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# The Outside Investor: Citizen Shareholders & Corporate Alienation

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ARTICLE

**THE OUTSIDE INVESTOR:  
CITIZEN SHAREHOLDERS &  
CORPORATE ALIENATION**

ANNE M. TUCKER\*

ABSTRACT:

*This Article explores the creation and conundrum of citizen shareholders—investors who enter the securities market primarily through employer-sponsored defined-contribution plans, invest in mutual or index funds, and are saving for long-term goals like retirement. Citizen shareholders are a consequence of a retirement revolution, and are the fastest growing group of investors.*

*Citizen shareholders are distinguishable from other shareholders on the grounds of choice, exit, and the number of intermediaries inserted into the investment chain in defined-contribution plans. They are largely missing from corporate policy and scholarship debates; few discussions have incorporated the growing reality that shareholder status has changed over the last several decades with how, why, and in what form individual investors enter the securities market. This group of investors, estimated to be nearly 75 million Americans, is alienated from traditional corporate governance mechanisms at both the operating company and the investment company levels. Citizen shareholders complicate corporate law assumptions about shareholder empowerment, exacerbate tensions between management and control, and undermine corporate regulatory solutions such as those advanced in Dodd Frank. Additionally, the disclosure-based regime required under federal securities and Employee Retirement Income Security Act (“ERISA”) laws are incomplete, fractured, and not tailored to the needs of citizen shareholders, a group of investors that includes low-dollar and often unsophisticated investors. As a result, citizen shareholders*

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\* Associate Professor of Law, Georgia State University College of Law. This paper has benefited from presentations at the University of St. Thomas: The Law & The History of Corporate Social Responsibility Symposium, the George Washington University C-LEAF Junior Scholar Workshop, and the faculties at Georgia State and Wake Forest. The thoughtful comments and questions contributed to the completion and ultimate improvement of this paper.

*are long-term investors locked in a market system that rewards short-term performance and facilitates exit over activism. Second, citizen shareholders exercise constrained control over their self-directed accounts with limited investment options, virtually no control over fee structures that erode retirement savings, and splintered and incomplete information about their investments and the fees charged to them. Recognizing that retirement investments play a crucial role for the individual and for society, this Article proposes both theoretical and practical approaches to better incorporate the interests of citizen shareholders into the markets.*

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## I. INTRODUCTION

Corporate law scholarship has begun addressing the nuances and complexity of the corporate governance framework.<sup>1</sup> The simple two-party agency framework of shareholders as principles and corporate management as agents captures very little of modern corporate and investment structures.

Corporate law scholarship theorizes the balancing act and benefit of direct shareholder rights.<sup>2</sup> It also grapples with the role of retail, indirect shareholders for whom corporate governance mechanisms are diluted by their rational apathy, and representation by intermediaries.<sup>3</sup> Corporate law scholarship, to date, has not fully recognized a third category of investors, a group that I call the citizen shareholders, and their unique position in the governance and securities frameworks that regulate their investments.<sup>4</sup>

Citizen shareholders are investors who enter the securities market primarily through employer-sponsored, self-directed defined-contribution plans, such as the 401(k),<sup>5</sup> and are the fastest growing group of investors.<sup>6</sup>

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1. See generally JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* (2000) (describing the change in corporate ownership and the consequences); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *COL. L. REV.* 863 (2013) (describing the dominance of institutional shareholders).

2. Shareholder primacy theory includes two bedrock principles: (1) maximizing long term shareholder value is the only legitimate objective of the corporation and (2) designing ways to assist shareholders in exerting control through their powers, including the power to vote at annual meetings, will minimize the agency costs that result from the separation of ownership from control in publicly traded and diffusely held corporations. It is a direct outgrowth of agency theory. See generally Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 *HARV. L. REV.* 833 (2005); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 *J. FIN. ECON.* 365, 366 (1996). Cf. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 *HARV. L. REV.* 1735, 1752 (2006) (describing the director primacy theory where the board of directors is self-interested in company performance and is assumed to be in the best position to monitor the company).

3. Christopher Gulinello, *The Retail-Investor Vote: Mobilizing Rationally Apathetic Shareholders to Preserve or Challenge the Board's Presumption of Authority*, 2010 *UTAH L. REV.* 547, 547 (2010) (acknowledging the “millions of other individual shareholders in the stock market, otherwise known as ‘retail investors,’ who never pay attention to those annual reports and proxy cards they receive in the mail. . . . It is simply too costly for retail investors . . . to make intelligent voting decisions.”).

4. Current corporate law scholarship describing retirement investors includes STEPHEN DAVIS ET AL., *THE NEW CAPITALISTS: HOW CITIZEN INVESTORS ARE RESHAPING THE CORPORATE AGENDA* (2006) (describing the evolution of corporate ownership and its link to retirement benefits and the resulting civil economy); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 *U. PA. L. REV.* 1961, 2003–04 (2010) (discussing retirement investors); William A. Birdthistle, *The Supreme Court's Theory of the Fund*, 37 *J. CORP. L.* 771, 774 (2012) (discussing retirement investors).

5. Certain plans that mimic defined-benefit and defined-contribution plans are not “qualified plans” under ERISA and therefore are not subject to certain ERISA regulations on funding

As a group of investors they have assumed legal protections arising under corporate and securities law as well as ERISA,<sup>7</sup> but in reality are alienated from these legal regimes that provide more lip service than substance to their rights. The unique circumstances under which citizen shareholders enter the market challenge assumptions about the voluntariness of their investment and distort investors' power balance within the corporate governance framework. While shareholders as a whole are a diverse and multi-interested group,<sup>8</sup> we can identify commonalities among citizen shareholders—who are primarily indirect investors saving for long-term goals like retirement and education<sup>9</sup>—to which corporate law and corporate actors alike should be responsive.

Citizen shareholders invest in the market and bear the risks of market performance—they are the economic interest holders. To the extent that American employees have retirement benefits today, they are largely provided in self-directed, defined-contribution plans.<sup>10</sup> This is the new reality

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and vesting. 1 Phyllis Borzi, *ERISA: A Basic Approach to Key Terms and Concepts Under Title 1 of ERISA*, in ABA 25TH ANNUAL NATIONAL INSTITUTE ON ERISA BASICS A-17 (2011). These plans include benefits offered by the government, public schools, nonprofit corporations, and church plans that do not opt-in to ERISA; plans established under workers' compensation, disability, or unemployment laws; plans outside of the United States; and excess benefit plans only offered to certain employees. BARRY KOZAK, *EMP. BENEFIT PLANS* 47, 51–61, 555 (2010); 29 U.S.C. § 1101(a)(1) (1996). Employer sponsors who are outside of the scope of ERISA and thus cannot offer qualified plans have alternative tax-deferred savings options available through Internal Revenue Code § 457(b) for government, church, and nonprofit employers and §§ 403(a-b) for schools, churches, and nonprofit organizations. *Id.* at 47–48; *see also* 29 U.S.C. § 1103(b)(5) (2012).

6. *See generally* INVESTMENT COMPANY INSTITUTE, 2012 INVESTMENT COMPANY FACT BOOK (52nd ed. 2012), available at [http://www.icifactbook.org/2012\\_factbook.pdf](http://www.icifactbook.org/2012_factbook.pdf) (reporting data for year end 2011); U.S. DEPT. OF LABOR, *Private Pension Plan Bulletin: Abstract of 2010 Form 5500 Annual Reports*, 1–2 (2010), available at <http://www.dol.gov/ebsa/PDF/2010pensionplanbulletin.pdf> (summarizing 2010 data regarding the number of current defined-contribution participants). Only current participants are included in the seventy-five million estimates, which does not capture former participants who have changed jobs or retired and converted accumulated defined-contribution benefits into an individual savings account (IRA).

7. Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406, 88 Stat. 829 (2012) (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.) [hereinafter ERISA].

8. LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* 69 (2012); Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1829 (2011) (Horizontal conflicts “exist when investors have conflicts of interest, not with managers, but amongst themselves. If shareholders have different interests, most notably divergent investment time horizons, then simply empowering investors risks advantaging one group of shareholders to the detriment of the rest.”).

9. “[M]ore than half (60 percent) of the \$3.6 trillion in 401(k) plan assets at year-end 2012 was invested in mutual funds . . . .” Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2012*, 19 ICI RES. PERSP., June 2013, at 6, available at [www.ici.org/pdf/per19-04.pdf](http://www.ici.org/pdf/per19-04.pdf).

10. Fifty-one million Americans participated in 401(k) plans in 2011. *Frequently Asked Questions about 401(k) Plans*, INVESTMENT COMPANY INSTITUTE, available at [http://www.ici.org/policy/retirement/plan/401k/faqs\\_401k](http://www.ici.org/policy/retirement/plan/401k/faqs_401k) (last visited Mar. 18, 2014). Roughly half of all compa-

for nearly 75 million American workers.<sup>11</sup> Sixty-three percent of first time securities investors do so through self-directed, defined-contribution plans suggesting both the strength and the longevity of this trend.<sup>12</sup> A confluence of events created an arranged marriage between individual financial security and the performance of private securities markets.<sup>13</sup> One way to promote a happy marriage between the two is to encourage governance and securities frameworks that incorporate the citizen shareholder identity. To that end, this Article is primarily descriptive in defining citizen shareholders, cataloguing their attributes, and articulating their differences from other shareholders currently discussed in corporate law literature. To illustrate the application of the citizen shareholder identity, I offer both a theoretical and a practical extension of the argument that citizen shareholders are distinguishable investors and that those differences matter for purposes of corporate governance and securities frameworks.<sup>14</sup>

In previous work, I focused on the limitations of the ERISA legislation originally enacted to protect pension benefits, to adapt to the current landscape of retirement savings through individual securities accounts.<sup>15</sup> In this Article, I articulate how (1) choice, (2) exit, and (3) number of intermediaries inserted into the investment chain distinguish citizen shareholders relative to other investors and the resulting consequences. The differences are obvious with direct shareholders and more nuanced with indirect shareholders, of which citizen shareholders are a subcategory. All differences highlight the limitations of state corporate law and federal se-

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nies offer retirement benefits in the form of 401(k) plans. See *The Retirement Gamble Transcripts*, PBS FRONTLINE, <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/retirement-gamble/transcript-43/>. Among Fortune 1000 companies, only 11 percent offer defined-benefit or traditional pension plans. Steve Vernon, *Retirement Plan Shift Is Creating a Generation of Workers Unable to Retire*, CBSNEWS.COM, <http://www.cbsnews.com/news/retirement-plan-shift-is-creating-a-generation-of-workers-unable-to-retire/> (last visited Aug. 2, 2014).

11. See generally INVESTMENT COMPANY INSTITUTE, *supra* note 6 (reporting data for year end 2011); U.S. DEPT. OF LABOR, *supra* note 6 (summarizing 2010 data regarding the number of current, defined-contribution participants).

12. “Employer-sponsored retirement plans increasingly are the gateway to mutual fund ownership. Sixty-three percent of mutual fund-owning households that purchased their first fund in 2005 or later purchased that fund through an employer-sponsored retirement plan, compared with 52 percent of those that made their first purchase before 1990.” Kimberly Burham, Michael Bogdan & Daniel Schrass, *Characteristics of Mutual Fund Investors, 2013*, 19 ICI RES. PERSP. 1 (2013), available at <http://www.ici.org/pdf/per19-10.pdf>.

13. See *infra* Section II.

14. “The risk [of defined-contribution plan shortcomings] is not merely a problem for the individual retirees. Rather, it is in our societal interest to ensure employees will retire with adequate income security.” Susan J. Stabile, *Freedom to Choose Unwisely: Congress’ Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL’Y 361, 363 (2002).

15. Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 Hous. L. Rev. 153 (2013) [hereinafter *Retirement Revolution*]; Anne Tucker, *The Citizen Shareholder: Modernizing the Agency Paradigm to Reflect How and Why a Majority of Americans Invest in the Market*, 35 SEATTLE U. L. Rev. 1299 (2012) [hereinafter *The Citizen Shareholder*].

curities laws as applied to citizen shareholders and their weak position relative to other investors.

The remaining five sections of this Article are organized as follows: Part II articulates the definition of the citizen shareholder and identifies the ways in which this class of investors is distinct from direct shareholders. Part II also establishes that citizen shareholders are a unique subgroup of, and are distinguishable from, indirect investors, like those who invest in retail mutual and index funds.<sup>16</sup> Parts III and IV describe the securities and corporate governance frameworks, respectively, as well as highlight the unique constraints for citizen shareholders. Part V suggests both a theoretical and regulatory approach to better incorporate citizen shareholders' interests. Part VI offers concluding thoughts.

## II. DISTINGUISHING CITIZEN SHAREHOLDERS FROM DIRECT & INDIRECT INVESTORS

The retirement landscape has undergone a regulatory revolution resulting in the defined-contribution society<sup>17</sup> we have today where the average worker saves for retirement by investing in private securities markets, thereby becoming a shareholder.<sup>18</sup> Retirement benefits are governed by ERISA,<sup>19</sup> which, when enacted in 1974, focused primarily on defined-benefit plans like traditional pensions where retirees received fixed-sum payments from employers based on salary and years of service.<sup>20</sup> Self-directed, defined-contribution plans—where an employer-sponsor provides individual

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16. A mutual fund is:

[A]n investment company registered with the SEC that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal (investment objective). Mutual funds can have actively managed portfolios, where a professional investment adviser creates a unique mix of investments to meet a particular investment objective, or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index. One hallmark of mutual funds is that they issue "redeemable securities," meaning that the fund stands ready to buy back its shares at their current net asset value (NAV).

INVESTMENT COMPANY INSTITUTE, *supra* note 6, at 228. An index mutual fund is "[a] fund designed to track the performance of a market index. The fund's portfolio of securities is either a replicate or a representative sample of the designated market index. Often referred to as passively managed portfolios." *Id.* at 226.

17. "In a defined-contribution society, the policies more likely to be adopted are those that channel government subsidies through individual accounts controlled by the taxpayer herself." Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 *YALE L.J.* 451, 453 (2004).

18. See also TERESA GHILARDUCCI, *WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM* (2008); see generally ELLEN SCHULTZ, *RETIREMENT HEIST: HOW COMPANIES PLUNDER AND PROFIT FROM THE NEST EGG OF AMERICAN WORKERS* (2011).

19. ERISA, *supra* note 7.

20. Alicia H. Munnell, *Employer-Sponsored Plans: The Shift from Defined Benefit to Defined Contribution*, in *OXFORD HANDBOOK ON PENSIONS AND RETIREMENT INCOME* 365 (Gordon L. Clark et al., eds., 2006) (providing the example of 1.5 percent of final three-year average pay for each year of service, which adds up to 30 percent of income for an employee with a twenty-year employment history with the firm).

accounts as a savings vehicle for retirement<sup>21</sup>—have supplanted the defined-benefit plan as the dominant vehicle of retirement savings.<sup>22</sup>

The shift from defined-benefit to defined-contribution plans created a retirement revolution<sup>23</sup> and can be attributed, in part, to retirement evolutions including (1) creating the individual retirement account (IRA) and a successful model for self-directed savings, (2) strictly regulating defined-benefit plans as compared to the relatively light regulation of self-directed defined-contribution plans, (3) reducing fiduciary standards for self-directed accounts, and (4) relaxing company stock holding rules in defined-contribution plans.<sup>24</sup> These four changes to the ERISA landscape promoted the model of self-directed retirement accounts like the 401(k).<sup>25</sup> With self-di-

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21. Borzi, *supra* note 5, at A-15 to A-16.

22. “The predominant form of private pension was the [defined-benefit] (DB) plan, under which an employee receives a pension of a specified amount upon retirement.” Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 922 (2013); *see also* Steven Sass, *The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980*, in OXFORD HANDBOOK ON PENSIONS AND RETIREMENT INCOME, *supra* note 20, at 83–84 (Gordon L. Clark & Alicia H. Munnell eds. 2007) (noting a “dramatic” expansion of coverage from 15 percent in 1940 to approaching 50 percent in 1980).

23. For a compelling discussion of the shift in the retirement benefit landscape and the consequences, *see generally* Ellen Schultz, *supra* note 18; Ghilarducci, *supra* note 18. *See* Tucker, *Retirement Revolution*, *supra* note 15; *see also* Gilson & Gordon, *supra* note 1 (discussing the complicated issues of consequences of the shift from defined-benefit to defined-contribution systems under ERISA).

24. Publicly traded companies may offer company stock as an investment option in their 401(k) plans. 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4) (2012). Company stock is often offered as a part of an employee stock ownership plan, also known as an ESOP. “[E]mployer stock regulations for 401(k) plans with an ESOP differ from those for plans without one.” James J. Choi et al., *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY, 151, 155 (2005), available at [http://www.brookings.edu/~media/projects/bpea/fall%202005/2005b\\_bpea\\_choi.pdf](http://www.brookings.edu/~media/projects/bpea/fall%202005/2005b_bpea_choi.pdf). For a general discussion of ESOPs and a summary of the unique standards of review associated with them, *see* Lanfear v. Home Depot, Inc., 679 F.3d 1267, 1279 (11th Cir. 2012), which describes ESOP standards of review and compliance duties. *See also* José Martin Jara, *What Is the Correct Standard of Prudence in Employer Stock Cases?*, 45 J. MARSHALL L. REV. 541, 547–48 (2012) (discussing ESOP plans). There is no 10 percent limit on employer stock holdings in defined-contribution plans as there is in defined-benefit plans giving employer-sponsors greater flexibility in structuring defined-contribution plans. Choi et al., *supra*, at 155.

25. Common defined-contribution plans include Money Purchase plans, Target Benefit plans, Profit Sharing plans, 401(k) plans, Stock Bonus plans, and Employee Stock Ownership plans. *See generally* Borzi, *supra* note 5, at A-15 to A-16. The distinguishing feature of self-directed defined-contribution plans, which is the subject of this paper, is that employers provide separate benefit accounts that the plan maintains for each participant. Participants direct the investment allocation in these accounts and the employer may provide a matching or minimum level of contribution to the account as well, 403(b) plans, available for employees of public schools, employees of certain tax-exempt organizations, and certain ministers, and 457 plans, available for certain state and local governments and non-governmental entities tax exempt under IRC 501, are also self-directed accounts. *403(b) Plan Basics*, IRS, <http://www.irs.gov/publications/p571/ch01.html> (last visited May 7, 2014); *IRC 457(b) Deferred Compensation Plans*, IRS, [http://www.irs.gov/Retirement-Plans/IRC-457\(b\)-Deferred-Compensation-Plans](http://www.irs.gov/Retirement-Plans/IRC-457(b)-Deferred-Compensation-Plans) (last visited May 7, 2014). These plans have some unique distinguishing features including pass through voting. *See e.g.*, 26 U.S.C.A. § 409 (2014) (discussing pass through voting rights of certain qualified plans including ESOPs). For purposes of this Article, those distinctions are not addressed in the main arguments.



rected defined-contribution plans, participants began to rely heavily on mutual and index funds<sup>26</sup> as investment options, thus increasing the number of indirect investors and the significance of institutional investors.<sup>27</sup>

The political, regulatory, and economic changes facilitated the emergence of the defined-contribution society—where a majority of individual retirement savings are invested in private securities markets.<sup>28</sup> These changes also created citizen shareholders—investors who enter the securities market primarily through self-directed, defined-contribution plans, invest in mutual or index funds, and are saving for long-term goals like retirement.<sup>29</sup>

#### A. *Diluted Indirect Investor Rights*

Citizen shareholders are indirect owners with diluted information and voting rights as compared to direct shareholders. Indirect shareholders invest in an intermediary like a mutual or index fund, which expands the original two-party framework in corporate law from shareholders as owner and the board of directors as managers to include intermediaries.<sup>30</sup> The separation of ownership from control in modern corporations is augmented for indirect owners who are further distanced from corporate management of

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26. See INVESTMENT COMPANY INSTITUTE, *supra* note 6, at 9; see also Sean Collins et al., *supra* note 9, at 8 (finding that more than half of 401(k) assets were invested in mutual funds).

27. The expansion of the mutual funds industry is due in part to the rise of the 401(k) plan where much of participants' savings are invested. Gelter, *supra* note 22, at 960.

Mutual fund ownership has become so widespread largely because mutual funds are a primary way that Americans save for retirement. Defined-contribution retirement plans and individual retirement accounts (IRAs) often hold mutual funds, and the rapid growth of these plans and accounts has increased mutual funds' total share of retirement assets.

Mutual funds now hold approximately a quarter of U.S. retirement savings.

Molly Mercer et al., *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, 7 J. EMPIRICAL LEGAL STUD. 429, 432 (2010).

28. “[W]ith the rise of self-directed defined contribution plans came the corresponding dependence of participants on private securities markets, particularly in the form of mutual and index funds.” Tucker, *Retirement Revolution*, *supra* note 15, at 176. “In a defined contribution society, the policies more likely to be adopted are those that channel government subsidies through individual accounts controlled by the taxpayer herself.” Zelinsky, *supra* note 17, at 453–54.

29. See Gelter, *supra* note 22, at 923 (“There were 20,035 DB plans and 8,587 DC plans with more than 100 participants in 1975, but only 11,368 DB plans and 70,125 DC plans with more than 100 participants in 2006.”).

30. “Mutual funds are financial intermediaries through which investors pool their money for collective investment, usually in marketable securities.” Iman Anabtawi, *Some Skepticisms about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 580 (2006). “[A] mutual fund is generally regarded as an investment company (i) that publically sells the securities it issues; (ii) that, when requested by investors holding its securities, redeems these securities; and (iii) that manages the securities in its portfolio.” Larry D. Barnett, *The Regulation of Mutual Fund Boards of Directors: Financial Protection or Social Productivity?*, 16 J.L. & POL’Y 489, 493–94 (2008). An index mutual fund is “[a] fund designed to track the performance of a market index. The fund’s portfolio of securities is either a replica or a representative sample of the designated market index.” INVESTMENT COMPANY INSTITUTE, *supra* note 6, at 226.

operating companies<sup>31</sup> resulting in a separation of ownership from ownership.<sup>32</sup>

Stock held through intermediaries, like mutual funds, decouples the economic risks of investment from the management rights, intensifying the original agency conflict.<sup>33</sup> Economic risks and management rights are decoupled from indirect ownership because the investor bears the risk of a market decline (as well as the reward of a market rise) of the operating companies in which the intermediary invests. But the intermediaries, not the indirect investor, exercise voting and information rights in the direct companies.<sup>34</sup> Here we must make a crucial distinction between an investment company and an operating company. In the last example, the intermediary is an investment company, typically thought of as mutual, index, and hedge funds.<sup>35</sup> Operating companies produce products or services, whereas investment companies produce neither, but invest in operating companies that

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31. ADOLF A. BERLE, JR. & GARDNER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4 (1932); HAWLEY & WILLIAMS, *supra* note 1, at xii-xiii.

32. “[O]wnership is no longer simply separate from control, but also from ownership—that is, when the ultimate beneficial owners of corporations do not themselves own shares in any real sense, but instead rely on institutional fund managers and other intermediaries.” Rodrigues, *supra* note 8, at 1824.

33. Gilson & Gordon, *supra* note 1, at 876–78 (noting in Figure 1 the basis of their theory of agency capitalism); Jill Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 878 (2010).

34. Where direct shareholders vote in annual director elections of the operating company as well as various proxy proposals and end-of-company life decisions, like a merger, indirect shareholders do not. The direct shareholder also receives operating company information before annual meetings and any special votes. The indirect shareholder has no information or voting rights in the operating company elections. Tucker, *Retirement Revolution*, *supra* note 15, at 178 (describing the decreased voting and information rights of citizen shareholders as indirect owners as compared to direct owners); see also Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523 (1990) (describing direct shareholder notice and voting rules). The intermediary fund receives the information and the right to vote in the operating company. “[T]he corporation’s vote holder is not the ultimate beneficial owner of the corporation, but instead an intermediary that enables the investor to own an interest in a mix of shares packaged as a unitary investment vehicle.” Rodrigues, *supra* note 8, at 1828–29; see also Fisch, *supra* note 33, at 879 (“[I]nvestors delegate to that intermediary complete authority over investment decisions subject only to the specified terms of the investment vehicle. Investors have neither the power to approve, choose, or veto specific investment decisions, nor do they have the power to initiate a change in intermediary’s investment strategy.”).

35. Intermediaries is a term associated with citizen shareholder investment and can implicate many different actors in the investment framework such as investment advisers, custodian or record-keeping services, brokerage firms, clearing agents, research providers, etc., Matthew D. Hutcheson, *Uncovering and Understanding Hidden Fees in Qualified Retirement Plans*, 15 ELDER L.J. 323, 344–48 (2007) (describing fourteen different intermediaries that can be paid from defined-contribution plan assets). In this Article, I primarily refer to mutual and index funds as passive investment companies, which are also intermediaries. Passive investment companies, i.e., mutual funds, are distinguishable from active investment companies and intermediaries like hedge funds. See generally Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, forthcoming in 113 COLUM. L. REV. 1637 (2013) (describing the value of activist hedge fund intermediary investors).

do.<sup>36</sup> Indirect shareholders receive periodic information<sup>37</sup> about the intermediary fund including financials, a management discussion of fund performance, and a statement of how the fund voted portfolio securities in operating company elections.<sup>38</sup> Limitations of shareholders' corporate governance role in intermediaries and intermediaries' flawed representation of citizen shareholders' interests are discussed in more detail in Section IV(D) of this Article.

### B. *Voluntariness of Investment*

How citizen shareholders enter the market distinguishes them from direct and other indirect owners.<sup>39</sup> Citizen shareholders have reduced choice:<sup>40</sup> the voluntariness or the "choice" involved in the investment decision for citizen shareholders is different in nature from other types of investors.<sup>41</sup> Citizen shareholders are strongly encouraged to enter into the securities market through tax incentives, the possibility of employer matching contributions, automatic enrollment, and a lack of viable alternatives for long-term savings goals.<sup>42</sup> These features tip the scales in favor of market

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36. 29 C.F.R. § 2510.3-101(c)(1) (2012) (stating "[A]n 'operating company' is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital."); 15 U.S.C. § 80a-3(a)(1)(A) (2012) (defining "investment company" as any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.").

37. Limitations of the disclosure regime for citizen shareholders are discussed in more detail in Section IV.E of this Article, *infra*.

38. Jill Fisch, *supra* note 4, at 1970 (2010); *see also* 17 C.F.R. §§ 249.331, 274.130 (2013) (requirements to report schedules of portfolio holdings); Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8393, Exchange Act Release No. 49,333, Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,254, (Mar. 9, 2004) (codified as amended in scattered parts of 17 C.F.R.) (describing the management discussion of fund performance); C.F.R. § 270.30b1-4 (describing the requirement that investment companies disclose proxy voting record for the year).

39. "Other indirect owners" means investors in mutual or index funds who do so as retail investors in accounts separate from employer-sponsored defined-contribution plans, such as an IRA or a private brokerage account.

40. *See* Cass R. Sunstein, *Empirically Informed Regulation*, 78 U. CHI. L. REV. 1349, 1393-1401 (2012) (describing the consequences of automatic enrollment defaults with defined-contribution plans and how they increased participation by altering participants' choice); *see also* Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 481 (2001) (discussing the role of automatic enrollment and other incentives to participate in defined-contribution plans).

41. Citizen shareholders' constrained choice to invest in the market, the challenges it poses to voluntary assumption of risk, and the consequences on investor incentives and motivations are the subject of a separate article. For a general discussion on notions of choice and assumption of risk, *see* Sunstein, *supra* note 40 and accompanying text; *see also* Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 331-37 (2007) (discussing the role of automatic enrollment and other incentives to participate in defined-contribution plans).

42. *See, e.g.*, Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMP. L. REV. 809, 812 (2007) ("To encourage asset accumulation, the Act allows employers to automatically enroll plan participants in the salary

participation, promote investment, and are good for savings. These features also affect the voluntary assumption of risk of market performance, which likely has consequences for fundamental economic theories underlying investor behavior regarding rationality and information.<sup>43</sup>

For citizen shareholders, the voluntariness of the decision to invest is different from a self-initiated decision to invest discretionary money, as may be the case with many direct and indirect investors.<sup>44</sup> “[M]ost ordinary Americans have little choice but to invest in the market. They are in essence ‘forced capitalists.’”<sup>45</sup> The menu of investment options offered within a defined-contribution plan—often mutual or index funds along with money market, bonds, or company stock<sup>46</sup>—alters investment choice for citizen shareholders as well. They are not investing in an open market but, instead, choose<sup>47</sup> among a limited range of investment vehicles<sup>48</sup> where choice is context-dependent.<sup>49</sup> Empirical research has documented the relationship

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deferral feature of a 401(k) plan, essentially forcing participants to opt out of making contributions, and then provides for annual increases in the automatic salary deferral contribution percentage.”); see also D. Bruce Johnsen, *Who Captures the Rents From Unionization? Insights From Multiemployer Pension Plans*, 1 AM. U. BUS. L. REV. 193, 219 (2012) (“Rather than making a pension promise to workers in the form of a life annuity on retirement conditional on continued employer solvency, defined-contribution plans simply make ongoing contributions to a trust on workers’ behalf for the duration of his or her working life.”).

43. For a discussion of investor-focused challenges to the modern portfolio theory, see James Hawley et al., *Reclaiming Fiduciary Duty Balance*, ROTMAN INT’L J. OF PENSION MGMT, Fall 2011, at 4, 5.

44. Investors who roll over a 401(k) or other defined-contribution account into an IRA or private brokerage account upon retirement or a job change confront a similar problem with “choice” as do citizen shareholders. See U.S. Gov’t Accountability Office, *401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants* 29 (2013), <http://www.gao.gov/assets/660/652881.pdf>.

45. Leo E. Strine Jr., Keynote Address at William Mitchell College of Law Public Square Lecture Series, *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance* (Mar. 10, 2007) (transcript available at <http://www.dorsey.com/files/upload/MinnesotaSpeech.pdf>).

46. See, e.g., INVESTMENT COMPANY INSTITUTE., *supra* note 6, at 110–11 (describing defined-contribution asset allocations in equities, funds, company stock, bonds, and money market accounts).

47. Participant choice, or “control” over plan assets in his individual account creates a safe harbor that shields the employer-sponsor and any plan fiduciary from liability. ERISA § 404(c); 29 U.S.C. § 1104(c) (2006); 29 C.F.R. § 2550.404c-1(d)(2)(i) (2012) (“If a participant or beneficiary of an ERISA section 404(c) plan exercises independent control over assets in his individual account in the manner described in paragraph (c), then no other person who is a fiduciary with respect to such plan shall be liable for any loss, or with respect to any breach of part 4 of title I of the Act, that is the direct and necessary result of that participant’s or beneficiary’s exercise of control.”).

48. McClendon, *supra* note 42, at 813 (“ERISA Section 404(c) participants face the often daunting task of choosing between an average of eighteen fund options.”); Anne M. Tucker, *The Citizen Shareholder*, *supra* note 15, at 1333–34 (2012) (describing investment options within a defined-contribution plan); *id.* at 1336–40 (describing the mutual funds included in defined-contribution plans offered by the three case study companies Wal-Mart, IBM, and Well-Point discussed in the Article).

49. Fisch, *supra* note 4, at 2003–04 (2010) (describing the limited choice of retirement investors within a 401(k) plan); Stabile, *supra* note 14, at 378–79.

between choice options and choice preference in consumer goods and in investment decisions.<sup>50</sup> Within this universe of restricted choice, citizen shareholders invest heavily in mutual or index funds and therefore are more likely to be indirect, rather than direct, shareholders.<sup>51</sup> These features of the retirement system positively (although insufficiently) promote retirement savings,<sup>52</sup> but also create investment circumstances unique to citizen shareholders.

Constrained choice is also evident in the percentages employees invest in employer provided stock when it is an option in the plan.<sup>53</sup> Even where employers include an open window brokerage account,<sup>54</sup> which gives participants access to a wide range of funds traded on the market, choice is still constrained because of behavioral biases such as endorsement, inertia, immobilization, and procrastination that prevent many participants from utilizing this option.<sup>55</sup> Because they rely upon biases and hierarchies, investors

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50. Stabile, *supra* note 14, at 379–80 (describing work by Professor Cass Sunstein, Professors Shlomo Benartzi, and Richard Thaler as well as a recent EBRI study).

51. “At year-end 2012, mutual funds held in DC plans and IRAs accounted for \$5.3 trillion, or 27 percent, of the \$19.5 trillion U.S. retirement market. The \$5.3 trillion in mutual fund retirement assets represented 41 percent of all mutual fund assets at year-end 2012.” Investment Company Institute, *2013 Investment Co. Fact Book* at 132 (2013), available at [http://www.ici.org/pdf/2013\\_factbook.pdf](http://www.ici.org/pdf/2013_factbook.pdf) (reporting data for year end 2012). “The spread of 401(k) plans contributed to the enormous expansion of the mutual funds industry, in which much of these savings are invested. Gelter, *supra* note 22, at 960:

Mutual fund ownership has become so widespread largely because mutual funds are a primary way that Americans save for retirement. Defined-contribution retirement plans and individual retirement accounts (IRAs) often hold mutual funds, and the rapid growth of these plans and accounts has increased mutual funds’ total share of retirement assets. Mutual funds now hold approximately a quarter of U.S. retirement savings.

Mercer, *supra* note 27, at 432.

52. See *supra* note 18 and accompanying text.

53. Participant choices regarding company stock may be subject to biases such as loyalty (feeling like they should invest in the company), endorsement (inclusive signals endorsement of the safety of the investment), and familiarity (in a world of unknown investments the informed decision to go select the one you know). See Choi et al., *supra* note 24, at 157–58. “[M]any employees invest heavily in employer stock out of a sense of loyalty to their employers, an example of bounded self-interest. This loyalty may be particularly true of women, who make up a growing part of the workforce.” Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 92 (2002). Investment in company stock, in employer stock as a percentage of total 401(k) assets, declined “from 19% in 1996 to 8% in 2010.” David Blanchett, *Employer Stock Consideration in 401(k) Plans*, MORNINGSTAR INVESTMENT MANAGEMENT, 3 (2012), available at <http://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/EmployerStockIn401kPlans.pdf>.

54. See Stabile, *supra* note 14, at 385 (“One way to avoid problems created by framing is moving to so-called ‘open option’ plans, as a number of employers have done.”); see also McClendon, *supra* note 42, at 831 (“[A]n increasing number of plan sponsors offer[ ] a brokerage option with virtually unlimited investment options. Most participants invest in just two or three investment alternatives, with each selected investment concentration significantly more than the recommended ten to twenty percent concentration.”).

55. See generally Richard H. Thaler, *Shifting our Retirement Savings into Automatic*, N.Y. TIMES, Apr. 6, 2013, available at <http://faculty.chicagobooth.edu/richard.thaler/research/pdf/Shifting%20Our%20Retirement%20Savings%20Into%20Automatic.pdf> (discussing procrastination biases). “Recent lessons from behavioral economics also yield powerful lessons, explaining such

behave similar to consumers in ordinary commercial transactions when faced with a decision for which they lack information.<sup>56</sup>

Citizen shareholders' retirement savings are funneled into securities markets under conditions that call into question the voluntariness of the decision to invest, and subsequent allocations which have consequences for axioms of the "general" investor regarding assumptions of risk, as well as incentives and capacity to monitor investments.<sup>57</sup>

### C. *Diluted Rights of Citizen Shareholders: Exit*

Citizen shareholders are distinguishable from both direct and other types of indirect shareholders on an important element of shareholder rights: exit.<sup>58</sup> When a direct shareholder is unsatisfied with the operating company's performance or policy, she can exit by selling her shares on the market and investing in a more suitable alternative. For indirect investors who invest through brokers or individual online accounts, and do so outside of the context of a defined-contribution plan—in other words, retail investors—they have strong exit rights.<sup>59</sup> Retail investors have been compared to traditional consumers of ordinary products like breakfast cereal who can "sever their relationships with suppliers by refusing to buy from the sup-

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phenomena as procrastination (people delay saving, do not save, or do not save enough), inertia (people stay where they are), and immobilization (whereby conflicts and confusion lead people to behave passively, like a deer in the headlights)." Nicholas Barr & Peter Diamond, *Reforming Pensions: Lessons from Economic Theory and Some Policy Directions*, 11 *ECONOMIA* 1, 9 (2010); Choi et al., *supra* note 24, at 157–58.

56. See Stabile, *supra* note 14, at 378–79 (describing choice theory).

57. "[B]ecause of the wholesale shift from defined benefit pensions to defined contribution plans by both corporate and governmental employers, many fund shareholders have come to hold their investments involuntarily." William A. Birdthistle, *supra* note 4, at 774.

58. I will address the practical and theoretical implications of weakened exit rights and disproportionate effects on citizen shareholders in a separate, dedicated paper in order to seriously position these arguments within the existing literature.

59. Traditional indirect shareholders are also thought to have robust exit rights because they can redeem their interest in an open-ended fund at "the funds' net asset value per share (NAV)," usually within twenty-four hours. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 *YALE L.J.* 84, 102–05 (2010) (describing exit as a dominant mutual fund investor strategy despite the presence of switching costs such as load fees and potential tax consequences); see also Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 *HASTINGS BUS. L.J.* 67, 74 (2006) (describing open-ended funds as dominating the market).

A complete discussion of exit rights of indirect investors should take into consideration exit fees, also called sales load or deferred sales charges. Investors withdrawing assets subject to an exit fee are charged a percentage of their total investment at the time of withdrawal. See e.g., *Mutual Fund Fees and Expenses*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/mffees.htm#salesloads> (last visited Jan. 15, 2013). The Investment Company Institute reported that "[i]n 2012, the average maximum sales load of equity funds offered to investors was 5.3 percent." *Average Expense Ratios Paid by Mutual Fund Investors Continued to Decline in 2012*, INVESTMENT COMPANY INSTITUTE, [http://www.ici.org/pressroom/news/13\\_news\\_trends\\_expenses](http://www.ici.org/pressroom/news/13_news_trends_expenses) (last visited Apr. 11, 2013). The ICI report noted that fees actually paid by investors were lower due to fee waivers and that load fees overall had declined "roughly 75 percent since 1990." *Id.*

plier again.”<sup>60</sup> The threat of strong exit rights are thought to exert some market forces on the mutual fund market such as focus on quarterly earnings reports and competition with regard to fund fees, expenses, and services.<sup>61</sup> For citizen shareholders, however, exit rights are constrained by the terms of the employer-sponsored, self-directed defined-contribution plan. Control over plan options exercised by the employer-sponsor or plan administrators, and additional intermediaries unique to the citizen shareholder investment chain, warp exit remedies.

Citizen shareholders invest their contributions in one of the approximately seventeen to twenty funds typically included in a plan by the employer-sponsor or plan administrator.<sup>62</sup> To exit from a fund included in the employer’s plan, there must be a suitable alternative investment within the plan that offers a similar asset risk level and eliminates the source of dissatisfaction with the first fund (i.e., lower fees, non-inclusion of objectionable operating company, etc.).<sup>63</sup> How citizen shareholders enter the market constrains their choice as to the initial investment allocation, but it also constrains their choice to exit.<sup>64</sup>

Additionally, the robust exit rights of retail investors can have negative consequences for unsophisticated investors who lack the financial understanding or ability to exit effectively, such as citizen shareholders.<sup>65</sup> With

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60. Morley & Curtis, *supra* note 59, at 88.

61. *Id.* at 103 (distinguishing between redemption rights of mutual fund holders versus direct stockholders in operating companies who do not usually have unilateral exit by redemption rights). See *infra* Part IV.E for a discussion of market competition and earnings returns.

62. See Tucker, *The Citizen Shareholder*, *supra* note 15, at 1327–28 (describing investment options within a defined-contribution plan); *id.* at 1336–40 (describing the mutual funds included in defined-contribution plans offered by the three case study companies Wal-Mart, IBM and Well-Point discussed in the article); McClendon, *supra* note 42, at 831 (finding an average of eighteen funds included in defined-contribution plans). See also ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

63. *Cf.* Morley & Curtis, *supra* note 59, at 113.

Exit still dominates voting and litigation even for investors in 401(k) plans, however, because the costs of voting and litigating against funds held in 401(k) plans are particularly high and the benefits are particularly low. The tax code restricts participation in these plans to individuals and to small amounts of money—currently a maximum of \$15,500 per year. These small individual investors are the least likely investors to become active because they encounter the standard collective action problem of corporate governance most severely. Moreover, even though switching costs are high, they are not impossibly high: employees can ask their employers to switch providers or expand choices.

*Id.* Additionally the presence of brokerage window features within plans may make exit a more viable option for sophisticated participants.

64. Once again, the presence of an open brokerage window lessens the constraint of investing through an employer-sponsored plan but does not eliminate constraint for investors who may be inhibited by behavioral biases such as endorsement, inertia, etc. See Choi et al., *supra* note 24, at 157–58.

65. See generally Jason Karceski et al., Mutual Fund Brokerage Commissions 9 (Jan. 2004) (unpublished manuscript), available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.167.6016&rep=rep1&type=pdf> (discussing costs to shareholders); see also Fisch, *supra* note 4, at 1994.

ready exit, there is little incentive for shareholder monitoring activity by large and sophisticated investors on which competitors and unsophisticated investors can free-ride.<sup>66</sup> A sinking ship analogy works well here. Imagine that all of the investors in an intermediary fund are passengers on a sinking ship, which will represent a poorly performing mutual fund. Retail investors who invest outside of a defined-contribution plan can (and rationally should) exit. Even if many retail investors do not actually exit, their easy exit ability should act as a powerful disincentive for other investors to monitor and seek management changes to improve the performance of the fund. Ready exit rights have the potential to distort which investors bear negative economic risks, as well as the incentives, for shareholder activism.

In either scenario (exit of other investors or merely activism disincentive), citizen shareholders are disadvantaged relative to other investors in the fund as a result of their constrained exit rights. In a poorly performing fund in which both indirect and citizen shareholders invest, citizen shareholders are more locked into the investment and thus more likely to bear negative economic risks.<sup>67</sup> In other words, weakened exit means that a decline should disproportionately affect citizen shareholders. Monitoring and participation are then likely left to the class of investors with few tools of negotiation, low dollar amounts invested, high monitoring costs, and market-entry conditions that challenge the voluntariness of market participation.

Citizen shareholders, like all indirect shareholders, have diluted information and voting rights in operating companies as compared to direct shareholders because of their distance from the operating company and investment through intermediaries. Citizen shareholders, however, are distinguishable from other indirect retail shareholders because of unique features of their investment chain. Funneling retirement investors in private securities markets and inserting additional intermediaries specific to the defined-contribution system challenges voluntariness, constrains choice in asset allocation, and restricts exit. The net effect of these differences is that citizen shareholders bear economic risks similar to direct and indirect shareholders, but do so with relatively weakened rights.

### III. FEDERAL SECURITIES LAWS

As stated, citizen shareholders are predominantly indirect owners, investing in public mutual and index funds. Investment companies, like other

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66. Morley & Curtis, *supra* note 59, at 130. *But see id.* (arguing that investors may benefit because the ready exit remedy should promote market competition and increase efficiency as a result).

67. Note that some citizen shareholders will remove funds via a loan or subject to the early withdrawal penalty. *See e.g.*, ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 39 (2004) (discussing the lure to cash out retirement plans for cash or when changing jobs despite the penalties).



financial service providers, are regulated under securities laws including the Securities Act of 1933 and the Securities Exchange Act of 1934,<sup>68</sup> the Investment Advisers Act of 1940,<sup>69</sup> the Investment Company Act of 1940 (ICA),<sup>70</sup> and the corresponding Securities Exchange Commission (SEC) rules.<sup>71</sup> Together, these laws establish the regulatory framework for public investment companies. Under the ICA, public investment companies, including mutual funds, must register with the SEC, which requires extensive disclosures modeled after the disclosures mandated for operating companies.<sup>72</sup> In addition to the disclosures required by the SEC, citizen shareholders also receive disclosures required by the Department of Labor (DOL), which oversees employer-sponsored benefit plans.<sup>73</sup>

The securities regulation regimes attempt to create a “system of full disclosure” to protect investors.<sup>74</sup> Securities regulations seek to protect investors from opportunistic behaviors within the securities markets that take advantage of information asymmetries by addressing information disparities.<sup>75</sup> A ready line of defense in corporate reform is often enhanced disclo-

68. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77b (2006)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78o (2012)).

69. Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1–21 (2000)).

70. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2000)).

71. See 17 C.F.R. §§ 275.0-2 to 275.222-1 (2012) for Investment Advisers Act of 1940; 17 C.F.R. §§ 270.0-1 to 270.60a-1 (2012) for Investment Company Act of 1940.

72. Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11, 15 (2006).

73. U.S. DEP’T OF LABOR, FINAL RULE TO IMPROVE TRANSPARENCY OF FEES AND EXPENSES TO WORKERS IN 401(K)-TYPE RETIREMENT PLANS 2 (2012), available at <http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html>; 29 C.F.R. § 2550.404a-5. For a discussion of DOL disclosure obligations, see Section IV.E.

74. THOMAS L. HAZEN, FEDERAL SECURITIES LAW 2 (3d ed. 2011), available at [http://www.fjc.gov/public/pdf.nsf/lookup/fedsec3d.pdf/\\$file/fedsec3d.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/fedsec3d.pdf/$file/fedsec3d.pdf); see also 15 U.S.C.A. § 80a-1 (describing the purpose and policy of the Investment Company Act of 1940 in regulating the purchase of securities issued by investment companies “without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management” because it adversely affects national public interest).

75. Securities regulation exists to ensure that investors are adequately protected from potential opportunistic behavior by securities market counterparties, whether they be issuers or broker-dealers or other market participants. It seeks to force those counterparties to internalize the costs of their activities and to correct power and information imbalances, such as those between management and shareholders. In other words, the purpose of securities regulation is to correct a perceived market failure: investors, in policymakers’ perceptions, are not capable of fully protecting their interests given the natural information disparities between investors and those who would be the target of or intermediary for their investment capital.

Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 274–75 (2013); see also Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 COLUM. BUS. L. REV. 51, 104 (2000).

sure obligations.<sup>76</sup> The disclosure-based regime as it is currently enacted, however, is subject to substantial criticisms and is discussed in more detail in Section IV(E).<sup>77</sup>

#### IV. EMPOWERMENT OF SHAREHOLDERS, BUT NOT CITIZEN SHAREHOLDERS

The retirement revolution that resulted in the rise of self-directed defined-contribution plans and the creation of the citizen shareholders has been linked to rising popularity of shareholder primacy reforms, which seek to enhance shareholder voice in corporate governance to serve as a balancing mechanism against managerial control.<sup>78</sup> Professor Martin Gelter attributes the regulatory emphasis on shareholder empowerment<sup>79</sup> in part to the dependence of the “politically relevant middle class” on the securities markets to save for retirement and college education for children.<sup>80</sup> The growth of citizen shareholders parallels the rise of shareholder primacy. “The hope of reducing agency costs through institutional activism has led to regulatory and structural changes to increase shareholder power.”<sup>81</sup> As retirement wealth became dependent, not on specific employer success, but on the success of the capital markets as a whole, greater public attention was paid to the role of the shareholder in the corporate management equation. “Numerous developments, including recent calls for increased shareholder activism, regulatory reforms that increase institutional investor obligations to vote responsibly, attempts to expand shareholder voting rights (via proxy access and say-on-pay initiatives), and the move from plurality to majority voting in director elections,”<sup>82</sup> enhance the role of shareholder voting and attempt to increase shareholder power. But the identity (and rights) of a direct shareholder is different from the identity (and rights) of citizen shareholders. Increasing shareholder voice and vote in corporate management largely

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76. “[D]isclosure is the chief tactic that financial reform legislation has embraced. . . . [A]lthough it is politically easy to impose a disclosure mandate, recent research questions whether disclosure alone is enough to influence investor behavior.” Rodrigues, *supra* note 8, at 1850.

77. See, e.g., Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 325 (2008) (describing mutual fund disclosures as “dismal”). Cf. the disclosure and structural mandates of the ICA to the disclosure-only model of the 1933 and 1934 Acts.

78. See Gelter, *supra* note 22, at 922–23.

79. *Id.* at 910.

80. By contrast, [Gelter argues] that one of the most important reasons [if not the main reason] for the shift is a fundamental change in the supply side of the capital market, which has led to the heightened importance of interests of financial investors. Specifically, [Gelter suggests] that changes in the pension system helped to transform corporate governance into a system dominated by the shareholder interest, to the detriment of the managerial model . . . [A] large part of the populace, at least the politically relevant middle class, became dependent on capital markets for retirement savings. . . .

*Id.* at 911.

81. Fisch, *supra* note 33, at 884.

82. Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650–51 (2009); see also Fisch, *supra* note 33, at 884.

excludes citizen shareholders—those very investors who embodied the need for such mechanisms.

A. *Why Shareholder Empowerment Means Little for Citizen Shareholders*

Despite the shareholder empowerment focus of corporate reforms, citizen shareholders are not empowered by augmented disclosures or voting rights. Who then is empowered? Individual investors and intermediaries such as mutual, hedge, and pension funds that invest directly in operating companies are empowered by augmented shareholder accountability mechanisms.<sup>83</sup> Empowering intermediaries decouples the economic risks borne by indirect investors, including citizen shareholders, from the governance rights exercised by intermediaries. Decoupling is a documented problem for all indirect investors because intermediaries may not provide effective representation.<sup>84</sup> Intermediary representation is a heightened problem for citizen shareholders in particular because they invest through employer-sponsors and plan administrators. These additional intermediaries in the investment chain exert pressures on the checks and balances of the governance framework and extract their own costs from citizen shareholders. As a result, unique conflicts of interest also arise in the context of defined-contribution plans such as client identity, fee structures, and investment time horizons.

1. *Decoupling Effect of Distance and Intermediaries for Indirect Investors*

Shareholder accountability procedures have limited applicability to indirect investors, especially citizen shareholders who are invested through defined-contribution plans. Many corporate governance reforms focus on increased shareholder disclosures<sup>85</sup> and enhanced shareholder voting rights, including, for example, increased proxy access and shareholder say on executive compensation.<sup>86</sup> Such reforms, however, largely exclude the inter-

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83. See Gilson & Gordon, *supra* note 1, at 867 (2013) (“[T]he move to reconcentrated ownership in investment intermediaries is a consequence of two factors: first, the political decisions to privatize retirement provisioning . . . and to facilitate advance funding; and second, the intellectual triumph of modern portfolio theory, which promotes diversification as the touchstone investment strategy.”).

84. *Id.*

85. “[I]n an environment in which the investor has not made a conscious investment choice at all, the SEC’s solution is to require more disclosure.” Rodrigues, *supra* note 8, at 1865. Disclosure is discussed in more detail in Sections IV.E and V of this Article.

86. See Choi et al., *supra* note 82, at 650–51 (describing regulatory reforms aimed at increasing shareholder voting power); see also *Federal Stimulus Bill and TARP Mandate Additional Corporate Governance Requirements*, CORPORATE COMPLIANCE INSIGHTS, <http://www.corporatecomplianceinsights.com/corporate-governance-requirements-federal-stimulus-bill-tarp/> (last visited May 7, 2014) (outlining some of the corporate governance mandates for companies receiving government funding from the Troubled Assets Relief Program (TARP)).

ests of indirect owners.<sup>87</sup> The decoupling effect of indirect ownership has “substantial consequences for the debate over shareholder empowerment.”<sup>88</sup>

Little of [corporate law scholarship] considers that the “empowerment” of stockholders does not empower end-user investors so much as it empowers intermediaries . . . [or] the fact that undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand of . . . institutions who have short-term . . . objectives that are at odds with the interests of individual . . . investors.<sup>89</sup>

For example, in response to the financial crisis, Congress enacted Dodd-Frank<sup>90</sup> in 2010, which imposed additional regulatory obligations on all publically traded companies pertaining to proxy access and say-on-pay. In response, the SEC promulgated executive compensation disclosure rules.<sup>91</sup> Only direct owners, like intermediary fund managers and individual direct owners, can exercise the enhanced say-on-pay voting rights, not indirect shareholders.<sup>92</sup>

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87. “While it would be obviously wrong to equate shareholder primacy with shareholder power, there are reasons to believe that pro-shareholder mechanisms such as ‘modern’ executive compensation are often cosmetic and do not actually benefit shareholders all that much.” Gelter, *supra* note 22, at 920; *see also id.* at 969 (“Many shareholder primacists would probably agree that pro-shareholder reforms often remain cosmetic.”). *Cf.* Bebchuk, *supra* note 35, at 1639–1644 (describing the positive returns associated with activist intermediary investments by hedge funds).

88. Fisch, *supra* note 33, at 883–84.

89. Strine, *supra* note 45, at 12; *cf.* Bebchuk, *supra* note 35, at 1667 (criticizing claims of short-termism by Chancellor Strine, Justice Jacobs, and Martin Lipton as unsubstantiated). “Insulation advocates have thus far failed to provide empirical evidence showing that activist interventions are followed in the long term by losses to target companies or their shareholders.” *Id.*

90. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in various sections of 7 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., 22 U.S.C., 31 U.S.C., and 42 U.S.C.).

91. *See Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml> (last modified Oct. 28, 2013) (describing enhanced shareholder disclosures and votes on executive compensation under sections 951-955 of Dodd-Frank). The combined effect of these reforms was to increase corporate disclosures to shareholders and their voting rights with regard to executive compensation and management proxy slates. *See* Fisch, *supra* note 33, at 885–86 (describing increased shareholder voting power as a result of reforms focused on say-on-pay and director nominations). The proxy access rules, proposed by the SEC under Dodd-Frank authority, were challenged by the Business Roundtable and were struck down by the D.C. Court of Appeals on the basis of an inadequate regulatory record. *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1150 (D.C. Cir. 2011) (“The petitioners also maintain, and we agree, the Commission relied upon insufficient empirical data when it concluded that Rule 14a-11 will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees.”).

92. Citizen shareholders, as indirect owners, would neither receive the compensation package disclosures directly nor cast a vote in support or rejection of the pay packages. Direct shareholders (including funds in which citizen shareholders are invested), would exclusively exercise both the information and voting rights on say-on-pay.

Additionally, the rational apathy of citizen shareholders, as indirect owners, makes these corporate reforms symbolic, but ineffective, tools. “[T]he feasibility of improving corporate decision-making through shareholder empowerment depends critically on the actions and incentives of those empowered shareholders.”<sup>93</sup> For all indirect shareholders, including citizen shareholders, the incentives to monitor and participate in corporate governance are so diluted as to be meaningless, exacerbating the widely discussed “rational apathy” of shareholders in public companies.<sup>94</sup>

The monitoring burden increases with indirect owners. To monitor corporate-level actions, an indirect investor must know the companies in which her funds are invested, which she can obtain from the fund’s prospectus and annual disclosures.<sup>95</sup> She must then monitor the operating companies’ disclosures about voting rights and major corporate events. If she has a preference regarding an upcoming vote, corporate event, or policy debate, she must communicate that to the intermediary. Next, she would have to monitor the intermediaries’ disclosures about how it cast its vote or proxy in the operating company’s vote<sup>96</sup> and monitor the operating company’s disclosures to learn of the outcome of the vote. The direct shareholder, on the other hand, personally receives the operating company’s disclosure, along with the proxy solicitation form to be completed, and will also receive information regarding the outcome.<sup>97</sup> Even if the motivations to monitor the actions of operating companies were the same as between direct and indirect shareholders, the participation burden is appreciably increased in terms of time and money for indirect investors.

### B. *Intermediary Representation*

Indirect shareholders, including citizen shareholders, are represented by the intermediary fund in which they invest, such as a mutual fund. The mutual fund, a passive investment company or intermediary, participates in

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93. Fisch, *supra* note 33, at 879.

94. See, e.g., Stephen J. Choi, *A Frame Work for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 45–46 (2004) (describing “collective action” problems with shareholder activism).

95. See, e.g., Form N-Q, 17 C.F.R. §§ 249.332, 274.130 (2014) (SEC form used by registered management investment companies pursuant to requirements to report quarterly schedules of portfolio holdings which the SEC then makes public); U.S. SEC. & EXCH. COMM’N, *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Securities Act Release No. 33-8393. <https://www.sec.gov/rules/final/33-8393.htm> (last visited Mar. 2, 2004) (explaining the SEC’s adoption of the rule and form amendments to improve disclosure).

96. See Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,254, (Mar. 9, 2004) (codified as amended in scattered parts of 17 C.F.R.) (describing the management discussion of fund performance); 17 C.F.R. § 270.30b1-4 (describing the requirement that investment companies disclose proxy voting record for the year).

97. See 17 C.F.R. § 240.14a-101 (2012) (indicating the information that is required in a proxy statement).

governance at the operating company level. Intermediaries vote on behalf of large blocks of capital and should have expertise as well as increased monitoring and participation incentives over indirect shareholders.<sup>98</sup> Intermediary representation of indirect investors has been widely criticized in corporate scholarship as passive and not in alignment with indirect investors' interests.<sup>99</sup> The following is a brief summary of the work of other scholars in this area.

Mutual funds and index funds, as intermediary investment companies,<sup>100</sup> have a reputation of passivity rather than shareholder activism.

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98. See, e.g., Gilson & Gordon, *supra* note 1, at 886 (documenting the dominance of financial intermediaries in control of large blocks of U.S. equity assets); Katharine V. Jackson, *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L.J. 309, 323 (2011) (describing the power of mutual fund managers due to the size of votes they represent); William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1409 (2006) (arguing that the mutual fund "industry's faults can be found in the idiosyncratic structure of mutual funds, a structure that exacerbates the ability of managers to wield substantial power and to use that power to extract rents both overtly and surreptitiously from shareholders.").

[S]ome observers have criticized possible conflicts of interest of mutual fund managers. Arguably, [they] are sometimes inclined to please corporate managers, who are in the position to direct employees' 401(k) wealth to investment companies that do not object to the firm's corporate governance practices. There is some evidence that business ties make mutual funds vote in a more manager-friendly way, but the data are not entirely unambiguous.

Gelter, *supra* note 22, at 960–61.

99. "[I]t would be passing strange if corporate law scholars truly believed that professional money managers would, as a class, be less likely to exploit their agency than the managers of corporations that make products and deliver services." Strine, *supra* note 45, at 11; see also *id.* at 13 ("Instead, the equity holders of public corporations represent a new and powerful form of agency, which presents its own risks to both individual investors and more generally to the best interests of our nation."). Fisch, *supra* note 33, at 882 ("An additional layer of agency costs occurs within the intermediary. Those who make decisions on behalf of the intermediary, such as portfolio managers and investment advisers, may act out of self-interest . . ."). See also Choi, *supra* note 94, at 52 (describing the self-interested motivations of intermediaries' agents who take into account their "own self-interest in making decisions"); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1062 (2009) ("[P]ortfolio managers are entirely rational and opportunistic, they will not maximize returns to their investors if their personal incentives point in a different direction and marketplace discipline is weak."); Gilson & Gordon, *supra* note 1, at 887 (Citing to the low number of institutional investor initiated proxy proposals in the 2007–2009 seasons as evidence of institutional passivity).

100. Hedge funds, on the other hand, are an active version of intermediaries. Bebchuk, *supra* note 35. An example of mutual fund passivity is found in delegated voting decisions to professional proxy voting services like Institutional Shareholder Services (ISS), which empirically vote in favor of the operating company's management recommendations. See also Gilson & Gordon, *supra* note 1, at 887 (citing to low proxy proposals); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1430–31 (2002) (summarizing academic studies concluding that mutual funds are passive investors); Gelter, *supra* note 22, at 961–62; Fisch, *supra* note 33, at 878–79, 881–83 (describing conflicts of interests between investors and intermediaries like mutual funds, low activism to reduce costs and serving employer-sponsor, not individual investor interests). Cf. Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 177 (2001) (discussing shareholder activism and its effects on firm performance); Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 920 (2011) (describing mutual fund opposition to management proposals on corporate gov-

There are two reasons why investment companies with expertise, access to information, and relative voting power would be passive.<sup>101</sup> The first reason is one of free riding. Mutual funds hold “stock in myriad companies” and therefore lack the incentive to expend research costs in determining which votes in which particular companies would most increase value.<sup>102</sup> Spending resources to engage in activism is also less desirable when the fruits of improved corporate governance and performance would be enjoyed by all shareholders, including other competitive funds, not just the stock held by the acting fund.<sup>103</sup> Thus, the free rider problem discourages mutual funds from bearing costs of shareholder activism when they cannot secure the sole benefit for those efforts.<sup>104</sup> Similarly, the hope that other investment companies may incur the costs and take a leadership role is also a powerful disincentive.<sup>105</sup> Not just the fear of others free riding but the hope to free ride on the efforts of other shareholders weighs logically against intermediary activism.

Free riding does not capture the full force of the disincentive, which may be more accurately described as herding or the desire to not be an outlier.<sup>106</sup> In mutual fund markets, performance is primarily relative, not absolute. The goal is to perform better than competitors, which is different from performing the best. Institutional investors often employ similar investment strategies, which erode incentives for activism.<sup>107</sup>

The second reason for passive voting power is closely related to exit rights of retail investors. High liquidity in the form of easily redeemed investments means that investors can flee in the face of poor performance relative to other funds, even if that poor performance is temporary.<sup>108</sup> To the extent that investors monitor, they track relative performance and chase positive past returns.<sup>109</sup> Focusing on short-term returns means that intermediaries will likely exit a poorly performing operating company invest-

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ernance like poison pills, staggered boards and minority elections). INSTITUTIONAL SHAREHOLDER SERVICES, <http://www.issgovernance.com/about> (last visited May 28, 2013).

101. Under the heading of intermediary investors there are the passive mutual and index fund investors as well as active hedge funds. Bebchuk, *supra* note 35, at 1673–76 (discussing empirical support for target’s positive stock price at the forty-day, two-year, and five-year marks).

102. Rodrigues, *supra* note 8, at 1830–31.

103. Gilson & Gordon, *supra* note 1, at 889–90 (describing the unique agency cost as a preference for relative competitive performance not absolute performance).

104. Roberta Romano, *Institutional Shareholders and Corporate Governance in the US*, in *CORPORATE GOVERNANCE IN THE US AND EUROPE: WHERE ARE WE NOW?*, 55 (Geoffrey Owen et al., eds., 2006); *see also* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 270 (2012).

105. Fisch, *supra* note 33, at 879.

106. *See, e.g.*, Russ Wermers, *Mutual Fund Herding and the Impact on Stock Prices*, 54 J. FIN. 581 (1999).

107. Gilson & Gordon, *supra* note 1, at 891–94 (describing activism disincentives in part because of relative performance benchmarks).

108. Rodrigues, *supra* note 8, at 1830–31.

109. Gilson & Gordon, *supra* note 1, at 893.

ment rather than invest time and money resources in active monitoring and participation.<sup>110</sup> Mutual fund managers are thus tied to short-term returns and quarterly statements in order to retain current investors and attract new investors.<sup>111</sup> Because mutual fund managers' performance evaluations and compensation models are also tied to quarterly and annual performance, there is additional incentive for the mutual fund manager to exit the operating company rather than engage in activism.<sup>112</sup>

### C. *Confounding Effects of Citizen Shareholder Status: The Ultimate Outsider*

This Article is not focused on indirect owners in general; rather, the spotlight is on a subset of indirect owners—citizen shareholders. Citizen shareholders' unique investment circumstances insert additional intermediaries into the investment chain, exerting pressure on the representative function of mutual funds as evidenced by not-my-client and time horizon conflicts. Citizen shareholders present a puzzle because the presence and prevalence of these investors fueled shareholder empowerment trends in corporate governance, yet the interests of these same shareholders are easily discarded.

#### 1. *Not My Client: Conflicts of Interest*

As stated, citizen shareholders enter securities markets through self-directed, employer-sponsored, defined-contribution plans and are subject to unique conflicts of interest as a result of additional intermediaries inserted into the investment chain. For example, the employer-sponsor of the defined-contribution plan often acts as the consumer of funds included in a defined-contribution plan. In this position, the employer or plan administrator interacts with the fund and determines whether or not the fund will have

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110. See *id.* (describing incentives for exit over activism); Fisch, *supra* note 33, at 878–79, 881–83 (describing conflicts of interests between investors and intermediaries like mutual funds, low activism to reduce costs, and serving employer-sponsor, not individual, investor interests). See also Rodrigues, *supra* note 8, at 1830–31 (“Mutual fund managers thus feel intense pressure to maximize short-term returns in order to attract and retain investors.”).

111. “[I]nstitutional stockholders assess the performance of the investment managers who control their stock portfolios over a short time frame, typically quarter to quarter or year to year, on the basis of the change in the portfolio’s market value during the specified time period.” Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 206 (1991). See also Jack B. Jacobs, “*Patient Capital*”: *Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1650 (2011) (“[I]nstitutional investors are managed by persons or firms whose compensation depends on generating short-term returns from the portfolio company shares under fund management.”).

112. Jennifer S. Taub, *Able But Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders’ Rights*, 34 J. CORP. L. 843, 867–75 (2009) (describing in detail conflicts of interests between managers and indirect owners); see also Dallas, *supra* note 104, at 272 (describing managers’ tactics to increase compensation, bonuses, and performance evaluations based upon short-term performance which may create detrimental long-term effects within the fund and the invested in companies).



access to the employee participants. From the mutual fund perspective, access to the pool of retirement investors will increase assets under management, a crucial determinant in compensation.<sup>113</sup> As a result, employer-sponsors can be viewed as the *client* of the intermediary mutual fund, rather than the individual participants, and employer-sponsor interests can be prioritized over the interests of the individual participants.<sup>114</sup> For example, poor fund performance is often reacted to at the employer-sponsor level, not the individual citizen shareholder level, meaning that a sponsor will eliminate a fund as an investment option and reallocate participants into the substitute fund.<sup>115</sup>

Another way these conflicts of interests play out is in fee arrangements. A common third-party payment practice, known as revenue sharing, creates the potential for conflicts of interest in selecting funds that are included in the 401(k) plan.<sup>116</sup> Revenue sharing<sup>117</sup> occurs when a portion of fees charged on the mutual fund options are used to fund the administration of the plan and offset the employer-sponsor's administrative costs associated with the plan. Under a revenue sharing arrangement in defined-contribution plans, higher plan fees "reduce or effectively eliminate the plan [employer's] own costs in offering a 401(k) plan . . . ."<sup>118</sup> The extra fees charged to citizen shareholders to offset plan administration by the *client* erode investment returns and impact overall retirement savings and illustrate a serious conflict of interest.<sup>119</sup> Revenue sharing practices add opacity to the fees charged to citizen shareholders, leading them to believe that their costs are lower than may actually be charged or are competitive with retail investors.<sup>120</sup>

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113. *Id.* (describing the potential for compensation to "influence the plan provider's selection of investment alternatives.").

114. "[T]he [mutual fund] industry's true customers are not individual investors, but rather portfolio companies that can decide how to allocate their employee-thrift business." James Cotter et al., *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 9 (2010).

115. "In 2012, 47 percent of plan sponsors indicated that they had replaced a fund in the last year because of poor performance." Collins et al., *supra* note 9, at 11.

116. U.S. GOV'T ACCOUNTABILITY OFFICE, 401(K) PLANS: IMPROVED REGULATION COULD BETTER PROTECT PARTICIPANTS FROM CONFLICTS OF INTEREST 16 (Jan. 2011), available at <http://www.gao.gov/assets/320/315363.pdf>.

117. "Revenue sharing, in the pension plan industry, generally refers to indirect payments made from one service provider, such as the investment fund provider, to another service provider in connection with services provided to the plan, rather than payments made directly by the plan sponsor for plan services." *Id.*

118. Stephen D. Rosenberg, *Retreat from the High Water Mark: Breach of Fiduciary Duty Claims Involving Excessive Fees After Tibble v. Edison International*, 18 J. PENSION BENEFITS 12, 13 (2011).

119. Asset weight-adjusted average 401(k) expense ratios for 2012 were sixty-three basis points compared to the weighted average of all mutual funds was seventy-seven basis points. Collins et al., *supra* note 9, at 11.

120. Fisch, *supra* note 4, at 2005. ("First, the hidden nature of the payments may mislead participants to believe that their investment costs are lower than they actually are.").

Asset weight adjusted average 401(k) expense ratios for 2012 were sixty-three basis points compared to the weighted average of all mutual funds was seventy-seven basis points.<sup>121</sup> These numbers do not tell the complete story. The expense ratio does not reflect the total cost of investment through defined-contribution plans. One study attempted to quantify the all-in fee associated with 401(k) investment and established an average fee of seventy-eight basis points (based on 2009 data).<sup>122</sup> The reported “all-in” fee suggests that there is no savings, but perhaps a cost to investment in the 401(k) format, despite the economies of scale and decreased marketing expenses that should lower fund fees for 401(k) participants.<sup>123</sup> Additionally, all numbers reported reflect the average, which is susceptible to skewing by high or low outliers making the average appear different from the most frequently occurring fees. Finally, that some plans may offer lower average fees does not eliminate the not-my-client conflict. Employers may still choose between two plans, the one that offers the greatest potential for revenue sharing even if the cost of that choice keeps the fees within the averages.

Neither the employer-sponsor nor the fund negotiates with the citizen shareholder, nor do they view the citizen shareholder as the *client*. The securities consumer, the citizen shareholder, is left out of the equation but remains responsible for the cost. Here the addition of the employer-sponsor and plan administration into the investment chain exerts pressure on a traditional check and balance of market transactions and alignment of interests that is unique to citizen shareholders. Fees are discussed in greater detail in Section V(E).

## 2. *Investment-Time-Horizon Conflicts of Interest*

Investment-time-horizon conflicts illustrate a central problem with shareholder accountability procedures, which empower intermediary investment companies. As defined, citizen shareholders use these funds to save for retirement and other long-term goals such as college education savings for children.<sup>124</sup> The investment-time-horizon conflict may be the same for other indirect investors, especially in light of studies where mutual fund

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121. Collins et al., *supra* note 9, at 11.

122. DELOITTE, ICI, INSIDE THE STRUCTURE OF DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE ‘ALL-IN’ FEE 8 (2011), available at [http://www.ici.org/pdf/rpt\\_11\\_dc\\_401k\\_fee\\_study.pdf](http://www.ici.org/pdf/rpt_11_dc_401k_fee_study.pdf).

123. *Id.*

124. Strine, *supra* note 45, at 6 (describing the investment-time-horizon conflict between retirement investors and institutional managers); see also Jacobs, *supra* note 111, at 1662 (“The fundamental problem is that the institutional investor community no longer thinks like the end-user investors that they serve. The end-user investors (i.e., you and I) want our investments to grow for the long-term to fund our children’s college educations and our retirement. But, the institutional investors who manage our retirement plans and other investments are interested mainly in the short-term.”).

investors self-report that they invest, in part, for retirement savings.<sup>125</sup> This Article makes a distinction between optional savings outside of dedicated retirement accounts and retirement savings in self-directed defined-contribution plans with stated objectives of retirement savings and regulations, like withdrawal penalties,<sup>126</sup> that structurally reinforce the long-term time horizon of citizen shareholders. Of course, as an investor nears retirement age, the time horizon appears to shrink. However, upon reaching retirement age, the assets are paid (more accurately, rolled over) from an ERISA-governed plan into a private securities account where the now-retired employee continues to manage the assets through retirement until death.<sup>127</sup> Reaching retirement age is not the end of the time horizon, but marks a change in legal protections attached to the investments.

Despite citizen shareholders' long-term investment interests, many intermediaries utilize easy exit remedies and invest with a short-term time horizon tied to quarterly and annual returns.<sup>128</sup> The following discussion outlines the empirical support for the conclusion that managed funds have short-term investment time horizons, as well as highlights the specific problems this raises for citizen shareholders.<sup>129</sup>

Mutual funds are actively managed investment companies attempting to deliver investment returns above average market returns. Funds try to beat average market returns by identifying and investing in stocks that are

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125. INVESTMENT COMPANY INSTITUTE, *supra* note 51, at 132.

126. Aside from the stated purpose of defined-contribution plans as retirement benefits, assets invested in these plans are subject to early withdrawal penalties if funds are removed before age 59 ½. See IRS, *Topic 424-401(k) Plans*, <http://www.irs.gov/taxtopics/tc424.html> (last visited May 7, 2014).

127. See SEC, *Beginners' Guide to Asset Allocation, Diversification, and Rebalancing*, U.S. SEC. & EXCH. COMM'N (Aug. 2009), <http://www.sec.gov/investor/pubs/assetallocation.htm>; see also Anne M. Tucker, *Retirement Revolution*, *supra* note 15, at 192–94 (describing asset management after retirement); IRS, *supra* note 126 (discussing roll overs for 401(k) accounts).

128. See generally Bebchuk, *supra* note 35 (debunking corporate board isolationist supporters on the theory that short-termism fears are overstated in both their prevalence and effect).

129. Short-termism is described as “taking of actions that result in a short-term gain, but which sacrifice the long-term benefit of the firm to a suboptimal degree.” Rodrigues, *supra* note 8, at 1823. For a brief discussion on the view that institutional investors are activist and long-term investors, see Sharon Hannes, *Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51, 74–75 (2004).

[N]ot only did institutional investors grow in size, they also changed their habits and became active players on the market in the late 1980s. The rise in institutional activism coincided with a change in the investment strategies of institutional investors. Traditionally, institutions expressed dissatisfaction with firm management by taking the “Wall Street Walk” and selling their shares. However, with the increased concentration of equity in institutional hands, this exit strategy became difficult to employ. Consequently, institutions became long-term investors, a position that heightened interest in their monitoring role.

*Id.*; see also Lipton & Rosenblum, *supra* note 111, at 206–07 (“The investment manager trying to outperform the market average in each quarter or each year will always have an incentive to accept even seek, a short-term premium for a portfolio stock.”).

undervalued or appreciating faster than average.<sup>130</sup> They attempt to do this, in part, by monitoring and capitalizing on temporary fluctuations in the market as a whole and in individual stocks to achieve their earnings goals.

Asset managers [i.e., mutual funds] make their money by identifying instances of mispricing. They assume dual risks: the risk that the fundamental value of the asset they purchase may fall before the market eliminates the mispricing (fundamental risk) and the risk that the mispricing may get worse before the market eliminates it at a point when the trade must be liquidated (noise trader risk).<sup>131</sup>

General market and individual stock fluctuations are easier to capture in the short-term, rather than with long-term horizons, for two reasons. First, the opportunity for a fundamental risk and noise trader risk increases with the length of the time horizon.<sup>132</sup> This simply means that, over time, there is a greater likelihood that a bad event will occur (fundamental risk) or that there will be imperfect information and market incomprehension of all risks for a particular asset (noise)—both of which affect asset pricing.<sup>133</sup> Second, a high turnover rate more quickly builds a record of asset management success than does a few long-term trades.<sup>134</sup> The average holding periods for mutual fund shares listed on the New York Stock Exchange (NYSE)

130. Rodrigues, *supra* note 8, at 1830 (“Actively managed mutual funds attempt to beat the market by investing in stocks that appreciate faster than average.”).

131. Dallas, *supra* note 104, at 295. *See also* Lipton & Rosenblum, *supra* note 111, at 208–09 (citing to cognitive psychology literature establishing that stockholders overweigh current information creating an artificial “discount rate for future earnings estimates” and undervaluing long-term investments and assets).

132. Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, 149–50 (1990) (describing fundamental and noise trading risks); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERV. RES. 261, 268 (1989) (describing noise traders as those who trade on information, like consumer confidence and predictions about consumer behaviors rather than estimates based upon the fundamental values of the assets held by the company).

133. If, for example, an asset is underpriced relative to its fundamental value, and a smart investor buys it, he has to bear the risk that before mispricing is eliminated or reduced the fundamental value actually falls. In this case, his . . . trade results in a loss even though it was *ex ante* attractive. In addition to fundamental risk, the smart investor bears the risk that the mispricing gets worse before it is eliminated, called “noise trader risk” . . . Both fundamental and noise trader risk are more important for assets where the elimination of underpricing take longer, since there is more time for bad news or a wave of pessimism to hit. These risks raise the cost of arbitraging long-term assets relative to short-term assets.

Shleifer & Vishny, *supra* note 132, at 149. *See generally* Fischer Black, *Noise*, 41 J. FINANCE, Issue 3, 529–43 (1986) (providing a comprehensive discussion on noise trading).

134. Dallas, *supra* note 104, at 296. Additional evidence of short-term time horizons can be found in increased volume in trading on the stock exchanges, where for example, the average daily share trading volume in the NYSE-listed stock increased 181 percent from 2.1 billion shares to 5.9 billion shares from 2005 to 2009. *Id.* at 296–97 (attributing the rise in trading volume, in part, to the technological platform of trading as well as the decline in per-trade transaction costs thus facilitating short-term trading). *Cf.* Bebchuk, *supra* note 35, at 1661 (discrediting the conclusion of pervasive short-termism as a result of increased trading volumes).

have significantly decreased from a five-year average to a less than one-year average.<sup>135</sup> “At actively managed mutual funds, which constitute the primary investor of American 401(k) retirement funds, the annual turnover is about 100%.”<sup>136</sup> Averages can be skewed by high and low outliers that can pull the mean score in either direction, but, that criticism notwithstanding, a 2010 study by the Investor Responsibility Research Institute found that “nearly two-thirds of portfolio managers have higher annual portfolio turnover than claimed, some by as much as 200 percent.”<sup>137</sup>

The short-term time horizon of intermediary investment companies, like mutual funds, contributes to short-term focus at the operating company level as well because “outside investors and analysts typically rely on current-period earnings when forming their expectations on future earnings.”<sup>138</sup> For example, operating companies with mutual fund investors are more likely to engage in earnings management.<sup>139</sup> Accrual-based earnings management “manipulate[s] reported earnings through discretionary accrual choices that are allowed under Generally Accepted Accounting Principles (GAAP)” and “typically occurs toward the end of an accounting period once most real operating activities are completed.”<sup>140</sup> The Enron and the WorldCom scandals are the most notorious examples of earnings management where companies manipulated accounting and financial statements to hide debt, losses, and poorly performing assets.<sup>141</sup>

Since the passage of the Sarbanes-Oxley Act of 2002,<sup>142</sup> a direct response to the Enron and WorldCom scandals, companies are more likely to engage in real earnings management, which is not solely an accounting

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While insulation advocates point to the increase in the volume of trading over time, this increase might be driven by an increase in high-frequency trading by a minority of investors and not reflect shortened horizons for most institutional investors. Indeed, recent empirical work suggests that the holding duration of institutional investors has been stable over the past quarter of century and, if anything, slightly lengthened over time.

*Id.*

135. James Hawley et al., *supra* note 43, at 5.

136. Jacobs, *supra* note 111, at 1651. *See also* Anabtawi, *supra* note 30, at 579; NYSE, *Report of the New York Stock Exchange Commission on Corporate Governance* 12–13 (2010), available at <http://www.nyse.com/pdfs/CCGReport.pdf>.

137. Hawley et al., *supra* note 43, at 5.

138. Jeong-Bon Kim & Byungcherl Charlie Sohn, *Real Versus Accrual-Based Earnings Management and Implied Cost of Equity Capital* 2 (2012), available at <http://ssrn.com/abstract=1297938>.

139. *See* Dawn A. Mastumoto, *Management's Incentives to Avoid Negative Earnings Surprises*, 77 ACCT. REV. 483, 507 (2002) (finding a relationship between shares held by intermediary investors and earnings management by the company to minimize negative forecasts and boost earnings reports).

140. Kim & Sohn, *supra* note 138, at 2.

141. Matur Rahman et al., *Accounting Scandals and Stock Performance: Life After Enron*, 7 J. BUS. & ECON. RES. 13, 13–22 (2009) (describing the Enron and other accounting scandals using accrual earnings management), available at <http://journals.cluteonline.com/index.php/JBER/article/viewFile/2266/2314>; *see also* Dallas, *supra* note 104, at 278.

142. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 245 (codified as amended in scattered sections of 15 U.S.C., 29 U.S.C., and 18 U.S.C.).

trick to manipulate financial statements, but deals with expense and asset decisions made for the purpose of affecting short-term gains.<sup>143</sup> For example, real earnings management alters “the timing and scale of real activities such as production, sales, investment, and financing activities throughout the accounting period in such a way that a specific earnings target can be met.”<sup>144</sup>

Real earnings management poses a threat to operating companies because, unlike with accrual earnings management, it can directly impact current and future cash flows.<sup>145</sup> Additionally, real earnings management is more difficult to detect and is less strictly monitored by internal auditing committees, regulatory agencies, and analysts.<sup>146</sup>

Intermediary investment companies’ short term time horizons can drive short termism at the operating company level, which intensifies the investment-time-horizon conflict with citizen shareholders. Shareholder empowerment reforms “ignore[ ] the fact that the immediate shareholders of the vast majority of publicly traded corporations have short-term investment horizons” and may exercise their enhanced voting rights with a view towards short-term interests even when doing so on behalf of long-term investors.<sup>147</sup>

#### D. Citizen Shareholders’ Governance Rights Are Inadequate to Neutralize Representation Concerns

Indirect shareholders, including citizen shareholders, have certain corporate governance rights—such as access to information and voting—in the intermediary investment companies in which they invest. Structural differences between the organization of operating companies and the organiza-

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143. Jacobs, *supra* note 111, at 1650 (attributing the compensation arrangement of institutional managers to exerting “significant pressure on corporate managements and boards to deploy corporate assets and develop business strategies that will yield short-term profits, often at the expense of the long-term.”). See also Dallas, *supra* note 104, at 278–81 (comparing earnings management with real earnings management, describing the pervasiveness of the practices, and describing the consequences for long-term investors by linking short-term practices with “significant future negative returns for [short-term] firms”).

144. Kim & Sohn, *supra* note 138, at 2.

145. *Id.* at 3.

146. *Id.* In this study the authors sought to establish the harm of real earnings management relative to accrual earning management by studying the cost of capital. Their study concluded that real earnings management “distorts the role of earnings as an indicator of a firm’s true future cash flows, and thus exacerbates information problems faced by outside investors to a greater extent than does [accrual earnings management].” *Id.*

147. Hawley et al., *supra* note 43, at 5 (“[S]hort termism is being fostered through the adoption of regulatory frameworks that constrain the ability of investors with long-term liabilities to use long-term investment strategies.”); see also Rodrigues, *supra* note 8, at 1823–24, 1829 (“[S]hareholder empowerment cannot solve the problem of managerial myopia if it is only the short-term intermediary (e.g., the mutual fund, the hedge fund, or the pension fund) that is empowered, and not the ultimate holder, who is investing for the long term.”).

tion of investment companies, particularly mutual funds, dilute the effectiveness of these accountability mechanisms.

Investment companies, like mutual funds, are regulated under a similar structure of registration, disclosure, and voting requirements that govern operating companies. Investment companies must register public offerings under the Securities Act of 1933<sup>148</sup> and the ICA.<sup>149</sup> The ICA also requires mutual funds to register with the SEC<sup>150</sup> and “mandates extensive disclosure, and . . . imposes . . . requirements and prohibitions [related to] capital structure, the composition and structure of their boards of directors, the types of transactions in which [mutual funds] can engage . . . and the diversification of their investments among different industries.”<sup>151</sup>

Much of the regulatory framework of investment companies is modeled on the operating company.<sup>152</sup> Perhaps this is unsurprising as investment companies, like mutual funds, appear to be structured similarly to operating companies with centralized control vested in boards of directors,<sup>153</sup> the presence of shareholders, and accountability measures through voting rights.<sup>154</sup> The similarities, however, end with appearances.

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148. Securities Act of 1933, 15 U.S.C. §§ 77, 80a-4 (2011); 17 C.F.R. §§ 270.0-1–270.60a-1 (2012); see also *Investment Company Registration and Regulation Package*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/investment/invcoreg121504.htm> (last visited May 8, 2014).

149. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2012).

150. Mutual funds are regulated under each of the four principal securities laws: the Securities Act of 1933 (the Securities Act), the Securities Exchange Act of 1934 (the Exchange Act), the Investment Advisers Act of 1940 (the Advisers Act), and the Investment Company Act of 1940 (the ‘40 Act). Often described as the most complex of these laws, the ‘40 Act was enacted specifically to regulate mutual funds and other types of investment companies as well as the investment advisers who manage them.

Nagy, *supra* note 72, at 14–15; see also *Investment Company Registration and Regulation Package*, *supra* note 148.

151. Nagy, *supra* note 72, at 15. Registration with the SEC is the “hook for the substantive regulation” of mutual funds. Markham, *supra* note 59, at 77.

152. “U.S. investment company regulation embodies a ‘corporate governance’ regulatory paradigm.” Anita Krug, *supra* note 75, at 266. “Although the economic power of institutional investors has grown enormously, corporate and securities laws continue to focus obsessively on operating companies. This ignores the reality that most Americans invest in funds controlled by institutional investors, rather than in operating companies.” Strine, *supra* note 45, at 29.

153. Corporate boards of directors have statutory authority to control the corporation. See, e.g., *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 729 (Del. 1988). In many corporations, de facto control is exercised by the officers or management of the corporation. See, e.g., Megan Wischmeier Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer’s Duty of Obedience*, 66 BUS. LAW. 27, 28 (2010) (“Wielding considerable power and influence over a corporation’s business and affairs, officers have replaced directors as the individuals occupying the central role in corporate decision making. Senior executive officers, in particular chief executive officers, have dominated corporate affairs, being referred to as ‘the boss’ and ‘monarchs.’”).

154. Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 553 (2009). For a detailed discussion on the evolution of investment companies and the circumstances under which their regulatory frameworks were originally established, see Krug, *supra* note 75, at 269–74; Markham, *supra* note 59, at 69–79.

Regulations focus on the corporate structure of an investment company, even though the company, such as a mutual fund, is often a “shell” that produces no products nor provides any services and has no employees.<sup>155</sup> Investment companies are almost entirely reliant on the investment adviser,<sup>156</sup> yet the governance model is focused on a centralized board of directors where liability, fiduciary duty, and disclosures are focused.<sup>157</sup> The role of the investment advisers and the limited control that a mutual fund board of directors can exert over its advisers warps the power and accountability balances assumed in operating companies and replicated in investment companies.

The following is a discussion of criticisms of the mutual fund board and importance of the governance framework in investment companies as established by previous corporate law scholars. Some scholars discount the empty signal of stewardship in investment company governance and rely instead on the robust exit rights of indirect investors.<sup>158</sup> The empty governance framework is particularly problematic for citizen shareholders, however, who have weakened exit rights and are in many ways locked in the investments offered within their plan.<sup>159</sup> In light of weakened exit rights and locked in capital for citizen shareholders, the criticisms of inadequate governance, as described below, take on heightened importance.

### 1. *Decreased Power of the Mutual Fund Board*

The cornerstone of the investment company governance structure is the independent board of directors<sup>160</sup> heralded to be the watchdog that is

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155. “Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, [called ‘investment advisors’] that are separately owned and operated.” *Burks v. Lasker*, 441 U.S. 471, 480–81 (1979) (internal edits omitted); *see also* Krug, *supra* note 75, at 265.

156. “The professional financial managers (or ‘advisers’) who actually run mutual funds’ day-to-day operations are typically legally distinct from the funds. Funds formally contract with adviser entities for management services, and the adviser entities employ individual portfolio managers.” *Morley & Curtis, supra* note 59, at 92; *see also* Krug, *supra* note 75, at 273 (describing the investment adviser as “not ‘internal’ to the investment company but, rather may be thought of as a third-party service provider, and the terms of the relationship between the company and the adviser are set forth in an investment-advisory contract.”); *Schwartz, supra* note 154, at 553. (“Nearly all of the affairs of the fund are managed by its investment adviser, an outside company with its own group of shareholders who demands profits from the firm’s management activities.”).

157. *See, e.g., Jones v. Harris Associates L.P.*, 559 U.S. 335, 338 (2010) (attaching liability for false disclosures at the mutual fund level, not the investment adviser level).

158. *Morley & Curtis, supra* note 59, at 102–05 (describing the robust exit rights of indirect investors).

159. Employer matching contributions, if offered, are a part of the compensation package so to opt out of defined-contribution plans would leave compensation on the table. Additionally, penalties for early withdrawal impact exit. Finally, the constrained universe of plan investments make “exit” rights for citizen shareholders relatively weak as compared to other indirect investors.

160. If the investment company is a corporation (like Fidelity), it has officers and directors, but if it is organized as a business trust, it is governed by trustees. INVESTMENT COMPANY INSTI-



monitoring investment advisers.<sup>161</sup> The SEC stated in introductory remarks regarding the 2004 director independence rules that:

Fund independent directors play a central role in policing the conflicts of interest that advisers inevitably have with the funds they advise . . . the paramount principle that must prevail, and should animate all decisions directors are called upon to make, is that a fund must be managed on behalf of its investors rather than on behalf of the adviser or other affiliated persons of the fund.<sup>162</sup>

Independence requirements focus on affiliations between the director and the investment company, limiting ownership percentages of her or her immediate family members in the fund and other forms of restricted transactions.<sup>163</sup> This “relational nexus”<sup>164</sup> approach to independence, however, does not preclude an investment company director from also serving as a director for other funds managed by the investment adviser.<sup>165</sup> “Independent directors may become ‘house directors’ serving on the boards of many funds within a fund family, and receive considerable compensation as a result of maintaining friendly relations with a particular investment adviser.”<sup>166</sup>

The aspirational role of the investment company board of directors quickly gives way to the realities of how these boards are created and operate, as was illustrated in the 2011 Supreme Court case of *Janus Capital*

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TUTE, *supra* note 51, at Appendix A. For purposes of this Article, I will use the term board of directors to address the governance structure of investment companies in either situation.

161. Under the ICA, 75 percent of investment company directors must be independent. SEC, *Securities and Exchange Commission 17 C.F.R. Part 270*, U.S. SEC. & EXCH. COMM’N, (July 27, 2004), <http://www.sec.gov/rules/final/ic-26520.htm>; 17 C.F.R. § 270.0-1(a)(7)(i) (2013). The ICA was amended to increase the independence requirement in an effort to promote the “watch dog” function of boards monitoring investment advisers. See A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 748, 750 (2008). See also Jones v. Harris, *supra* note 157, at 1427–28 (2010).

162. U.S. SEC. & EXCH. COMM’N, INVESTMENT COMPANY GOVERNANCE, 17 C.F.R. pt. 270 (2004), available at <http://www.sec.gov/rules/final/ic-26520.htm>.

163. Independence is established by demonstrating that a director is not an affiliated or interested person, meaning that she cannot own more than a 5 percent interest in the investment company, be a family member of a controlling person, be legal counsel, engage in restricted transactions such as loans with the investment company, or have a material business or professional relationship with the investment adviser. 15 U.S.C. §§ 80a-2–3, 80a-19, 80a-20 (2012); see also U.S. SEC. & EXCH. COMM’N, INTERPRETIVE MATTERS CONCERNING INDEPENDENT DIRECTORS OF INVESTMENT COMPANIES, 17 C.F.R. pt. 271 (1999), available at <http://www.sec.gov/rules/interp/ic-24083.htm>.

164. Warburton, *supra* note 161, at 748, 751 (describing the independence test as focusing on the “relational nexus” between the investment company director and the investment company adviser). Additionally, the relationship is fixed at the time that the board member is selected, and does not change by reason of a sustained working relationship between the member and the investment adviser through their work with the fund. *Id.* at 751–52 (describing the initial distance of the independent director as narrowing over time).

165. 15 U.S.C. § 80a-35 (2010).

166. Warburton, *supra* note 161, at 748, 752 (2008).

*Group v. First Derivative Traders*.<sup>167</sup> Even in respecting the formal separation between the fund and the adviser for purposes of fraud liability,<sup>168</sup> the opinion highlighted the functional coordination and symbiotic relationship between fund and adviser.<sup>169</sup> Unlike boards of operating companies, which hire key officers like the CEO,<sup>170</sup> the equation is flipped in investment companies, where the key employee (i.e., the investment adviser) selects the board.<sup>171</sup> The ICA requires directors of mutual funds to be elected when the fund is first formed and this is usually done by the investment adviser who elects the initial directors, often before the shares of the fund are sold publicly.<sup>172</sup> Thereafter, the directors are allowed to “serve indefinitely without reelection and can appoint replacement board members without holding shareholder votes” under many circumstances.<sup>173</sup> In light of this “special relationship” between the investment company’s board of directors and its investment adviser, it is unsurprising that there are few examples where a board has replaced a fund’s adviser.<sup>174</sup> “[A] Mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm’s-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.”<sup>175</sup>

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167. 131 S. Ct. 2296, 2299–300, 180 L. Ed. 2d 166 (2011).

The following arrangements are typical. A separate entity called an investment adviser creates the mutual fund, which may have no employees of its own. The adviser selects the fund’s directors, manages the fund’s investments, and provides other services. Because of the relationship between a mutual fund and its investment adviser, the fund often “cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm’s-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.”

*Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 338 (2010) (internal citations omitted).

168. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 (2011) (holding that JCM, financial adviser, was not liable for false statements included in the prospectuses made by Janus Investment Fund under Rule 10b-5).

169. *Id.* at 2299 (describing the creation of the fund by the parent corporation and the management of the fund by the adviser, noting that all of the officers of the fund were the officers of the adviser but that only one member of the fund’s board was associated with the adviser). *Id.* at 2312 (Breyer, J., dissenting) (“The relationship between Janus Management and the Fund could hardly have been closer. Janus Management’s involvement in preparing and writing the relevant statements could hardly have been greater. And there is a serious suggestion that the board itself knew little or nothing about the falsity of what was said.”).

170. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2012).

171. *Jones*, 559 U.S. at 338; see also Morley & Curtis, *supra* note 59, at 92.

172. Warburton, *supra* note 161, at 748–49, 752 (“[M]ost directors are initially selected by the adviser.”).

173. Morley & Curtis, *supra* note 59, at 94; see Bibb L. Strench, *Board Structure and Processes*, in MUTUAL FUND REGULATION § 14:3 (Clifford Kirsch ed., 2010); see also Investment Company Act of 1940, 15 U.S.C. §§ 80a-16(a) (no terms for unclassified boards).

174. Warburton, *supra* note 161, at 752 n.27 (citing to four instances where an investment company board of directors replaced its investment adviser, including when the Korea Fund replaced its adviser Deutsche Asset Management in 2007, and the Japan Fund replaced Deutsche Asset Management in 2006).

175. *Burks v. Lasker*, 441 U.S. 471, 481 (1979); *Jones*, 559 U.S. at 338 (quoting *Burks*).

Additional structural constraints arise from the board's lack of relative power over investment advisers.<sup>176</sup> In investment companies where the business of the firm is investing, investment policy *is* corporate policy. An investment adviser, not the board, provides essentially all of the operational components of the fund as well as sets and implements its investment strategy.<sup>177</sup> Without the adviser there is no fund function and this reality "imposes a critical limit on a director's ability to act as an effective fiduciary."<sup>178</sup> Because the investment company board is stripped of effective management control over the virtually nonexistent fund employees and has no ability to set corporate policy, it is no longer analogous to an operating company's board of directors, which hires and fires officers and sets corporate policy.<sup>179</sup> Additionally, critics argue that investment company boards have limited resources and are dependent upon the investment adviser for information about the fund, thus stripping them of information and expertise necessary to perform the monitoring function well.<sup>180</sup>

Importing operating company corporate governance solutions to investment intermediaries fails to recognize the structural differences between the two corporate models. The differences in the investment company context erode the board of directors' balancing powers, which impacts citizen shareholders who are relatively locked in as compared to other indirect investors.

## 2. *Weakened Shareholder Voting in Investment Companies Compounds Governance Constraints*

Similarly, the documented weakened role of shareholder voting in investment companies—due to rational apathy and robust exit rights of other indirect investors—impacts citizen shareholders as compared to other in-

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176. Mutual funds are "but a means, or a mechanism, through which the investment adviser provides its services, and . . . is under the adviser's control." Anita Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039, 2061–62 (2013). The investment adviser uses the fund to provide its services to investors in the fund. In order to do so, the adviser often creates the fund, and is "primarily responsible for selecting not only the fund's service providers . . . but also the members of the fund's initial board of directors" and the adviser's employees staff the fund. *Id.* at 2062; see Fisch, *supra* note 4, at 2010–12.

177. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2299 ("Janus Investment Fund has no assets apart from those owned by the investors. JCM provides Janus Investment Fund with investment advisory services, which include "the management and administrative services necessary for the operation of [Janus] Fun[d]. . . ."). See also Schwartz, *supra* note 154, at 556 ("[T]here is no role for the board to play as policy-setter."). Compare with the boards of directors in operating companies that generally provide monitoring and strategic planning expertise. Warburton, *supra* note 161, at 751.

178. Fisch, *supra* note 4, at 2011. See also Krug, *supra* note 75, at 275–79 (describing corporate governance standards as setting a "default legal framework for structuring private relationships" and documenting its failures in the investment company context).

179. See, e.g., Schwartz, *supra* note 154, at 556–57.

180. Warburton, *supra* note 161, at 751 ("If directors do not possess full information or expertise, critics argue that it is not realistic to expect them to strike the best deal for investors.").

vestors. While shareholder voting rights in operating companies are often eroded by the rational apathy of small and diffuse shareholders necessitating the proxy process in order to achieve voting quorums,<sup>181</sup> those constraints are magnified with respect to indirect investors in mutual funds, particularly citizen shareholders. Mutual funds have even lower investor participation rates than operating companies, so management routinely must engage in costly re-solicitation of proxies when required because of insufficient responses to achieve a quorum.<sup>182</sup> As a result, initial advisory contracts and fee charges are approved at the formation of the fund with built in room for discretion and possible fee increases to avoid future shareholder votes.<sup>183</sup> Many mutual funds do not hold regular annual meetings, absent a required vote, which “highlights the insignificance of [mutual fund] shareholder voting rights.”<sup>184</sup> Because few investors participate in mutual fund votes, the votes that do occur are largely controlled by management, who are strongly linked to the advisers.<sup>185</sup>

When is a shareholder vote required in mutual funds? Shareholders must approve significant changes in a fund’s investment objectives.<sup>186</sup> There is an implicit incentive, therefore, for mutual funds to write vague investment objectives with built in discretion for change to avoid future shareholder votes.<sup>187</sup> Additionally, investment objectives shape asset allocation by fund managers. When these policies are intentionally written with ambiguity and discretion to avoid shareholder votes, they undermine the disclosure process and hinder risk assessment.

Additionally, shareholder voting in mutual funds is complicated by exit remedies for retail investors in which redemption value of mutual fund shares make exiting a dominant strategy over voting and other corporate

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181. Schwartz, *supra* note 154, at 558.

182. Morley & Curtis, *supra* note 59, at 115–16.

183. *Id.* at 93 (“In practice, advisers avoid shareholder votes on advisory contracts at the time funds are started by distributing all of a fund’s initial shares to affiliates of the advisers and then holding a vote on the contract before any shares have been sold to the public. The ICA then allows initial contracts and board members’ teams to be extended indefinitely without shareholder votes so long as independent directors vote annually to approve the contracts.”).

184. Fisch, *supra* note 4, at 2014–15.

185. Affiliates of the advisers often select the initial board of director members. Initial directors are often elected in an initial vote when the fund’s shares are distributed to “affiliates of the advisers” who vote “before any shares have been sold to the public” and those directors can serve indefinitely. Morley & Curtis, *supra* note 59, at 93–94. *See also id.* at 118 (“There is very little evidence of [mutual fund] boards challenging fund managers over any significant issue.”). *See also* Knute Salhus & Jeffries Oliver-Li, *SEC Approves Elimination of Broker Discretionary Voting in Uncontested Elections of Directors*, WILMERHALE.COM (July 2, 2009), <http://www.wilmerhale.com/pages/publicationsandNewsDetail.aspx?NewsPubId=93237> (citing to the increased control that will be exercised by institutional investors such as mutual funds as a result of eliminating discretionary broker voting in uncontested investment company election of directors).

186. *See* Investment Company Act of 1940: 15 U.S.C. § 80a-13(a)(1)–(4) for specific changes requiring approval by shareholder vote.

187. Fisch, *supra* note 4, at 2020.

governance remedies (i.e., proxy fights).<sup>188</sup> “Shareholder activism, however, is unheard of in the mutual-fund arena. The shareholders have technical authority over the board members, but in reality, it is the management company that is attuned to their performance.”<sup>189</sup> The corporate governance style of investment company organization and regulation sends “the signal of stewardship to the investing community without actually delivering it.”<sup>190</sup> Indirect shareholders are excluded from the corporate power accountability equation, yet still bear the financial risks of market performance. The implications of weakened voting rights are theoretically neutralized when investors have robust exit rights but remain problematic for relatively locked-in investors such as citizen shareholders.

### *E. Market Forces & Fees*

A central component of my argument that citizen shareholders are distinguishable from other investors is the significance of the number of intermediaries in the investment chain who exert pressure on the governance system and extract fees from citizen shareholders. As discussed above, not-my-client conflicts can increase the fees paid by citizen shareholders as a way to offset employer sponsor costs. The following is a discussion about such investment fees and fee disclosures, first generally and then specifically as to how those investment fees and fee disclosures affect citizen shareholders.

#### *1. Mutual Fund Fee Components*

Investors pay ongoing fees associated with their investment as well as potential one-time event fees (when the assets are purchased, transferred, or sold).<sup>191</sup> The ongoing fees include operating expenses like adviser fees and administrative fees paid out of net assets.<sup>192</sup> Ongoing fees also include 12b-1 fees for distribution and marketing as well as some legal and administrative fees.<sup>193</sup> The ongoing fees are indirectly paid by investors and are reflected in the expense ratio, which is an expression of the overall fees compared to the assets under management.<sup>194</sup> Additional hidden fees may be associated with the fund operations through SEC Rule 28(e) soft dollar

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188. Morley & Curtis, *supra* note 59, at 121–22 (describing the phenomenon in mutual funds as the “selection effect,” where investors who think fund performance is poor will exit rather than vote).

189. Schwartz, *supra* note 154, at 558.

190. *Id.* at 560.

191. See *Mutual Fund Fees and Expenses*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/mffees.htm> (last visited May 8, 2014).

192. *Id.*

193. See, e.g., *12b-1 Fees*, MORNINGSTAR INVESTING GLOSSARY, [http://www.morningstar.com/InvGlossary/Glossary.aspx?term=12b-1\\_fee](http://www.morningstar.com/InvGlossary/Glossary.aspx?term=12b-1_fee) (last visited Feb. 22, 2014).

194. Collins et al., *supra* note 9, at 4.

fees<sup>195</sup> and sub-transfer agent fees, which are charged to funds, but not always reflected in expense ratios.<sup>196</sup> Revenue sharing practices, mentioned above, can include both expenses reflected in expense ratios and those falling outside of the scope.

## 2. *Extended Investment Chain for Citizen Shareholders*

Citizen shareholders' investment through self-directed defined-contribution plans inserts additional intermediaries like the employer-sponsor and the plan administrators into the investment chain, which can add a layer of costs.<sup>197</sup> The typical 401(k) plan requires administrative, participant-focused, and regulatory compliance services.<sup>198</sup> Administrative services include recordkeeping, transaction processing and plan creation, amendments, and termination.<sup>199</sup> Participant-focused services for equity investment include communications, possibly education services, investment management, brokerage window (if offered), and possibly an employer stock fund.<sup>200</sup> Regulatory compliance services include plan document services, consulting, accounting and audit services, legal compliance, plan testing, and processing orders.<sup>201</sup> Fees for these services can be "assessed per plan, per participant, or per dollar invested (asset based fees)."<sup>202</sup> Fees for these services can be paid by participants (either individually or through a fee charged to the plan) or the employer-sponsor.<sup>203</sup> Many of the recordkeeping and administrative fees can be paid through asset based expenses that are subject to revenue sharing practices discussed above.<sup>204</sup>

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195. 15 U.S.C. § 78bb(e) (2010). "Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to use client funds to purchase 'brokerage and research services' for their managed accounts under certain circumstances without breaching their fiduciary duties to clients." U.S. SEC. & EXCH. COMM'N, *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, 17 C.F.R. pt. 241 (2006), available at <https://www.sec.gov/rules/interp/2006/34-54165.pdf>.

196. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 12-328, *Defined Contribution Plans: Approaches in Other Countries Offer Beneficial Strategies in Several Areas* 31 (2012), available at <http://www.gao.gov/assets/590/589541.pdf>.

197. 29 U.S.C. § 1002(21)(A) (2008); *In re Luna*, 406 F.3d 1192, 1201 (10th Cir. 2005).

198. DELOITTE, *supra* note 122. Collins et al., *supra* note 9.

199. Collins et al., *supra* note 9, at 4.

200. *Id.*

201. *Id.*

202. *Id.* at 6.

203. *Id.* at 5 ("The DOL requires that the plan sponsor pay the costs associated with the initial design of the plan, as well as any design changes. Beyond these design services, employers can share the costs of the plan services with their employees. However, many employers voluntarily cover some or all plan related costs that legally could be shouldered by the plan participants. Any costs not paid by the employer, which may include administrative, investment, legal, and compliance costs are effectively paid by plan participants.").

204. "Some or all of [the] recordkeeping or administrative fees also can be paid through a portion of the asset-based investment expenses (e.g., in the form of 12b-1 fees, shareholder servicing fees or administrative servicing fees), which is often referred to as revenue-sharing." DELLOITTE, *supra* note 122, at 6.

Retirement investing through benefit plans positively promotes retirement savings, but also inserts additional intermediaries that exert pressure on the governance framework and extract costs from citizen shareholders.

### 3. *Fee Standards*

A key function that the investment company board could play, but does not, is in negotiating the advisory contracts and the fees awarded to the investment adviser. The investment adviser is in a conflicted position with a duty to serve the fund hiring it and a duty to its own shareholders to increase profits by generating fees to be paid by the fund.<sup>205</sup> The inherent conflict heightens the potential oversight role that the investment company board could exert over the adviser. Investment company boards, however, rarely negotiate advisory contracts—it “happen[s] in only 10% of funds”<sup>206</sup>—creating a “consistent and disturbing story of the failure of fund boards to negotiate lower fees in the face of economies of scale generated by rising fund assets and enhanced computer and telecommunications technologies.”<sup>207</sup>

Fiduciary standards imposed by the ICA<sup>208</sup> prohibit advisers from charging fees “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.”<sup>209</sup> This broad standard effectively puts compensation outside of the review of the court in deference to the scrutiny of the advisers’ fees provided by the independent board, despite clear evidence that such scrutiny often comes in the form of a rubber stamp.<sup>210</sup> As such, adviser fees are not subject to comparisons between different funds, such as a retail mutual fund, and an option in a benefit plan.<sup>211</sup> The Supreme Court in *Harris* cautioned that, “courts should be mindful that the Act does not

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205. Schwartz, *supra* note 154, at 557; Warburton, *supra* note 161, at 748–50.

206. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 190–91 (2006).

207. *Id.* at 189–90; *see also* Schwartz, *supra* note 154, at 559.

208. ERISA imposes duties on fiduciaries such as loyalty, prudence, and obedience. ERISA § 404(a), 29 U.S.C. § 1104(a) (2012).

209. *Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 344 (2010) (*citing* *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982); 15 U.S.C. § 80a-35(b) (describing a breach of fiduciary duty).

210. Under the Act, “scrutiny of investment adviser compensation by a fully informed mutual fund board is the cornerstone of the . . . effort to control conflicts of interest within mutual funds. The Act interposes disinterested directors as ‘independent watchdogs’ of the relationship between a mutual fund and its adviser.” *Jones*, 559 U.S. at 348 (internal citations and quotations omitted). Deference to the board is context dependent and requires a process of board review. *Id.* at 349.

[W]here the board’s process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. When an investment adviser fails to disclose material information to the board, greater scrutiny is justified because the withheld information might have hampered the board’s ability to function as “an independent check upon the management.”

*Id.* at 351–52.

211. *Id.* at 349–50.

necessarily ensure fee parity between mutual funds and institutional clients.”<sup>212</sup>

#### 4. Fee Competition

A discussion of investment company fees is not complete without mentioning existing research critiquing the competitiveness of such fees. Criticisms that the mutual fund market is inefficient point to the wide variety of fees<sup>213</sup> charged for substantially similar services and information asymmetries among securities consumers facilitating the persistence of high fees despite the detrimental impact of returns.<sup>214</sup> “Even within a particular investment objective, fund expense ratios can vary considerably. For example, ten percent of aggressive growth equity funds have expense ratios of eighty-five basis points or less, while ten percent have expense ratios of 219 basis points or more.”<sup>215</sup>

Market competition, especially in light of retail investors’ robust exit rights, should correct inefficiencies and regulate fees, but it does not.<sup>216</sup> The large number of funds in the market and the relatively low barriers to entry should also encourage robust market-based regulation, but do not.<sup>217</sup> One suggested explanation for competition failure is that price competition occurs in fee waivers, and not in the stated fees charged<sup>218</sup> (think of a member

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212. *Id.* at 350.

213. The SEC estimates that mutual fund expense ratios have risen from an average of 1.14% in 1979 to 1.36% in 1999. One study calculates that average expense ratios for U.S. funds increased from 0.96% in 1971 to 1.44% in 1990. Another study claims that expense ratios have, on average, doubled over four decades. Critics note that this escalation in expense ratios has occurred simultaneously with the growth of the fund industry, which should permit large economies of scale and hence declining expense ratios for investors.

Warburton, *supra* note 161, at 753.

214. See, e.g., Lori Walsh, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns* 18 (working paper), available at <http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf> (“Furthermore, these higher expenses do not translate into higher gross returns. Indeed, fund flows may be more volatile and gross returns may be lower for funds with 12b-1 plans. These results highlight the significance of the conflict of interest that 12b-1 plans create. Fund advisers use shareholder money to pay for asset growth from which the adviser is the primary beneficiary through the collection of higher fees.”).

215. INVESTMENT COMPANY INSTITUTE, *supra* note 51. Expense ratios may be expressed in basis points. A basis point is one, one-hundredth of one percent, which is expressed as 0.01%. An expense ratio of eighty-five basis points is 0.85%, and an expense ratio of 219 basis points is 2.19%.

216. See, e.g., Ian Ayres & Quinn Curtis, *Enabling Mutual Fund Arbitrage: Short Redemptions and Improved Performance Guarantees* (working paper), available at <http://islandia.law.yale.edu/ayres/Improved%20Performance%20Guarantee%203-26.pdf>.

217. John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151, 167–70 (2007) (discussing low market barriers in the mutual fund industry).

218. “[F]unds . . . frequently offer to waive some of those fees. One study finds that almost half of money market fund expenses were being waived, and that 37% of equity funds were offering fee waivers. Moreover the study found that these fee waivers changed frequently throughout the year.” Warburton, *supra* note 161, at 755.



of a chain grocery store paying a reduced “member” price over the stated retail price for non-members). Another explanation is that many investors do not actively monitor their investments or the mutual fund market<sup>219</sup> and, as a result, “fail to respond to chronic poor performance by withdrawing their funds, allowing some of the worst performing mutual funds to survive.”<sup>220</sup>

Information asymmetries and financial illiteracy can also account for some of the market inefficiencies.<sup>221</sup> “[Investors] are systematically disadvantaged [because] the costs of obtaining accurate, relevant, intelligible, and *personally usable* information about the risks of alternative investments in financial intermediaries is excessively high . . . in relation to the amounts to be invested.”<sup>222</sup>

In the context of citizen shareholders, consider a 2007 study conducted by the Government Accountability Office (“GAO”) finding that “many employees don’t know how much they pay in fees, and that much of the fee information they get from their employers is ‘piecemeal.’”<sup>223</sup> Perhaps this ignorance is rational, or at least understandable, given the instant diversification of mutual fund investing and that these investors effectively “hire” the mutual fund to manage and monitor performance and fees.<sup>224</sup>

219. “Those who do compete for retail investor money may find themselves with ambiguous incentives. Some segments of the mutual fund industry, for example, compete for funds in channels where sensitivity to performance is less than in other channels.” Langevoort, *supra* note 99, at 1062.

220. Fisch, *supra* note 4, at 1994; *see also* Jonathan B. Berk & Jing Xu, Persistence and Fund Flows of the Worst Performing Mutual Funds 16 (Oct. 2004) (unpublished manuscript), *available at* <http://finance.wharton.upenn.edu/departement/Seminar/2004Fall/MicroFall2004/micro-berk-pa-per2-persist-120204.pdf> (discussing persistence and survival of worst-performing mutual funds).

221. The subject of financial literacy and comprehension is vast and established by many scholars in legal and other fields. The following is a list of sources that may point an interested reader in the right direction for a more in-depth discussion of this rich field. Annamaria Lusardi, *Household Savings Behavior in the United States: The Role of Literacy, Information, and Financial Education Programs*, in POLICYMAKING INSIGHTS FROM BEHAVIORAL ECONOMICS 109, 121 (Christopher L. Foote et al., eds., 2009); MUNNELL & SUNDÉN, *supra* note 67, at 47–49; Molly Mercer, et al., *supra* note 27; Colleen E. Medill, *supra* note 41.

222. Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 15 (1976) (emphasis added).

For example, an elderly retired person about to invest \$200 in a savings account at an unregulated savings and loan association might find that a substantial portion of the investment, as well as a significant amount of time and effort, would be consumed were he to seek and obtain information relevant to the risk presented by the account. An expenditure of money for financial statements might itself be purposeless, if he lacks the sophistication and training necessary to assess such information properly . . . . While the example is extreme, similar market imperfections undoubtedly affect many public suppliers of capital.

*Id.* at 15–16.

223. Kelly K. Spors, *Small 401(k) Plans Often Pay Big Fees*, WALL ST. J., <http://online.wsj.com/article/SB10001424052970204621904574251883387338254.html> (last visited Aug. 2, 2014); Morley & Curtis, *supra* note 59, at 123 (describing fee disclosures as “complicated and difficult for investors to understand as fees are buried and disclosed in multiple locations.”).

224. Langevoort, *supra* note 99, at 1049 (describing how “many investors seek to shift responsibility for the investments to others. This is an opportunity—the core of the full-service broker-

While indirect investors are not as aware of fees as they should be to make rational investment decisions, they are aware of and swayed by a fund's past performance in making their initial investment decision.<sup>225</sup> Although investors pay little attention to a fund's objectives, risk, and costs, they pay great attention to a fund's historical returns.<sup>226</sup> There is evidence of investors' "trend-chasing . . . buying funds with strong recent performance even though there is little reason to suspect the hot hand to continue for more than a brief period of time, at best."<sup>227</sup> Past returns are not a guarantee or even a good predictor of future, positive returns.<sup>228</sup> The fees associated with active management and attempts to consistently beat the market are "widely believed by experts to be a futile practice."<sup>229</sup>

Information asymmetries and high information costs relative to overall investment amount lead investors to inaccurately weigh past fund performance over fees when making investment allocation decisions. Inefficient market criticisms are applicable to all investors. Citizen shareholders, however, are both more locked into this investment form and have fewer tools to exert market pressure as securities consumers. Their investment choices are structurally constrained by the options presented for initial investment allocation and their weakened exit rights potentially diminishing the remedy of competition.

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age business—to use trust-based selling techniques, offering advice that customers sometimes too readily accept.”).

225. See Fisch, *supra* note 4, at 2033–34 (suggesting that past performance data is heavily relied upon by investors because of the structure of disclosures which highlight past performance). See, e.g., Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1270 & n.1 (2004) (noting that mutual fund performance is “largely unpredictable from past relative performance” with the evidence of persistent returns “concentrated in low-liquidity sectors or at shorter horizons”); see also Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors’ Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 651 (2003) (describing the predictive value of past returns as to future performance as being “weak and controversial” noting that it remains “difficult to consistently outperform passively managed index funds.”).

226. Mercer et al., *supra* note 27, at 432.

227. Langevoort, *supra* note 99, at 1034–35.

228. Mercer et al., *supra* note 27, at 430, 433–34 (documenting the reliance of individuals on past performance in making investment allocation decisions and the evidence that dispels a relationship between past high returns and future, positive performance). “Capon, Fitzsimons, and Rice’s survey of households that invest in mutual funds found that a fund’s ‘investment performance track record’ was the most important factor in investors’ choice of funds. Also, a survey sponsored by the Investment Company Institute—the trade association of the mutual fund industry—found that 69 percent of fund investors reviewed a fund’s ‘historical performance’ before investing.” *Id.* at 433. See also Michael Finke & Shaun Pfeiffer, *Performance Gap: The Impact of Broker Advice and Fund Valuation* (working paper, 2011), available at <http://www.academyfinancial.org/wp-content/uploads/2013/10/5B-Finke-Pfeiffer.pdf> (describing recent research confirming the priority investors place on past returns rather than other, more predictive fund features such as fees and costs).

229. Hutcheson, *supra* note 35, at 345.

### 5. *Limitations of Fee Disclosure*

Investors receive fee information through a series of SEC-required disclosures at the time of investment<sup>230</sup> and periodically (quarterly and annually) throughout the life of the investment.<sup>231</sup> Citizen shareholders, because they invest through ERISA-governed plans, receive additional disclosures from the DOL.<sup>232</sup> Investor disclosures are criticized for an inappropriate focus on the fund rather than the investment adviser, failure to reach individuals making investment decisions, lack of comprehension by individuals, and incomplete comparative data as to fund fees.

The first criticism can be summarized as the entity-theory criticism,<sup>233</sup> which challenges disclosures that focus on the mutual fund as a separate entity and ignore the function and control of the investment advisers. As highlighted in *Janus Capital*, the formal distinction that funds *make* required disclosure as a legally distinct entity prevented securities fraud liability against the investment adviser—the very entity that drafted and provided the information contained in the disclosure at issue.<sup>234</sup> Professor Anita Krug leverages the entity-centrism criticism as grounds to encourage security regulators, as well as other regulators, to adopt the reality of how investment companies operate.<sup>235</sup> Focusing disclosures on the investment adviser rather than the mutual fund and acknowledging individual investors in the funds as the clients of investment advisers, rather than the funds that

230. Mutual funds must provide a prospectus containing summary and detailed investment information to investors at the time of purchase. U.S. SEC. & EXCH. COMM'N, *Enhanced Disclosures and New Prospectus Delivery Option For Registered Open-End Management Investment Companies*, 17 C.F.R. pts. 230, 232, 239, 274 (2009), available at <http://www.sec.gov/rules/final/2009/33-8998.pdf>.

231. U.S. SEC. & EXCH. COMM'N, *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, 17 C.F.R. pts. 210, 239, 249, 270, 274 (2004), available at <https://www.sec.gov/rules/final/33-8393.htm>.

232. U.S. DEP'T OF LABOR, *supra* note 73; 29 C.F.R. § 2550.404a-5.

233. In focusing on entities, financial services regulation tends to neglect how interest-entity relationships and activities may further or impede regulatory objective. Instead, it is informed by corporate governance norms, which characteristically have centered on the entity and, in particular, its internal relationships and functions, usually without reference to persons (individuals or other entities) outside the entity.

Krug, *supra* note 176, at 2049.

234. “[The adviser] disseminated the fund prospectuses through its parent company’s Web site. [The adviser’s] employees drafted and reviewed the Fund prospectuses, including language about ‘market timing.’ And [the adviser] may well have kept the trustees in the dark about the true ‘market timing’ facts.” *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2312 (2011) (Breyer, J., dissenting).

235. Krug, *supra* note 176, at 2048.

This tendency may be discerned, for example, in the doctrine that deems a hedge fund or other private fund (and not its investors), as the client of the fund’s investment adviser and in the mutual fund regulatory regime, which aims regulation at the fund rather than its investment adviser, even though the former is but an instrument for the latter’s providing of its services.

*Id.* at 2093.

sell the pooled investments, are two examples of reforms born of this critique.<sup>236</sup>

Second, disclosures are subject to effectiveness and comprehension critiques. Investment company disclosures suffer from the competing noise resulting from the inundation of technical, financial disclosures.<sup>237</sup> For example, the mutual fund prospectuses required under the SEC regulations and which are available to all investors “have been universally criticized because they are ‘long and complicated’ and ‘often prove difficult for investors to use efficiently in comparing their many choices.’”<sup>238</sup> A litany of criticisms deride the efficiency of such disclosures as they relate to individual investors’ decisions. Such criticisms include assertions that “ordinary investors likely pay little attention to or are overwhelmed by the minutia currently presented, and expert analysis of these disclosures, even if it exists, does not seem to be engendering competition.”<sup>239</sup> Investors “face the daunting task of interpreting the information, determining its credibility, and collectively pursuing their shareholder rights.”<sup>240</sup>

The SEC and the DOL have not been unresponsive to disclosure concerns. For example, the SEC in November 2007, proposed a layered approach to disclosures to include a summary section of “key information” in plain English at the beginning of the prospectus.<sup>241</sup> Additionally, new DOL regulations regarding citizen-shareholder-specific disclosures attempted to enhance clarity of fee structures for funds included in employer-sponsored

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236. *Id.* at 2058–59. To better serve the securities regulation goal of investor protection and market integrity, regulations should focus on the end-user investors (like citizen shareholders) as the clients and the ultimate bearers of risk, as well as the actors (investment advisers as actors not the funds). *Id.* at 2044.

237. Rodrigues, *supra* note 8, at 1853–55 (describing disclosures as failures because additional disclosures are “noisy” and “easy for investors to ignore” and offering little by the way of tangible result).

238. Black, *supra* note 77, at 325.

239. Schwartz, *supra* note 154, at 568.

240. Choi, *supra* note 94, at 46.

241. Black, *supra* note 77, at 327. The SEC also issued new Investment Company advertising rules that require sales materials to contain information not always found in the prospectus, such as disclosures regarding “investment objectives, risks and fees, and to present explanatory information” prominently as well as include the most recent month-end performance data. U.S. SEC. & EXCH. COMM’N, *Amendments to Investment Company Advertising Rules*, 17 C.F.R. pts. 230, 239, 270, 274 (2003), available at <http://www.sec.gov/rules/final/33-8294.htm>; see also FIN. INDUS. REG. AUTH., *SEC Amends Investment Company Advertising Rules*, (Jan. 8, 2004), available at <http://www.finra.org/Industry/Regulation/Guidance/MemberAlerts/2004/p002756>.

The SEC focused on target date funds because of the decline of defined-benefit pensions and the growth of the defined-contribution society where “Americans are increasingly responsible for constructing and managing their own retirement portfolios”; a task that can be “challenging” and require “significant knowledge and commitment of time.” U.S. SEC. & EXCH. COMM’N, *Investment Company Advertising: Target Date Retirement Fund Names and Marketing*, 17 C.F.R. pts. 230, 270 (2010), available at <http://www.sec.gov/rules/proposed/2010/33-9126.pdf>.

plans.<sup>242</sup> The DOL rules address two categories of disclosures: (1) plan related information and (2) investment information.

New regulations regarding plan related information require fiduciaries to provide participants with (a) general plan information including investment options within the plan and whether participants can select investments outside of the plan through a brokerage window,<sup>243</sup> (b) information regarding administrative fees and expenses which are charged or deducted from participant accounts, and (c) information regarding individual expenses or fees for account actions such as load fees for allocation decisions.<sup>244</sup> In addition, fiduciaries must provide participants with at least quarterly statements “showing the dollar amount of the plan-related fees and expenses (whether ‘administrative’ or ‘individual’) actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made.”<sup>245</sup>

The investment data to be provided is a subset of plan information because it requires fiduciaries to disclose information regarding plan options including (a) historical performance data of one-, five-, and ten-year returns or fixed rates of return,<sup>246</sup> and (b) benchmark data for non-fixed return rate options including historical returns of the market over one-, five- and ten-year periods. Participants are also entitled to receive information regarding the total annual operating expenses, “expressed as both a percentage of assets and as a dollar amount for each \$1,000 invested” and information regarding restrictions on additional purchase or withdraw decisions.<sup>247</sup> In addition, participant disclosures must include a website address with additional investment information and a glossary of investment-related terms to facilitate participant comprehension of disclosed information.<sup>248</sup>

Opaque fee components, loose standards for maximum fees, decreased competition, and obstacles to comprehension create a flawed disclosure sys-

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242. The final rule also provides that when a plan allocates investment responsibilities to participants or beneficiaries, the plan administrator must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan and the plan’s investment options, including fee and expense information, to make informed decisions with regard to the management of their individual accounts.

U.S. DEP’T OF LABOR, *supra* note 73; 29 C.F.R. § 2550.404a-5 (2010).

243. “Your employer can simply add something called a self-directed option, also known as a brokerage or mutual fund window. At that point, your 401(k) or similar account becomes like a regular brokerage account, where you can buy any mutual or exchange-traded fund (and in some cases, any individual stock) you want.” Ron Lieber, *Seeking Investment Flexibility In a 401(k)*, N.Y. TIMES, (July 8, 2011), [http://www.nytimes.com/2011/07/09/your-money/401ks-and-similar-plans/a-401k-window-to-more-investing-choices-yourmoney.html?\\_moc.semityn.www=&page\\_wanted=print](http://www.nytimes.com/2011/07/09/your-money/401ks-and-similar-plans/a-401k-window-to-more-investing-choices-yourmoney.html?_moc.semityn.www=&page_wanted=print).

244. U.S. DEP’T OF LABOR, *supra* note 73, at 2–3; 29 C.F.R. § 2550.404a-5 (2010).

245. U.S. DEP’T OF LABOR, *supra* note 73, at 2; 29 C.F.R. § 2550.404a-5 (2010).

246. Investment options with fixed rates of return include bonds, CDs, and certain annuities.

247. U.S. DEP’T OF LABOR, *supra* note 73, at 2–3; 29 C.F.R. § 2550.404a-5 (2010).

248. U.S. DEP’T OF LABOR, *supra* note 73, at 3; 29 C.F.R. § 2550.404a-5 (2010).

tem for indirect investors that is especially acute for citizen shareholders who are more locked into their investments.

## V. CITIZEN SHAREHOLDERS: A WAY FORWARD

In this Article I developed the citizen shareholder identity as distinct from other investors on the grounds of choice, exit, and number of intermediaries inserted into the investment chain. I argued that these differences impact citizen shareholders in several ways, focusing primarily on relatively weakened exit rights, unique conflicts of interest, exacerbated mutual fund governance critiques, additional expense charges, and increased opacity of fees.

The defined-contribution society inextricably links individual and social financial security with the success of private securities markets. It is of vital importance that this great experiment succeed. The following discussion highlights two possible paths (out of a set of solutions that are limited only by creativity)<sup>249</sup> to begin addressing some of the criticisms raised in this Article and to promote the success of our defined-contribution society.

### A. *A Theoretical Approach to Incorporating Citizen Shareholders' Interests*

The theoretical approach requires a conceptual shift in thinking and the adoption of new corporate language responsive to the growing and evolving reality of how many investors enter the market and why. The theoretical approach asks that corporate law—its academics, its regulators, and its practitioners—first acknowledge the existence of the citizen shareholder under the larger heading of “shareholder.” In adopting a nuanced and complex view of corporate actors and governance structures, we should have language to describe this group of investors with their unique constraints in how they enter and invest in the markets. Recognizing citizen shareholders’ identity and structural constraints will likely challenge dominant corporate theories regarding assumption of risk, ameliorating exit remedies, and investment theory.<sup>250</sup>

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249. Additional reforms could focus on stricter regulations of employer-sponsors or the plan service providers, caps set on fees, greater standardization of investment options included in defined-contribution plans, enhanced reporting of fees, limitations with regard to revenue sharing, enhanced voting, and information rights extended to indirect shareholder.

250. See U.S. SEC. & EXCH. COMM’N, *Determine Your Risk Tolerance*, <http://www.sec.gov/investor/pubs/roadmap/risk.htm#Risk> (last visited May 8, 2014) (“But what about risk? All investments involve taking on risk. It’s important that you go into any investment in stocks, bonds or mutual funds with a full understanding that you could lose some or all of your money in any one investment.”). See also Morley & Curtis, *supra* note 59, at 102–05 (describing exit as a dominant mutual fund investor strategy despite the presence of switching costs such as load fees and potential tax consequences); Hawley et al., *supra* note 43, at 5 (discussing challenges to modern portfolio theory based upon known investor herding behavior and information asymmetries).

While investors as a group have diverse interests in ownership, the commonalities of citizen shareholders allow us to make assumptions based on how they enter the securities market. For example, citizen shareholders can be presumed to have a long-term investment time horizon. Additionally, citizen shareholders are predominantly invested in mutual and index funds and are, thus, indirect shareholders. Market analysis reveals that the major mutual and index funds included in employer-sponsored, self-directed defined-contribution plans are invested in many of the same top companies.<sup>251</sup> What citizen shareholders own is not a small interest in a direct company, or even the mutual fund; rather they own a stake in the performance of the market as a whole. For example, the 2008 stock market crash had disastrous effects on individuals' retirement savings (and confidence in the defined-contribution system), but retirement portfolios generally rebounded with the bull market of early 2013.<sup>252</sup> An interest in market performance is consistent with common mutual fund portfolios as well. Approximately 75 percent of a typical investment company's portfolio returns come from average market performance rather than equity holdings unique to a particular fund.<sup>253</sup>

The exposure to systemic risk for individual and institutional investors lends support to the notion of an identifiable interest in long-term investment strategies that advocate sustainable health and growth of the markets for this group of shareholders.<sup>254</sup> The universal investor theory, first articulated by Professors Hawley and Williams, acknowledges that many institutional investors own an interest in the economy as a whole and that their "long-term return is determined not merely by the performance of each individual firm it owns, but by the performance of the economy as a whole."<sup>255</sup> Establishing the citizen shareholder as a unique corporate actor

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251. Tucker, *The Citizen Shareholder*, *supra* note 15, at 1334–40 (describing the interconnectedness of top mutual funds and public companies in which they invest).

252. See, e.g., Chris Farrell, *Record Stock Market and Your Retirement Portfolio*, FORBES.COM, (Mar. 8, 2013), <http://www.forbes.com/sites/nextavenue/2013/03/08/record-stock-market-and-your-retirement-portfolio/>.

253. In general (after controlling for interaction effects), about three-quarters of a typical fund's variation in time-series returns comes from general market movement, with the remaining portion split roughly evenly between the specific asset allocation and active management. In a year like 2008, almost all funds are down, whereas in a year like 2009, almost all funds are up, despite their specific asset allocation or active management activities. Roger G. Ibbotson, *The Importance of Asset Allocation*, 66 FIN. ANALYSIS J. 18, 20 (2010), available at <http://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/ImportanceOfAssetAllocation.pdf>.

254. "The recent financial crisis illustrates this phenomenon, which produced an unexpected global correlation of risks that lopped \$5.4 trillion (20%) off global pension assets in 2008 alone, accelerated the closure of defined benefit (DB) pension plans, and ravaged retirement security for millions of plan participants." Hawley et al., *supra* note 43, at 5.

255. HAWLEY & WILLIAMS, *supra* note 1, at xv–29. "The universal owner's concern with the overall economic performance is the recognition that it 'owns' the economy (typically, a highly representative sample of the economy) and, therefore, bears the cost of any shortfall in economic efficiency and reaps the rewards of any improvement." *Id.* at 21. See also ROBERT A. G. MONS

with an identifiable interest in long-term investment and preference for mutual or index funds lends modern support to the notion of the universal investor. Our national retirement system is leveraged, in significant part, on the success of private securities markets *as a whole*. The theoretical approach advanced here would recognize citizen shareholders and encourage corporations—at both the operating and the investment company levels—to recognize long-term sustainability as a goal of corporate performance.

Additionally, incorporating the citizen shareholder identity into the corporate governance and securities frameworks facilitates careful examination of how the system works for this group of investors and identifies weaknesses, inequities, and disproportionate consequences. Only after thorough inquiry, examination, and debate, can robust solutions be identified and tested. For example, recognizing citizen shareholders as relatively disadvantaged indirect owners lends support for existing calls to reform the investment company governance structure made by Professors Jill Fisch,<sup>256</sup> William Birdthistle,<sup>257</sup> and Anita Krug.<sup>258</sup>

For example, employing the citizen shareholder lens focuses critiques on fee disclosures and suggests that they should be designed with the structural constraints and information asymmetries of citizen shareholders in mind. Doing so could promote greater fee competition and market efficiency, discourage conflicts of interests that add extra costs, and encourage better investment practices. The following discussion explores disclosure criticisms and reforms with special attention paid to the unique position of citizen shareholders.

### *B. A Practical Approach: Focusing on Fees*

My regulatory suggestion focuses where citizen shareholders have the most incentives to participate—in their investment decisions made at the plan level. Better, not more, disclosure could facilitate improved investment decisions by citizen shareholders and promote greater competition in the mutual and index fund markets by making the focus of disclosures investor comprehension, rather than employer-sponsor liability avoidance.

Facilitating better choices and comprehension by citizen shareholders of their investment options and the consequences of their choices is imperative to encourage competitive mutual fund markets as well as to securing sufficient individual and social retirement savings. The revised DOL dislo-

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AND NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE IN THE 21ST CENTURY 121 (1996); Stout, *supra* note 8, at 89–90 (2012).

256. See, e.g., Fisch, *supra* note 4; Fisch, *supra* note 33, at 878.

257. See, e.g., William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 69–70 (2010); Birdthistle, *supra* note 4, at 785–86; Birdthistle, *supra* note 98.

258. See, e.g., Krug, *supra* note 75, at 305–18 (discussing a financial services approach to investment companies as an alternative).



asures described in Section IV(E) are a step in the right direction; however, they do not cure the underlying criticisms of the disclosure-based regime, which assumes that the disclosed information is relevant to and understandable by the recipients. Two criticisms remain: (1) incompleteness of information disclosed (and its form) and (2) comprehension.

The information transparency and comprehension problems (collectively referred to as information asymmetries) are aggravated with citizen shareholders, as compared to indirect investors, for three reasons. First, employer sponsors (or a third-party investment adviser) select investment options limiting choice. While there is some obligation to maintain reasonable fees under ERISA, that duty is easily satisfied if the fees are comparable to market fees, even though the mutual fund market is arguably inefficient in the fee arena.<sup>259</sup> Second, revenue sharing practices allow investors in defined-contribution plans to be charged additional fees as a means to offset the administrative costs otherwise charged to the employer-sponsor to oversee the plan. Citizen shareholders face conflict of interest problems both at the investor adviser level and at the employer-sponsor level. Third, the self-directed aspect of defined-contribution plans eliminates most fiduciary duty liability for employer-sponsors. Additionally, investment advisers and investment companies that comprise the menu options within an employer's plan are usually structured so that they are not fiduciaries under ERISA and, thus, owe no fiduciary duties to citizen shareholders.<sup>260</sup>

As to the first criticism (incompleteness), certain mutual fund fees remain hidden from disclosure. Hidden fees include "expense ratios and a second category of transaction costs such as commissions between fund managers and brokerage firms, soft dollar expenses, variable annuity charges, pass through fees associated with administrators or auditors, and retail versions of institutional funds."<sup>261</sup> Additionally, the DOL's revised fee regulations do not show citizen shareholders the impact that fees have on their individual accounts over time but instead include "generic language" about the impact fees have on investment returns over time.<sup>262</sup> Moreover, the fee disclosures provided to citizen shareholders do not in-

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259. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A)(ii) (2006).

260. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 116.

261. Hutcheson, *supra* note 35, at 356.

[T]he expense "ratio is somewhat misleading because it leaves out costs incurred by the fund when it buys and sells securities on the fund's behalf. These transaction costs include, among other things, brokerage commissions, which are separately reported on the SAI, and the presence of bid-ask spreads, which go unreported. Excluding these figures causes the expense ratio to understate—at times fairly significantly—the actual costs incurred by investors."

Schwartz, *supra* note 154, at 547; *see also* Fisch, *supra* note 4, at 2017–18 ("The use of soft dollars also masks a fund's true operating expenses.")

262. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 196, at 29–30.

In their current form, Labor's fee disclosure improvements will not actually show U.S. participants the effect of fees on their accounts over time. Instead, Labor's recently issued regulations will require that participant disclosures include generic language on

clude a “cumulative cost” estimate of fees and do not state all fees charged to their accounts. For example, fund management fees are not to be included in quarterly statements, although estimates on a hypothetical account balance are included in annual disclosures.<sup>263</sup>

To calculate the total amount of fees paid, a citizen shareholder must save quarterly statements for a year to aggregate the service expenses reported quarterly charged to her account.<sup>264</sup> In addition, she must review the annual statement to identify the total operating expenses for the year, which is expressed as a percentage and illustrated as a cost per \$1,000 invested.<sup>265</sup> The dollar amount reported in the statement must be multiplied until it reflects the amount of assets actually invested in the plan (i.e., multiply by 25 if \$25,000 is invested, multiply by 50 if \$50,000 is invested). That total, added to the reported expenses disclosed quarterly, would represent the approximate fees charged for the year. As currently structured, the fee information is disclosed but is done in a way that is piecemeal; citizen shareholders remain responsible to compile, compute, compare, and comprehend financial disclosures, including fees.

Disclosures, as required by both the SEC and the DOL, should be regulated and drafted with the goal of informing investment consumers to make knowledgeable decisions, not for the primary purpose of avoiding plan litigation. Transparency and comprehension of disclosures by citizen shareholders are particularly relevant with regard to fee disclosures and compilations where gatekeepers—mutual fund boards of directors, the markets, and employer-sponsors—have proven to be ineffective in monitoring and imposing fee constraints. Recall that a primary purpose of securities regulation is to protect investors from opportunistic behaviors within the securities markets that take advantage of information asymmetries.<sup>266</sup> Additionally, if citizen shareholders are relatively locked into their plan investments, complete disclosures will inform them about the risks they have assumed, whether voluntarily or not.

While not a complete solution, enhancing transparency and comprehension of fees is a foundational element in encouraging market competition and counterbalancing the potential conflicting interests of employer-

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the long-term impact of fees and expenses, including that the cumulative effect of fees and expenses can reduce the growth of a participant’s account.

*Id.*

263. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 196, at 30.

264. U.S. DEP’T OF LABOR, *supra* note 73, at 3; 29 C.F.R. § 2550.404a-5 (2010).

265. U.S. DEP’T OF LABOR, *supra* note 73, at 2–3; 29 C.F.R. § 2550.404a-5 (2010).

266. Securities regulations exist to ensure that investors are adequately protected from potential opportunistic behavior by securities market counterparties, whether they be issuers or broker-dealers or other market participants. . . . In other words, the purpose of securities regulation is to correct a perceived market failure: investors, in policymakers’ perceptions, are not capable of fully protecting their interests given the natural information disparities between investors and those who would be the target of or intermediary for their investment capital.

Krug, *supra* note 75, at 274–75. See also Licht, *supra* note 75, at 104.

sponsors and other plan servicers like investment advisers. The following suggestions are based, in part, on examples of more complete and comparative disclosures found in other countries with robust defined-contribution pension systems such as Chile, the United Kingdom, Australia, and Sweden.<sup>267</sup> Because fund fees impact retirement returns, but are difficult for individual investors to identify, understand, and compare, disclosures should be (1) standardized, (2) individualized, and (3) comparative.

Citizen shareholders should receive fee information both at the time of investment and in annual statements, written in plain language that is standardized so that fees are reported in similar ways for similar investment vehicles in all employer-sponsored plans.<sup>268</sup> As employees move from one job to the next, the information would be presented in familiar formats reducing information costs for the consumer. Consistent presentation of information would familiarize participants with the disclosures, facilitate investor education that is not idiosyncratic to individual employers, and streamline disclosure formats for employers.

Fee disclosures should be complete and descriptive of the total fees paid by each participant.<sup>269</sup> Other countries provide this level of information to defined-contribution participants in what is called individualized disclosures.<sup>270</sup> Individualized disclosures to citizen shareholders should provide information as to what each investor pays in total administrative and management fees, expressed as a single dollar amount relative to the individual account. Individualized disclosures should not allow for soft dollar exclusions and should include transactional and operational costs incurred on the account.<sup>271</sup>

Finally, disclosures should facilitate comparisons not only of return rates,<sup>272</sup> but also of fees. The comparisons should include the funds and investment options selected by the participant, a benchmark or industry average for that type of asset class, as well as the fees charged by other investment options within the employer's plan. Comparative disclosures would enhance investors' ability to assess and compare fees and would help investors understand the importance and impact of fees on fund returns.<sup>273</sup> "Ac-

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267. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 196, at 22–41.

268. *Id.* at 23–24. Australian "regulations have enhanced and streamlined the fee disclosures that participants receive and provide greater certainty and consistency by defining the fees and costs that were included in a standardized fees and costs template. Officials noted that these improved disclosures have increased the transparency and comparability of data and felt that participants were more aware of cost issues with respect to their [defined-contribution] plans." *Id.* at 24.

269. *Id.* at 30.

270. *Id.* at 23–29 (describing individualized statements provided to investors in Sweden, Chile, and Australia).

271. *Id.*

272. U.S. DEP'T OF LABOR, *supra* note 73, at 2–3; 29 C.F.R. § 2550.404a-5 (2010).

273. The "literature readily explains why investors rely so heavily on performance data—fund disclosures tell them to. The funds' mandated disclosure documents and marketing materials present performance as the single most important fund characteristic." Fisch, *supra* note 4, at 2033.

cess to clear comparative information makes it easier for investors to determine whether the fund they are considering is an expensive one, a necessary precondition if investors are to choose less expensive alternatives.”<sup>274</sup> With citizens shareholders who allocate their savings to be invested among a limited range of investments included in an employer’s defined-contribution plan, comparative and complete disclosures would be relatively simple to generate among the limited investment menu within each plan, regulate, and distribute to participants using existing channels of investor communication.

Focusing disclosure requirements and structure on comprehension by distributing complete, individualized, and comparative information would enhance citizen shareholders’ ability to allocate their investments in a way that could promote competition and exert market pressure on employer sponsors and mutual fund managers to help keep fees low.

## VI. CONCLUSION

The retirement revolution from defined-benefit to defined-contribution plans created citizen shareholders. The shifting risks that followed have been described as a “vast experiment to see how Americans fare in a world in which retirement planning is an individual responsibility and in which families bear the resulting risks on their own . . . [with] dire side effects.”<sup>275</sup> These challenges have grave potential to impact the financial stability of our society, as well the ability to affect the level of comfort with which an individual retires.<sup>276</sup>

In this Article, I discussed the ways in which citizen shareholders—investors who enter the securities market primarily through employer sponsored, self-directed defined-contribution plans—are distinguishable from other investors (both direct and indirect). Investing through a retirement benefit plan positively promotes retirement savings. But that benefit is not without its costs. It also imposes structural constraints on citizen shareholders in terms of choice, exit, and number of intermediaries inserted into the investment chain. These differences exert pressure on governance accountability mechanisms (most notably in the form of exit and conflicts of interest) and extract additional fees. My observations should not be read as a veiled call to end defined-contribution plans. My intent is to fully examine the consequences—both intended and unintended—of the defined-contribution society where the dominant form of retirement savings in this country funnels investors into the securities markets.

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274. Schwartz, *supra* note 154, at 570.

275. JACOB S. HACKER, *THE GREAT RISK SHIFT: THE ASSAULT ON AMERICAN JOBS, FAMILIES, HEALTH CARE, AND RETIREMENT AND HOW YOU CAN FIGHT BACK* 125 (2006).

276. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 116, at 4; *see also* Schultz, *supra* note 18; Ghilarducci, *supra* note 18.

Citizen shareholders are the fastest growing group of investors, and yet they remain invisible, largely silent, and distanced from traditional corporate governance debates. Their capital fuels the markets, but their voices have few entry points, and the unique constraints of their investment are largely ignored. Adopting a nuanced view of shareholders that incorporates the citizen shareholder identity can add context and clarity to both governance debates and calls for regulatory reform.