HEARING OF THE U.S. JOINT ECONOMIC COMMITTEE

Examining the Impact of Shareholder Primacy: What it Means to Put Stock Prices First

March 16, 2022

WRITTEN TESTIMONY OF FREDERICK ALEXANDER
Chief Executive Officer
The Shareholder Commons

CONTENTS

A. SUMMARY 3
B. WHY SHAREHOLDER PRIMACY? 3
1. The Agency Problem 4
2. Shareholder Primacy and Market Economies 4
3. Shareholder Primacy and Modern Portfolio Theory 4
C. INDIVIDUAL COMPANY FINANCIAL RETURNS DO NOT ACCOUNT FOR THE TRUE COSTS AND BENEFITS OF CORPORATE ACTIVITY 5
1. The Invisible Hand Has Blind Spots 5
2. Diversified Shareholders Internalize Company Externalities in Their Portfolios 5
3. Positive Externalities Are Undervalued under Current Version of Shareholder Primacy 7
D. LONG-TERMISM DOES NOT ADDRESS THE BETA/ALPHA DIVIDE 8
E. CURRENT POLICIES THAT PRIORITIZE ALPHA 9
1. Corporations 9
2. Investment Trustees 9
3. Disclosure 10
F. POLICY OPPORTUNITIES 10
G. FURTHER READING 11

A. ***SUMMARY***

Shareholder primacy is the idea that business enterprises owe their chief loyalty to shareholders. The doctrine fulfills two important roles: first, it encourages equity investment, which provides the high risk, first loss capital upon which a dynamic, Schumpeterian economy depends; second, it facilitates the profit-seeking that a market economy uses to price inputs and outputs, thereby efficiently allocating resources.

The current manifestation of shareholder primacy is failing on both accounts and is driving many business decisions that misallocate resources and harm shareholders in the long run. The misapplication of shareholder primacy does not hurt only shareholders—it also harms working Americans who depend on an efficient, innovative and fair economy. It also threatens the critical resources, environmental and otherwise, upon which all Americans rely.

The flaw in the current practice of shareholder primacy is the assumption that the interests of shareholders and the economy are best served by using the financial returns of a company as the sole measure of its success. This focus on financial return at the individual company level inevitably encourages conduct that creates costs for the rest of the economy. At the same time, it undervalues investments that create positive spillover effects for other companies and the economy at large.

The assumption that investors automatically benefit whenever companies increase their own value ignores two critical facts: (1) most investors are diversified so that their investment returns depend largely upon overall market returns (“beta”), rather than the relative returns of individual companies (“alpha”) and (2) a company can improve its alpha with decisions that drag down beta. As a result, the current version of shareholder primacy works against most shareholders by creating a less efficient economy and a consequently lower beta.

A properly conceived shareholder primacy model would recognize that the interests of diversified shareholders extend far beyond individual company financial success and that shareholders do best when companies compete and innovate without creating economic damage or shunning investments with positive spillover effects.

Many federal policies impact the practice of shareholder primacy and can be used to encourage corporate behavior that recognizes the importance of beta to most investors, so that companies will be encouraged to maximize enterprise value only to the extent they can do so without undermining the critical structures upon which a strong economy relies.

B. ***WHY SHAREHOLDER PRIMACY?***

Although the concept of shareholder primacy is not a common topic of discussion among policymakers, it impacts just about everything that happens in our economy. Indeed, it can be argued that our economy is driven by the idea that for-profit enterprises are run primarily for the benefit of their shareholders. There are two important policy rationales underpinning the shareholder primacy model.

1. The Agency Problem

At the corporate level, the standard explanation for shareholder primacy begins with the concern that if corporate managers have the discretion necessary to run complex businesses, they may abuse that discretion and use investors' capital for their own benefit. This "agency problem" is especially acute for common shareholders, because they bear the "residual risk" of company performance. In other words, their only economic entitlement is the right to receive whatever value is left over after everyone else involved in the corporation is paid—suppliers, lenders, workers, and creditors of any kind. Shareholder primacy addresses this concern through a fiduciary obligation to shareholders (and only shareholders) that creates a clear rule, giving investors the confidence to invest in this back-of-the-line, "trust me" security. In turn, the availability of large amounts of residual-risk capital allow companies to take the risks necessary to innovate and build business enterprises.

2. Shareholder Primacy and Market Economies

Beyond agency theory, shareholder primacy reinforces our use of markets to price and allocate scarce resources. Market theory explains shareholder primacy as more than a mere protective device: it postulates that returns to shareholders come from profits, which represent the excess value of corporate output over inputs. Accordingly, profit represents value created, more profit means more value to share, and maximizing returns to shareholders should lead to the most efficient overall use of resources.

In other words, shareholder primacy is viewed as a mechanism to increase overall welfare through the proper pricing of goods, services, labor and resources. In this light, shareholder primacy is simply an application of the view that well-functioning markets, guided by the profit motive, create a vibrant economy. This second rationale for shareholder primacy is summed up by Milton Friedman's aphorism that "The social responsibility of business is to increase its profits."

Adam Smith used the metaphor of the invisible hand to describe the value-enhancing effects of the profit motive in the eighteenth century, famously stating that "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest." The formalization of this idea came about in the twentieth as the First Fundamental Theorem of Welfare Economics. As discussed below, a closer look at the First Theorem reveals important gaps in the utility of using enterprise value alone as a guide to value creation, and suggests a better form of shareholder primacy that will protect shareholders and guide the economy by accounting for the true cost and value of corporate activities.

3. Shareholder Primacy and Modern Portfolio Theory

Understanding the current application of shareholder primacy requires understanding the current investing ecosystem, which is anchored by the adoption of Modern Portfolio Theory (MPT) and the institutionalization of the equity markets. Whereas fifty years ago, equity was held largely in the accounts of individuals, it is now primarily owed by institutions. In part, this reflects the advent of MPT, which encourages those institutions to own diversified common stock portfolios in order to earn the greater

returns available from equity without an undue increase in risk. Over the last fifty years, equity markets have come to be dominated by large institutional holders practicing MPT—resulting in large pools of savings invested into equity markets that are diversified and invested for the long term.

These investors are naturally attuned to the alpha of their portfolios--whether they exceed, match or underperform average market returns. Under MPT, investors can seek to improve alpha by picking the right stocks or reducing costs (or hiring asset managers who promise to do so), but beta is treated as an uncontrollable variable that simply accept. This means that investors measure a company's success based upon *shareholder return relative to other companies* and not on the return of the market overall. By the same token, they measure the success of investment managers by the alpha they deliver.

Thus, under the prevailing theory of investing, which governs the allocation and stewardship of most of our private investment capital, no one takes responsibility for overall market performance. Only outperformance of other companies is rewarded.

* * * * *

In sum, shareholder primacy is conceived of as a tool to both protect shareholders from wayward agents and to maximize societal wealth. Seen in this light, shareholder primacy is not just an internal corporate governance regime; it is a key feature of an economic system based on the superiority of market mechanisms for creating value. However, for shareholder primacy as currently practiced to properly perform that role, the model that equates economic value with the value returned to shareholders at the company level must reflect the real world. It does not.

C. ***INDIVIDUAL COMPANY FINANCIAL RETURNS DO NOT ACCOUNT FOR THE TRUE COSTS AND BENEFITS OF CORPORATE ACTIVITY***

1. The Invisible Hand Has Blind Spots

The market model of the invisible hand addresses only the value of exchanges to those *within a closed value chain* such as a corporation and its suppliers, workers, customers and others with whom the company has a commercial relationship. It ignores costs imposed or benefits visited on those outside that value chain. Orthodox economics acknowledges this, but there is a tendency to believe that external costs and benefits are adequately addressed through substantive regulation (or are not worth addressing at all), so that little attention is addressed to the impact of externalities that businesses can create within the bounds of law or the effect that those impacts have on diversified portfolios.

2. Diversified Shareholders Internalize Company Externalities in Their Portfolios

A company's financial returns do not reflect the costs it externalizes such as pollution, resource depletion or harmful social inequality. Instead, those costs are borne by the economy and population as a whole, and can endanger the stable, healthy systems that a rising stock market depends upon. While individual

companies can externalize costs in a race to outperform, diversified investors re-internalize many of these costs through a lowered return on their diversified portfolio.

The return to such diversified investors chiefly depends upon beta, not the performance of individual companies. For an indexed investor, 100% of returns depend upon beta. But even for active portfolios where properly diversified investors try to pick stocks that will deliver superior returns, between 75 and 90% of returns will still be based on beta. A large percentage of the beneficiaries of the securities markets are diversified, and the relative importance of beta compared to alpha should affect the calculus of these investors when considering the impact of a portfolio company's social and environmental externalities.

Why? *Because negative externalities burden the economy and beta.* For example, if carbon emissions stay on the current trajectory, rather than aligning with the Paris Accords, there is a significant risk that GDP will be 10% less in 2050.[1] More immediately, the difference between an efficient response to COVID-19 and an inefficient one could create a $9 trillion swing in GDP.[2] Contributions to inequality also reduce GDP over time; a recent study by Citigroup suggested that racial disparities will cost the US economy $5 trillion over five years.[3] Antimicrobial resistance may cost the world economy $100 trillion between now and 2050 according to some estimates.[4] If companies increase their own bottom line by emitting excess carbon, refusing to share technology that will slow the pandemic, contributing to inequality, or overusing antibiotics, the financial benefits earned for their individual companies will be dwarfed by comparison to the costs borne by the economy.

When the economy suffers, so do diversified shareholders. Over long time periods, beta is influenced chiefly by the performance of the economy itself, because the value of the investable universe is equal to the percentage of the productive economy that the companies in the market represent.[5] Thus, as shown in Figure 1, diversified shareholders internalize costs that individual companies can profitably externalize:

---

[1] Swiss Re Institute, *The Economics of Climate Change: No Action Not an Option* (April 2021) (Up to 9.7% loss of global GDP by mid-century if temperature increase rises on current trajectory rather than Paris Accords goal) available at https://www.swissre.com/dam/jcr:e73ee7c3-7f83-4c17-a2b8-8ef23a8d3312/swiss-re-institute-expertise-publication-economics-of-climate-change.pdf ;

[2] Ruchir Agarwal and Gita Gopinath, *A Proposal to End the COVID-19 Pandemic*, IMF Staff Discussion Note (May 2021), available at https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2021/05/19/A-Proposal-to-End-the-COVID-19-Pandemic-460263.

[3] Dana Peterson and Catherine Mann, *Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.* (2020) (closing racial gaps could lead to $5 trillion in additional GDP over five years) available at https://ir.citi.com/%2FPRxPvgNWu319AU1ajGf%2BsKbjJjBJSaTOSdw2DF4xynPwFB8a2jV1FaA3Idy7vY59bOtN2lxVQM%3D; *Inequality is Slowing U.S. Economic Growth,* Economic Policy Institute (December 12, 2017) (Inequality reduces demand by 2-4% annually) available at https://www.epi.org/publication/secular-stagnation).

[4] *Antimicrobial Resistance: Tackling a Crisis for The Health and Wealth of Nations*, UK Government Review on Antimicrobial Resistance (December 2014), available at https://amr-review.org/sites/default/files/AMR%20Review%20Paper%20-%20Tackling%20a%20crisis%20for%20the%20health%20and%20wealth%20of%20nations_1.pdf.

[5] Principles for Responsible Investment & UNEP Finance Initiative, Universal Ownership: Why Environmental Externalities Matter to Institutional Investors, Appendix IV, https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf.

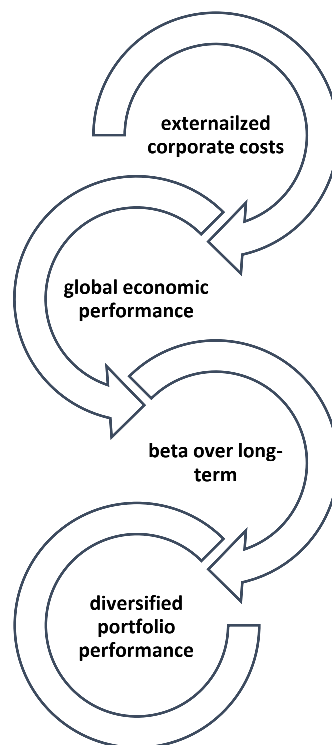

Figure 1

This relationship represents a trade made on behalf of diversified shareholders. When a company saves costs by locating jobs in regions where it can avoid paying a decent wage, it is trading away support for the intrinsic value of the economy in exchange for more internal profit. While this trade might financially benefit a hedge fund with concentrated ownership in that company, it harms a diversified shareholder by threatening beta. Often, the investors in such hedge funds are themselves otherwise broadly diversified, yet generously reward the hedge fund managers for making these bad trades on their behalves.

3. Positive Externalities Are Undervalued under Current Version of Shareholder Primacy

The flipside of shareholder primacy's tendency to encourage negative externalities is its tendency to ignore the value of positive externalities. Many corporate decisions can create significant value for the economy as a whole, and thus increase beta. But such spillover effects do not add to enterprise value, and are thus not valued in the current shareholder primacy paradigm.

For example, a pharmaceutical company might have the option to spend $1 billion to either (1) buy the rights to an established drug that pairs well with its current portfolio and sales network, creating sales and cost synergies that it can capture through increased profits (although there may be some positive spillover in reduced prices/better access) or (2) invest in R&D for a new drug, where much of the value (assuming success) would accrue outside of the corporation, including better medical outcomes and publicly available technology after the drug goes off-patent. Corporate managers focused on the enterprise value alone might choose the established drug even if investment in the new drug would be a better allocation of scarce resources and a better economic choice from the perspective of the

company's diversified shareholders. In fact, they could choose to use the cash to fund a share buyback, ensuring all of the value went to the company's own shareholders, and no value escaped to benefit the economy or diversified shareholders.

Failure to value such spillovers can be very costly to our economy. It has been estimated that gross social returns to R&D are at least twice as high as the private returns. In other words, the current structure of shareholder primacy fails to account for two-thirds of the benefits of research and innovation. Investment in a company's workforce is likely to tell a similar story; it creates a large amount of social value that is not reflected in the company's cash flows or enterprise value, but that would nevertheless benefit its diversified shareholders.

D. LONG-TERMISM DOES NOT ADDRESS THE BETA/ALPHA DIVIDE

Of course, there would be no need to decide among alpha, beta and the nation's economy if business decisions that optimize one always optimized all three. As unlikely as this proposition seems, the Business Roundtable, an organization composed of the CEOs of all of the country's major corporations, promotes this idea under the moniker "stakeholder capitalism," and claims that if a company treats all of it stakeholders well (which can be another way of saying it optimizes its economic impact), it will also maximize its return to its shareholders as long as it is focused on the long term.

But interests do not magically align, even in the long term. As the First Fundamental Theorem recognizes, profit-seeking firms in free market economies will not account for negative externalities, and there are many profitable strategies that harm stakeholders, society and the environment. A recent study from Schroders (an investment manager with more than $900 billion in assets under management) determined that in 2018, publicly listed companies around the world imposed social and environmental costs (net of benefits) on the economy with a value of $2.2 trillion annually—more than 2.5 percent of global GDP. This cost was more than 50 percent of the profits those companies reported. Indeed, one-third of the companies had net social costs that exceeded their profits—they were value destroyers.

While it might be comforting to think that companies create these externalities merely because they are not engaging in long-term thinking, this ignores the brute fact that the financial returns of individual companies do not reflect the costs and benefits that they externalize, even over the long term. This mismatch is illustrated by a recent report from YUM! Brands, the publicly-traded owner of Pizza Hut, Taco Bell and KFC. The report addressed YUM's efforts to reduce antibiotic use in its supply chain, as the overuse of such medicines is increasing the prevalence of antimicrobial resistance ("AMR"). As noted above, AMR threatens to reduce global GDP by $100 trillion between now and 2050. In explaining why they could not make the investment necessary to reduce antibiotic use, YUM highlighted the fact that they would bear all of the financial costs of such investment, but share the benefits, making it competitively infeasible:

> *AMR is a significant healthcare challenge facing society today . . . . This research appears to show that one of the most significant barriers to meeting the challenge of AMR is the balance between the rewards of proactive AMR mitigation and the cost of changing established husbandry practices.*

> *The challenge of individual costs and widely distributed societal benefits, a situation common in many sustainability issues, plays a key role in antimicrobial resistance. This may make it difficult to pursue AMR mitigation while remaining competitive on costs.*
> . . .

Unchecked pressure to increase individual company enterprise value will inevitably lead companies to deplete common resources and avoid positive spillover, contrary to the interests of diversified shareholders and Americans generally. Simply readjusting timeframes cannot align individual company financial interests with the interests of society or diversified shareholders.

E. CURRENT POLICIES THAT PRIORITIZE ALPHA

1. Corporations

Delaware law, which dominates corporate law in the United States, starts from an understanding that directors and officers of corporations must focus on the best interests of shareholders, and that maximizing enterprise value (although not necessarily short-term share price) is the way to satisfy that duty. One recent Delaware Chancery court case described the duty to maximize an entity's economic value:

> *the . . . directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that. Thus, I cannot accept as valid . . . a corporate policy that specifically, clearly, and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders . . . .*[6]

2. Investment Trustees

At the level of investment fiduciaries, there is still confusion as to the need to steward beta. BlackRock, the largest asset manager in the world, recently told the Securities and Exchange Commission that a shareholder proposal asking it to address portfolio company impacts on beta in order to protect its clients' portfolio returns would be contrary to the interests of its clients and thus illegal under fiduciary principles:

> *The Proposal would cause BlackRock to violate its fiduciary duties because it would require BlackRock to place the interests of others above its own clients. In this regard, the Proposal requests that BlackRock "adopt stewardship practices designed to curtail corporate activities that externalize social and environmental costs . . . even if such curtailment could decrease returns at the externalizing company."*[7]

[6] *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010).
[7] Available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/mcritchieblackrock012422-14a8-incoming.pdf

In other words, the largest asset manager in the world believes that shareholder primacy prevents it from prioritizing beta and the systemic health that underlies it if doing so would lead any individual company to surrender any financial value.

3. Disclosure

Currently, the United States' corporate disclosure system requires companies to disclose data material to an individual company's value, but not data that reveals how its activity affects the broader economy, even when that information may impact beta, which, as shown above, is of great importance to most investors.

F. POLICY OPPORTUNITIES

The laws governing corporations, investment trustees and corporate disclosure are all interpreted to apply a narrow view of shareholder primacy that does not serve shareholder interests and that leads to social and environmental costs and poor use of scarce resources. This narrow interpretation of shareholder primacy costs the global economy trillions of dollars each year, as estimated in the Schroders report cited above. It has played a significant role in lowering wages, hollowing out the work force and expanding inequality, all of which contribute to significant social and economic instability.

But to reiterate the theme of this testimony, the prioritization of shareholder interests is not the problem. As discussed above, there are important policy reasons to encourage companies and investment fiduciaries to view companies as having a primary obligation to shareholders. Importantly, putting shareholders first does not preclude companies from considering the interests of workers, customers, other stakeholders and the environment—it would be difficult to manage a successful business without doing so. But ultimately, the United States has an economy that relies on private capital to fund most of its commercial activity, and such a system requires some form of shareholder primacy to encourage equity investment and the pursuit of profit.

However, as discussed in the prior sections, we are doing shareholder primacy wrong. The policies that enable and encourage it should recognize that beta, and the healthy economy that supports it, is of primary importance to most savers. Accordingly, the laws and regulations that support shareholder primacy should be crafted to encourage companies to appropriately prioritize the impact they have on the social and environmental systems that undergird the economy and beta.

Congress and federal agencies have the ability to influence the way that shareholder primacy is practiced by changing the rules that govern fiduciaries and disclosure through legal regimes such as the Investment Acts of 1940, ERISA, and rules governing the Federal Thrift Plan. Securities and antitrust rules that make it difficult for shareholders to collaborate on beta concerns could also be modified. Although corporate law is governed at the state level, federal policy could encourage companies to use alternative structures, such as Delaware's public benefit corporation model, that allow companies to opt out of shareholder primacy.

These policies changes would serve the interests of shareholders, but would also improve the economy for all Americans, and do so without relying solely on substantive legislation.

G. ***FURTHER READING***

Many of the ideas included in this testimony are taken from Frederick Alexander, *The Benefit Stance: Responsible Ownership in the Twenty-First Century*, 36 OXFORD REVIEW OF ECONOMIC POLICY, 341 (*2020*). A recent extensive report from an internationally recognized law firm explains how the reality of externalized costs reverberates in the fiduciary duties of investment trustees across jurisdictions. Freshfields Bruckhaus Deringer, *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (2021). The Shareholder Commons has summarized the report in a short memo. The Shareholder Commons, *A Refreshing Look at Fiduciary Duties* (2021).

Despite the clear guidance from Freshfields, many legal structures and outdated interpretations of those structures continue to lead investment fiduciaries in the direction of enterprise value maximization. The Shareholder Commons and B Lab recently provided a comprehensive comment letter to the SEC, detailing the reasons that its regulations should incorporate the need for investors to actively manage beta. Shareholder Commons and B Lab USCAN, *Comment Letter on Proposed Amendments to Rule N-PX (December 12, 2021).* This followed an earlier white paper drafted by those organizations that recommended comprehensive policy changes to encourage and enable beta management. Frederick Alexander, Holly Ensign-Barstow, Lenore Palladino and Andrew Kassoy, *From Shareholder Primacy to Stakeholder Capitalism: A Policy Agenda for Systems Change* (September 2020).

A recently published book explores the problems created by asset managers who rely on Modern Portfolio Theory and fail to attend to beta. Jon Lukomnik & James P. Hawley, MOVING BEYOND MODERN PORTFOLIO THEORY: INVESTING THAT MATTERS, Chapter 5, (Routledge 2021). PRI, an investor initiative whose members have $89 trillion in assets under management, recently described a variety of corporate practices that can boost individual company returns while threatening the economy and diversified investor returns, and urged investors to steward companies away from such practices. PRI, *Active Ownership 2.0: The Evolution Stewardship Urgently Needs*, (2019). The YUM! Brands report referenced in the testimony is available on the company's website. *2021 Yum! Antimicrobial Resistance Report*.

The Schroders report referenced in the testimony details multiple examples of externalized costs and benefits of publicly traded companies around the world. Andrew Howard, *Sustainex: Examining the Social Value of Corporate Activities*, Schroders (April 2019). The Dasgupta Review, a 2021 study of the economics of biodiversity commissioned by the United Kingdom Treasury, details many of the external costs to the natural world that go unaccounted for. THE ECONOMICS OF BIODIVERSITY: THE DASGUPTA REVIEW: ABRIDGED VERSION ("The inability of societies to honour [extra-legal] property rights even when they can be defined gives rise to externalities, which are the unaccounted-for consequences for others, including future people, of actions taken by one or more persons.")

Frederick ("Rick") Alexander is the CEO of The Shareholder Commons, a non-profit organization dedicated to helping shareholders use their power to protect common resources and vulnerable populations. He is the author of *Benefit Corporation Law and Governance: Pursuing Profit with Purpose* (Berrett Koehler 2017).

Rick practiced law for 29 years at the Wilmington-based law firm Morris, Nichols, Arsht & Tunnell, including four years as managing partner. During that time, he was selected as one of the ten most highly regarded corporate governance lawyers worldwide and as one of the 500 leading lawyers in the United States. In 2015, Rick became Head of Legal Policy at B Lab, where he worked to create sustainable corporate governance structures around the globe.

Rick is a member of the Delaware Corporation Law Council, the body responsible for maintaining the premier corporate statute in the United States. He previously served as Vice-Chair and Chair, testifying multiple times in the Delaware General Assembly. He drafted and shepherded important corporate legislation, including provisions addressing mandatory arbitration, proxy access, majority voting, and benefit corporations.

Rick also serves on the Council of Institutional Investors Markets Advisory Council, is the Treasurer of the American College of Governance Counsel, a member of the Commonwealth Climate and Law Initiative Advisory Board, a Research Fellow of British Academy Future of the Corporation Program, and serves on the Advisory Board of Beren Pharmaceuticals, P.B.C.