The Changed Landscape of American Corporate Ownership: What Does It Mean for Socially-Responsible Investing?

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The Changed Landscape of American Corporate Ownership: What Does It Mean for Socially-Responsible Investing?

As time has gone on, the shareholder landscape in the United States has seen a decline in retail, or individual, shareholder holdings and an increase in institutional shareholder holdings.\(^1\) In 1950, retail shareholders held 90\% of the U.S. equity market; by 2009, they held only 36\% of that market.\(^2\) Meanwhile, institutional ownership of the U.S. equity market has increased substantially, from 6\% in 1950, to about 50\% in 2009.\(^3\) More recently, from 1995 to 2007, the value of total assets under institutional shareholder control increased by about 250\%, from $7 trillion to $25.1 trillion.\(^4\) This trend brings to mind questions regarding its possible implications for U.S. corporate practices. One such question is, what does this increase in institutional equity ownership mean for socially responsible investing (“SRI”) in the American corporate landscape?\(^5\) SRI inevitably involves subjective decisions based on ethical and moral values.\(^6\) One would intuitively think that individual investors would be more likely to engage in SRI than institutional investors, as an individual investor is surely more likely to make investment decisions based on subjective motivations than institutional investors, whose investment decisions are made by professional managers. Based on this intuition, the rise of institutional equity ownership bodes poorly for SRI in the U.S.

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2. Id.
3. See id.
5. Socially responsible investing mainly takes three forms: 1) avoiding investing in corporations that engage in activities antithetical to the investor’s moral beliefs; 2) buying shares in corporations because of these objectionable activities, in order to change corporate behavior; and 3) investing in a corporation because of the corporation’s positive social and environmental performance. See Maria O’Brien Hylton, “Socially Responsible” Investing: Doing Good versus Doing Well in an Inefficient Market, 42 Am. U.L. Rev. 1, 7, 11 (1992); David Hess, Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development, 2 Va. L. & Bus. Rev. 221, 236 (2007).
This paper will explore what the continuous rise of institutional ownership in the U.S. means for the future of SRI.\(^7\) The inquiry here is not whether these institutional owners engage in SRI \textit{at all} but rather, whether they engage—or likely will engage—in SRI to such an extent as to be effective, non-governmental monitors of corporate practices. This paper concludes that the institutional investors with the largest holdings in the U.S. equity market do not, and likely will not, engage in SRI. This paper does find that SRI funds can serve as corporate monitors, but their effectiveness in this role is limited. To reach these conclusions, this paper will examine the investment practices of three traditional types of institutional investors that together comprise a majority of U.S. institutional equity ownership: pension funds, mutual funds, and hedge funds. These investors will be discussed in Parts I, II, and III, respectively. These investors’ structural characteristics, respective regulatory regimes, and current investment practices will be examined to determine whether such investors engage, or are likely to engage, in SRI. In Part IV, this paper will examine a relatively new type of institutional investor, the SRI fund, and the likelihood of its success as an effective corporate monitor. Finally, possible changes that could reverse the current trend of lack of SRI practices by institutional investors will be observed.

Before beginning, it is important to note the difficulty of defining and measuring SRI.\(^8\) As noted above, SRI involves personal values and subjective thinking. It is therefore difficult not only to agree if a practice is an SRI practice, but also to know if investors engaged in such practices because of subjective motivations consonant with SRI.\(^9\) For example, is supporting board diversity an SRI practice? One can certainly argue that it is socially responsible to ensure minorities are represented on corporate boards because such diversity empowers the historically


\(^8\) See Hylton, \textit{supra} note 5, at 6.

\(^9\) See \textit{id.} at 6-7.
disenfranchised and benefits the broader community. However, some deem board diversity a matter of corporate governance, not SRI. Moreover, an investor may also support board diversity, even in part, because board diversity can improve firm performance. Does this financial motivation mean that the investor is not engaging in SRI, but rather just sound investing that happens to have a positive social effect? If investors’ motivations matter for purposes of SRI, it will be all but impossible to pragmatically measure SRI. Therefore, this paper will make two assumptions about SRI. First, it will assume that SRI constitutes investments that consider social and environmental consequences and/or the needs of outside “stakeholders,” such as company employees, customers, and local communities, regardless of whether the practice can be linked to financial performance. Second, it will assume that no kind of subjective motivation on the part of investors is necessary for a corporate practice to be considered an SRI practice.

I. Public and Private Pension Funds: Two Funds, Similar SRI Story

Pension funds in the United States, despite a drop in their total asset holdings since 2007, still have the largest share of the total assets under institutional shareholder management, with $10.1 trillion in total holdings as of 2009, $4.185 trillion of which were equity holdings. In order to properly gauge the propensity of pension funds to engage in SRI, it is pertinent to distinguish between public pension funds and private pension funds and to observe their SRI practices separately. As will be shown, the difference in management personnel and the varying legal obligations of each type of pension fund can substantially influence these funds’ SRI

10 See, e.g., SOC. INV. FORUM, supra note 4, at 25. Indeed, in its report, the Social Investment Forum categorized board diversity and excessive executive compensation as “crossover issues,” i.e. corporate governance issues that “cross-over” into social or environmental concerns. See id.

11 See id. at 2.

practices. But in the end, despite these different factors, neither public pension funds nor private pensions funds practice—or can be expected to practice—SRI to be effective corporate monitors.

A. Public Pension Funds

Public pension funds are pension funds comprised of the retirement savings of state and local government employees. The largest U.S. public pension fund is the California Public Employees’ Retirement System (“CalPERS”).13 Public pension funds, unlike private pension funds, are exempt from the Employee Retirement Income Security Act of 1974 (“ERISA”), a federal statute that imposes a fiduciary duty on private funds’ management personnel towards the funds’ beneficiaries.14 Instead, state laws dictate the investment policies of public pension funds, most of which prescribe a “prudent person” fiduciary standard.15 State statutes further prescribe the composition of public fund boards, which are made up of three categories of members.16 Two of these member categories are political appointees and state officials.17 These statutes essentially guarantee that public fund boards have strong political affiliations, which make public funds particularly vulnerable to political pressure from state governments.18

1. The Public Fund Board and Its Politicization of SRI

Because of its politicized boards, public funds are likely to engage in some types of SRI practices. The most common of these practices is when a public fund, swayed by political pressure, finances development projects in local communities or otherwise uses its assets to help distressed local political entities.19 Public funds engage in other types of SRI practices because of

13 See Fairfax, supra note 1, at 50.
14 See Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 COLUM. L. REV. 795, 800 (1993).
15 See id.
16 See id.at 800-01.
17 See id.at 801.
18 See id.at 820; see also Lisa M. Fairfax, Making the Corporation Safe for Shareholder Democracy, 69 OHIO ST. L.J. 53, 101 (2008).
19 See Romano, supra note 14, at 800.
the board members’ personal ambitions and values. These politically-appointed or state official board members tend to have aspirations for higher political office. Consequently, they may use the public fund as an instrument to confront corporate management or imbue their own moral values into their funds’ investment portfolios to enhance their reputations amongst voters.

However, public funds’ politicized management cause public funds to only sporadically engage in SRI, while only a few funds consistently engage in SRI. These trustees may use their positions, to the dismay of some, to express their political views or take a popular stand against the issue of the day. What is more, studies have shown that it may only take one such trustee to galvanize the whole board to act on a particular social issue. Even in the absence of such a trustee, public funds are susceptible to political influence that can pressure them into SRI, such as to invest in a local industry or a local community. A recurrent example of this is when political bodies pressure the board of trustees to direct the fund to purchase bonds from economically-distressed municipalities. Therefore, because public fund SRI can hinge on the gusto of one politically-charged trustee, or on whether the board will bend under political pressure to engage in local investing, public fund SRI is sporadic and difficult to predict.

2. The Exception: Large Public Fund SRI

Most instances of consistent public fund SRI involve few, very large funds, such as CalPERS, the New York State Common Retirement Fund, and the five New York City public

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20 See id. at 822.
21 See id.
22 See id. at 795, 820, 822.
23 See Hess, supra note 5, at 226. Vice Chancellor Leo Strine, Jr., of the Delaware Court of Chancery, is known to have said that retail shareholders lament the fact that corporations are becoming “a therapy couch for politically motivated institutional investors to vent their causes of the moment.” Id.
24 See Romano, supra note 14, at 822.
26 See Romano, supra note 14, at 812.
pension funds. Unlike the smaller public funds, these large funds can take certain actions that can make their SRI predicable, such as joining collaborative shareholder groups. And just based on past actions and reputation, certain large public funds, such as the five New York City public pension funds and CalPERS, can be expected to engage in SRI. However, while these funds each have large asset holdings, their total asset holdings represent less than twenty percent of the total asset holdings of the 100 largest public pension funds in the United States. These statistics therefore show that the very large funds’ SRI practices are the exception of U.S. public fund SRI, not the norm.

3. Public Fund Investment: Diversified and Therefore Antithetical to SRI

Concomitantly, public funds’ politicized boards can also drive their funds’ investment strategy in the opposite direction, towards diversification. A diversified investment strategy reduces the public funds’ ability to effectively engage in SRI because it involves passively holding relatively small blocs in a plethora of companies that essentially reflect the whole market. As a result of their diversified portfolios, public funds lack the leverage of large

28 See Hess, supra note 5, at 237. For example, in 2007, CalPERS, the California State Teachers’ Retirement System, the Connecticut Retirement Plans and Trust Funds, the New York City Employees Retirement Systems and others joined the Carbon Disclosure Project, an international group of institutional investors that makes annual requests for greenhouse gas emissions disclosures from the largest corporations worldwide. See id. Almost all these same member funds are also signatories to the United Nation’s Principles of Responsible Investment. See id.
29 Id. at 236-38.
31 See Aronson, supra note 25, at 587-88.
32 See Conley & O’Barr, supra note 27, at 837.
ownership stakes, and thus cannot effectively pressure the corporate management of their portfolio companies to institute socially responsible corporate practices.  

Public fund boards favor diversified portfolios for two reasons. First, because of the (politicized) boards’ lack of investment expertise, diversification allows public fund boards to avoid focused investing, which requires more expertise to properly analyze the risks and gains involved. Second, because these diversified portfolios are supposed to reflect the market as a whole, they provide small steady returns with low levels of risk. In the rare instance where losses do occur with diversified portfolios, public fund boards can avoid criticism for poor fund performance by simply faulting an overall economic downturn for the losses rather than their investment decisions. Public fund trustees are thus noted to be more bureaucrats than investors, because of their lack of expertise. Therefore, diversification not only reduces the risk of fund asset losses, but also enables the lack of expertise on public fund boards to persist because it reduces the boards’ accountability.

4. Public Fund Anti-SRI Proxy Voting

Public funds are unlikely to engage in SRI through the proxy process because such funds mostly delegate their shareholder voting power to external money managers, and generally, these external money managers are incentivized only to achieve short-term financial gains. Most public funds evaluate their money managers on a quarterly basis; this mechanism thus encourages money managers to invest on a short-term rather than on a long-term basis, which is

33 See Aronson, supra note 25, at 585, 587-588.
34 See id. (a more active investment strategy aimed to achieve above-market performance is riskier in terms of costs).
35 See id.
36 See Conley & O’Barr, supra note 27, at 836-37.
37 See Aronson, supra note 25, at 587.
38 See Conley & O’Barr, supra note 27, at 836-37.
39 See Hess, supra note 5, at 240-41, 245.
essential for most SRI practices. These managers tend to side with corporate management, which knows best how to maximize short-term returns, and vote against SRI proposals that would most likely only render long-term financial returns. Most public fund boards also do not provide their money managers with voting guidelines that incorporate SRI policies. Therefore, most public funds fail to provide a mechanism to counter their money managers’ short-term, quarterly-based investment approach which fails to support SRI.

Even the public funds that do not delegate their shareholder voting power to external money managers nonetheless vote very similarly to funds that do delegate their voting power. This is due to these funds’ reliance on the advice of proxy advisory firms. These firms, like external money managers, advise funds to side with management on socially-related and environmentally-related shareholder proposals so to maximize short-term returns. Because of these governance practices, public funds ironically invest on a short-term basis, despite the fact

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40 See id. at 245-46. Short-term investing is essentially contrary to SRI, because such investing does not account for “stakeholders,”—employees, customers, and the broader community—whose interests are better served by long-term investing. See Fairfax, supra note 18, at 57, 83; Lisa M. Fairfax, Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power, 3 VA. L. & BUS. REV. 1, 32 (2008). Short-term investing “can be defined as the focus of investors and managers on short-term gains, whether quarterly earnings or short-term portfolio returns, at the expense of long-run shareholder value.” Dionysia Katelouzou, Myths and Realities of Hedge Fund Activism: Some Empirical Evidence, 7 VA. L. & BUS. REV. 459, 477 (2013); see also Conley & O’Barr, supra note 27, at 839.

41 See Hess, supra note 5, at 245.

42 See id. at 241. In David Hess’s survey of 58 public funds from 22 states, only 10% of board trustees indicated they were aware of an environmental issues voting policy for their fund’s money managers, while 17% of the trustees knew of a social issues voting policy for their fund’s money managers. Id. Paul Myners’s survey of U.K. pension fund trustees reaches similar conclusions. See Paul Myners, Institutional Investment in the United Kingdom: A Review 10, 40 (2001).

43 See Hess, supra note 5, at 257.

44 See id. at 242, 257.

that they have strong, long-term investment interests since they provide retirement benefits for their beneficiaries.\textsuperscript{46}

As a consequence their diversified portfolios and external money managers, public funds are “passive investors,” with small holdings in a large number of portfolio companies, and thus lack the ability to engage in SRI effectively.\textsuperscript{47} Because of the low ownership stakes in their portfolio companies, public funds become less influential on their portfolio companies’ corporate practices, both through proxy voting and through other, more informal means of influencing corporate practices. Meanwhile, fund beneficiaries—the government employees—are an unlikely force to challenge these diversified, passive investment practices because of their own lack of expertise.\textsuperscript{48}

B. Private Pension Fund SRI and Its Constraints

More so than public pension funds, private pension funds do not and likely will not serve as effective monitors of corporate practices through SRI because of their investment practices and legal constraints. In contrast to public pension funds, private pension funds are funds managed by corporations or other entities for the benefit of corporate employees.\textsuperscript{49} The sole goal of private pension funds is to provide its beneficiaries—once the time has come—with the funds they are owed in accordance with their employment agreement.\textsuperscript{50} Unlike public pension funds, private funds are not so vulnerable to political pressure, for two reasons. First, because of no statutory requirements for governmental and political appointments, private fund boards are not so politically-charged; therefore, private fund managers do not have an incentive to enhance their

\begin{flushright}
\textsuperscript{47} See Aronson, \textit{supra} note 25, at 585.
\textsuperscript{48} See id. at 590.
\textsuperscript{49} See FAIRFAX, supra note 1, at 50.
\textsuperscript{50} See Richardson, \textit{supra} note 46, at 312.
\end{flushright}
public reputations through SRI.\textsuperscript{51} Second, the fiduciary duty ERISA imposes on private funds, many argue, precludes SRI.\textsuperscript{52} While it has not been legally decided whether engaging in SRI violates this duty, private fund trustees largely seem to believe that it does, because SRI poses higher financial risk but does not offer returns commensurate with that risk.\textsuperscript{53} SRI could therefore violate ERISA, while compromising private funds’ overarching objective of yielding the most returns for their beneficiaries.\textsuperscript{54} Thus, even if faced with political influence, private funds trustees will not subordinate ERISA’s statutory obligation to this influence.

Even if ERISA could be construed to allow social investing, private funds are still unlikely to engage in SRI because of a crucial contingency: private funds, unlike public funds, are not backed by the state and therefore run a much greater risk of default on obligations to its beneficiaries and/or filing for bankruptcy.\textsuperscript{55} Thus, operating under higher stakes, private funds have large disincentives to engage in SRI and run the risk of lower returns.\textsuperscript{56} As a result, private funds are substantially less likely to engage in SRI than public funds.

Private funds’ investment practices also disfavor SRI. Interestingly, statutes covering private funds induce them to engage in less diversified investing, which consequently discourage private fund trustees from engaging in SRI. State law does not dictate private fund board appointments; private funds thus have professionalized boards unlike public fund boards, which are mostly composed of political figures.\textsuperscript{57} Under the guide of these professionals, private funds tend to focus their investments more than public funds do, in order to increase their financial

\textsuperscript{51} See Romano, supra note 14, at 822. As will be seen, despite this difference, public funds and private funds’ proxy voting is not significantly different. See id. at 839.

\textsuperscript{52} See id. at 811 n.61; see also Richardson, supra note 46, at 312-13 (although, if the private fund informs its beneficiaries of its increased risks and costs, a socially-responsible investment portfolio may comply with ERISA’s requirements).

\textsuperscript{53} See Hess, supra note 5, at 246.

\textsuperscript{54} See Richardson, supra note 46, at 312-13.

\textsuperscript{55} See Romano, supra note 14, at 811.

\textsuperscript{56} See id.

\textsuperscript{57} See id. at 800-01; Conley & O’Barr, supra note 27, at 837.
outputs per their beneficiaries’ contributions. Therefore, private fund trustees do not engage in as much diversified passive investing as public funds do. Private fund trustees also tend to follow the advice of consultants and commonly-accepted practices of their peer group. Both financial consultants and private fund trustees tend to invest traditionally and disfavor SRI strategies when the current data evaluating their effectiveness is inadequate. Given that private funds already engage in higher-risk investments than public funds, private trustees are highly unlikely to further contribute to that risk by also engaging in SRI.

Finally, with regards to proxy voting policies, private funds either assign proxy voting internally to a committee or delegate the voting to external money managers. With regard to internal voting committees, the fund provides general guidelines that result in voting with corporate management almost every time. With regard to external money managers, the voting pattern is the same: siding with management almost every time. Therefore, private funds are unlikely to effectuate SRI practices in their portfolio companies through proxy voting as well.

II. Mutual Funds’ Mismatch with SRI

Mutual funds are the second-largest institutional shareholder group to pension funds in the U.S. in terms of total asset holdings, with almost $7 trillion, $4.136 trillion of which is equity holdings. Moreover, mutual funds are ubiquitous savings vehicles for individual American
investors. Approximately 77.7 million Americans hold equity investments through mutual fund stocks. These individuals largely invest in mutual funds through their employer pension funds, the largest source of equity for mutual funds.

A mutual fund is a legal entity, something between a trust and a corporation, where the pooled money of its shareholders is invested in a portfolio of securities, such as stocks or bonds. Mutual fund shareholders may be individual investors, corporations, and/or institutional investors such as pension funds and even other mutual funds. While the mutual fund is controlled by a board of directors or trustees, its actions are almost solely directed by an adviser firm (hereinafter, “the adviser”). The adviser, usually a subsidiary of a financial services firm, creates the fund by initially nominating a slate of directors to serve on the fund’s board; these directors often are employees in the adviser firm as well. These directors subsequently “hire” the adviser to manage the investments of the fund; the adviser then hires individual employees as portfolio managers who make the fund’s everyday investment decisions. Sometimes these advisers are known as “fund families,” because such advisers launch and run multiple mutual funds. As will be shown below, mutual funds do not—and likely will not—engage in SRI given their investment practices, structural norms, fiscal incentives, and practical constraints.

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67 See id. In fact, nearly half of all U.S. households, 51.8 million, own stocks through mutual funds. Id.
68 See id. at 851.
69 See id. at 848-49.
70 See id.
71 See id.
72 See id. at 850.
73 See id.
74 See id. Despite the vastness of mutual fund asset holdings, and the more than 4,000 mutual funds in the U.S., mutual funds financial holdings are extremely concentrated; in 2005, the top ten mutual fund families held about 48% of the total U.S. mutual fund assets, and the top 25 families held 71% of the total assets. See James Cotter et al., The Rise (and Fall?) of the New Shareholder: Sovereign Wealth Funds, Hedge Funds, and Private Equity, 55 VILL. L. REV. 1, 3-4 (2010).
A. A Mutual Fund Conflict of Interest and Its Constraint on Fund SRI

Beginning with mutual funds’ investment practices, the adviser’s ability to invest fund assets in its own corporate-shareholders’ securities—essentially making the fund’s client a portfolio company as well—causes a severe conflict of interest that thwarts SRI by mutual funds. When a mutual fund holds corporate stocks, it is the fund that is considered the shareholder of the portfolio company, while the individual or firm that provided the money for the stocks is considered the shareholder of the mutual fund. When an employer-sponsored private pension fund invests in the mutual fund, it is the pension fund that legally owns the shares in the mutual fund, not the beneficiary employee. Private corporate pension funds are the largest source of revenue for U.S. mutual funds. This fact causes a pronounced conflict of interest for the adviser when the mutual fund manages a corporation’s pension fund assets while owning securities in that same corporation. At the risk of alienating their corporate clients and losing their business, funds forego shareholder activism in these portfolio companies. In these situations, a mutual fund will support management recommendations to avoid a potential conflict with one of its clients.

B. the Normative Fund-Adviser Compensation Scheme

The prevalent compensation scheme for mutual fund advisers is another reason why mutual funds do not, and likely will not, engage in SRI. The compensation for these adviser firms include a management fee based on the total dollar value of the assets managed by the

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75 See Taub, supra note 66, at 848-49.
76 See id. at 851.
77 See id.
78 See id. at 866.
79 Gerald F. Davis & E. Han Kim, Would Mutual Funds Bite the Hand that Feeds Them? Business Ties and Proxy voting 4 (Feb. 15, 2005) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=667625. For instance, Fidelity, a fund active regarding corporate governance issues in Europe, is silent in the U.S., where a substantial amount of its revenue comes from corporate (i.e. private) pension funds. Id.
80 See Taub, supra note 66, at 866.
Therefore, advisers can receive payment for this fee regardless of whether existing fund assets increase in value. This compensation scheme creates conflicts of interest between the fund shareholders and the adviser firm. Because the larger the fund’s pool of assets grows, the larger the management fees become, advisers engage in marketing in order to attract new capital. This marketing diverts fund shareholders’ capital from further investing to gathering new assets. These new assets could come from a current portfolio company. This gives advisers further incentive to support management proposals and reject any SRI-related shareholder proposals. Despite several procedural safeguards and a fiduciary duty of good faith and fair disclosure the adviser owes to the fund’s board of directors, the adviser dominates the board because of its monopoly over information about the fund and its ability to set the board’s agenda. As a result of the interests of and influence by fund advisers, mutual fund boards overwhelmingly vote in favor of management proposals and against shareholder proposals. While these studies indicate that mutual fund support of shareholder proposals varies depending on the type of proposal in question, it is apparent that of all the proposal types, SRI-related shareholder proposals received the least support from mutual funds.

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81 See id. at 852.
82 Id. Albeit financially, good performance does matter to the adviser because a higher profit margin will not only increase the existing total assets but also attract new capital to invest in the fund, thus increasing the fund’s total assets and consequently, the management fees. Id.
83 See James Cotter et al., supra note 74, at 9.
84 See Taub, supra note 66, at 879.
85 See id.
86 See id.
87 See id.
88 See id. at 850.
89 See James Cotter et al., supra note 74, at 13-18. The authors of this article in fact argue that mutual funds have increasingly sided with other shareholder activists and vote against management. See id. at 2. However, this article finds this trend evaluating fund voting outcomes generally, without providing data on the voting outcomes of SRI proposals alone. See id. at 24-40. In fact, the studies it does provide that consider SRI fund voting trends alone showed either a very low level of fund support of SRI proposals (about 10%); that fund support increased and decreased by small figures from year to year; and that funds increased their abstention votes on SRI proposals. See id. at 18, 20, 21-22.
90 See id. at 20.
C. Further Constraints on Mutual Fund SRI: Diversified Investing and Liquidity Needs

It is even more unlikely that mutual funds file SRI-related proposals because of their diversified investment strategy and their need for liquidity. Mutual funds are known as passive investors who follow the traditional “Wall Street rule:” sell shares in underperforming portfolio companies rather than engage in shareholder activism.\(^9\) This repute stems from the fact that mutual funds are short-term, diversified investors.\(^9\) Mutual funds have diversified investment portfolios not only to reduce risk of economic loss, but also to obtain pass-through taxation.\(^9\) Subchapter M of the Internal Revenue Code subjects 50% of a mutual fund’s assets to certain diversification requirements in order to qualify for pass-through taxation: no fund may invest more than 5% of (50% of) its assets in any one portfolio company; and 50% of fund assets may not hold more than 10% of the total shares of a portfolio company.\(^9\) Also, if funds wish to advertise themselves as “diversified,” they are required by the Investment Company Act to maintain the aforementioned diversification requirements for 75% of their total assets.\(^9\) Because of these legal incentives for diversified portfolios, mutual funds do not hold a significant enough blocks of shares in any one portfolio company to care to engage in any kind of shareholder activism in their portfolio companies.

Apart from these tax incentives, mutual funds also engage in short-term diversified investment because they must maintain liquid assets.\(^9\) Shareholders in mutual funds range from

\(^9\) See id. at 2.
\(^9\) See id. at 10.
\(^9\) See id.
\(^9\) Id.
\(^9\) See James Cotter et al., *supra* note 74, at 10.
pension funds, individuals, and corporations—all of whom may, on any business day, wish to redeem their shares, pro rata of the fund’s total assets.  

This need affects mutual fund investment in two ways that consequently discourages SRI by mutual funds. First, the liquidity need limits the funds’ ability to obtain a controlling block in a portfolio company because such a block may be difficult to sell quickly. Therefore, mutual funds are likely to be diversified investors with too small of stakes in their portfolio companies to care to make shareholder proposals. Second, the liquidity requirement encourages short-term investing, because of the constant need for returns. As short-term, diversified investors, mutual funds are thus highly unlikely to make or support SRI-related proposals.

D. A Cost-Benefit Concern for Mutual Fund Activism: The Free-Rider Problem

Mutual funds are also unlikely to make SRI-proposals because shareholder activism is not cost-effective for the funds in the first place. Advisers refrain from making shareholder proposals because, even if the proposal is adopted and later leads to increased returns for the portfolio company, all of the company’s shareholders—not just the proposing fund—would benefit (in proportion to their ownership). These other shareholders of the portfolio company may be competing mutual funds of the fund that initially made the proposal. These other funds’ higher returns will subsequently attract new capital to them, depriving the proposing fund of potential increases to its own assets, which would have increased the fund’s adviser’s

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97 See Taub, supra note 66, at 849 (for example, a corporation may buy shares in a mutual fund and liquidate the next business day just to have its daily cash revenue accumulate interest in the fund overnight). When a mutual fund shareholder cashes out her shares, the value of each of her shares is based on the daily value of the portfolio securities (minus management fees and other expenses) divided by shares outstanding. See id. at 849, 852.
98 See James Cotter et al., supra note 74, at 10.
99 See id.
100 Cf. Hess, supra note 5, at 245-46.
101 See Taub, supra note 66, at 880.
102 See id. at 882.
103 See id.
management fees. As a result, mutual fund activism that successfully increases the value of a portfolio company can result in a loss to an active fund, because the lost profits caused by the “free rider” problem will likely outweigh any profit gained from the small holdings the fund owns in the company. Because of this “free rider” problem, mutual fund advisors care more about asset gathering than enhancing asset performance through shareholder activism.

E. Sporadic Demand for Mutual Fund SRI by Fund Shareholders

Another noteworthy reason why mutual funds are unlikely to engage in SRI-related shareholder activism is that there simply is no consistent demand for such activism from the funds’ own shareholders. This phenomenon has two possible explanations: 1) fund shareholders are unaware of the importance of proxy voting; and/or 2) they feel reluctant to vote—and therefore do not vote—because their votes are only advisory and/or because their holdings in the fund are too insignificant to influence the outcome of the vote. In either case, fund advisers do not know what their shareholders’ SRI agenda is and therefore have even less reason to engage in shareholder activism.

However, in the event of a public outcry by fund shareholders for SRI, advisers have taken their shareholders’ concerns into account. Such was the case during the Darfur Genocide, where fund shareholders called for divestitures of portfolio companies that profit from

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104 See id. If the proposing fund is heavily invested in the portfolio company, it could outperform other competing funds with holdings in the same company; this is rarely the case however, since mutual funds are diversified investors. See id.
105 See id. at 880.
106 See id. at 880-81.
107 See id.
108 See id. at 884.
109 See id.
110 See id. at 885.
111 See id. at 886.
business in Sudan. But public outcries from poignant events and practices, such as the Darfur Genocide or the apartheid regime of South Africa, are few and remain too unpredictable to provide effective corporate monitoring. Some have argued that the Securities Exchange Commission’s (“SEC”) 2004 rule, which requires mutual funds to disclose their voting in portfolio companies to their shareholders, could encourage more fund shareholder demands for SRI-oriented voting policies like the demands that arose during the Darfur Genocide. Yet these scholars provide evidence of only a handful of specific instances to bolster their claim that mutual fund SRI has increased as a result of the SEC’s 2004 rule, and they even concede that mutual funds still tend to side with corporate management and largely remain silent in the SRI arena.

F. A New Trend: Mutual Fund Environmental SRI

There is one area of SRI where mutual funds may become more active and that is environmentally-oriented SRI. Although the large fund families consider social and environmental issues as unrelated to the funds’ shareholder value, and leave such matters to corporate management’s discretion, these families have indicated that they would vote in favor of SRI proposals if such proposals will lead to economic benefits. When fund directors view corporate environmental practices as a serious financial issue, their funds do support

112 See id.
114 See Williams & Conley, supra note 113, at 96-97; Williams & Conley, supra note 113, at 528 nn.195-96, 546. The SEC’s rule was actually promulgated at the behest of a minority of institutional shareholders--labor unions and SRI funds—and opposed by the large, “mainstream” mutual funds, such as Fidelity, Magellan, and TIAA-CREF. See Williams & Conley, supra note 113, at 528. It should also be kept in mind that just like corporate shareholder voting, fund shareholder voting is advisory, so mutual fund boards still may not adopt their shareholders’ SRI-related proposals. See Taub, supra note 66, at 884.
115 See Williams & Conley, supra note 113, at 546.
environmentally-related proposals. However, when fund directors view environmental practices as social or (purely) environmental issues instead, the funds do not vote in support of environmentally-related proposals.

Although there is a growing trend of mutual fund support for environmental resolutions, the trend remains small. In 2013, mutual fund support for environmentally-related proposals reached an all-time high of 29%. But as mentioned above, it appears that financial considerations are the main drivers behind this fund support; on average, the funds that supported environmental-related shareholder proposals do so at a much higher rate than they supported socially-related proposals. This discrepancy indicates that funds consider environmental issues more financially important than other social issues.

G. Conclusion on Mutual Fund SRI: Sporadic and Inchoate

The mutual funds’ adherence to the “Wall Street rule” is therefore explained by juxtaposing the diversification incentives for mutual fund investment, the funds’ liquidity needs, and the low cost-efficiency of shareholder activism. Mutual funds utilize their “exit” option—simply selling their shares in a particular company—rather than attempt to change the corporate practices of a firm through shareholder activism that, in the end, may lead to lost profits because of the “free-rider” problem. This financial rationale explains why the mutual fund boards do

117 See id.
119 See BERRIDGE & COOK, supra note 116, at 12. An SEC’s rule reversal in 2009, which allowed investors to inquire about corporate environmental practices, marked the SEC’s recognition that corporate environmental practices have serious financial implications, such as “far-reaching physical, regulatory and litigation risks.” Id. at 3.
120 See id. at 12.
121 Cf. Hylton, supra note 5, at 31 (showing data that socially-responsible mutual funds do not consistently outperform mutual funds that follow traditional investment methods).
122 See Aronson, supra note 25, at 590; Taub, supra note 66, at 882.
not engage in shareholder activism in their portfolio companies even on routine matters of corporate governance, such as “withhold the vote” campaigns or declassifying a corporate board of directors.123

While mutual funds’ embracement of the “Wall Street rule” is deleterious for mutual fund SRI, mutual funds shareholder demand may serve as a check on egregious corporate practices.124 However, mutual fund shareholder demand for SRI is sporadic at best.125 And while mutual fund concern about environmental issues may be on an upward trend, it is still too nascent to suggest any general trend about mutual fund SRI.126 Evidence therefore evinces that, for the meantime, mutual funds are unlikely to act as effective monitors of corporate practices.

III. Hedge Funds Activism and SRI: An Oxymoron

A. General Characteristics of Hedge Funds

The hedge fund market has grown exponentially over recent years, from about 3,000 funds in 1998, to about 8,000 funds in 2006.127 Correspondingly, total hedge fund assets grew from about $300 billion in 1998, to over $1 trillion in 2006.128 A 2013 estimate found more than 9,000 hedge funds in the U.S., with over $1.8 trillion in total asset holdings.129

“There is no generally agreed-upon definition of a hedge fund,” but hedge funds do generally have four characteristics: (1) they are privately pooled investment funds; (2) managed by professional investment managers; (3) not widely available to the public; and (4) not required to follow SEC regulatory and registration requirements.130 Hedge funds largely avoid federal

123 See Taub, supra note 66, at 845, 878.
124 See discussion supra p.17-18.
125 See id. at 18.
126 See id. at 19.
128 See id.
129 See Katelouzou, supra note 40, at 468.
130 See Partnoy & Thomas, supra note 127, at 22-23; see also Katelouzou, supra note 40, at 468.
securities law because they make private offerings only to a relatively small number of wealthy and sophisticated individual and institutional investors.  

The typical hedge fund is a partnership managed by a general partner; its shareholders are passive, limited investors that have little or no control over the fund’s operation. Hedge fund management charges high fees, usually 2% of the total assets under management, and receive an additional 20% of the fund’s annual profits. As stated above, mutual fund advisers often engage in product marketing because they are usually compensated based on the fund’s total assets alone. In contrast, hedge fund managers are highly motivated by the annual profits fee to increase fund performance. This motivation can be even stronger because often, hedge managers invest their own personal wealth in the fund. Hedge funds also require that their investors “lock in” their investments in the fund for a fixed period of time, ranging from six months to two years or more. The financial incentives, lack of federal regulation, and “locking-in” of fund assets allow hedge fund managers to operate more independently than managers of other institutions and spur them to implement aggressive investment strategies to improve the fund’s absolute returns.

B. Hedge Fund Activism’s Incongruence with SRI

As a result, hedge funds are structured to increase their investors’ assets, without regard to social or environmental issues, and typically engage in aggressive short-term investing that is...

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131 Partnoy & Thomas, supra note 127, at 23. Hedge funds are still subject to certain disclosure requirements, such as when they own more than 5% of the equity securities of a public company, per section 13(d) of the Securities Exchange Act. See Kahan & Rock, supra note 94, at 1062. Hedge fund managers must also disclose their holdings on a quarterly basis per section 13(f). Id. at 1063.
132 See Partnoy & Thomas, supra note 127, at 26.
133 See id. at 25. As a result, hedge fund managers are among the most highly compensated employees in the world, with certain individuals making more than $100 million per year. See id.
134 See Taub, supra note 66, at 879.
135 See Kahan & Rock, supra note 94, at 1064.
136 See id.
137 See id. at 1063.
Not conducive to SRI. Notably, hedge funds generally do not engage in any kind of shareholder activism, much less in SRI-related activism. Some hedge fund activism did come into being in the early 2000s, as a result of hedge funds becoming a prominent investment option in the 1990s and the dot-com market “bubble” in 2000. Then and now, active hedge funds try to increase target firms’ value by influencing corporate governance, capital structure decisions, and performance of these firms. This activism may take the form of publicly pressuring a portfolio company to change its corporate practices, running a proxy contest to gain board seats, or engaging in litigation.

While hedge fund activism is growing, active hedge funds still comprise a very small portion of the hedge fund community. In 2006, there were only about 100 active funds out of approximately 9,000 U.S. hedge funds. These active funds managed $50 billion of assets, only 5% of the total U.S. hedge fund asset holdings. With such a small share of holdings, active hedge funds are not likely to be effective monitors of corporate practices.

Moreover, whatever little hedge fund activism there is, it does not encompass SRI at all. Hedge fund activism efforts are orientated completely with the bottom line: increasing profits in portfolio companies. Active funds leverage their pool of capital to push for corporate

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139 See Kahan & Rock, supra note 94, at 1071; Fairfax, supra note 40, at 30.
140 See Kahan & Rock, supra note 94, at 1046.
142 See Katelouzou, supra note 40, at 482.
143 See id. at 468; Kahan & Rock, supra note 94, at 1029.
144 See Katelouzou, supra note 40, at 468.
145 See Kahan & Rock, supra note 94, at 1046.
146 See id.
147 See Katelouzou, supra note 40, at 507-08.
149 See Brav, Jiang & Kim, supra note 148, at 12-13. See also Katelouzou, supra note 40, at 492 (stating the ultimate goal of activist hedge funds is to “provide absolute or real returns for their investors.”); Kahan & Rock, supra note 94, at 1069.
restructuring, share buybacks, assets sales, increased dividend payments and other strictly financial corporate actions.\textsuperscript{150} Using comprehensive data, Alon Brav and his coauthors provide a table of “actions” taken by active hedge funds.\textsuperscript{151} These “actions” were divided into five categories based on the funds’ underlying objective for the action: “General undervaluation/maximize shareholder value,” “Capital Structure,” “Business Strategy,” “Sale of Target Company,” and “Governance.”\textsuperscript{152} Hedge fund “actions” motivated by SRI were not even designated a category, and none of the five categories provided conceivably encompass SRI concerns.\textsuperscript{153} This evidence is telling of the hedge fund activism’s complete disregard of SRI.

Also telling of the lack of SRI-motivated hedge fund activism is the ongoing debate of whether hedge fund activism is beneficial.\textsuperscript{154} The scope of this debate has been confined to whether this activism benefits the funds’ target companies’ other shareholders.\textsuperscript{155} Proponents of hedge fund activism only argue that the activism benefits the financial value of other shareholders’ holdings in the funds’ target companies.\textsuperscript{156} The fact that the debate about hedge fund activism does not even consider the activism’s social and environmental impact shows that there is nothing to examine when it comes to hedge fund activism and SRI. This activism, if beneficial, benefits only the other shareholders of the target company on purely financial terms, and therefore is highly unlikely to effectuate any SRI-related goals. In fact, SRI-related goals are effectuated at times by other shareholders rebuffing hedge fund activism, out of social and

\textsuperscript{150} See Partnoy & Thomas, supra note 127, at 2; Katelouzou, supra note 40, at 492.
\textsuperscript{151} See Brav, Jiang & Kim, supra note 148, at 58 tbl.1.
\textsuperscript{152} See id.
\textsuperscript{153} See id.
\textsuperscript{155} See, e.g., id.
\textsuperscript{156} See id. at 1271-72; see also Katelouzou, supra note 40, at 482, 468 (“[W]hile [a]ctivist hedge funds’ ultimate goal is . . . to provide absolute or real returns for their investors . . . they are doing so in a way that can benefit the entire shareholder body.”) (emphasis added).
environmental concerns. Therefore, hedge funds are highly unlikely to engage in SRI so to serve as effective corporate monitors.

IV. SRI Funds: A (Relatively) New SRI Path

A. General Characteristics of SRI Funds

A relatively newer kind of institutional shareholder is the SRI fund. SRI funds invest with consideration towards “stakeholders,” i.e. employees, customers, and the broader community, and advance social and environmental concerns. In 1976, the SEC removed the “social cause” exclusion from the shareholder proxy process. This allowed for shareholder proposals advancing stakeholder-oriented policies to be considered in the corporate proxy process. Faith-based organizations were among the first to respond to the SEC’s rule change and began to submit proposals on specific social issues. A famous early example is the Episcopal Church’s shareholder proposals calling for divestiture from South Africa, due to its apartheid regime. These faith-based organizations were the forerunners to the SRI fund. Still today, faith-based investors are the majority filers of stakeholder-oriented shareholder proposals.

SRI funds’ main purpose is to cause portfolio companies to account for their impact on stakeholders. SRI funds use three main strategies when they engage in SRI: 1). they use either positive or negative screens on their portfolio companies; 2). they engage in shareholder advocacy, either by directly engaging corporate management or by filing, co-sponsoring, and/or

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157 See Fairfax, supra note 154, at 1272.  
158 See Fairfax, supra note 18, at 84.  
159 See id. at 86.  
160 See id.  
161 See id. at 87.  
162 See id. at 86-87.  
163 See id.  
164 See Soc. Inv. Forum, supra note 4, at 36.  
165 See Fairfax, supra note 18, at 85.  
166 See note 5 supra, for an elaboration on positive and negative SRI screening.
voting on shareholder proposals; and/or 3). they directly invest in distressed communities otherwise undeserving of investment per traditional financial standards.167

B. SRI Fund Equity Constraints and Need for Collaboration

While SRI funds can be effective corporate monitors, they are limited in that capacity because of their small asset holdings. Concededly, it is true that assets under SRI fund management are increasing; in its 2007 report, the Social Investment Forum found SRI-fund total asset holdings increased from about $12 billion in 1995 to $201.8 billion in 2007.168 The report further found the number of these funds increased, from 55 in 1995, to 260 in 2007.169 Despite this positive growth trend, SRI funds’ asset holdings in the equity market is still very small, with asset holdings of only $201.8 billion of the $25.1 trillion in total holdings under institutional ownership control.170

Despite their small holdings, SRI funds can legitimize a social or environmental issue by persistent proposal resubmissions through the proxy process.171 These resubmissions either guarantee that the issue remains on the corporate radar or allow the funds to gradually reframe the issue in order to appeal to a larger shareholder base and thus gradually gain more support.172 This phenomenon is observed in the Institutional Shareholder Services’ (“ISS”) 2013 proxy season review report.173 ISS further found that SRI funds have moved away from submitting special interest proposals, such as those targeting tobacco companies, and from proposals calling for certain actions by portfolio companies.174 Instead, SRI proposals have shifted towards

167 See SOC. INV. FORUM, supra note 4, at 3.
168 See id. at iv, 7 fig.2.1.
169 See id. at 7.
170 Compare id. at iv, 7, and TONELLO & RABIMOV, supra note 12, at 14 tbl.5.
171 See Fairfax, supra note 18, at 92.
172 See id.
174 See id.
requesting improved disclosures on SRI-related issues that also present a business concern to the companies.\textsuperscript{175} This shift shows SRI funds’ ability to adapt their proposals in order to garner broader support from fellow investors.

It seems therefore, that SRI funds’ success in influencing corporate governance depends on collaboration with other institutional investors. And in fact, there has been an increased level of collaboration between SRI funds and traditional institutional investors, generating a greater level of support for SRI-related shareholder proposals.\textsuperscript{176} This collaboration is attributed to traditional investors’ recognition that consideration of stakeholder concerns may inure long-term benefits to portfolio companies.\textsuperscript{177} Indeed, in 2013, among the SRI-related issues that received the most average support in proxy voting were board diversity (35.8% average support) and environmental sustainability (33% average support).\textsuperscript{178} Recent research has recognized that traditional institutional investors are beginning to view both of these issues as economically significant.\textsuperscript{179} It seems then that SRI funds can be effective monitors of corporate practices but to a limited degree; that is, to the extent they are able to appeal to other institutional shareholders. But to do this, these funds must pick SRI-related issues of financial consequence and moderate their proposals (for example, by requesting firm disclosure rather than specific actions).

V. Conclusion and a Possible Path Forward

As has been observed, pension funds, mutual funds, and hedge funds do not, and most likely will not, engage in SRI to the extent they can serve as effective corporate monitors. SRI funds can serve as corporate monitors, but their effectiveness is very limited because of their small asset holdings. In examining all of the hurdles to SRI in the present U.S. corporate

\textsuperscript{175} See id.
\textsuperscript{176} See Fairfax, supra note 18, at 89.
\textsuperscript{177} See Fairfax, supra note 40, at 32.
\textsuperscript{178} See WEIZMANN ET AL., supra note 173, at 8.
\textsuperscript{179} See BERRIDGE & COOK, supra note 116, at 8, 12.
landscape, one factor emerges that can leapfrog all these hurdles and change this current trend: information establishing a positive nexus between SRI and long-term investment.\textsuperscript{180} If further research can prove SRI offers long-run profits that justify the risks involved, traditional institutional shareholders will likely engage in SRI. Pension funds would likely do so because the prospect of high, long-term returns aligns with the funds’ long-term objective of providing their beneficiaries with retirement savings.\textsuperscript{181} If SRI is proven to be sound, long-term investing, non-expert public fund boards may overcome their trepidation of engaging in any focused investing (which SRI may entail).\textsuperscript{182} Private pension funds would likely engage in SRI because, the prospect of promising long-term returns would allow their trustees to comply with ERISA’s fiduciary duty requirements and to intelligibly account for the risks of fund default and/or bankruptcy.\textsuperscript{183} Hedge funds would also engage in more SRI, because they too have long-term investment objectives, as shown by their “locking-in” of fund assets.\textsuperscript{184} Concededly, mutual funds may not respond as much to such information because of their need for constant liquidity.\textsuperscript{185} Finally, if SRI is found to offer long-term profits that justify its risks, paradoxically SRI funds may disappear—if not in name, then at least in substance—because, SRI would no longer be SRI, but just plain sound investing.\textsuperscript{186}

\textsuperscript{180} See discussion supra pp. 7-8, 10-11.
\textsuperscript{181} See id. at 4, 9.
\textsuperscript{182} See id. at 7.
\textsuperscript{183} See id. at 10.
\textsuperscript{184} See id. at 21.
\textsuperscript{185} See id. at 16.
\textsuperscript{186} See id. at 24.