

PUBLIC PENSION FUND ACTIVISM IN CORPORATE GOVERNANCE RECONSIDERED

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A key organizational feature of large United States corporations is the separation of ownership from control. This separation creates an agency problem, that managers may run the firm in their own, rather than the shareholders' interest, choosing the quiet life over the maximization of share value. In the 1980s, corporate takeovers provided a measure of discipline by threatening poor performers with replacement by bidders who would reunite ownership and control.¹ With the lull in takeovers in the 1990s, commentators concerned about corporate performance have turned their attention to identifying alternative mechanisms for disciplining management. The principal solution has been to call for more active monitoring of management by institutional investors.² The focus has been on a subset of these investors, public pen-

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1. See Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 Yale J. on Reg. 119, 122-33 (1992).

2. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 575-91 (1990) (arguing that institutional investors' combination of large shareholdings and economies of scale allow them to overcome the traditional problems of shareholder passivity and thus effect changes in corporate policy and emphasizing the major role of public pension funds); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811, 873-88 (1992) (proposing modest reform to provide institutional investors with greater voice in corporate policy as means of inducing more active monitoring); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1336-38 (1991) (proposing reforms that would align pension fund managers' interests with those of their funds in order to increase the incentives for corporate monitoring); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863, 882-92 (1991) (calling on institutional investors to elect cadre of professional directors with the ability and incentives to engage in active monitoring); Mark J. Roe, *A Political Theory of*

sion funds (the pension funds of state and local government employees), because managers of corporate pension funds and financial institutions have other business relations with issuers that are thought to generate conflicts of interest preventing them from opposing corporate management.³

This Article seeks to add a dose of realism to the debate over shareholder activism in corporate governance by underscoring what was once widely recognized in the literature but of late has been overlooked: public pension funds face distinctive investment conflicts that limit the benefits of their activism.⁴ Public fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios' assets. This tension is not an isolated phenomenon. Much of the activity of states in what is referred to as economic development—providing tax concessions or direct payments to in-state businesses—is in response to similar concerns. Pressure may come from the federal government as well. During the recent presidential campaign, Bill Clinton advocated using public pension funds to finance infrastructure projects, a proposal also endorsed by a congressional commission.⁵

The hypothesized conflict that prevents private funds from opposing incumbent management is consequently not unique to that sector: corporate managers who threaten private fund managers or their employers with loss of business as the price of opposition can just as effectively threaten public funds with economic loss through, for example,

American Corporate Finance, 91 Colum. L. Rev. 10, 53–65 (1991) (describing the political forces which act as a check on large financial institutions' ability to act as effective monitors).

3. See, e.g., James E. Heard & Howard D. Sherman, Conflicts of Interest in the Proxy Voting System 40–49 (1987); Edward S. Herman, Commercial Bank Trust Departments, in Twentieth Century Fund, Abuse on Wall Street: Conflicts of Interest in the Securities Markets 23, 72–79 (1980) [hereinafter Abuse on Wall Street]; John Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. Fin. Econ. 237, 242–43 (1988); see also Chris Welles, Nonprofit Institutions, in Abuse on Wall Street, supra, at 498, 545 (discussing conflicts for foundations). For a general review of private funds' conflicts that does not specifically discuss the voting context, see John Brooks, Corporate Pension Fund Asset Management, in Abuse on Wall Street, supra, at 224.

4. See, e.g., Louis M. Kohlmeier, State and Local Pension Fund Asset Management, in Abuse on Wall Street, supra note 3, at 267, 274–304 (discussing, *inter alia*, incentives for funds to invest in low-yield government bonds and the influence of political patronage in selecting management); Kathleen Paisley, Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions, 4 Yale L. & Pol'y Rev. 188, 196–206 (1985) (discussing the potential conflicts facing public fund trustees and legislative attempts to ameliorate the problems).

5. See Joel Chernoff, Funds Fear Clinton Pressure, Pensions & Investments, Nov. 23, 1992, at 1, 35; cf. Christine Philip, Irish Funds Hit with Tax Threat, Pensions & Investments, Mar. 8, 1993, at 2 (Irish government threatens pension funds to make social investments or lose their special tax status).

local plant closings. Such pressure is, however, likely to be geographically constrained compared to that created by private sector financial relationships, because state officials are most concerned with effects on local labor markets. Although public funds could attempt to coordinate investment strategies so as to protect each other's employment level,⁶ the aggressive competition among states for businesses suggests that coordination will be difficult, if not impossible, to maintain. It is an empirical question whether the geographically-based conflicts confronting public funds impose greater constraints on their managers' decision-making than conflicts involving other business relations that confront private fund managers.⁷

Public funds have, in fact, been more active than other institutional investors in corporate governance over the past few years, offering shareholder proposals and engaging in other highly publicized activities to influence management actions.⁸ In addition, they vigorously advocated recently-adopted reforms in the Securities and Exchange Commission's (SEC) proxy regulations to enhance their ability to play an active role in corporate governance. But as public funds increase their activism and that activism affects the interests of politically organized groups, such as unions and corporate managers, political pressure on these funds will increase significantly.⁹ For instance, after it was disclosed that a New York state pension fund had invested in a leveraged buyout fund that financed contested tender offers, including the RJR/

6. For example, the Illinois state treasurer not only threatened to withhold future investments in a leveraged buyout fund if the fund did not preserve jobs in an Illinois plant that it was selling to its employees, but also stated that he would "alert state pension boards across the country about the situation." State Treasurer Uses Pension Funds to Pressure Owners to Sell Printing Plant, 19 Pension Rep. No. 48 (BNA), Dec. 7, 1992, at 216I [hereinafter State Treasurer]. The effectiveness of such notification is, of course, an open question.

7. It should be noted, however, that the evidence that conflicts of interest affect private fund managers' decisions is, at best, circumstantial. For example, John Pound finds less support for challengers in proxy contests in firms with a higher percentage of shares held by institutional investors, but he cannot distinguish a conflict-of-interest explanation from an equally plausible monitoring explanation, that firms with high levels of institutional ownership experience proxy contests that are less credible because such investors effectively monitor management's performance. See Pound, *supra* note 3, at 243. Pound does not have data on how individual institutions voted in his sample's proxy fights, and, accordingly, he does not have any direct evidence of a significant difference in voting practices between private and public funds.

8. See, e.g., Steven Dickson, Pension Funds Explore Corporate Governance as New Strategy for Bringing About Social Change, Bond Buyer, Jan. 27, 1992, Review & Outlook Supp., at I6A; Kevin G. Salwen & Joann S. Lublin, Giant Investors Flex Their Muscles More at U.S. Corporations, Wall St. J., Apr. 27, 1992, at A1; Some Institutional Investors Turn to Negotiations, But High Level of Proposal Activity Predicted to Continue, BNA's Corp. Couns. Wkly., Jan. 1, 1992, at 8.

9. This hypothesis is the clear implication of Mark Roe's contention that much of the federal regulation of financial institutions is directed at preventing them from effectively monitoring corporate management. See Roe, *supra* note 2, at 31-53.

Nabisco buyout, the governor created a task force to investigate pension fund investment policy. The task force recommended restricting public pension funds' involvement in hostile takeovers and instructing them to take local concerns, such as the state economy and in-state employment, into account when acquiring or voting shares.¹⁰ If activist public funds are required to embrace such an investment agenda, then their investment objective will diverge from that of other equity holders, who desire to maximize share value and will therefore not benefit from public funds' increased role in corporate governance.

This Article takes three tacks in exploring the limits of public pension funds' activism in corporate governance. After providing an overview of the magnitude of public pension fund investments and the regulatory regime, Part I.A recounts anecdotes of political pressure exerted on public funds' investment activities and voting practices over the past twenty years in order to convey a sense of the environment in which the funds operate. Part I.B examines political pressure on public funds from a more systematic empirical perspective, by investigating the relation between fund performance and organizational form and corporate activism. There is an inverse relation between the return on funds' investments and the degree of political involvement in their organizational form, and between return on investments and policies favoring social investing. There is no evidence that more activist funds are poorer performers or have significantly different board composition than non-activist funds. Part I.C then examines whether there are significant differences in proxy voting practices between public and private funds. On most issues there are scant differences in the voting policies of the two types of funds.

The anecdotal accounts and statistical evidence suggest that there are limits to what can be expected from shareholder activism by public institutional investors. Increasing public funds' activism is therefore a problematic substitute for a well-functioning market for corporate control as a means of mitigating the agency problem at the heart of corporate law. Proposals that advocate increasing corporate governance activism to discipline managers and enhance share value without paying careful attention to the political environment in which institutional investors operate miss the mark. At a minimum, if public pension funds are to play their prophesied role in mitigating the agency problem, workable mechanisms must be devised to insulate funds pursuing active corporate governance strategies from the adverse political repercussions that will surely accompany such activity.

Part II explores several institutional reforms that could alleviate political pressure on public funds: ensuring that membership of public

10. See Governor's Task Force on Pension Fund Investment, *Our Money's Worth* 45-48 (1989) [hereinafter *Our Money's Worth*]. For a detailed discussion of this report, see *infra* notes 74-85 and accompanying text.

fund boards includes individuals elected by fund beneficiaries; applying the Employee Retirement Income Security Act of 1974 (ERISA)¹¹ fiduciary standard for private funds to public funds; increasing the proportion of fund assets that are passively invested, a strategy referred to as "indexing"; constitutionalizing public funds' independence; and shifting public retirement systems from defined benefit to defined contribution plans. Some proposals, such as increasing the use of indexing or adopting the ERISA standard, are more effective at restricting social investing than at diminishing political pressure on voting decisions. Others, such as shifting to defined contribution plans, resolve the problem of political pressure on public fund managers by eliminating their role in corporate governance. The latter proposal relies on mutual fund managers, in whose funds state employees' pensions would be invested, to monitor management.

This Article concludes that there are no practical solutions to the problem of political influence on public pension funds short of a substantial restructuring of the funds toward defined contribution plans. Yet such restructuring reduces, rather than increases, public funds' activism in corporate governance. Moreover, although the motivation for shifting to defined contribution plans involves corporate governance concerns, the shift implicates a broad range of questions involving public policy toward pensions in general, over which policy analysts disagree. Caution is therefore warranted in implementing such a proposal, despite its decisive advantages from a corporate governance perspective.

I. PUBLIC PENSION FUND CONFLICTS OF INTEREST

A. *Political Pressure on Public Pension Fund Investment and Voting Decisions*

Pension funds hold a substantial and growing proportion of all corporate equity. In 1950, they held less than one percent of equities; by 1989, they held twenty-six percent.¹² Public pension funds are a sizeable subset of this sector—an estimated thirty percent in 1988–89.¹³ The total cash and investment holdings of public pension funds in 1989 was, at book value, over \$600 billion, of which close to one-third was in corporate stock.¹⁴ This contrasts sharply with a total

11. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at 29 U.S.C. §§ 1001–1461 (1988 & Supp. 1990)).

12. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *Geo. L.J.* 445, 447 (1991).

13. See Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 *Brook. L. Rev.* 1, 17 (1991).

14. The Census Bureau's comprehensive time-series data on public funds' assets, which are used in the statistical analysis following *infra* note 108, are reported at book value and not market value. See Bureau of the Census, U.S. Dep't of Commerce, Series GF-89-2, *Finances of Employee-Retirement Systems of State and Local Governments: 1988–89*, at vii, 8 (1991) [hereinafter *Census Report*] (corporate debt valued at par and

book value of \$5.3 billion in 1950.¹⁵ These figures convey the magnitude of the phenomenal growth of public pension funds,¹⁶ which makes policymakers' heightened attention toward the funds' investment activities understandable.

Public pension funds are regulated by the states, as they are exempt from ERISA, the federal regime applicable to private pension funds. Two dimensions of state regulatory schemes are of particular interest. First, state laws prescribe the investments public pension funds can make. A majority of states subject funds to a "prudent person" fiduciary standard. Although the standard's phrasing varies, a common formulation requires funds to be managed with "prudence, discretion, and intelligence" "under the circumstances then prevailing."¹⁷ In addition, many states have "legal list" statutes that enumerate types of permissible investments.¹⁸ Such lists typically limit the percentage of a fund's aggregate portfolio that can be invested in equities, or in the stock of any individual firm. Although several states combine both the legal list and prudent person approaches to fiduciary duty, others have repealed legal lists altogether and replaced them with the more flexible prudent person fiduciary standard.¹⁹

Second, state statutes fix the composition of public pension fund boards. Designated board members typically fall into one of three cate-

corporate stock at book value). The Census data include 2,387 public employee retirement systems (of which 204 are state-administered) covering almost 13 million employees. See *id.* at xi. Using 1986 data, Buxbaum calculates that public funds hold over 7.5% of the market value of publicly-traded common stocks. See Buxbaum, *supra* note 13, at 18. Heard and Sherman indicate that, as of 1986, public pension funds held 5.7% of corporate stock (market value), second only to private pension funds' holdings of 14.9%. See Heard & Sherman, *supra* note 3, at 11.

15. See Kohlmeier, *supra* note 4, at 270.

16. The growth in public funds' holdings is due, at least in part, to large increases in state and local government employment, see *id.* at 271, and the removal of statutory restrictions on funds' equity investments. The holdings of private pension funds increased dramatically over this period as well. See *id.* at 270 (book value of private pension fund assets increased from \$12.1 billion in 1950 to \$216.9 billion in 1975).

17. See, e.g., Ark. Code Ann. § 24-3-411 (Michie 1992) (requiring "the judgment and care, under the circumstances then prevailing, which an institutional investor of ordinary prudence, discretion, and intelligence exercises"). See also Congressional Research Serv., Public Pension Plans: The Issues Raised over Control of Plan Assets, prepared for the Subcomm. on Labor-Management Relations of the House Comm. on Educ. and Labor, 101st Cong., 2d Sess. 35 (Comm. Print 1990) [hereinafter CRS, Pensions]. For a discussion of the prudent person rule and its distinctive incorporation in ERISA, see Norman Stein, Trust Law and Pension Plans, in *Proxy Voting of Pension Plan Equity Securities* 1, 14-16, 42-46 (Dan M. McGill ed., 1989) [hereinafter *Proxy Voting*].

18. See, e.g., N.Y. Retire. & Soc. Sec. Law § 13 (McKinney 1987) (permitting investment in, *inter alia*, banks, commercial and residential mortgages, debt securities, and common stock).

19. For example, in 1985 Arizona replaced its legal list with a prudence standard subject only to certain limits on equity investments. See Ariz. Rev. Stat. Ann. § 38-757 (1985 & Supp. 1992).

gories: gubernatorial appointees; representatives elected by fund beneficiaries; and individuals named by virtue of their office.²⁰ The designation of employer executives (state officials) as fund trustees is not unique to public pension plans—trustees of private plans are typically officers of the employer-sponsor.²¹ It does, however, raise potentially serious conflict of interest problems, as trustees have dual roles, representing employers as well as employees. The political affiliation of a significant number of fund trustees renders public pension funds especially vulnerable to pressure by other state officials. This vulnerability is exacerbated by the magnitude of fund holdings. Particularly in times of fiscal difficulty, fund assets are an inviting target for state officials seeking new sources of financing for local projects. There are numerous examples of governors pressuring public pension funds to use their assets to assist distressed local entities, both public and private.

1. *Social Investments*. — The best-known examples of political pressure on fund investment decisions involve the New York state and city pension funds' assistance to four financially distressed state agencies engaged in lending to local housing and business development projects, and to New York City, which was on the brink of insolvency in

20. See, e.g., Ala. Code § 36-27-23 (1991); Idaho Code § 59-1326 (1976). Statutes often designate the types of individuals who are eligible for gubernatorial appointment. See, e.g., Ariz. Rev. Stat. Ann. § 38-742 (1988); Del. Code Ann. tit. 29, § 8308 (1988). These are usually financial experts (investment bankers, pension lawyers, insurance specialists, or actuaries), government officials, or employees (fund beneficiaries). See, e.g., Del. Code Ann. tit. 29, § 8308 (1988). Designated *ex officio* trustees, who also vary across the states, include the governor, treasurer or comptroller, education director, personnel director, finance director, and budget director. See, e.g., Ala. Code § 36-27-23(b) (1988) (governor, state treasurer, state personnel director, director of finance); Alaska Stat. § 37.10.210(b) (1992 Supp.) (commissioner of revenue); Mass. Gen. L. ch. 32, § 23 (1988) (state treasurer). A small number of states designate members of the legislature as trustees. See, e.g., La. Rev. Stat. Ann. § 11:511 (West Supp. 1993) (chairman of House Retirement Committee and chairman of Senate Finance Committee); S.C. Code Ann. § 1-11-10 (Law. Co-op. 1986) (chairman of House Ways & Means Committee and chairman of Senate Finance Committee). In many states, state employees and teachers' retirement funds are operated separately, and the composition of the two funds' boards varies accordingly. For example, the director of education will be designated an *ex officio* trustee for the teachers' fund and not for the state employees' fund when these funds are separate entities. See, e.g., Cal. Educ. Code § 22200 (West Supp. 1993); Cal. Gov't Code § 20100 (West Supp. 1993); Ohio Rev. Code Ann. §§ 145.04, 3307.05 (Baldwin 1992). Similarly, when there is only a combined state employees' retirement fund and trustees are elected by members, teachers separately elect their own representatives. See, e.g., Miss. Code Ann. § 25-11-15(2)(g) (1991); R.I. Gen. Laws § 36-8-4 (1990).

21. Private plans are principally employer-based, but there are also multi-employer plans that are jointly administered by management and unions in a single industry. Corporate management or trade association employees typically represent the industry on the plan boards, while the union-designated trustees are the union's leaders. Despite equal numbers, the plans are dominated by union trustees. See Richard Blodgett, *Union Pension Fund Asset Management, in Abuse on Wall Street*, supra note 3, at 320, 329-34; Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1111-12, 1135-36 (1988).

the mid-1970s.²² After having been threatened with an "interception" of \$825 million of the state's annual contribution, the state pension funds agreed to purchase the agencies' bonds and thereby prevent their insolvency. State officials conceded that the proposed interception was "only a half-desperate plan" designed when the sole trustee of the retirement funds, the state comptroller, "appeared to have ruled out his cooperation."²³ To bail out New York City, both the New York state legislature and Congress enacted legislation to authorize the purchase of the city's bonds by its pension funds, and a federal court upheld the purchase as consistent with the trustees' fiduciary duty.²⁴ One city union leader, who had balked at this use of pension fund assets, charged that the pressure "was intense, amounting to blackmail."²⁵

In the 1990s, states experiencing fiscal difficulty have taken unilateral action against fund assets rather than employed the earlier New York approach of "requesting" their use in public debt purchases. Among the tactics employed are reducing contributions to retirement funds, altering actuarial and income assumptions in order to decrease contribution levels, and transferring assets from pension fund to general state accounts.²⁶ These policies are particularly troubling because

22. For reports of these bailouts, see Levitt Now Considering the Use of Pension Funds to Save Four State Agencies, *N.Y. Times*, Jan. 21, 1976, at 43 [hereinafter Levitt]; Steven R. Weisman, *City Avoids Default by Hours as Teachers Relent, Buy Bonds; Financial Markets Disrupted*, *N.Y. Times*, Oct. 18, 1975, at 1.

23. Levitt, *supra* note 22, at 43.

24. See *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248 (S.D.N.Y.), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979). These events are detailed in Paisley, *supra* note 4, at 193-96. An earlier statute that had required, rather than permitted, the pension funds to buy \$125 million of city bonds had been struck down in state court as violating the state constitutional provision prohibiting the impairment of retirement system benefits. See *Sgaglione v. Levitt*, 337 N.E.2d 592, 594 (N.Y. 1975).

25. Louis M. Kohlmeier, *Twentieth Century Fund Report, Conflicts of Interest: State and Local Pension Fund Asset Management* (1976), reprinted in *House Comm. on Educ. and Labor, Pension Task Force Report on Public Employee Retirement Systems*, 95th Cong., 2d Sess., 859, 869 (Comm. Print 1978) (quoting Albert Shanker, then president of the city's teachers union).

26. Jonathan Walters, *The Pension Fund Grab of '91, Governing*, Feb. 1992, at 18 (California transferred \$1.6 billion from state pension funds to general funds; Illinois transferred \$21 million; Texas and Rhode Island reduced contributions; by changing actuarial accounting, New York deferred \$429 million in contributions). California also transferred actuarial decisions from the fund board to an actuary chosen by the governor. See *Cal. Gov't Code* § 20006 (West Supp. 1993). California's transfer of funds and actuarial functions was upheld against fund member and union challenge. See *Claypool v. Wilson*, 6 Cal. Rptr. 2d 77, cert. denied sub nom. *California Bd. of Admin. of Pub. Employees' Retirement Sys. v. Wilson*, 113 S. Ct. 812 (1992). A member and union challenge to New York's legislative change of fund accounting prevailed in the lower court and is on appeal. See *McDermott v. Regan*, 587 N.Y.S.2d 533 (N.Y. Sup. Ct. 1992).

The use of such alternatives in place of public debt purchases is confirmed by a cursory examination of recent fund investments: in 1988-89, state and local government debt was an infinitesimal proportion of state pension fund portfolios

many state pension funds are in weak financial condition: in 1991, twenty state funds were less than seventy-five percent funded.²⁷ However, the most widespread type of political pressure on public fund investment policies today involves demands to stimulate local economic activity directly by financing development projects that over-extended states cannot fund rather than by bailing out government entities. Most such investments are “social investments”—investments whose return is not commensurate with their risk.²⁸ Such investments use pension assets for broader social purposes at the expense of fund beneficiaries or a subset of beneficiaries.²⁹

Three examples will serve to illustrate the pressures on funds to engage in social investing:

(1) the Pennsylvania public school employees’ and state employees’ retirement funds were pressured by state officials into assisting the financing of a new Volkswagen plant when the state was unable to come up with the funds it had promised Volkswagen in order to induce it to locate in Pennsylvania.³⁰ The plant closed a decade later, and it took

(median 0, mean .05%, maximum 1%). This is not, to be sure, surprising; state and local debt are not prudent investments for pension funds because they do not benefit from the debt’s tax exempt status. But, despite the tax disadvantage, if states were pressuring funds to acquire their debt in today’s difficult fiscal times, as New York did in the 1970s, fund holdings of such debt would be higher. For example, New York State debt equaled 16% of the state pension funds’ portfolios during the state’s 1976 fiscal crisis. See Kohlmeier, *supra* note 4, at 268.

27. See Pension Comm’n Clearinghouse, Report on State Pension Systems 4 (11th ed. 1992). Unlike private funds covered by ERISA, public funds are not subject to any minimum funding requirements. However, the risk that an underfunded plan will be unable to pay promised benefits is lower for public than private pension plans because their sponsors are governments, whose taxation power provides an alternative revenue source.

28. See Fischel & Langbein, *supra* note 21, at 1143. If the return on such investments were commensurate with their risk, there would be no question concerning their acceptability and both public and private pension funds and other investors would undertake them voluntarily. A possible qualification concerning the market’s ability to finance such investments adequately is Lawrence Litvak’s thesis of market gaps. See *infra* note 66 and accompanying text.

29. Fischel and Langbein contend that it would be better to distinguish between the two situations. See Fischel & Langbein, *supra* note 21, at 1143. Although the former (no benefits to any plan members) is clearly unjustifiable, the latter (benefiting some members over others) is a more complicated situation, even under ERISA’s exclusive benefit rule. They suggest that the proper formulation of fiduciary duty when there are conflicts of interest among beneficiaries, such as those between active employees and retirees, is to follow a rule of impartiality—not to allow one group to benefit at another’s expense. Because such a formulation still will not support social investing since it involves a wealth transfer across beneficiary groups—saving the jobs of current, and especially junior, employees at senior employees’ and retirees’ expense—this Article follows common usage and does not distinguish between the two categories of social investments.

30. See Pennsylvania Pension Funds Offer VW \$135 Million Loan to Help Set Up Plant, Wall St. J., July 9, 1976, at 5.

four years to obtain a new occupant, Sony, which required the state to forgive \$40 million of the original \$70 million loan and to provide additional subsidized loans of \$23 million as well as job-training grants.³¹

(2) the California Public Employees Retirement System (CalPERS) announced a plan to invest up to \$375 million in local single family home construction shortly after the governor pressured it to undertake investments to stimulate California's economy and attempted to increase his control over the fund.³² Fund officials denied that the decision was due to political pressure.³³ But the timing led the editors of the journal *Pensions & Investments* to question the "investment merits of the program as opposed to [its] political expediency."³⁴ In addition, the California state treasurer, a member of CalPERS' board, thereafter proposed that the fund's real estate portfolio be limited to financing projects using "responsible contractors" that pay "prevailing wages" and other benefits (i.e., projects employing only unionized labor).³⁵

(3) In a survey of eighteen state pension funds with social investment policies, officials of eight funds identified political pressure as an influencing factor in the development of social investment policies, including pressures from the governor's office (cited twice), the state legislature (cited once), the funds' board of directors (cited three times), fund administrators (cited four times), the housing industry (cited four times), and general "political and public pressure" (cited four times).³⁶

Public pension funds also engage in local investment initiatives without any visible state request for assistance, and the results have, on occasion, been disastrous. Even when such investments have not been a total loss, they have often significantly underperformed alternative projects with far less risk. Accordingly, such investments do not meet prudential fiduciary standards. Again, a few examples will suffice to convey the essence of these transactions and the problems that can arise:

31. See Robert Dvorchak, *States Trapped in a Losing Game with Corporations Holding All Aces*, *New Haven Reg.*, Oct. 4, 1992, at F1.

32. See *Jump-start Investing*, *Pensions & Investments*, Feb. 3, 1992, at 10 [hereinafter *Jump-start Investing*]; Richard W. Stevenson, *Pension Funds Becoming a Tool for Growth*, *N.Y. Times*, Mar. 17, 1992, at D1 [hereinafter *Pension Funds*].

33. See *Pension Funds*, supra note 32, at D1, D6.

34. *Jump-start Investing*, supra note 32, at 10. The fund unveiled the proposal in response to a letter from the governor requesting that the fund invest its "considerable assets" in "ways that would stimulate [California's] economy." *Id.* This exchange of correspondence occurred shortly after the fund agreed, at the governor's request, to contribute \$1.6 billion of its assets to close the state's budget deficit, and at a time when private investors were unwilling to lend to residential construction. See *id.*

35. See *Build to Suit the Unions?*, *Wall St. J.*, Dec. 17, 1992, at A18 (editorial).

36. See Kent F. Murrmann et al., *Social Investing by State Public Employee Pension Funds*, 35 *Lab. L.J.* 360, 364 (1984).

(1) the Connecticut pension fund provided the key investment for a leveraged buyout of a financially distressed local firm, Colt Industries, in order to maintain state jobs; the fund's \$25 million investment, intended as a bridge loan, turned into a longer-term investment (equal to 47% of the corporation) upon a further downturn in Colt's business, and its repayment is now in jeopardy after Colt's bankruptcy filing.³⁷

(2) the Kansas pension fund invested heavily in local businesses, including a steel mill that closed and a savings and loan that failed, which left the fund with a loss of over \$100 million.³⁸ After an investigation of the fund's direct placement investment portfolio by a committee of the state legislature documented the losses, the fund board placed a moratorium on direct placement investments and fired the investment management firms responsible for those investments.³⁹

(3) A popular social investment is the acquisition of privately insured mortgage-backed pass-through securities, which is intended to aid local housing markets by increasing the supply of mortgage funds for local home ownership. Alicia Munnell found that between 1980 and 1982, ten state funds invested in such products and "failed to exact appropriate returns . . . in the presence of obvious benchmarks, once they focused on social considerations."⁴⁰ Although the sacrifice of return could have been avoided if the fund managers had been more careful in their investing, as Munnell emphasizes, the problem of sacrificed returns is even greater for other social investments because valuation is far more difficult than it is for pass-through mortgages where comparable market investments exist.⁴¹

(4) A General Accounting Office (GAO) study of fifteen affordable housing investments undertaken by pension funds evaluated the returns on five projects. In each case, the pro-

37. See Adam Bryant, *Colt's in Bankruptcy Court Filing*, N.Y. Times, Mar. 20, 1992, at D1; Pension Funds, *supra* note 32, at D6.

38. See Pension Funds, *supra* note 32, at D6 (\$65 million lost on the savings and loan alone); Kansas Public Employees Retirement System, 1991 Component Unit Financial Report 5 [hereinafter KPERS].

39. See KPERS, *supra* note 38, at 5.

40. Public Employee Pension Benefit Plans: Joint Hearing Before the Subcomm. on Oversight of the House Ways and Means Comm. and the Subcomm. on Labor-Management Relations of the House Comm. on Educ. and Labor, 98th Cong., 1st Sess. 68 (1983) (statement of Alicia H. Munnell). The funds invested in mortgage-backed securities that were much riskier and less liquid than federally insured "Ginnie Maes," yet obtained yields below the Ginnie Mae rate.

41. See *id.* at 60. Housing loan programs that are restricted to in-state investments suffer from an additional irony: such strategies simply reallocate loan portfolios with a loss of diversification rather than increase the housing stock, which is the goal of their proponents. Instead of state funds holding some home mortgages across the 50 states, each fund holds a portfolio of in-state loans.

ject's returns were either lower than comparable benchmarks or the GAO could not determine the project's risk level and hence the appropriateness of market comparisons.⁴² Given these circumstances, it is difficult to conclude that these were fiscally prudent investments. Yet, in each case the GAO quixotically concluded that the returns were reasonable or adequate.⁴³

Political pressure by proponents of social investing can also take the form of limiting what are viewed by the professional investment community as thoroughly uncontroversial value-maximizing portfolio investment strategies, such as diversification. A telling example occurred in Minnesota. In 1988, the state enacted legislation authorizing international investments for its pension funds.⁴⁴ The State Investment Board, which manages retirement fund assets, decided in 1991 to allocate ten percent of the portfolio to international investments. But when the Board hired an international equity manager to implement the strategy in 1992, organized labor protested. It opposed international investments of any kind, contending that there was no need to invest in international equity when there was "no shortage of needs for investment . . . in the U.S. and in Minnesota."⁴⁵ In response to such objections, a task force was established to devise guidelines for the

42. See U.S. Gen. Accounting Office, *Pension Plans: Investments in Affordable Housing with Government Assistance* (1992). The first project, mortgages issued by a nonprofit organization, paid 65 basis points more than federally secured mortgages. The GAO concluded that this return was adequate because pension funds participated in the project, even though it admitted that the accuracy of the estimate of the risk difference was difficult to verify. See *id.* at 31. In the second project, state agency housing bonds, the GAO noted that the bonds' yields were difficult to match because terms and maturities differed, yet then concluded the return was adequate. The state bonds' yields of approximately 10% were, however, barely above those of medium grade corporate bonds in three of four issues (the difference between the state yields and comparable corporate bond yields ranged between -26 to +21 basis points on the four issues), and the agency bonds' rating was comparable to the medium grade bonds. See *id.* at 31-32. In the third project, a purchase of a series of FNMA mortgage-backed securities, the project bonds yielded 9.5%, 9.6%, and 10.2%, but the yield on other FNMA securities averaged 9.9%. See *id.* at 33. In the fourth project, a series of state housing loans with an increasing interest rate structure used to finance a mobile home park, the loans yielded 87 basis points less than medium grade corporate debt (9.40% compared to 10.27%). The GAO concluded that this investment was not out of line with market yields, although it did not determine whether the bonds, which were not rated, were actually less risky than the comparable corporate debt. See *id.* at 33-34. The final project, a purchase of state agency housing bonds, again yielded less than medium grade corporate debt that had the same credit rating as the housing bonds, by 69 and 123 basis points respectively for two separate issues, yet the report concluded that these are "not obviously out of line with market yields." *Id.* at 34.

43. See *id.* at 31-34.

44. See 1988 Minn. Laws, ch. 453, § 8 (codified at Minn. Stat. Ann. § 11A.24, Subd. 6 (West Supp. 1993)).

45. Christine Philip, *Minnesota Creates Rules, Pensions & Investments*, Oct. 26, 1992, at 27.

Board's international investments, to ensure that they would meet "labor, human rights and environmental standards."⁴⁶ The opposition to foreign investments was motivated by the belief that such investments reduce local employment levels because they finance foreign competitors with lower labor costs. Minnesota's experience—adopting investment criteria unrelated to maximizing portfolio value but connected to social investing goals—illustrates the vulnerability of public funds to political pressure. Private funds, by contrast, have been investing internationally for decades without such interference.

A recent example from Illinois graphically illustrates the conflict of interest between a public pension fund and other shareholders that arises when considerations other than maximizing portfolio value enter into a fund's investment calculus. The workers of an Illinois printing company in financial difficulty sought to purchase the firm from its owner, a leveraged buyout fund operated by Kohlberg, Kravis, Roberts and Co. (KKR). The Illinois state treasurer threatened to withhold future investments by the state pension fund in KKR's leveraged buyout fund and to "alert state pension boards across the country about the situation" if KKR did not ensure that the plant continued to operate without any reduction in employment.⁴⁷ As a member of the State Investment Board, which is responsible for the pension fund's investments, the treasurer obtained a unanimous Board resolution asking KKR to "do everything in its power to secure financing for the [employee's] buyout and to make the deal happen."⁴⁸ KKR apparently did so.⁴⁹ Commentators suggested that this was the first time that an investor in a KKR leveraged buyout fund had ever raised an employment issue, as well as the first time that KKR had ever responded to such pressure.⁵⁰ This is a fascinating episode in which a public official, by virtue of his position as pension fund trustee, pressured a firm to secure benefits for a small number of state residents without any apparent consideration of the relation between such benefits and the return to the selling owners of the printing plant. Yet the state pension fund, as an investor in KKR's fund, was, of course, such an owner. Moreover,

46. *Id.*

47. State Treasurer, *supra* note 6, at 2161.

48. *Id.*

49. In commenting on his activity, the state treasurer stated that the resolution "wasn't designed to be a hammer or anything like that But if you have a \$130 million relationship with your investment manager and there's a matter that greatly affects other people in your state, I think it's something the pension board can express its view on The [resolution] was sent to KKR and lo and behold, a couple weeks later [the printing company] is more reasonable. The negotiations picked up pace."

Id. He also noted that a year earlier, KKR "had assured the investment board of [its] commitment to Illinois jobs" during a presentation to the State Investment Board seeking to increase its investment limit in the KKR fund from \$100 to \$130 million. *Id.*

50. See *id.*

Illinois' objective of maximizing in-state jobs is unlikely to coincide with the investment objectives of other investors in KKR's leveraged buyout fund.

Although many of the preceding examples involve decisions taken by pension funds without legislative prodding, numerous states have enacted statutes to encourage local investment by public pension funds. Table I provides a breakdown of statutes by state. The most prevalent legislation recommends that investments be made to enhance the economic climate or general welfare of the state or to increase local employment.⁵¹ Some statutes further specify the proportion of fund assets that may be used for local investments or classes of investments with a local preference, such as venture capital.⁵² Although several statutes qualify their social investment provisions with the caveat that such investments be prudent,⁵³ as is underscored by the GAO report's project evaluations, the difficulty of specifying comparable investment benchmarks provides tremendous leeway for a trustee undertaking such investments.

Local investments may also be favored by investment policies set by public fund boards themselves rather than by legislatures.⁵⁴ In addi-

51. See, e.g., Conn. Gen. Stat. § 3-13d(a) (West Supp. 1992) (factors to be considered with respect to all securities may be social, economic, and environmental implications of investments); Iowa Code Ann. § 97B.7.2.b (West Supp. 1992) (investments shall be made in manner that enhances state economy and in particular results in increased employment of state residents).

52. See, e.g., Ark. Code Ann. § 24-3-414 (Michie 1992) ("systems shall seek to invest not less than five percent (5%) nor more than ten percent (10%) . . . in Arkansas-related investments"); Cal. Gov't Code § 20205.81 (West Supp. 1993) (not more than 1% book value in small business venture capital; majority of such funds to be invested in firms based and operating in California); Cal. Gov't Code § 20205.7 (West Supp. 1993) (not less than 25% of funds available in fiscal year in California residential mortgages). Legislation fixing economically-targeted investments at 5-10% of fund investments has recently been proposed in several states. See Joel Chernoff, *State Pension Funds Tugged Toward ETIs, Pensions & Investments*, Feb. 22, 1993, at 4.

53. See, e.g., Ark. Code Ann. § 24-3-414 (Michie 1992) (system to "favorably impact the economic condition of and maximize capital investment in the State of Arkansas when appropriate investment alternatives are available"); Ohio Rev. Code Ann. § 145.11 (Baldwin 1992) (fund board to consider "investments that enhance the general welfare of the state and its citizens where . . . return and safety comparable to other investments currently available").

54. See, e.g., Kansas Public Employees Retirement System, 1990 Component Unit Financial Report 11 (describing a "policy of seeking investments which impact the Kansas economy"); The Retirement Systems of Alabama, 1991 Annual Report 5 (noting the systems' philosophy of "assist[ing] in enhancing the financial strength of the State of Alabama"). Voluntary board investment policies may not always be in the beneficiaries' interests. A good example of this possibility involves the Minnesota State Board of Investment, which manages the state pension funds. It restricts investments in liquor and cigarette companies as well as South African investments. See Christine Philip, A "Raging Debate" Hits Minnesota Fund, *Pensions & Investments*, Mar. 8, 1993, at 4. After a study estimated that the former restrictions had reduced fund returns by \$150 million, some board members, supported by retiree groups, considered removing the

TABLE 1. STATES WITH PUBLIC PENSION FUND SOCIAL INVESTMENT POLICIES

A. States with instructions to foster local economic development (numerical limitations in parentheses)

By statute:

Arkansas (5–10% range), California (25% residential realty, 1% small business venture capital), Colorado (non-statutory fund policy, 20%), Connecticut, Florida (2% local housing bonds), Iowa, Kentucky, Massachusetts, Michigan, Missouri (3–5% small business venture capital), Montana (3% venture capital), New Hampshire (10% home mortgages), New York (7.5%), Ohio, Pennsylvania (1% venture capital), Rhode Island (5%), Vermont (1% Vermont venture capital fund), Wisconsin

By Pension Fund Board or Investment Board policy:

Alabama, Alaska, Kansas, Minnesota, Oregon, Wisconsin, Wyoming

B. States with South African investment restrictions

By statute:

Arkansas, California, Connecticut, Florida, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Missouri, Nebraska, New Jersey, North Carolina, Oregon, Rhode Island, Tennessee, Vermont

By Pension Fund Board policy:

Hawaii, Indiana, Kansas, Minnesota, North Dakota, South Carolina

C. States with Northern Ireland investment restrictions:

By statute:

Connecticut, Florida, Maine, Massachusetts, Michigan, Minnesota, Montana (joint legislative resolution), New Jersey, New York, Rhode Island

By Pension Fund Board policy:

Indiana, Oklahoma

Sources: Various state codes; public employee retirement system annual reports; Buck Consultants' Report to the Permanent Commission on Public Employee Pension and Retirement Systems of New York State on In-State Investments by the Public Employee Retirement Systems of the City and State of New York (1988); Survey of State and Local Government Employee Retirement Systems (1991) ("Pendat" database).

tion, some states require that public funds use in-state brokers, custodians, consultants or investment managers;⁵⁵ such requirements can be financially disadvantageous if in-state firms are too small to achieve economies of scale in securities transactions, thereby raising a fund's transaction costs and diminishing its overall return.

As indicated in Table 1, other social investing legislation restricts, rather than encourages, particular fund investments. Statutes or board policies prohibit many state funds, in varying degrees, from investing in firms doing business with South Africa or Northern Ireland.⁵⁶ At least one state prohibits investments in corporations doing business in Iran as well.⁵⁷ In addition, some public funds are required to follow affirmative action practices in hiring outside investment managers.⁵⁸ Ohio

restrictions. See *id.* Despite these facts, some members opposed the change and suggested that the state legislature enact the restrictions into state law. See *id.*

55. See, e.g., Mo. Ann. Stat. § 104.550 (Vernon 1989); Mont. Code Ann. § 17-6-211 (1991). Local preferences of this kind appear to be accomplished more frequently by informal rather than by statutory means. For a detailed account of such conflicts during the 1970s, see Kohlmeier, *supra* note 4, at 283-86. Whether such policies create financial hardship is unclear. For instance, some local preference policies favor in-state brokers only if they meet the lowest out-of-state brokers' price. See, e.g., Teachers' Retirement System of Louisiana, Comprehensive Annual Financial Report 1991, at 46. In addition, local preference laws can sometimes be evaded by hiring in-state banks or trust companies that have correspondent relationships with out-of-state organizations; locally incorporated subsidiaries of foreign corporations also qualify under most statutes. See Margaret Price, N.J. Facing Hurdles in Foreign Investing, Pensions & Investment Age, Dec. 11, 1989, at 6.

56. Statutory restrictions on South African investments may be absolute or addressed only to firms not complying with the Sullivan principles. These principles of corporate conduct, formulated by the Reverend Leon Sullivan in the 1970s to guide the employee-relations practices of multinationals operating in South Africa, include non-segregation of races in all work, eating and common facilities, equal pay regardless of race for equal work, and development of training programs to prepare Blacks and other non-whites for supervisory or administrative jobs. Compare Cal. Gov't Code § 16641 (West Supp. 1993) (investments prohibited) with N.C. Gen. Stat. § 147-69.2(c) (Supp. 1992) (investments prohibited in firms that do not comply with Sullivan principles). There is more variety across the states in legislation concerning Northern Ireland investments. The most common form of legislation restricts investments in firms not complying with the MacBride principles, which require non-discrimination against Catholics, although in some states this legislation is precatory rather than prohibitory. Compare Conn. Gen. Stat. Ann. § 3-13h (West Supp. 1992) (mandating divestiture of funds in firms not complying with MacBride principles) with Mont. H.R.J. Res. 18, 52d Gen. Ass., 1991 Sess. (urging funds to consider firms' compliance with MacBride principles before investing). Other states prohibit investment in firms making weapons for use or deployment in Northern Ireland. See, e.g., Mass. Gen. Laws Ann. ch. 32, § 23(2A)(h) (West Supp. 1992).

57. See Conn. Gen. Stat. Ann. § 3-13g (West 1988).

58. See, e.g., Cal. Pub. Cont. Code § 10115 (West Supp. 1993) (15% of state contracts must be with minority-owned firms and 5% with women-owned firms); Ohio Rev. Code Ann. § 145.11 (Baldwin 1992) ("equal consideration" to firms owned or controlled by minorities and women). The California law was amended in 1989 to adjust the good faith exemption following pressure from the National Investment Managers Association, a coalition of twenty minority-owned investment management

goes further and espouses affirmative action goals for fund investments.⁵⁹

With or without statutory encouragement, the pressure for social investing is primarily a problem for public funds. Private funds, by contrast, do not engage in such activities.⁶⁰ One reason for the discrepancy is statutory: most commentators maintain that the ERISA fiduciary standard does not permit social investing.⁶¹ John Langbein suggests that private employers have no incentive to undertake social investments because the employers bear the risk of lower returns, since they operate defined benefit plans, which guarantee employees a fixed pension according to a formula based on years of service and final salary that the firm must pay whether or not the assets in its pension fund generate sufficient income to cover it.⁶² Such employers would therefore not adopt a social investment strategy even if it were permitted under ERISA. Although public pension plans are also defined benefit plans, they operate under substantially different investment incentives. Public pension benefits are backed by the state's taxing power rather than by a corporate promise; bankruptcy is therefore not a serious possibility. More important, the cost of lowered investment returns provides a weaker incentive for public fund managers to avoid suboptimal social investments than their private counterparts because the bearers of the cost, taxpayers, are an even more diffuse group, with many more concerns, than shareholders and are therefore even less likely to monitor a pension fund's management.

ERISA does not, of course, apply to public pension funds. But this does not necessarily mean that public pension funds are free of legal constraints. The Restatement on Trusts suggests that the common law fiduciary standard does not differ materially from that of ERISA: the

firms, and state pension funds lowered minimum requirements for money managers to comply with the revised statute. See Fred Williams, Funds Ease Requirements; Minority Firms Able to Compete for \$1.4 Billion, *Pensions & Investment Age*, Dec. 11, 1989, at 3.

59. See Ohio Rev. Code Ann. § 145.11 (Baldwin 1992) (mandating "equal consideration" to "investments . . . involv[ing] minority owned and controlled firms and firms owned and controlled by women").

60. See John H. Langbein, *The Conundrum of Fiduciary Investing Under ERISA*, in *Proxy Voting*, supra note 17, at 128, 135.

61. See, e.g., John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 104 (1980) ("neither the common law of trusts nor ERISA, correctly and conventionally understood, permits a trustee to adopt social investment criteria on his own initiative"). For the opposing minority view, see Ronald B. Ravikoff & Myron P. Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 Cal. L. Rev. 518, 530-36 (1980) (arguing that ERISA "can be construed to permit trustees to pursue non-traditional investment objectives [when] that investment has resulted in 'other benefits' for the plan's participants and beneficiaries").

62. See Langbein, supra note 60. The employer thus bears the risk of poor investments, for in such instances it will have to use corporate, rather than pension fund, assets to pay plan liabilities. For a detailed discussion of these plans, see infra notes 155-168 and accompanying text.

Restatement treats social investing as a breach of fiduciary duty, permitting only a narrow exception for charitable trusts, which are allowed to make social investments consistent with their charitable purposes.⁶³ Accordingly, a court could find a social investment to be a breach of fiduciary duty, notwithstanding statutory authorization for such investments under a legal list or other provision, by holding that the authorizing statute did not insulate the trustees from liability under the common law prudent investment standard. Although the diffident judicial response to pension fund investments in New York City bonds during the city's financial crisis can be distinguished from much social investing,⁶⁴ it does suggest that courts, like legislators, are sensitive to local political considerations and are not likely to pursue vigorously such an approach.

Quite apart from the issue of any potential legal liability, using public pension fund assets for social investment is not intelligent public policy. Advocates of such a use mistakenly view public pension fund assets as "free" money or money belonging to someone other than the beneficiaries.⁶⁵ This perception is deeply flawed. If the fund's return declines due to problematic, politically-driven investments, either employees' retirement benefits will be reduced or the state will have to increase its pension fund contributions, with a resultant reduction of other state services. Even a reduction in pension benefits will probably not decrease total government expenditures because public employee unions will, in all likelihood, demand other forms of compensation in future negotiations to offset their diminished pension benefits. Putting aside questions concerning the substantive merits of targeted state-subsidized investments, state governments do not gain from using pension assets rather than general revenues to finance such projects, except insofar as they camouflage the true cost of local projects from the public or transfer wealth from future to current taxpayers.

Some advocates of social investment maintain that the returns of such projects are commensurate with their risk, and hence that the use of pension funds for social investment is consistent with the goal of portfolio value-maximization. Lawrence Litvak, for example, contends that there are capital market gaps in the financing of small local businesses and low-income housing that create investment opportunities

63. See Restatement (Third) of the Law of Trusts § 227 cmt. c (1990) ("Prudent Investor Rule").

64. In upholding the New York City pension funds' purchase of municipal debt, the court emphasized that the purchase was necessary for the viability of the beneficiaries' employer, and hence for the protection of the plans' future funding. See Langbein & Posner, *supra* note 61, at 100-02. This consideration is not relevant in social investing that does not involve investments in the employer (i.e., government securities).

65. For example, the New York state task force on state pension fund investments explicitly viewed fund assets as "our" (all state citizens') money, and not as money held in trust for state employees. See *Our Money's Worth*, *supra* note 10, at 57.

for pension funds that will earn a non-concessionary return.⁶⁶ Litvak's contention is the sole justification for making such investments from a fiduciary standpoint and the best rationale from a social welfare perspective. The validity of Litvak's thesis is, however, an empirical question. If, on the contrary, local investments only temporarily delay the demise of an uncompetitive local firm or industry, then it would be more sensible for a state to fund employee retraining rather than to waste pension fund assets in firm-based investments that will eventually be written off as losses.

Although the investments Litvak contemplates do not, in principle, impose a tax on public pension funds, it is highly questionable that many exist in non-concessionary form. An undisputed conclusion of an early study by the Federal Reserve is that the unavailability of capital or credit is not a major obstacle to the development of new businesses.⁶⁷ In addition, there have been remarkable innovations and expansions in the financing of new business ventures and housing in recent years, such as the development of a publicly traded high yield debt market and the securitization of mortgages. If a particular small business or residential project is unable to attract financing from the private sector, it is far more probable that the difficulty is due to the market's inefficiently pricing the risk at a cost greater than the project developers are willing to pay, rather than the result of a capital market failure. Litvak's argument would have more force if he provided empirical support for his assertions.

Even accepting Litvak's questionable thesis and assuming that there are important local projects that cannot be financed by the private sector because they are public goods or because other market imperfections exist, there is still no basis for mandating social investments by pension funds. It is preferable for a state to fund these projects directly, from general revenues, rather than to impose a hidden tax on pension fund assets through regulation.⁶⁸ Direct funding would distribute the financial burden more equally across state residents: all taxpayers, not only those employed by the state, would pay for projects, which presumably benefit all residents and not just public employees. Direct funding would also make the cost of such projects more easily measurable.

A possible objection to allocating the financial burden of social investments among all state residents rather than on state employees alone turns on a particular understanding of the dynamics of the polit-

66. See Lawrence Litvak, *Pension Funds & Economic Renewal* (1981).

67. See Dick Netzer, *An Evaluation of Interjurisdictional Competition Through Economic Development Incentives*, in *Competition Among States and Local Government* 219, 236 (Daphne A. Kenyon & John Kincaid eds., 1991).

68. For similar arguments concerning problems with the use of indirect taxes, see Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. Rev. 225, 287-93 (1979).

ical process. Wage negotiations between public officials and unions may result in public employees earning more than their marginal product because politicians are likely to capitulate to union demands, since the benefits of agreeing to higher wages are concentrated on a clearly identifiable set of voters (public employees), while the costs are spread among all taxpayers. Given such a scenario, the contention is that the public can recoup at least part of the rents received by employees in monopoly wages by using pension fund assets rather than general revenues for social investing.

But this political economy analysis takes a superficial approach to the problem. If public employees are sufficiently well-organized to obtain monopoly wages, then they will in all likelihood be able to demand additional compensation for any portfolio losses caused by social investments. Hence, a strategy seeking to recapture taxpayer funds from employees by placing pension assets in social investments could well backfire and further increase the taxpayers' burden. Moreover, if public employees are "overpaid," it is socially more efficient to confront the problem directly by reorganizing the public sector⁶⁹ rather than to address the problem indirectly by lowering pension fund returns.

A backdoor approach also makes a shambles of contract law: social investing alters the contracted-for risk of employees whose pensions make them creditors of the state. Unless *ex post* risk shifting is fully anticipated by employees, this approach transfers wealth to taxpayers because the employees will be undercompensated—their compensation bargain assumed too low a level of risk. The message conveyed by a state opportunistically employing such a strategy is that government cannot be trusted. This has adverse third-party effects, as it lowers public confidence in the reliability of contracting with the government and thereby further increases the cost of government to taxpayers.

2. *Pressures on Public Fund Proxy Voting.* — Political pressure on public funds creates significant constraints on their pursuit of a value-maximizing investment strategy. Although the historic focus of state officials' concerns has been on redirecting fund dollars to socially preferred investments, their efforts can as easily be directed toward influencing the way public funds vote their shares. Such a redirection would, in fact, not be very far removed from the Illinois fund's intervention in KKR's negotiations with the employees of the printing plant.⁷⁰ The Iowa pension fund, for instance, follows a policy of voting against measures that hinder takeovers, but this practice is tempered in local contests by an additional requirement to consider a company's

69. This could be achieved, in part, by eliminating legislation and regulations that mandate inputs and instead providing better incentives regarding output. For a popular exposition of this common sense idea, endorsed by politicians across the ideological spectrum, see David Osborne & Ted Gaebler, *Reinventing Government* 138–45 (1992).

70. See *supra* notes 47–50 and accompanying text.

Iowa-based employment.⁷¹

A recent episode of political pressure on pension funds for shareholder activism is especially instructive of the probable thrust of future legislation in this area. In 1989, a New York state task force established to examine state pension fund investments advised the governor that state pension funds should be used to meet state needs, such as financing infrastructure programs.⁷² This recommendation drew criticism from employee and institutional investor groups.⁷³ At the same time, the task force criticized the state funds for supporting takeovers that were opposed by incumbent management.⁷⁴ Concern over institutional investors' support of corporate takeovers, as well as their activist efforts to curtail managerial entrenchment, is, in fact, a central theme of the report.⁷⁵

In addition to making proposals aimed at stemming funds' support of hostile takeovers,⁷⁶ the task force directed its attention to more general matters of corporate governance, although concern over takeovers seems to predominate even here. Two key proposals are the establish-

71. See Iowa Public Employees Retirement System, Annual Report Fiscal Year 1991, at 51.

72. See *Our Money's Worth*, supra note 10.

73. See, e.g., Council of Institutional Investors, *Our Money, Our Future: A Response to Governor Cuomo's Task Force Report Our Money's Worth 2* (1990) (on file with the Columbia Law Review) (criticizing Report as obscuring fact that "elected officials . . . want to spend or borrow public employees' pension money"); Nell Minow, Institutional Shareholder Servs., Inc., *Analysis of Cuomo Task Force Report 9* (1989) (on file with the Columbia Law Review) (raising concerns over social investments "that would otherwise not be considered prudent"); The Study Comm., Retired Public Employees Ass'n, *Our Money's Safety: A Response to the Governor's Task Force Report on Pension Fund Investment 1* (1989) (on file with the Columbia Law Review) (expressing fears over "a dilution of the original commitment" to fund beneficiaries).

74. See *Our Money's Worth*, supra note 10, at 30-31, 47. Task force members included state officials, corporate managers, union officials, lawyers, and investment bankers. See *id.* at 62-63. Despite the hostile attitude of the members of the governors' task force toward takeovers, the balance of the evidence indicates that takeovers benefit shareholders and do not significantly affect employees, with the notable exception of top management and headquarters staff. See Romano, supra note 1, at 177. For a recent review of the takeover literature, see generally *id.*

75. As noted above, see supra notes 9-10 and accompanying text, the task force attributed its creation to "controversy caused by the participation of the New York Common Retirement Fund in the leveraged buyout fund [that acquired] RJR Nabisco." *Our Money's Worth*, supra note 10, at 45.

76. The report admonishes fund trustees to consider all of the target firm's constituents' interests in responding to a takeover bid and reminds trustees that they are not required to obtain the "highest possible immediate return on each investment," but can "forego the takeover premium if they think the long-term interests of the fund will be better served by supporting the management." *Id.* at 47. The report then proposes that state pension funds be prohibited from investing in LBO funds that participate in hostile transactions or that require investments to be committed on a blind basis, whereby investors have no discretion over the LBO fund's investments once their money is committed to the fund. See *id.* Such a restriction would ensure that the state retirement funds could not finance a hostile bid for a New York corporation.

ment of a "duty to participate in corporate governance," which includes a "duty to be supportive of management when it has a viable long-term strategy for growth," and a requirement of "impact statements" for funds' "ownership decisions," that is, their investing and voting decisions.⁷⁷

The duty to be supportive of management is best understood as an effort to make funds support management in control contests, since this is the principal context in which shareholders can actively withdraw their support. Aside from proposing this variant of investor activism, the report is extremely critical of shareholder involvement in corporate governance, especially institutional investors' efforts at opposing management's defensive tactics to thwart takeovers.⁷⁸ Consequently, the shareholder activism that the New York state task force would enshrine in law is far removed from the aggressive monitoring envisioned by most advocates of active corporate governance by public pension funds. In fact, shareholder groups criticized the task force report for its cramped view of corporate governance, as well as its apparent endorsement of social investing.⁷⁹

The proposed impact statements would require public reports analyzing the effect of fund investment and voting decisions on a variety of factors, including local employment and the state economy. By making non-shareholder interests explicit and public, an impact statement would presumably facilitate fund boards' consideration of such interests when voting shares. If such a proposal were adopted, the benefit to other shareholders from public fund activism in corporate governance would be sharply attenuated, if not eliminated. If the task force had been interested in even-handed consideration, it would have included the future tax consequences of a fund's failure to maximize equity share prices when making investment, tendering, or voting decisions in its description of investment impact. This proposal also seems as much directed at restraining funds' activism in hostile takeovers as at spurring their investment in local projects. For example, by expressly flagging votes on shareholder proposals to rescind poison pills as an "ownership decision" requiring an impact statement, the task force demonstrated its anti-takeover motivation.

The New York state task force also recommended altering the organizational structure of New York's Common Retirement Fund, the one state fund that had participated in financing LBOs and which, in contrast with the other state retirement systems, has only one trustee, the state comptroller, who is an elected official. The task force proposed establishing a board of trustees for the fund.⁸⁰ The objection to a single fund trustee is not unreasonable. In fact, from 1982 until his

77. See *id.* at 41, 43.

78. See *id.* at 39-40, 47.

79. See, e.g., *Institutional Shareholder Servs.*, *supra* note 73, at 4, 9.

80. See *Our Money's Worth*, *supra* note 10, at 52-55.

recent resignation, the single trustee, state comptroller Edward Regan, advocated creating a board with members appointed by the comptroller and confirmed by the state senate.⁸¹ Nevertheless, it is highly probable that the impetus for the task force's proposal was the retirement fund's participation in the LBO fund.⁸² Moreover, restructuring the fund's administration would have wrested control of the fund from the state comptroller, a Republican who was more concerned with enhancing the pension fund's portfolio value than with engaging in social investing, compared to the Democratic governor who chose the task force participants. The import of the New York report is clear: fund administrators' positions will be jeopardized if their corporate governance activities are disliked by interest groups with political clout, such as corporate management.

Despite the task force's consensus, it produced no legislation. As the above analysis suggests, the state's pensioners would derive no benefit from its recommendations, and not surprisingly, the state Retired Public Employees Association opposed the report.⁸³ Institutional investor groups also voiced concern over the proposals.⁸⁴ Moreover, the political division of the state legislature, in which each of the two political parties control one chamber, undercut the governor's ability to reduce the comptroller's power. Finally, the absence of hostile takeover attempts on New York firms subsequent to the task force's work, and hence of visible pension fund support for such transactions, undoubtedly contributed to the legislature's inaction. A follow-up report, commissioned by the legislature to study economically targeted investment programs and to determine how to implement the task force's recommendation of increased in-state investments by the pension funds, backed away from the task force's suggestion of mandating social investments and proposed instead only the creation of a new state agency to identify worthy investments for the funds' consideration.⁸⁵ A change in the acquisitions climate or the political composition of the state legislature may well, however, revive the more intrusive proposals.

California provides a second example of an attack on the independence of a pension fund active in corporate governance, although the activity in California was a sidebar to an effort to redirect pension fund assets to general revenues in order to alleviate a budget deficit. In 1991, California's governor proposed replacing the current CalPERS

81. See, e.g., N.Y.S. Ass'y Bill No. 2454 (May 8, 1992).

82. See Anise C. Wallace, *Talking Business with Millstein of Pension Fund Task Force*, N.Y. Times, July 18, 1989, at D2 (task force chairman criticizing pension funds for investing in LBOs).

83. See Retired Public Employees Ass'n, *supra* note 73. As their study committee noted, there were no retirees on the governor's task force. See *id.* at 1.

84. See *supra* note 73 and accompanying text.

85. See Lee Smith et al., *Competitive Plus: Economically Targeted Investments by Pension Funds* (1990) (prepared by the New York State Industrial Cooperation Council and reviewed by the Governor's Task Force on Pension Fund Investment).

board with a new board, a majority of whose members the governor would appoint himself.⁸⁶ The proposal accompanied a plan to transfer \$1.6 billion that was earmarked for pensioners' cost-of-living increases from the fund to general state funds in order to help plug a \$14 billion state budget deficit.⁸⁷ An additional proposal transferred actuarial responsibilities from the fund to the governor's office; the expectation was that the new actuary would select a different set of actuarial assumptions so as to reduce the state's required contributions.⁸⁸

CalPERS executives charged that the proposal to reorganize the board was motivated by the governor's displeasure with the fund's monitoring of corporate managers; the implication was that the governor (a Republican who was said to be identified with business groups) wanted to "shut down" the fund's shareholder rights program.⁸⁹ In the months prior to the governor's proposal, CalPERS had criticized management at Sears, General Motors, and ITT, among others, for receiving excessive executive compensation. In prior years, it had challenged management at major California-based corporations such as Occidental Petroleum and Lockheed, and sought the creation of shareholder advisory committees.⁹⁰ Commentators feared that the proposed change in the CalPERS board would put an end to the fund's corporate governance efforts and discourage other funds from engaging in similar activism.⁹¹ The governor, however, denied that he was troubled by the fund's activism and maintained that the purpose of the proposed reorganization was purely to safeguard taxpayer dollars.⁹² The final proposal enacted by the legislature transferred the funds to general

86. See Denise Gellene, Q&A: A Guide to the State Retirement System, *L.A. Times*, June 19, 1991, at D1, D14 (the governor appoints four of the existing thirteen-person board, and would have appointed five of the proposed nine-person board).

87. The \$1.6 billion was "excess interest," investment income earned above CalPERS's target return of 8.5%. The fund's practice was to pay out the excess interest to retirees as cost-of-living adjustments if inflation had reduced their purchasing power by more than 25%. See *id.* at D14. The governor's plan, which recaptured the excess interest for the state, guaranteed cost-of-living increases regardless of the existence of excess interest in a particular year, but altered the formula so as to reduce future increases: pension adjustments would come into effect only when purchasing power fell by more than 32%, and Social Security benefits would be included in the calculation. See *id.*

88. See *id.*

89. See Steve Hemmerick, *California Fund Fighting Back*, *Pensions & Investment Age*, June 24, 1991, at 2; Tom Petruno, *Reforming CalPERS; A Case of Fixing What Ain't Broke*, *L.A. Times*, June 21, 1991, at D1, D3.

90. See Scot J. Paltrow, *Pension Experts Troubled by Plan to Tap CalPERS*, *L.A. Times*, June 19, 1991, at D1, D14; Petruno, *supra* note 89, at D3.

91. See Paltrow, *supra* note 90, at D14.

92. See Petruno, *supra* note 89, at D3; see also Hemmerick, *supra* note 89, at 39. In elaborating the fiscal reason for the move, the governor's press secretary contended that the current board was "making decisions that benefit the retirees without considering the cost to taxpayers." George Skelton, *Governor Pleads with Assembly Republicans*, *L.A. Times*, June 18, 1991, at A1, A20. For the current statutory

revenues and the actuary's appointment to the governor, but left the board's composition unchanged. As was true in New York, the proposed board reorganization would have shifted control of the pension fund to the governor, whose party did not control the legislature, a factor undoubtedly contributing to the legislature's inaction.

The New York and California attempts to restrain fund officials, not the proposals to enhance institutional investor activism advanced by academics, are the most likely harbingers of the legislative efforts that will be forthcoming across the states if public pension funds' activism in corporate governance accelerates. As the New York and California examples indicate, more active monitoring may well offend and galvanize into action important local constituencies, such as corporate management, who have considerable influence on state officials. Of course, unlike most shareholders, fund administrators are not without their own political resources: they can mobilize support from fund beneficiaries, who are unionized public employees, and other officials, including those who are board members, to offset management's lobbying efforts.⁹³ But the most probable reason for why neither the New York nor the California board reorganization proposal was enacted involves a special political dynamic: divided government. In both states, the restructuring proposals would have shifted control over the funds from one political party to another. The challenged party was able to block the change because it controlled at least one organ of government whose approval was necessary to effect the change. In states with one-party governments, where restructuring proposals would restrain activist funds without shifting the balance of power across political parties, the outcome is likely to differ.

Legislative and executive threats to usurp fund control need not be carried out in order for them to influence public pension fund boards' behavior. It is quite possible that fund boards comprised of political appointees will capitulate to local interest groups' investing and voting demands in order to forestall frontal attacks on fund organization and assets. This is, indeed, the most plausible reading of CalPERS' commitment of \$375 million to local housing development shortly after the governor's attack on its independence.⁹⁴ While neither CalPERS nor the New York Common Retirement Fund discontinued their corporate governance programs in 1992, both announced that they "would abandon the shareholder-proposal avenue in favor of direct negotiations," a so-called "quiet diplomacy" strategy, less confrontational with corpo-

provisions concerning CalPERS' board composition and the appointment of its actuary, see Cal. Gov't Code §§ 20100, 20006 (West Supp. 1993).

93. For example, the Democratic party *ex officio* members of the CalPERS Board, along with Democratic Congressmen, attacked the governor's board reconfiguration plan. See Hemmerick, *supra* note 89, at D3.

94. See *supra* notes 32-35 and accompanying text.

rate management than their prior approach.⁹⁵ Unless the funds return to a more activist strategy in the future,⁹⁶ the New York and California funds' defeat of the board reorganization proposals may turn out to be pyrrhic victories: governors may have lost the battle over fund board organization but won the larger war over fund board activism.⁹⁷

B. *Impact of Public Fund Organization on Investment Returns and Shareholder Activism*

The controversies over the organization of the California and New York pension fund boards suggest that board composition makes a difference for fund investment and voting policies. Given that many public fund board members are politicians or political appointees, investment and voting decisions may well be imbued with non-portfolio value-maximizing considerations even when there is no observable political pressure from other state officials. In order to determine whether this is so, one must examine whether fund performance varies significantly with board composition. In particular, do funds with a higher proportion of appointed and *ex officio* board members perform more poorly than those with less politicized board structures?

Board members who are elected by plan participants and are themselves fund beneficiaries are likely to be less susceptible to political influence or pressure because their personal retirement funds are at stake and their positions do not depend on the good graces of state officials.⁹⁸ This hypothesis draws support from research on the incentive

95. Some Institutional Investors Turn to Negotiations, But High Level of Proposal Activity Predicted to Continue, BNA's Corp. Couns. Wkly., Jan. 1, 1992, at 8.

96. This may be easier to undertake under the SEC's newly adopted proxy process reforms. For example, shareholders can now communicate with each other and publicly express how they intend to vote on particular proposals without having to comply with the stringent requirements for proxy solicitation. See Final Rules on Regulation of Communications Among Shareholders, Exchange Act Release No. 34-31326, 57 Fed. Reg. 48,276 (1992).

97. It is instructive to note that the CalPERS Board has apparently expressed concern that the fund's chief executive, Dale Hanson, is spending too much time on corporate governance and not enough on managing CalPERS. See George Anders, Restless Natives: While Head of CalPERS Lectures Other Firms, His Own Board Frets, Wall St. J., Jan. 29, 1993, at A1 [hereinafter Restless Natives]. The source of concern appears to be the low return on CalPERS's \$5 billion real-estate portfolio and international equity holdings. Although these are both sectors in which all investors are doing poorly, CalPERS had allocated a larger proportion of its portfolio to such investments than the average public fund. See *id.* at A9. But it is altogether possible that these financial results are simply providing an opportunity for board members to restrain Hanson's corporate governance activities in order to please constituents dissatisfied with CalPERS's policy of shareholder activism.

98. Although *ex officio* board members also have a financial stake in a state pension, their interest in reelection to public office conflicts with their interest as future pensioners when it comes to social investing and voting policies. The former interest, whose value is higher at reasonable discount rates, is most likely to dominate their decision-making. One would expect that this tradeoff would change as the politician

alignment problem caused by the separation of ownership and control in the modern corporation. Studies have found that corporate performance is positively correlated with the proportion of equity owned by management.⁹⁹ Elected board members, as participants in a fund's retirement plan, have a strong interest in plan performance, as do corporate managers who hold stock in their firms. In addition, in some states, pension fund earnings in excess of actuarial requirements can be used to provide cost-of-living adjustments to retirees.¹⁰⁰ The incentives of elected members to ensure that the board follows value-maximizing investment strategies are even greater in such states.

Appointed and *ex officio* members do not have similar financial incentives, and, although their reputations will be harmed if a plan experiences financial difficulty on their watch, the effect of social investments on plan performance may not be observed until several years later, when board membership has turned over. Unlike publicly traded corporations, for which low stock prices signal poor management decisions, there is no capital market monitoring public pension plan boards' decisions that could inform fund beneficiaries of poor investments and thereby mitigate the intertemporal mismatching of board members' incentives.

There is an important caveat to applying the corporate manager-owner analogy to public pension fund board members. Public employee pensions are government liabilities set by employment contract, and are independent of plan assets. If a plan's assets are insufficient to meet retiree claims, the state's annual contributions will be used entirely to pay current expenses rather than to increase plan assets

ages and becomes less likely to stand for reelection. Unfortunately, data such as a board member-politician's age or reelection margin are not available to test this more sophisticated hypothesis of board behavior.

99. See, e.g., John J. McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 *J. Fin. Econ.* 595 (1990); Randall Morck et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 *J. Fin. Econ.* 293 (1988). The relationship is nonlinear, with performance rising and then falling as management's ownership increases. In addition, differences in management reaction to takeovers depend on equity ownership—the more stock owned, the less managers resist. See Ralph A. Walking & Michael S. Long, Agency Theory, Managerial Welfare, and Takeover Bid Resistance, 15 *RAND J. Econ.* 54 (1984). The return that acquiring firms earn from bids is also positively related to their managements' stock ownership. See Wilbur Lewellen et al., Merger Decisions and Executive Stock Ownership in Acquiring Firms, 7 *J. Acct. & Econ.* 209 (1985). Similarly, productivity increases in U.K. leveraged buy-out firms are directly related to management's ownership share. See Mike Wright et al., Corporate Restructuring, Buy-Outs, and Managerial Equity: The European Dimension, *J. Applied Corp. Fin.*, Winter 1991, at 47, 56–57.

100. See, e.g., Alaska Public Employees' Retirement System, Teachers' Retirement System Component Unit, Annual Financial Report Fiscal Year Ended June 30, 1990, at 74 (employees hired before July 1, 1986 receive annual post-retirement pension adjustments to offset effects of inflation only if the financial condition of the trust fund permits). The California pension fund followed such a practice until the 1992 legislation discussed *supra* notes 86–92 and accompanying text.

through investment. Accordingly, even the more political board members have some interest in the growth of fund assets through investments because increased portfolio earnings will reduce required annual contributions. But again, the mismatching of the timing of investment returns and board tenure weakens these members' incentives.

The composition of public fund boards may also explain why public funds are more active in corporate governance than private funds even if private fund managers lack conflicts of interest involving other business relations with issuers. Public funds are frequently managed by individuals with aspirations to higher political office whose reputations can be enhanced by populist crusading against corporate management. For example, Elizabeth Holtzman, New York City comptroller and a trustee for the city's pension funds, publicized her active approach to corporate governance while campaigning for the Democratic party's nomination for U.S. Senator.¹⁰¹ Private fund managers do not obtain such personal professional benefits from corporate governance activism. In addition, on-the-job consumption benefits figure more importantly for financial managers in the public sector, where financial compensation is lower than in the private sector.¹⁰² The prototypical free rider problem of corporate governance activities—that only the activist bears the costs of activism while all of the firm's investors receive the benefits—could therefore be mitigated for public funds more readily than for private funds because public funds are more likely to be managed by political entrepreneurs, who benefit personally from such visible activity.¹⁰³

If this characterization of political entrepreneurship is accurate, then we would expect a positive relation between fund activism and the politicization of fund boards. However, it might take only one entrepreneurial board member to energize a fund to participate in corporate governance. It might also take only one politically-sensitive member to prod a board to engage in social investing. If personalities are critical to the dynamics of board decision-making, so that either a political entrepreneur or a politically-sensitive individual influences the other members, then the proportion of a board that has political affiliations (by office or appointment) could be an imprecise measure of

101. See Elizabeth Holtzman, *When Management Falls Down on the Job; Pension Funds Can Put Independent Directors on the Board*, Wash. Post, May 26, 1992, at A17.

102. A good example of such behavior is Dale Hanson, the head of CalPERS, who "by raising the flag of shareholder activism so high . . . has become a celebrity in his own right," such that his staff calls him "'Madonna' . . . [because h]e creates a stir wherever he goes." *Restless Natives*, supra note 97, at A9.

103. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457, 469 n.32 (1988); see also Rock, supra note 12, at 479. To the extent that activism is expensive, competition could prevent private fund managers from passing the costs on to their clients, a pressure not experienced by public funds that further diminishes private sector incentives to engage in corporate governance activities.

political pressure on the board. However, a large sample, such as that examined in this Article, of five years each of fifty boards, will sort out whether board composition affects performance because it eliminates noise generated by the charisma of a few individuals on some boards.

Proponents of public pension fund activism in corporate governance believe that such activities benefit investors. This position implies that there is a positive relation between activism and fund performance. But the relation between activism and performance is surely more complex than this simple hypothesis. For example, poor financial results could spur a fund to be active in corporate governance in order to increase future returns by improving the performance of companies in the fund's stock portfolio. Such a strategy would make fund performance appear to be inversely related to activism. Hence, if, as is likely, there is a lag between the fruits of activism and performance, then a negative relation between activism and performance should not automatically be interpreted as evidence that institutional activism hurts fund beneficiaries, while a finding of a positive relation between activism and performance might actually be a spurious result.¹⁰⁴

To determine whether the hypothesized relations between board composition, activism, and performance are accurate, these relations were investigated for the fifty state public employee retirement plans over a five year period, from 1985 through 1989. Table 2 provides descriptive statistics concerning these plans' board composition, portfolio composition, and performance.¹⁰⁵ In most states, the vast majority of trustees are not elected by beneficiaries. Over eighty percent of fund board members are political, having either appointed or *ex officio* positions. In fact, in thirty-two states, all board members are political. Investment returns are measured by earnings on investments, including realized net gains on asset sales as well as interest and dividend income, as a proportion of total investment holdings, valued at book value. This is necessary because the only comprehensive database on public fund finances reports book and not market values.¹⁰⁶ There are several

104. As reported in Table 3, *infra*, there is no significant relationship between performance and activism in this Article's data, although the sign is positive. Had the sign been negative, this Article's analysis would not have been able to determine whether the more complicated hypothesis of a negative relation was correct. The activism variable is a dummy variable that does not change over time, and lagged variables for performance and activism can therefore not be used to distinguish among effects (i.e., regressions cannot be run that distinguish the relation between activism in year t and performance in year $t-1$ versus years t or $t+1$.)

105. Investment information was obtained from Census Reports, see *supra* note 14; board composition was first obtained from CRS, Pensions, *supra* note 17, at 26-29, and then checked and corrected or updated for each state from the official state codes. Where a state investment board rather than a pension fund board is responsible for pension fund investments, the composition of the investment board is used.

106. See *supra* note 14, describing the Census Bureau data source. The advantage of using census data is that it provides uniformity, and hence comparability, across states and through time. I was able to obtain the most recent annual reports from 40 state

well-recognized difficulties in measuring performance using book value, not the least of which is a fund's ability to manipulate performance and report any desired return by selling appreciated shares. For example, in a rising stock market, a poorly performing fund could approximate the return of a better performing fund that did not take as much profit by selling stock.¹⁰⁷ But this measurement difficulty cannot be avoided, given the absence of market value data.

This simple model of the relation between fund performance and board composition was estimated using a random effects linear regression model. This is the appropriate technique for panel data because it permits the estimation of both an individual state-specific effect as well as a general ("macro") time effect, and the estimates will therefore be more efficient than those of an ordinary least squares regression on the pooled data.¹⁰⁸ The board composition regressor is the proportion of independent (beneficiary-elected) members, which equals one minus the proportion of political members. If the hypothesis concerning the relation between performance and fund organization is correct, the coefficient of the board composition variable should be positive. Because investment return varies with risk, any test of the relationship between performance and board composition must control for the asset allocation of the funds' portfolios. Indeed, empirical studies in corporate fi-

retirement systems; although several states report both book and market values of assets, the reporting is not sufficiently uniform or prevalent to be useful. I also contacted two well known private consulting firms to locate a private database for public fund performance, but none was available.

107. Cf. Gale Eisenstodt, "Tremendously Flawed," *Forbes*, Aug. 17, 1992, at 45 (discussing Japanese fund managers' ability to manipulate returns because assets are carried at book value).

108. See Cheng Hsiao, *Analysis of Panel Data* 32-41 (1986). The regression model, $y_{it} = X_{it}\beta + u_{it}$, is estimated in two stages. First, an ordinary least squares regression is estimated for the model and the residuals decomposed, according to the following structure: $u_{it} = \epsilon_i + \mu_t + \eta_{it}$, where ϵ is the individual effect, μ is the time effect, and η is a purely random effect. The data are then transformed by subtracting θ times the individual means, where

$$\theta = 1 - \sqrt{\frac{\text{var}(\eta_{it})}{\text{var}(\eta_{it}) + 5 \times \text{var}(\epsilon_i)}}$$

and the model is then reestimated on the transformed data.

A fixed effects model, which permits estimation of only an individual specific effect, was also estimated, although the board composition variable is relatively time invariant, suggesting that such a model may not be appropriate (board composition changed over the five years in the sample in less than ten states). In a fixed effects model, the variables are transformed by subtracting out the individual means to permit the intercepts to vary for each state. See *id.* at 29-32. When such a model was estimated, the board composition variable was negative and insignificant. However, a Hausman specification test of the appropriateness of the panel data model indicated that a fixed effects model was not appropriate: the coefficients on the fixed effects estimates were not significantly different from zero. See J.A. Hausman, *Specification Tests in Econometrics*, 46 *Econometrica* 1251, 1263 (1978).

TABLE 2. PUBLIC PENSION FUNDS, 1985-1989, DESCRIPTIVE STATISTICS

<u>Variable</u>	<u>Mean</u>	<u>Minimum</u>	<u>Maximum</u>	<u>Std.Dev.</u>
IndepBd	.1791	0	.8750	.2625
Exoff	.2527	0	1	.2705
NongovSec	.6090	.0694	.9877	.1725
Earnings	.1007	.0208	.2276	.0265

Notes: IndepBd is the proportion of the board that is elected by the membership of the pension plan, or one minus the proportion of board consisting of political (appointed and *ex officio*) members; Exoff is the proportion of board that is *ex officio* (designated membership by virtue of office); NongovSec is the proportion of investment holdings in nongovernmental securities, which includes corporate bonds, stocks and other investments; Earnings is earnings on investments, including realized gains, divided by total investment holdings, which are measured at book value.

Sources: Bureau of the Census, U.S. Dep't of Commerce, Finances of Employee-Retirement Systems of State and Local Governments (1984-85 through 1988-89); Congressional Research Serv., Public Pension Plans: The Issues Raised over Control of Plan Assets (1990); various state codes.

nance find that asset allocation explains the bulk of a portfolio's returns.¹⁰⁹ Given data limitations, the asset allocation variable equals the proportion of fund holdings invested in risky assets (nongovernmental securities).¹¹⁰ Table 3 reports the results of the panel data regression of the dependent variable, fund earnings, on the board composition and asset allocation variables.

The results are as predicted. Earnings are indeed significantly positively related to board independence. The smaller the proportion of board members who are appointees and *ex officio* members, the higher a fund's returns. This finding is consistent with the hypothesis that public pension funds experience political demands that adversely affect their performance. It is possible that board members who must stand for periodic election by fund beneficiaries are more sensitive to performance and thus more likely to manipulate asset sales to increase returns, and that the result is therefore an artifact of the use of book rather than market value to measure performance. But this interpretation is questionable because earnings are even more significantly positively related to the asset allocation variable, the proportionate investment in nongovernmental securities. If the earnings variable

109. See Roger G. Ibbotson & Gary P. Brinson, *Investment Markets* 257-59 (1987).

110. While the proportion of a fund's assets invested in corporate equities is a preferable variable, such data are not available prior to 1987, the year the Census Bureau began breaking out the nongovernmental securities category into corporate debt, equity, and other investments. I did, however, estimate regressions over the shorter three-year period using proportion of equity as the control variable. As reported in Table 3, the results of these regressions do not differ from those using five years of data with proportion of nongovernmental securities as the control for risk. Accordingly, only the results of the regressions over the longer five-year data period are discussed in the text, because it is preferable to use the longest possible time period, so as to reduce the noise in the performance measure.

TABLE 3. RELATION BETWEEN PUBLIC FUND BOARD COMPOSITION AND INVESTMENT RETURN

A. Panel data regressions, 1985-1989, dependent variable = earnings (n=250):

Variable	Coeff.	Coeff.	Coeff.	Coeff.
IndepBd	.0128 ⁺⁺ (.0077)	.0126* (.0077)	.0137 ⁺⁺ (.0079)	.0130 ⁺⁺ (.0077)
NongovSec	.0224 ^{**} (.0107)	.0258 ^{***} (.0108)	.0213 ^{**} (.0109)	.0267 ^{***} (.0109)
Econdev		-.0065* (.0040)		-.0052 ⁺ (.0041)
Activist			.0024 (.0048)	.0051 (.0048)
SAfrica				-.0102 ^{***} (.0039)
Constant	.0687	.0691	.0688	.0704
R ²	.0265	.0369	.0276	.0656
Adjusted R ²	.0186	.0251	.0157	.0464

B. Panel data regressions, 1987-1989, dependent variable = earnings (n=150):

Variable	Coeff.	Coeff.	Coeff.	Coeff.
IndepBd	.0166 ⁺⁺ (.0086)	.0168 ⁺⁺ (.0086)	.0166 ⁺⁺ (.0089)	.0158 ⁺⁺ (.0089)
Stock	.0445 ^{***} (.0162)	.0480 ^{***} (.0165)	.0445 ^{***} (.0166)	.0510 ^{***} (.0167)
Econdev		-.0054 (.0046)		-.0049 (.0048)
Activist			-.0001 (.0054)	.0026 (.0056)
SAfrica				-.0093 ^{**} (.0047)
Constant	.0788	.0802	.0788	.0818
R ²	.0662	.0749	.0662	.0994
Adjusted R ²	.0535	.0559	.0470	.0681

Notes: Dependent variable earnings is earnings on investments, which includes realized gains, divided by total investment holdings, which are measured at book value; IndepBd is the proportion of board elected by fund members and hence not political (neither appointed nor *ex officio*); NongovSec is the proportion of investment holdings in nongovernmental securities, which includes corporate bonds, stocks and other investments; Econdev is a dummy variable for whether fund has local investment policy or is subject to such legislation; Activist is a dummy variable for whether fund is active in corporate governance; SAfrica is a dummy variable for whether fund is restricted from investments in companies doing business in South Africa; Stock is the proportion of investment holdings in corporate equities (available only for three years of data, 1987-1989); standard errors in parentheses; + = significant at .10 (one-tailed); * = significant at .06 (one-tailed); ++ = significant at .05 (one-tailed); ** = significant at .025 (one-tailed); *** = significant at .01 (one-tailed).

The regression, $y_{it} = X_{it}\beta + u_{it}$, is estimated as a random effects model using RATS software, by first decomposing the residuals of the model estimated by ordinary least squares, $u_{it} = \epsilon_i + \mu_t + \eta_{it}$, where ϵ is the individual effect, μ is the time effect, and η is the purely random effect and then reestimating the model with the data transformed by subtracting θ times the individual means, where

$$\theta = 1 - \sqrt{\frac{\text{var}(\eta_{it})}{\text{var}(\eta_{it}) + 5 \times \text{var}(\epsilon_i)}}$$

were dominated by asset sale manipulations, asset allocation would not be a significant explanatory variable, since the ability to engage in such sales does not depend on portfolio mix. Moreover, it should also be noted that election by beneficiaries, and not simply identity as a fund beneficiary, is the key to better fund performance: regressions were run that included a board composition variable for the proportion of appointed employee and retiree members. The coefficient was negative and insignificant.¹¹¹

The relationship between board composition and earnings suggests that boards with elected members may choose riskier investment portfolios than those with only appointed or *ex officio* members. But there is little evidence of such a relationship between board composition and asset allocation because the two variables are not strongly correlated.¹¹² An alternative, more plausible, interpretation of the regression results is that, compared to boards with beneficiary-elected members, boards without elected members choose riskier social investments within asset classes, where the increased risk is firm-specific and hence not priced. Such a strategy would lower returns for those funds. This explanation suggests that the effect of politics on fund boards is twofold: boards that are less politically independent choose a different asset allocation as well as a different mix within asset classes. The effect of these choices is picked up partly in the nongovernmental securities variable and partly in the board composition variable, which is the measure, albeit imperfect, of political pressure on fund board decisions. A final possible interpretation of the results is that less independent boards are more apt to choose fund managers who are politically well-connected, rather than those who perform best.

It is possible that there are diminishing returns to an independent board: that is, performance increases as elected members are added to a board, but declines once they constitute a critical proportion of the board.¹¹³ To determine whether the relation between performance and board composition is nonlinear, the regression model was esti-

111. The estimated equation (standard errors in parentheses) is:

$$\text{Earnings} = .0705 + .0099 \text{ IndepBd} - .0081 \text{ Appemp} + .0229 \text{ NongovSec}$$

(.0060) (.0084) (.0096) (.0107)

If the proportion of appointed employee and retiree members is added to the proportion of beneficiary-elected members and used as the board composition variable ("allemp"), then the board coefficient is still positive, but no longer significant (standard errors in parentheses):

$$\text{Earnings} = .0688 + .0029 \text{ AllEmp} + .0212 \text{ NongovSec}$$

(.0059) (.0077) (.0108)

112. The Pearson correlation coefficient for the two variables is $-.08$.

113. Such a finding would be consistent with the finding that the relationship between corporate performance and management's stock ownership is nonlinear. See *supra* note 99 and accompanying text.

mated with a squared board composition term.¹¹⁴ The coefficient on the squared term, although negative, is insignificant.¹¹⁵ This is inconsistent with a nonlinear model. We thus cannot conclude that the simple linear model is misspecified and that there are diminishing returns to the proportion of elected members on a board.

The omission of a variable for fund size could also be obscuring the true relation between board composition and fund performance. For instance, if there are economies of scale in portfolio management, and if larger funds tend to have more elected board members, then the significance of board composition in explaining performance could simply be a proxy for an underlying scale factor. The regression was therefore reestimated with two different size variables: total portfolio book value and number of fund beneficiaries. Neither size variable was significant and the coefficient on the board composition variable remained positive and significant without changing substantially in magnitude.

In order to control for the impact on performance of measures of political interference in fund management other than board composition, additional regressions were estimated that included a series of dummy variables indicating whether a fund is subject to social investment legislation or has adopted a policy to favor local development, whether there are restrictions on South African investments by statute or official fund policy, and whether a fund has engaged in corporate governance activities.¹¹⁶ As reported in Table 3, the social investment dummy variable's coefficient is negative and at the borderline of statistical significance, as it is significant at only ten percent. This suggests

114. See William D. Berry & Stanley Feldman, *Multiple Regression in Practice* 53-59 (Sage Publications Quantitative Applications in the Social Sciences Series No. 50, 1985).

115. The estimated equation (standard errors in parentheses) is:

$$\text{Earnings} = .0690 + .0277 \text{ Indepbd} - .0230 \text{ Indepbd}^2 + .0214 \text{ NongovSec}$$

(.0057) (.0252) (.0370) (.0178)

116. The states with development policies and South African investment restrictions are indicated in Table 1. I did not include a Northern Ireland investment restriction variable because most states' regulations in this area are precatory rather than mandatory. Corporate governance activities include (i) sponsoring shareholder proposals on corporate governance, as identified in Investor Responsibility Research Ctr. (IRRC), *Shareholder Voting Almanac 3* (1991) [hereinafter *IRRC Almanac*]; (ii) being identified by the IRRC as a member of the Council on Institutional Investors (CII), see IRRC, *Voting by Institutional Investors on Corporate Governance Questions 1985 Proxy Season 26* (1985); and (iii) being identified as a strong supporter of shareholder proposals, see *id.* at 25. This identifies thirteen states, by respective category: (i) sponsoring proposals: California, Connecticut, Florida, Wisconsin; (ii) CII founders: Delaware, Illinois, Kansas, Massachusetts, Minnesota, New Jersey, South Dakota; (iii) otherwise strong supporter: Kentucky. I also included New York, because the state comptroller in the mid-1980s, the sole trustee of the state retirement system, was an advocate of corporate governance activism. See, e.g., Edward V. Regan, *A New Way to Discipline Badly Run Companies*, *Wall St. J.*, June 5, 1992, at A10.

that, consistent with the anecdotes detailed earlier, social investing may adversely affect fund performance. A plausible interpretation that reconciles the weak significance of the social investment variable with the anecdotal accounts is that less independent fund boards are as likely to evaluate local investments favorably with a statutory command as without one, and that board composition, rather than official investment policy, is therefore the more important factor affecting fund performance.

The South African investment restrictions have a significantly negative effect on fund performance. This finding is consistent with the broader literature on the financial impact of South African divestment. Studies of the effect of divestiture on portfolio performance have found that elimination of the stock of corporations doing business in South Africa weights a portfolio toward small firm stocks.¹¹⁷ Historically, small firms have returned a premium over their risk-adjusted return, and studies have found that portfolio performance in the 1970s and early 1980s did not suffer, and indeed, improved, with a South Africa-free investment strategy.¹¹⁸ But the small firm premium over the years 1985–1989, this study's sample period, was negative.¹¹⁹ The finding of negative significance in this Article, compared to earlier work, is thus not a mystery but readily interpretable: the portfolio impact of South African investment restrictions replicates the small firm effect, which was adverse to fund beneficiaries during the late 1980s. Hence, if states with South African investment restrictions do not understand their effect on portfolio investments, then they are taking on more risk in their pension fund portfolios than they desire. This finding is also consistent with the findings of a recent unpublished study on the impact of South Africa-free investment.¹²⁰ Since the other studies use market values, the statistical significance of the South Africa variable in the regression, like the significance of the asset allocation variable, increases confidence in the use of a book value measure for portfolio performance and, consequently, in the conclusion that fund performance is significantly related to board composition.

117. See Blake R. Grossman & William F. Sharpe, *Financial Implications of South African Divestment*, *Fin. Analysts J.*, July–Aug. 1986, at 15, 25; Andrew Rudd, *Divestment of South African Equities: How Risky?*, *J. Portfolio Mgmt.*, Spring 1979, at 5, 7; Wayne H. Wagner et al., *South African Divestment: The Investment Issues*, *Fin. Analysts J.*, Nov.–Dec. 1984, at 14, 15–16.

118. This result is uniform across the studies. See *supra* note 117 and accompanying text. If only firms failing to comply with the Sullivan principles are divested, then there is no perceptible effect on fund performance because the number of firms excluded is so small. See Grossman & Sharpe, *supra* note 117, at 28–29.

119. Ibbotson Assocs., Inc., *SBBI, Stocks, Bonds, Bills & Inflation 1992 Yearbook 109–10* (1992).

120. See Callan Assocs., Inc., *New York State Common Retirement Fund: Impact of South Africa Free Constraint Domestic Equity Portfolio 2*, 8, 14 (Apr. 26, 1990) (on file with the Columbia Law Review).

Although the small-firm effect interpretation of the negative coefficient on the South African investment restrictions variable is consonant with the finance literature, there is an alternative characterization of this result that is consistent with this Article's thesis. States that are willing to impose South African investment restrictions on their pension funds may also be more likely to pressure funds to engage in other forms of social investing. The South African investment dummy variable, in this perspective, is best understood as a proxy for the exertion of political influence on fund decisions, and as with the board composition variable, we find that such interference lowers returns.

Little can be concluded concerning the effect of corporate governance activism on fund performance. The shareholder activism dummy variable, while positive in all but one regression, is always insignificant. There is also no strong relationship between fund activism and board composition. The correlation between the proportion of the board that is elected and the dummy variable indicating fund activism is $-.23$. A logistic regression, which estimates the probability that a fund is active in corporate governance given its board composition failed to uncover a significant relationship between those variables.¹²¹ This suggests that a fund only needs one political entrepreneur to become an activist fund.

It is most probable, however, that the failure to find a relation between activism and fund performance and between board composition and activism is due to limitations of the available data. The activism dummy variable is only a rough approximation of funds' activism in corporate governance, which limits the power of statistical tests. Moreover, there is little variation in the activism variable: there are only thirteen funds for which the activist dummy variable is not equal to zero. The noisiness in the activism variable makes it understandable, as a purely technical matter, that no significance is observed.

The regression model provides a rough estimate of the welfare loss imposed by having a non-independent board and by mandated social investment policies. As summarized in Table 4, the estimated loss of investment income attributable to the absence of an independent board amounts to over \$15 billion during the period 1985–1989.¹²² If the

121. See G.S. Maddala, *Limited-dependent and Qualitative Variables in Econometrics* 22–27 (1983). The logit model was estimated separately for each year of data, 1985–1989, and for the average across the five years, because I was unable to estimate properly the error structure for a nonlinear panel data model. The results were indistinguishable across the annual and averaged regressions: the coefficient on the board composition variable ranged between -2.54 and -2.58 , with a standard error ranging between 1.67 and 1.69; and the log-likelihood ratio ranged between 2.99 and 3.06, which is significant at the 10% level under a two-tailed test.

122. The coefficients on the board composition variable and the social investment legislation and South African investment restriction dummy variables are interpretable as the percentage change in fund return from such practices. Multiplying the total asset value of the pension funds with no elected board members by 1.3% (the estimated

TABLE 4. ESTIMATED WEALTH LOSS, 1985-89 (IN THOUSANDS)

<u>Variable</u>	<u>Estimate</u>	<u>95% Confidence Interval</u>
IndepBd	-\$15,018,729	\$2,416,860 to -\$32,454,320
Econdev	-\$ 5,563,711	\$3,034,362 to -\$14,161,787
Subtotal:	-\$20,582,440	\$5,451,223 to -\$46,616,107
SAfrica	-\$ 7,641,225	-\$1,736,900 to -\$13,367,650
Total:	-\$28,223,665	\$3,714,322 to -\$59,983,757

Note: Estimated using full model regression reported in table 3A and book value of total assets of, respectively, 32 funds with no elected board members, 24 funds subject to legislated encouragement of social investment and 25 funds subject to South African investment restrictions.

effects of social investment and South African investment restrictions (estimated losses of \$5.6 billion and \$7.6 billion respectively) are combined with that related to board structure, the total estimated loss is over \$28 billion. Even if the effect of the South African investment restrictions is excluded because the small firm effect was negative in the sample period and would have been positive in earlier years, \$20.6 billion is a meaningful loss of income by anyone's calculation, although it is, of course, a small fraction of total public pension fund holdings.

The statistical findings—the insignificance of the relationship between fund performance and activism, the significant positive relationship between performance and independent board composition, and the negative relationship between performance and statutory policies of social investment—reinforce the anecdotal accounts describing political interference in public pension fund decisions. Together, they indicate that there are serious limits on the expected benefits of increased shareholder activism by public pension funds. Although public funds may not go so far as to introduce non-value-maximizing shareholder proposals in response to political pressures, they may well recede from engaging in value-maximizing corporate governance activities. For example, rather than offering value-maximizing proposals, they could instead endorse management actions that are not in the interests of other shareholders and are costly to taxpayers and fund beneficiaries.

C. Proxy Voting by Public and Private Funds

Another important issue concerning public pension fund activism

coefficient of the board composition variable), and that of the funds subject to the social investment and South Africa investment restriction legislation by 0.52% and 1.02% respectively (the respective dummy variables' coefficient) generates a measure of the losses to these funds. Table 4 also provides the 95% confidence interval for the estimated wealth effect. This interval is obtained by adding to and subtracting from the coefficient the standard error of the estimate of the coefficient multiplied by 1.96 (the critical value of a t-statistic at a 5% significance level for large samples). See Robert S. Pindyck & Daniel L. Rubinfeld, *Econometric Models & Economic Forecasts* 57 (3d ed. 1991).

is whether public funds vote their shares differently from other institutional investors and are therefore more effective monitors of management. Private pension funds typically delegate voting authority to external fund managers. Public pension funds are more likely to manage their portfolios internally and hence to vote their own shares, but even when they use external fund managers, they retain voting authority more frequently than private funds.¹²³ The core basis for commentators' emphasis on public funds' activism in corporate governance is the widely-shared belief that there are significant differences in the voting policies of public pension funds and other institutional investors, with a decided pro-management bias in the private sector.¹²⁴

The Investor Responsibility Research Center's (IRRC) annual surveys of institutional investors' proxy voting on corporate governance and social responsibility issues provide a database for investigating the hypothesis that voting differs across institutional investors. The corporate governance surveys ask whether institutions generally vote for, against, or consider case-by-case a broad range of governance issues that have been proposed by management or shareholders in the current and preceding proxy seasons. The social responsibility surveys ask institutions how they voted on specific shareholder proposals.

One important caveat on the use of the IRRC data is that we do not know how representative IRRC respondents are of the population of public and private fund managers. Because most respondents prefer anonymity, IRRC reports responses by category of institution. If IRRC respondents are more interested in matters of corporate governance and social responsibility than the typical fund manager—which is not an implausible scenario given that they are willing to take the time to respond to the surveys—then their responses may not be generalizable to the fund manager population. Moreover, the pool of respondents for

123. This divergent pattern of voting practice has persisted over time, with the number of public funds retaining voting authority increasing, as reported in the IRRC's annual institutional investor survey. See Ann Yerger & Elizabeth Lightfoot, IRRC, *Voting by Institutional Investors on Corporate Governance Issues 1991*, at 59-60 (1991) (68% of responding public funds vote all of their shares compared to 40% of private funds, whereas only 16% of public funds retain voting authority for less than 25% of their shares compared to half of private funds); Jeffrey W. Biersach, IRRC, *Voting by Institutional Investors on Corporate Governance Issues in the 1990 Proxy Season 5 (1990)* [hereinafter *Voting 1990*] (44% of responding private funds delegate all or most of voting power; 65% of responding public funds retain all authority); Lauren G. Krasnow, IRRC, *Voting by Institutional Investors on Corporate Governance Issues in the 1989 Proxy Season 6 (1989)* (85% of responding public funds retain all voting authority); Paul R. Bergin, IRRC, *Voting by Institutional Investors on Corporate Governance Issues in the 1988 Proxy Season 58 (1988)* (half of responding public funds retain all voting authority); Sharon Marciel & Peg O'Hara, IRRC, *Voting by Institutional Investors on Corporate Governance Issues in the 1987 Proxy Season 46 (1987)* [hereinafter *1987 Voting*] (only 2 of 9 private funds vote their own proxies whereas only 8 of 22 public funds delegate voting authority for all or most of their shares).

124. See, e.g., Pound, *supra* note 3, at 242-43.

the social responsibility issue survey is even more likely to be unrepresentative of the institutional investor population because, unlike the corporate governance survey, it is sent only to IRRC subscribers. Despite these limitations, this database is the best that is publicly available for evaluating claims that voting differs across institutional investors.

The IRRC's 1990 corporate governance survey solicited responses on sixteen varieties of shareholder proposals and twenty-four management proposals.¹²⁵ The largest category of responses concerns antitakeover defenses, which are surely a principal cause of the increase in shareholder activism that began in the late 1980s and remain at the center of current interest in the role of institutional investors in corporate governance. A simultaneous development also fostering fund activism was the increased use by large funds of portfolio indexing—a passive investment strategy that tracks the performance of the market as a whole by holding the stocks in a broad-based index, such as the Standard and Poor's 500.¹²⁶ A fund with an indexed portfolio cannot divest shares of a poorly performing company that is in the index. Such a locking-in of equity investments is believed to make the fund manager place greater emphasis on activism in corporate governance than would an active fund manager, because the passive manager can no longer follow the Wall Street rule of selling shares when he or she disagrees with corporate management or is disappointed with firm performance. However, even for the passive index fund manager, the cost of corporate governance activism is likely to outweigh the pro rata benefit for all but the very largest investors.

The survey respondents' voting policies are indicated in Table 5.¹²⁷ Private pension funds are grouped with investment managers because the private fund sample size is small and commentators generally view these groups as having similar conflicts of interest with management.¹²⁸ Since the results of a policy of case-by-case votes are obviously unavailable, such policy responses are excluded from the analysis.

The data appear, upon visual inspection, to support the hypothesis

125. Only the 1990 corporate governance survey provides usable data, because, in contrast to other survey years, it includes information on both the number of respondents as well as the proportion of responses for and against issues. The additional information identifying the number of respondents is important because we must be able to adjust for sample sizes in order to determine whether different response proportions across public and private institutions are significant.

126. See Steve Hemmerick, *Fund Jumps on Indexing, Pensions & Investment Age*, Oct. 16, 1989, at 1.

127. The respondents are 24 public pension funds, 39 investment managers and six private pension funds (only half of the private funds responding to the overall survey). See *Voting 1990*, *supra* note 123. Presumably, the other six private funds delegated voting decisions and therefore had no policy to report. An additional 24 nonprofit institutions—foundations, universities and church groups—participated in the survey; the policies of such respondents are not included in the discussion or in the statistical tests.

128. See, e.g., Pound, *supra* note 3, at 242–43.

TABLE 5. INSTITUTIONAL INVESTORS' PROXY VOTING POLICIES

A. Management Proposals

Type:	PubF	PubA	PubC	InvF	InvA	InvC	Prob.
Anti-greenmail prov.	16	2	6	30	2	13	.456
Approve poison pill	0	13	11	1	24	20	.658
Authorize blank stock	0	18	6	7	18	20	.015
Eliminate shareholder-called special meetings	0	20	4	3	23	19	.171
Eliminate written consents	0	20	4	2	21	22	.280
Increase blank stock	1	15	8	7	18	20	.092
Increase common stock	6	0	18	16	1	28	1.00
Indemnification prov.	21	n.a.	n.a.	32	n.a.	n.a.	
Limited liability	18	n.a.	n.a.	31	n.a.	n.a.	
Restructuring	1	2	20	3	3	39	.595
Restructuring w/antitakeover prov.	0	13	11	0	16	29	
Reincorporation	1	4	19	5	2	38	.121
Reincorporation w/antitakeover prov.	0	15	9	3	16	26	.162
Staggered board	n.a.	17	n.a.	10	20	15	*
Staggered board w/antitakeover prov.	0	18	4	n.a.	24	n.a.	**
Stakeholder prov.	0	11	13	5	15	26	.141
Stock Option Plans:							
Accelerated/cash-out	1	9	14	12	8	24	.011
Discounted exercise	2	15	7	8	16	21	.111
Omnibus plan	2	6	16	10	2	32	.015
Non-employee directors	7	6	11	23	4	17	.042
Pyramiding	3	10	10	12	10	22	.070
Underwater exchange	1	16	7	8	14	21	.028
Supermajority voting req.	0	18	6	2	28	15	.386
Unequal voting shares	1	17	6	3	26	16	.502

B. Shareholder Proposals

Type:	PubF	PubA	PubC	InvF	InvA	InvC	Prob.
Anti-greenmail prov.	22	0	2	31	0	14	
Confidential voting	23	0	1	27	9	9	.008
Cumulative voting	14	8	1	15	19	11	.124
Establish shareholder advisory committee	8	11	5	4	16	22	.125
Minimum share ownership for directors	6	14	4	10	21	12	.681
Outside director term limit	2	17	5	2	24	17	.568
Opt-out of Delaware anti-takeover statute	18	2	4	17	6	22	.169
Preemptive rights	11	12	1	7	23	15	.058
Prohibit golden parachutes	16	1	7	14	7	24	.045
Redeem poison pill	13	0	10	18	4	23	.140
Reduce supermajority voting req.	19	2	2	19	5	21	.267
Reform voting count	21	1	1	13	3	29	.192
Repeal staggered board	19	2	2	23	8	14	.134
Vote on golden parachutes	19	0	5	21	8	16	.011
Vote on poison pills	19	1	4	28	2	15	.651
Vote on targeted stock placements	21	1	1	14	6	25	.035

Note: PubF = number of public pension funds with general policy of supporting proposal; PubA = number of public pension funds with general policy of opposing proposal; PubC = number of public pension funds with policy on proposal determined case-by-case; InvF = number of private pension funds and investment managers with general policy of supporting proposal; InvA = number of private pension funds and investment managers with general policy of opposing proposal; InvC = number of private pension funds and investment managers with policy on proposal determined case-by-case; n.a. = not available because proportion of responses in indicated category and case-by-case policies not reported in survey; Prob. = significance level of test statistic, for differences across investors in policy of support or of opposition to proposal, which is chi-square or Fisher's exact test when more than 25 percent of cells have expected frequencies less than 5; * = tests run for all possible permutations of missing data on public pension funds and 4 of 5 tests insignificant; ** = tests run for all possible permutations of missing data on private pension funds and 3 of 3 insignificant.

Source: Jeffrey W. Biersach, IRRC, Voting by Institutional Investors on Corporate Governance Issues in the 1990 Proxy Season (1990).

in the literature that there is a difference in public and private fund managers' voting. The proportion of public pension funds supporting shareholder proposals and opposing management proposals is higher than that of private funds in all but three cases: management proposals to increase the shares of common stock, and shareholder proposals to require minimum stock ownership for directors and to prohibit green-mail.¹²⁹ There is, however, a simple test of the hypothesis that public fund managers are more likely to oppose management proposals and less likely to oppose shareholder proposals than private fund managers. This involves tabulating response frequencies across institutional investor groups and comparing the resulting distribution of voting policies with a random distribution.¹³⁰ If the test statistic produced by this comparison is significant (i.e., using conventional levels, .05 or less), the null hypothesis of no difference across the two groups of investors is rejected in favor of the hypothesis in question, that there is a difference.

Table 5 provides the results of cross-tabulations of voting policies for and against proposals by institutional investor type.¹³¹ The last column, labeled "prob.," reports the probability that the observed distribution of responses is the same as that which would occur by chance (this is the significance of the test statistic). In the vast majority of cases (twenty-nine of thirty-eight proposals), we cannot reject the null hypothesis that voting policies are the same across institutional investors: the observed differences in proportions are equivalent to what would

129. If the case-by-case policy responses are included in the database, then the public fund percentages are higher in all but the proposals to increase common stock. If, however, the responses of private pension funds and investment firms are examined separately, then the relevant proportions of private pension fund responses are equal to or higher than those of public pension funds in ten cases, and those of investment firms, in four cases (six and two, respectively, when case-by-case policy responses are included in the base).

There is one curious inconsistency in these data. While public funds always support shareholder anti-greenmail proposals, 11% always oppose management anti-greenmail proposals, a higher proportion than private funds and investment firms. But these proposals do not differ substantively. One possible explanation is that opposition to management proposals has an ideological, as well as a substantive, component: public fund managers may vote against management proposals more frequently than private fund managers simply because they have an anti-establishment bias, which translates into a preference for opposing corporate management regardless of a proposal's merits, analogous to differences in the political sphere, where Democrats are more likely than Republicans to opt for government solutions.

130. The test statistic comparing the observed and predicted frequencies is a chi-square. See, e.g., Sidney Siegel & N. John Castellan, Jr., *Nonparametric Statistics for the Behavioral Sciences* 111-14, 123-24 (2d ed. 1988). Where the cell expected frequencies are small (less than 5%), Fisher's test (one-tailed) is used instead. See *id.* at 123-24, 104-11.

131. I assume that respondents answer each question separately. This assumption is necessary for statistical testing, because it is impossible to determine how to correct the standard errors of estimation if responses are clustered.

be observed if voting policies were randomly assigned to investor types.¹³² This finding is consistent with a recent study of the impact of institutional holdings on the performance of firms that make takeover bids. Despite expecting the effect of public pension funds to be positive and that of private fund managers and other financial institutions to be negative for the same reason that voting practices are expected to differ—conflicts of interest—the researchers found no difference; there was, in fact, an inverse relationship between bidding-firm performance and the holdings of both types of institutions.¹³³

Alfred Conard cites the IRRC's 1987 corporate governance voting survey as providing evidence of significant voting differences across public and private firms.¹³⁴ However, Conard did not perform any statistical tests to bolster this conclusion. In only two categories of 1987 proxy proposals, those to increase the number of shares of authorized stock and those to stagger the election of directors to the board, is the difference in proportion so visibly striking as to suggest that it may be statistically significant. Conard considers these proposals to be antitakeover measures, but such a classification is far from obvious. There are bona fide, non-takeover-related reasons to undertake each policy. Newly authorized shares can be used in acquisitions or sold to raise capital, and staggering board membership maintains continuity and enhances the stability of board decision-making. Moreover, the analysis of the 1990 IRRC survey data, where statistical tests can be undertaken, does not reveal a significant difference between public and private funds in voting on proposals to increase common stock or for proposals to stagger boards, especially when the proposal is offered in conjunction with other antitakeover provisions.

The observed difference in voting policies across public and private fund managers in the 1990 data is significant for five management proposals and four shareholder proposals. In six of these nine cases, the majority of private funds and investment managers follow the same voting policy as the majority of public funds, a pattern that undercuts the finding of a statistically significant difference in voting policy. In addition, voting differences are more exacerbated on issues not involving changes in control, the quintessential agency problem where opposition to management has the most severe consequences and thus conflicts of interest might be thought to matter most: four of the five management proposals that public funds oppose more frequently than

132. If the statistical test is undertaken by grouping all proposals together, then the difference in voting practice is significant. I do not put much credence in this result, however, because it is likely to be an artifact of the technique—statistical significance is more likely to be found when the number of observations increases.

133. See Chuan-Yang Hwang et al., *Institutional Investors, Corporate Decision Making, and Shareholder Wealth: The Case of Corporate Acquisitions 21* (1992) (unpublished manuscript, on file with the Columbia Law Review).

134. See Alfred F. Conard, *Fiduciary Obligation of the Asset Manager, in Proxy Voting*, *supra* note 17, at 86, 100–01.

private funds and investment managers involve changes to stock option plans rather than the elimination of antitakeover defenses. In fact, the pattern of the general findings on governance proposals persists in proxy fights, the voting context most directly related to management discipline by control battles. In the two 1990 proxy fights for which the IRRC provides voting data, there is no significant difference in the voting of public pension funds and investment managers: both groups supported management.¹³⁵ These data indicate that commentators' intuition that public and private funds' proxy votes meaningfully differ on corporate governance issues is not well-founded.

Because IRRC corporate governance surveys only report general voting policies that cannot be matched with votes on specific proposals, I also examined whether voting differs across institutions on social responsibility issues, where actual votes are available. The hypothesis of interest is that public funds will support social responsibility shareholder proposals more frequently than do private fund managers, particularly because they are subject to greater political pressure to factor non-financial social policy considerations into their decisions. In an effort to retain at least temporal comparability with the corporate governance voting policy data, a random sample of votes on social responsibility issues in the 1990 proxy season was constructed.¹³⁶ Votes on proposals in the same IRRC issue category are tallied together for hypothesis testing. Abstentions are counted as no votes because corporate voting rules frequently require either a majority of the shares present (in person or by proxy) or a majority of the outstanding shares entitled to vote for a proposal's adoption.¹³⁷

IRRC's categorization of anonymous respondents in the social re-

135. The battles were over Armstrong World Industries and USX; the voting breakdown, with the test statistic's significance in parentheses, were as follows: for Armstrong, 73% of public funds for management, 77% of investment managers (.715); and for USX, 67% of public funds for management, 82% of investment managers (.164).

136. The source of votes is Krista M. Johnson, IRRC, *How Institutions Voted on Social Policy Shareholder Resolutions in the 1990 Proxy Season* (1990). The 1990 survey reports votes on 88 proposals on South Africa, 22 on Northern Ireland, 15 on environmental issues, and a miscellaneous set of 39 other proposals involving, among other issues, animal welfare, military production facilities conversion, nuclear power, and tobacco. A random sample of 41 votes was stratified by proposal category and selected using a random numbers table. For a description of the proposals included in the sample, see Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered* tbl. 5 (1992) (Yale Law School, Center for Studies in Law, Economics, and Public Policy, Working Paper #159, on file with the Columbia Law Review).

137. See, e.g., Del. Code Ann. tit. 8, § 216(2) (1991); Rev. Model Business Corp. Act § 8.63(a) (1991) (ratification of interested director action). Although the conventional rule treats abstentions as negative votes, the Revised Model Business Corporation Act changes that rule, and does not count abstentions as votes. A transaction is instead treated as approved if the votes cast for it exceed the votes cast against it. See Rev. Model Business Corp. Act § 7.25 official cmt. 4 (1991).

sponsibility surveys differs from that of the corporate governance surveys: all pension funds (public, private, union, and non-profit) are grouped together, while investment firms are classified separately from banks and insurance companies.¹³⁸ Given the hypothesis of interest, that public and private fund managers' incentives, and hence votes, differ, it would be inappropriate to compare aggregated pension fund votes with those of financial firms. This is not an insurmountable difficulty, however, because several public pension funds chose to be identified. The hypothesis is therefore tested by cross-tabulating votes of the identified public pension funds and all investment firms.¹³⁹ It is impossible to determine how, if at all, this approach biases the results. To do so one would need information concerning the motivation for requests of anonymity—for example, whether public funds are more or less likely to request anonymity when they vote against social responsibility proposals—and that information is not available. But it reinforces the earlier caveat that care must be exercised in extrapolating from this sample's behavior to the fund manager population.

Table 6 reports the cross-tabulation results for voting on social responsibility issues. There are no significant differences on social responsibility votes across public and private fund managers except for proposals on South Africa. Although this result may be due to the sample—it comes from the IRRC subscriber pool, which may consist of investors more concerned about social issues than the average institutional investor, and within this group, the public funds are limited to those willing to be identified—it does corroborate the finding of scant differences across investors in corporate governance proxy voting policies, where the respondent pool is not as circumscribed. The difference in voting practices for South African divestment proposals is consistent with the possibility that public funds experience more political pressure on their decisions than private funds. But if this explains the difference, then, one must ask, why is the difference only significant for such proposals? One possible explanation is that investment in South Africa is a more salient political issue than the concerns raised by other proposals. However, the funds in the South Africa proposal sample are not located in states with South African investment restriction statutes (otherwise they would not own shares in companies doing business there), which suggests that the South Africa investment issue may well not be of heightened political interest in those states.

The assertion that public and private fund proxy voting differs significantly simply does not hold up in these data. This is evidence that differences in the sources of pressure on public and private funds do

138. There were 94 respondents, 49 of which desired anonymity. See Johnson, *supra* note 136, at 1.

139. There is no difference in results if identified public fund votes are compared to votes of investment firms only, as reported in the text, or to votes of all private financial managers (investment firms, banks, and insurance companies combined).

TABLE 6. VOTING ON SOCIAL RESPONSIBILITY ISSUES

A. South Africa Proposals (22)

Vote total: Yes: 68 public pensions; 18 investment firms
 No: 21 public pensions; 89 investment firms

Prob.: .000

B. Northern Ireland Proposals (6)

Vote total: Yes: 7 public pensions; 7 investment firms
 No: 22 public pensions; 32 investment firms

Prob.: .532

C. Environmental Issues (4)

Vote total: Yes: 5 public pensions; 2 investment firms
 No: 18 public pensions; 18 investment firms

Prob.: .269

D. Miscellaneous Other Issues (9)

Vote total: Yes: 8 public pensions; 6 investment firms
 No: 34 public pensions; 45 investment firms

Prob.: .328

E. All Non-South Africa Proposals (19)

Vote total: Yes: 20 public pensions; 15 investment firms
 No: 74 public pensions; 95 investment firms

Prob.: .149

F. All Proposals, including South Africa (41)

Vote total: Yes: 88 public pensions; 33 investment firms
 No: 95 public pensions; 184 investment firms

Prob.: .000

Note: Prob. = significance level of test statistic, which is chi-square or Fisher's exact test where more than 25 percent of cells have expected frequencies less than 5.

Source: Krista M. Johnson, IRRC, How Institutions Voted on Social Policy Shareholder Resolutions in the 1990 Proxy Season (1990).

not necessarily translate into differences in voting practices, a finding that leads to two conclusions. First, it calls into question the literature's assumption that private financial institutions have greater conflicts of interest with other shareholders than do public funds. Second, assuming that the common voting policies of both types of funds maximize stock value, it suggests that political pressure on public funds may be principally directed to investment rather than voting decisions. However, the cross-tabulations of institutional voting do not answer the question whether public pension funds' proxy voting is susceptible to political pressure. To do so, it would be necessary to disaggregate the IRRC data and match actual votes with fund performance and the variables serving as proxies for political pressure, such as board composition; such data are not, however, available. More important, if public funds increase their corporate governance activities, then the political pressure that has been directed at investment decisions will most likely be refocused on voting, and voting practices may well turn out to differ across investors in the future.

II. SOLUTIONS TO THE POLITICIZATION OF PUBLIC PENSION FUND INVESTMENTS

Several reforms to the administration of public pension plans could mitigate the demonstrated effect of political pressure on fund investment and voting decisions. Some reforms are better at protecting investment practices and others at insulating voting practices, but none are perfect solutions to the problem. The most effective proposal—switching public pensions from a defined benefit to a defined contribution plan structure—is also the most drastic, since it solves the problem by eliminating public fund managers' role in corporate governance. The adoption of such a proposal would thus shift the focus of attention back to the private sector and, in particular, to the incentives of mutual fund managers to engage in effective corporate governance.

A. Reforming Public Pension Fund Boards

The results of this Article's statistical analysis suggest one reform to mitigate political influence on public fund investments: ensuring that fund boards have beneficiary-elected members. Others have at times made such a proposal.¹⁴⁰ In fact, in response to the poor performance of local investments made by the Kansas Public Employees Retirement System detailed earlier, the board was expanded to include two beneficiary-elected members beyond the existing seven appointees.¹⁴¹ The data do not demonstrate that a wholly-elected board is necessary, nor whether some specified proportion of elected members is optimal, because the regressions did not uncover diminishing returns to elected board membership. However, if elected members have less investment experience than *ex officio* members or political appointees who are chosen by an expertise criterion, then the more politically-affiliated members' ability to influence investment decisions may well be greater than that of the members elected by beneficiaries.¹⁴²

There are, however, several reasons why disparate expertise on a board with beneficiary-elected members should not be a substantial problem. First, as a practical matter, the formal financial expertise of board members does not appear to be a factor in fund performance. The regressions discussed in Part I.B were reestimated using the proportion of members required by statute to have investment expertise as the board composition variable. The coefficient on the board composition variable was not significant and the wrong sign—negative.¹⁴³ Sec-

140. See, e.g., Kohlmeier, *supra* note 4 at 278–83.

141. See Christine Philip, *Kansas Takes Up Reforms, Pensions & Investments*, Feb. 22, 1993, at 32. See also *supra* notes 38–39 and accompanying text.

142. See Terry Williams, *Turmoil at Atlanta Fund, Pensions & Investments*, Sept. 14, 1992, at 6, 28 (elected members of Atlanta's pension fund express frustration and anger at inability to evaluate investment choices of *ex officio* member, who was the city's chief financial officer).

143. The estimated equation (standard errors in parentheses) is:

ond, it is questionable to assume that employees and retirees would not consider a candidate's expertise if experience mattered. The more realistic assumption is that voters will be sufficiently informed (by their unions if not by their own self-interest), or at least will become so over time, and will choose individuals who are more literate in finance if inexperienced representatives adversely affect their interests. Third, structural protections can be adopted in conjunction with board reform to limit any problems that would be presented by having financially-inexperienced elected board members. For example, states could require that all or some number of elected board members meet minimum expertise requirements, or they could provide board members with rudimentary financial training. Finally, they could follow the example of some states and establish advisory councils composed of individuals with investment expertise to provide recommendations to fund boards concerning investment strategy.¹⁴⁴

Although differential expertise will not, therefore, limit the effectiveness of fund board reform, increasing the number of independent board members may not completely extirpate political influence on public funds' decision-making. Although the statistical analysis indicates that boards with beneficiary-elected members perform better than more politicized ones, such boards may still be subject to more political pressure than private funds. In fiscally troubled times, even independent board members may be unable to prevent political interference in fund decisions and, as mentioned earlier, they may find the courts to be less than vigorous supporters of their efforts to resist political uses of pension fund assets.¹⁴⁵

B. *Applying ERISA's Fiduciary Standards to Public Funds*

Another approach to the problem of political influence on public pension fund decision-making would be to extend ERISA's fiduciary standard to public funds. This need not be achieved by preemptive federal legislation: states can enact the ERISA regime on their own. As noted earlier, most commentators attribute the absence of social investing in the private pension fund sector to the mandates of ERISA and its interpretation by the Department of Labor.¹⁴⁶ However, applying

$$\begin{array}{r} \text{Earnings} = .0722 + .0220 \text{ NongovSec} - .0136 \text{ AppExp.} \\ \quad (.0055) \quad (.0107) \quad \quad (.0084) \end{array}$$

This is a crude test of the relation of expertise and performance, however, because the board composition variable does not take account of individuals whose membership on a board does not depend on an expertise criterion, such as state financial officers, but who nevertheless are likely to have investment experience.

144. See, e.g., Fla. Stat. Ann. § 215.444 (West 1989); N.Y. Retire. & Soc. Sec. Law § 423 (McKinney 1987).

145. See *supra* notes 24, 64 and accompanying text.

146. See, e.g., Langbein & Posner, *supra* note 61, at 96-98 (discussing DOL's position that ERISA prohibits trustees from investing for any object other than

ERISA will not resolve all of the problems identified in this Article. Although it would alleviate pressure to engage in social investing, it would not eliminate political pressure on voting decisions. ERISA permits plan sponsors to select the fund's investment managers or to be the fund manager themselves, and hence to exercise authority over voting fund shares.¹⁴⁷ ERISA therefore tolerates, indeed incorporates, fiduciary conflicts of interest in fund decisions.¹⁴⁸ Even if ERISA were amended to remove fund administration from plan sponsors and place voting decisions in the hands of external money managers, the structural conflict would not necessarily be eliminated because outside investment managers understand the power of appointment: if their voting policies displease fund sponsors, they may well be replaced.¹⁴⁹

C. Mandating Passive Investment Strategies

Increased use of passive (indexed) investment strategies will also reduce the opportunities for state officials to pressure public pension fund managers to engage in social investing or non-value-maximizing share voting.¹⁵⁰ Passive investment management would eliminate the ability of public funds to engage in the most egregious economically-targeted types of social investments. A separate advantage of this approach is its impact on portfolio value: there is no evidence that the benefits of active portfolio management outweigh the costs. A uniform finding of a large body of research is that pension funds' active money managers are consistently outperformed by stock market indexes; these managers tend to subtract value from a portfolio, rather than to en-

achieving the highest return at the proffered risk level); see also Stein, *supra* note 17, at 44, *supra* notes 60–62 and accompanying text.

147. See ERISA § 408(c)(3) (codified at 29 U.S.C. § 1108(c)(3) (1988)).

148. See John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 553, 599 (1990); Langbein, *supra* note 60, at 129, 136–37. In fact, as Fischel and Langbein contend, the employer's interest should be considered in investment and voting decisions because in defined benefit plans, where pension benefits are guaranteed, the employer bears the risk of poor fund performance. See Fischel & Langbein, *supra* note 21, at 1112–13. For a more detailed discussion of defined benefit plans, see *infra* note 162 and accompanying text. Moreover, if employers could not exercise control over plans, they may be less likely to provide pension benefits to their employees. See Langbein, *supra* note 60, at 136.

149. In Avon Products Letter, U.S. Dep't of Labor Letter on Proxy Voting by Plan Fiduciaries (Feb. 23, 1988), reprinted in Langbein & Wolk, *supra* note 148, at 562–64, the Department of Labor found that a plan sponsor's explicit direction of a fund manager's proxy voting was a violation of ERISA, as the sponsor had delegated, rather than reserved to itself, the shares' voting rights. However, as Langbein contends, enforcement of the Avon Products Letter standard is "essentially futile," because constructing paper records that establish voting guidelines and respect fiduciary independence will not eliminate the power that derives from manager selection. See Langbein, *supra* note 60, at 136–37.

150. Cf. John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 *Am. B. Found. Res. J.* 1.

hance it.¹⁵¹

There are, however, two limitations on the effectiveness of the indexing proposal. First, a totally passive investment strategy will not maximize fund value because some asset classes necessary for portfolio diversification, such as real estate and venture capital, are not easily indexed and hence not appropriate for passive investment management. These asset categories are also often social investment targets (i.e., purchasing local real estate for development or investing in small local start-up businesses). This difficulty does not, however, implicate the corporate governance issues of concern in this Article because such asset classes do not entail shareholder voting, although it does indicate that the problem of pressure to engage in social investing will not be easily eliminated. Second, and more important, shares held in passively managed plans must still be voted. Hence the possibility of political influence on fund voting remains. This difficulty can be reduced if funds hire outsiders to manage indexed investments and then delegate voting to those managers. But, as noted in the discussion of the ERISA approach to the problem, there is slippage in such a solution because it is still possible for a board to exert pressure on external managers' voting decisions through its appointment power.

D. *Constitutionalizing Fund Board Independence*

An alternative strategy, which public pension funds have recently undertaken to prevent raids on their assets by fiscally distressed state governments, is to constitutionalize the independence of fund boards. In reaction to the 1992 legislative assault on CalPERS discussed in Part I,¹⁵² an initiative entitled the "California Pension Protection Act" was placed on the ballot to amend the state constitution and vest fiduciary power and obligation, including investment management and system administration, in the retirement fund board exclusively.¹⁵³ Another provision in the initiative stated that the board's fiduciary duty to its participants and beneficiaries has precedence over any other duty, such as a duty to employers and taxpayers to minimize administration costs.

151. See, e.g., Josef Lakonishok et al., *The Structure and Performance of the Money Management Industry*, in *Brookings Papers on Economic Activity: Microeconomics 1992*, at 339, 378 (Martin N. Baily & Clifford Winston eds., 1992) (finding pension fund equity managers subtract rather than add value relative to the S&P 500 Index's performance); Burton G. Malkiel, *A Random Walk Down Wall Street* 199-200 (5th ed. 1990) (70% of pension fund equity managers outperformed by S&P 500 Index in fifteen-year period ending Dec. 31, 1989). In contrast to the studies of pension fund managers' performance, some studies of the performance of mutual funds have found that active "funds' risk-adjusted performance, net of expenses, is statistically indistinguishable from that of index funds." Richard A. Ippolito, *On Studies of Mutual Fund Performance, 1962-1991*, 49 *Fin. Analysts J.*, Jan.-Feb. 1993, at 42, 49.

152. See *supra* notes 86-92 and accompanying text.

153. See Prop. 162, 1992 Cal. Legis. Serv. (West); S.J. Res. 28, 43d Leg., 2d Sess., 1992 Okla. Sess. Law Serv. (West).

Finally, the initiative required voter approval of any legislative change in the composition of any retirement board with elected members. An initiative to protect the assets and independence of the public pension fund was also proposed in Oklahoma. Voters approved both initiatives.¹⁵⁴

Although constitutional protection of the integrity of public pension funds has obvious popular appeal, like the proposal to apply ERISA's fiduciary standard to public funds, it is ultimately an inadequate solution. Constitutionally enshrined board independence prevents the more flagrant forms of legislative interference in fund affairs, such as redeployment of fund assets or changes in board composition. It also more successfully bonds the state to honor its contracts because it is more difficult to renege on constitutional than statutory commitments. However, it does not eliminate state officials' ability to influence politically sensitive board members on decisions regarding social investments or voting policies that aid local firms' managers at the expense of fund beneficiaries.

E. Switching to Defined Contribution Plans

The most promising reform for curtailing political pressure on public pension funds is, in my judgment, to reorganize state retirement plans as defined contribution rather than defined benefit plans. A defined benefit plan guarantees a pension according to a formula that adjusts benefits based on years of service and final salary that is independent of the value of the assets in the plan. In contrast, a pension received in a defined contribution plan consists of financial assets that accrue in employees' accounts from employer and employee contributions over their working lives. The standard account choices that private employers offer employees participating in defined contribution plans are bond and stock index funds, managed by reputable, typically national, mutual funds, and guaranteed insurance contracts (GICs), which are sold by life insurance companies and promise a specified return.¹⁵⁵ Reorganizing public pension plans as defined contribution plans, following the private sector model, transfers control over investments into the hands of individual employees from pension fund boards.

With decisional power diffused across numerous plan beneficiaries, the likelihood that political pressure will push substantial pension fund assets into high-risk, low-return projects decreases. Indeed, it is unlikely that state officials would even try to persuade individual employees, as opposed to fund boards and their managers, of the wisdom of

154. See Sabine Schramm & Terry Williams, *State Voters Approve Pension Initiatives, Pensions & Investments*, Nov. 9, 1992, at 4. The California proposition passed with a vote of 51%; the Oklahoma initiative with 67%. See id.

155. See Michael J. Clowes, *Fidelity Wins 401(k) Sweepstakes, Pensions & Investments*, Aug. 3, 1992, at 17.

investing their retirement savings in specific local projects. Even if such an approach were feasible, public employees would be able to choose, on an individual basis, whether they wished to subsidize local projects or other social investments through their pension savings. The employee alone, not future taxpayers, would bear the cost of such a choice.

Although it is questionable whether the local investments presently marketed to fund managers would be in the menu of investment choices offered employees, such a scenario is not impossible. For example, firms could package such projects into portfolios and market them to public employees, just as money managers have created individualized real estate and venture capital portfolios for public funds that target local investments.¹⁵⁶ Socially responsible investment strategies are currently available to private pension funds, as are union labor-only real estate portfolios; socially responsible investment funds are also available to individual investors.¹⁵⁷ For example, the largest de-

156. Presumably, a minimum number of employees would have to express interest in the investments to make such marketing feasible. If local projects were in fact offered among a state's defined contribution plan's investment choices, there might be concern that employees would somehow be duped into making poor investments in order to support the local economy. Such a fear would, in my judgment, be misplaced; data on private firm employees' pension asset choices indicate that, if anything, individuals are conservative in their pension investment choices and take on too little investment risk. See Hillary Durgin, *Fighting the Conservatives: Companies Moving Education Efforts into High Gear, Pensions & Investments*, July 6, 1992, at 16; Ellen E. Schultz, *Passing the Buck: In New Pension Plans, Companies Are Putting the Onus on Workers*, *Wall St. J.*, July 7, 1992, at A1. It should be noted that the question of suboptimal employee investment choices is not a long-run problem. Private employers who sponsor defined contribution plans, for example, have begun to undertake vigorous and ongoing educational efforts, and firms specializing in providing employee educational services have sprung up. See Durgin, *supra*; Ellen E. Schultz, *Competition Revolutionizing Financial Planning*, *Wall St. J.*, Sept. 16, 1992, at C1; Schultz, *supra*; Curtis Vosti, *Firms Filling the Void on Plan Education, Pensions & Investments*, Aug. 3, 1992, at 17. In one instance, after providing such information, employees' deposits in the most conservative fund option offered dropped from 40% to 28% of contributions. See Lynda McDonnell, *Firms Doing More to Help Workers Plan Retirement*, *New Haven Reg.*, Feb. 1, 1993, at 15. States can therefore implement techniques similar to those employed in the private sector to provide financial planning assistance to their employees.

157. These funds offer South Africa-free investments, as well as portfolios free of stock in companies producing tobacco and alcohol products. See Amy Friedman, *Field of Dreams*, *Fin. Services Wk.*, Aug. 19, 1991, at 19; Mary G. Moore, "Socially Responsible" Funds Adopt Global Focus, *Fin. Services Wk.*, Jan. 13, 1992, at 22. There are also more innovative investment vehicles, such as socially responsible variable annuities. See *Socially Responsible Stock Portfolio Bows as VA Option*, *Fin. Services Wk.*, Sept. 7, 1992, *Retirement Products Supp.*, at I 13. For examples of union labor restricted investment pools, see the following Department of Labor (DOL) advisory opinion letters approving such investments: DOL Advisory Opinion 85-36 A, *Re: Annuity Fund of the Electrical Industry of Long Island* (Oct. 23, 1985); DOL Letter to Theodore R. Groom (Jan. 16, 1981) (Prudential Life Insurance Co. of America pooled separate account); DOL Letter to James S. Ray (July 8, 1988) (Union Labor Life Insurance Co. pooled separate account), reproduced in Albany Law School,

defined contribution plan, TIAA-CREF, which is for college professors and administrators, offers its members the choice of investing in such a fund, and there are a number of private funds offering investors similar portfolios.

Thus in contrast to the other proposals discussed in this section, the typical defined contribution plan eliminates political pressure on share voting. A fund board no longer holds any assets, including corporate stock, because all assets are in individual accounts managed by financial intermediaries, and even the fund beneficiaries hold equity investments only indirectly via mutual fund investments. Political pressure is, then, not a factor in a defined contribution pension plan because investment assets are removed from a fund board's control.

Although the investments of public pension fund defined benefit plans are more frequently managed internally than those of private plans, public pension systems would in all likelihood use external managers for defined contribution plan accounts, as do most private firms. It would be difficult for internal management to compete effectively with the vast number of account choices available in the private sector because the economies of scale that exist with a defined benefits plan would no longer be relevant. In fact, an advantage of a defined contribution plan from the employee's perspective is the increase in individual choice of investment vehicles offered in such a plan. In the private sector, workers with defined contribution plans have sought increased investment choice. For example, calls from university faculty members for additional investment vehicles led universities to provide multiple alternatives to the traditional TIAA-CREF plan, and CREF itself responded by substantially expanding its investment products. Employee demand has also stimulated the recent growth in defined contribution plans' offerings of international investment options.¹⁵⁸

The same dynamic of employee demand for multiple investment options would likely occur in the public sector, resulting not only in numerous investment choices for employees but also in the external management of their retirement accounts. The use of external management for state defined contribution plans could also be mandated in order to maintain the integrity of the reform proposal. Alternatively, if internal management was still less costly for the largest states, the fund boards could be prohibited from exercising voting rights, as is the federal government's defined contribution retirement system's board.¹⁵⁹

However, even with external management, defined contribution

Economically Targeted Investments by Public Pension Funds 197-206 (Rev. Materials, Mar. 1991).

158. See Margaret Price, *Overseas Options Gaining Popularity: Employee Demand Behind Growth Surge, Pensions & Investments*, Dec. 7, 1992, at 17.

159. See 5 U.S.C. § 8438(g) (1988). Such a practice would not be sensible for defined benefit plans because employers bear the risk of poor investments in such plans, and therefore should be able to exercise decisional authority for a proper matching of

plans may not be completely insulated from political pressure: state officials could still attempt to exert pressure through the selection of the external managers. Of course, such pressure is not unique to a defined contribution plan setting. The board of a defined benefit plan fund that does not vote its own shares could use its appointment power to exert pressure on the external investment manager to vote as the board desires.¹⁶⁰ However, such pressure would not be as significant a problem for defined contribution plans as for defined benefit plans because the vast majority of defined contribution plan assets will be invested with national mutual funds or insurance companies. It is not likely that any one public pension plan will be able to intimidate mutual fund managers with a viable threat of imposing a devastating financial penalty from loss of business. Moreover, increased employee involvement in investment decisions provides a further safeguard for defined contribution plans. If employees are satisfied with a particular external fund manager, they will object if that investment option is removed and thereby limit political pressure points in the account manager selection process.

Proposing such a fundamental change in public retirement plans implicates broad issues of public policy that are far removed from the corporate governance debate. Although this Article cannot resolve the broader debate, it can provide a sense of the policy tradeoffs entailed in the proposal to shift to defined contribution plans and suggest why, on balance, there is much to recommend it. There are, in fact, a number of additional advantages of defined contribution plans over defined benefit plans besides their effect of removing political interference from fund administration. The most obvious advantage is that defined contribution plans safeguard public pension assets from raids by fiscally troubled states. There are no surplus earnings in a defined contribution plan because all fund revenues and income are deposited in individual employee accounts. In addition, annual contribution levels do not depend on actuarial assumptions and states therefore cannot reduce promised payments by changing accounting conventions.

The protection of pension assets, though benefitting employees, presents a corresponding disadvantage to fiscally troubled states. An advantage for states with defined benefit plans is that such plans need not be fully funded: a state need only meet current retirees' benefit payments. Depending on work force demographics, states can there-

incentives and interests. See Fischel & Langbein, *supra* note 21, at 1112-13; Langbein, *supra* note 60, at 131-33.

160. As noted at note 149 *supra*, ERISA prevents a private pension fund from explicitly requiring a manager to vote in a particular way once it delegates voting power. It is possible that courts would hold that state fiduciary law imposes a similar restriction on public fund managers. But with good legal counsel and the use of industry-based standards of prudent conduct, given the porousness of benchmark comparisons for social investments, see *supra* note 42 and accompanying text, it will not be difficult for fund sponsors to exert influence on managers' voting.

fore use such a system to shift current expenses to future taxpayers. The ability to engage in such an intergenerational wealth transfer will be reduced to the extent that pension underfunding is impounded in property values—future taxpayers will pay less for real property in the state to compensate for their future pension liabilities. Whether pension liabilities are fully capitalized is, however, problematic: in addition to the question whether property purchasers have access to complete information about a state's pension liabilities, property tax receipts are not a significant proportion of state revenues.¹⁶¹ This makes it probable that states can redistribute wealth across generations of taxpayers by following an underfunding policy.

Underfunding is not an option with a defined contribution plan: payment of current expenses cannot be deferred because contributions are paid to current employees. A shift to defined contribution plans may thus prove politically difficult to implement in states whose defined benefit plans are underfunded, and in financially troubled states that are seeking to reduce current funding levels without having to renegotiate labor contracts.¹⁶² State officials whose retirement systems are underfunded therefore have incentives to oppose a pension reform that replaces defined benefit plans with defined contribution plans. Employees and their unions, who would benefit from the greater protection afforded pension assets, might be able to rally enough political support to negate state officials' opposition. However, they might hesitate to do so because the public will more easily observe how much it is paying state employees under a defined contribution plan than under a defined benefit plan, whose costs are difficult to value and, depending on work force demographics, extremely opaque. The public, for this

161. Proper impounding of future pension liabilities into property values is more likely in the municipality than in the state context because, in contrast to state expenditures, municipal liabilities are funded principally by property taxes. A study of unfunded municipal pension liabilities found evidence that the liabilities were capitalized in local property values, but concluded that more empirical work was necessary before a definitive conclusion concerning whether such liabilities are fully capitalized could be reached. See Dennis Epple & Katherine Schipper, *Municipal Pension Funding: A Theory and Some Evidence*, in *Carnegie Papers on Political Economy* 141, 169–70 (A. Meltzer et al. eds., 1981). The mitigation of intergenerational wealth transfers by impounding in property prices does not arise in the social investing context discussed *supra* notes 22–69 and accompanying text because lower returns from poor social investments or voting strategies may not be predictable at the time of the particular investment or voting decision. Moreover, such decisions are not disclosed to taxpayers. As a result, subsequent financial losses will not be anticipated by property purchasers.

162. The switch would not eliminate the states' existing liability. If a defined benefit plan is underfunded, a shift to a defined contribution plan would require the state to continue making payments into the terminated defined benefit plan until it is fully funded. The present value of future benefits for the plan's full funding is calculated by using the employees' salaries as of the plan's termination date, which is the fund's legal liability, rather than at what their salaries would have been at retirement. See Richard A. Ippolito, *Pensions, Economics and Public Policy* 36–42, 63–65 (1986).

very reason, would also benefit from the proposed reorganization in public pensions.

Despite the increased transparency of pension costs to taxpayers, employees would benefit from defined contribution plans in several ways beyond the fiscal protection already noted. In addition to offering greater individual choice and control over retirement assets, defined contribution plan pensions are fully portable across the public and private sectors. If an individual covered by a defined benefit plan pension switches employers, his or her pension is substantially diminished because benefits are pegged to years of service and final salary, with no credit granted for service with another employer. Benefits under defined contribution plans consist of the annual contributions to the employee's account and the account's accrued earnings. Thus, under such plans an individual can search for the best employment opportunity without being penalized.

Defined contribution plans also have several potential disadvantages, though none is decisive. Employees bear the risk under such plans that their investments will not provide sufficient income upon retirement. By contrast, in a defined benefit plan, employers bear this risk because the schedule of promised benefits is unrelated to fund assets. Employees can, however, duplicate a defined benefit plan's schedule of guaranteed annual payments by purchasing investments like GICs for their defined contribution accounts. In addition, although pension portability is an important benefit from the employee's perspective, it can be a disadvantage from the employer's perspective, because it eliminates a useful method of reducing work force turnover. However, it has been contended that certain defined contribution plans offset this disadvantage: to the extent that there is a correlation between the workers who are most valued by an employer and workers who are savers, then a defined contribution plan is equally or more useful to the employer in reducing turnover than is a defined benefit plan. By matching contributions, the employer can pay selectively higher wages to workers who reveal themselves as savers and such matching will be disproportionately valued by workers intending to stay with the firm over the long run.¹⁶³

A related concern of employers is the fashioning of incentives to induce employees to retire, given Congress' prohibition of involuntary retirement.¹⁶⁴ The structure of a defined benefit plan provides greater incentives for employees to retire than does that of a defined contribution plan. The funds that employers contribute into a defined contribution account belong to the employee immediately and they are an asset

163. See Pension Benefit Guarantee Corp., *Pension Plan Choice 14* (Dec. 1990).

164. See Age Discrimination in Employment Act, § 4(f)(2), 29 U.S.C. § 623(f)(2) (1988). Corporate executives and individuals in "high policymaking" positions are excluded from the involuntary retirement ban if they are entitled to receive certain retirement benefits. See 29 U.S.C. § 631(c).

of the employee's estate if the employee dies before retirement. A defined benefit plan pension, however, is not an asset that passes into an employee's estate. An employee must retire to receive the pension, and the total payout decreases the later one retires because benefit payments are not actuarially adjusted and terminate upon death, although there are joint survivorship rights in vested pensions for spouses.¹⁶⁵ A simple example illustrates the difference. Assume an unmarried, sixty-five-year-old employee, with a life expectancy of twenty years (age eighty-five), can retire at full benefits. If she retires now, she receives twenty years of pension benefits. If she continues to work until age seventy, she will receive only fifteen years of benefits. Although the annual benefit level will be somewhat higher insofar as her final salary will have increased over the five additional working years, the present value of the pension will, in general, be lower if she continues to work than if she retires at age sixty-five. This creates an incentive to retire. The value of the pension in a defined contribution plan, however, will not decrease over time (the account earns interest and continually grows). Accordingly, compared to defined benefit plans, defined contribution plans offer less of an inducement to retire. The tax code does require distribution of assets in defined contribution plans to commence when an individual reaches age seventy-and-a-half.¹⁶⁶ This requirement might lessen the differential impact of the two kinds of pension plans on retirement incentives for employees over age seventy, but that impact will not be eliminated because the amount the employee receives under the defined contribution plan does not vary according to whether or not he or she has retired.

The differential effect on retirement choices of defined benefit plans compared to defined contribution plans does not, in any event, appear to be significant in practice. The average retirement age has fallen sharply over the past twenty-five years despite the prohibition on mandatory retirement, and a number of studies indicate that the primary influence on retirement is the availability of Social Security benefits at age sixty-two, not the payout structure of private pension plans.¹⁶⁷ In addition, studies comparing retirement ages under defined contribution and defined benefit plans provide only mixed evidence of

165. See Langbein & Wolk, *supra* note 148, at 433-34 (discussing augmentation of nonemployee spouses' rights under the Retirement Equity Act of 1984). Some defined benefit plans, such as New York state's plan, provide options that pay benefits to a designated beneficiary upon the retiree's death.

166. See I.R.C. §§ 401(a)(9) (1988 & Supp. II 1990), 403(b)(10) (1988), 408(a)(6) (1988 & Supp. II 1990), 457(d)(2)(A) (1988) (covering qualified plans, and all tax-favored retirement arrangements including IRAs, tax-sheltered annuities known as 403(b)(3) plans, and eligible deferred compensation plans of governments and tax-exempt employers known as 457 plans). For a discussion of the federal tax code's minimum distribution rules, see Langbein & Wolk, *supra* note 148, at 292-98.

167. See Michael D. Hurd, *Research on the Elderly: Economic Status, Retirement, and Consumption and Saving*, 28 *J. Econ. Literature* 565 (1990).

a difference in retirement age attributable to plan type.¹⁶⁸ Of course, what is a disadvantage to employers regarding retirement choices under a pension plan may well be an advantage from the vantage point of older workers. One's assessment of this feature of defined contribution plans depends on one's evaluation of the effects of the congressional decision to prohibit mandatory retirement on productivity, employment levels, and individual workers' welfare.

This brief overview of the general issues concerning the choice of pension plan form suggests that, although defined contribution plans are not a panacea, their benefits decisively outweigh their disadvantages. They may, for example, adversely affect workers' incentives to retire or remain in their jobs. They also place the risk of accumulating adequate retirement savings solely on the employee. But they have compelling advantages over defined benefit plans. Defined contribution plans eliminate state officials' opportunities to conscript pension assets into economic development and other types of social investing as well as restrict their ability to influence share voting and other corporate governance activities. In addition, such pensions are portable and secure—they cannot be underfunded or transferred to general revenue accounts.

CONCLUSION

Recent proposals to enhance the role of public pension funds in corporate governance implicitly assume that such funds are free of the conflicts of interest that plague private fund managers. This Article's data suggest that enthusiasm for such proposals ought to be more

168. These studies involve retirement patterns of university faculty. See G. Gregory Lozier & Michael J. Dooris, *Projecting Faculty Retirement: Factors Influencing Individual Decisions*, 81 *Am. Econ. Rev.*, May 1991, at 101, 103. For a critique of the elimination of mandatory retirement for universities, which notes that defined contribution plans compound the problem, see Richard A. Epstein, *Forbidden Grounds: The Case Against Employment Discrimination Laws 459-73* (1992). It should be noted that the finding that most individuals continue to retire at normal retirement ages, despite the absence of mandatory retirement policies, appears not to be duplicated in the research university setting. In many states, state university pension plans are separate from the plans of other public employees, including those of public school teachers. Consequently, if the desire to encourage faculty retirement is thought to outweigh the concerns expressed in this Article over the politicization of the management of pension fund assets, the pension plans of state university professors could, without difficulty, be maintained as defined benefit plans. Alternatively, these institutions need not be exempt from the switch to defined contribution plans. Rather, other incentive schemes to induce retirement could be devised, such as implementing plans similar to those adopted by private universities, which are now fashioning retirement incentive plans as they approach the end of their exemption from the Age Discrimination in Employment Act's prohibition of a mandatory retirement policy. See 29 U.S.C. § 631(d) (1988) (to be repealed Dec. 31, 1993, see Age Discrimination in Employment Amendments of 1986, § 6(b), Pub. L. No. 99-592, 100 Stat. 3344 (1986) (termination provision)).

-muted: political pressure to support local firms and engage in other forms of social investing places important limits on the effectiveness of public fund activism in corporate governance. Such pressure creates conflicts of interest for public fund managers analogous to the business conflicts of private fund managers, although these conflicts are likely to be more geographically constrained than those of their private counterparts.

The data bolster the Article's thesis that public funds face political pressure on their decision-making. Funds with more politicized board structures perform significantly more poorly than those with more independent boards. Policies favoring social investments also appear to affect performance negatively, although the relationship is statistically significant only at ten percent. Restrictions on South African investments adversely affect fund performance, most probably because of their impact on asset allocation—portfolios weighted toward small firm stocks performed poorly over the sample period. A fund's activism in corporate governance does not appear to affect its performance.

There is little evidence that public and private fund managers differentially support corporate management in proxy voting. In the vast majority of cases, especially matters touching upon corporate control, both groups of investors appear to follow the same voting strategy. Of course, these data do not address recent gubernatorial efforts to interfere in the internal organization of the New York and California state pension funds. These events indicate that, as public funds become increasingly active in corporate governance, they will experience increased political pressure on both voting and investment decisions. This pressure will produce non-value-maximizing decisions at odds with the interest of other investors. This tendency suggests that shareholder activism by public pension funds will not be able to replace an active market in corporate control as the most potent disciplining force for aligning managers' incentives with shareholders' interests.

There are several organizational changes that could mitigate the impact of political pressure on public funds' decision-making: (1) Fund boards could be made more independent by increasing the number of fund trustees elected by plan participants; (2) The fiduciary standards of the federal ERISA statute could be extended to state plans; (3) State constitutions could identify fund boards as the sole fiduciary of pension funds so as to create a firewall against legislative interference in their organization and administration; and (4) Greater reliance could be placed on passive indexed investment strategies to reduce the opportunities for exertion of political pressure on fund managers. None of these proposals, however, completely eliminates the possibility of political pressure on fund voting.

A more effective, albeit more drastic, structural reform would be for states to switch from defined benefit plans to defined contribution plans. This change would transfer pension assets from fund board to

individual employee control. By eliminating the state's direct ownership of fund assets, the opportunity to apply damaging political pressure on decisions concerning those assets is diminished, if not eliminated. However, by successfully depoliticizing board decisions, the proposal also eliminates the role of public pension funds in corporate governance. Whether their replacements, financial intermediaries such as mutual funds and insurance companies, would assume a more active role in corporate governance in the absence of public fund efforts is an open question.