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## REFORMING PENSIONS WHILE RETAINING SHAREHOLDER VOICE

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### ABSTRACT

*Public pension and labor union funds have been the driving force in diversified shareholder activism. They have also fended off attacks on jobs and proactively created jobs for fund contributors. These funds currently represent almost \$4 trillion in assets over which workers have substantial control. That worker control—and the collective nature of defined benefit pension plans—is the necessary precondition for their shareholder activism. Both worker control and collective investment are directly threatened by the rise of defined contribution funds, particularly by well-funded efforts to promote the 401(k) in the public sector, the last bastion of the traditional pension plan (unlike traditional pensions, defined contribution funds do not guarantee fixed payments to retirees). Due to a purported nationwide underfunding crisis for public pensions in particular—a crisis whose scale, scope, and even existence is contested by economists and actuaries—many states and cities have wholly or partly abandoned, or are contemplating abandoning, collectively managed defined benefit pension plans in favor of 401(k) plans that are outsourced to existing private mutual funds. Far more than legal reforms, like changing shareholder voting thresholds or the prospect of mandatory arbitration provisions, these reforms pose an existential threat to the ability of workers to wield the collective shareholder voice they now wield via defined benefit pension plans.*

*This Article does not concede that traditional pensions should be reformed out of existence. There are excellent reasons to defend them, and excellent reasons to attack defined contribution funds. That said, to the extent that traditional pensions continue to be reformed out of existence, this Article illustrates that there are defined contribution alternatives to the 401(k) that would still preserve collective shareholder voice. This Article sketches out examples of defined contribution funds that could restore shareholder voice which the transition from defined benefit to 401(k) plans has stripped away, and could preserve that voice in jurisdictions that have not yet taken action.*

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## INTRODUCTION

Pension reform is on the agenda of state legislatures and city councils across the country. The issue is the sustainability of defined benefit pension funds.<sup>1</sup> Long the gold standard for retirement in the United States, the defined benefit pension fund guarantees workers fixed payments in retirement, the size such payments are usually determined by job title and length of service.<sup>2</sup> Such pension plans have largely disappeared in the private sector, but they have survived in the public sector as the dominant form of retirement plan for state and local government employees.<sup>3</sup> Since the financial crisis a decade ago, these traditional pensions have come under withering attack as pension liabilities began to exceed pension assets, quite sharply in some jurisdictions.<sup>4</sup> The dominant proposed cure for purported underfunding is to convert defined benefit pension funds into defined contribution funds like the 401(k), replicating the reform pattern that occurred in the private sector in the 1980s and 1990s.<sup>5</sup> Defined contribution plans, like 401(k) plans, set aside contributions for workers but do not guarantee workers fixed payments, shifting the ultimate retirement burden onto workers. 401(k) advocates argue that this reduces the cost burden for state and local governments, though this point is hotly contested by 401(k) critics.<sup>6</sup>

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<sup>1</sup> Matthew Cochrane, *Is My Pension Safe?*, MOTLEY FOOL (May 28, 2018, 9:04 AM), <https://www.fool.com/investing/2018/05/28/is-my-pension-safe.aspx> [<https://perma.cc/UJX7-W8ZE>] (describing increasing concern over whether employee pensions are “safe” and explaining how to determine whether pension funds are sustainable).

<sup>2</sup> See DAVID WEBBER, *THE RISE OF THE WORKING-CLASS SHAREHOLDER* 214-15 (2018) (first citing Nat’l Endowment for Fin. Educ., *Explore Your Retirement Decisions*, MY RETIREMENT PAYCHECK, <https://www.myretirementpaycheck.org/> [<https://perma.cc/98HU-V9Y5>] (last visited Apr. 3, 2019); then citing *Which Is Better? Defined Contribution vs. Defined Benefit Pensions*, PENSION RETIREMENT, <http://pensionretirement.com/which-is-better-defined-contribution-vs-defined-benefit-pensions/> [<https://perma.cc/WJ7Y-PW2S>] (last visited Apr. 3, 2019)).

<sup>3</sup> *Id.* at 215 (stating that while thirty million public employees use defined benefit plans, their use has “almost disappeared” in the private sector).

<sup>4</sup> Mark Funkhouser, *The Real Story of Public Pensions*, GOVERNING (Nov. 19, 2012, 11:00 AM), <http://www.governing.com/gov-institute/on-leadership/col-alicia-munnell-book-public-pensions.html> [<https://perma.cc/HQP4-GXJ9>] (describing drop in funded ratio for public pension plans from 103% in 2000 to 76% in 2010).

<sup>5</sup> Rich Berger, *From Defined Benefit to Defined Contribution: A Systematic Approach to Transitioning Retirement Plans*, SOCIETY FOR HUMAN RESOURCE MANAGEMENT (Jan. 5, 2012), <https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/transitioningplans.aspx> [<https://perma.cc/VGN4-KFZY>] (“The trend toward DC retirement plans has been underway for 30 years.”).

<sup>6</sup> See G.E. Miller, *Defined Benefit vs. Defined Contribution Plans*, 20 SOMETHING FINANCE (Jan. 3, 2018), <https://20somethingfinance.com/defined-benefit-vs-defined-contribution-retirement-plans/> [<https://perma.cc/2F3P-SNUH>] (“A defined contribution plan is a type of retirement plan where an individual, employer, or both contribute funds—with no promised payout of future funds.”).

Whether defined benefit public sector pensions are truly in crisis, whether they must be reformed, whether defined contribution 401(k) plans are adequate substitutes, and whether 401(k) plans are themselves in crisis are all subjects addressed in the author's recently published book, *The Rise of the Working Class Shareholder: Labor's Last Best Weapon*.<sup>7</sup> Credible economists and actuaries can be found on both sides of this debate.<sup>8</sup> There are also strong reasons to believe that defined benefit pension plans are not in crisis, and that they are sustainable in current form. One reason is that forty-nine states have reformed defined benefit pension plans since the financial crisis to increase worker contributions, and decrease employer contributions.<sup>9</sup> Similarly, high fees and undersaving strongly suggest that 401(k) plans are themselves in crisis—that they are plainly insufficient vehicles for supporting Americans in retirement.<sup>10</sup> The recent renunciation of the 401(k) by the very people who invented it supports that claim, which remains contested.<sup>11</sup>

To oversimplify a complex debate, whether public pensions are underfunded turns almost entirely on a known unknown: interest rates and markets' future performance. Low interest rates can make it difficult to meet pension obligations. Correspondingly, if markets perform in the coming decades as they have performed in the last century, then most funds are not in crisis. If they severely underperform, then states and cities may need to make significant payments to close the funding gap. The existence and scope of underfunding becomes an actuarial question of what future rate of return states and cities

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<sup>7</sup> See WEBBER, *supra* note 2, at 214-15.

<sup>8</sup> Compare Funkhouser, *supra* note 4 (“Overall, Munnell’s main message is probably that, in her words, we should ‘dispense with some of the hysteria’ over public pensions. The issues confronting state and local pensions, while not trivial, are manageable.”), with JOSH B. MCGEE, LAURA & JOHN ARNOLD FOUND., CREATING A NEW PUBLIC PENSION SYSTEM 1 (2011), [<https://perma.cc/U3TM-LG66>] (“Failing to address the public pension crisis promptly would be economically catastrophic, triggering bankruptcy of cities, school systems and potentially even entire state governments.”).

<sup>9</sup> See Hazel Bradford, *Pace of Pension Reform Ebbs After 49 States Change Laws*, PENSIONS & INV. (Apr. 14, 2014), [<https://www.pionline.com/article/20140414/PRINT/304149975/pace-of-pension-reform-ebbs-after-49-states-change-laws>] [<https://perma.cc/XG4J-G5YF>] (quoting Munnell as arguing, “[I]n the long run these cuts are going to get the costs below what they were before the recession”).

<sup>10</sup> Michael Hiltzik, *Bad News: Your 401(k) Won't Give You a Decent Retirement*, L.A. TIMES (Oct. 10, 2017, 1:25 PM), [<https://www.latimes.com/business/hiltzik/la-fi-hiltzik-401k-20171010-story.html>] (“401(k) plans are destined to fail millions of Americans. They’re not offered by enough employers, they’re not taken up by enough workers, and for most people, their balances aren’t large enough to provide for a decent retirement.”).

<sup>11</sup> Jeremy Olshan, *The Inventor of the 401(k) Says He Created a ‘Monster,’* MARKET WATCH (Sept. 26, 2016, 3:20 PM), [<https://www.marketwatch.com/story/the-inventor-of-the-401k-says-he-created-a-monster-2016-05-16>] [<https://perma.cc/GJ5M-QCX4>] (“The plans had grown so overcomplicated and so fraught with hidden fees and opportunities for bad decisions that they were better at enriching the financial industry than the actual savers . . .”).

should use to estimate pension liabilities. Pension reformers argue for the “risk-free” rate of return, or the rate of return on U.S. Treasury bills, the most conservative and stable investment in the world.<sup>12</sup> In their view, guaranteed liabilities should be backed by guaranteed assets. Defenders of traditional pensions argue that historical rates of growth for stock markets are sufficient estimates of future returns.<sup>13</sup> The former number makes pensions look severely underfunded. The latter makes them look solvent. The 401(k) shifts the burden of miscalculation from the employer to the individual worker. However, this shift may be somewhat illusory because the state may still incur the burden of caring for financially insecure workers through other social programs, like food stamps and Medicaid. Nevertheless, the 401(k) continues its forward march as the new retirement vehicle of choice.

Perceived or actual underfunding—the “liability” side of the balance sheet—is undisputedly driving the reform question. That framing of pension reform critically omits the asset side of the balance sheet: how pensions are invested and how they function as investors. The reality is that these same targeted pensions have become some of the most active and engaged investors. The conversion of defined benefit pension plans into 401(k) plans will fatally undercut worker ability to exercise the substantial shareholder power and shareholder voice embedded in their retirement funds, to the detriment of workers and, in this Article’s view, markets overall.

Defined benefit pension plans remain the gold standard and defensible on affordability grounds, even if some require reform. That said, this Article offers some modest compromise solutions between the defined benefit pension plan and the 401(k). Specifically, this Article proposes several alternative defined contribution structures to the 401(k) that could reduce pension liabilities for states and cities while preserving shareholder voice. To understand the significance of preserving that voice, it is first necessary to have a sense of how labor’s defined benefit pension plans have exercised it. This activism is already extensively detailed in *The Rise of the Working Class Shareholder*. This Article provides only a very brief summary of it.

#### I. A BRIEF SURVEY OF LABOR’S RECENT SHAREHOLDER ACTIVISM

Public pension funds and labor union funds have exercised their shareholder power to advance the interests of their contributors both as long-term, diversified investors saving for retirement and as workers. The weight of the evidence suggests that these efforts have in fact enhanced worker welfare along both

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<sup>12</sup> WEBBER, *supra* note 2, at 228-29 (citing Mary Williams Walsh, *A Sour Surprise for Public Pensions: Two Sets of Books*, N.Y. TIMES, Sept. 17, 2016, at BU1) (“Some finance economists have taken the position that because defined-benefit pension funds are a guaranteed payment, pensions must assume a ‘risk-free’ rate of return.”).

<sup>13</sup> Funkhouser, *supra* note 4 (stating that “the work of several university economists has been used to make the case that the plans’ liabilities essentially have been deliberately understated by using a rate of return that is too high”).

dimensions, though much more work needs to be done before definitively reaching that conclusion. This Article cites the studies that support this conclusion throughout its discussion. That said, the purpose of this Part is not to prove that labor's shareholder activism enhances its interests, or net social welfare more generally. Instead, it aims to illustrate the breadth and depth of labor's shareholder activism. This Part will demonstrate that the necessary precondition for this activism is that workers have separate, pooled sources of capital over which they exercise substantial control, something which is not an option in 401(k) plans, but could be. This Part demonstrates this latter point by concluding with a brief overview of the passivity of other diversified shareholders, suggesting that the disappearance of worker shareholder voice would not be replaced by the mutual funds that would manage the workers' 401(k) plans.

A. *Activism Targeting Public Companies*

In the last ten to fifteen years, labor's capital has emerged as a powerful force in markets. For example, it has been the driving force behind the transformation of shareholder voting.<sup>14</sup> Shareholder voting has long been an oxymoron, but it has recently been transformed by the widespread adoption of three innovations: proxy access, majority voting, and the destaggering of corporate boards. Labor's capital was the driving force behind all three.<sup>15</sup> Proxy access empowers shareholders to nominate candidates to run for board positions and to have those candidates automatically listed on the company's proxy (the ballot circulated to shareholders for the annual meeting).<sup>16</sup> Up until recently, companies refused to add shareholder nominees to the proxy, forcing dissidents to print up and circulate their own proxies to investors at enormous cost. This cost was enough to dissuade insurgent candidacies from all but the most concentrated investors: hedge funds.<sup>17</sup> A highly successful campaign by New York City's \$190 billion pension funds led to the adoption of proxy access at hundreds of companies,

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<sup>14</sup> WEBBER, *supra* note 2, at 45-78 (“[W]hen it comes to shareholder voting, labor picked the right battles. It fought and won them early, in ways that will make these victories difficult to dislodge.”).

<sup>15</sup> *Id.* (discussing lobbying efforts of public pension funds and labor union funds to reform shareholder voting policies).

<sup>16</sup> *Id.* at 47-48 (citing Kaja Whitehouse, *Shareholders Threaten Boards over ‘Proxy Access,’* USA TODAY (Jan. 27, 2015, 12:43 PM), <https://www.usatoday.com/story/money/business/2015/01/27/proxyaccess-investors-businessroundtable-wholefoods/22234271/> [<https://perma.cc/VPA7-RJ89>]) (explaining that proxy access “would allow a limited number of long-term, diversified shareholders . . . to directly place their own competing nominees on the same proxy as the board’s nominees, at no cost”).

<sup>17</sup> *Id.* at 47 (“Even hedge funds only run a proxy fight in the most exceptional circumstances, because the cost is so high.”).

empowering large, long-term, diversified investors to nominate board candidates who will be listed directly on the proxy.<sup>18</sup>

Similarly, shareholder voting was long hobbled by plurality voting rules.<sup>19</sup> Given the lack of proxy access, most shareholder elections consist of boards of directors nominating themselves and then running unopposed.<sup>20</sup> Plurality voting rules for unopposed elections defeat the purpose of having an election. *The Rise of the Working Class Shareholder* compares it to winning a gold medal for placing first in a solitaire competition.<sup>21</sup> The United Brotherhood of Carpenters Union filed shareholder proposals at over seven hundred companies successfully pushing for the adoption of majority voting rules that would require any board candidate to obtain a voting majority before being seated.<sup>22</sup> Majority voting rules empower shareholders to run “withhold vote” campaigns to unseat even unopposed directors.<sup>23</sup> Public pension funds also backed Harvard Law School’s Shareholder Rights Project that successfully fought for destaggering boards at companies.<sup>24</sup> Finally, as it pertains to publicly held companies, public pension funds and labor union funds have served as lead plaintiffs in forty percent of

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<sup>18</sup> *Id.* at 47-48 (“In 2001, the American Federation of State, County, and Municipal Employees (AFSCME), a prominent public employees union, began drafting proxy access shareholder proposals and submitting them to a handful of companies.” (first citing BUS. ROUNDTABLE & U.S. CHAMBER OF COMMERCE, PROXY ACCESS LEGAL CHALLENGE: ISSUE BACKGROUNDER 1 (2010), [https://www.uschamber.com/sites/default/files/legacy/press\\_release/1009proxyaccess\\_backgrounder.pdf](https://www.uschamber.com/sites/default/files/legacy/press_release/1009proxyaccess_backgrounder.pdf) [http://perma.cc/R3US-AJTY]); then citing Telephone Interview with Richard C. Ferlauto, Dir., Corp. Governance & Pension Inv., Am. Fed’n of State, Cty., and Mun. Emps. (Apr. 20, 2016))).

<sup>19</sup> *Id.* at 74-75 (citing *Plurality and Majority Voting—Who Really Cares?*, ACTIVIST INV. BLOG (June 18, 2012), [http://www.theactivistinvestor.com/The\\_Activist\\_Investor/Blog/Entries/2012/6/18\\_Plurality\\_and\\_Majority\\_Voting\\_-\\_Who\\_Really\\_Cares.html](http://www.theactivistinvestor.com/The_Activist_Investor/Blog/Entries/2012/6/18_Plurality_and_Majority_Voting_-_Who_Really_Cares.html) [https://perma.cc/5DT7-PZ9L]) (“Until very recently, U.S. corporate elections applied a plurality voting rule, that is, if you received a plurality of the vote, you won.”).

<sup>20</sup> *Id.* at 75.

<sup>21</sup> *Id.* at 74.

<sup>22</sup> *Id.* at 75 (“The United Brotherhood of Carpenters Fund, a labor union fund, has played a particularly important role in this fight. It alone filed 717 majority voting proposals between 2004 and 2014 . . . .” (citing *Issue Report: Carpenter Funds’ Majority Vote Election Standard Advocacy*, UNITED BROTHERHOOD OF CARPENTERS, <https://www.carpenters.org/issue-report-carpenter-funds-majority-vote-election-standard-advocacy/> [https://perma.cc/X3DC-RB4A] (last visited Apr. 3, 2019))).

<sup>23</sup> *Id.* (“[M]ajority voting empowers shareholders to prevent the election of a board member they dislike by running a ‘withhold vote’ or a ‘just vote no’ campaign. The board member will not be reelected if he fails to reach the 50 percent threshold.”).

<sup>24</sup> *121 Companies Agreed to Move Towards Annual Elections*, SHAREHOLDER RIGHTS PROJECT, <http://www.srp.law.harvard.edu/companies-entering-into-agreements.shtml> [https://perma.cc/PMN3-4LPB] (last visited Apr. 3, 2019) (detailing 121 companies that decided to work on implementing annual elections after being engaged by Shareholder Rights Project during its three year mission).

securities fraud and transactional class actions.<sup>25</sup> Substantial evidence shows that cases with public pension lead plaintiffs correlate with both better recoveries and lower attorneys' fees in both federal securities fraud and Delaware transactional class actions.<sup>26</sup>

### B. *Labor's Capital as Lobbyist*

Labor's capital institutions, like American Federation of State, County and Municipal Employees's ("AFSCME") Capital Strategies group, fought for and obtained say on pay votes in Dodd-Frank, ultimately leading to annual say-on-pay votes at publicly held companies, in which shareholders vote on the compensation of senior executives.<sup>27</sup> Preliminary evidence suggests that these votes have had a modest downward effect on executive compensation.<sup>28</sup> The AFL-CIO Office of Investment similarly fought for and obtained private fund registration in Dodd-Frank, forcing private equity companies to register with the Security and Exchange Commission ("SEC") for the first time.<sup>29</sup> That registration revealed securities law violations at half of all registered firms, particularly around fee disclosures.<sup>30</sup> The AFL-CIO Office of Investment also

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<sup>25</sup> WEBBER, *supra* note 2, at 171-72 (first citing David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157, 166-67 (2012); then citing C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 357-58 (2010); then citing Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J. EMPIRICAL LEGAL STUD. 368, 369-70 (2012); then citing Adam B. Badawi & David H. Webber, *Does the Quality of the Plaintiffs' Law Firm Matter in Deal Litigation?*, 41 J. CORP. L. 359, 371 (2015); then citing *Fiduciary Responsibilities*, U.S. DEP'T OF LAB., <https://www.dol.gov/general/topic/retirement/fiduciaryresp> [<https://perma.cc/32V8-X3DT>] (last visited Apr. 3, 2019) ("About 40 percent of all U.S. securities fraud class actions . . . are brought by public pension funds and labor union funds.").

<sup>26</sup> *Id.* ("Public pension funds correlate with both higher recoveries and lower attorneys' fees in both securities fraud class actions and deal cases.").

<sup>27</sup> *Id.* at 136-43 (describing efforts of activists in pushing for legislation that required say on pay voting).

<sup>28</sup> *Id.* at 142 ("[S]ay-on-pay votes have had a real, if modest, impact in reducing CEO pay relative to overall company performance . . .").

<sup>29</sup> *Id.* at 155-58 (first citing Telephone Interview with Heather Slavkin Corzo, then-Dir., Office of Inv., AFL-CIO (July 27, 2016); then citing Heather Slavkin Corzo, LINKEDIN, <https://www.linkedin.com/in/heather-slavkin-corzo/> (last visited Apr. 3, 2019); then citing DAVID L. GORET, SCOTT H. MOSS & COLE BEAUBOUF, LOWENSTEIN SANDLER PC, DODD-FRANK BILL MOVES TOWARDS PASSAGE: HIGHLIGHTS OF THE INVESTMENT ADVISER REGISTRATION REQUIREMENTS 1-5 (2010), <https://www.lowenstein.com/files/publication/702160be-65ce-4b02-b7b7-095b863fae5b/presentation/publicationattachment/9ae6b780-a6c1-4a80-91c6-1faff4292377/dodd-frank%20bill%20moves%20closer%20to%20passage.pdf> [<https://perma.cc/33W2-8MKH>] ("Dodd-Frank included the requirement that private equity funds register and disclose their holdings . . .").

<sup>30</sup> *Id.* at 157-59 ("[P]rivate equity funds were cheating on their fees and expense allocations 'over 50% of the time.'" (citing Andrew J. Bowden, Dir., Office of Compliance Inspections



successfully pushed for annual reporting of the CEO/worker pay ratio, highlighting runaway CEO compensation.<sup>31</sup>

Not all labor's capital endeavors have been successful. For example, these funds filed shareholder proposals to force companies to disclose their political activity and received little traction.<sup>32</sup> They also had mixed success at splitting the CEO and Chair roles.<sup>33</sup> Though overall, splitting the roles has become more common in recent years, perhaps as an indirect result of these proposals.<sup>34</sup>

C. *Labor's Capital and Alternative Investments: Hedge Funds and Private Equity Funds*

So far, this Article has only described the efforts of labor's capital with public companies. However, labor's capital has also had a profound effect in the alternative investment space, with hedge funds and private equity funds. When the American Federation of Teachers realized that many hedge fund managers were simultaneously investing teacher pension funds and then turning around and attacking teacher pensions—usually via support for charter schools that do not participate in teacher pensions—it created a “hedge fund watch list” for the offending hedge fund managers.<sup>35</sup> The watch list sent a shockwave through the

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and Examinations, Sec. & Exch. Comm'n, Speech at Private Equity International (PEI), Private Fund Compliance Forum, Spreading Sunshine in Private Equity (May 6, 2014), <https://www.sec.gov/news/speech/2014--spch05062014ab.html> [<https://perma.cc/BMR2-SARN>]).

<sup>31</sup> Raul Amoros, *Revealed: The 20 Companies with the Worst Pay Gaps Between CEOs and Workers*, HOW MUCH (June 10, 2018), <https://howmuch.net/articles/top-20-companies-with-largest-pay-ratio> [<https://perma.cc/FNG9-FSKH>] (noting that the worst ratio was from Mattel, with a ratio of 4987 to 1, with McDonald's taking second place with a ratio of 3101 to 1).

<sup>32</sup> Brian Croce, *Corporate Political Disclosure Moves Firmly into Mainstream*, PENSIONS & INV. (June 25, 2018), <https://www.pionline.com/article/20180625/PRINT/180629921/corporate-political-disclosure-moves-firmly-into-mainstream> [<https://perma.cc/75S2-EDY4>] (explaining that although eighty-five shareholder proposals were filed to mandate disclosure of political activity, “no proposal has received majority support this year”).

<sup>33</sup> WEBBER, *supra* note 2, at 114-26 (detailing unsuccessful efforts of activists to split CEO and Chair position at JPMorgan).

<sup>34</sup> Kevin McCoy, *Wells Fargo Separates CEO and Chair Jobs*, USA TODAY (Dec. 1, 2016, 6:19 PM), <https://www.usatoday.com/story/money/2016/12/01/wells-fargo-splits-ceo-chair-jobs-amid-account-scandal/94754918/> [<https://perma.cc/4EJR-EWVL>].

<sup>35</sup> WEBBER, *supra* note 2, at 91-92 (first citing AM. FED'N OF TEACHERS, RANKING ASSET MANAGERS: A RETIREMENT SECURITY REPORT ON MONEY MANAGERS FOR PENSION FUND TRUSTEES 2 (5th ed. 2015), <https://www.aft.org/sites/default/files/rankingassetmanagers0115.pdf> [<https://perma.cc/E8BP-XMZH>]; then citing AM. FED'N OF TEACHERS, RANKING ASSET MANAGERS: A RETIREMENT SECURITY REPORT ON MONEY MANAGERS FOR TRUSTEES 2 (2013), <http://online.wsj.com/public/resources/documents/AFTRetirementSecurityReport0417.pdf> [<https://perma.cc/3C7A-MJYD>]; then citing Julia La Roche, *The American Federation of Teachers Sent out a Big Watch List of Hedge Funds 'Attacking' Their Pension Plans*, BUS. INSIDER (Apr. 28, 2013, 4:01 PM),

hedge fund community, and led to the immediate cessation of attacks on teacher pensions by several hedge funds that had participated in such attacks while managing teacher pension money.<sup>36</sup> Some pension funds, like the California Public Employees Retirement System (“CalPERS”), have gone even further, divesting entirely from hedge funds.<sup>37</sup>

Some pension funds have taken similar steps to assert their interests vis-à-vis private equity funds. New York City’s pension funds have adopted a responsible contractor policy, requiring that private equity funds pay fair wages and benefits to workers on infrastructure or real estate projects invested in by the city.<sup>38</sup> After adoption of that policy, the North America’s Building Trades Union approached Blackstone, a private equity fund that had recently raised \$100 billion for infrastructure investment in the United States.<sup>39</sup> It urged Blackstone to apply the responsible contractor policy to this fund, which it did. This policy now has the

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funds-2013-4 [<https://perma.cc/2T34-JXSA>]; then citing Julia La Roche, *Hedge Funders Say It’s ‘A Badge of Honor’ to Be Targeted by ‘Thuggish’ Teachers Unions*, BUS. INSIDER (Apr. 25, 2013, 9:36 AM), <https://www.businessinsider.com/aft-attacking-hedge-funds-2013-4> [<https://perma.cc/4DEA-4AHA>] (discussing creation of Investment Manager Watch List, which “listed thirty-three hedge funds that supported education reform movements that advocated gutting teacher pensions”).

<sup>36</sup> See *id.* at 91-92 (citing Jim Gallagher, *Sinquefield Quits DFA Board Under Union Attack*, ST. LOUIS POST-DISPATCH, (May 3, 2013), [https://www.stltoday.com/business/local/sinquefield-quits-dfa-board-under-union-attack/article\\_de9a6391-cc98-5953-832f-ddc22d47bf91.html](https://www.stltoday.com/business/local/sinquefield-quits-dfa-board-under-union-attack/article_de9a6391-cc98-5953-832f-ddc22d47bf91.html) [<https://perma.cc/MRK2-5WKM>]) (explaining how Sinquefield, co-founder of investment company Dimensional Fund Advisors, quit company’s board after American Federation of Teachers listed company on their Watch List because of his support of groups which pushed for public defined contribution pension plans); see also *id.* at 93 (describing letter in which Kapnick assures American Federation of Teachers that his company will not continue to support StudentsFirstNY after that support landed his company on the watch list (citing Letter from Scott Kapnick, Chief Exec. Officer, HPS Investment Partners, to Am. Fed. of Teachers (Dec. 17, 2014) (on file with author))).

<sup>37</sup> Ed Mendel, *As CalPERS Exits Hedge Funds, CalSTERS Adds More*, CALPENSIONS (Jul. 18, 2016, 7:28 AM), <https://calpensions.com/2016/07/18/as-calpers-exits-hedge-funds-calstrs-adds-more/> [<https://perma.cc/B9X5-Q33W>] (discussing how CalPERS decided to end its \$4 billion hedge fund program in 2014).

<sup>38</sup> THOMAS P. DINAPOLI, OFFICE OF THE N.Y. STATE COMPTROLLER, RESPONSIBLE CONTRACTOR POLICY: NEW YORK STATE COMMON RETIREMENT FUND 1 (2017), <http://www.osc.state.ny.us/pension/responsible-contractor-policy.pdf> [<https://perma.cc/5RQL-ALY9>] (describing New York City’s policy that would “enhance the value of real estate properties and infrastructure investments, as evidenced by . . . compliance with applicable statutes and payment of fair wages and benefits to employees”).

<sup>39</sup> Press Release, Blackstone, Blackstone’s Infrastructure Business Adopts Responsible Contractor Policy to Promote Fair Wages and Benefit for Workers on Infrastructure Projects (Sept. 5, 2017), <https://www.blackstone.com/media/press-releases/article/blackstone%27s-infrastructure-business-adopts-responsible-contractor-policy-to-promote-fair-wages-and-benefits-for-workers-on-infrastructure-projects> [<https://perma.cc/G5ZD-ESAZ>] (“Overall, through the equity in this vehicle and additional debt financing, Blackstone expects to invest in more than \$100 billion of infrastructure projects, principally in the United States.”).

potential to create thousands of union jobs, and new contributors to union pension funds.<sup>40</sup> A recent example demonstrates how this can work in practice. In September 2018, the United Labor Life Insurance Company (“ULLICO”) teamed up with private equity fund Carlyle to invest in the rebuilding of New York’s Terminal One at JFK Airport.<sup>41</sup> ULLICO was founded on May 1, 1927 by Samuel Gompers, founder of the American Federation of Labor, to write life insurance policies for industrial workers when other companies would not do so.<sup>42</sup> It continues to operate and today it maintains an investment arm that requires investees to exclusively hire union labor.<sup>43</sup> Consequently, Terminal One will be built by union labor, creating four thousand union jobs, supporting eight thousand permanent jobs, and all of them paying into worker pension plans.<sup>44</sup>

Some pension funds have exercised their shareholder power to cushion the blow of job losses rather than create jobs. Minnesota and Washington successfully demanded that Kohlberg, Kravis and Roberts (“KKR”) and Bain Capital contribute \$10 million each to fund severance packages for workers laid off in the Toys “R” Us bankruptcy.<sup>45</sup> As noted above, the AFL-CIO Office of Investment pushed for the adoption of private fund registration in Dodd-Frank,

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<sup>40</sup> *Id.* (stating that Blackstone policy would create jobs for construction workers throughout country).

<sup>41</sup> Press Release, The Carlyle Group, Terminal One Welcomes Port Authority Decision to Redevelop JFK Terminal One as Part of Advancing Airport’s Ambitious Vision Plan (Oct. 4, 2018), <https://www.carlyle.com/media-room/news-release-archive/terminal-one-welcomes-port-authority-decision-redevelop-jfk> [<https://perma.cc/M89U-ZVHN>] (announcing decision to “move forward with the redevelopment and expansion of John F. Kennedy (JFK) Airport’s Terminal One”).

<sup>42</sup> *Our History*, ULLICO, <https://www.ullico.com/about-ullico/our-history> [<https://perma.cc/7N46-36C6>] (last visited Apr. 3, 2019) (“When the labor market found itself without viable solutions for life and health insurance, workers’ compensation, fiduciary and union liability insurance and investment products, Ullico stepped in to fill the void.”).

<sup>43</sup> *Investments*, ULLICO, <https://www.ullico.com/investments> [<https://perma.cc/8EUT-TQG3>] (last visited Apr. 3, 2019) (stating that ULLICO “brought together expert resources and partners to create a range of asset management services and union-friendly investment solutions to better meet the needs of institutional and tax-exempt investors”).

<sup>44</sup> Hazel Bradford, *Union Leaders Praise JFK Airport Update*, PENSIONS & INV. (Oct. 4, 2018, 3:30 PM), <https://www.pionline.com/article/20181005/ONLINE/181009873/union-leaders-praise-jfk-airport-update> [<https://perma.cc/TB46-6JK2>] (describing thousands of jobs that Terminal One project will create); Press Release, The Carlyle Group, *supra* note 41 (illustrating project’s commitment to labor participation).

<sup>45</sup> Abha Bhattarai, *Toys R Us Owners Set Up Fund Laid-Off Workers After Bankruptcy*, WASH. POST, Oct. 1, 2018, at A22 (“Bain Capital and Kohlberg Kravis Roberts—two of the three firms that bought Toys R Us in a 2005 leveraged buyout and loaded it with billions of dollars in debt before liquidating the chain in June—are setting aside millions of dollars in a fund to be distributed to retail workers . . .”).

requiring private equity funds to register and report some of their holdings for the first time.<sup>46</sup>

Perhaps most importantly, pension funds have begun to organize to push back on fees. For example, New York City recently negotiated a deal with private equity fund KKR that it would not pay any fees to the fund until its investments returned more than seven percent.<sup>47</sup>

#### D. *Labor's Capital as Private Attorney General*

Public pension funds and labor union funds are also the primary force behind the private enforcement of U.S. securities law and corporate fiduciary duties in the transactional context. They have served as lead plaintiffs in approximately forty percent of all federal securities fraud class actions, leading the charge in such notable cases as the Enron, Wells Fargo, and WorldCom actions.<sup>48</sup> These funds have also served as lead plaintiffs in forty percent of transactional class actions in Delaware.<sup>49</sup> Such suits typically allege breaches of fiduciary duty by target company boards for failing to vindicate the interests of target shareholders in mergers and acquisitions, often by underselling the company for a variety of improper and self-interested reasons. Substantial empirical research has shown that cases with public pension fund lead plaintiffs correlate with better outcomes for shareholders, including both higher settlements and lower attorney's fees.<sup>50</sup>

Those empirical results cohere with the theory behind the legal changes that led to the regular appointments of these funds as representative plaintiffs. Those reforms were embedded in the Private Securities Litigation Reform Act of 1995, and in a series of Delaware cases in the early 2000s, both of which favored selection of institutional investors with comparatively large dollar sums at stake to lead shareholder class actions.<sup>51</sup> Both Congress and the Delaware Court of

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<sup>46</sup> WEBBER, *supra* note 2, at 155-58 (“Dodd-Frank included the requirement that private equity funds register and disclose their holdings, alongside many other financial reforms, including creation of the Consumer Financial Protection Bureau.”).

<sup>47</sup> *Id.* at 161-62 (“New York City comptroller Scott Stringer’s office negotiated an arrangement between the NYC funds and KKR in which the private equity fund would not collect any fee on investment gains until those gains exceeded 7 percent.” (citing Josh Kosman, *Under Pressure KKR Poised to Take Pension Money Deal*, N.Y. POST (Sept. 14, 2017, 11:05 PM), <https://nypost.com/2017/09/13/under-pressure-krk-poised-to-take-pension-money-deal/> [<https://perma.cc/B46V-T2J7>])).

<sup>48</sup> Webber, *supra* note 25, at 166-67 (discussing increasing role of institutional investors as lead plaintiffs).

<sup>49</sup> *Id.* (“[I]nstitutional investors now lead over 40% of securities fraud class actions and around 40% of transactional class actions in Delaware.”).

<sup>50</sup> *Id.* (explaining that when institutional investors serve as lead plaintiffs, class actions tend to have better outcomes).

<sup>51</sup> WEBBER, *supra* note 2, at 56 (“In 1995, Congress passed the Private Securities Litigation Reform Act, which placed institutional investors like public pension funds in control of class-action lawsuits brought on behalf of defrauded investors, such as those against Enron and WorldCom for accounting fraud.”).

Chancery were concerned that too many class actions were being led by handpicked individual lead plaintiffs with small financial stakes and little or no sophistication.<sup>52</sup> They therefore lacked both the incentive and the ability to monitor class counsel. In contrast, institutional investors like these funds, with substantial sums at stake in frauds or deals, who already function as fiduciaries with some legal and financial sophistication, would be better placed to monitor class counsel to improve outcomes for shareholders.<sup>53</sup> That theoretical assumption has been largely borne out by the facts.

E. *The Relative Silence of Other Shareholders*

Just as striking as the prominence of labor's capital institutions in all these fields is the lack of activism by almost all other diversified investors. For example, mutual funds hold even more assets than public pension funds do.<sup>54</sup> They could serve as lead plaintiffs in nearly every class action, but they rarely do.<sup>55</sup> They could file shareholder proposals, but they do not. They have played almost no leadership role in the transformation of shareholder voting—a transformation that could affect them more than any other shareholders—apart from voting in favor of proposals brought by others. Much has been made of recent gestures in the direction of shareholder activism by mutual funds. Famously, BlackRock's CEO Larry Fink surprised markets last year in arguing that companies should pursue “the social good” and not just profits.<sup>56</sup> State Street has adopted a policy stating that it will vote against nominating committee directors at companies that have all male boards.<sup>57</sup> In 2017, for the first time,

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<sup>52</sup> See Webber, *supra* note 25, at 164-66 (finding that individual lead plaintiffs with “very small financial stakes” and minimal sophistication were less effective as lead plaintiffs than institutional investors).

<sup>53</sup> WEBBER, *supra* note 2, at 56 (“Institutional investors with large losses could help monitor lawyer behavior, assuring better outcomes for shareholders.”).

<sup>54</sup> Jeff Benjamin, *10 Largest Mutual Funds Companies By Assets*, INVESTOR NEWS, <https://www.investmentnews.com/gallery/20180824/FREE/824009999/PH/10-largest-mutual-fund-companies-by-assets> [https://perma.cc/E6ZN-DXXM] (last visited Apr. 3, 2019) (“The mutual fund industry currently has \$18.9 trillion in total assets, \$10.8 trillion of which is held by 10 companies.”).

<sup>55</sup> WEBBER, *supra* note 2, at 53 (“[M]utual funds, which primarily invest the retirement savings of white-collar workers, engage in comparatively little activism since they face conflicts of interest.”).

<sup>56</sup> Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose & Profit*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> [https://perma.cc/62VH-UTLN] (last visited Apr. 3, 2019) (“Unnerved by fundamental economic changes and the failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues.”).

<sup>57</sup> See Amy Whyte, *State Street to Turn Up the Heat on All-Male Boards*, INSTITUTIONAL INVESTOR (Sept. 27, 2018), <https://www.institutionalinvestor.com/article/b1b4fh28ys3mr9/State-Street-to-Turn-Up-the-Heat-on-All-Male-Boards> [https://perma.cc/RZ4C-JPYZ]

Fidelity and Vanguard voted in favor of shareholder proposals calling upon companies to do more about the threat of global warming.<sup>58</sup> But the reality is that the activism of these funds has trailed far behind that of labor's capital institutions. This tendency is because passivity is built into the business DNA of these entities.

First, mutual funds make most of their money managing corporate 401(k) plans, particularly those for large S&P 500 companies.<sup>59</sup> Such companies comprise eighty percent of U.S. market value.<sup>60</sup> These are the companies where filing shareholder proposals matter most, and where executive compensation or corporate political activity matter most. Thus, mutual funds squarely face a business conflict of interest from activism at such companies. Attacking the CEO's pay is not a great way to get on—or stay on—that company's 401(k) platform. Neither is suing the company. More subtly, though perhaps of greater day-to-day significance, activism at that company could also lead the CFO to cease communicating with analysts at that mutual fund complex. Mutual fund analysts prize their relationships with corporate management, particularly the CFO, who can signal to the analyst whether their quarterly earnings per share targets are reasonable, and provide other critically useful information. Analysts do not want to jeopardize that relationship with activism. Thus, mutual funds' preferred mode of activism, if it can even be called activism, is to write letters to corporate management and hold private meetings to discuss issues.

Other factors keep mutual funds passive, including both the free rider problem and social network effects. Filing shareholder proposals or bringing shareholder lawsuits incur costs while conferring benefits on competitors. Mutual funds may also face social network effects, as the investment managers who run mutual funds graduate from the same schools and move in the same circles as many of the corporate managers with whom they might engage.<sup>61</sup>

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(reporting that “State Street will vote against the entire slate of board members on the nominating committee of any company not meeting its gender diversity criteria”).

<sup>58</sup> Rob Berridge, *Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds?*, CERES (Dec. 21, 2017), <https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about> [<https://perma.cc/LAR2-R4SY>] (describing new trend of asset management companies voting for climate-related proposals).

<sup>59</sup> WEBBER, *supra* note 2, at 53-54 (citing Ross Kerber, *Amid Business Ties, Some Fund Firms Eased Proxy Pressure: Study*, REUTERS (Apr. 18, 2017, 7:05 AM), <https://www.reuters.com/article/us-climate-investors-idUSKBN17K16V> [<https://perma.cc/A8GN-ZQVL>]) (explaining that mutual funds “profit from having their 401(k) plans on the platforms of large public corporations, again like Disney or Safeway or, for that matter, Wal-Mart”).

<sup>60</sup> S&P 500®, S&P DOW JONES INDICES, <https://us.spindices.com/indices/equity/sp-500> [<https://perma.cc/ACJ5-WXCD>] (last visited Apr. 3, 2019) (“The [S&P 500] index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.”).

<sup>61</sup> Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. (forthcoming 2019) (manuscript at 58).

Public pension funds and labor union funds lack all of these inhibiting conflicts. They do not have business relationships with the companies in which they invest, apart from the investment itself, except in instances when their own workers are employed by the company—an irrelevant consideration for public pension funds which invest the retirement savings of government workers. They are not trying to win 401(k) business. These pension funds also do not have competitors. A CalPERS pensioner cannot take her pension and invest it in New York City Employees' Retirement System ("NYCERS"), at least not without switching jobs and moving from California to New York City. Therefore, pensions are largely indifferent to free rider concerns. The workers who serve on pension boards—teachers, firefighters, police officers—do not move in the same social circles as corporate management. And even if the politicians who also serve on pension boards—governors, mayors, state treasurers or attorneys general—do move in the same social circles as corporate management, they may be rewarded by voters for confronting Wall Street or corporate America, depending on their constituents. Thus, many of the conflicts that neutralize and pacify mutual funds do not exist for labor's capital institutions. This also explains why no one will fill the void if their shareholder voice disappears.

Hedge funds are also activists, but they are not diversified. They tend to focus their activism on companies in which they have a large stake—the activism is the purpose of the large stake—and thus the objectives and tactics of their activism differ decisively from that of diversified investors.

This Section briefly demonstrated how labor's capital institutions have played a critical role as shareholders in several capacities. They have emerged as a leading shareholder voice vis-à-vis public companies on everything from shareholder voting to executive compensation to corporate political activity. They have similarly exercised their shareholder muscle with hedge funds and private equity funds to create jobs that enhance pensions or resist attacks on those same pensions. They have directly and indirectly lobbied Congress and the SEC for legislation and regulatory reform, and have served as primary drivers of shareholder litigation. The next Section demonstrates how pension reform threatens that activism.

#### F. *The Pension Reform Threat to Labor's Shareholder Power*

Collective, pooled sources of capital with substantial worker oversight are the necessary precondition for labor's shareholder activism. The conversion of these funds from collective defined benefit plans into individually managed 401(k) plans will eliminate their capacity for shareholder activism. It will undermine their ability to create jobs, collectively negotiate fees, and lobby for favorable regulation. While intuitively, these losses would harm the participants and beneficiaries of such funds, others might take a different view. But a couple points cannot be disputed: (1) the transition from defined benefit funds to individually-managed 401(k) plans would lead to an absolute reduction in the shareholder power of workers (the only plausible argument that this would benefit workers is if the agency costs of pension trustees swamp the benefit of

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being able to wield collective shareholder voice); and (2) the underfunding debate has so completely dominated the pension reform issue that reforms have been adopted or are actively being considered with little or no regard for how these reforms would take existing state and worker shareholder power embedded in collectively managed defined benefit funds, and turn that power over to the mutual funds who will manage the new 401(k) plans.

At a minimum, this Article will illustrate what has already been lost in this transition from defined benefit funds to 401(k) plans on the asset/shareholder side of the equation. It will further illustrate a range of intermediate options between the defined benefit pension plan and the 401(k). These options range from in-house mutual funds, to defined contribution trusts, to defined contribution funds outsourced to existing mutual funds that retain voting, asset allocation, and litigation decisions in the hands of a separate board of trustees. Each of these structures will have the effect of shifting the retirement burden from the employer to workers, mimicking the effect of 401(k) plans so desired by pension reformers. In that sense, they will have the same “benefit” as 401(k) plans, at least from the perspective of employers. But, in contrast to 401(k) plans, these structures would maintain the collective shareholder voice that is the necessary precondition of shareholder activism. There are still excellent reasons to preserve defined benefit pension plans as they are. There are also reasons why less generous versions of such plans would be preferable than any defined contribution structure, at least from the perspective of workers.

Having reviewed this debate in detail elsewhere,<sup>62</sup> this Article will not recapitulate it. For the sake of argument, this Article will assume defined contribution funds actually do reduce the burden on states and cities, and propose some alternatives to the 401(k) that will preserve shareholder voice.

## II. RETIREMENT FUND ALTERNATIVES THAT PRESERVE SHAREHOLDER VOICE

This Part offers a cursory introduction to investment structures other than the defined benefit pension plan and the 401(k) that could preserve the collective shareholder voice of worker pensions while reducing employer pension obligations.

### A. *Target Benefit Plans*

Defined benefit pension plans offer just that: defined, fixed benefits to workers in retirement. As noted earlier, there are excellent reasons for both workers and employers to continue to support such plans. That said, the defined benefit structure burdens the employer with liability for shortfalls. If workers are owed  $X$  and the assets available to fund those benefits are something less than

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<sup>62</sup> See WEBBER, *supra* note 2, at 89 (arguing that “[d]efined benefit plans are better for employees”).



$X$ , employers must make up the difference. These unfunded liabilities are central to the debate over pension reform.

Target benefit plans are similarly self-explanatory; they target, rather than guarantee, specific levels of retirement benefit. Should the assets required to pay  $X$  fall instead to  $0.9X$ , then worker benefits are cut to  $0.9X$ .<sup>63</sup> Such plans already exist in Canada, with an estimated 120 plans and roughly \$31 billion in assets.<sup>64</sup> They would preserve the collective shareholder voice of defined benefit plans without burdening employers with shortfall liability. Unlike 401(k) plans, which require substantial expenditures on investor education to enable individual investors to manage their retirement funds—education that has proven woefully inadequate—these funds retain centralized investment decision-making. The central decision-making also allows for centralized control over proxy voting, litigation decisions, and all the standard tools of investor voice that U.S. defined benefit plans have utilized to such great effect in recent years.

B. *State-Controlled and Sponsored Mutual Funds: The Collective Investment Trust*

Collective Investment Trusts (“CITs”), also known as Collective Investment Funds, are unregistered investment vehicles currently under the jurisdiction of the Office of the Controller of the Currency, as opposed to the SEC.<sup>65</sup> In some respects, CITs may be thought of as trusts of trusts—that is, they are themselves trusts that are designed to facilitate investments by other trusts.<sup>66</sup> Hence, they are designated as “collective.”<sup>67</sup> Both 401(k) plans and defined benefit plans are often themselves set up as CITs.<sup>68</sup> The CIT itself may be set up and then managed by a bank or a trust company, but it cannot directly market its products

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<sup>63</sup> Randy Bauslaugh, Partner, McCarthy Tétrault, Address at the 31st International Congress of Actuaries: Target Benefits – A Bold Innovation in Pension Plan Design (June 7, 2018).

<sup>64</sup> *Id.*

<sup>65</sup> See Robert Powell, *Retirement: Everything You Need to Know About Collective Investment Trusts*, THESTREET (July 30, 2018, 6:24 AM), <https://www.thestreet.com/retirement/retirement-everything-you-need-to-know-about-collective-investment-trusts-14665782> [https://perma.cc/K9F7-993C] (explaining that although CITs are not registered with the SEC, they “are regulated by the bank regulators that oversee trusts, either the Office of the Comptroller of the Currency or a state banking regulator”).

<sup>66</sup> *Id.* (“Collective investment trusts are aptly named because to invest in a CIT, the investor must be a legal trust. Thus, 401(k) plans and defined-benefit plans are legally set up as trusts . . .”).

<sup>67</sup> *Id.* (“‘Collective’ means that a CIT provider can allow multiple trusts to invest in the same CIT.”).

<sup>68</sup> *Id.* (“401(k) plans and defined-benefit plans are legally set up as trusts.”).

to investors.<sup>69</sup> That is because of regulation dating back to the Great Depression, under which such trusts were deemed to be a primary cause of the market crash of 1929.<sup>70</sup> As a result, today, banks or mutual funds may establish CITs, but members of the general public may not.<sup>71</sup> Mutual funds will set up CITs, and then turn around and sell their products to the public.<sup>72</sup>

The primary advantage of a CIT is economies of scale.<sup>73</sup> Funds are grouped into one master account overseen by a trustee, often a bank.<sup>74</sup> The trustee is a fiduciary for the fund and also holds legal title to it.<sup>75</sup> Fund participants and beneficiaries—such as the workers who contribute to pension funds—are beneficiaries of the fund, even if they do not hold direct title to it.<sup>76</sup> They are entitled to their pro rata share of the fund’s value. If the fund increases in value, so do the participants and beneficiaries’ proportional shares, and vice versa. That distinguishes such structures from defined benefit pension plans, in which the participants and beneficiaries retain the same benefits in retirement regardless of the assets currently allocated to the pension fund.<sup>77</sup> In the defined benefit pension plan, the employer or trustee must meet its obligations to fund that benefit regardless of fund size or performance.<sup>78</sup> It must make up for the

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<sup>69</sup> ERACH DESAI & JASON DAUWEN, DST SYSTEMS, COLLECTIVE INVESTMENT TRUSTS – A PERFECT STORM 4 (2017), <https://www.ctfcoalition.com/portalsresource/AM-WP-CollectiveInvestmentTrustsAPerfectStorm-030317.pdf> [<https://perma.cc/K2KW-DYWY>] (“CITs were restricted to being offered to only trust clients under the umbrella of an employee benefit plan.”); Elizabeth O’Brien, *These Sneaky Trusts Are Hiding in Your 401(k)*, MONEY (June 21, 2017), <http://money.com/money/4807790/low-fee-401k-choices/> [<https://perma.cc/KF9R-6JCP>] (stating that CITs are “are open only to retirement plans and some other institutional investors”); Robert Steyer, *NAGDCA: Collective Investment Trusts Gaining Ground in DC Plans*, PENSIONS & INV. (Sept. 24, 2018, 2:24 PM) <http://www.pionline.com/article/20180924/ONLINE/180929945/nagdca-collective-investment-trusts-gaining-ground-in-dc-plans> [<https://perma.cc/FM75-U7CW>] (describing increasing popularity of CITs among government defined contribution plans).

<sup>70</sup> DESAI & DAUWEN, *supra* note 69, at 4 (“Two years later, when the stock market crashed, some market observers blamed these newly-created pooled funds.”).

<sup>71</sup> *Id.* at 6 (“[A] CIT sponsor must be a bank or trust company.”).

<sup>72</sup> *Id.* (describing how public can access CITs only through qualified retirement plans).

<sup>73</sup> *Id.* at 18 (highlighting cost-saving advantage of using CITs).

<sup>74</sup> Lennie Occhino, *Collective Investment Trusts – What DC Plan Fiduciaries Should Know*, BENEFITS & COMPENSATION BLOG (Nov. 27, 2017), <https://www.usbenefits.law/2017/11/collective-investment-trusts-what-dc-plan-fiduciaries-should-know/> [<https://perma.cc/BW6L-HA9X>] (discussing “commingled” nature of CITs and role of banks or other trustees as fiduciaries).

<sup>75</sup> *Id.* (“[T]he CIT trustee and investment manager (if any) are considered fiduciaries under ERISA to each plan investor with respect to the assets of the plan invested in the CIT.”).

<sup>76</sup> *Id.* (explaining that those who invest in CITs delegate “authority over the plan’s assets to the CIT trustee and its investment manager”).

<sup>77</sup> WEBBER, *supra* note 2, at 89 (“Defined benefit plans are better for employees because they guarantee a fixed payment to the worker in retirement.”).

<sup>78</sup> *Id.* (highlighting that defined benefit plans guarantee retirement payments).

shortfalls. For public pension funds, the burden of such shortfalls may be borne by taxpayers, which is precisely what concerns reformers who promote the 401(k) as an alternative to traditional pensions.

But in contrast to 401(k) plans, these funds should be structured to avoid individually managed accounts. Instead, like public pension funds now, they can be overseen collectively by a board of trustees. Rather than be credited with an individual sum of money per worker, these funds retain their collective structure. That retains the collective shareholder voice. Such boards of trustees could be elected much in the same way that they are now, as a combination of politicians and fund participants elected by peer participants and beneficiaries, often union members. In essence, they would be the same as public pension funds are now, retaining the collective shareholder voice, but not guaranteeing workers' fixed payments in retirement. Legislation has been introduced in the U.S. House of Representatives that would create "Composite Plans" that would largely fit the above description.<sup>79</sup>

At least one quasi-model for this already exists. Seven states have recently adopted "Secure Choice Pensions."<sup>80</sup> These programs offer 401(k) retirement plans for workers employed by businesses that do not offer retirement plans. These have been adopted despite massive resistance by the mutual fund industry, and despite a successful effort by the Republican-controlled Congress to use the Congressional Review Act to revoke regulation that had given legal cover to states to create such pensions.<sup>81</sup> For at least some of these states, these 401(k) plans will be directly administered by a state entity, rather than turned over to an existing mutual fund complex.<sup>82</sup> In such structures lie a kernel of a new structure that could substitute for both existing defined benefit pension plans and 401(k) plans subcontracted to mutual funds. At the moment, California has not yet subcontracted management of these pensions to the mutual fund industry, retaining the program in house.<sup>83</sup> Yet another model for such funds could be the

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<sup>79</sup> See generally JOHN J. TOPOLESKI, CONG. RESEARCH SERV., R44722, PROPOSED MULTIEMPLOYER COMPOSITE PLANS: BACKGROUND AND ANALYSIS (2017).

<sup>80</sup> *Id.* at 251 (citing Greg Iacurci, *Congress Seeks to Kill DOL Rules on State, City Auto-IRA Programs*, INV. NEWS (Feb. 8, 2017, 1:46 PM), <https://www.investmentnews.com/article/20170208/FREE/170209912/congress-seeks-to-kill-dol-rules-on-state-city-auto-ira-programs> [<https://perma.cc/9NQF-69WU>]) (explaining that Secure Choice Pensions spread to several states, including "California, Connecticut, Illinois, Maryland, Oregon, New York City, and Philadelphia").

<sup>81</sup> *Id.* at 251-52 (describing attempts to prevent use of these accounts and Congress's intervention with Congressional Review Act).

<sup>82</sup> *Id.* ("At the moment, some of these plans may be managed in-house by state entities . . .").

<sup>83</sup> *CalSavers Retirement Savings Program*, CAL. ST. TREASURER, <https://www.treasurer.ca.gov/scib/> [<https://perma.cc/GN26-UGRK>] (last visited Apr. 3, 2019) (detailing CalSavers retirement program, which will be managed by state).

Australian Superannuation Funds.<sup>84</sup> These are mandatory defined contribution funds that are managed collectively in superfunds by retail or union sectors.<sup>85</sup> Here, too, the collective shareholder voice is preserved within a defined contribution structure. Additionally, shortly before this Article went to press, the United Kingdom's Department of Work and Pensions and the Royal Mail announced successful passage of legislation that would create collective defined contribution structures for the Royal Mail retirement system.<sup>86</sup> Such structures would also preserve and enable the type of shareholder activism promoted here.

Some might question whether the public sector is capable of recreating funds with the same degree of skill as the private sector. In the author's view, the answer is yes. First, as demonstrated by the 401(k) performance evidence cited above, the funds created by the private sector have hardly proven themselves to be desirable, and have proven particularly egregious regarding fee structures.<sup>87</sup> Second, in the author's view, the investment choices that should be made available to investors should primarily be passive index funds like target retirement date funds or the gold standard, the S&P 500 index fund. Such funds are comparatively straightforward and inexpensive to construct. With an S&P 500 index fund, you purchase the funds on the index and rebalance the portfolio periodically to maintain diversification and to mimic index performance. These

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<sup>84</sup> *Super Basics*, INDUSTRY SUPERFUNDS, <https://www.industrysuper.com/understand-super/super-basics/> [<https://perma.cc/Q568-ZUGV>] (last visited Apr. 3, 2019) (defining superannuation funds, which are retirement funds comprised of "money that's put aside and saved while you're working, so you can enjoy a regular income later in life when you retire").

<sup>85</sup> *Id.* ("If you work for a company or organisation, your employer must pay money into a super account in your name, which is then managed by a super fund.")

<sup>86</sup> See DEP'T FOR WORK & PENSIONS, DELIVERING COLLECTIVE DEFINED CONTRIBUTION PENSION SCHEMES 14 (Mar. 2019), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/786395/response-delivering-collective-defined-contribution-pension-schemes.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786395/response-delivering-collective-defined-contribution-pension-schemes.pdf) [<https://perma.cc/Z6Y2-VZ3G>]; *Collective Defined Contribution Pension Legislation: RSA/Royal Mail Response*, ROYAL SOCIETY ENCOURAGEMENT ARTS, MANUFACTURES & COMM. (Mar. 18, 2019), <https://www.thersa.org/about-us/media/2019/collective-defined-contribution-pension-legislation-rsaroyal-mail-response> [<https://perma.cc/54VG-QYD5>].

<sup>87</sup> Hiltzik, *supra* note 10 (arguing that 401(k) plans are "destined to fail millions of Americans"); see also WEBBER, *supra* note 2, at 217 (first citing Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and 'Dominated Funds' in 401(k) Plans*, 124 YALE L.J. 1476, 1479 (2015); then citing James Kwak, *Improving Retirement Savings Options for Employees*, 15 U. PA. J. BUS. L. 483, 483 (2013); then citing Anne Tergesen, *Is There Really a Retirement-Savings Crisis*, WALL STREET J., Apr. 23, 2017, at R4; then citing Carla Fried, *5 Ways to Protect Your Retirement if the Market Tanks*, MONEY (Mar. 21, 2016), <http://money.com/money/4259056/protect-retirement-bear-market/> [<https://perma.cc/ET8U-EPRC>]; then citing Kelley Holland, *For Millions, 401(k) Plans Have Fallen Short*, CNBC (Mar. 23, 2015, 7:02 AM), <https://www.cnbc.com/2015/03/20/1-it-the-401k-is-a-failure.html> [<https://perma.cc/PUX6-ZWM6>] ("There are many problems with individually managed accounts like 401(k)s. One of the most glaring is the excessive fees charged to unwitting individual holders who lack the skill or leverage to keep fees low.").

are some of the least expensive and most straightforward investments in the world. Moreover, several states have run far more sophisticated investment structures than these. The Ontario Teachers' pension system has capitalized and runs its own private equity fund, and CalPERS is contemplating doing the same.

Still, for those who remain skeptical about public sector creation of straightforward index funds, or who prefer the economies of scale and experience of existing private sector mutual funds, the next Section briefly notes an alternative: the governance trust.

### C. *Governance Trusts*

Another alternative would be for employers to negotiate arrangements with existing mutual funds to utilize existing mutual fund products. However, instead of the usual arrangement, the states and cities would retain control over two vital aspects of shareownership: voting rights and litigation rights. Given the sums of money at stake, it seems likely that large mutual fund complexes would be willing to accommodate these demands, though they would still prefer the 401(k) structure in which they earn the fees, make all the investment choices, and vote the shares. Such a structure might require a departure from the usual legal structures but, for the reasons stated above, would remain preferable from the shareholder power point of view. But there is no reason to think this could not work. For example, CalPERS retains one hundred percent of its proxy voting power over its largest fund, the Public Employees' Retirement Fund, including over the portion that is externally managed.<sup>88</sup>

### D. *Cash Balance Plans*

Finally, cash balance plans may offer an alternative to both the 401(k) and the traditional pension. Such plans are in fact defined benefit plans.<sup>89</sup> In that sense, they preserve some retirement security for workers and retain ultimate responsibility for those pensions on the employers' books. They are simply less generous forms of defined benefit plans than most public sector workers currently enjoy. Here too, workers and unions might be rational in seeking to preserve defined benefit pension plans as they are. But from the perspective of shareholder power, the cash balance plan remains collective, subject to worker voice via pension boards of trustees, and therefore preferable to the 401(k).

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<sup>88</sup> See E-mail from Simiso Nzima, Inv. Dir. – Glob. Equity, Head of Corp. Governance, CalPERS, to David Webber, Professor of Law, Bos. Univ. Sch. of Law (Mar. 19, 2019) (on file with author); see also CAL. GOV'T CODE § 20171 (Deering 2019); CAL. PUB. EMPS.' RET. SYS. BD. OF ADMIN., GOVERNANCE POLICY 4 (May 2018), <https://www.calpers.ca.gov/docs/board-governance-policy.pdf> [<https://perma.cc/3K3N-MQ6M>].

<sup>89</sup> Eleanor Laise, *The Pros and Cons of Cash Balance Pension Plans*, KIPLINGER (Oct. 2014), <https://www.kiplinger.com/article/retirement/T047-C000-S004-the-pros-and-cons-of-cash-balance-plans.html> [<https://perma.cc/RK95-9QS2>] (“Cash-balance plans are like traditional defined-benefit pension plans with a 401(k) twist.”).

## CONCLUSION

There are excellent reasons for workers and employers to preserve defined benefit pension plans. But to the extent those efforts fail, there are better options than the standard defined contribution alternative: the 401(k). Collective defined contribution structures would preserve the shareholder voice that public pension funds and labor union funds have used to advance their interests. Governance trusts that subcontract to existing private mutual funds but collectively retain shareholder voting and litigation rights would do this too. Other, less generous forms of defined benefit plans, such as cash balance plans, could also preserve shareholder voice. Some structures may be preferable in certain jurisdictions. But regardless of the jurisdiction, there is never a good reason to give away the shareholder voice of defined benefit pension plans without a thorough investigation of the alternatives.