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Corporate Democracy and the Intermediary Voting Dilemma

Law Working Paper N° 685/2023

February 2023

Jill E. Fisch
University of Pennsylvania and ECGI

Jeff Schwartz
University of Utah

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ECGI Working Paper Series in Law

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We are grateful to conference participants at the Notre Dame/University College London Symposium on Law and Finance, the Berkeley Organizations and Social Impact Workshop, and the Berkeley Boosts Webinar: Can ESG Change Investor Expectations and Voting Behavior? and to Lynne Dallas, Brett McDonnell, Alessio Pacces, and Natalya Shnitser for helpful comments.

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Abstract

Corporate governance is changing. For the past two decades, the focus of shareholder voting and engagement was deconstructing impediments to shareholder power and increasing managerial accountability. The goal of these interventions was to increase firm value by reducing agency costs. Increasingly, however, environmental and social issues have risen to the fore. This new focus is arguably more about values than value. This Article is the first to argue that, because of this shift, institutional intermediaries—namely, pension and mutual fund managers—can no longer vote and engage on the affairs of their portfolio companies without seeking the input of the pension-plan participants and mutual-fund shareholders who are their beneficiaries. We argue that the fiduciary duties of fund managers compel them to seek this input. We further argue that regulators should supplement existing fiduciary standards by adopting formal requirements that managers of mutual funds and pension funds seek input from their beneficiaries on their views, reflect those views in their engagement efforts and their votes, and publicly disclose how they have complied. At the same time, we caution against an approach in which fund managers shirk their intermediary role by implementing pass-through voting or rigidly voting in proportion to the preferences expressed by their beneficiaries. Instead, fund managers should act like elected representatives. They should continue to exercise voting power for the securities in the portfolios that they manage and should have discretion in how to incorporate the input they receive from fund beneficiaries. This enables professional fund managers to use their sophistication and experience to translate beneficiary preferences—which might be incomplete, vague, and contradictory—into individualized and informed votes at each of their portfolio firms. It also retains the ability of fund managers to leverage the economic power of dispersed beneficiaries consistent with their historical success in reducing the traditional collective action problems associated with shareholder voting. In reconceptualizing the role of intermediaries, this approach preserves the benefits of intermediation while better aligning intermediary stewardship with beneficiary best interests.

Keywords: Corporate governance, fiduciary duty, mutual funds, pension funds, institutional investors, shareholder voting, environmental, social & governance, ESG, shareholder activism, retail investors, intermediaries, securities regulation, fund management, agency, socially responsible investing

JEL Classifications: G23, G28, K22

Jill E. Fisch*
Saul A. Fox Distinguished Professor of Business Law
University of Pennsylvania, School of Law
3501 Sansom Street
Philadelphia, PA 19104, United States
phone: +1 215 746 3454, fax: +1 215 573 2025
e-mail: jfisch@law.upenn.edu

Jeff Schwartz
Hugh B. Brown Professor of Law
University of Utah
383 South University Street
Salt Lake City, UT 84112, USA
phone: (801) 581–3773
e-mail: jeff.schwartz@law.utah.edu

*Corresponding Author

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RESEARCH PAPER NO. 23-06

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Jill E. Fisch

UNIVERSITY OF PENNSYLVANIA CAREY LAW SCHOOL

Jeff Schwartz

UNIVERSITY OF UTAH – S. J. QUINNEY COLLEGE OF LAW

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CORPORATE DEMOCRACY AND THE INTERMEDIARY VOTING DILEMMA

JILL FISCH * & JEFF SCHWARTZ **

FORTHCOMING TEXAS LAW REVIEW 2023

ABSTRACT

Corporate governance is changing. For the past two decades, the focus of shareholder voting and engagement was deconstructing impediments to shareholder power and increasing managerial accountability. The goal of these interventions was to increase firm value by reducing agency costs. Increasingly, however, environmental and social issues have risen to the fore. This new focus is arguably more about values than value.

This Article is the first to argue that, because of this shift, institutional intermediaries—namely, pension and mutual fund managers—can no longer vote and engage on the affairs of their portfolio companies without seeking the input of the pension-plan participants and mutual-fund shareholders who are their beneficiaries. We argue that the fiduciary duties of fund managers compel them to seek this input. We further argue that regulators should supplement existing fiduciary standards by adopting formal requirements that managers of mutual funds and pension funds seek input from their beneficiaries on their views, reflect those views in their engagement efforts and their votes, and publicly disclose how they have complied.

At the same time, we caution against an approach in which fund managers shirk their intermediary role by implementing pass-through voting or rigidly voting in proportion to the preferences expressed by their beneficiaries. Instead, fund managers should act like elected representatives. They should continue to exercise voting power for the securities in the portfolios that they manage and should have discretion in how to incorporate the input they receive from fund beneficiaries. This enables professional fund managers to use their sophistication and experience to translate beneficiary preferences—which might be incomplete, vague, and contradictory—into individualized and informed votes at each of their portfolio firms. It also retains the ability of fund managers to leverage the economic power of dispersed beneficiaries consistent with their historical success in reducing the traditional collective action problems associated with shareholder voting. In reconceptualizing the role of intermediaries, this approach preserves the benefits of intermediation while better aligning intermediary stewardship with beneficiary best interests.

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* Saul A. Fox Distinguished Professor of Business Law, University of Pennsylvania Law School. We are grateful to conference participants at the Notre Dame/University College London Symposium on Law and Finance, the Berkeley Organizations and Social Impact Workshop, and the Berkeley Boosts Webinar: Can ESG Change Investor Expectations and Voting Behavior? and to Lynne Dallas, Brett McDonnell, Alessio Pacces, and Natalya Shnitser for helpful comments.

** Hugh B. Brown Presidential Professor of Law, University of Utah, S.J. Quinney College of Law.

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INTRODUCTION

Growing societal attention to issues ranging from climate change to Black Lives Matter has led corporate governance in a new direction as shareholders increasingly seek to have the companies in which they invest address social problems and operate sustainably.[1] Even traditional business decisions—plant closings, employment policies, product choices—now must include consideration of broader societal

[1] *See, e.g.,* Stephanie Creary, *Why More Companies Are Standing Up on Social Issues,* KNOWLEDGE AT WHARTON (May 10, 2022), https://knowledge.wharton.upenn.edu/article/why-more-companies-are-standing-up-on-social-issues/ (explaining that investors and consumers are pressuring corporations to take responsibility for social issues); Cone Communications, *Gen Z Sees Social Media Activity As More Effective Than Community Involvement According To New Research By Cone Communications*, CISION PR NEWSWIRE (Sept. 13, 2017), https://www.prnewswire.com/news-releases/gen-z-sees-social-media-activity-as-more-effective-than-community-involvement-according-to-new-research-by-cone-communications-300518245.html (reporting survey results showing that 94% of Gen Zers "believe companies should help address critical [social and environmental] issues"); Alan Murray & David Meyer, *Coca-Cola And Novartis's CEO's Don't Care If 'ESG' Has Become A Toxic Phrase Among Some*, FORTUNE (Jan. 23, 2023), https://fortune.com/2023/01/23/coca-cola-novartis-ceos-esg-quincey-narasimhan/ ("My business strategy is constant and clear and centered around the business and the things that consumers care about and that fix societal problems," quoting the CEO of Coca Cola) ("If we actually deliver on our mission in a sustainable way, that's why our corporations exist," quoting the CEO of Novartis).

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concerns. Shareholders are leading this drive through voting and engagement on a range of environmental, social, and governance (ESG) issues.[2]

The key players are not individuals, but rather institutional investors, which control a substantial percentage of shareholder votes and are therefore pivotal to the outcome of contested matters.[3] Because of their crucial role in corporate governance, the voting and engagement practices of institutional investors have drawn regulatory attention.[4] Outside the United States, regulators have turned to stewardship codes to push institutional investors toward greater engagement with their portfolio companies.[5] Most recently, these codes have explicitly directed institutional investors not merely to pursue economic objectives and the reduction of agency costs,[6] but to engage with respect to sustainability, stakeholder interests, and broader societal values.[7]

Institutional investors in the United States are also moving in this direction. Several mutual fund complexes, for example, have taken high profile positions with respect to their ESG voting. Larry Fink has brought an urgency to corporate actions addressing climate change by using BlackRock's substantial shareholdings to support

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[2] *See, e.g.*, Matteo Tonello, *Shareholder Voting Trends (2018-2022)*, HARV. L. SCH. F. ON CORP. GOV. (Nov. 5, 2022), https://corpgov.law.harvard.edu/2022/11/05/shareholder-voting-trends-2018-2022/ (documenting rise in importance of shareholder voting on ESG issues).

[3] *See, e.g.*, Jacob Greenspan, *How Big a Problem Is It That a Few Shareholders Own Stock in So Many Competing Companies*?, HARV. BUS. REV. (Feb. 19, 2022), https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies ("Overall, institutional investors (which may offer both active and passive funds) own 80% of all stock in the S&P 500.").

[4] *See, e.g.*, Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, 87 Fed. Reg. 78770, 78770 (Dec. 12, 2022) (adopting rules to enhance disclosure of mutual fund votes because of "funds significant voting power and the effects of funds' proxy voting practices on the actions of corporate issuers and the value of these issuers' securities") [hereinafter Enhanced Reporting Rule]; Vishal Mehta & Megan E. Gerking, *FTC Hearings Examine the Antitrust Implications of Common Ownership*, MORRISON & FOERSTER CLIENT ALERT (Feb. 1, 2019), https://www.mofo.com/resources/insights/1901-ftc-antitrust-common-ownership (describing Federal Trade Commission hearing on the potential antitrust implications of common ownership by institutional investors).

[5] For an expansive analysis of stewardship codes around the world, see GLOBAL SHAREHOLDER STEWARDSHIP (Dionysia Katelouzou & Dan W. Puchniak eds., 2022)

[6] Dionysia Katelouzou terms these topics "orthodox stewardship." Dionysia Katelouzou, *The Rhetoric of Activist Shareholder Stewards,* 18 N.Y.U. J. L. & BUS. 665, 732 (2022).

[7] *See* FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE 2020, at 8, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf (defining objective of stewardship as to provide "sustainable benefits for the economy, the environment and society."); *Id.* at 15 (requiring that "signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities"). Dionysia Katelouzou describes this as "enlightened" shareholder stewardship. Katelouzou, *supra* note 6, at 72.

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shareholder proposals on environmental issues.[8] State Street credits its Fearless Girl campaign with the addition of 681 female directors.[9]

Institutional investors—specifically mutual and pension funds—however, are intermediaries.[10] Their votes are cast by fund managers rather than the mutual-fund shareholders and pension-plan participants whose interests are at stake.[11] One of us has described this distinctive structure as "empty voting."[12] Fund managers are fiduciaries and, as such, have an obligation to exercise their power in accordance with the best interests of their beneficiaries. As the range of issues on which they engage expands beyond the pursuit of firm-specific economic value, however, their participation in corporate governance increasingly raises the question of whether they are acting in a manner consistent with those interests. Engagement on environmental and social issues implicates contested values—and there is nothing to suggest that fund managers consider the ideological diversity of their beneficiaries when they engage in stewardship. Failure to represent beneficiaries' views harms not only those whose views are ignored but is also deeply undemocratic. Issues like how to address climate change are fundamental public policy questions, and fund managers lack the legitimacy to make such choices on their own.

Recognition that corporate governance is infused with values brings a new perspective—and new urgency—to long simmering concerns about fund manager voting and influence.[13] Worries about the concentration of equity ownership in mutual funds led the SEC, in 1977, to study fund stewardship as part of its "broad re-examination of its rules related to shareholder communication, shareholder

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[8] *See* Dawn Lim, *BlackRock Starts to Use Voting Power More Aggressively*, WALL ST. J. (Apr. 30, 2021), https://www.wsj.com/articles/blackrock-takes-aggressive-posture-on-esg-proxy-votes-11619775002.

[9] Press Release, State Street, State Street Global Advisors Marks Third Anniversary and Progress of Fearless Girl Campaign, Reports 681 Companies Added Female Board Members (Mar. 5, 2020), https://newsroom.statestreet.com/press-releases/press-release-details/2020/State-Street-Global-Advisors-Marks-Third-Anniversary-and-Progress-of-Fearless-Girl-Campaign-Reports-681-Companies-Added-Female-Board-Members/default.aspx.

[10] Both defined contribution plans and defined benefit plans can be understood as types of pensions. In a defined benefit plan, "[t]he employer is responsible for funding the benefit, investing and managing plan assets, and bearing the investment risk." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-176T, PRIVATE PENSIONS: CHANGING FUNDING RULES AND ENHANCING INCENTIVES CAN IMPROVE PLAN FUNDING 1 n.1 (2003), http://www.gao.gov/new.items/d04176t.pdf. "In a defined contribution plan, individual employees contribute a portion of their wages" to the retirement plan and typically determine how that money will be invested. Jill E. Fisch Annamaria Lusardi & Andrea Hasler, *Defined Contribution Plans and the Challenge of Financial Illiteracy*, 105 CORNELL L. REV. 741, 748-49 (2020). We use the term pension fund here to refer to defined benefit plans.

[11] We note that the voting and engagement practices of university endowments present related but more complex issues given the challenges in identifying the relevant stakeholders.

[12] Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, 16 BROOK. J. CORP. FIN. & COM. L. 71, 72 (2021).

[13] Concerns about the potential influence of mutual fund managers were central to first regulating the industry in 1940. *See generally* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139. U. PA. L. REV. 1469 (1991).

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participation in the corporate governance electoral process and corporate governance generally."[14]

Ahead of its time, the SEC sought input on whether mutual fund shareholders should be able to express their views to mutual fund managers "by means of a polling or pass-through voting requirement."[15] Virtually all commentators opposed the idea, arguing that pass-through voting would be technologically difficult and that fund shareholders were unlikely to be interested in casting their own votes.[16] Today, however, technological improvements in both the dissemination of information and the communication of voting preferences offer the potential for fund beneficiaries to play a greater role.[17] These improvements have led some commentators to renew their calls for pass-through voting.[18] They argue that pass-through voting would reduce the agency problems associated with intermediated investing and democratize corporate governance.[19] The industry is also moving in this direction. In January 2022, BlackRock began to offer certain institutional clients the ability to vote their own shares, and in June 2022, it announced that it was expanding the program to more of its institutional clients and exploring the potential for individual investors to participate.[20] Pending legislation in Congress, the Investor Democracy is Expected Act, would require mutual fund managers to implement pass-through voting.[21]

We, however, argue that pass-through voting is not the right way to address the agency problem that exists between fund managers and their beneficiaries. Fund beneficiaries are not well-situated to participate directly in corporate governance. Given the small stake that mutual fund shareholders hold in any given portfolio

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[14] Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, 43 Fed. Reg. 31945, 21945 (July 24, 1978) [hereinafter Proposed Communications Rules].

[15] *Id.* at 31950 ; *see also* DIV. OF CORP. FIN., SEC. & EXCH. COMM., STAFF REPORT ON CORPORATE ACCOUNTABILITY 26 (Sept. 4, 1980) ("With respect to the subject of passthrough voting, the staff notes that some groups have expressed concern about whether the interests of persons having an economic interest in the accounts managed by institutions are reflected adequately in the investment and voting decisions made by investment managers.").

[16] *See* Proposed Communications Rules, 43 Fed. Reg. at 31950 ("substantially all of the commentators who addressed the issue of the desirability of obtaining the views of persons having an economic interest in the securities being voted, by means of a polling or pass-through voting requirement, were opposed to such a requirement").

[17] *See infra* text accompanying notes 237-244.

[18] *See, e.g.*, Saura Masconale & Simone M. Sepe, *Citizen Corp. - Corporate Activism and Democracy*, 100 WASH. U. L. REV. 257, 317 (2022) (explaining that "the implementation of pass-through voting . . . has recently gained traction in the broader debate around excessive index fund power").

[19] *See id.*

[20] Press Release, BlackRock, BlackRock Expands Voting Choice to Additional Clients (June 13, 2022), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/2022-blackrock-voting-choice.

[21] *See* S. 4241, 117th Cong. 2nd Sess. (2022), https://www.govinfo.gov/content/pkg/BILLS-117s4241is/pdf/BILLS-117s4241is.pdf.

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company and the large number of companies in a mutual fund portfolio, fund shareholders lack the incentive and capacity to exercise pass-through voting rights effectively. As a result, shares are likely to go unvoted or may be voted based on limited analysis.[22] In sacrificing the sophistication and influence of fund managers, pass-through voting threatens to weaken corporate governance.

History also counsels against pass-through voting. Intermediated voting has dramatically reduced the agency cost problem between corporate managers and shareholders. When voting was dispersed among millions of individual investors, managers held little regard for shareholder views. [23] This was the lament of generations of corporate law scholars.[24] Now, however, corporate leaders are extraordinarily responsive to institutional investor demands. The problem today is the agency costs between fund managers and their beneficiaries.[25] The solution is not to return to the previous era of unaccountable corporate executives, but to render fund managers accountable to fund beneficiaries.

Therefore, we advocate a different approach. Although the way that fund managers currently engage in stewardship is problematic, they enjoy economies of scope and scale that can be leveraged to advance beneficiary interests through both voting and private engagements with corporate executives.[26] To preserve these advantages, intermediation should be reregulated rather than abandoned. In particular, although it is a fund's obligation to vote and engage in accordance with the interests of fund beneficiaries, neither existing regulations nor stewardship codes require fund managers to take affirmative steps to determine their preferences. Accordingly, we call for fund managers to employ explicit mechanisms to discern those interests.

We ground this obligation in existing law—specifically we argue that a fund's fiduciary duty to act in the best interests of its beneficiaries requires it to make a

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[22] *See, e.g.*, Paul Schott Stevens, *SEC Should Reject Complex, Costly "Pass-Through" Proxy Voting*, ICI VIEWPOINTS (Oct. 2, 2018), https://www.ici.org/viewpoints/view_18_passthrough_voting (arguing that mutual fund beneficiaries "for the most part do not have the time, expertise, or particular views on the myriad of matters, some of them quite complex, that are subject to proxy voting.").

[23] The classic authority for the proposition that dispersed shareholding generates managerial agency costs is ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 117 (1932).

[24] *See, e.g.*, Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEX. L. REV. 863, 868-72 (2020) (describing how, under both the "traditional management-power model" and the "shareholder-power model," the central role of corporate law was to minimize agency costs).

[25] *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013). (arguing that "[t]he Berle-Means premise of dispersed share ownership is now wrong.").

[26] *See* Jill E. Fisch, Asaf Hamdani, & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 67 (2020) ("The ability of fund managers to pool the informational advantages of their multiple funds and fund managers generates economies of scale.").

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reasonable effort to identify and evaluate beneficiary preferences.[27] When voting and engagement focused on traditional governance issues, fund managers could legitimately view stewardship as an extension of investing. The primary mission of fund managers is typically to maximize the value of their portfolios through sound investment decisions. Stewardship was a tool that—consistent with the fund manager's fiduciary duty—could be leveraged to that end. Now that voting implicates contested values, however, the simplifying assumption that stewardship follows investing no longer holds. To represent beneficiary best interests faithfully, fund managers need some guidance on what those beneficiaries think.

As with much of the literature in this area, we focus on mutual fund managers, but we extend the discussion to include pension funds (i.e., employer-sponsored retirement accounts, in which the employer promises employees a defined benefit after retirement).[28] Like mutual fund managers, pension fund managers invest other peoples' money and owe them a fiduciary duty to act in accordance with the interests of those beneficiaries. We similarly argue that pension fund managers fail to live up to this duty by not ascertaining the interests of their beneficiaries on voting and engagement issues.

Although we argue that fund managers are not meeting their fiduciary obligations, we do not suggest a litigation-based approach to enforcement. Caselaw alone would provide insufficient direction and accountability. Instead, we argue that regulators should draft rules requiring that fund managers take beneficiary views into account in their voting and engagement efforts and publicly report on how they do so.[29]

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[27] *See* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 399 (2020) (explaining the fiduciary principles of trust law and how they apply to intermediary investment decisions).

[28] *See* Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. LEGIS. 53, 55 (2012).

[29] A unified approach to fund fiduciary duties would necessitate coordination across lawmaking bodies. The securities laws and the SEC regulate mutual funds. *See Investment Company Registration and Regulation Package*, SEC, https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg 121504 (last visited Feb 4, 203) (providing an overview of mutual fund regulation). ERISA and the Department of Labor regulate private pension funds. *See* 29 U.S. Code § 1003(b)(1) (2022) (exempting "governmental" plans from ERISA); *Fact Sheet: What Is ERISA*, DOL, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/what-is-erisa (last visited Jan. 10, 2023) (providing a very brief overview of ERISA). The Federal Employees' Retirement System Act of 1986 (FERS) and Congress regulate federal public pensions. *See* 5 U.S. Code § 8402(a); GOV'T ACCOUNTABILITY OFFICE, GAO-07-611, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD, MANY RESPONSIBILITIES AND INVESTMENT POLICIES SET BY CONGRESS 5-7 (2007), https://www.gao.gov/assets/gao-07-611.pdf (summarizing federal retirement system). State laws govern state and local public pensions. *See Legal Protections for State Pension and Retiree Health Benefits*, PEW (May 30, 2019), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/05/legal-protections-for-state-pension-and-retiree-health-benefits (reporting the results of a 50-state survey of state pension laws). Given this regulatory framework, the best path forward would be for the SEC and DOL to design regulations and regulatory guidance and for other federal and state lawmakers to incorporate this rulemaking into their own laws.

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To allow fund managers to compete and innovate, we warn against regulatory efforts to detail specific procedures for soliciting beneficiary views. We suggest, however, that regulators provide guidance with concrete examples for how fund managers might meet this obligation. To illustrate the feasibility of our proposal, we provide such examples and discuss promising fintech innovations that facilitate engaging with beneficiaries.[30]

Importantly, our proposal gives fund managers discretion in how to incorporate the views they collect into their stewardship practices. As in a representative democracy, their job would be to use their experience and expertise to translate aggregate individual preferences—which might be incomplete, inconsistent, or uninformed—into appropriate and well-considered votes.

Finally, although we identify considerations relevant in determining whether a fund manager has met its compliance obligations, we recommend that only regulators, and not private plaintiffs, be tasked with enforcement. A private right of action might chill innovation and make fund managers fearful of exercising their discretion, particularly as they adapt to the new rules.

Our approach resolves fundamental defects in existing reform proposals. Stewardship codes and the like make no room for shareholder input, and thus provide no assurance that institutional investor engagement and voting practices represent shareholder views. Pass-through voting, and similar proposals that would require fund managers to proportionally reflect beneficiary views with their votes, would return corporate governance to the era of managerial agency costs. Instead, our proposal would allow fund managers to retain their role as the dominant force in corporate governance but would harness their power for the good of the mutual fund investors and pension fund participants who are the true investors in portfolio firms.

The Article proceeds as follows. In Part I, we provide background on the intermediated approach to shareholder participation in corporate governance, highlighting both voting and other forms of engagement by institutional shareholders. Part II explains how shareholder involvement in corporate governance has shifted from traditional economic issues to ESG and the implications of that shift for the logic of intermediation. Part III explores and rejects the leading potential solutions to the agency problem that intermediated stewardship causes. Finally, Part IV introduces our preferred alternative, which we call "informed intermediation."

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[30] *See infra* text accompanying notes 234-244.

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I. THE ROLE OF INSTITUTIONAL INVESTORS IN CORPORATE GOVERNANCE

A. The Expansion of Institutional Engagement

The current role of shareholders in corporate governance is unprecedented. They are more engaged than ever before, and the scope of issues on which they engage has expanded dramatically. Traditionally, shareholders voted to elect the board of directors, to ratify the company's selection of auditors, and on a handful of other issues. The annual meetings at which these issues were decided were sparsely attended sleepy compliance exercises where management's position was almost always rubber stamped.[31]

In the last twenty years, however, shareholders have become far more engaged. Shareholders have leveraged their voice in three related ways. First, hedge fund activists began buying stakes in companies and agitating for change.[32] Threatening to challenge incumbent board members through proxy contests if ignored, hedge funds demanded share buy backs, cuts to research and development, reorganizations, and other structural changes. Among the most notorious hedge fund managers, whose multiple campaigns are regularly featured in the headlines, are Carl Icahn (Icahn Enterprises), Bill Ackman (Pershing Square), and Jeff Smith (Starboard).[33] Many such campaigns are successful. From 2016 to 2021, for example, hedge fund activists launched an average of more than 200 campaigns per year against U.S. companies and enjoyed broad success in doing so.[34] Notably, activists are rarely required to conduct a full proxy contest to achieve all or some of their objectives; the vast majority of activist campaigns end in negotiated settlements with the issuer agreeing to provide the activist with some level of board representation.[35]

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[31] *See, e.g.*, Yaron Nili & Megan Wischmeier Shaner, *Virtual Annual Meetings: A Path Toward Shareholder Democracy and Stakeholder Engagement*, 63 B.C. L. REV. 123, 128 (2022) ("As the shareholder base for public companies became more geographically dispersed and the proxy system for shareholder voting emerged, the annual meeting became a shell of the deliberative convocation it once was, disenfranchising certain shareholders and limiting substantive engagement.").

[32] *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) (explaining the rise and distinctive features of hedge fund activism).

[33] *See, e.g.*, Jim Osman, *Who Is The King Of The Activists?* FORBES (May 15, 2020), https://www.forbes.com/sites/jimosman/2020/05/13/activist-king-google/?sh=272df0eb5aa2 (describing Jeff Smith as hedge fund manager king "hands-down beating legends Carl Icahn and Bill Ackman").

[34] *See Review and Analysis of 2021 U.S. Shareholder Activism and Activist Settlement Agreements*, SULLIVAN & CROMWELL, LLP 11 (Dec. 20, 2021), https://www.sullcrom.com/files/upload/sc-publication-review-analysis-2021-US-shareholder-activism.pdf. The average number of directors elected from 2014 to 2020 was .62 directors per campaign; the average during 2021 was lower. *Id.* at 12.

[35] *See id.*; Jay Frankl & Steve Balet, *The Rise of Settled Proxy Fights*, HARV. L. SCH. F. ON CORP. GOV., (Mar. 22, 2017), https://corpgov.law.harvard.edu/2017/03/22/the-rise-of-settled-proxy-fights/; Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 2 (2020).

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Second, hedge fund activists, pension funds, and other shareholders began making greater use of the shareholder proposal process. Under state law, shareholders have the right to make precatory proposals to the board.[36] The securities laws require that public companies include these proposals in company proxy materials if certain conditions are met.[37] Shareholder proposals used to have little impact on firm operations, but they are now ubiquitous and routinely gain significant backing.[38]

The first wave of successful shareholder proposals focused on increasing shareholder voice. These proposals called for companies to elect boards of directors annually (rather than allowing directors to serve staggered terms), to nominate directors with fewer ties to management, to require that each director earn a majority vote for election, to institute proxy access, and for other shareholder-empowering governance structures.[39] Although shareholder proposals are cast as recommendations, the vast majority of S&P 500 companies adopted these changes because of this shareholder pressure.[40] Part of the reason shareholder proposals have been so influential is that they play a significant role in shaping the voting policies of the leading proxy advisory firm, Institutional Shareholder Services (ISS).[41] Among the factors that ISS takes into consideration in its director recommendations is whether the board adopted a previously approved shareholder proposal.[42]

Finally, shareholders frequently push their goals in informal meetings with management and by announcing voting policies.[43] Activists meet with targets to negotiate settlement of their demands; proponents of shareholder proposals similarly negotiate concessions from management in exchange for withdrawal of their

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[36] *See, e.g.*, H. Rodgin Cohen & Glen T. Schleyer, *Shareholder vs. Director Control over Social Policy Matters: Conflicting Trends in Corporate Governance*, 26 ND J. L. ETHICS & PUB POL'Y 81, 126 n. 165 (2012) ("if a proposal is in the form of a non-binding request, then the SEC takes the view that it is not contrary to state law.").

[37] *See* 17 CFR § 240.14a-8 (b) (2022).

[38] *See* Jill E. Fisch, *Purpose Proposals*,1 U. CHI. BUS. L. REV. 113, 122-126 (2022) (describing evolution and impact of shareholder proposals).

[39] *See* James D. Cox & Randall S. Thomas, *The SEC's Shareholder Proposal Rule: Creating a Corporate Public Square*, 3 COLUM. BUS. L. REV. 1147, 1163 (2021).

[40] *See* Marc S. Gerber, *U.S. Corporate Governance: From the Frying Pan into the Fire?*, SKADDEN LLP (Jan. 21, 2020), https://www.skadden.com/insights/publications/2020/01/2020-insights/us-corporate-governance.

[41] For an overview of ISS and its role in influencing shareholder voting, see Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649 (2009).

[42] *See* ISS, U.S. PROXY VOTING GUIDELINES BENCHMARK POLICY RECOMMENDATIONS 13 (Dec. 13, 2022), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf (explaining that ISS will analyze, on a case-by-case basis whether to recommend voting against directors if "[t]he board failed to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year").

[43] *See generally* Willard T. Carleton, James M. Nelson & Michael S. Weisbach, *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998) (demonstrating the success of TIAA-CREF's informal engagement efforts).

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proposals.[44] In other private engagements, investors with large stakes voice their opinions on the issues of the day. BlackRock, for instance, might push its view that staggered boards are bad for shareholders. Contained in these conversations is the implicit or explicit threat to vote against unsympathetic board members or for shareholder proposals that institute the shareholder's favored policies. Institutional investors also announce voting policies and threaten to vote against directors at companies that do not make changes to align with these policies.[45] BlackRock CEO, Larry Fink, famously pens a letter to CEO's each year in which, among other things, he discusses his views on the firm's engagement policies.[46] These letters alone change corporate behavior.

Why have shareholders become so much more engaged? Institutionalization of the stock market is the key factor. Historically, equity ownership was dispersed among millions of individual investors, leading to a severe collective action problem. Shareholders as a group are better off if they monitor corporate leaders, but it makes little sense for any individual investor to engage in corporate governance. A single shareholder enjoys only a slice of any gains from engagement but incurs all of the costs involved with agitating for change. Since each investor owns such a small stake, it makes much more sense to sell than to try to improve performance. The result is widespread shareholder apathy and management slack.

In recent years, however, institutional investors have largely replaced individual investors. Today, institutional investors control the voting power with respect to approximately 71% of publicly traded equities.[47] In addition, industry consolidation has led to large players that are able to exert influence through their voting power. The Big Three, in particular, own large stakes in all of the companies in the S&P 500.[48] This

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[44] *See generally* Sarah Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 26 YALE L. J. 262 (2016) (discussing negotiated settlements of shareholder proposals).

[45] *See, e.g.,* BLACKROCK INVESTMENT STEWARDSHIP: PROXY VOTING GUIDELINES FOR US SECURITIES (Jan. 2023), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; Saijel Kishan, *BlackRock Voted Against 255 Directors for Climate Issues*, BLOOMBERG (July 20, 2021), https://www.bloomberg.com/news/articles/2021-07-20/blackrock-voted-against-255-directors-for-climate-related-issues#xj4y7vzkg.

[46] *See* Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (Jan. 18, 2022), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[47] Kate Dore, *Few Individual Investors Participate in Shareholder Voting. Here's How That May Be Changing*, CNBC (Oct. 12, 2021), https://www.cnbc.com/2021/10/12/few-individuals-participate-in-shareholder-voting-but-that-may-change.html.

[48] The term "Big Three" refers to BlackRock, Vanguard and State Street. *See* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 298, 304 (2017) (terming BlackRock, Vanguard and State Street the "Big Three"). Collectively, the Big Three are the largest shareholder in 88% of S&P 500 firms. *Id.* at 313. Because of economies of scale, the majority of the assets managed by the Big Three are in passive investment vehicles such as index funds. *See generally* Fisch, Hamdani & Solomon, *supra* note 26 (describing index funds and the business model of the Big Three).

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gives them a greater incentive to participate than retail investors. Their larger stakes mean they enjoy a larger share of the gains from improved performance. It also means they have a much greater chance of influencing the outcome. Participation is also relatively cheaper because they can spread the cost of engagement across the funds they manage. Further still, the growth of passive investing concentrated in the Big Three has led to giant fund managers forced to invest in companies for the long term and unable to simply sell if displeased with a corporation's direction.[49] To improve performance, their only choice is to participate.

Regulators have also pushed institutional investors to engage. The first mover was the Department of Labor. In a series of advisory letters and then in an interpretive bulletin, it made clear that advisers to private pension plans owe a fiduciary duty to vote shares in portfolio firms in the best interests of pension fund participants.[50] The SEC followed suit in 2003, explaining that mutual fund managers owe a fiduciary duty to vote the shares in their portfolio companies and to vote in the best interests of the shareholders in the funds they oversee.[51] The SEC also began requiring investment advisors to report their votes and voting polices.[52] Before the SEC's involvement, institutional investors were notoriously passive.[53] Now, however, they vote over 90% of their shares whereas individuals vote less than 30%.[54]

These institutions also have a greater say than shareholders of the past. Delaware corporate law has placed increasing weight on shareholder votes.[55] In *Corwin v. KKR Financial Holdings LLC*, the Delaware Supreme Court held that change of control transactions would be subject to review under the deferential business judgment rule if supported by a majority vote of the fully informed and uncoerced shareholders.[56]

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[49] *See* Dov Solomon, *The Importance of Inferior Voting Rights in Dual-Class Firms*, 2019 B.Y.U.L. REV. 553, 562 (2019) ("As opposed to actively managed funds, [passive investors] are unable to exercise the 'Wall Street Walk' and to simply sell their shares if they are dissatisfied.").

[50] *See* Letter from Department to Helmulth Fandl, Chairman of the Retirement Board of Avon Products (Feb. 23, 1988), reprinted in 15 Pens. & Ben. Rep. (BNA) 391 (Feb. 29, 1988) [hereinafter Avon Letter]; Letter from Department to Robert A.G. Monks of Institutional Shareholder Services, Inc. (Jan. 23, 1990), reprinted in 17 Pens. & Ben. Rep. (BNA) 244, 245 (Jan. 29, 1990); Interpretive Bulletins Relating to the ERISA of 1974, 59 Fed. Reg. 38,860, 38,863 (1994) (codified at 29 C.F.R. pt. 2509.94-2 (1994).

[51] 17 C.F.R. § 275.206(4)-6 (2022).

[52] *Id.* at § 270.30bl-4.

[53] *See* Schwartz, *supra* note 91, at 421.

[54] Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 14 (2017) ("Currently, 91% of institutional shares are voted, but voting turnout by retail investors averages less than 30%.").

[55] *Cf.* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 122 YALE. L.J. 553, 553 (2002) (discussing Delaware's "dominate" role in corporate law, particularly with respect to public companies).

[56] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 308 (Del. 2015) (holding that "the Chancery Court correctly held that fully informed, uncoerced vote of the disinterested shareholders invoked the business judgment rule standard of review").

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Similarly, the court in *Kahn v. M&F Worldwide Corp.* held that controlling shareholders in squeeze-out transactions would be subject to the business judgment rule if, among other things, the transaction was conditioned on, and received support from, a fully informed majority of the minority shareholders.[57]

Congress has also increased shareholder voting rights . The Sarbanes-Oxley Act of 2002 gave shareholders the right to approve executive compensation and golden parachute plans.[58] Although this so-called "Say on Pay" vote is non-binding, studies show that it has caused issuers to restructure their compensation practices.[59]

Institutionalization, combined with a regulatory focus on shareholder involvement, has proved a powerful combination. Satisfying shareholders and attending to their interests has gone from an afterthought to a central part of running a public company. Shareholders are now powerful and engaged, and maintaining favorable investor relations is a critical component of management's responsibility.[60]

As institutional investors began to engage, they focused primarily on broad-based corporate governance issues. They backed shareholder proposals that enhanced shareholder rights, engaged directly with management on perceived governance failures, and adopted voting guidelines that signaled their commitment to preserving shareholder influence.[61]

Mutual and pension funds also played a critical role in vetting the firm-specific initiatives spearheaded by hedge fund activists.[62] Hedge funds invest in a limited number of portfolio companies and propose structural or operational changes based on firm-specific analyses often involving deep dives into a company's business plan. Because hedge funds typically purchase less than 10% of the shares in a target company, they rely on the voting support of other institutional investors to implement their plans.[63]

Whether institutional investors were supporting activist campaigns or shareholder governance initiatives, their efforts focused on reducing managerial agency costs and

[57] Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

[58] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78n-1).

[59] David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON. 173 (2013) (reporting that "a substantial number of firms change their compensation programs in the time period before formal shareholder votes in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid negative voting recommendations").

[60] Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 66 (2010) ("The importance of strong 'investor relations' is itself driving many companies to open new channels to engage with shareholders, including direct shareholder surveys and web-based communications.").

[61] *See, e.g.*, Fisch, *supra* note 12, at 76-77.

[62] *See* Gilson & Gordon, *supra* note 25, at 867.

[63] *Id.* at 899.

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increasing accountability—goals consistent with maximizing shareholder economic value. Commentators worried about whether the one-size-fits-all approach to corporate governance was effective[64] and whether short-termism explained institutional investor support for hedge fund activism.[65] It was taken for granted, however, that increasing shareholder value was the appropriate goal of institutional engagement.[66]

B. The Shift to ESG Engagement

More recently, however, institutional investors have begun to use their influence in a new way. They have shifted their focus from traditional matters—governance, management, finance—to environmental and social issues that were once considered irrelevant to successfully running companies.

In recent years, the number of environmental and social issues has climbed.[67] In the 2022 proxy season, shareholders submitted 868 shareholder proposals at Russell 3000 companies, 53% involved environmental and social issues and only 28% implicated corporate governance.[68] Social proposals alone accounted for 33% of all proposals, the largest single subcategory.[69] Environmental proposals were up 51% over the previous year, social proposals were up 20%, and governance proposals were *down* 14%.[70]

Environmental proposals typically seek transparency regarding greenhouse gas emissions and commitments to sustainable policies. One example comes from Costco.[71] A 2022 shareholder proposal that received 70% of the vote recommended that the company "adopt short, medium and long-term science-based greenhouse gas emissions reduction targets, inclusive of emissions from its full value chain, in order to achieve net-zero emissions by 2050 or sooner and to effectuate appropriate emissions reductions prior to 2030."[72] Similarly, social proposals seek transparency regarding diversity, equity, and inclusion (DEI) and related goals and commitments.

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[64] *See, e.g.,* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 891 (2007) (criticizing the corporate governance industry for "a reliance on one-size-fits-all governance checklists").

[65] *See, e.g.*, Mark J. Roe, *Stock Market Short-Termism's Impact*, 167 U. PA. L. REV. 71 (2018) (reviewing and rejecting the claims that investors are driven by short termism).

[66] *See, e.g.,* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 496–97 (2018) (expressing concern that "fund managers are not doing enough to push management to maximize shareholder welfare").

[67] *Shareholder Proposal Developments During the 2022 Proxy Season*, GIBSON DUNN (July 11, 2022), https://www.gibsondunn.com/wp-content/uploads/2022/07/shareholder-proposal-developments-during-the-2022-proxy-season.pdf.

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *See* Emile Hallez, *Behind that Bombshell Shareholder Vote at Costco*, ESGCLARITY (Feb. 2, 2022), https://esgclarity.com/costco-shareholder-vote-emissions/.

[72] *Id.*

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Pfizer faced a 2022 shareholder resolution requesting that the company report on the "the effectiveness of the company's [DE&I] efforts…using quantitative metrics for recruitment, retention and promotion of employees, including data by gender, race and ethnicity."[73] Another form of proposal seeks to implement stakeholder governance by asking corporations to convert to public benefit corporations.[74]

Even hedge fund activists, once critiqued for their sole focus on maximizing short-term profits, have begun to advocate for environmental and social issues. Most notably, in 2021, a small hedge fund, Engine Company No. 1, waged a proxy contest at Exxon that resulted in the election of three new board members committed to shifting the company's focus from oil to renewable energy.[75] In 2022, Carl Icahn, a figure long known for financially driven activism, called on McDonalds to improve its treatment of animals.[76] Although his campaign was unsuccessful,[77] his involvement in an animal-rights issues shows the new way that shareholders are viewing the companies they own.

Institutional investors are also using private engagements and other informal mechanisms to push for environmental and social goals. For instance, in Larry Fink's 2020 letter to CEOs he said, that "[g]iven the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when

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[73] Ben Maiden, *Pfizer Faces Shareholder Proposal on DE&I Disclosure*, CORPORATE SECRETARY (Feb. 24, 2022), https://www.corporatesecretary.com/articles/shareholders/32918/pfizer-faces-shareholder-proposal-dei-disclosure.

[74] Fisch, *supra* note 38.

[75] To be fair, Engine No. 1 defended its campaign in terms of Exxon's economic value. *See* Proxy Statement of Engine No. 1 LLC (March 15, 2021), https://www.sec.gov/Archives/edgar/data/0000034088/000090266421001931/p21-0957defc14a.htm, (explaining that Exxon's approach showed "a lack of adaptability to changing industry dynamics, including higher production costs and growing long-term oil and gas demand uncertainty. This approach stands in contrast to the Company's peers who performed better for shareholders over these periods, including by focusing on returns over production growth and beginning to evolve their businesses for a decarbonizing world."). As we discuss *infra* text accompanying note 254, this illustrates how values and value can be intertwined in any particular corporate decision. Framing the issue in terms of value, rather than values, enables fund managers to defend their support for the proposal as consistent with their obligations as fiduciaries. *See infra* text accompanying note 106.

[76] *See* Hugh Son, *Carl Icahn Launches Proxy Fight with McDonald's over Treatment of Pigs*, CNBC (Feb. 20, 2022), https://www.cnbc.com/2022/02/20/carl-icahn-launches-proxy-fight-with-mcdonalds-over-treatment-of-pigs.html (describing Carl Icahn's proxy fight at McDonalds over its treatment of pigs).

[77] *See* Amelia Lucas*, Carl Icahn Loses Proxy Fight With McDonald's Over Animal Welfare,* CNBC (May 26, 2022), https://www.cnbc.com/2022/05/26/carl-icahn-loses-proxy-fight-with-mcdonalds-over-animal-welfare.html.

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companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[78]

This growing concern for environmental and social issues among shareholders is part of a broader reevaluation of the role of corporations in society. For the past forty years, managers ran their firms under a "shareholder primacy" view of the corporation.[79] Under this view, their sole obligation was to maximize long-term shareholder value. Their job is no longer as straightforward. Management now must be conscious of the social and environmental implications of what were once viewed solely as business decisions. A manufacturing firm, for example, can no longer simply source components from the cheapest supplier or locate its factories where wages are lowest. Socially or environmentally insensitive choices are met with blowback from shareholders, consumers, and politicians, in the media, at annual meetings, and on social media.[80]

Companies also face pressure to have a social conscience and to act in accordance with that conscience. Disney used to focus solely on family-friendly movies and amusement parks. In 2022 it was forced into the debate about sex education for young children.[81] The list of issues on which corporations are expected to act grows daily. In March 2021, Merck CEO Ken Frazier campaigned for corporations to take stands against efforts to restrict voting rights.[82] When Russian troops attacked the Ukraine, a substantial number of corporations announced that they would stop doing business in Russia.[83] As one commentator explains, "the business world has become enmeshed in an international geopolitical conflict with a whole new force."[84] In connection with

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[78] Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, BLACKROCK (2020), https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter. State Street announced a similar policy. *See* Chuck Callan, *2022 Proxy Season Preview*, HARV. L. SCH. F. ON CORP. GOV. (Mar. 14, 2022), https://corpgov.law.harvard.edu/2022/03/14/2022-proxy-season-preview/ ("State Street Global Advisors said it will start voting against directors at some companies that don't disclose (1) emissions reduction targets or (2) how their boards are overseeing climate change-related risks…").

[79] *See generally* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006) (describing the "shareholder primacy norm").

[80] *See* Saabira Chaudhuri, *Does Your Mayo Need a Mission Statement?,* WALL ST. J. (May 20, 2022), https://www.wsj.com/articles/unilever-purpose-marketing-social-cause-11653050052 ("Surveys have found that people are increasingly willing to use or drop brands based on a company's response to calls for racial justice.").

[81] *See* Elizabeth Blair, *After Protests, Disney CEO Speaks Out Against Florida's 'Don't Say Gay' Bill,* NPR, Mar. 8, 2022, https://www.npr.org/2022/03/08/1085130633/disney-response-florida-bill-dont-say-gay.

[82] Kevin Stankiewicz, *'There is No Middle Ground' — Black CEOs Urge Companies to Oppose Restrictive Voting Laws*, CNBC (Mar. 31, 2021), https://www.cnbc.com/2021/03/31/ken-frazier-black-ceos-urge-firms-to-oppose-restrictive-voting-laws.html.

[83] *See* Belinda Luscombe, *Hundreds of CEOs Came Out Against Russia. Their Involvement Could Change War Forever*, TIME (Mar. 11, 2022), https://time.com/6155725/corporations-war-russia-ukraine/.

[84] *Id.*

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Supreme Court's decision to overturn Roe v. Wade, corporations are facing "pressure from shareholders, employees and local governments to take a stance on access to abortion."[85]

Similarly, many have argued for a shift in business objectives from a focus exclusively on shareholder primacy to stakeholder governance—an approach that considers the interests of non-shareholder stakeholders including employees, customers and society at large.[86] In an acknowledgment of the shifting expectations on corporations, the Business Roundtable, a business lobbying organization that long advocated a shareholder primacy view, announced a commitment among its members to run corporations with "stakeholders" in mind.[87] Many originally dismissed this statement as puffery,[88] but it is now difficult to argue that, whether because they want to or because they have to, managers must now look beyond shareholder value in making corporate decisions.

This shift raises an issue that has gone heretofore unexamined. When corporations and corporate governance focused largely or exclusively on shareholder economic value, it was reasonable to assume that fund managers could represent beneficiary views by supporting measures aligned with this goal. In addition, since fund beneficiaries delegated to fund managers decisions about how to invest the fund's assets to maximize shareholder value, it also made sense to delegate decisions about how to vote and engage to maximize the value of those assets.[89] Finally, because of their connection to value, there was a plausible case that fund managers were representing shareholder views when voting and advocating for mechanisms to increase management accountability, such as annual board elections, proxy access, and majority voting.

But, as corporations are increasingly viewed more holistically, as social and economic institutions, rather than just economic ones, the relationship between beneficiary interests and value maximation breaks down. As a result, it is no longer safe to assume that fund managers automatically represent their beneficiaries' interests when they engage with portfolio firms. With this potential gap between fund

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[85] Mengqi Sun, *Abortion Debate Puts Corporate Initiatives in the Spotlight*, WALL ST. J. (May 4, 2022), https://www.wsj.com/articles/abortion-debate-puts-corporate-initiatives-in-the-spotlight-11651687778.

[86] *See* Fisch, *supra* note 38, at 120 (canvassing support for stakeholder governance).

[87] *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'* BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[88] *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell L. Rev. 91, 98 (2020) (arguing that the Business Roundtable's "statement is largely a rhetorical public relations move rather than the harbinger of meaningful change.").

[89] Not everyone took this position. *See, e.g.*, Lee Harris, *Missing in Activism: Retail Investor Absence in Corporate Elections*, 2010 COLUM. BUS. L. REV. 104 (expressing concern about activist hedge funds starting proxy contests that do not reflect the views of retail shareholders).

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engagement policies and the preferences of fund beneficiaries, it becomes critically important to examine the structure that permits this divergence—intermediation.

II. THE STRUCTURE AND PITFALLS OF INTERMEDIATED VOTING

When institutional investors—primarily mutual funds and pension funds—vote shares in portfolio firms, they act as intermediaries.[90] The distinguishing feature of institutional intermediaries is that the funds hold legal title to the securities in their portfolios and therefore have the authority to vote those securities, but the underlying economic interest in the securities belongs to the funds' beneficiaries.

Allowing fund managers to command the voting power of millions of individual beneficiaries makes productive engagement possible. The heft they command by virtue of the quantity of assets (and resulting voting power) that they manage allows them to command management's attention much more readily than any individual. They are also more sophisticated than their typical beneficiaries and have far greater resources to analyze issues and lobby for change.

As currently structured, however, intermediation fails to live up to its promise. Even with respect to traditional governance issues—where, as discussed above, it is plausible to assume that fund managers can dutifully represent their beneficiaries' best interests by pursuing long-term value—there are both theoretical and empirical reasons to question whether fund managers are acting as faithful agents. Stewardship, it turns out, is relatively hard, potentially costly, and generates little, if any, profit for fund managers.[91] This means they have a limited incentive to do a good job.

Building on this insight, commentators have criticized managers as insufficiently engaged, motivated by private benefits or political objectives, or focused merely on compliance with minimum regulatory requirements.[92] Empirical evidence also offers reasons to question the claimed benefits of the good governance measures and hedge fund activist challenges that fund managers tend to back. Although improved corporate governance increases the voice and potential power of shareholders, and

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[90] *See generally* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries,* 158 U. PA. L. REV. 1961, 1963-63 (2010) ("In addition to mutual funds, retail money is invested through other intermediaries including exchange-traded funds (ETFs), pension funds, and money market funds").

[91] *See* Jeff Schwartz, *Stewardship Theater*, 100 WASH. U. L. REV. 393, 410-19 (2022) (assessing the costs and benefits of stewardship from the fund manager's perspective).

[92] *See, e.g., id.* at 396 (arguing that "politics largely motivates voting at the largest managers"); Jeff Schwartz, *'Public' Mutual Funds*, *in* CAMBRIDGE HANDBOOK ON INVESTOR PROTECTION 42 (Arthur Laby ed., 2021) (arguing that large mutual fund managers "participate in corporate governance just enough to ward off public opprobrium and potential regulation"); Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2095-2116 (2019) (critiquing mutual funds for being too passive in corporate governance); Lund, *supra* note 66, at 495 (expressing concern that "passive fund managers will … adhere to low-cost voting strategies").

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hedge fund activism generates short-term price gains, a variety of academic studies have failed to demonstrate that either increases long-term value.[93]

The shift toward environmental and social issues adds an additional layer to the problem. At least with respect to traditional governance matters, it could generally be assumed that beneficiaries shared a common goal—maximize long-term portfolio value—and that stewardship should be used to advance that goal. Investors in an S&P 500 index fund, for example, presumably would support governance proposals that increase firm economic value. When it comes to environmental and social issues, however, investors may have vastly different views and there is no unifying principle to guide stewardship efforts. An investor's decision to invest in an S&P 500 index fund does not provide a basis for determining how that investor would want the fund to vote on racial equity audits.

Without long-term value serving as common ground, the current system cannot claim to represent the interest of fund shareholders. The fundamental problem is that voting and engagement on environmental and social issues implicate contested values, and fund managers make no effort to represent or even learn about the ideological diversity of their beneficiaries. This fails those beneficiaries whose values do not align with the fund managers' positions.

For many years, large fund managers had a cautious relationship with ESG. While they often spoke publicly in support of environmental and social goals, they regularly voted against such proposals.[94] This earned the ire of scholars, investors, politicians, and nonprofits.[95] In 2021, however, the large fund managers began strongly supporting shareholder proposals related to these topics.[96] Now, they are at odds with different groups, including some politicians.[97] Although there is currently no direct way to ascertain the positions of mutual fund shareholders on ESG issues, there are reasons to question the extent to which they support the voting decisions of fund managers. For example, one study found that in 2021, only 18% of retail investors supported

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[93] *See, e.g.*, Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013) (finding no long-term benefits to investors from investments in firms with better governance practices); Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475 (2018) (surveying conflicting empirical results on the economic impact of staggered boards); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921-50 (1999) (finding inconclusive evidence on the value of independent directors); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 581-592 (2016) (surveying empirical studies on hedge fund activism).

[94] Schwartz, *supra* note 91, at 423-24.

[95] *See id.* at 429.

[96] *See id.* at 442.

[97] *See, e.g.,* Saijel Kishan & Jeff Green, *Onetime Trump Appointee Helps Spark Sweeping ESG Backlash*, BLOOMBERG (Nov. 20, 2022), https://www.bloomberg.com/news/articles/2022-11-20/onetime-trump-appointee-helps-spark-sweeping-esg-backlash (describing "ESG backlash" against BlackRock and other financial firms).

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such proposals.[98] While retail investors are not the same as mutual fund investors, the statistic is nevertheless telling.[99]

Similarly, although mutual fund investors are not the same as citizens generally,[100] as one commentator put it:

> If American fund managers asked clients about this, their answers might be very different from what ESG proponents favor. … While ESG activists seek to curtail U.S. energy production, 61% of Americans favor expanding domestic production of natural gas. While ESG activists demand race and sex quotas for corporate boards, 74% of Americans believe that employment decisions should be based on qualifications alone. And while ESG funds often exclude gambling companies from their investments, 80% of Americans support legal sports betting.[101]

Additional evidence of widespread disagreement is that environmental and social issues are among the central topics that separate the Democrat and Republican parties.[102] Since ordinary citizens are split on these issues, it is likely that fund beneficiaries themselves disagree.[103]

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[98] Broadridge Financial Solutions, *Growing Gap in Support of ESG Voting Between Retail and Institutional Investors*, CISION PR NEWSWIRE (Feb. 24, 2022), https://www.prnewswire.com/news-releases/growing-gap-in-support-of-esg-voting-between-retail-and-institutional-investors-broadridge-reports-301489416.html#:~:text=Retail%20investor%20support%20for%20environmental,2020%20to%2045%25%20in%202021.

[99] The two groups overlap significantly. *See* INV. CO. INST., CHARACTERISTICS OF MUTUAL FUND INVESTORS 2022 at 6 fig. 3 (Oct. 2022), chrome-extension://efaidnbmnnnibpcajpcglcl efindmkaj/https://www.ici.org/system/files/2022-10/per28-10.pdf (showing that 41% of mutual fund investors own individual stocks).

[100] A significant portion of the population—about 102.6 million individuals—owns mutual funds. INV. CO. INST., 2022 INVESTMENT COMPANY FACT BOOK 117 (62nd ed. 2022). "Seventy percent of individuals heading households that owned mutual funds were married or living with a partner, 57 percent were college graduates, and 75 percent worked full- or part-time." *Id.* These shareholders, by and large, invest in diversified equity funds, rather than funds with a specific ESG focus. *See id* at 7 fig. 5 (showing that 81% of mutual fund owners held equity funds); *After Two-Year Surge in Demand, ESG Fund Assets Still Have Room to Run*, ISS INSIGHTS (Mar. 30, 2022), https://insights.issgovernance.com/posts/after-two-year-surge-in-demand-esg-fund-assets-still-have-room-to-run/ (noting that, as of March 2022, ESG funds held 1.4% of mutual fund assets).

[101] Vivek Ramaswamy & Alex Acosta, *Biden's ESG Tax on Your Retirement Fund*, WALL ST. J. (July 19, 2022), https://www.wsj.com/articles/bidens-esg-tax-on-your-retirement-fund-pension-planning-regulation-climate-change-investment-returns-portfolios-11658245467?mod=itp_wsj&mod=djemITP_h.

[102] Even if one were to somehow argue that the fund managers' votes align with the views of most beneficiaries, this would be an unconvincing argument to support the *status quo* because this could easily change if fund managers start to support more niche issues.

[103] Although the demographics of mutual fund owners differ from that of the citizenry, the way in which they differ likely means the above discussion understates the amount of disagreement with pro-ESG positions. *See infra* text accompanying note 265.

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The final evidence that mutual fund managers are numb to their beneficiaries' views comes from a recent empirical study. Relying on data about how mutual fund shareholders vote when they also own shares in operating companies directly, the study compared "mutual fund votes to the votes of individuals who own those mutual funds."[104] It found no relationship.[105]

Unsurprisingly, fund managers deny that their votes are unmoored from their beneficiaries' views. Instead, they argue that environmental and social initiatives are no different than traditional governance proposals because they too increase the long-term economic value of their portfolio companies. Fund managers then defend their support of such proposals as in the best interests of their shareholders and argue that this is all their fiduciary duty requires.[106]

This logic, however, is flawed. While some firms might perform better if they were operated more sustainably or employed a more diverse workforce, the benefits of any given environmental or social initiative are often unclear. Much depends on the nature of the proposal and its connection to the targeted company's business. A proposal to improve McDonald's treatment of pigs may turn out to be good for business if customers embrace the company's commitment to animal welfare.[107] It also likely has a relatively small impact on the company's operations. A proposal to end Phillip Morris's production of cigarettes in three years, in contrast, is unlikely to improve Philip Morris's profitability.[108] Perhaps because the financial impact of environmental and social issues is so fact dependent, empirical evidence fails to show that they lead to improved performance.[109] Indeed, given the broad and amorphous scope of what counts as ESG, it is difficult to imagine how one could empirically test the relationship between ESG and firm economic value.[110] It is, therefore, a vast

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[104] Jonathon Zytnick, *Do Mutual Funds Represent Individual Investors?* 4 (Oct. 7, 2022), NYU Law and Economics Research Paper No. 21-04, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3803690.

[105] *See id.* at 4-5.

[106] *See, e.g.,* Austin R. Ramsey, *BlackRock, State Street Defend ESG Policy After Republican Slam*, BLOOMBERG LAW (July 1, 2021), https://news.bloomberglaw.com/daily-labor-report/blackrock-state-street-defend-esg-policy-after-republican-slam.

[107] *See* Son, *supra* note 76.

[108] *See* Trinity Health, Notice of Exempt Solicitation (Apr. 13, 2022), https://www.sec.gov/Archives/edgar/data/1413329/000121465922005454/o413225px14a6g.htm.

[109] David F. Larcker, Brian Tayan & Edward M. Watts, *Seven Myths of ESG*, STANFORD CLOSER LOOK SERIES, Nov. 4, 2021, https://www.gsb.stanford.edu/sites/default/files/publication/pdfs/cgri-closer-look-94-seven-myths-esg_1.pdf (citing empirical research and describing the claim that ESG improves performance as a "myth").

[110] *See, e.g.*, Elizabeth Pollman, *The Making and Meaning of ESG* 20 (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4219857 (explaining that "consensus on the meaning of ESG does not currently exist.").

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oversimplification to say, as the leading fund managers do, that they vote for environmental and social proposals because they increase long-term value.[111]

Fund manager behavior is also inconsistent with the narrative that environmental and social issues are linked to firm value. As noted above, the large fund managers routinely voted against environmental and social proposals until the 2021 proxy season.[112] This aligns with a political explanation—the shift from the anti-ESG Trump administration to the pro-ESG Biden administration—rather than some sudden insight about the financial benefits.[113]

Moreover, tying environmental and social issues to long-term value does not resolve the fundamental ideological disagreement. A liberal might see the long-term financial benefits of sustainability while a conservative sees a trade-off with firm value. How one views the impact of environmental and social proposals on firm performance is largely a function of values and political leanings, not finance. Because support for such measures is based on contested values, not just financial analysis, fund managers cannot, at the same time, ignore beneficiary views and claim to faithfully represent them.

The failure to represent beneficiary views is more than an abstract harm. Fund managers' current support for environmental and social proposals has subtle deleterious impacts on those opposed. When large fund managers adopt an ESG view for their non-ESG funds, it limits the ability of investors to participate in funds without this perspective. Although a handful of anti-ESG funds are now available, they are new, small, and higher cost than broad-based index funds.[114] Moreover, like the

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[111] Fund managers could argue that they only support environmental and social proposals that increase firm value. This claim, however, is inconsistent with their broad issued-based voting policies. The claim also understates the complexity of the financial analysis involved with whether environmental and social issues increase firm value. For one, the financial calculation depends on future political developments. A company that leads in sustainability, for example, would be well positioned if regulators begin imposing environmental restrictions that are costly for competitors to implement. If environmental regulations are watered down in the future, however, then the company would be at a disadvantage. The future of consumer sentiment also matters. Future consumers may be more willing to pay for sustainably produced goods if times are good, but in recessions or inflationary times, consumers may be less willing to pay extra for such products. Political risk also comes into play. Russia's invasion of Ukraine, for instance, drove up fossil fuel prices. Because of this development, a fund's decision to divest from fossil fuel, as well as a fossil fuel company's decision to transition away from this sort of energy, suddenly appear quite costly.

[112] *See supra* note 96 and accompanying text.

[113] *See* Schwartz, *supra* note 91, at 442.

[114] *See, e.g.*, *Why MAGA ETF?,* POINT BRIDGE CAPITAL, https://www.pointbridgecapital.com/etf/ (last visited Feb. 4, 2003) (explaining that the MAGA ETF allows investors "to invest in companies that align with your Republican political beliefs" at a cost of 72 basis points); *DRLL Strive U.S. Energy ETF*, STRIVE ASSET MANAGEMENT, https://www.strivefunds.com/drll (last visited Feb. 4, 2003) (explaining that DRLL provides investors with broad exposure to the energy sector and "aims to unlock value in the U.S. energy sector by mandating companies to focus on profits over politics" at a cost of

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explicitly pro-ESG funds they oppose, they reflect a values-based approach to investing and stewardship that leaves no alternative for what is likely a large group of investors—those who want ESG to play little or no role in either stewardship or portfolio selection.[115]

The homogeneity among the Big Three is particularly problematic given the role that the large fund managers play in retirement savings. They administer the bulk of employee 401(k) plans.[116] While the fund managers provide employees in these plans with some options outside of their funds, they typically do not offer directly competing funds.[117] For example, a Fidelity-managed 401(k) plan may offer another manager's emerging growth fund, but not another manager's large cap index fund. An employee interested in a large cap index fund would be forced to invest in Fidelity's product regardless of its voting policies. Their votes would then be cast for positions they oppose. Nor are the anti-ESG funds likely to appear on 401(k) plan menus.

These problems are magnified in the context of pension funds. Traditional pension funds do not offer employees a menu of investment options—the funds' trustees choose investments and determine how to vote the shares of their portfolio companies.[118] Although a pension fund may delegate voting and investment decisions to a mutual fund company such as BlackRock, the pension fund beneficiaries play no role in that delegation.[119] Overall, there is less transparency around pension fund engagement and less reason to believe that their stewardship efforts map onto beneficiary views.[120]

Some commentators argue that fund managers are permitted or even obligated to take ESG positions in order to enhance the overall value of their portfolios.[121] They argue that certain ESG initiatives, such as reducing climate change, reduce systemic

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41 basis points). In contrast, Vanguard's S&P 500 index fund has an expense ratio of 3 basis points. *VOO Vanguard S&P 500 ETF*, VANGUARD, https://investor.vanguard.com/investment-products/etfs/profile/voo (last visited Feb. 4, 2003).

[115] As discussed *infra* text accompanying notes 176-182, recent regulatory efforts to promote informed choice in the mutual fund marketplace also fail to account for this group.

[116] *See* Robert Steyer, *Overall Assets Jump Nearly 22% for Top 25 Firms*, PENSION & INVS. (June 1, 2020), https://www.pionline.com/largest-money-managers/overall-assets-jumpnearly-22-top-25-firms.

[117] *See* Veronika K. Pool, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, 71 J. FIN. 1779, 1788 (2016) ("[A]ffiliated funds are more likely to be more basic investment options (such as standard domestic equity funds or passively managed index funds), whereas unaffiliated funds are more likely to be specialized funds (such as international or sector funds))".

[118] *See* Avon Letter, *supra* note 50.

[119] GOV'T ACCOUNTABILITY OFFICE, GAO-04-749, PENSION PLANS: ADDITIONAL TRANSPARENCY AND OTHER ACTIONS NEEDED IN CONNECTION WITH PROXY VOTING 10 n. 12 (2004), https://www.govinfo.gov/content/pkg/GAOREPORTS-GAO-04-749/html/GAOREPORTS-GAO-04-749.htm.

[120] *Id.* at 28-29 (discussing the lack of transparency around pension fund engagement compared to mutual funds).

[121] *See, e.g.*, Jeffrey Gordon *Systemic Stewardship*, 47 J. CORP. L. 628 (2022).

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risk, which enhances the value of a diversified portfolio even if it reduces the economic value of specific companies in that portfolio.[122] The problem with this theory is the impact of fund managers is limited to the companies in which their funds invest. In response, pollution producing activities can migrate offshore or to private companies rather than disappear. For example, a French utility sold its coal plants in 2019 and then touted its move to eliminate carbon emissions.[123] The plants were simply purchased by a private equity company that continued to operate them.[124] The result in this, and similar examples, is that public investors continue to bear the costs of the pollution but do not share in the benefits. This might be defensible if it represented the will of fund beneficiaries, but it is particularly problematic when many are opposed.

Those beneficiaries opposed to the fund managers' positions are most directly harmed, but they are not the only ones. A democratic system is designed to reflect the views of its citizens. Only a fraction of citizens are shareholders, directly or indirectly,[125] and there are only a few powerful fund managers.[126] Yet incorporating environmental and social issues into corporate governance means that corporate managers are adopting policy positions, not in response to regulation, but in response to the voting and engagement efforts of a small group of fund managers. If the government were setting the rules, democratically-elected public officials would impose the environmental rules and regulations. If the corporate governance process is yielding similar rules, legitimacy demands public participation in that process.[127] It is undemocratic to rely on unelected, largely unaccountable, financial institutions to set public policy without any input from the public.

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[122] *Id* at 629.

[123] Catherine Boudreau, *When Companies Go Green, the Planet Doesn't Always Win*, POLITICO (Mar. 30, 2021), https://www.politico.com/news/2021/03/30/companies-green-planet-doesnt-always-win-478460.

[124] *Id.*

[125] Only about 58% of people own stocks. Lydia Saad & Jeffrey M Jones, *What Percentage of Americans Own Stock?*, GALLUP (May 12, 2022), https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx. Those who do are wealthier and less diverse than the overall population. *See, e.g.*, William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489, 491 (2013) ("The modal shareholder in the data is rich, old, and white. It follows that there is nothing inherently democratic or progressive about the shareholder interest in corporate politics."); Sarah C. Haan, *Voter Primacy*, 83 FORDHAM L. REV. 2655, 2700 (2015) ("Stockholding Americans are more likely to be white, male, and older than non-stockholding Americans, and more likely to identify as Republican.").

[126] *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 1 (Harvard Pub. Law Working Paper No. 19-07, 2018) (noting that the continued growth and concentration of the mutual fund industry means that the heads of the large fund managers, about twelve people, will soon have "practical power over the majority of U.S. companies.").

[127] There is still a legitimacy problem. As noted *supra* note 125, Only 58% of people own stocks, and the owners are wealthier and less diverse than the overall population. Mutual fund shareholder participation in corporate governance does not resolve this problem, but it at least makes the process more democratic. *See infra* text accompanying notes 265-270.

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Concerns about legitimacy are already spurring a political backlash. Because it manages significant sums on behalf of public pension funds,[128] BlackRock, in particular, has become a target. Nineteen Republican-led states recently penned a letter to the firm criticizing its ESG stance as an inappropriate "use [of] the hard-earned money of our states' citizens to circumvent the best possible return on investment, as well as their vote."[129] West Virginia has barred BlackRock from doing business with the state.[130] Florida pulled out $2 billion in public pension money from BlackRock over its ESG stance.[131] Texas is threatening to follow suit.[132]

This pressure may have caused BlackRock to reevaluate its ESG stance,[133] but that shift is irrelevant to the core problem. Whether BlackRock leans Republican or Democrat, it is failing to represent beneficiary views. This failure is a structural problem that requires a solution that targets the structure of fund management.

III. POTENTIAL SOLUTIONS

There are several possible solutions to our concern that institutional intermediaries are not fairly representing the interests of their beneficiaries. In this Part, we consider solutions enacted or proposed elsewhere—increased disclosure obligations, stewardship codes, and pass-through voting—and identify potential weaknesses in them. In the next Part, we describe our proposed alternative for giving fund beneficiaries a voice.

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[128] For example, BlackRock manages $62.5 billion in NY public pension money. *See* Dominic Webb, *Missouri Pulls BlackRock Funds as New York City Reiterates Climate Criticisms*, RESPONSIBLE INVESTOR (Oct. 10, 2022), https://www.responsible-investor.com/missouri-pulls-blackrock-funds-as-new-york-city-reiterates-climate-criticisms/#:~:text=BlackRock%20was%20responsible%20for%20 %2462.5,at%20the%20end%20of%20May.

[129] Letter from Mark Brnovich, Arizona Attorney General, et al., to Laurence Fink, BlackRock, dated Aug. 4, 2022, https://www.texasattorneygeneral.gov/sites/default/files/images/executive-management/BlackRock%20Letter.pdf.

[130] Pete Schroeder, *West Virginia Bars Five Financial Firms for Deemed Fossil Fuel 'Boycotts',* REUTERS (July 28, 2022), https://www.reuters.com/business/sustainable-business/west-virginia-bars-five-financial-firms-deemed-fossil-fuel-boycotts-2022-07-28/.

[131] Ross Kerber, *Florida pulls $2 Bln from BlackRock in Largest Anti-ESG Divestment*, Reuters, Dec. 11, 2022, https://www.reuters.com/business/finance/florida-pulls-2-bln-blackrock-largest-anti-esg-divestment-2022-12-01/.

[132] Ross Kerber, *Facing Texas Pushback, BlackRock Says It Backs Fossil Fuels*, REUTERS (Feb. 17, 2022), https://www.reuters.com/markets/us/facing-texas-pushback-blackrock-says-it-backs-fossil-fuels-2022-02-17/; Ross Kerber & Pete Schroeder, *BlackRock*, *European firms face Texas pension ban over energy policies*, REUTERS (Aug. 24, 2022), https://www.reuters.com/business/sustainable-business/texas-comptroller-names-blackrock-credit-suisse-boycotting-fossil-fuels-2022-08-24/; *see also Internal Documents Shed Light on SFOF's Attack on Climate Policy*, DOCUMENTED (Aug. 5, 2022), https://documented.net/investigations/sfof-resources-and-evidence-3 (comprehensively outlining state-level pushback to climate advocacy in the financial sector).

[133] *See BlackRock Pulls Back Support for Climate and Social Resolutions*, FIN. TIMES (July 26, 2022), https://www.ft.com/content/48084b34-888a-48ff-8ff3-226f4e87af30.

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A. Disclosure Obligations and Constraints on Stewardship

The core problem with fund-manager stewardship is agency costs. Because fund managers are agents of fund beneficiaries, they are obligated to represent their interests when they vote. Agency costs arise when—as now—fund managers fail to do so. The typical response to agency costs is fiduciary duties backed by the threat of litigation. Directors and officers of a corporation, for example, owe the firm and its shareholders fiduciary duties and face liability for breaches of the duty of care or loyalty.[134] This same obligation is the backbone of fund stewardship. Under federal and state law, pension-fund and mutual-fund managers owe fiduciary duties of loyalty and care to vote shares in their beneficiaries' best interests.[135]

The problem is that this structure, on its own, is an ineffective check on fund-manager behavior. These laws do not specify what beneficiary best interests are or how intermediaries should make that determination. Nor does existing law impose any obligation for intermediaries to ascertain the preferences of their beneficiaries. As such, the law provides limited guidance for intermediaries that seek to comply with this requirement and scant liability exposure for intermediaries that act in whole or in part out of self-interest. Indeed, the fiduciary duty at this point is toothless. To our knowledge, there has not been a successful claim that institutional investors have failed the best interest standard when voting shares in their portfolio companies.[136]

One possible solution is to impose greater constraints or obligations on fund managers through regulation. This is currently the primary approach in the US, as well as abroad. These regulations typically take the form of increased disclosure obligations, affirmative stewardship responsibilities, or a combination of the two. As discussed above, the US rules not only require disclosure of voting policies and voting records,

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[134] *See, e.g.*, Gantler v. Stephens, 965 A.2d 695, 709 (Del. 2009) ("[O]fficers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty.").

[135] *See Proxy Voting by Investment Advisors*, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003) ("Under the Advisers Act…an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own."). For pension funds, see GOV'T ACCOUNTABILITY OFFICE, *supra* note 29, at 11 (summarizing that pension plan "fiduciaries must exercise an appropriate level of care and diligence given the scope of the plan and act for the exclusive benefit of plan participants and beneficiaries, rather than for their own or another party's gain").

[136] To the extent that fund managers face fiduciary duty litigation, it centers exclusively on the fees that they charge. *See, e.g.*, Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010); Quinn Curtis, *The Past and Present of Mutual Fund Fee Regulation*, *in* RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS 166-170 (John Morley & William Birdthistle eds., 2018) (describing recent mutual fund fee cases).

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but also mandate that institutional intermediaries vote the stock of their portfolio companies.[137] The latter rule is an example of an affirmative stewardship obligation.

Neither disclosure nor stewardship obligations, however, offer a satisfying solution to fund-manager agency costs. While, in theory, disclosure allows beneficiaries to police fund managers for failure to represent their best interests, in practice, it is of limited practical value. The current US rules are a case in point. First, the voting policies that fund managers create and disclose are often vague[138] or simply provide that the fund will vote on a case-by-case basis,[139] making it difficult for a fund owner to predict actual voting practices by reviewing those guidelines.

Second, although funds are required to disclose how they vote the shares of their portfolio companies, they do not do so in a user-friendly manner. It is common for funds to simply list all the votes cast at each individual shareholder meeting, but the task of calculating the frequency with which a fund voted against, for example, shareholder proposals on climate change, would be substantial.[140] Fund disclosures do not allow investors to sort or select based on specific proxy voting issues or to compile aggregate voting results. Although some market providers such as Morningstar collect information on how funds vote and make some of that information publicly available,[141] much is only accessible to paying customers.[142] In addition, to date, providers have not offered ratings of fund voting records.[143]

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[137] *See supra* notes 51-52 and accompanying text.

[138] *See, e.g.*, BLACKROCK, *supra* note 45, at 18 ("When presented with shareholder proposals requesting increased disclosure on corporate political activities, BIS will evaluate publicly available information to consider how a company's lobbying and political activities may impact the company").

[139] *See, e.g.*, FRANKLIN MUTUAL ADVISERS, LLC, PROXY VOTING POLICIES & PROCEDURES, AN SEC COMPLIANCE RULE POLICY AND PROCEDURES 7 (Mar. 2022), https://franklintempletonprod.widen.net/s/z7xjkbxjnl/fma_proxyvotingpolicies ("The Investment Manager will consider each proposal relating to carbon emissions or Net Zero on its own merits, in light of the relevant regulatory environment(s) and economic impact on the business.").

[140] *See, e.g.*, *Voting Records*, FRANKLIN TEMPLETON, , https://www.franklintempleton.com/accounts/account-services-support/account-resources/proxy-voting/voting-records/index (last visited Feb 4, 2023); *Proxy Voting Records*, VANGUARD, https://vds.issgovernance.com/vds/#/MjAxMA==/ (last visited Feb 4, 2023).

[141] *See, e.g.*, Jackie Cook & Lauren Solberg, *The 2021 Proxy Voting Season in 7 Charts*, MORNINGSTAR (Aug. 5, 2021), https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts.

[142] *Elevate Your Investment Story*, MORNINGSTAR DIRECT, https://www.morningstar.com/products/direct (last visited Feb. 4, 2023).

[143] *Morningstar Proxy Data: Fund Voting, Aggregate Data Frequently Asked Questions*, MORNINGSTAR DIRECT (May 2021), https://morningstardirect.morningstar.com/clientcomm/FundProxyDataFAQs.pdf.

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The SEC recently enacted minor changes to the voting disclosure rules,[144] but the potential value of these changes is unclear. Disclosure is only a useful regulatory tool if investors understand it and use it to police how fund managers vote. But, as we discuss further below, there are serious questions about whether it is possible to produce easily digestible voting information and whether individual investors have the capacity and desire to engage with it, particularly in the context of mutual fund portfolios that hold hundreds of companies, each of which holds an annual meeting at which shareholders may face dozens of issues on which to vote.[145]

Stewardship codes offer a more directive approach to policing fiduciary conduct.[146] A variety of stewardship codes abroad set out guidance for fund managers in investment decision-making and engagement.[147] The UK pioneered these efforts with its 2010 Stewardship Code,[148] which was substantially revised in 2020.[149] The goal of the Code was to harness the voting power of institutional investors to address managerial agency problems that were perceived to contribute to the 2008 financial crisis. The chosen approach was "to incentivize institutional investors, through the use of soft law, to act as 'good stewards' by exercising their control over listed companies through their collective voting rights—with the goal of mitigating the excessive risk-taking and short-termism by corporate management" that led to the crisis.[150]

The first versions of the UK Code focused almost exclusively on promoting more active engagement. The Code was voluntary and adopted a comply-or-explain approach in which signatories committed to engagement with management through voting, discourse, and shareholder proposals. Signatories were also required to disclose how they complied with the Code's stewardship principles and any deviations.[151] As

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[144] *See* Enhanced Reporting Rule, *supra* note 4, 87 Fed. Reg. at 78778 (requiring, among other things, that mutual funds disclose voting matters in categories, including, for example, environmental or climate; human rights or human capital/workforce; and diversity, equity and inclusion).

[145] *See infra* text accompanying notes 187-189.

[146] One trio of scholars defines a stewardship code as "a set of principles that articulate how institutional investors should behave as stewards of the capital that they are responsible for investing on behalf of their ultimate beneficiaries." Gen Goto, Alan K. Koh & Dan W. Puchniak, *Diversity of Shareholder Stewardship in Asia: Faux Convergence*, 53 VAND. J. TRANSNAT'L L. 829, 831 (2020).

[147] *See generally* GLOBAL SHAREHOLDER STEWARDSHIP, *supra* note 5 (describing stewardship codes around the world).

[148] *See UK Stewardship Code Archive*, FIN. REPORTING COUNCIL, https://www.frc.org.uk/investors/uk-stewardship-code/origins-of-the-uk-stewardship-code (last visited Feb. 4, 2022). Minor amendments to the Stewardship Code were adopted in 2012. *See* FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2012), https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf.

[149] *See* FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2020), https://www.frc.org.uk/investors/uk-stewardship-code.

[150] Goto, et al. *supra* note 146, at 932.

[151] *See* Kate Hilder & Mark Standen, *Focus On Outcomes Not Policies*: *2020 UK Stewardship Code Released*, MINTERELLISON (Oct. 29. 2019), https://www.minterellison.com/articles/overview-2020-uk-

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one commentator observed, however, fund-manager obligations were framed largely in generalities, leaving it to them to determine, on a firm-specific basis, the extent to which engagement was warranted.[152] The UK's soft touch approach meant that, although the Code was regulatory in nature, managers did not face repercussions for failure to comply, other than potential reputational sanctions.[153] Regulators created a "public tiering system" that highlighted the quality of the top engagement policies,[154] but the effort to give the rules some bite failed to drive engagement, and compliance with the Code devolved into boilerplate reporting.[155]

As a result, some commentators have described the initial UK approach as a "failure."[156] In response, the UK revised its Stewardship Code substantially in 2020. The Code remains voluntary, but instead of comply-or-explain, it now instructs signatories to "apply and explain" their adherence to its governance principles.[157] The changes also include a shift from focusing primarily on engagement to a specification of issues and policies that are the subject of good stewardship. The 2020 Code encourages signatories to focus on market-wide as opposed to firm-specific risks.[158] Importantly, the Code also provides an explicit and heavy emphasis on ESG factors.[159]

A substantial number of other jurisdictions have followed the UK in adopted stewardship codes to foster institutional engagement.[160] These codes vary in terms of both their scope and effectiveness.[161] In addition, the 2019 EU Shareholder Rights Directive requires fund managers, on a comply or explain basis, to explain, inter alia, how they incorporate engagement into their investment strategy, exercise their voting

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stewardshipcode#:~:text=The%202012%20was%20primarily%20directed,separate%20principles%20for%20each%20group.

[152] Paul Davies, *The UK Stewardship Code 2010-2020 From Saving the Company to Saving the Planet?* 8 (Eur. Corp. Governance Inst., L. Working Paper No. 506/2020, 2020), https://ecgi.global/sites/default/files/working_papers/documents/davies5062020final.pdf., at 11.

[153] *See generally* Aaron A. Dhir, Sarah Kaplan, & Maria Arabella Robles, Corporate Governance and Gender Equality: A Study of Comply-or-Explain Disclosure Regulation (2022) (unpublished manuscript) (on file with authors) (questioning the value of comply or explain approaches to regulation).

[154] Davies, *supra* note 152 at 18. As Davies notes, the rationale for this approach was "to avoid governmental action which might turn a comply-or-explain Code into more intrusive regulation." *Id.*

[155] *See* Hilder & Standen, *supra* note 151.

[156] Davies, *supra* note 152 at 9; *see also* John Kingman, Independent Review of the *Financial Reporting Council* 7-11 (Dec. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf (concluding that the first version of the UK code was "not effective in practice").

[157] *See* FIN. REPORTING COUNCIL, *supra* note 149, at 4; *UK Stewardship Code Signatories*, FIN. REPORTING COUNCIL, https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-signatories (last visited Feb. 4, 2023).

[158] FIN. REPORTING COUNCIL, *supra* note 149, at 11.

[159] *See id.* at 15 (stating "Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities").

[160] *See generally* GLOBAL SHAREHOLDER STEWARDSHIP, *supra* note 5.

[161] *See* Goto, et al., *supra* note 146.

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rights, and conduct a dialogue with their portfolio companies.[162] Although the Directive does not explicitly require fund managers to focus on ESG issues, commentators view its increased transparency requirements as encouraging them to support such measures.[163]

In endorsing ESG policies, the UK and EU stewardship codes make a values judgment without shareholder input. While this raises the concern that regulators are forcing fund managers to take positions that may be contrary to their investors, it might not be as problematic as it first seems. These issues are far less controversial and polarizing in the UK and the EU as compared to the US.[164] Therefore, it is at least plausible that these codes can be seen as democratically-generated determinations of the appropriate objectives behind institutional engagement.

In the absence of comparable political consensus about the role of fund managers and corporations in society, such top-down normativity is inappropriate in the US. It is unsurprising, therefore that in the US, regulatory proposals tend to focus on procedure. For example, in an influential paper, Professors Lucian Bebchuk and Scott Hirst propose a variety of reforms designed to improve intermediary stewardship. Among other things, they propose mandating that fund managers devote a minimum percentage of their resources to stewardship and requiring greater disclosure about how fund managers engage with management.[165] They also seek to relax the existing regulatory barriers to engagement, such as limits on institutional collective action, to provide fund managers with greater leverage.[166]

These proposals, while they might inspire greater fund-manager engagement, would do nothing to assure that the views forwarded through such engagement align with beneficiary goals. One way to deal with this problem would be to narrow the scope of the agency relationship through limitations on the institutional power to engage—reducing rather than increasing institutional stewardship.

Professor Dorothy Lund, for example, proposed that, to address problems with intermediation, index funds be precluded from voting their shares.[167] Sean Griffith made a similar but more limited proposal, arguing that institutional investors should vote on proxy fights, mergers and corporate governance issues, but not on environmental and social issues, because they lack a comparative information

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[162] *See Shareholders' Rights Directive Q&A*, EUROPEAN COMMISSION (March 14, 2017), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_17_592.

[163] *See, e.g., id.;* Hans-Christoph Hirt & Andy Jones, *The Shareholder Rights Directive II*, HARV. L. SCH. F. ON CORP. GOV. (Apr. 4, 2019), https://corpgov.law.harvard.edu/2019/04/04/the-shareholder-rights-directive-ii/.

[164] For example, there is broad support in the UK for climate-change regulation. *See* Aaron Wherry, *A Bipartisan Consensus on Climate Change? The U.K. Suggests it's Not a Pipe Dream*, CBC (May 3, 2021), https://www.cbc.ca/news/politics/climate-change-u-k-emissions-canada-1.6009671.

[165] Bebchuk & Hirst, *supra* note 92, at 2121-26.

[166] *Id.* at 2120-2121. Bebchuk & Hirst's analysis focuses primarily on index funds. *See generally id.*

[167] Lund, *supra* note 66 at 528.

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advantage on those topics.[168] One of us has observed elsewhere that the SEC could limit the scope of issues on which intermediaries vote by narrowing the shareholder proposal rule.[169] In particular, the SEC could limit shareholder proposals on social and political issues or require proposals to have a greater nexus to firm-specific economic value. Notably, in 2021, however, the SEC staff moved in the opposite direction, issuing new interpretive guidance rejecting a company-specific approach to evaluating the permissibility of social policy proposals and announcing that it would no longer approve the exclusion of shareholder proposals raising "issues with a broad social impact."[170]

Disempowering fund managers with respect to ESG issues would resolve the agency-cost concerns that arise in connection therewith. The agency relationship between fund managers and their beneficiaries would simply no longer extend that far. This approach, however, is suboptimal because it eliminates the potential for fund managers to serve as the vehicle for their beneficiaries' voices. As we propose in Part V, it would be better to realize this potential by demanding that fund managers take beneficiaries' views into account.

B. Market Segmentation

Some of the mutual fund disclosure requirements described above can be understood not only as mechanisms to help investors police the engagement practices of the intermediaries that manage their money, but also as tools to enable investors to select intermediaries with the voting and engagement policies they prefer.[171] For example, the SEC requirement that funds disclose voting policies and votes not only allows current shareholders to police agency costs, but it also allows investors, *ex ante*, to choose a fund with agreeable voting preferences.[172] To the extent disclosure requirements seek to improve market functioning, they should be understood, not

[168] Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1030 (2020).

[169] Fisch, *supra* note 12.

[170] SEC Staff Legal Bulletin No. 14L (Nov. 3, 2021), https://perma.cc/EJ5Y-5VTK; Sanford Lewis, *SEC Resets the Shareholder Proposal Process*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE (Dec. 23, 2021), https://corpgov.law.harvard.edu/2021/12/23/sec-resets-the-shareholder-proposal-process/ (explaining the significance of the SEC's position and arguing that it will "make it easier for shareholders to write clear and specific proposals that will survive a no-action challenge—which is a good thing"); *see also* Letter from Frederick Alexander, CEO, S'holder Commons, to Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Aug. 20, 2021), https://theshareholdercommons.com/wp-content/uploads/2021/08/SEC-Nexus-Letter-Final-20210820.pdf (expressing concern that SEC staff was inappropriately excluding shareholder proposals about company's externalization of costs).

[171] *Cf.* Jeff Schwartz, *De Facto Shareholder Primacy*, 79 MD. L. REV. 652, 675 (2020) (discussing how securities law disclosure rules aid investors in choosing firms and in policing management).

[172] *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 n.14 (Feb. 7, 2003).

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only as regulatory constraints on stewardship behavior, but also as market-enhancing tools.

In theory, market segmentation could address existing agency problems. Investors could select the fund or fund managers whose voting and engagement policies they support by investing in a particular fund. Such investments would implicitly authorize the fund to act in accordance with those policies. A fund, for example, that advertised itself as seeking to encourage businesses to adopt net zero climate emissions would vote in favor of net zero shareholder proposals, vote against directors who failed to implement net zero transition polices, and engage with management about the most effective transition plans. If investors self-sorted into likeminded funds, then so long as the funds vote in the way they advertise, there would be no concern about failure to represent investor views.

While, historically, the regulatory focus was on using rules to police agency costs, EU regulators and the SEC have recently adopted or proposed rules more directly seeking to facilitate market segmentation. None of these recent efforts, however, are promising. Taking market segmentation seriously requires attention to three foundational components: distinguishing between investment and voting preferences, constructing useful disclosures, and enabling meaningful investor choice.

First, investors must be able identify and select funds based not only on their investment practices, but also their stewardship practices. While it is plausible to assume that investors who choose a mutual fund with a distinctive sustainability investment mandate also expect that fund to vote and engage in accordance with that mandate,[173] the opposite is not necessarily true. Investors who choose a non-ESG fund may prefer that the fund vote in favor of social and environmental issues. They may prefer the opposite. The point is that their investment decision provides no information from which to discern their preferences. For market segmentation to work, investors must have choices regarding, and information about, the investment and stewardship practices of, not only ESG and anti-ESG funds, but also non-ESG funds.

Similarly, as noted above, the concept of ESG is capacious.[174] Knowing that a fund is environmentally responsible, for instance, does not provide information on how the fund will vote with respect to gender diversity on corporate boards.[175] Thus, even those who choose a fund based on its ESG credentials have no insight into how the fund will vote on the broad range of ESG topics unrelated to its specific charter.

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[173] Empirical evidence supports this proposition. *See* Zytnick, *supra* note 104, at 29 (finding that investors in ESG funds voted similarly to the funds themselves).

[174] *See supra* note 110 and accompanying text.

[175] For a discussion of the increased complexity of inferring fund beneficiary preferences in the context of diversity, see Jill Fisch, *Promoting Corporate Diversity: The Uncertain Role of Institutional Investors*, SEATTLE U. L. REV. (forthcoming 2023) (on file with authors).

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Making it easier for investors to choose ESG funds, therefore, provides only superficial market segmentation.

Recent market-segmentation initiatives in the EU and the US do not account for these issues. The EU's Sustainable Finance Disclosure Regulation (SFDR), which became effective in March 2021,[176] requires fund managers to classify investment products within one of three categories – "mainstream products, products promoting environmental or social characteristics or products with sustainable investment objectives."[177] Similarly, effective August 2022, the European Union Markets in Financial Instruments Directive II (MiFID II) requires EU fund managers to determine client sustainability preferences as part of their obligation to select suitable investments.[178]

The focus of these efforts on investment preferences, as opposed to voting and engagement, leaves no guidance for those looking to select non-ESG funds based on their stewardship activities. Moreover, MiFID II takes a relatively simplistic approach to sustainability. Clients self-select into one of three sustainability categories without any requirement that advisors provide disclosure about potential tradeoffs between sustainability and economic value.[179] An investor's choice of one of these categories similarly provides no assurance that the person's views map onto the votes of funds in the selected category on topics not directly related to the fund's goals.

The SEC proposed two rule changes in 2022 with similar ambitions and pitfalls. The first would implement refinements to the Fund Names Rule, which would require a closer nexus between the terms used in a fund's name and the characteristics of the fund's portfolio holdings.[180] The second would increase the obligations of ESG fund managers "to categorize certain types of ESG strategies broadly and require funds and advisers to provide more specific disclosures in fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue."[181] Both of these rules

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[176] *EU SFDR Explained: A Guide to the EU Sustainable Finance Disclosure Regulation for Investors*, JP MORGAN ASSET MANAGEMENT (Jan. 1, 2023), https://am.jpmorgan.com/dk/en/asset-management/adv/investment-themes/sustainable-investing/understanding-SFDR/.

[177] *The Sustainable Finance Disclosure Regulation*, PWC, https://www.pwc.be/en/challenges/sustainability/sustainability-assurance-and-reporting/sustainable-finance-disclosure-regulation-sfdr.html (last visited Feb. 4, 2023).

[178] *Explaining the Impact of EU MiFID II Regulation on Sustainable Investing*, JP MORGAN ASSET MANAGEMENT (Aug. 2022), https://am.jpmorgan.com/fi/en/asset-management/liq/investment-themes/sustainable-investing/explaining-the-sustainability-preferences-amendments-to-the-european-union-markets-in-financial-instruments-directive-II-delegated-regulation/. For example, firms are directed to determine client preferences as to the minimum proportion of a portfolio to invest sustainably. *Id.*

[179] *Id.*

[180] Investment Company Names, 87 Fed. Reg. 36594, 36594 (June 17, 2022).

[181] Press Release, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices (May 25, 2022),

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focus only on investment strategy rather than stewardship, and the latter rule, which only applies to ESG funds, would only provide investors with insight into fund stewardship practices that flow from its ESG agenda.[182]

Second, market segmentation requires that regulators demand and fund managers provide disclosures that allow investors to effectively choose among stewardship alternatives. But providing meaningful disclosures is extraordinarily difficult. Consider the SEC's proposal on fund names. A fund's name is a significant driver of investor choice.[183] Names, however, are confusing,[184] a fact reflected in the SEC's current effort to revise the names rule.[185] Moreover, there are limits to the amount of information that can be conveyed by a name. Even a perfect name can only give a limited sense of a fund's investment strategies and even less sense of its stewardship objectives.[186]

The proposal to increase transparency surrounding ESG strategies is similarly limited. For investors to have full information, funds would need to specify not only the ESG considerations that are the subject of their investment focus (as the rule requires), but also the extent to which they pursue those considerations in their voting and engagement strategies, their policies for considering the relationship between value and values, and the priorities between different value-based and values-based

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https://www.sec.gov/news/press-release/2022-92. The SEC's proposal to increase ESG-related disclosure appears to not only aim to allow for market segmentation, but also appears designed to encourage funds to engage more by requiring that they report in more detail on their engagement and its impacts. These requirements may generate greater engagement, but they may also cause funds to incur greater costs, which are likely to be passed on to investors in the form of higher fees. Alternatively, the requirements may reduce fund claims about their behavior, but leave investors with fewer meaningful choices.

[182] One could argue that the SEC rules requiring disclosure of voting policies and votes allow investors to sort by stewardship practices. *See supra* note 52 and accompanying text. As noted, however, these rules are not useful. The disclosure of voting policies is too vague, and the disclosure of votes is too disorganized and complex. *See supra* note 138-143 and accompanying text.

[183] SEC Commissioner Allison Herren Lee, *What's in a Name? Aligning Fund Names with Investor Expectations*, SEC (May 25, 2022), https://www.sec.gov/news/statement/lee-names-rule-statement-052522 ("investors may often rely on fund names in deciding where to invest their savings"); Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2826 (2005); *cf.* Silla Brush*, One Fund, Three Names and Lots of Questions for 'ESG,'* BLOOMBERG (July 25, 2022), https://www.bloomberg.com/news/articles/2022-07-25/how-blackrock-rebranded-one-sustainable-mutual-fund (discussing the frequent rebranding of one of BlackRock's ESG funds and the resulting increases in assets under management).

[184] *Mutual Fund Names are Confusing*, THIRTY NORTH INVESTMENTS LLC (Sept. 20, 2017), https://thirtynorth.com/mutual-fund-names-are-confusing/; *see also* Jill Fisch & Adriana Robertson, What's in a Name? ESG Mutual Funds and the SEC's Names Rule (working paper dated Jan. 2023) (on file with authors).

[185] Investment Company Names, 87 Fed. Reg. 36594, 36594 (June 17, 2022).

[186] *See* Fisch & Robertson, *supra* note 184 (illustrating this point with synthetic ESG funds).

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considerations.[187] More problematic still, investors may be unable or unwilling to wade through such complex descriptions. Studies indicate that investors use a very limited set of information in choosing among funds, and have limited capacity even to evaluate fund choices based on economics,[188] making their capacity to select funds based on disclosures about their voting and engagement policies even less likely.[189] While intermediaries like Morningstar offer fund ratings based on such disclosures, whatever they come up with is likely to be an over-simplified approximation.[190]

Finally, for true market segmentation, investors must be offered a range of genuinely different investment and stewardship approaches, including ESG funds, anti-ESG funds, and equity funds with ESG-neutral investing and engagement strategies.[191] Such diversity is absent today,[192] and recent regulatory efforts may further constrain investor options. Moves to increase disclosure mandates for funds that focus on ESG factors or seek to have an ESG impact, by increasing regulatory risk and costs for such funds, could reduce fund offerings. This is especially problematic because, at present, many fund managers appear to be herding on ESG issues—all claiming that greater attention to ESG is "something that's fundamental to investing."[193] This messaging reduces the potential for market segmentation by making it difficult for investors to differentiate among products. The more significant concern, however, is that products may not differ substantially. Even if the SEC's proposed ESG disclosure

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[187] For example, a fund that invests only in environmentally sustainable companies would need to describe, in a concrete way, how it approaches sustainability issues in its voting and engagement and how it weighs costs to other stakeholders, including shareholders and employees, against environmental concerns. It would also need to similarly describe its position and engagement practices on non-environmental issues, like DEI.

[188] *See, e.g.*, Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes?* 162 U. PA. L. REV. 605, 621-22 (2014) (citing studies showing that investors are insensitive to fee differences in choosing among mutual funds).

[189] *See* Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 648 (2003).

[190] Morningstar has provided various mutual fund ratings for many years. A 2000 study raised questions about Morningstar's most famous ratings—its star system—reporting little evidence that funds receiving Morningstar's highest rating outperformed next to highest and median rated funds. Christopher R. Blake & Matthew R. Morey, *Morningstar Ratings and Mutual Fund Performance*, 35 J. FIN. & QUANT. ANAL. 451 (2000). On the other hand, Morningstar ratings can have a substantial impact on fund flows. *See, e.g.*, Manuel Ammann, Christopher Bauer, Sebastian Fischer & Philipp Müller, *The Impact of the Morningstar Sustainability Rating on Mutual Fund Flows*, 25 J. EUR. MGMT. 520 (2019) (finding strong evidence that investors shifted money into funds receiving high Morningstar ESG ratings).

[191] *See, e.g.*, Vivek Ramaswamy & Riley Moore, *The Market Can Curtail Woke Fund Managers*, WALL ST. J. (June 9, 2022), https://www.wsj.com/articles/the-market-can-curtail-woke-fund-managers-index-act-votes-shareholders-11654786033?mod=itp_wsj&mod=djemITP_h (noting "the absence of large asset managers that take different approaches to shareholder advocacy").

[192] As noted above, while a few anti-ESG funds exist, the options tend to be more costly, and they are neither offered by large fund managers nor included in employer-sponsored 401(k) plans. *See supra* note 114 and accompanying text.

[193] *See* Ramaswamy & Moore, *supra* note 191 (describing Invesco as following BlackRock's approach to integrating ESG into all its investment decisions).

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rules help investors differentiate between ESG options, they are of little help if the options are all essentially the same. Moreover, if the differences are small and nuanced, investors are likely to have difficulty identifying them.

The prominent role of 401(k) plans in the mutual fund market heightens concerns about investor choice.[194] As noted above, participants in a 401(k) plan typically have a limited number of investment options, those options are chosen by the employer, and the options never involve funds that invest in similar asset classes but differ on a governance or voting strategy.[195] Moreover, concerns about liability exposure have made many employers hesitant even to include ESG funds as investment options.[196]

In addition, many company 401(k) plans automatically enroll a substantial number of employees into their employer's plan.[197] As part of this process, the plan places employee funds into a default investment option, typically a target date fund.[198] When this happens, the employee does not engage in any meaningful investment choice. The complete absence of market segmentation makes the incorporation of ESG—or any type of values-based considerations—into target date funds particularly troubling.[199]

The lack of meaningful choice is equally problematic for pension funds. As with mutual funds, it is the pension trustees, not the beneficiaries, that direct the fund's investments and, more significantly for purposes of this Article, determine the fund's engagement policy.[200] Although in theory a person chooses a pension plan through their choice of employer, that choice is obviously highly constrained, and it is doubtful that the pension plan's engagement policies—as opposed to the economic generosity

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[194] *See generally* Fisch, et al., *supra* note 10 (describing employer role in construction of 401(k) plan menus).

[195] Concededly, about a quarter of 401(k) plans offer a broader range of funds through a brokerage window. *See* ERISA ADVISORY COUNCIL, REPORT TO THE HONORABLE MARTIN WALSH, US SECRETARY OF LABOR, UNDERSTANDING BROKERAGE WINDOWS IN SELF-DIRECTED RETIREMENT PLANS 32 (Dec. 2021), https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/about-us/erisa-advisory-council/2021-understanding-brokerage-windows-in-self-directed-retirement-plans.pdf. But such windows are subject to limited use and, in some cases, involve investment caps and additional fees. *See id.* at 15; VANGUARD, HOW AMERICA SAVES 2021 at 70, https://institutional.vanguard.com/content/dam/inst/vanguard-has/insights-pdfs/21_CIR_HAS21_HAS_FSreport.pdf ("I]n plans offering a self-directed brokerage feature, only 1 percent of these participants used the feature in 2020. In these plans, about 2 percent of plan assets were invested in the self-directed brokerage feature.'").

[196] *See, e.g.*, Quinn Curtis, Jill Fisch & Adriana Robertson, *Do ESG Mutual Funds Deliver on their Promises?,* 120 MICH. L. REV. 393, 418 (2021) ("To date, ESG funds are rarely included as an investment option in 401(k) plans").

[197] *See* VANGUARD, *supra* note 195, at 4 (noting that "at year end 2020, 54% of Vanguard plans had adopted automatic enrollment").

[198] *See id.* at 4 (noting that target-date funds are the default option for 98% of employers).

[199] *See, e.g.*, Edward Farrington, *Target-Date Funds Catching the Tailwind of ESG Investing*, PENSION & INVESTMENTS (Oct. 15, 2018), https://s3-prod.pionline.com/s3fs-public/CO1174771010.PDF (predicting the growth of ESG target date funds for retirement plans and explaining that "that ESG target-date funds can be included as a qualified default investment alternative").

[200] *See* Avon Letter, *supra* note 50.

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of the pension benefit—would be a driving factor in a prospective employee's decision where to work.[201] As with mutual funds, the prospects for market segmentation are therefore dim.

This insight highlights the problem with pension fund engagement. To a large degree, pension funds have led the effort to influence corporate policies through their voting and engagement—CalPERs, the California Public Employees Retirement System, for example, has been described as a "leader" in corporate governance.[202] In recent years, the NYC Comptroller, as fund manager for five New York City public pension funds, has taken an active role in voting, engaging with its portfolio companies, and sponsoring shareholder proposals.[203] As with mutual funds, when this engagement focused on maximizing economic value of the funds' investments, there was little to challenge about it.[204] With the shift to values-based engagement, it has become deeply problematic that they cannot plausibly claim to represent their beneficiaries' views.[205]

In sum, recent attempts to foment market segmentation offer little promise. We have described specific problems with these efforts, but the deeper problem is with the pursuit of market segmentation itself. Although the idea of market segmentation is conceptually appealing, it assumes away frictions in the fund marketplace. Drafting comprehensive, meaningful, and clear disclosures that articulate a fund's position across a growing range of issues would be exceedingly difficult and investors likely lack the patience to wade through such disclosures. In addition, the fund marketplace fails to offer a full range of stewardship alternatives and is not set up to do so. Because mutual and pension funds function within the employment-based retirement system, they exist in an artificial and heavily constrained choice environment. These problems mean regulators should pursue a different approach.

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[201] *See, e.g.*, Richard Hiller, *The Role of Retirement Plan Design in Recruiting Workers to the Public Sector*, REASON FOUNDATION (Mar. 7, 2022), https://reason.org/commentary/the-role-of-retirement-plan-design-in-recruiting-workers-to-the-public-sector/ ("an employer's retirement plan is typically a secondary, at best, issue in recruiting").

[202] Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 315 (2008).

[203] *See* SCOTT STRINGER, NEW YORK CITY PENSION FUNDS, SHAREOWNER INITIATIVES POSTSEASON REPORT 2022, https://comptroller.nyc.gov/wp-content/uploads/documents/2022-Postseason-Report.pdf (describing the funds' shareholder initiatives).

[204] Some commentators have warned, however, that pension fund initiatives, such as those promoting labor interests, may conflict with the funds' duty to their beneficiaries. *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 Mich. L. Rev. 1018, 1039 (1998) (identifying some of the conflict-of-interest concerns that have been raised about union and public pension fund engagement in corporate governance).

[205] For an example of pushback against pension fund voting, see Institute for Pension Fund Integrity, *What is the Role of Public Pension Plans in Proxy Voting* (Oct. 2018), https://www.sec.gov/comments/4-725/4725-4571019-176247.pdf.

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C. Pass-Through Voting

Commentators have long advocated pass-through voting as the solution to the agency problem.[206] For many years, it was generally viewed as too costly or complicated. Technological developments have reduced those concerns and made pass-through voting a viable option.[207] Indeed, in May 2022, several Senators introduced the Investor Democracy is Expected Act, S4241,[208] which would require passively-managed funds to provide pass-through voting for their customers.[209] BlackRock recently started providing a pass-through voting option to its institutional clients through its "BlackRock Voting Choice" initiative.[210] The company has hinted at a willingness to expand the program to individual investors.[211] With BlackRock moving this direction, along with nascent efforts in Congress, pass-through voting has momentum.

We, however, warn against this change. Pass-through voting is problematic for several reasons.[212] First, and most obvious, is the potential for low voter turnout. Direct retail investors only vote 29% of their shares, and mutual fund investors show even less interest in voting.[213] Indeed, mutual funds have traditionally experienced considerable difficulty in obtaining sufficient turnout when it is necessary for them to have a shareholder vote at the fund level.[214] The prospect for turnout with respect to portfolio firms may be just as bleak. Mutual fund shareholders own shares in hundreds

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[206] *See, e.g.,* John C Wilcox, *Electronic Communication and Proxy Voting: The Governance Implications of Shareholders in Cyberspace*, 11 INSIGHTS 8, 11 (1997); Lund, *supra* note 66, at 530.

[207] *See, e.g.*, Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Power of Retail Investors*, 22 NEV. L. J. 51 (2021) (observing that "blockchain, distributed ledgers, or even virtual reality" can provide retail investors with access to voting at "very affordable costs").

[208] S. 4241, 117th Cong. 2nd Sess. (2022), https://www.govinfo.gov/content/pkg/BILLS-117s4241is/pdf/BILLS-117s4241is.pdf.

[209] To address problems of low turnout, the Act requires managers to cast its votes in proportion to the shares actually voted by fund beneficiaries. *Id.* The Act also authorizes the fund managers to engage in mirror voting on certain issues as an alternative to soliciting voting instructions. *Id.*

[210] BlackRock, *supra* note 20.

[211] *See id.*; Fink, *supra* note 46 ("We are committed to a future where every investor—even individual investors—can have the option to participate in the proxy voting process if they choose.").

[212] *See, e.g.*, Letter from Paul Schott Stevens, Inv. Co. Inst. to Vanessa Countryman, SEC, Mar. 15, 2019, https://www.ici.org/doc-server/pdf%3A19_ltr_proxy.pdf; Stevens, *supra* note 22.

[213] Fisch, *supra* note 54. It is possible that institutional fund beneficiaries, like insurance companies, corporations, and pension funds, may be more likely to vote their shares than retail investors. Early results from BlackRock, however, suggest otherwise. As of Sept. 30, 2022, only a quarter of eligible assets had committed to using BlackRock's Voting Choice program. *Empowering Investors through BlackRock Voting Choice*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship/blackrock-voting-choice (last visited Feb. 4, 2023). In addition, accountability problems remain, because many of these institutional fund owners are themselves intermediaries, such as pension funds, for whom their votes may not reflect the views of their beneficiaries.

[214] *See* Stevens, *supra* note 22 ("When funds themselves must solicit proxies from their own shareholders, they find it very difficult to get individual shareholders to vote on matters directly affecting the funds they've selected.").

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or even thousands of portfolio companies in which they have not made the affirmative decision to invest. As a result, they may not know anything about them. Even if these investors were motivated to vote, the costs of making an informed decision likely far outweigh the benefits of doing so. Moreover, mutual funds were designed for people who did not want to expend the effort of actively managing their investments and are therefore more likely to exhibit rational apathy than ordinary retail shareholders.

This then raises the challenge of what fund managers should do with respect to the unvoted shares in their portfolio companies—which shares are likely to reflect, at least in some cases, a substantial majority of the shares held by the funds. If those shares are not voted at all, it is likely that the issuers will have difficulty obtaining a quorum.[215] Moreover, leaving fund shares unvoted increases the voting impact of other shareholders, and those shareholders may be even less representative of the interests of fund beneficiaries.

That said, rational apathy may not be as pronounced as it was in the past.[216] Although people may not be interested in managing their money or in the details of corporate governance, investors might be interested in voicing their opinion on issues like climate change and racial equity audits. Moreover, these topics are likely to arise in multiple companies across an investor's portfolio. If fund beneficiaries were given a simplified way to vote their shares, such as by expressing their preferences in a way that would automatically fill the ballots when an issue came up at a particular company, we might see an increase in voting turnout. We discuss options like this in more detail below in connection with our proposal that fund managers ascertain fund beneficiary preferences.[217]

Rational apathy is not the only potential problem with pass-through voting, however. Even if fund investors could be nudged to vote, there are reasons to question whether their votes would be informed. Although fund beneficiaries likely have values-based preferences that extend across their fund's portfolio, and technology now exists that allows companies to autofill these preferences when such issues arise, it is unclear that this one-size-fits-all system is an appropriate approach to shareholder voting. Neither shareholder proposals nor companies are one-size-fits-all. Proposals on the same topic may differ in their details or in how they affect companies. Similarly, as with ballot propositions, shareholder proposals might be framed in ways that make it

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[215] Smaller companies with a retail investor base already have this problem. Broc Romanek, *The Quorum Problem for Smaller Companies is Growing*, PUBLIC CHATTER (Aug. 2, 2021), https://www.publicchatter.com/2021/08/the-quorum-problem-for-smaller-companies-is-growing/. Issuers would also face difficulties obtaining the necessary vote for issues like amending the charter, which require a majority of outstanding shares. *See, e.g.*, Scott Hirst, *Frozen Charters*, 34 YALE J. REG. 91 (2017) (discussing how low turnout has frustrated corporate efforts to amend their charters).

[216] *See* Sergio Alberto Gramitto Ricci & Christina Sautter, Wireless Investors and Apathy Obsolescence (working paper Jan. 2023) (on file with authors) (arguing that social media provides tools enabling retail shareholders to overcome rational apathy).

[217] *See infra* text accompanying note 237-245.

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difficult for retail investors to predict their impact.[218] As a result of these complexities, a system that tries to simplify pass-through voting may fail to represent the true interests of fund beneficiaries or steer companies in the wrong direction.

Moreover, issue-voting is unlikely to produce an informed shareholder vote on many of the most economically consequential issues, such as the approval of a merger, contested elections, and proposals to amend the corporation's charter. In addition to the firm-specific nature of these votes, they often involve complex issues for which the sophistication of fund managers, and their ability to expend resources on analysis, are likely to be particularly valuable. Pass-through voting is appealing in its simplicity, but it fails to account for the significant loss of sophistication, expertise, and efficiency that institutional intermediaries provide.

IV. FIXING INTERMEDIATION

A. The Advantages of Preserving Intermediation

Many of the foregoing reforms seek to reduce the agency costs associated with intermediated stewardship by reducing intermediation. But, as noted above, intermediation in voting and engagement has important benefits. One key benefit is that fund managers vote and engage based on the total value of their portfolios. Because of the concentration of equity ownership and the associated voting power in the hands of fund managers (and in the hands of a few fund managers at that), these institutions own significant stakes in most public companies and can consequently exercise substantial power.[219] This size enables them to affect corporate policy not only through their votes, but also through informal engagement efforts. They boast thousands of such engagements per year.[220] Disintermediation would forfeit this important stewardship channel.

In addition, fund managers bring experience and sophistication to corporate governance. Industry leaders like BlackRock and Vanguard have dedicated stewardship teams that gather information, research the relevant issues, and develop policies and practices to make informed decisions.[221] As noted above, their expertise may be particularly valuable for significant firm-specific issues, like whether to sell the

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[218] This concern has been raised about so-called anti-ESG proposals. *See* Ruth Saldanha, *The Rise of Anti-ESG Shareholder Proposals,* MORNINGSTAR (Apr. 1, 2022), https://www.morningstar.com/articles/1086978/the-rise-of-anti-esg-shareholder-proposals (explaining that these proposals "contribute noise to analyses of ESG voting").

[219] *See supra* note 48 and accompanying text.

[220] Mark Brnovich, *Arizona Defends Retirees Against ESG*, WALL ST. J. (Aug. 15, 2022), https://www.wsj.com/articles/arizona-defends-retirees-against-esg-blackrock-asset-management-retirement-net-zero-greenhouse-gas-fiduciary-duty-pension-gender-quota-california-11660571998 (noting that BlackRock had 2,331 climate-related engagements from 2020-2021).

[221] *See, e.g.*, *BlackRock Investment Stewardship*, BLACKROCK (2020), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.

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company, but they are also well-positioned to make good decisions on more general ESG proposals. While these issues are cross-cutting, not every proposal is a good fit for every company, and fund-manager stewardship teams have the resources to judge which proposals make sense. While the size and efficacy of these teams has been critiqued,[222] they nevertheless bring diligence, sophistication, and experience that far surpass that of retail investors and many institutions.

Finally, it is far more efficient for fund managers to research and engage than to push those responsibilities out to each individual fund beneficiary. Even if those beneficiaries are willing and able to engage and vote, expending the effort to do so with respect to the potentially thousands of companies in their funds would result in a wasteful duplication of resources. A fund manager, in contrast, can do the analysis on behalf of millions of investors.

A fund manager can also conduct its analysis more effectively and efficiently. Having dealt with hundreds of thousands of shareholder proposals over the years, fund managers can identify nuanced differences among them and respond accordingly. They can also leverage their expertise and experience with portfolio firms. Knowledge about best practices and industry trends gained from one portfolio company can be used to inform their engagement with others.[223] Similarly, fund managers can leverage their sector-specific and industry-specific knowledge to cast informed votes without starting from scratch with each company and each proposal. Notably also, because of the scale of their operations, institutional investors have access to resources that are unavailable to retail investors, like ISS research and recommendations, which allow them to cast informed votes at lower cost.

In sum, concentrated voting has significant benefits that should be preserved. Indeed, the concentration of voting power in fund managers is the reason that corporate governance matters. In the previous era of dispersed ownership, shareholders had little sway. But today's corporate executives respond to fund manager demands. The problem is not concentration; it is that those with all the votes are not seeking to determine if their votes accurately reflect the interests of their constituents.

B. Informed Intermediation

Rather than eliminate intermediation, we see the challenge as increasing the accountability of intermediaries to their beneficiaries. Our solution is a system by which fund managers ascertain the preferences of their beneficiaries and incorporate

[222] *See, e.g.*, Bebchuk & Hirst, *supra* note 92, at 2076.

[223] For example, investors can convey information from one company to another about best practices for dealing with data privacy and cyber security risks. *See, e.g.*, Steve W. Klemash, Jamie C. Smith & Chuck Seets, *What Companies are Disclosing About Cybersecurity Risk and Oversight*, HARV. L. SCH. F. ON CORP. GOV. (Aug. 25, 2020), https://corpgov.law.harvard.edu/2020/08/25/what-companies-are-disclosing-about-cybersecurity-risk-and-oversight/.

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those preferences into their voting and engagement practices, a system we term "informed intermediation."

1. A Proposal for Informed Intermediation

Because fund managers are agents, we maintain that their existing fiduciary duties already require them to be informed about their beneficiaries' interests and preferences. Under the securities laws, fund managers have as a duty to represent the "best interests" of fund shareholders;[224] pension laws dictate that fund managers act "solely in the interests of the participants and beneficiaries."[225] Though the language varies slightly, the concept is the same. Fund managers are agents and must represent the interests of their principals.

There has long been an understanding among the industry and regulators that fund managers act in the interests of their beneficiaries when the goal of their engagement efforts is to maximize shareholder value. Department of Labor (DOL) regulations, which apply to private pension funds, instruct fund managers to vote "solely in accordance with the economic interest" [226] of its participants as measured by a "risk and return analysis";[227] the SEC has noted the "important role" engagement plays "in maximizing the value of the funds' investments";[228] and, accordingly, fund managers repeatedly and uniformly justify their efforts as promoting long-term value.[229] This understanding, however, no longer represents the reality of corporate governance.

As the SEC itself recently noted, a fund manager's bedrock fiduciary obligation is to "'to adopt the principal's goals, objectives, or ends.'"[230] The idea that pursuit of

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[224] *See, e.g.*, Schwartz, *supra* note 91, at 421.

[225] Letter from Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel, Calvert Group Limited (May 28, 1998), reprinted in 25 Pens. & Ben. Rep. (BNA) 1328 (June 8, 1998).

[226] 29 C.F.R. § 2550.404a-1(d)(2)(ii)(a) (2022).

[227] *Id.* at § 2550.404a-1(b)(4).

[228] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6566 (Feb. 7, 2003).

[229] *See, e.g., Pursuing Long-Term Value for our Clients: BlackRock Investment Stewardship*, BLACKROCK 4 (2021), https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf; John Galloway, *Investment Stewardship: A Voice for Long-term Shareholder Value*, VANGUARD (July 12, 2022), https://advisors.vanguard.com/insights/article/investmentstewardshipavoiceforlong termshareholdervalue; *Asset Stewardship*, STATE STREET GLOBAL ADVISERS, https://www.ssga.com/us /en/institutional/ic/about-us/what-we-do/asset-stewardship (last visited Jan. 26, 2023) ("We utilize our Asset Stewardship program to engage with investee companies to seek long-term value and mitigate risk to our clients' portfolios.").

[230] Commission Interpretation Regarding Standard of Conduct for Inv. Adv., 84 Fed. Reg. 33669, 33671 (July 12, 2019) (quoting Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 BUFFALO L. REV. 99, 104 (2008)). The fundamentals of pension law are the same. *See* 3 RESTATEMENT THIRD OF TRUSTS § 78(1) cmt. f. ("The trustee has a duty to the beneficiaries not to be influenced by

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economic value satisfies a manager's fiduciary duties assumes that shareholders want value maximization. When engagement efforts focused on corporate governance and financial matters, this simplifying assumption made some sense,[231] but it no longer holds up now that engagement and voting implicate contested values. When stewardship implicates values as much as value, the only way to truly reflect beneficiary views is to ask them what they think. At present, however, fund managers do not attempt to ascertain beneficiary preferences with respect to voting and engagement. In flying blind with respect to their beneficiaries' views, fund managers violate their fiduciary duty "to adopt the principal's goals, objectives, or ends."[232]

Ignoring this deeper understanding of fiduciary duties, and instead adhering to an outdated assumption that beneficiary interest equates with value maximization, allows fund managers to skirt their obligations. It also encourages intermediaries to claim that ESG votes are predicated on economic considerations despite a paucity of supporting evidence. This rhetoric is a disservice to beneficiaries who may believe it. A key goal in this area is to provide transparent communications to beneficiaries, so beneficiaries can police fund managers and choose funds that align with their goals. The rote assumption that ESG engagement maximizes shareholder value *ipso facto* runs directly afoul of this ambition. It is more accurate and honest to acknowledge that ESG is about values and may involve tradeoffs against economic goals.

Though a requirement that fund managers seek beneficiary input is an application of existing fiduciary principles, we argue that regulators and lawmakers—the SEC in the case of mutual funds and the DOL in the case of pension funds—should explicitly require as much through formal rulemaking.[233] The problem with reliance on fiduciary principles alone is that they provide little guidance to fund managers, and they fail to provide a realistic accountability mechanism. The absence of firm standards or ways for beneficiaries to assess compliance has rendered fiduciary duties largely ineffectual in other contexts. Our approach, which uses fiduciary principles as a basis for regulatory guidance, avoids this outcome.

Our proposal builds on existing laws, discussed above, that supplement fund manager fiduciary duties with regulations that require them to develop and disclose

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the interest of any third person or by motives other than the accomplishment of the purposes of the trust.").

[231] *Cf.* Schanzenbach & Sitkoff, *supra* note 27, at 404-05 (interpreting ERISA's financial conception of beneficiary best interest as a paternalistic policy decision).

[232] *See supra* note 230 and accompanying text.

[233] As discussed *supra* note 29, federal pensions are governed by FERS, and state pension plans, like CalPERS, are governed by a patchwork of state laws. To harmonize the rules around intermediary stewardship, we recommend that Congress and states lawmakers incorporate new SEC and DOL rules and guidance into federal and state law. Public pensions manage approximately $5 trillion in assets. *See Public Pension Assets*, NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS, https://www.nasra.org/content.asp?admin=Y&contentid=200 (last visited Jan. 26, 2023).

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their voting policies and, in the case of mutual fund managers, their votes.[234] Under our proposal, fund managers would, in addition, be required to take reasonable steps to ascertain the voting and engagement preferences of fund beneficiaries and to take those views into account in their stewardship activities. In related disclosures, fund managers would be expected to discuss the steps they have taken to determine beneficiary views, summarize their findings, and describe how those views factored into the funds' voting and engagement.

We recommend that regulators supplement this requirement by providing guidance as to what constitutes a reasonable effort to ascertain beneficiary views. We envision that fund managers would have a range of options. They could poll their beneficiaries when they open an account and periodically thereafter. They could also poll beneficiaries when a new issue arises to determine the extent to which they support engagement on that issue. They could offer web-based tools through which beneficiaries could create individual profiles, indicating the issues they support and their priorities. Funds could operate dedicated forums, either on their own websites or through social media, for beneficiaries to post their views, either in general, or with respect to individual portfolio companies. They could host focus groups or online discussion groups prior to shareholder meetings. They could highlight specific issues or campaigns online and allow customers to convey their support or disagreement. Fund managers could also seek input on or approval by their beneficiaries of their posted voting policies or guidelines. Finally, fund managers could provide mechanisms for beneficiaries to expressly delegate voting and engagement decisions to the fund's governance team or authorize such delegations to a third party, much in the way that institutional investors have the option of voting in accordance with ISS's voting policies.

Several industry participants are already experimenting with ways to provide fund beneficiaries with greater input into their decisions. Vanguard launched a pilot program in 2023, where individual investors in several of its equity index funds would be able to choose "proxy voting policy options."[235] Schwab also announced a pilot program—partnering with Broadridge Financial Solutions, a fintech firm—to poll investors in three of its funds "about their feelings on topics like executive

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[234] *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 n.14 (Feb. 7, 2003). ERISA requires that pension funds provide their proxy voting guidelines to participants upon request. *See.* GOV'T ACCOUNTABILITY OFFICE*, supra* note 119, at 12-13 & n. 16.

[235] *Your Money, Your Voice: How Vanguard is Piloting Proxy Voting Options for Everyday Investors*, VANGUARD, https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/perspectives-and-commentary/your_money_your_voice.pdf (last visited Feb. 6, 2023).

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compensation, board composition and the environment" and promised to use the results to "determine the firm's approach to company proxies."[236]

Such efforts are part of a broader push to engage with investors. Several startups and nonprofits are also developing mechanisms to ascertain the views of investors and amplify their voice. Say Technologies offers tools that allow investors to ask questions of management and provide managers with feedback about their priorities for the company.[237] Through the platform, a company might ask, for example, "which of the following is most important for you to see from our company?" A shareholder can then choose "market share growth," "revenue growth," "margin improvement," or "product innovation."[238] As You Sow has implemented As You Vote, a voting platform that enables institutional investors to vote in line with As You Sow's progressive voting policies.[239]

Iconik, however, is perhaps the most promising new effort to engage investors through a platform for shareholders to indicate their voting preferences.[240] Based on expressed preferences, it creates a voting profile, which it calls the shareholder's "Investor Archetype," and votes the investor's shares in accordance with this profile.[241] Its website provides an example. A question iconik poses to investors to find out their preferences concerns political lobbying. It asks, "would you support proposals to report on direct and indirect lobbying and political advocacy activities?"[242] If investors check "yes," iconik votes their shares in favor of related proposals in the investors' portfolio. In the example portfolio, this includes a yes vote on a lobbying report at Alphabet, a report on charitable contributions at Amazon, and a proposal on political spending at abbvie.[243] Iconik claims that "[i]t only takes minutes to create an iconik voting profile that automatically votes shares to match values across a portfolio or group of portfolios."[244] This is precisely the type of polling we envision and illustrates the feasibility of our approach.

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[236] Annie Massa, *Schwab Tests Strategy Letting Shareholders Weigh In for Proxies*, BLOOMBERG LAW (Oct. 13, 2022), https://news.bloomberglaw.com/securities-law/schwab-tests-strategy-letting-shareholders-weigh-in-for-proxies.

[237] *Join the Conversation with the Companies You Invest In*, SAY, https://www.saytechnologies.com /investor (last visited Feb. 4, 2023).

[238] *Id.*

[239] Press Release, As You Sow, AS YOU VOTE™ — A New Proxy Voting Service From As You Sow (Mar. 17, 2021), https://www.asyousow.org/press-releases/2021/3/17/as-you-vote-a-new-proxy-voting-service-as-you-sow.

[240] *Examples*, ICONIK, https://www.iconikapp.com/individuals (last visited Feb. 4, 2023).

[241] *Id.*

[242] *Id.*

[243] *Id.*

[244] *Value and Choice*, ICONIK, https://www.iconikapp.com/advisors/client-experience (last visited Jan 10, 2023).

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Notably, iconik is in the process of partnering with fund managers to provide them with the voting preferences of fund beneficiaries.[245] Fund managers can then determine how best to incorporate those preferences into their voting decisions. We anticipate further market innovation in response to an affirmative regulatory requirement and related guidance; we also anticipate that regulators would periodically update their guidance to adapt to evolving technology.

Moreover, Schwab's partnership with a fintech firm to aid its engagement efforts demonstrates that fund managers can either develop internal mechanisms for ascertaining beneficiary preferences or outsource the activity. Engagement consultants could develop expertise in the area and offer their services to multiple fund managers. Although the fund managers themselves would retain the ultimate authority over how to collect preference data and reflect beneficiary views, the potential for a new class of expert intermediaries is promising because of the efficiencies that come with specialization.

The innovation in this area, although limited, demonstrates the industry's receptiveness to increasing accountability. It also demonstrates the range and variety of viable approaches. Both highlight the need for greater regulatory guidance. Our proposal would reinforce this innovation and provide a roadmap for nascent industry efforts and innovators in this space.

Though our reform proposal is largely motivated by the shift in corporate governance described above, we argue that it should not be limited to ESG issues but should extend to shareholder engagement on all issues. We take this position for several reasons. First, as noted above, there are reasons to question whether fund managers have been faithful to the interests of fund beneficiaries even with respect to traditional economic issues.[246] One example is the concern that the short-term perspective of fund managers leads them to favor corporate actions that maximize short term stock price at the cost of long run productivity.[247] Conflicts of interest may also compromise their voting.[248] Engaged stewardship may mean straining relationships with management at portfolio companies. But these relationships can be important sources of information for the fund manager's active managers.[249] In addition, fund managers often depend on these relationships because they compete to provide 401(k) services to the companies in their funds. Voting against management

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[245] *Engage Your Clients*, ICONIK, https://www.iconikapp.com/ (last visited Feb 4, 2023).

[246] *See supra* text accompanying notes 64-65.

[247] *See* Schwartz, *supra* note 171, at 666 (discussing short-term incentives of fund managers).

[248] *See generally* Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019).

[249] *See, e.g.*, Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 9 B.U.L. REV. 971, 982 (2019) ("The buy-side analysts working for the asset manager need direct contact with portfolio companies in order to improve the investment decisions of the funds").

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risks this key aspect of their business.[250] It would make it more difficult for fund managers to allow such conflicts to dictate how they vote if they had to demonstrate the way in which their votes map onto beneficiary preferences.

Second, even issues traditionally viewed through a financial lens are now infused with values. An example is Engine No. 1's proxy campaign at Exxon, which many, including the media, reasonably viewed as a conflict over environmental values,[251] but which Engine No. 1 described in its proxy statement as a contest about economics, explaining that "the Company has failed to evolve in a rapidly changing world, resulting in significant underperformance to the detriment of shareholders and risking continued long-term value destruction."[252] A similar example is Elon Musk's purchase of Twitter. The shareholder vote to approve the transaction implicated both economics (the price offered) and values (the free-speech policies that Musk threatened to, and has since, imposed).[253]

Because corporations are now expected to consider the societal impacts of all their decisions,[254] values will be a part of almost every corporate-governance matter. A decision about whether to support a hedge-fund activist's campaign for a stock buy-back, for example, is not just about shareholder returns anymore, it is about how the balance-sheet impact might affect the corporation's employees, its sustainability efforts, or any other stakeholder interests. Indeed, financial considerations are best conceptualized as one of the many values that must be balanced in any particular stewardship decision. It, therefore, makes sense to require fund managers to seek beneficiary input regardless of the corporate-governance matter at hand.

Finally, although our analysis has focused primarily on mutual funds, as we have stated above, pension funds are in the same position. Pension fund managers vote on

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[250] *See, e.g.*, Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholders Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1308 (2020) ("Public company employees' 401(k) retirement funds are a critically important revenue source for index funds, and managers of those companies have a crucial source of leverage over index fund investors: final say over which funds to offer on their 401(k) platforms.").

[251] *See, e.g.*, Rakesh Gopalan & John Hoke, *Little Engine (No. 1) That Could: Exxon's Proxy Battle and SEC's Focus on ESG Disclosures*, MCGUIREWOODS (June 2, 2021), https://www.jdsupra.com/legalnews/little-engine-no-1-that-could-exxon-s-8841533/ ("As Engine No. 1's victory reveals, environmental, social and governance ("ESG") issues are gaining prominence among shareholders").

[252] Proxy Statement of Engine No. 1 LLC, Exxon Corp. (Mar. 15, 2021), https://www.sec.gov/Archives/edgar/data/0000034088/000090266421001931/p21-0957defc14a.htm#:~:text=In%20that%20vein%2C%20Engine%20No,time%20in%20the%20Company's%20history.

[253] Stockholders voted to approve the merger on Sept. 13, 2022. Lauren Feiner, *Twitter Shareholders Vote to Approve Elon Musk's Bid to Buy the Company*, CNBC (Sept. 13, 2022), https://www.cnbc.com/2022/09/13/twitter-shareholders-vote-to-approve-elon-musks-bid-to-buy-the-company.html. In a nod to free-speech principles, the platform was the first to reinstate Donald Trump. *Shannon Bond*, *Elon Musk Allows Donald Trump back on Twitter*, NPR (Nov. 19, 2022), https://www.npr.org/2022/11/19/1131351535/elon-musk-allows-donald-trump-back-on-twitter.

[254] *See* text accompanying *supra* note 1.

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behalf of their beneficiaries, and as a result, owe fiduciary duties with respect to voting and engagement. Some of the language around fiduciary duties differs in the pension-fund context,[255] but the fundamental principle that fund managers must follow the instruction of their principals remains the same.

Like securities regulators, pension regulators have conflated beneficiary best interest with wealth maximization. But our interpretation of fiduciary duties—to represent the views of beneficiaries regardless of whether those views maximize value—is more accurate and a better fit to modern-day corporate governance. Our view acknowledges engagement's social overtones and would require fund managers to represent, not only their beneficiaries' financial goals, but also their moral and social views, to the extent that beneficiaries want those views reflected in their stewardship activities. Since pension-fund and mutual-fund managers are similarly situated, the SEC and the DOL should work together to harmonize the fiduciary frameworks that govern the participation of these financial intermediaries in corporate governance.

2. Challenges

Some might worry that it would be difficult to design effective questions to tease out beneficiary views or that fund managers would bias the polling with how they frame their questions. Neither of these troubles us. There are many ways to collect beneficiary views, and as discussed above, firms like Say Technologies and iconik have already begun.[256] As a start, shareholder proposals are typically tied to public policy issues. Fund managers can simply ask beneficiary views on these policies. Polls and efforts to solicit feedback are ubiquitous in society today, and we see no reason that this context is different. Biases are always a risk. Our proposal addresses this risk through disclosure. Fund managers would be required to disclose how they solicited beneficiary views—and biases in the solicitation process would quickly come to light.

A bigger obstacle is that fund beneficiaries may not respond to outreach efforts. There is no guarantee that managers will be successful in obtaining the views of a substantial number of fund beneficiaries; indeed, experience suggests that mutual fund beneficiaries are unlikely to engage.[257] Moreover, those fund beneficiaries who do respond may not be representative of fund beneficiaries generally—they may be wealthier, more informed, or favor particular policy views. There is also a significant risk that those fund beneficiaries with strong views on an issue would be more likely to register those views, making it difficult for a fund manager to ascertain the extent to which the expressed views reflect those of a majority of fund beneficiaries. As a result, it may be difficult for fund managers to know what weight to give to the views they receive, especially if overall turnout is low.

[255] *See* text accompanying note 225.
[256] *See* text accompanying *supra* note 237-244.
[257] *See supra* note 215 and accompanying text.

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Turnout concerns should not be overstated, however. As noted above, even financially disengaged investors might wish to give input on value-based issues, especially if fund managers facilitate participation through thoughtful engagement tools. As noted, iconik claims that assembling a voting profile takes minutes.[258] Moreover, fund managers do not need to hear from everyone to know what their beneficiaries think. Polling companies can render precise estimates of population-wide views with small sample sizes.[259] Combining the vast information that fund managers have about their beneficiaries with insights from expressed preferences, even if only provided by a minority of beneficiaries, can likely paint a fairly accurate picture of where beneficiaries stand.

Another worry is that fund beneficiaries may be uninformed. Unlike direct retail investors, fund beneficiaries often have only a vague sense of which portfolio companies their money is invested in; indeed, many fund beneficiaries are invested through employer-sponsored 401(k) plans and may not even know which mutual funds their money is in.[260] Research has shown that people who are invested exclusively through their employer's 401(k) plan demonstrate the lowest overall levels of financial literacy, raising questions about their ability to cast consequential shareholder votes in an intelligent way.[261]

Once views are collected, other questions arise. Should fund managers consider a fund owner's economic stake or, like a political election, weigh views on a per capita basis? How should managers deal with an issue on which their beneficiaries are split? Should fund managers mirror beneficiary views on complex topics even when these views are potentially uninformed or unscientific?

These challenges highlight the limitations of proposals to require pass-through voting. Similarly, they create problems for a system in which fund managers are required to adhere strictly to the expressed preferences of fund beneficiaries.[262] Consequently, our proposal is more limited; we simply require that fund managers take beneficiary preferences into account. While we argue that managers have an affirmative obligation to make a reasonable effort to seek information from fund beneficiaries as to their preferences and to consider those preferences, along with all other information, in determining their voting and engagement policies, we would not require them to reflect those views rigidly.

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[258] *See infra* note 241 and accompanying text.

[259] *See* Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 238 (2018).

[260] Eighty-one percent of households with mutual funds held them in 401(k)s or similar tax-favored retirement accounts. *See* INV. CO. INST., *supra* note 100, at 123.

[261] Fisch, et al., *supra* note 10 at 743 (citing "data from the National Financial Capability Study (NFCS) demonstrate[ing] that workplace-only investors suffer from higher levels of financial illiteracy than other investors").

[262] *See* Hirst, *supra* note 215, at 141 (discussing proportional voting).

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Consider an example. Suppose a fund manager's polling reveals that sixty percent of a particular fund's beneficiaries are in favor of measures to improve transparency around corporate environmental impacts. At any particular portfolio firm, the fund manager could choose to vote in favor of a shareholder proposal supporting greater environmental disclosure, but it could also vote against if it believes that the specific proposal is poorly worded or an attempt to micromanage the company, if it believes the issuer's existing disclosures are sufficient, or for any other legitimate reason. [263] The key is that fund managers would be required to explain their reasoning. By requiring fund managers to demonstrate that they sought shareholder input, and to explain how it was considered, our proposal increases accountability while retaining a role for fund managers' expertise.[264]

Finally, some might critique our proposal on ideological grounds. Incorporating the views of fund beneficiaries might dampen fund support for environmental and social issues, disappointing those who support such measures. Fund beneficiaries are also more affluent and less diverse than the US citizenry and may adopt positions that entrench their status and worsen inequality.[265]

These concerns have some purchase, but they result from a flawed system in which corporate governance has partially supplanted public governance. The role of public corporations, and their environmental and moral obligations, is properly a question for the public. Accepting, however, that these public questions are currently channeled through corporate governance, our proposal has a greater claim to democratic legitimacy than the *status quo*. About forty-five percent of US households own mutual funds.[266] Twenty percent of workers participate in pension plans.[267] It is far better to give these individual beneficiaries a say than to delegate responsibility to a handful of fund managers.

Moreover, the long-term ideological impact of our proposal is unclear. The large fund managers may retract their support for environmental and social issues in the

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[263] *See, e.g.*, *2022 Climate-Related Shareholder Proposals More Prescriptive Than 2021*, BLACKROCK (May 2022), https://www.blackrock.com/corporate/literature/publication/commentary-bis-approach-shareholder-proposals.pdf (explaining "that many of the climate-related shareholder proposals coming to a vote in 2022 are more prescriptive or constraining on companies and may not promote long-term shareholder value").

[264] One could respond that the flexibility our proposal invites may perpetuate a continuation of the *status quo*, with fund managers voting however they want and defending their votes with boilerplate statements about beneficiary views. Death through boilerplate is all too common. Our proposal mitigates this risk through its specifics. It is hard to respond with boilerplate about how fund managers ascertained beneficiary views, what they found, and how they incorporated those views. As discussed, the prospect of meaningful compliance and related disclosures would also be enhanced through SEC dialogue with fund managers and SEC enforcement. *See* discussion *infra* Part V.B.4.

[265] *See supra* note 125.

[266] INV. CO. INST., *supra* note 100, at 117 fig. 7.1.

[267] *Worker Participation in Employer-Sponsored Pensions: Data in Brief*, CONG. RESEARCH SERV. 4 tbl. 1 (Nov. 23, 2021), https://sgp.fas.org/crs/misc/R43439.pdf.

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future if it serves their interests. Indeed, there are already signs of a pullback. BlackRock reduced its support for environmental and social proposals in 2022.[268] Vanguard quit the Net Zero Asset Managers initiative, an effort to push portfolio firms to achieve net zero emissions by 2050.[269] At the same time, beneficiaries may prove more supportive than they are today. Younger investors, in particular, are more engaged than previous generations, and are pushing for more corporate environmental and social accountability.[270] This points to the value of our proposal—it is based on principles of fairness and efficiency, not ideology.

3. The Benefits of Informed Intermediation

Institutional investors, primarily mutual fund managers, have been criticized both for their stewardship efforts and for failing to engage. While many of the concerns are warranted, proposals for reform often fail to appreciate the significant advantages that come with intermediation, both vis-à-vis individual investors and vis-à-vis regulators. Informed intermediation, in contrast, leverages intermediary power rather than extinguishes it.

If regulators called upon fund managers to remove themselves from corporate governance by requiring pass-through voting, or by enacting similar measures, individuals would be forced to decide firm-by-firm and issue-by-issue across potentially thousands of companies. This is inefficient and unrealistic. With our proposal, however, beneficiaries would be able to express broad preferences and it would be up to fund managers to incorporate them. Fund managers would add great value by collecting these views and appropriately applying them across the array of companies in their portfolios. Their expertise, as well as their economies of scope and scale, would amplify and refine beneficiary views.[271] Fund manager involvement would also mitigate the risk that beneficiaries are uninformed or unengaged.

In many ways, informed intermediation looks like representative democracy—and has the same benefits. In most cases, individual citizens do not vote on specific political decisions. In fact, political systems with high levels of direct democracy have generated substantial criticism.[272] Issue-level engagement, it turns out, leads to bad governance because of problems with apathy and expertise, problems that

[268] *See supra* note 133.

[269] Ross Kerber & Noor Zainab Hussain, *Vanguard Quits Net Zero Climate Effort, Citing Need for Independence,* REUTERS (Dec. 7, 2022), https://www.reuters.com/business/sustainable-business/vanguard-quits-net-zero-climate-alliance-2022-12-07/.

[270] Barzuza, et al., *supra* note 250.

[271] The significant benefits of intermediation would also be lost in a system where fund managers were required to proportionally mirror the preferences of their fund beneficiaries.

[272] *But see* Arthur Lupia & John G. Matsusaka, *Direct Democracy: New Approaches to Old Questions,* 7 ANNU. REV. POLIT. SCI. 463 (2004) (challenging traditional skepticism about direct democracy and offering evidence that it can make sitting legislatures govern more effectively).

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intermediation through elected representatives mitigates. Intermediation in the corporate governance context offers the same advantage.

Our proposal also exploits fund manager expertise about their beneficiaries. Rather than requiring regulators to specify processes and procedures for collecting beneficiary preferences, we leave it to fund managers to determine how best to engage their constituents. The former would be burdensome on regulators and likely lead to clumsy one-size-fits-all rules. The latter takes advantage of the fund managers' institutional knowledge. Fund managers have control of their engagement platforms as well as demographic information about their beneficiaries. Mutual fund managers know the age of their investors, how much they have saved, how long they have been invested, how frequently they move their money, whether their investments are inside or outside of a 401(k) plan, whether they chose their investments or whether their employer selected default investments on their behalf. This knowledge enables fund managers to gauge how best to illicit responses and design appropriate engagement tools. The appropriate tool for a 401(k) plan with a substantial number of participants who have simply been defaulted into the plan may be different than for engaged investors in an impact fund or Gen-Z investors who use the Robinhood trading app. Fund managers would be free to design their engagement efforts accordingly. Although to comply with our proposal, they must choose a suitable mechanism, a variety of engagement mechanisms are likely to work, and regulators would be well-positioned to consider whether the fund manager chose an appropriate tool given its beneficiary response rate, as well as considerations of cost, beneficiary base, and available technology.

A final advantage of deferring to fund managers is that it allows them to compete, not on the basis of their engagement policies with issuers, but on the quality of their efforts to engage with their beneficiaries. Giving fund managers discretion transforms beneficiary engagement from a compliance exercise into a space for innovation, experimentation, and competition. We thus incorporate market forces, not merely into the development of engagement mechanisms, but as a tool for stimulating fund managers to engage more effectively and to respond to fund beneficiary needs and demands. These market forces are particularly likely to be effective as younger, more engaged, investors enter the market.[273]

4. Enforcement

As the foregoing discussion indicates, informed intermediation raises a variety of new issues. We anticipate compliance efforts will evolve over time as fund managers experiment with outreach mechanisms, fund beneficiaries become aware of the opportunity to convey their views, and market entrants offer new vehicles to simplify the communication process. We also envision a learning curve in which fund managers

[273] *See, e.g.*, Barzuza, et al., *supra* note 250; Ricci & Sautter, *supra* note 207.

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evaluate the information they receive from fund beneficiaries and determine how to incorporate that information into their engagement decisions.

A key to our proposal is its flexibility in giving fund managers space to design their own engagement tools and to deviate from the beneficiary views they receive. If fund managers fear a stiff response from regulators, however, they may herd toward similar ways to solicit beneficiary preferences and adhere strictly to the expressed preferences they collect. To avoid this pallid version of compliance, regulatory oversight, at least initially, would be most effective if it takes the form of a "light touch" in which regulators advise fund managers of emerging best practices or prompt them to remedy perceived deficiencies.[274] Fund managers should be able to respond to regulator inquiries in the same manner that issuers respond to SEC comments—by explaining the process by which they solicited beneficiary input, the input received as a result of that process, and how that input factored into their decisions.

For similar reasons, we advocate that our proposal be implemented exclusively through public enforcement, and that any government regulation exclude a private right of action.[275] Because it would be easy for a private litigant to claim that a particular engagement tool was ineffective or an fund manager's vote was insufficiently representative, a private right of action would, like overzealous enforcement, run the risk of stymying the very innovation and use of discretion that informed intermediation is designed to foster. Although fiduciary duty litigation in the mutual fund context has been extremely limited, there has been an expansion in private litigation challenging mutual fund fees under section 36(b) of the Investment Company Act, and there are serious reasons to question whether that litigation is socially valuable.[276] Public-only enforcement of the rule we propose avoids the potential for similarly questionable litigation in this context.

CONCLUSION

Institutional intermediation is at an inflection point. Scholars, investors, and policymakers are increasingly frustrated by the *status quo*, where mutual-fund and pension-fund managers are largely unaccountable for their voting and engagement

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[274] The UK Financial Conduct Authority (FCA) has famously defended its "light touch" approach to regulation as helping London cultivate a reputation for being business friendly. *See, e.g.*, Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1394-95 (2103) (describing defense of "light touch" approach by FCA enforcement director Margaret Cole, who worried that a more aggressive regulatory approach can have "damaging effects . . . on creativity, innovation and competition").

[275] *See generally* William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69 (2011) (evaluating the relative advantages and disadvantages of public versus private enforcement of federal securities regulation).

[276] *See, e.g.*, Curtis, *supra* note 136 ("There is little evidence that suits are effective in bringing fees down in sued funds or that such suits target particularly expensive funds").

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efforts. This has led to a slew of reform proposals and to fund managers themselves experimenting with change.

The alternative receiving the most attention—pass-through voting—is also the most problematic. Paradoxically, the probable result of returning voting power to individual shareholders would be to disenfranchise them. Like pass-through voting, our proposal would engage shareholders in the stewardship process. This is particularly important given the value-infused nature of corporate governance today. Crucially, however, we would leave voting power and ultimate authority with fund managers, allowing them to continue to play their valuable—even essential—role in corporate governance.

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