF possesses internal checks lacking in Ullico, Inc. A supervisory board oversees the performance of TIAA and CREF, which operate as two separate companies with their own boards of directors, and pension plan beneficiaries participate in the selection of company directors.¹⁷⁷

174. See Ullico 2005 annual report, at <http://www.ullico.com> (follow to the 2005 annual report, p. 5 and note 1). For information on Ullico's pooled investment accounts, see Michael Calabrese, *Building on Success: Labor-Friendly Investment Vehicles and the Power of Private Equity*, in *WORKING CAPITAL*, *supra* note 123, at 99-102, 114-116.

175. For surveys of the tax qualification rules of Internal Revenue Code section 403(b), see David A. Pratt, *Very Serious Business: Sense and Nonsense under 403(b) of the Internal Revenue Code of 1986*, 59 ALB. L. REV. 1197 (1996); 2 MICHAEL J. CANAN, *QUALIFIED RETIREMENT PLANS* 95-119 (2006 ed.).

176. A plan qualified under Internal Revenue Code § 403(b) will not be regarded as a pension plan "established and maintained by an employer" within the meaning of ERISA § 3(2), 29 U.S.C. § 1002(2) (2007), if it meets the conditions specified in 29 C.F.R. § 2510.3-2(f) (2007). Among other things, these conditions require that employee participation is voluntary, all contractual rights are enforceable by the employee, and the involvement of the employer is limited to holding an annuity contract in the employer's name and performing certain other minor administrative functions.

177. See *GOVERNING TIAA-CREF, AN INTRODUCTION TO THE TIAA-CREF GOVERNANCE SYSTEM*, at <http://www.tiaa-cref.org>.

It is now a familiar and respected institution in the educational and research communities.

Ullico, Inc. has kept faith with the union constituency for 80 years, despite some financial buffeting;¹⁷⁸ it is surely unfair that it has been legislatively denied the logical and profitable paths of expansion pursued by other similar insurance companies. TIAA-CREF has shown the value of a membership-responsive company providing packaged retirement plans to multiple employers within a professional constituency. There is an unmet need for similar multiple employer plans in other segments of the economy, particularly in the healthcare, non-profit, and public school communities, where private retirement plans are still dominated by insurance companies providing unregulated annuities under IRC 403(b).¹⁷⁹ Without the restrictions of Taft-Hartley, labor unions in this sector of the economy might have been instrumental in establishing plans on the successful model of TIAA-CREF.¹⁸⁰

It is easy enough to recognize Section 302 of the Taft-Hartley Act as a legislative anomaly with a peculiar historical explanation, but it is more difficult to say what should replace it. The question was squarely posed in 1990 when Representative Peter Visclosky introduced legislation that would have made a jointly managed board of trustees on the Taft-Hartley model mandatory for all corporate pension plans, whether or not under a collective bargaining agreement. Supporters of the legislation argued that mandatory reforms must apply to all pension plans. The proposed legislation, H.R. 2664, called on the Department of Labor to supervise secret-ballot elections of trustees representing employee constituencies.

The bill gained 46 co-sponsors¹⁸¹ and drew strong support of labor unions and vehement opposition of management. A hearing before the Subcommittee on Education and Labor revealed an ideological

178. Ullico has recently recovered from a period of restructuring probably due to defects in its organizational structure. See Ullico 2005 annual report, *supra* note 174, notes 1 and 14k.

179. Tom Lauricella, *Teachers Have Few Defenses When Investing in 403(b)s*, at <http://www.post-gazette.com/pg05237/559905.stm>. See also <http://www.403bwise.com> for an array of information on 403(b) plans. Fees for such insurance products can be high and are not always fully disclosed. See PENSION AND WELFARE BENEFITS ADMINISTRATION, STUDY OF 401(K) PLAN FEES AND EXPENSES 17, 27-28 (Apr. 13, 1998).

180. In 2005, union representation among healthcare practitioner and technical occupations was 14.4% and among healthcare support occupations it was 10.7%. See <http://www.bls.gov/news.release/union2.t03.htm>. All states have public teacher retirement systems, but 403(b) plans are still marketed to school districts that are not to affiliated with the public system or that wish supplemental retirement benefits. See generally, CYNTHIA L. MOORE, NATIONAL COUNCIL ON TEACHER RETIREMENT, PROTECTING RETIREES' MONEY (5th ed. 2005); NATIONAL EDUCATIONAL ASSOCIATION, CHARACTERISTICS OF 100 LARGE PUBLIC PENSION PLANS (Nov. 2002).

181. 135 CONG. REC. 14476, 20205, 21590, 22744, 23924, 23414, 26589; 136 CONG. REC. 752, 6672, 83, 16186.

divide as labor claimed the right to control workers' pension funds and management viewed pensions as a form of compensation within the purview of personnel administration.¹⁸² Management representatives maintained that corporate pension funds were on a sound footing – an argument that could not be made today – and raised three more weighty objections. First, the election of employee representatives would place an impossible burden on the Department of Labor. An IBM executive explained that the company employed a population of 200,000 in 325 locations in 50 states.¹⁸³ Secondly, the administration of pension benefits through a jointly trustee board, with elected employee representatives, would put an additional burden on pension plans, giving management an incentive to withdraw or simplify benefit programs. Thirdly, management representatives pointed out that the Taft-Hartley Act does not prohibit negotiation of jointly trustee plans with single employers, but only a handful of such plans exist.¹⁸⁴ They inferred that the establishment of jointly trustee plans was not really a priority of labor.¹⁸⁵ A labor consultant countered that unions are subject to a legal handicap in negotiating a jointly trustee plan. In his experience, management uniformly refused to negotiate the composition of the pension board on the ground that it was a permissive rather than a mandatory subject of bargaining.¹⁸⁶

An amendment incorporating the Visclovsky bill was defeated by a vote of 250 to 173 and a similar bill introduced in the mid-1990s also failed.¹⁸⁷ The episode serves to underscore the practicality of the more modest model of fiduciary reform offered by the British Pension Act 1995. This incremental reform avoids the management objections raised against the Visclovsky bill, while leaving labor free to extend its participation in pension benefit programs by negotiation and institutional innovation. The British formula for selecting a one-third minority contingent of employee trustees by a principle-based process

182. *Legislative Hearings on H.R. 2664, supra* note 170.

183. *Id.* at 142.

184. Examples included Newspaper Guide and New York Times; Machinists and TWA Airlines; and Airlines Pilots Association and TWA Airlines, United Airlines and Pan Am Airlines. *Id.* at 188, 310.

185. Union leadership has long advocated worker participation in pension fund management. *Id.* at 170, 200, 381. But Levin suggests that union officials at a local level frequently prefer to leave the management of pension plans to the employer in order to avoid exposure to criticism, presumably because they lack experience and organizational support for assuming this highly technical responsibility. NOEL ARNOLD LEVIN, *ERISA AND LABOR MANAGEMENT BENEFIT FUNDS* 354 (2d ed. 1975).

186. *Legislative Hearings on H.R. 2664, supra* note 170, at 94.

187. *Id.* at 25; GHILARDUCCI, *supra* note 123, at 178.

would allow for a transitional period of improvisation and experimentation without disrupting pension administration.¹⁸⁸

Our analysis leads to the need for three modifications in the Taft-Hartley Act and its administration. Two additional exceptions to the general prohibition of the Act should be added to section 302(c): (1) annuities offered by a union-owned insurance company (the Ullico model) and (2) pension plans offered by a multiple employer plan, with cooperative or member-regulated form of organization (the TIAA-CREF model). Lastly, without resort to legislation, the Department of Labor can lay to rest by an opinion letter the notion that a demand for a jointly trustee plan is not a mandatory subject of bargaining under section 8(d) of the National Labor Relations Act. The decision most closely on point supports this point of view and there is no contrary authority.¹⁸⁹

The subject of collectively bargained pension funds abounds with false concerns about the exercise of union power to promote special interests. Some Taft-Hartley funds, particularly in the construction industry, have experimented in investing to promote jobs, but the so-called economically targeted investments have generally been cautious and financially rewarding; they have proven to be consistent with the conservative investment policies of the funds.¹⁹⁰ Experience has

188. For non-union employees, a two-staged election procedure would reduce the risk of management manipulation of the selection of employee representatives. Groups of perhaps 50 to 250 employees would elect representatives who would then select the pension trustees from among their number. Research reveals that there is a cognitive limit on the number of individuals with whom a person can maintain a stable relationship and the typical limit is about 150 individuals. See R.I.M. Dunbar, *Coevolution of neocortical size, group size and language*, 16 BEHAV. & BRAIN SCI. 681, 685-687 (1993). Elections within such employee groups are less vulnerable to management manipulation because employees will rely on existing personal relationships or those of trusted colleagues. This two-stage process could be adapted to other purposes, such as employee participation in the nomination of corporate board members and the formation of an employee committee to review corporate contributions – an exemplary practice of Adobe Systems. Personal communication with Charles Geschke, founder and CEO (Oct. 29, 2006).

189. Pension benefits are a mandatory subject of collective bargaining under section 8(d) of the National Labor Relation Act. *Chem. Workers v. Pittsburgh Glass*, 404 U.S. 157, 159 (1971). *Cent. Fla. Sheet Metal v. NLRB*, 664 F.2d 489, 501 (5th Cir. 1981) holds that the mechanism for selection of a trustee in a multiemployer plan has a “sufficient nexus” to the “efficient and stable administration” of pension benefits to come within the subject of pension benefits. The same reasoning should apply to the organization and composition of the governing board of a pension plan.

190. See Calabrese, *supra* note 174; Jayne E. Zanglein, *Overcoming Institutional Barriers on the Economically Targeted Investment Superhighway*, in *WORKING CAPITAL*, *supra* note 123, at 181; Thomas M. Griffin, *Investing Labor Union Pension Funds in Workers: How ERISA and the Common Law Trust May Benefit Labor by Economically Targeting Investment*, 32 SUFFOLK U. L. REV. 11 (1998). Economically targeted investments usually make up no more than 5% of a Taft-Hartley fund portfolio. See Tessa Hebb, *Introduction: the Challenge of Labor's Capital Strategy*,

shown that Taft-Hartley plans do not vote as a cohesive bloc in proxy contests. Many Taft-Hartley plans follow, to varying degrees, the proxy voting guidelines of the AFL-CIO, but others disregard these guidelines.¹⁹¹ The elements of the guidelines that directly concern worker interests, such as stock options, employee training and foreign contracting, seldom figure in proxy voting. As shareholder activists, unions have pragmatically sought informal coalitions with other shareholders on issues calculated to gain widespread support. In particular, they have emphasized issues relating to corporate governance procedures, management entrenchment and executive compensation – all matters relating to the long-term health of the corporation rather than to specific worker interests.¹⁹²

The empirical record shows that union funds in fact have a unique potential in evolution of a more responsive system of corporate governance. Unions have an incentive to consider the long-term strength of management since workers cannot shift jobs with the ease that an investment manager can change stocks in a portfolio. Many unions can draw on the expertise of research staffs and possess sophisticated understanding of compensation issues.¹⁹³ Moreover, union leaders tend to calculate the cost/benefit ration of shareholder activism differently from most other institutional investors, seeing political benefits and enhanced public credibility in advocating popular causes.¹⁹⁴ Though marginal in size and surprisingly moderate, the union-influenced funds have the potential of acting as a catalyst in forming new patterns of corporate monitoring.

in *WORKING CAPITAL*, *supra* note 123, at 11. In Interpretative Bulletin 94-1, the Department of Labor approved the consideration of collateral benefits, such as job creation, in the choice of investments, provided the investments otherwise meet fiduciary standards. The concept of economically targeted investments, however, has been repeatedly attacked at a theoretical level. See, e.g., Edward A. Zelinsky, *Economically Targeted Investments: a Critical Analysis*, 6 KAN. J. L. & PUB. POL'Y 39 (1997).

191. Marleen O'Connor, *Labor's Role in the Shareholder Revolution*, in *WORKING CAPITAL* *supra* note 123, at 79; Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: the Changing Face of Corporate Governance*, 11 DEPAUL BUS. L.J. 43, 86 (1998).

192. See Schwab & Thomas, *supra* note 167, at 1036-1040, 1086-1088 (1998); Zanglein, *supra* note 191, at 73-79, 87-97. The AFL-CIO Guidelines may be found at <http://www.aflcio.org/corporatewatch>. For data on union-supported proposals in 2005, see GEORGESON SHAREHOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW figs. 4, 7, 14, available at <http://www.georgesonshareholder.com> (research and press releases).

193. Schwab & Thomas, *supra* note 167, at 1037, 1086.

194. I am relying on Prof. O'Connor's discussion of this point. See Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97, 122-123 (2000); Marleen O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, 31 U. RICH. L. REV. 1345, 1381-1383 (1997).

E. *The Strange Case of FERS*

The legislative neglect of corporate governance has taken a peculiarly strange turn in the case of the Thrift Savings Plan of the Federal Employees Retirement System (FERS). Established 20 years ago by the Federal Employees' Retirement System Act of 1986,¹⁹⁵ the Plan offers a defined-contribution pension plan to federal workers as a supplement to their civil service pension benefits. The assets of the FERS Thrift Savings Plan have grown to over \$170 billion and are increasing substantially year by year.¹⁹⁶ Approximately \$100 billion are in three index funds of corporate equities administered by Barclays Global Investors, NA., under contract with the FERS Board.¹⁹⁷ The 1986 legislation expressly prohibits the retirement system board or any federal agency or employee from exercising "voting rights associated with the ownership of securities by the Thrift Savings Fund."¹⁹⁸ Hence, Barclays, a division of a global banking firm, votes proxies for the federal employees pension fund without consultation with beneficiaries or democratically selected pension managers.

The anomaly arose as the result of a dilemma awkwardly resolved in conference committee. Congress was justifiably concerned about the possibility of political manipulation of the fund, particularly by parties affected by federal procurement and regulatory powers.¹⁹⁹ Both the House and Senate agreed that the specter of such manipulation would be minimized by requiring corporate equities to be invested in index funds that were essentially self-managed and do not require extensive day-to-day investment decisions.²⁰⁰ As a further precaution, the Senate Bill called for the exercise of proxy voting rights by an employee advisory committee, separate from the managing board of the retirement system. The House Bill lacked this provision.²⁰¹ The final legislation created an employee advisory committee but withheld proxy voting powers from the committee as well as from

195. Pub. L. No. 99-335, 100 Stat. 517 (codified as amended at 5 U.S.C. § 8401 through 8479 (2007)).

196. See Financial Statements of the Thrift Savings Fund—2005 and 2004, at <http://www.tsp.gov/forms/financial-stmt.pdf>. The annual report discloses assets of \$172 billion on December 31, 2005, and \$151 billion at the close of the previous year. In 2005, contributions were \$18 billion and benefits paid \$5 billion. Asset appreciation and other factors account for the balance of the increase in asset value.

197. See <http://www.tsp.gov/curinfo/pressrel/index-2006.html>.

198. 5 U.S.C. § 8438(f) (2007).

199. 1986 U.S.C.C.A.N. 1479, 1519-21.

200. See 131 CONG. REC. part 22, S8493 at 31066 (Nov. 7, 1985) (statement of Sen. Stevens, a sponsor of the legislation).

201. 1986 U.S.C.C.A.N. 1479, 1520-1521; 131 CONG. REC. part 22, S8493 at 31055.

the retirement system board, leaving proxy voting by default to the investment manager of the index funds.²⁰²

The equity investments of the FERS Thrift Savings Plan now account for 0.6 percent of the total capitalization of the U.S. equity market.²⁰³ The responsible exercise of proxy voting rights to this fund is important enough to be included in a program of corporate governance reform. One possible approach is suggested by the Railroad Retirement and Survivors Improvement Act of 2001, which transferred \$18 billion of assets from an existing retirement account to a newly created entity, the National Railroad Retirement Investment Trust.²⁰⁴ The Trust is managed by a seven-member board of trustees which is directed to invest in accordance with accepted portfolio management principles.²⁰⁵ Three members of the board are selected by railroad unions; three by railroad management; and the seventh member is selected jointly by the union and management members. Since it was established on February 1, 2002, the assets of the trust increased to \$27.6 billion by September 30, 2005.²⁰⁶ The investments in U.S. equities amounted to 40% of the Trust portfolio²⁰⁷ and were voted in compliance with a proxy voting policy.²⁰⁸

The National Railroad Retirement Investment Trust offers an excellent model for the large mass of federal employees belonging to agencies that provide services unrelated to federal regulatory and procurement powers. The Postal Service with more than 700,000 employees²⁰⁹ falls within this category and is a participant in the Federal Employees Retirement System.²¹⁰ The list of non-politically sensitive agencies could be extended to include such agencies as the Library of Congress, National Archives, Government Printing Office, Department of Veterans Affairs, and perhaps also the Social Security Administration.²¹¹ There is no reason why the supplemental pension plans of

202. See MONKS & MINOW, *supra* note 111, at 153-155, for a personal interpretation of the legislative history. Monks was a founding trustee of the FERS board. See also <http://www.ragn.com>.

203. SECURITIES INDUSTRY FACTBOOK 2006, *supra* note 3, at 69.

204. Pub. L. No. 107-90, § 105, 115 Stats 882 (codified as amended at 45 U.S.C. § 231n (2007)).

205. 45 U.S.C. § 231n(iv)(4)(A) (2007).

206. See <http://www.rrb.gov/pdf/nrrit/reportFY2005.pdf>.

207. *Id.*

208. See <http://www.rrb.gov/pdf/nrrit/appendicesFY2005.pdf>.

209. See <http://www.usps.com/communication/newsroom/postalfacts.htm>

210. 39 U.S.C. § 1005(d)(1) (2007).

211. At the end of 2001, the social security administration had over 50,000 employees in exclusive recognition units, and the Department of Veteran Affairs had over 150,000 employees in such units. U.S. OFFICE OF PERSONNEL MANAGEMENT, UNION RECOGNITION IN THE FEDERAL GOVERNMENT AS OF JANUARY 2001, OWR-58, at 63, 321 (Mar. 2002).

employees working for agencies immune from political pressure should be burdened by concerns relating to the procurement and regulatory powers of other federal agencies.

The Senate version of the 1986 legislation still remains an attractive alternative. The exercise of proxy voting rights by an employee panel separate from the fund management reduces the risk of political misuse of the funds to something close to the vanishing point. Any remaining concern about the centralized exercise of proxy voting power in a federal employees' plan could be addressed by disaggregating the proxy voting process. The equity index fund of the International Brotherhood of Electrical Workers suggests a possible procedure. The fund delegates the exercise of proxy voting rights to a consulting firm that follows the AFL-CIO's proxy voting guidelines.²¹² Federal unions could similarly be authorized to delegate to an investment adviser the exercise of voting rights to the portion of the Thrift Savings Plan proportional to their members' contributions, subject to terms regulated by the Employee Advisory Council. The federal workforce is represented by a complex diversity of unions.²¹³ The devolution of proxy voting rights under a multiplicity of contracts, regulated by an agency distinct from fund management, would effectively dispel the possibility of political manipulation of equity investments.

F. *Employee-directed 401(k) Plans*

The subject of 401(k) plans and corporate governance takes us through complex terrain, marked by incidental disclosure issues, and leads in the end to a familiar conclusion: the fiduciary structure of ERISA poorly serves the interests of beneficiaries and has other unfortunate effects on the larger system of corporate governance in the United States. I will briefly sketch the institutional setting and disclosure issues and then focus on the fiduciary issues that pertain most closely to our inquiry.

1. Institutional Setting

At the outset, it is necessary to observe some legal distinctions. The phenomenon of 401(k) plans involves the convergence of distinct provisions of the Internal Revenue Code and ERISA. Internal Revenue Code Section 401(k) allows an employee to defer taxation on a portion of his or her compensation by contributing it to a qualified pen-

212. Calabrese, *supra* note 174, at 119.

213. See U.S. OFFICE OF PERSONNEL MANAGEMENT, *supra* note 211.

sion plan.²¹⁴ An entirely separate provision of ERISA, Section 404(c), provides an exception to the generally applicable fiduciary rules of 404(a) where a plan gives the participant the power to choose among designated investment alternatives.²¹⁵ Not all plans under ERISA Section 404(c) qualify under Internal Revenue Code Section 401(k), and some Section 401(k) plans do not contain a menu of investment options coming within Section 404(c). Nevertheless, the bulk of 401(k) plans come within ERISA Section 404(c). According to a recent study, 87 percent of medium and large 401(k) plans offer employees a menu of investment options that will ordinarily bring them within the fiduciary rules of ERISA Section 404(c).²¹⁶

At the time ERISA was enacted in 1974, it was not possible to defer taxation on a portion of an employee's contribution that the employee might *elect* to contribute to a retirement plan. Plans providing for such elective contributions were funded with after-tax dollars. Beginning with the 1980 tax year, Section 401(k) allowed employees for the first time to defer tax on a percent of their compensation that they chose to contribute to a plan meeting certain participation and withdrawal requirements.²¹⁷ The plans proved popular with both employers and employees, though for different reasons.²¹⁸

In 1994, the assets in 401(k) plans amounted to \$675 billion and by 2005 the assets stood at \$2,443 billion,²¹⁹ about half of which was invested in domestic corporate stock, or roughly 7 percent of the total U.S. equity market.²²⁰ Today 401(k) plans account for 26 percent of all retirement plan assets (excluding annuities and IRAs)²²¹ and their relative importance is growing. They cover about half of employees benefited by a retirement plan and account for almost two thirds of

214. See CANAN, *supra* note 175, at ¶ 3:107 *et seq.*

215. 29 U.S.C. § 1104(c) (2007).

216. OLIVIA S. MITCHELL, *NEW TRENDS IN PENSION BENEFIT AND RETIREMENT PROVISIONS*, at 24, tbl. 30B (National Bureau of Economic Research, Working Paper 7381, 1999).

217. See Revenue Act of 1978, Pub. L. No 95-600, § 135(c), 95th Cong. (effective for plan years after December 31, 1979).

218. ALICIA H. MUNNELL & ANNIKA SUNDEN, *COMING UP SHORT, THE CHALLENGE OF 401(K) PLANS 2-5* (2004) (explains popularity of plans and sketches history of the provision).

219. INVESTMENT COMPANY INSTITUTE, *THE U.S. RETIREMENT MARKET 2005* fig. 7 (15 Research Fundamentals, No. 5, July 2006).

220. *Id.* at fig. 10. The calculation of one half of assets includes 15 percent of assets invested in employer stock. See *infra* note 229. It assumes that 60% of hybrid funds shown in fig. 10 were invested in stock and that the total U.S. equity market was \$17, 389 billion in 2005. See SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, at 19.

221. INVESTMENT COMPANY INSTITUTE, *supra* note 219, at figs. 1, 7.

new plan contributions to retirement plans, assuring that most retirement plans in the future will fall within this category.²²²

The rapid increase in 401(k) plans has been accompanied by another phenomenon of historic importance: the dramatic growth of mutual funds.²²³ Between 1980 and 1999 the net assets of mutual funds grew at an average rate of over 20 percent.²²⁴ U.S. equities held by mutual funds rose from 122.9 billion in 1985 to 8.9 trillion in 2005.²²⁵ At the beginning of the new century, corporate stock in mutual funds represented almost 23 percent of all publicly traded U.S. corporate equity.²²⁶ Since mutual fund managers actively engage in trading, mutual funds account for the bulk of equity trading and have a dominant influence in stock-market pricing.²²⁷

The role of 401(k) plans in corporate governance is a subplot of the larger drama of the influence of mutual funds on the U.S. corporation. Apart from employer stock – a topic outside our inquiry – nearly all the equities invested in 401(k) plans are in mutual funds.²²⁸ These equity investments made through mutual funds constitute at least 40 percent of the assets in 401(k) plans.²²⁹ The growth of mutual funds

222. Susan J. Stabile, *Freedom to Choose Unwisely: Congress's Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361, 362 (2002).

223. Mutual funds are management investment companies under the Investment Company Act of 1940 (See 15 U.S.C. § 80a-1 through 80a-64 (2007)) and fall into two categories, open-end mutual funds and closed-end mutual funds. Approximately 85 percent of investment company assets are held by open-end mutual fund, which issue securities that are redeemable at any time. Closed-end funds issue securities in traditional offerings that are later traded in secondary markets. See Victoria E. Schonfeld & Thomas M. J. Kerwin, *Organization of a Mutual Fund*, 459 BUS. LAW. 107, 111 (1993).

224. SMITH & WALTER, *supra* note 143, at 131.

225. Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why not Disclose?*, 23 CARDOZO L. REV. 1419, 1426 (2002).

226. COMPARE SECURITIES INDUSTRY ASSOCIATION, *supra* note 3, at 69, with Proxy Voting by Investment Companies, Securities Act Release No. 8188 (Transfer Binder 2002-2003), Fed. Sec. L. Rep. (CCH), ¶ 86826, at 87,144 (Jan. 31, 2003).

227. SMITH & WALTER, *supra* note 143, at 121.

228. PENSION AND WELFARE BENEFITS ADMINISTRATION, STUDY OF 401(K) PLAN FEES AND EXPENSES, at ¶ 2.4, 2.5 (Apr. 13, 1998) [hereinafter DOL Fee Study].

229. INVESTMENT COMPANY INSTITUTE, *supra* note 219, at figs. 8, 10 (calculation assumes that 60% of hybrid funds in table 10 are in equities). Employer stock currently accounts for 15% of plan assets. See Alicia H. Munnell & Annika Sunden, *401(k) Plans are Still coming up Short*, ISSUE IN BRIEF NO. 43, at 4 (Center for Retirement Research at Boston College, Mar. 2006). A separate publication of the Investment Company Institute gives a significantly higher estimate of mutual fund equity holdings based on 2003 data. See Sarah Holden & Jack VanDerhei, *401(k) Plan Assets Allocation, Account Balances, and Loan Activity in 2003*, 10 PERSP., No. 2, at 2 (Investment Company Institute, August, 2004) (45 percent in equity funds and 9 percent in balanced funds). It reports that guaranteed investment contracts and other stable value funds offered by insurance companies and banks account for about 13 percent of assets; bond funds for 10 percent; and money market funds for 5 percent. The balance presumably consists of group variable annuities, participant brokerage accounts, and other investment vehicles administered

has been stimulated in part by the popularity of 401(k) plans. The 401(k) market represents about 25 percent of the total business of mutual funds;²³⁰ and 45 percent of the market for individual retirement accounts – representing approximately 15 percent of the mutual fund market — represents rollovers of lump sum distributions from 401(k) and other defined contribution plans.²³¹

In the deregulated environment of the 1990s, the market for 401(k) assets and mutual funds led to an interpenetration of markets by an array of financial service firms and to the prominence of large integrated financial service companies. The investment management companies operating mutual funds offered their services as investment managers to corporate sponsors of 401(k) and traditional plans. Commercial banks launched their own families of mutual funds and competed with insurance companies in the field of investment management. Insurance companies expanded beyond their traditional sideline of annuity contracts into guaranteed investment contracts and mutual fund ownership.²³² Investment advisers with staffs of thousands of employees were found as departments of large financial conglomerates.²³³

2. Conflicts of Interest

The profit-making incentive of the investment managers of pension plans creates a basic conflict of interest issue: the managers wish to increase fee income and assets under management, while pension plan beneficiaries want the best possible risk-adjusted investment performance net of fees and expenses.”²³⁴ Proxy voting presents narrower and more specific conflict of interest issues. Investment managers have much to lose by courting corporate disfavor, especially when they are aggressively seeking other lines of business. Anti-management votes may invite reprisal or simply engender a reputation for

by financial service firms. See MUNNELL & SUNDEN, *supra* note 218, at 68-94. The Pension and Welfare Benefits Administration gives a generally comparable breakdown of 401(k) assets based on 1996 data. See DOL Fee Study, *supra* note 228, at ¶ 2.4.

230. In 2005 U.S.-regulated Investment Company Assets were \$9.5 trillion; 94 percent of the assets or 8.9 was held by mutual funds. INVESTMENT COMPANY INSTITUTE, THE INVESTMENT COMPANY FACT BOOK, available at http://www.icifactbook.org/pdf/2006_factbook.pdf. For assets of 401(k) plans, see references *infra* notes 219 and 221.

231. See INVESTMENT COMPANY INSTITUTE, *supra* note 219, at figs. 5-6.

232. SMITH & WALTER, *supra* note 143, at 121-138.

233. For information on the investment adviser industry, see the website of the Investment Advisers Association (until recently Investment Counsel Association of America), at <http://www.icaa.org>.

234. SMITH & WALTER, *supra* note 143, at 123.

activism that is bad for profitable business relationships.²³⁵ Only a relatively few corporate governance measures relating to takeover defenses and management entrenchment have an immediate impact on the market value of corporate stock, and their impact is of marginal importance.²³⁶ Thus, proxy-voting decisions figure little in an individual investment manager's quarterly performance record, even though the decisions have an important system-wide impact on corporate monitoring. Where mutual funds are actively managed (and most are), investment managers are likely to have another compelling concern. The managers commonly see their competitive advantage as depending on access to corporate executives for quality information.²³⁷ They may be reluctant to take any action that could antagonize corporate executives who are in a position to issue invitations to briefings, respond to inquiries and notify them of the release of sensitive information.

The conventional remedies for conflict of interest are the superficially inconsistent strategies of disclosure and confidential voting. The former is now in effect as the result of a 2003 SEC disclosure rule. Recognizing the important impact of proxy voting by mutual funds, the SEC required that, beginning with the 2003-2004 fiscal year, mutual funds must file with the Commission a detailed record of how they voted all proxies for the twelve-month period ending June 30. The voting record must be filed no later than August 31 of the year and must be made available to stockholders either on the fund's website or on request.²³⁸ The filings now reveal for the first time how mutual funds exercise their proxy voting power.

As separately analyzed by researchers at Baruch College and the University of Michigan, the proxy voting patterns of mutual funds since mandatory disclosure reveal considerable differences among funds and particular issues, but still display an alignment with management positions that is sufficiently strong to frustrate the goal of corporate self-regulation.²³⁹ Of the ten largest fund families, Vanguard

235. PETER A. GOUREVITCH & JAMES J. SHINN, *POLITICAL POWER AND CORPORATE CONTROL, THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* 241 (2003).

236. See LUCIAN BEBCHUK ET AL., *WHAT MATTERS IN CORPORATE GOVERNANCE?* 6-9 (Olin Center for Law, Economics and Business, Discussion Paper No. 491, 2004). The authors list staggered boards, limits to amendment of by-laws, supra-majority requirements for mergers and charter amendments, poison pills, and golden parachutes. *Id.*

237. Palmiter, *supra* note 225, at 1481.

238. See Securities Act Release No. 8188, *supra* note 226, at 87, 142. The release also requires mutual funds to file statements of policies or practices guiding how they vote proxies for stocks in their portfolio.

239. See GERALD F. DAVIS & E. HAN KIM, *WOULD MUTUAL FUNDS BITE THE HAND THAT FEEDS THEM? BUSINESS TIES AND PROXY VOTING* (Stephen M. Ross School of Business, Uni-

voted against management 29 percent of the time, though mostly on issues where its vote had little effect;²⁴⁰ T. Rowe Price opposed management on only 8 percent of the votes.²⁴¹ The compelling interest of preserving access to corporate sources of information was evidence among firms relying on such information. A group of funds that selectively pick long-term positions in particular companies voted with management on no less than 95 percent of the votes;²⁴² similarly, the broad category of actively managed funds voted with management somewhat more often than index funds.²⁴³ A certain tendency toward herd behavior appeared in the nearly wholesale defection of funds from management support of classified boards²⁴⁴ and a frequent opposition to management on anti-takeover and management entrenchment issues.²⁴⁵ The funds, however, generally supported management on executive compensation issues, voting overwhelmingly against measures to limit executive compensation and, by varying margins, against most related proposals.²⁴⁶ In all, the Baruch study found that the ten largest mutual funds favored management positions on 83 percent of the votes, with most votes opposing management concentrated in shareholder proposals related to management entrenchment issues and takeover defenses.²⁴⁷

Paradoxically, the long-championed practice of confidential voting remains a viable strategy to complement mutual fund disclosure.²⁴⁸ True, as one critic charged, confidentiality is the “exact opposite” of disclosure.²⁴⁹ But a rule requiring confidential voting of proxies

versity of Michigan, working paper, 2005) [hereinafter Michigan study]; BURTON ROTHBERG & STEVEN LILIEN, MUTUAL FUNDS AND PROXY VOTING: NEW EVIDENCE ON CORPORATE GOVERNANCE (Zicklin School of Business, Baruch College, working paper, 2005) [hereinafter Baruch study]. The Michigan study included data of 21 fund families; the Baruch study was limited to the 10 fund families with largest equity holdings.

240. JOHN C. HARRINGTON, *THE CHALLENGE TO POWER* 286-287 (2005).

241. The Baruch study, *supra* note 239, at 15, 34.

242. *Id.* at 18-19, 36. The sample was based on a group of funds featured by the Wall Street Journal as exemplars of this approach to investing.

243. *Id.* at 20, 36.

244. The Michigan study, *supra* note 239, at 19.

245. *Id.* at 20, Tables 4 and 5; the Baruch study, *supra* note 239, at 35.

246. Compare the Michigan study, *supra* note 239, at 17 (“essentially unanimous in voting against limiting executive compensation”) and the Baruch study, *supra* note 239, at 13 (13 percent voted against management on “executive compensation”).

247. The Baruch study, *supra* note 239, at 16, 35.

248. The idea of the secret ballot in corporate elections has a long history and today about 27 percent of S&P 500 companies have confidential voting procedures. See 5 LOSS & SELIGMAN, *supra* note 66, at 1967-1968 n.133; Preamble, Securities Act Release No. 8188, *supra* note 226, at 87,149 n.35; MONKS & MINOW, *supra* note 111, at 231-232.

249. Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 J. LEGAL STUD. 465, 479 (2003).

serves to shield fiduciary voting from management interference *prior* to the shareholder meeting; the mutual fund disclosure rule allows public scrutiny of voting two months or more after the shareholder meeting.²⁵⁰ At this interval, proxy votes against management may be less likely to draw corporate displeasure and will be offset by other influences in the market. Confidential voting, however, is directed at a minor manifestation of conflict of interest – actual intervention by corporate executives in proxy voting. Because conflicts of interest operate in pervasive and concurrent ways, it is not surprising that a corporation's adoption of confidential voting has not historically changed voting patterns significantly. Confidential voting belongs in a package of corporate reforms as an assurance of propriety in corporate elections, but it does not itself have much impact on proxy voting.²⁵¹

3. Fiduciary Issues

The modest effect of reforms based on disclosure or confidentiality highlights the vital importance of the fiduciary structure of 401(k) plans. The primary purpose of the fiduciary rules, however, pertains to the beneficiaries' financial interest in securing a retirement income. Considerations of corporate governance are persuasive only if they are congruent with policies relating to the beneficiaries' interests in the administration of retirement benefits. Thus, to reach the subject of our inquiry, we must first examine the fiduciary rules governing employee-directed plans and examine their effect in serving the beneficiaries retirement needs.

The fiduciary provision governing the bulk of 401(k) plans, ERISA Section 404(c), serves a function today that could not have been foreseen at the time ERISA was enacted.²⁵² As discussed in an earlier section, Section 404(a) was intended to incorporate the common law fiduciary principles of trust law. Subsection (c) of Section 404 recognized a rule of minor importance in trust law that was then pertinent to certain savings plans funded with after-tax employee contribu-

250. In the preamble to the mutual fund disclosure rule, the SEC made this distinction in rejecting arguments that the rule would undermine the principles of confidential voting. Securities Act Release No. 8188., *supra* note 226, at 87,149.

251. See Romano, *supra* note 249, at 487.

252. ERISA § 404(c) has come under close scrutiny in recent legal scholarship. Studies of particular interest include: Stabile, *supra* note 222; Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L. J. 1 (2000); Jayne Elizabeth Zanglein, *Investment Without Education: the Disparate Impact on Women and Minorities in Self-Directed Defined Contribution Plans* 5 EMP. RTS. & EMP. POL'Y J. 223 (2001).

tions:²⁵³ the rule required the trustee to act in accordance with the exercise of a power granted to the beneficiary or a third party by the trust instrument.²⁵⁴ Applying the rule to retirement plans, subsection (c) provided that, where a pension plan permits a beneficiary to exercise control over the assets in an individual account, the plan fiduciary is not liable for any loss resulting from the beneficiary's exercise of such control.²⁵⁵ In the ERISA conference report, the explanation of subdivision (c) occupies 2 paragraphs out of 152 pages and appears under the heading 'certain individual account plans.'²⁵⁶

With the historic shift toward 401(k) plans, the exception of 404(c) has become the most common pattern for fiduciary relationships in private employer-sponsored pension plans. In this new role, Section 404(c) effectively relieves the corporate sponsor of fiduciary responsibility for the plan. It is true that ERISA offers the possibility of holding 404(c) fiduciaries accountable under the general fiduciary standards in initially choosing or maintaining investment alternatives in a 401(k) plan.²⁵⁷ But Section 404(c) offers a potent affirmative defense that discouraged any litigation²⁵⁸ until the post Enron and WorldCom era.²⁵⁹ It is only in the past five years that the courts have held corporate sponsors liable for selecting or failing to monitor an

253. Stabile, *supra* note 222, at 362 n.11.

254. RESTATEMENT (SECOND) OF TRUSTS § 185, provides: "If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power."

255. ERISA § 404(c) states in pertinent part: "in the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)— . . . (B) no person who is otherwise a fiduciary shall be liable under this part for any loss, . . . which results from such participant's or beneficiary's exercise of control." 29 U.S.C. § 1104(c) (2007).

256. H.R. REP. NO. 1280, at 5085-5086 (1974) (Conf.Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5038-5190.

257. See Letter from the Pension and Welfare Benefits Administration, U.S. Dept. of Labor, to Douglas O. Kant (Nov. 26, 1997) *quoted in In re Enron Corp. Sec., Derivative & ERISA*, 284 F. Supp. 2d 511, 578 (S.D.Tex. 2003). Medill discusses alternative scenarios for holding 401(k) fiduciaries liable under this general fiduciary standard. See Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 MICH. J. L. REFORM 469 (2001).

258. With regard to the status of section 404(c) as an affirmative defense, see *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 444-445 (3d Cir. 1996); *Woods v. S. Co.*, 396 F. Supp. 2d 1357, 1367 (N.D. Ga. 2005); *In re Sprint Corp. ERISA Litig.*, 388 F. Supp. 2d 1207, 1234 (D. Kan. 2004).

259. In 2003, the District Court in the Enron litigation remarked that "[t]here is little case law regarding s 404(c) plans." See *In re Enron*, 284 F. Supp. 2d. at 575. *But see Allison v. Bank One-Denver*, 289 F.3d 1223, 1238 (10th Cir. 2002) (finding that the fiduciary never implemented a participant-directed option); *In re Unisys Sav. Plan Litig.*, 74 F.3d 145, 443-448 (3d Cir 1996) (holding that the employer had not established a 404(c) defense for purpose of summary judgment); *Franklin v. First Union Corp.*, 84 F. Supp. 2d 720, 731-732 (E.D.Va. 2000) (rejecting con-

investment option, and the decisions have been confined to investment in employer stock, usually with matching employer stock contributions.²⁶⁰ Even in this area, a plan provision restricting the employee to investing no more than 50 percent of their contributions in employer stock served to shield one employer from liability.²⁶¹

In 1992, recognizing the new importance of Section 404(c), the Department of Labor issued regulations setting forth standards that must be satisfied to give participants meaningful control over plan investments as required by the statute.²⁶² First, the plan must offer “a broad range of investment alternatives” that includes three diversified investment alternatives with “materially different risk and return characteristics.”²⁶³ The prologue to the regulations describes these investments as the “core” investment alternatives.²⁶⁴ The participants, however, are free to decide whether or not to make such diversified investments. If they wish, they may place all their investments in fixed-income securities or employer stock. Secondly, the plan must give participants an effective power to instruct the trustee, with reasonable frequency, as to their investment choices.²⁶⁵ Thirdly, the plan participants must be given a list of relevant information – sometimes included in a mutual fund prospectus — and the right to request certain other information.²⁶⁶

Ironically, one effect of the regulations has been to define more clearly the safe harbor that employers may use to minimize further fiduciary involvement in a plan. A well-crafted plan complying with the regulations will go far toward insulating employers from further responsibility for the success of the plan.²⁶⁷ The same undesired effect

tention that section 404(c) restricted amendment of plan); *Connor v. MidSouth Ins. Agency*, 943 F. Supp 647 (W.D. La. 1995) (holding the plan at issue did not come within section 404(c)).

260. See *In re WorldCom, Inc.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003); *In re Williams Co. ERISA Litig.*, 271 F. Supp. 2d 1328 (N.D. Okla. 2003); *In re Enron*, 284 F. Supp. 2d. 511 (S.D. Tex. 2003); *In re Syncor ERISA Litig.*, 351 F. Supp. 2d 970 (C.D. Cal. 2004); *Rogers v. Baxter Intern., Inc.*, 417 F. Supp. 2d 974, 988-989 (N.D. Ill. 2006); *Lively v. Dynegey*, 420 F. Supp. 2d 949 (S.D. Ill. 2006).

261. *In re Schering-Plough Corp. ERISA Litig.*, 387 F. Supp. 2d 392 (D. N.J. 2004). The plan provided that employees could not elect to invest more than 50 percent of their contributions to an employer stock fund. Distinguishing the Enron decision, the court noted the Enron employee contributions were invested primarily in employer stock with employer matching contributions. *Id.* at 400.

262. For an overview of the regulations, see Nell Hennessy & Frank Daniele, *Participant-Directed Retirement Plans under section 404(c)*, in *ERISA FIDUCIARY LAW*, *supra* note 117, at 175.

263. 29 C.F.R. § 2550.404c-1(b)(3)(i) (2007).

264. 57 Fed. Reg. 46, 906 (1992).

265. 29 C.F.R. § 2550.404c-1(b)(2) (2007).

266. 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1) (2007).

267. See Stefanie Kastrinsky, *ERISA Section 404(c) and Investment Advice: What is an Employer or Plan Sponsor to Do?*, 80 CHI-KENT L. REV. 903, 915 (2005)

of drawing boundaries to the corporate sponsor's fiduciary responsibility has resulted from regulations defining investment advice.²⁶⁸ The functional definition of a fiduciary in Section 3(21)(A) contains a subdivision (ii) that imposes fiduciary responsibility on a person who gives investment advice for compensation.²⁶⁹ The Department of Labor has issued interpretative regulations of this provision²⁷⁰ and elaborated on the definition of investment advice in a 1996 revenue ruling describing certain kinds of educational materials that would not trigger fiduciary responsibility.²⁷¹ Though applying to investment advisers, the regulatory guidelines draw a bright line defining where fiduciary responsibility ends. The corporate sponsor, who has no affirmative duty to provide investment advice,²⁷² can avoid triggering fiduciary responsibility by avoiding activity that comes within the precise guidelines defining investment advice.

Three systemic problems of 401(k) plans have a connection with the existence of limited fiduciary responsibility under ERISA 404(c): the erosion of benefits by fees and other costs, naïve and uninformed investment decisions, and the absence of financial planning in the distribution of lump sum benefits. Because the primary purpose of fiduciary rules is to serve retirement needs, we must examine these systemic problems and possible remedies before addressing the effects on corporate governance.

a. Fees and Other Expenses

Total annual costs of 401(k) plans charged to beneficiaries' accounts amount, on average, to roughly 1.4 percent of plan assets, according to two surveys of firms providing 401(k) plan services reported in a 1998 study of the Department of Labor.²⁷³ But the expenses vary widely among plans; some charge as little as 0.6 percent and others over 2

268. See CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC., EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA): AN EVALUATION AFTER 25 YEARS, at 4 (An Educational White Paper, 1999); Medill, *supra* note 252, at 69; Zanglein, *supra* note 252, at 262.

269. 29 U.S.C. § 1002(21)(A)(ii) (2007). See also definition of a fiduciary in IRC § 4975(e)(3) and general discussion of the provision in BINES & THEL, *supra* note 16, at 744-745.

270. 29 C.F.R. § 2510.3-21 (2007).

271. 29 C.F.R. § 2509.96-1(d) (2007). The materials fall in four categories: plan information, general financial and investment information, asset allocation models, and interactive investment programs to assist in financial planning.

272. See 29 C.F.R. § 2550.404c-1(c)(4) (2007) ("fiduciary has no obligation . . . to provide investment advice to a participant or beneficiary under an ERISA section 404(c) plan.") and 29 C.F.R. § 2509.96-1(b) n.1 (2007) (compliance with section 404(c) "does not require that participants and beneficiaries be offered or provided either investment advice or investment education . . . to assist them in making investment decisions.")

273. DOL Fee Study, *supra* note 228, at § 4.3.

percent—a variance by a factor of nearly four.²⁷⁴ The amount of fees will materially affect ultimate retirement benefits of participants. Over the course of an employee's career, an additional fee equal to 1 percent of assets may result in a reduction of the employee's ending balance by 20 to 25 percent.²⁷⁵ Critics claim that many plans absorb as much as 1 percent of unnecessarily high fees and expenses,²⁷⁶ and the claim is inherently plausible since a differential of 1 percent is frequently encountered in the market place for 401(k) plan services.²⁷⁷

In managing fees and expenses, plan sponsors face an array of options, many of dizzying complexity and presenting difficult problems of comparison. A study cited by the Department of Labor report found that “78 percent of plan sponsors did not know how much their costs were, largely because there are about 80 different ways in which vendors charge fees.”²⁷⁸ Some fixed income funds and insurance products do not disclose management fees.²⁷⁹ While the SEC does require mutual funds to disclose management fees and expenses in the fund prospectus and in annual reports to shareholders,²⁸⁰ anyone diligent enough to find the mandated disclosures will still need a high level of technical knowledge and an ample allowance of time to ferret out hidden costs and to estimate the actual impact of fee schedules on a particular plan.²⁸¹ Most plan sponsors retain a financial services firm to provide all investment management services and specified administrative tasks. These firms typically offer varying services and options, which all come at a cost that must be weighed against their benefits.²⁸²

274. *Id.* at tbl. IV-6.

275. *See id.* at § I; MUNNEL & SUNDUN, *supra* note 218, at 78 (similar hypotheticals).

276. DOL Fee Study, *supra* note 228, at § 3.7.

277. *Id.* at tbls. IV-2, IV-3, IV-8, and § 5.3; Jeffrey M. Laderman, *That 401(k) May Cost More than You Think*, BUS. WEEK, Nov.10, 1997, at 130 (full service providers charge fees as high as 2.87; the average is 1.29); Ellen E. Schultz & Vanessa O'Connell, *A 401(k) Surprise: Fees Keep Going Up and Up*, WALL ST. J., Nov. 12, 1997, at C1 (investment fee .53 to 2.56; administrative fees 0 to \$75 per account); J.B. Quinn, *Your 401(k) Plan Could Be Robbing You*, WASH. POST, Jan. 11, 1998, at H2 (total cost often 2 or 3 percent).

278. DOL Fee Study, *supra* note 228, § 3.7. For a succinct description of the various categories of mutual fund fees, see Nell Hennessy, *Follow the Money: ERISA Plan Investments in Mutual Funds and Insurance*, 38 J. MARSHALL L. REV. 867-874.

279. DOL Fee Study, *supra* note 228, § 2.4.2, 2.5.1, and 3.7.

280. *See* I.C. Release 26327, Shareholder Reports and Quarterly Portfolio Disclosures of Regulated Management Investment Companies, 69 Fed. Reg. 11243-11246 (Mar. 9, 2004). Supplements earlier releases, *see* I.C. Release No 16244, 53 Fed. Reg. 3192 (Feb. 1, 1988); I.C. Release no. 26195, 68 Fed. Reg. 57760 (Sep. 29, 2003).

281. *See* John P. Freeman & Steward L. Brown, *Mutual Fund Advisory Fees: the Cost of Conflict of Interest*, 26 J. CORP. L. 609, 662-667 (2004)

282. *See* Kastrinsky, *supra* note 267, at 916-921 (discussing investment advisory services).

The bulk of 401(k) mutual fund investments are in retail funds charging fees that have drawn criticism from financial experts.²⁸³ The growth of mutual funds might be thought to introduce economies of scale,²⁸⁴ but in fact fees have crept upward in the past quarter century. Estimates of fee increases, measured by the value of expenses to total assets in a fund, cluster around an increase of 30 to 40 percent.²⁸⁵ The mutual fund market, it appears, has displayed a low level of cost competition;²⁸⁶ most mutual fund purchasers do not understand fees and do not trouble themselves about them.²⁸⁷ Freeman and Brown found that the management fees paid by public pension funds as the result of arm's-length negotiations are about a half the size of fees paid by the purchasers of retail funds.²⁸⁸ Yet, 401(k) plan sponsors do have low-cost options: one major family of funds touts its low fee schedules, index fund fees are generally lower, and funds available only to institutional investors, such as pension funds charge fees that are about half a percentage point lower than retail funds.²⁸⁹

Plan fiduciaries also face issues of dual loyalties in managing administrative costs of 401(k) plans (*i.e.* the costs of collecting money, keeping records, making required filings, distributing money, and providing information).²⁹⁰ Many of these expenses may be charged either to the corporation or to the account balances of plan beneficiaries.²⁹¹ The 1998 Department of Labor study found a strong trend for corporate sponsors to pass on to the beneficiaries' administrative expenses that were once almost universally borne by management.²⁹²

283. See DOL Fee Study, *supra* note 228, at § 2.4.1 (retail funds account for 80% of mutual fund investments). For criticisms of retail mutual fund fees, see Andrea L. Prochniak, *Does Your Fund cost Too Much?*, FORTUNE, Dec. 25, 1995, at 145; Maggie Topkis, *Getting Wise to Mutual Fund Fees*, FORTUNE, Dec. 23, 1996, at 191; Christopher Oster, *Fees? You Mean Mutual Funds have Fees?*, WALL ST. J., July 14, 2000, at C1.

284. Freeman & Brown, *supra* note 281, at 619-627.

285. Freeman & Brown, *supra* note 281, at 620-621; DOL Fee Study, *supra* note 228, at § 3.4.3.

286. *Id.* at 655; D. K. Malhotra, *An Empirical Analysis of Mutual Fund Expenses*, 20 J. FIN. RES. 175-176 (1997).

287. Oster, *supra* note 283.

288. Freeman & Brown, *supra* note 281, at 627-636.

289. The Vanguard family of funds seeks to appeal to price conscious investors. See Freeman & Brown, *supra* note 281, at 618. For fees of index funds and institutional funds, see DOL Fee Study, *supra* note 228, at §§ 2.4.1.3 and 4.2.1 and tbl. IV-3.

290. See Hennessy, *supra* note 278, at 875-878.

291. See DOL Fee Study, *supra* note 228, at § 3.4.1. A consideration of equity among beneficiaries arises when costs may be assessed either as a percentage of assets or on a per capita basis, shifting more of the burden to low-income employees. For a general discussion of administrative costs, see PETER DIAMOND, ADMINISTRATIVE COSTS AND EQUILIBRIUM CHARGES WITH INDIVIDUAL ACCOUNTS (National Bureau of Economic Research, Inc. Working Paper 7050, 1999).

292. DOL Fee Study, *supra* note 228, at §§ I and 5.3.2. Such administrative and non-investment management expenses typically account for between 25 and 10 percent of total plan costs.

Plan participants have no control over the fees and expenses in the menu of options offered by their plan sponsor and ordinarily have little opportunity to engage in a cost comparison among these options. The responsible management of expenses must come from corporate executives who have the financial expertise to control plan expenses and to introduce more price competition into the market for plan services.²⁹³

b. Investment Decisions

“Choices are beneficial,” the economist and psychologist George Loewenstein remarks, “when people know what they are deciding about and believe that their decisions are important. They can be harmful, however, when people lack relevant information or expertise.”²⁹⁴ While the opportunity for choice offered by 401(k) plans appeals to some participants,²⁹⁵ other employees, who lack expertise or interest in financial matters, make their investment decisions while burdened by anxiety, fear of failure, and information overload.²⁹⁶ Ultimately, these employees tend to rely on one of several adaptive strategies that most readers – if they are honest – will confess to having used themselves in similar circumstances. There is the strategy of

DOL Fee Study, *supra* note 228, at § 3.6. See also Virginia Munger Kohn, *When Hidden Fees Erode 401(k)'s*, N.Y. TIMES, July 22, 2001, at Bus. 8; Laderman, *supra* note 277; Schultz & O'Connell, *supra* note 277.

293. See CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC, *supra* note 268, at 3-4 (“Before there were participant-directed plans, investment decisions were made by investment committees. These committees consisted of corporate financial officers, portfolio managers, professional analysts, and investment management consultants – all of whom typically had formal education and experience in finance and investments. It was not at all uncommon to find CFOs, CPAs, MBAs, CFAs, and others will similar backgrounds holding positions on the investment committee. With the advent of participant direction, everyone from the receptionist to the research chemist now is expected to be his or her own investment committee.”).

294. George Loewenstein, *Is More Choice Always Better?*, at 1 (National Academy of Social Insurance, Social Security Brief, 1999). See also Zanglein, *supra* note 252, at 246-255 (surveying research showing the inadequate financial knowledge of 401(k) participants).

295. JAMES J. CHOI ET AL, PLAN DESIGN AND 401(K) SAVINGS OUTCOMES, 8, 15, (National Bureau of Economic Research, Working paper 10486, 2004); Zanglein, *supra* note 252, at 248; Medill, *supra* note 252, at 19 (A 1994 survey revealed that 62% of participants wanted to make their own investment decisions, but the same survey found that only 26% of participants believed themselves to be well qualified to do so).

296. MUNNELL & SUNDEN, *supra* note 218, at 83 (large number of options offered in large plans); JULIE AGNEW & LISA R. SZYKMAN, ASSET ALLOCATION AND INFORMATION OVERLOAD: THE INFLUENCE OF INFORMATION DISPLAY, ASSET CHOICE AND INVESTOR EXPERIENCE (Center for Retirement Research at Boston College, 2004) (finding that many investors lack even a basic understanding of financial concepts; explores effects of information overload); Shlomo Benartzi & Richard H. Thaler, *How Much is Investor Autonomy Worth?* 57 J. OF FIN., at 1593, 1598 (2002) (employees tend to be unhappy with their investment choices and prefer the median choice of other investors).

extremes avoidance; when faced with a spectrum of choices employees will choose the middle course.²⁹⁷ Alternatively, some employees employ the 1/n strategy by dividing their investment in each option by the number of choices.²⁹⁸ Other strategies are calculated to minimize the psychic cost of uninformed decision making. Some employees will seek to minimize the likelihood of future regret by choosing conservative options that will not fail.²⁹⁹ Finally, there is the phenomenon of "anchoring." Once having made a decision, employees are reluctant to expend the time and effort to revisit it, even though circumstances may change and the decision itself may have been based on more or less arbitrary criteria.³⁰⁰

In light of such naïve adaptive strategies in 401(k) investments, it is not surprising to find recurring deficiencies in the investment patterns in 401(k) accounts. The first casualty is the cardinal principle of diversification. While plan sponsors are required to offer a core group of diversified investment options,³⁰¹ roughly half of 401(k) plan participants stray widely from the principle of diversification by concentrating excessively in fixed income investment, equity investments,³⁰² or employer stock.³⁰³ It is particularly unfortunate that low-income employees figure prominently among those who opt for conservative

297. Benartzi & Thaler, *supra* note 296, at 1607-1611.

298. Shlomo Benartzi & Richard H. Thaler, *Naïve Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. REV. 79-81, 87 (Mar. 2001)

299. Loewenstein, *supra* note 294, at 3.

300. Olivia S. Mitchell & Stephen P. Utkus, *Lessons from Behavior Finance*, in PENSION DESIGN AND STRUCTURE 18 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004); Benartzi & Thaler, *supra* note 296, at 1596; INVESTMENT COMPANY INSTITUTE, 401(K) PLAN PARTICIPANTS: CHARACTERISTICS, CONTRIBUTIONS, AND ACCOUNT ACTIVITY 6-7 (Spring 2000) (60% of plan participants in survey had not changed the allocation of their contributions at any time since joining the plan).

301. See discussion *infra* Part II.F.3.

302. Sarah Holden & Jack VanDerhei, *supra* note 229, at figs.6, 7 (Investment Company Institute, August 2004); Julie Agnew *et al.*, *Portfolio Choice and Trading in a Large 401(k) Plan*, 93 AM. ECON. REV. 193 (2003); MUNNELL & SUNDEN, *supra* note 218, at 80-81; Gordon P. Goodfellow & Sylvester J. Shreiber, *Investment of Assets in Self-directed Retirement Plans*, in POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY, at 77-80, tbls. 6-7 (Michael S. Gordon *et al.* eds. 1997).

303. In plans that offer company stock as an option, this investment accounts for nearly 42 percent of plan assets. See Benartzi & Thaler, *supra* note 298, at 90, tbl. 5. This disproportionate investment in company stock has been rightly criticized as an egregious departure from the principle of diversification. See MUNNELL & SUNDEN, *supra* note 218, at 95-124. But the issue is complicated. While a cap on employee investments in employer stock seems warranted, there are reasonable arguments to allow some departure from diversification principles in this area. Many employers match employee investments in company stock, thereby mitigating the investment risk; a low cap would curtail this source of plan contributions. Moreover, the employee stock holdings in their employer's represent in theory an avenue for an employee voice in the corporation, which could be encouraged by appropriate rules regarding voting and employee communication. See 29 C.F.R. §§ 2550.404c-1(d)(2)(ii)(E)(4)(v) and (vi) (2007) See generally

fixed income investments, such as money market funds and guaranteed investment contracts.³⁰⁴ They are the segment of the workforce that most need to balance security and growth in their 401(k) investments. The consequences of inappropriate asset allocations are familiar to those with specialized investment knowledge,³⁰⁵ but employees seizing on simple rationales to resolve complex issues will inevitably err with some frequency in choosing allocations suitable for their age and financial circumstances.³⁰⁶ There is evidence that the trauma of decision making actually tend to discourage participation in 401(k) plans³⁰⁷ and hence can be counted among the causes of the inadequate preparation for retirement affecting a broad segment of the population.³⁰⁸

c. Distribution Decisions

Upon leaving a job covered by a 401(k) plan, employees must again navigate a course through poorly mapped reefs and shoals.³⁰⁹ Younger employees seeking new employment may leave assets in the existing 401(k) accounts, roll over the assets into an IRA or the 401(k) of a new employer, or take the account balance in a cash payment or series of payments. Most employees with small balances take and spend the cash balance, treating it as a kind of small windfall.³¹⁰ Employers can in any event compel cash distributions from small ac-

Jack L. VanDerhei, *The Role of Company Stock in 401(k) Plans*, 5 RISK MGMT & INS. REV., No. 1 (2002)

304. MUNNELL & SUNDEN, *supra* note 218, at 81-82; AGNEW & SZYKMAN, *supra* note 296, at 24.

305. Michael J. Brennan & Walter N. Torous, *Individual Decision-Making and Investor Welfare*, 28 ECON. NOTES, No. 2, 119-143 (July 1999) (calculating that the opportunity cost of investing half the optimal amount in equities for 20 years is comparable to having a portfolio management fee of 1 and a half percent per year); Dave Veeneman & Elizabeth McWhirter, *Implementing Effective Asset Allocation*, in WHEN WORKERS CALL THE SHOTS: CAN THEY ACHIEVE RETIREMENT SECURITY? (Dallas L. Salisbury ed., 1995).

306. Benartzi & Thaler, *supra* note 298, at 96.

307. Sheena Sethi-Iyengar *et al.*, *How Much Choice is Too Much? Contributions to 401(k) Retirement Plans*, in PENSION DESIGN & STRUCTURE, *supra* note 300, at 88-92; MUNNELL & SUNDEN, *supra* note 218, at 71-73.

308. CONGRESSIONAL BUDGET OFFICE, *BABY BOOMERS' RETIREMENT PROSPECTS: AN OVERVIEW 2* (Nov. 2003); Annemaria Lusardi, *Saving and the Effectiveness of Financial Education*, in PENSION DESIGN & STRUCTURE, *supra* note 300, at 157-159; Mark J. Warshowski & John Ameriks, *How Prepared are Americans for Retirement?*, in FORECASTING RETIREMENT NEEDS AND RETIREMENT WEALTH (Olivia Mitchell *et al.* eds., 2000) ("A majority of American households are predicted to fall short in funding retirement"). For a discussion of gender and ethnic disparities, see Zanglein, *supra* note 252, at 232-244.

309. See Susan J. Stabile, *The Behavior of Defined Contribution Plan participants*, 77 N.Y.U. L. REV. 71, 95-98 (2002).

310. Mike McCarthy & Liz McWhirter, *Are Employees Missing the Big Picture?*, BENEFITS Q., at 27 (First Quarter 2000).

counts of \$5,000 or less.³¹¹ The percentage taking cash distributions declines slowly as the size of the account rises. Thirty one percent of employees with accounts between \$25-50,000 request cash distributions but only 6 percent of those with accounts above \$100,000.³¹² The option of rolling over assets into an IRA has risen in popularity, but no more than 6 percent of employees exercise option of transferring their account balances to the 401(k) of a new employer, though it is often worthy of serious consideration.³¹³ The new employer's 401(k) plan may have lower costs or offer the option of a group annuity.

Investment decisions on retirement will vitally affect employees' financial future. The most recent statistics drawn from the period of 1992-2000 reveal that only 7.5 percent of retiring employees covered by a 401(k) plan applied their account balance to purchase a annuity offering lifetime income; 78 percent chose some form of installment payment of benefits or rollover to an IRA (which must later be distributed in cash by age 70 1/2) and about 15 percent requested a lump sum cash distribution at the time of retirement.³¹⁴ The foregone option of an annuity providing lifetime income has fateful consequences for the employee and society. Studies show that happiness during retirement is positively correlated with an assured lifetime income, that is, an annuity.³¹⁵ When employees take a lump sum or installment distribution, a significant fraction will outlive their retirement assets, causing distress in their own lives and a probable cost to society.³¹⁶

Why do employees retiring from 401(k) plans neglect the option of an annuity? The most obvious explanation is that about one third of 401(k) plans traditionally offered employees only the option of participating in a group annuity and individual annuities are notoriously more expensive.³¹⁷ But employees also find the choice of an annuity to involve difficult trade-offs. By using an account balance to

311. I.R.S. Reg. 1.411(a)-11(c)(3)(ii).

312. McCarthy & McWhirter, *supra* note 310, at 27.

313. *Id.* at 26. The figure of 6 percent is from 1998 but it had remained flat in previous years.

314. See GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: PARTICIPANTS NEED INFORMATION ON RISKS THEY FACE IN MANAGING PENSION ASSETS AT AND DURING RETIREMENT, GAO-03-810, at 43, tbl. 2 (July 2003). For mandatory IRA distribution, see I.R.C. § 401(a)(9) (2007).

315. Constantyn W. A. Panis, *Annuities and Retirement Well-Being*, in PENSION DESIGN & STRUCTURE, *supra* note 300, at 259-274.

316. For a discussion of social harm of inadequate retirement planning, see Stabile, *supra* note 222, at 394-396.

317. The GAO study found that 38 percent of defined contribution plans had an annuity option, but it notes that a separate study of the Profit Sharing Council of America found only 28 percent had this option. GENERAL ACCOUNTING OFFICE, *supra* note 314, at 11, 14. With regard to individual annuity costs, see DIAMOND, *supra* note 291, at 13 (1999).

purchase an annuity, employees give up irrevocably things of certain value – the immediate enjoyment of accumulated wealth and prospect of a legacy to children — and in exchange they get a flow of income with a value based on arcane technical calculations and uncertain expectations of mortality. Faced with such a tradeoff, employees tend to undervalue annuities or to procrastinate. TIAA-CREF, a defined contribution plan, traditionally only offered employees the option of converting their ending balance into an annuity, but in the 1990s it introduced three other choices: the possibility of deferring payment while receiving income, an installment payout, and a lump sum payout. In 2001, 45 percent of retiring employees chose an annuity, 17 percent chose deferred distribution and 38 percent took a cash payout.³¹⁸ The statistics provide a kind of percentage benchmark of employees that (wisely or unwisely) will choose an annuity if they are given sound advice and a financially attractive group annuity. The fact that only 7.5 percent of employees retiring from 401(k) plans make this choice can be explained only by poor financial guidance and the unavailability of employer-sponsored group annuities.

3. Fiduciary Responsibility

These problem areas of 401(k) plans are each rooted in the limited and diffuse fiduciary structure of employee-directed plans. Like other pension plans, 401(k) plans demand continuous supervision: costs must be monitored, investment options reviewed, educational programs scheduled, and counseling services tailored to meet employee needs. The experience of 401(k) plans shows that they cannot run on a kind of auto-pilot, driven by employee choices, without active involvement of a plan fiduciary. In other words, responsible plan administration cannot be achieved without assigning responsibility for the effective administration of the plan.

In the past 15 years, there have been repeated efforts to improve 401(k) plans without addressing the underlying fiduciary structure provided by ERISA Section 404(c). It must be immediately conceded that these reform efforts have often been constructive and that other non-fiduciary reforms might be helpful. The SEC rules regulating the disclosure of mutual fund costs have prepared the ground for more effective cost monitoring.³¹⁹ The Department of Labor interpretative bulletin 96-1 creates ground rules for educational seminars, which

318. Loewenstein, *supra* note 294, at 5-6.

319. See discussion *infra* Part II.F.3.a.

have proven valuable,³²⁰ and authorizes interactive computer education that responds to the needs of some employees.³²¹ The Pension Protection Act of 2006 now allows financial services firms to engage in investment education and counseling within a safe harbor from prohibited transaction rules;³²² it may encourage the already expanding market for such services, though problems of costs and conflict of interest remain.³²³ The need for counseling on termination and retirement has been sadly neglected, but the recent GAO study discusses the possibility of improved employee notices and mandated group annuities.³²⁴

Nevertheless, reforms will fall short of their potential unless administered by a responsible fiduciary body. We may consider as an example the well conceived provision of the Pension Protection Act of 2006 removing barriers to automatic enrollment of employees in 401(k) plans.³²⁵ Plan provisions for automatic enrollment have proven an effective means of increasing participation by placing the burden on employees to opt out of the plan, but they must provide default options for individual investment accounts if an employee fails to exercise choice.³²⁶ Employers are exposed to liability for their default option choice and ordinarily take the safe course of stipulating a conservative investment, such as money market funds. For their part, employees are prone to accepting the default options without exercising the choice permitted in a 404(c) plan. Thus, automatic enrollment unfortunately tends to cause a shift in employee investment away from ap-

320. Lusardi, *supra* note 308, at 157, 171; David D. McCarthy & John A. Turner, *Pension Education: Does it Work? Does it Matter?*, BENEFITS Q., at 64 (First Quarter 2000).

321. Zanglein, *supra* note 252, at 259.

322. Section 601 of the Act adds a new subdivision 14 to ERISA § 408(b), which provides an exemption from the prohibited transaction rules from an "eligible investment advice arrangement," designed to reduce conflict of interest problems. Either the arrangement must provide that the fee received by the investment adviser will not vary depending on the investment option selected for the plan beneficiaries or it must employ a computer model, relying on objective criteria, that complies with detailed statutory specifications. See JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE PENSION PROTECTION ACT OF 2006, at 127-132. The Act and the Technical Explanation are available at the website of the Profit Sharing/401(k) Council of America. See www.pasca.org.

323. See Kastrinsky, *supra* note 267, at 916-921; John Hechinger, *Hiring a Pro to Pick Your Funds: Professional Management is Latest Option in Some 401(k) Plans, but Fees Can Be Steep*, WALL ST. J., at D1 (Oct. 21, 2003); Medill, *supra* note 252, at 52-62, 71-72 (discussing conflict of interest issues).

324. GENERAL ACCOUNTING OFFICE, *supra* note 314, at 22-29, 52-59.

325. Section 902 of the Pension Protection Act of 2006 adds a new section 401(k)(13) providing that an employer who adopts a "qualified automatic enrollment feature" will be regarded as complying with the nondiscrimination rules and the top heavy rule.

326. Rev.Rul. 98-30, 1998-1 C.B. 1273; Rev. Rul 2000-8, 2000-1 C.B. 617.

propriate standards of diversification and asset allocation.³²⁷ To achieve its potential, it must be combined with a judicious selection of investment options and active programs to educate and advise beneficiaries regarding suitable investment choices.

The most direct way to promote fiduciary responsibility is to impose such responsibility on a well identified group of administrators with the capacity to discharge their assigned duties. In large 401(k) plans, such a fiduciary body is likely to bear a strong resemblance to the boards of pension trustees required by the British Pension Act 1995. An effective fiduciary body must enlist the expertise of executives who are most likely to have the qualifications to monitor costs and investment strategies, but the presence of employee representatives – one third of the board in the British plan – is essential for successful plan administrations. The employee representatives, if properly chosen, can check conflicts of interest while providing needed input in the selection of investments and services. Their presence is particularly important in a 401(k) plan because of the need to present employees with appropriate options and services to guide their retirement planning.³²⁸ The plan fiduciaries must understand employees' needs and preferences. If they do not include employee representatives in their deliberations, the plan fiduciaries will labor under a handicap and may not fully grasp employees' needs.

4. Corporate Governance

Our analysis of 401(k) plans again reveals a form of management domination of pension fund participation in corporate governance. The power of management to select mutual fund investments in 401(k) plans creates a systemic pressure on the funds that tends to generate passive acceptance of management positions in proxy voting. An independent board of trustees on the British model can be expected also to loosen conflicts of interest and to inject a new element into the demand part of the equation – the preferences of employee representatives drawn from outside the circle of management.

327. Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. ECON., no. 4, 1149-187 (2001) (analyzing a large 401(k) plan before and after adoption of an automatic enrollment provision); Lowenstein, *supra* note 294, at 4-5; AGNEW & SZYKMAN, *supra* note 296, at 6.

328. The expectations of participants are a key factor in creating an effective program of financial education and advice. See Richard D. Glass, *Investment Education or Advice? That's the Wrong Question to Ask*, EMP. BENEFITS J., at 19 (June 2000). On the relationship between plan design and participant choice, see Mitchell & Utkus, in PENSION DESIGN & STRUCTURE, *supra* note 300, at 16-17, 31-34; AGNEW & SZYKMAN, *supra* note 296, at 13-15, 22.

The conflict of interest problems most affecting corporate governance are derived from the business relationships between mutual funds and management. An independent board of trustees, with beneficiary representatives, would insulate pension administration, to some degree, from management. Mutual funds would then do business with a clientele consisting of pension boards separated from management by clearly defined fiduciary accountability and the presence of a beneficiary representative. To the extent that their clientele would enjoy independence, the mutual funds themselves would be more free to exercise independent judgment in the proxy voting of corporate equities in pension funds.

The practical importance of this conflict of interest factor is admittedly uncertain since the proxy voting of mutual funds is subject to complex and concurrent explanations. The preference of most institutional investors for active trading and administrative inertia both work strongly in the favor of management.³²⁹ Shareholder activism requires an investment of staff time that is more easily justified with a long investment horizon. In addition, the investment managers overseeing the proxy voting process are tied to management by training and a common business culture. But the proxy voting of mutual funds still exhibits considerable variability; some pension managers *do* vote against management on some issues. The mitigation of conflict of interest can be expected to increase this variability, though the precise impact is impossible to predict.

Fiduciary reform of 401(k) plans could also change the demand factor affecting proxy voting by mutual funds. Management influence over such proxy voting serves to constrain the preference of constituencies in American society, outside the circle of management, that are concerned about corporate conduct. The participation of beneficiaries in the governing boards of 401(k) plans, while intended to assist the administration of retirement benefits, would also change the composition of the boards from the marketing perspective of mutual fund managers. The so-called socially responsible mutual funds, which are today almost shut out of the 401(k) market, would find a different, and possibly more receptive, market in boards of trustees with a new social composition.³³⁰ Other mutual fund managers, concerned about their image of corporate responsibility, might find a new incentive to claim a responsible proxy voting record and to vote in a

329. Coffee, *supra* note 9, at 1318-1335.

330. Personal communication with John C. Harrington, principal Harrington Investment, Inc. (Nov.17, 2006) (describing the difficulty of selling to corporate customers 401(k) plans that vote against management positions).

manner supporting such a claim. It is noteworthy that the huge Vanguard family of funds took certain tentative steps following the 2003 proxy disclosure rule to appeal to the post-Enron backlash of popular sentiment.³³¹ In short, the marketing of pension funds to independent pension boards, with beneficiary members, would create sales opportunities for mutual funds seeking to align their proxy voting record more closely to the values and expectations of segments of American public outside the circle of management.

As a practical matter, the proxy voting policies of mutual funds can be modified *only* by freeing a market demand for change. No one doubts that mutual funds are sensitive to all sectors of the market, but the internal governance of the funds is notoriously unresponsive to the investing public. With a few exceptions, mutual funds are operated by investment advisors that control all aspects of the funds' life, including investment decisions, marketing, and administrative services.³³² The funds have recourse to their own corporate governance procedures only on an *ad hoc* basis as required by the Investment Company Act of 1940.³³³ As an SEC release states, the investment advisers typically dominated the funds they advise as a result of "extensive involvement" in fund management and "the general absence of shareholder activism."³³⁴

One cannot predict with any confidence what effect the fiduciary reform of 401(k) plans would have on the corporate governance activities of mutual funds marketed to the 401(k) industry. The effect might be quite modest. On the other hand, it might gain significance in combination with other reforms suggested in this article. It is not implausible to suppose that mutual funds linked to the 401(k) market would more often join in coalitions of investors engaged in the active pursuit of corporate responsibility and that the herd behavior, now

331. In 2002, Vanguard voted in favor of the full slate of directors nominated to serve on the board of directors in 90 percent of the contests in which they voted; in 2003, they voted in favor of the full slate in 20 percent of the contests. In 2002, it voted for all auditor approvals; in 2003, it voted for 79 percent of the approvals. In the latter year, it also voted to approve only 36% of employer stock option plans. See Ken Brown, *Vanguard Gives Corporate Chiefs a Report Card*, WALL ST. J., Nov. 10, 2003, at C1, cited in GENERAL ACCOUNTING OFFICE, *supra* note 314, at 19.

332. For a good introduction to mutual fund organization, see Schonfeld & Kerwin, *supra* note 223. The Investment Company Act of 1940 is codified as 15 U.S.C. § 80a-1 through 80a-64 (2007).

333. Schonfeld & Kerwin, *supra* note 223, at 122-125; 3 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS, MUTUAL FUNDS AND ADVISORS* § 21.17, at 21.149 (2006 Supp.); Freeman & Brown, *supra* note 281, at 614-616.

334. See Role of Independent Directors of Investment Companies, Sec. Act Release No. 33-7754, [1999-2000 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212, at 82,451 (Oct 14, 1999).

apparent on the issue of classified boards, would spread to more issues.³³⁵

The speculative nature of these scenarios is not a reason to maintain the status quo. A reformed 401(k) fiduciary structure is dictated independently by the beneficiaries' interest in improved administration of retirement benefits. The benign effects on corporate governance are an additional consideration favoring reform. Though generally neglected in studies of 401(k) plans, the system-wide effects of the fiduciary structure on effective corporate monitoring is a factor that bears on the important question whether the power of mutual funds can be brought to serve the goal of corporate self-regulation.

III. CORPORATE SELF-REGULATION

My analysis thus far, if it has been persuasive, makes its own case for reform. I first noted the benefits of construing the statutory requirement of diversification in light of modern portfolio theory and a duty to monitor. In other sections, I have traced regulatory and legal anomalies lacking any legal or policy justification. Falling within this category are the discussions of overly broad securities regulations, the strange case of the Federal Savings Plan, and the restrictive impact of the Taft-Hartley Act. The most important issues have concerned the defective fiduciary structures imposed by ERISA on both employer-directed plans and 401(k) plans. The British Pension Act 1995 offers a compelling model for an independent board of trustees. This board would not only assure sound benefit administration but would also positively impact corporate monitoring by pension plans.

The reforms advocated here aim to partially restore to pension funds an influence proportionate to their share ownership by removing offensive obstacles and burdens. But it may be asked: what is the urgency of pursuing more effective corporate monitoring as a policy objective? The question is particularly acute when reforms can be expected to make no more than incremental improvements in a weak existing system of monitoring. The answer depends on whether the modest reforms advocated in this article can form part of a broader strategy for achieving a higher level of corporate self-regulation. Before discussing the prospects of such a strategy, I will turn to the theory of corporate self-regulation and the value of a pension plan voice in corporate governance.

335. For a critical view of potential herd behavior of mutual funds, see Palmiter, *supra* note 225, at 1485-1486.

A. *The Theory of Self-Regulation*

While economic theories have dominated legal scholarship on corporate governance,³³⁶ the scholarly literature of business administration has pursued a tradition of scientific management that borrows at times from allied fields of the life sciences.³³⁷ In recent decades, early twentieth century engineering methodologies have been complemented by concepts of organizational learning, renewal, and self-regulation that mirror in certain respects the architecture of life.³³⁸ At the same time, network organizations that radically depart from old hierarchical models, such as Visa International,³³⁹ W. L. Gore and Associates,³⁴⁰ and the Mondragon cooperatives,³⁴¹ have achieved recognition and business success. By positing new ways of structuring an enterprise, this new brew of management theories and practice calls into question the corporate forms that calcified early in the past century and inevitably blurs the distinction between studies of corpo-

336. The theories of Coase continue to hold interest for corporate governance scholars and have been described as "the 'dominant legal academic view.'" William T. Allen, *Contracts and Communities in Corporate Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601; Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301 (1993); Frank H. Easterbrook & Daniel R. Fischell, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989). See RONALD H. COASE, *THE NATURE OF THE FIRM* (1937) reprinted in R. H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 33 (1988). An extensive literature exists on the "agency problem," i.e. the tendency of corporate management make a different assessment of corporate interests than shareholders would choose. See, e.g., Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 565 n.11 (2006) (collecting sources); Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1 (1996).

337. See e.g. STAFFORD BEER, *BRAIN OF THE FIRM* (1972); John Matthews, *Holonc Organizational Architectures*, 15 HUMAN SYS. MGMT. 27 (1996); ARIE DE GEUS, *THE LIVING COMPANY* (1997); MARGARET J. WHEATLEY, *LEADERSHIP AND THE NEW SCIENCE* (3d ed. 2006).

338. Milan Zeleny, *Amoeba: The New Generation of Self-Managing Human Systems*, 9 HUMAN SYS. MGMT. 57-59 (1990); Ikijiro Nobaka, *Creating Organizational Order Out of Chaos: Self-Renewal in Japanese Firms*, 30 CAL. MGMT. REV. 57 (1988); Bo Hedberg, *How Organizations Learn and Unlearn*, in 1 HANDBOOK OF ORGANIZATIONAL DESIGN 3-27 (Paul Nystrom & William Starbuck eds., 1981); Shann Turnbull, *Stakeholder Governance: A Cybernetic and Property Rights Analysis*, in CORPORATE GOVERNANCE, at 401, 406-411 (R. I. Tricker ed., 2000).

339. See DEE HOCK, *BIRTH OF THE CHAORDIC AGE* (2000). Hock is the founder and former CEO of Visa International.

340. See ROBERT LEVERING & MILTON MOSKOWITZ, *THE 100 BEST COMPANIES TO WORK FOR IN AMERICA* 151-156 (1993); Michael Weinreb, *Power to the People*, SALES & MARKETING MGMT., Apr. 2003, at 30-35.

341. See GEORGE CHENEY, *VALUES AT WORK, EMPLOYEE PARTICIPATION MEETS MARKET PRESSURE AT MONDRAGON* 35-65 (1999) (providing a succinct history of the development of the cooperative complex); WILLIAM FOOTE WHYTE & KATHLEEN KING WHYTE, *MAKING MONDRAGON: THE GROWTH AND DYNAMICS OF THE WORKER COOPERATIVE COMPLEX* (1988).

rate management and corporate governance — a new mode of business organization will affect both spheres.³⁴²

The narrow focus of this essay calls for only a limited excursion into this field of management science. I will confine myself to two observations. First, self-regulation in its most elementary form necessarily entails a separation of power between interdependent components of the organization.³⁴³ The point might seem unduly obvious if it did not run counter to the still entrenched hierarchical modes of organization. As Shann Turnbull remarks, the implication of this principle is only that management cannot set its own exams or grade its own examination papers.³⁴⁴ The self-regulating organization will instead have mechanisms for receiving negative feedback and processing it to generate corrective adjustments. For its part, management will be accountable for its performance to a control center or centers capable of holding it to a desired standard. This separation of power inherent in any degree of self-regulation may be simple or complex and may depend on assigned responsibilities within the organization or a distribution of power to corporate stakeholders.

We are concerned here with a simple separation of power based on one important stakeholder, the shareholders. The weakness of the present system of self-regulation can be partially traced to the lack of a shareholder constituency with the capacity to carry out effective monitoring. The potential for self-regulation would be enhanced to the extent that this deficiency is remedied. It may be true that a shareholder base, possessing effective power within a system of corporate governance, would not assure the success of a shareholder-based system of self-regulation – the design of the system is critical – but it would still create a potential for self-regulation lacking today.

There is a point of intersection between this aspect of the theory of self-regulation and the republican principle of separation of powers.

342. Philip B. Evans & Thomas S. Wurster, *Strategy & The New Economics of Information*, HARV. BUS. REV., Sept.-Oct. 1997, at 71 (stating information technology favors modular organization); David W. Cravens et al., *New Organizational Forms for Competing in Highly Dynamic Environments: the Network Paradigm*, 7 BRIT. J. MGMT. 203-218 (1996); Charles Handy, *Balancing Corporate Power: a New Federalist Paper*, HARV. BUS. REV., Nov.-Dec. 1992, at 59; Ricardo Semler, *Managing Without Managers*, 89 HARV. BUS. REV., Sept.-Oct. 1989, at 76 (describing a radical departure from hierarchical organization similar to W. L. Gore and Associates); PATRICIA McLAGAN & CHRISTO NEL, *THE AGE OF PARTICIPATION* (1995).

343. Shann Turnbull, *Charters with Competitive Advantages*, 74 ST. JOHN'S L. REV. 89, 144 (2000); Shann Turnbull, *Self-Regulation* 2-4, 8-10 (July 6, 1997), at SSRN: ssrn.com/abstract=630041; *Corporate Governance: Its Scope Concerns and Theories*, in CORPORATE GOVERNANCE 415, 431 (R. I. Tricker ed., 2000).

344. SHANN TURNBULL, *A NEW WAY TO GOVERN* 8 (New Economics Foundation, London, Working paper No. 5, 2002).

Both favor dismantling hierarchical concentrations of power. In a brilliant essay, John Braithwaite presents a closely related idea: a separation of power in the corporation facilitates the task of checking abuse of power.³⁴⁵ Empirical research shows that the tactic of checking abuse of power with countervailing power often fails for a number of reasons. Among others, the more powerful the offending actor the greater is likely to be its ability to deploy effective countermeasures so as to neutralize attempted regulation. The most effective strategy to check abuse of power is commonly to enlist the cooperation of gatekeepers and enablers within the organization who do not benefit from the abuse of power but are able to control it. Herein lies the importance of internal separation of power. “[T]o the extent that we have richer, more plural separation of power” in a corporation the greater will be the number of third parties, with power to check abuses, whose cooperation can be secured through soft sanctions and dialogue.³⁴⁶

Braithwaite lists nine ways of separating private power in a business enterprise. The first is relevant to our inquiry: “better securing the separation of the three major branches of corporate governance – shareholders, directors, and managers.”³⁴⁷ His argument against hierarchical concentrations of power parallels the theory of self-regulation.³⁴⁸ In either case, an internal separation of power in the corporation has the potential of reducing the burden of regulatory enforcement, either by rendering it unnecessary or by increasing the effectiveness of soft sanctions and dialogue.

Secondly, self-regulation depends on a sufficient *variety* of information being available to control centers in the corporation. On this point, I rely on Stafford Beer, who is known for applying the insights of cybernetics to management science. In the science of cybernetics, variety is the measure of complexity; it represents “the number of possible states of whatever it is whose complexity we want to mea-

345. John Braithwaite, *On Speaking Softly and Carrying Big Sticks: Neglected Dimensions of a Republic Separation of Powers*, 47 U. TORONTO L. J. 305 (1997).

346. *Id.* at 340.

347. *Id.* at 353.

348. The Sarbanes Oxley Act of 2002 presupposes a hierarchical command-and-control structure of the corporation by directing the weight of civil and criminal liability against top officers and directors. See Pub. L. No. 107-204, 116 Stat 745 (2002), e.g. § 302, 15 U.S.C. § 7241 (2007); § 304, 15 U.S.C. § 7243 (2007); § 802, 18 U.S.C. § 1519 (2007); § 906, 18 U.S.C. § 1350 (2007); § 904, 29 U.S.C. § 1131 (2007); § 1106, 15 U.S.C. § 78ff(a) (2007). This concentration of sanctions on top management seems likely to have a centripetal influence on corporate organization and to reinforce a hierarchical corporate structure, thereby undermining the principles of self-regulation and a republican separation of power.

sure.”³⁴⁹ A fundamental principle, known as Ashby’s law, is that only variety can absorb variety. This means that “the regulator has to be capable of generating a variety equivalent to the variety that has to be regulated – or the regulator will fail.”³⁵⁰ A control center can function consistently only if it receives feedback information from a sufficient variety of sources to match the complexity of situations to which it is expected to respond. According to Beer, the law of requisite variety stands in “the same relation to management as the law of gravity stands to Newtonian physics.”³⁵¹

The value placed on the *variety* of information in the science of self-regulation can sometimes run counter to a simple logic founded in common experience. This logic may be expressed in the phrase: “give the best guy the job” and it is vividly captured by a comment from Charles Wohlstetter, the former CEO of Contel. Inveighing against public pension funds, he complains, “In sum, we have a group of people with increasing control of the Fortune 500 who have no proven skills in management, no experience in selecting directors, no believable judgment in how much should be spent for research or marketing – in fact, no experience except that which they have accumulated controlling other people’s money.”³⁵² One may easily concede that Wohlstetter may be right in insisting that managers as a class are far better qualified to direct a corporation than institutional investors. But he does not take into account that a variety of channels of information is necessary to respond to the complexity of the world. An organization that suppresses variety in decision-making by excluding a valuable source of information will inevitably overlook opportunities and generate dysfunctions. Yes, the best qualified person should get the job – and it may not be an institutional investor – but within a corporate structure which assures that information beyond the manager’s own area of competence is received and processed. The point is not that institutional investors make good managers but that they can add to the variety of feedback channels available to control centers in the corporation.

349. STAFFORD BEER, *THE HEART OF THE ENTERPRISE: THE MANAGERIAL CYBERNETICS OF ORGANIZATION* 32 (1979).

350. *Id.* at 89.

351. *Ibid.*; see also STAFFORD BEER, *DECISION AND CONTROL* 247, 272-344 (1966); Shann Turnbull, *supra* note 338, at 401, 408; HIROTAKA TAKEUCHI & IKUJIRO NONAKA, *THE KNOWLEDGE-CREATING COMPANY* 82-83 (1995).

352. Charles Wohlstetter, *The Fight for Good Governance*, *HARV. BUS. REV.*, Jan-Feb, 1993, at 78.

B. *A Pension Fund Voice*

The literature on corporate governance identifies five benefits of a pension fund voice in the corporate decision-making process, both to the corporation itself and to society at large. It is necessary to qualify the empirical basis for each of these benefits: they apply to some pension funds but not others, or apply to many funds to some extent, or merely represent a plausible future role of the funds. Nevertheless, I suggest that there is enough residual validity in the proposed benefits to show that a pension fund voice could usefully enhance the variety of information available for corporate decision-making.

1. Long Term View

Fifteen years ago there was little dissent from the assumption that an excessively short-term investment horizon of United States business was the source of many economic ills. The phenomenon was linked to the increased prominence of institutional investors in the market. By focusing on quarterly returns, institutional investors were seen as pressuring management to adopt short-term expedients and to scrimp on research and development and needed capital projects.³⁵³ Unions raised the additional concern that the “short-termism” was the cause of job loss caused by mergers and leveraged buyouts.³⁵⁴ More recent research has cast doubt on the importance of this factor, at least as a primary diagnosis of economic ills, but few would question that business planning should be shielded from an undue emphasis on quarterly returns.³⁵⁵

Pension funds are dedicated to the long-term by their commitment to provide retirement benefits. On average, 30 years elapses between contributions and payouts,³⁵⁶ but the actual administration of the plans reveals many variables in investment strategies. Mutual funds in 401(k) plans are part of a larger market of funds that are often characterized by rapid turnover of investments. The money-managers employed by employer-sponsored plans are under competitive pressures to produce quarterly results; large public plans commonly retain a number of external investment managers who must continually

353. MICHAEL T. JACOBS, *SHORT-TERM AMERICA, THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* 7-24 (1991); O'BARR & CONLEY, *supra* note 36, at 160-161; ROE, *supra* note 7, at 240.

354. Dean Baker & Archon Fung, *Collateral Damage: Do Pension Fund Investments Hurt Workers?*, in *WORKING CAPITAL*, *supra* note 123, at 13, 17-22.

355. CAROLYN KAY BRANCATO, *INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE* 28-33 (1997). *But see Ownership Matters*, *ECONOMIST*, Mar. 11, 2006, at 10; Constance Bagley & Karen Page, *The Devil Made Me Do It*, 36 *SAN DIEGO L. REV.* 897, 921 (1999).

356. MONKS & MINOW, *supra* note 111, at 143.

demonstrate the value of their services.³⁵⁷ Still, although good statistical comparisons are hard to find, there is no doubt that the portfolios of pension funds tend to display lower annual turnovers than other categories of institutional investors.³⁵⁸

2. Systematic View

In an influential 1992 article, Bernard Black presented empirical evidence of a series of “systemic shortfalls in corporate performance” that arise when the private interests of corporate executives impinge on the interests of shareholders.³⁵⁹ The evidence of these systemic shortfalls has continued to accumulate.³⁶⁰ In general they fall into three categories: (1) empire building through ill-conceived acquisitions and diversification, (2) excessive retention of cash, (3) and unreasonably high executive compensation.³⁶¹

Without effective monitoring, executives can hardly be expected to exercise restraint in matters affecting their own compensation. Similar conflicts of interest frequently color the issues of cash retention and empire building. Lucien Bebchuk observes, “Having a larger empire serves management’s private interests. Management can derive greater private benefits, in both pecuniary and non-pecuniary terms, from running a large firm. In addition, retaining undistributed liquid funds (‘free cash flow’) or assets that can be turned into such funds increases the autonomy of management vis-a-vis the capital markets and bolsters its freedom to pursue expansion plans. Indeed, some scholars have viewed these concerns as the most significant agency problems that large public companies face.”³⁶²

Both Black and Bebchuk argue for an increased role of institutional investors to monitor corporate planning for signs of executive self-

357. Coffee, *supra* note 9, at 1325-1326.

358. Useem, *supra* note 83, at 32; Brancato, *supra* note 355, at 27; HAWLEY & WILLIAMS, *supra* note 106, at 7.

359. Bernard Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 898 (1992).

360. See sources cited in Lucien A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 903-904 (2005).

361. See also Michael B. Dorff, *Softening Pharaoh’s Heart: Harnessing Altruistic Theory and Behavioral Law & Economics to Rein in Executive Salaries*, 51 BUFFALO L. REV. 811, 824-829 (2003); Randall S. Thomas, *Should Directors Reduce Executive’s Pay?*, 54 HASTINGS L. J. 437, 440-442, 453-458 (2003); Lucian A. Bebchuk *et al.*, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 754, 783-795 (2002); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002); Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 146-149 (2000).

362. See Bebchuk, *supra* note 360, at 903.

aggrandizement. The argument has particular force in the case of pension funds. Faced with current obligations to beneficiaries, pension funds have an incentive to insist on an appropriate distribution of cash reserves. Moreover, those institutional investors actively monitoring executive compensation in fact come from the ranks of pension funds. Some Taft-Hartley funds have played an active role in challenging excessive executive compensation through shareholder resolutions and public disclosure campaigns.³⁶³ CalPERS and TIAA-CREF have well-defined policies on the issue but usually favor the indirect approach of recommending that the corporate compensation committees be guided by independent advice.³⁶⁴

3. Responsiveness to Stakeholders

Pension fund managers are tied by the nature of their fiduciary duty to a strict interpretation of management's duty to maximize shareholder value.³⁶⁵ No other objective but shareholder wealth maximization will serve the interest of funding pension benefits.³⁶⁶ While a more pluralistic view of corporate objectives continues to be debated,³⁶⁷ the pension fund community is necessarily allied to the accepted norm affirming the primacy of the shareholder's economic interests.

This fiduciary restraint, however, should not bar pension fund managers from responding to the social preferences of their constituents in two broadly relevant circumstances. First, as Christopher Stone observed: "In the life of the enterprise, there are many occasions on

363. See Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CINN. L. REV. 1021, 1036-1037 (1999); Schwab & Thomas, *supra* note 167, at 1086-1088. To encourage shareholder activism by Taft-Hartley funds, the AFL-CIO publicizes egregious instances of excessive compensation through Executive PayWatch at <http://www.aflcio.org/paywatch>.

364. See Thomas & Martin, *supra* note 363, at 1044. See TIAA-CREF POLICY STATEMENT ON CORPORATE GOVERNANCE, available at www.tiaa-cref.org/about/governance/ (follow links to voting policies). For CalPERS policy statement, see www.calpers-governance/ (follow links to proxy_voting).

365. The shareholder wealth maximization norm has been described as the "prevailing academic and business view [of management's fiduciary duty] in the United States." See Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2002). It is often traced to Dodge v. Ford Motor Co., 170 N.W. 668, 684 (1919).

366. See ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (2007) (explaining that the fiduciary must act "for the exclusive purpose of . . . providing benefits to participants and their beneficiaries").

367. See Thomas W. Dunfee, *Corporate Governance in a Market with Morality*, 62 LAW & CONTEMP. PROB., no. 3, 129 (1999); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998). For an impassioned critique of the shareholder primacy norm, see Marjorie Kelley, *THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY* 4-7, 52 (2001).

which the managers have no ‘most profitable’ option lying on their desks. Considering the uncertainties in any business environment and the limited data available to it, there will be some range of choices all equally consistent with that ill-defined and elusive favorite of the economics textbooks, the investment uniquely calculated to maximize the shareholder’s wealth.”³⁶⁸

Within “this profit-undifferentiable range,” the duties of pension fiduciaries leave them free to favor measures corresponding to their beneficiaries’ social values. For example, work rules and childcare facilities that serve the needs of working parents involve costs and possible inefficiencies, but they may help to attract a well qualified work force. Where the calculus of costs and benefits is uncertain – as it usually will be – pension fund managers may properly vote for shareholder proposals affecting parent-employees on the ground that the beneficiaries favor these proposals.³⁶⁹ The managers are, of course, under no duty to do so; they are obliged only to administer pension benefits. But the welfare of society is served, and the demand for regulatory controls reduced, whenever a corporation respects the interests of those affected by its operations. Pension fund managers may properly encourage such corporate conduct in proxy voting.

Secondly, when corporate executives *themselves* exceed the scope of their fiduciary duty by lending the power of the corporation to causes with a tenuous connection with business operations, pension fund managers are free to vote in favor of shareholder measures designed to tell the executives to tend the corporate shop. Such issues commonly arise in the context of compelled speech.³⁷⁰ Shareholders (or

368. Christopher D. Stone, *Corporate Social Responsibility, What it Might Mean, if it Were Really to Matter*, 71 IOWA L. REV. 557, 568 (1986).

369. O’Connor-Felman advocates the adoption of proxy voting guidelines that favor parental support policies. See Marleen O’Connor-Felman, *American Corporate Governance and Children, Investing in Our Future Human Capital During Turbulent Times*, 77 S.CAL. L. REV. 1255, 1342-1346 (2004). See also Jaime Koniak, Note, *The Impact of Corporate-Sponsored Day Care on Business in the New Millenium*, 2002 COLUM. BUS. L. REV. 193 (2002).

Among public pension funds, CalPERS is the only large fund that evaluates labor practices as a criterion for investment and proxy voting. See Marleen O’Connor, *Labor’s Role in the Shareholder Revolution*, in WORKING CAPITAL, *supra* note 123, at 67, 92. Thus, when IBM converted its defined benefit plan to a cash-balance basis that reduced the benefits of mid-career employees, CalPERS supported a shareholder proposal opposing the measure on the ground that it was bad business policy to alienate a portion of the company’s highly trained workforce. See Sanford M. Jacoby, *Employee Representation and Corporate Governance: a Missing Link*, 3 U. PA. J. LAB. & EMP. L. 449, 488 (2001). For a criticism of CalPERS’s social criteria, see Debra J. Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees’ Social Agenda*, 29 SAN DIEGO L. REV. 39 (1992).

370. Shareholder proposals demanding corporate disclosure of political contributions represent a recent tactic by shareholder activists to control undue corporate political influence. See DAVIS & KIM, *supra* note 239, at 17. In the past decade, the issue of compelled speech has been

beneficial owners of corporate equities) may object to the use of their ownership share to support causes with a questionable connection to actual business operations. Though pension benefits may be unaffected, the managers are likely to serve the interests of democracy by acting in accordance with the preferences of their beneficiaries.

4. Externalities

Institutional investors holding securities for the long-term across a broad cross-section of the economy possess a perspective on economic externalities – benefits or costs shifted to third parties – that is different from that of an individual firm. Hawley and Williams term such firms “universal owners” and mention large pension funds as examples.³⁷¹ Among externalities benefiting third parties, they stress the importance of employee training and basic research. The individual firm may find that its investment in employee training is lost when the employee leaves the firm and that competitors are avoiding this expense by recruiting employees trained by others. Similarly, the benefits of research work that pushes back the frontiers of scientific knowledge may be captured by other firms that are adept at adapting basic scientific knowledge to product development. In the case of negative externalities, an individual firm can often gain a short-term cost advantage by shifting environmental damage onto third parties, but other firms may suffer a portion of the harm, or, more likely, may incur indirect costs in the form of more burdensome restrictions and regulations.³⁷²

While universal owners are committed to the maximization of share value, it is the cumulative, long-term consequences to their entire portfolio that matters to them. Accordingly, they may rationally favor investments in employee training and basic research, even though the costs outweigh the benefits for an individual firm; or they may favor environmental policies that internalize environmental costs, even though the policies involve avoidable short-term costs for a particular

presented, most notably, by corporately funded public relations campaigns devoted to climate change denial and advocacy of social security privatization. See DAVID SIROTA, HOSTILE TAKE-OVER 130-131 (2006) (writing on social security privatization); Harrington, *supra* note 240, at 230; Dashka Slater, *Confessions of a 401(k) Schizophrenic*, MOTHER JONES, May/June 2006, at 70. These issues deserve more detailed analysis, which must be reserved for another article, but two excellent scholarly contributions should be noted: Alan Hirsch & Ralph Nader, “*The Corporate Conscience*” and *Other First Amendment Follies in Pacific Gas & Electric*, 41 SAN DIEGO L. REV. 483 (2004); David R. Lagasse, Note, *Undue Influence: Corporate Political Speech, Power and the Initiative Process*, 61 BROOK. L. REV. 1347 (1995).

371. HAWLEY & WILLIAMS, *supra* note 106, at xiv-xv, 3.

372. *Id.* at 4-7.

firm. Hawley and Williams see evidence of such a perspective among some public pension funds, particularly in a new interest in “high performance workplaces” (a code word for well-trained workforces), and a favorable view of responsible environmental policies.³⁷³ They argue that the universal owner’s perspective on externalities is good for the economy and ultimately for the health of a democratic society.

5. Strategic Corporate Citizenship

Everyone knows that it can be hard to do the right thing alone but it is easier when others join in. A remarkable note in the Harvard Law Review applies this homely wisdom to corporate conduct through a game theory analysis that reveals many dimensions of the problem that might otherwise escape our attention.³⁷⁴ Greatly simplified, the note explains that individual contribution to the public good does not pay when “all firms share in an equal distribution of the public good produced by an individual contributor.” However, when the benefits are produced by a “*cooperative* coalition,” they may “outweigh the cost for individual firms to participate in that coalition [and]. . . a positive incentive for individual contribution is formed. Corporate social responsibility is transformed into strategic corporate citizenship” (italics added).³⁷⁵

The classic response to “the destruction of a social good by rampant individual self-interest is to impose a Hobbesian Leviathan.”³⁷⁶ The Sarbanes-Oxley Act is a version of this response. “The alternative to Leviathan control is to cultivate a set of *self-enforcing* institutions to encourage strategic corporate citizenship.”³⁷⁷ Such institutions must be designed to foster “open communication, trust, and transparency,”³⁷⁸ to assign market value to good citizenship, and to impose costs on destructive conduct. Under favorable circumstances, it may be possible to internalize a norm of corporate citizenship throughout an industry. If “a critical mass of firms” take the first step, “a cascade of firms” will sometimes follow.³⁷⁹ Thus, a decade after “Lotus Development Corporation became the first publicly traded company to of-

373. *Id.* at 21-28.

374. Note, *Finding Strategic Corporate Citizenship: A New Game Theoretic View*, 117 HARV. L. REV. 1957 (2004).

375. *Id.* at 1968-1969.

376. *Id.* at 1973.

377. *Id.* at 1974.

378. *Ibid.*

379. *Id.* at 1978.

fer domestic partner benefits,” the practice had become widespread throughout society.³⁸⁰

Pension funds are well-suited by their wide holdings in the economy and relatively long-term perspective to play a part in the set of self-enforcing institutions, described in the note, which can support the practice of strategic corporate citizenship. For the sake of industry-wide benefits, the funds have an incentive to encourage transparency, to favor cooperative pursuit of ethical norms,³⁸¹ and to monitor firms for deviations from standards of citizenship.

C. *The Prospects of Corporate Self-regulation*

Descending now from the realm of theory to a more practical plane, it must be recognized that the potential value of a pension plan voice can be realized only in the context of a stronger shareholder-based system of corporate self-regulation. In the present world of corporate governance, a pension plan voice, even if amplified somewhat, can have no more than a modest impact on corporate decision making. We have seen that corporate self-regulation comes with a difficult precondition – it requires some separation of power within the corporation. In the absence of such a division of power, shareholders will remain supplicants at the gates of corporate power, invited in only on rare occasions when shareholder approval is needed for corporate restructuring.

Are institutional shareholders with diversified holdings capable of sustaining an effective system of corporate monitoring? The question has been asked in a debate initiated some fifteen years ago on the possibility of more effective relational investing by shareholders. Apart from those who prefer the current separation of ownership and control, there are skeptics who question whether effective shareholder monitoring is possible. Two of the most insightful of the skeptics are John Coffee, Jr., and Iman Anabtawi. Coffee argues that many institutional investors face an inevitable tradeoff between liquidity and

380. *Ibid.*

381. A variety of institutions now exist to encourage corporate conformance to norms of socially responsible behavior. They include Coalition for Environmentally Responsible Economies (CERES) (a common reporting format for environmental stewardship), Social Accountability 8000 (a uniform system to evaluate labor practices), Forest Stewardship Council (a program to monitor forestry practices) and the Convention for Combating Bribery of Foreign Public Officials in International Business Transactions. See Claire Moore Dickerson, *Human Rights: The Emerging Norm of Corporate Social Responsibility*, 76 TUL. L. REV. 1431 (2002); Douglas M. Branson, *Corporate Social Responsibility Redux*, 76 TUL. L. REV. 1207 (2002).

control.³⁸² If the investor desires a relationship with management conferring influence or a degree of control, it must maintain a substantial holding over the long-term, thereby sacrificing the liquidity of its investment. Most institutional investors, including open-end mutual funds, banks, and insurance companies, have a distinct preference for liquidity because “their shareholders, depositors, or policyholders can withdraw their funds on short notice.”³⁸³ Pension funds are not subject to the same demands for liquidity, but any potential they might have for corporate monitoring is nullified by the extremely diversified nature of their holdings and the practice of delegating investment decisions to money managers or, worse, to a number of competing money managers.³⁸⁴ Possessing relatively small investments in individual firms and typically placing these investments under the control of money managers, pension funds have insufficient financial incentive to incur the costs of effective monitoring or concerted action that might increase their influence with management.³⁸⁵ Coffee sees the so-called activism of public pension funds as consisting largely of staged confrontations, performed for political reasons that have little actual substance.³⁸⁶

It should be added that Coffee sees a value in more effective shareholder monitoring and to this end he advocates selective deregulation and certain other measures mentioned in this article.³⁸⁷ He merely doubts that the deregulation thesis “takes us very far”,³⁸⁸ and appears to harbor the same skepticism of other suggested reforms. In contrast, Anabtawi takes a negative view of enhanced shareholder power. He begins with an assumption of this article: “shareholders presently have the potential to operate as only a weak constraint on managers.”³⁸⁹ He argues that the “deep rifts” among shareholders are a cause, and in fact a justification, for this weak level of influence of individual shareholders.³⁹⁰ He identifies “five schisms that place the interests of some shareholders in conflict with those of other shareholders”: (1) short-term versus long-term shareholders, (2) universal owners with diversified economy-wide holdings versus undiversified shareholders,

382. See Coffee, *supra* note 9, at 1281-1289; John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1985 (1997) [hereinafter Coffee (1997)].

383. Coffee, *supra* note 9, at 1318.

384. *Id.* at 1336-1342.

385. *Id.* at 1283, 1326; Coffee (1997), *supra* note 382, at 1976-1978.

386. *Id.* at 1978.

387. See also Coffee, *supra* note 50 and note 58.

388. Coffee, *supra* note 339, at 1280.

389. Anabtawi, *supra* note 336, at 570.

390. *Id.* at 564.

(3) employee and executive shareholders versus outside shareholders, (4) public and union pension funds with non-economic interests versus other shareholders, and (5) hedge funds investing in equity derivatives and other financial contracts versus the ordinary shareholder.³⁹¹ “In certain political contexts,” he acknowledges, parties with divergent interests can engage in “logrolling” or the exchange of votes in order to secure some approximation of the common interests.³⁹² He assumes that no such mechanism exists in the corporate sphere. As a consequence, any additional power conferred on shareholders will have the harmful effect of enabling them to pursue private interests that are inevitably at odds with “overall shareholder welfare.”³⁹³

While Coffee is an eminently credible scholar, I suggest that his skepticism might be tempered by the consideration that innovation may encourage further innovation. The shareholder passivity produced by dispersion of ownership and investment turnover rests on a cost/benefit calculation. An initial reform, or institutional innovation, may alter the calculation by making monitoring more effective or less costly – thus stimulating further innovations. Reforms, in other words, can open opportunities for further innovations and strengthen past innovations. After all, the weak self-regulatory effects of the existing system are due in large measure to two institutional innovations in the past quarter century — the development of proxy voting advisers and the growth of socially responsible investing. Both offer the promise of further development. The reforms suggested in this article would in fact have the effect of increasing the market for professional proxy advisers, and an expanded market for these services might lead to greater variety and effectiveness.

For his part, Anabtawi dismisses too easily the possibility of “log rolling” in the corporate governance sphere. In fact, there are now mechanisms that serve to unite disparate groups of shareholders. We have noted that the small group of Taft-Hartley funds pursues relatively conservative proxy voting tactics for which it can find support among the larger body of public pension funds. The Council of Institutional Investors, composed of 130 pension funds with equity holdings of approximately \$1,500 billion, serves to give this implicit coalition an institutional glue.³⁹⁴ The proxy advisory services are also coalition builders. As profit-making businesses, they have an incen-

391. *Id.* at 593.

392. *Id.* at 595.

393. *Id.* at 565.

394. See www.cii.org/about/. The estimate of \$1,500 assumes that one half of the members' assets consist of equities.

tive to appeal to the largest possible market, thereby forming coalitions among their prospective customers. Unlike Anabtawi, I see nothing harmful in broad coalitions held together by institutional ties. They may potentially evolve into something resembling political parties – an outcome that would greatly facilitate the expression of a shareholder voice.³⁹⁵

I will refrain from expanding this article with a discussion of other avenues toward corporate self-regulation. Complex issues lose cogency if briefly sketched and are best left to another article. It is important, however, to recognize that we have pursued the narrow perspective of a particular shareholder group, without considering institutional means of integrating a shareholder voice into the corporate decision-making process. Clearly the strengthening of a shareholder voice and the creation of an effective feedback mechanism are mutually reinforcing strategies; both must be addressed to fundamentally alter the cost/benefit calculus involved in shareholder monitoring.

IV. CONCLUSION

In tracing institutional constraints that contribute to the marginalization of pension plans in the forum of corporate governance, we have found that the most important issues relate to the fiduciary structure of pension plans under ERISA. The British Pension Act 1995 offers a compelling model for reform. Other significant constraints include the phenomenon of redundant regulation, the Taft-Hartley Act, and the proxy voting arrangements of the Federal Employees Retirement System.

At present, the prospects of corporate self-regulation are uncertain, but the guidelines for creating systems of corporate self-regulation do represent an alternative to the kind of Hobbesian controls exemplified by the Sarbanes-Oxley Act and point in the direction of a more democratic society. For those who value this objective, it is important to craft corporate reforms in a manner that will strengthen internal separations of power and the variety of information available to corporate decision making. This article is offered as a contribution to that end.

395. See Michael E. Murphy, *Dispelling TINA's Ghost from the Post-Enron Corporate Governance Debate*, 43 SANTA CLARA L. REV. 63 (2002) (TINA is the British acronym for Margaret Thatcher's favorite expression: "there is no alternative.").

