

**EXAMINING THE IMPACT OF  
SHAREHOLDER PRIMACY: WHAT IT MEANS  
TO PUT STOCK PRICES FIRST**

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**HEARING**  
BEFORE THE  
**JOINT ECONOMIC COMMITTEE**  
OF THE  
**CONGRESS OF THE UNITED STATES**  
ONE HUNDRED SEVENTEENTH CONGRESS  
SECOND SESSION

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MARCH 16, 2022  
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# EXAMINING THE IMPACT OF SHAREHOLDER PRIMACY: WHAT IT MEANS TO PUT STOCK PRICES FIRST

WEDNESDAY, MARCH 16, 2022

UNITED STATES CONGRESS,  
JOINT ECONOMIC COMMITTEE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 2:21 p.m., in Room 106, Dirksen Senate Office Building, before the Joint Economic Committee, Hon. Donald S. Beyer Jr., Chairman, presiding.

**Representatives present:** Beyer, Schweikert, Estes, and Peters.

**Senators present:** Cruz, Lee, and Hassan.

**Staff:** Ismael Cid-Martinez, Chelsea Daley, Hugo Dante, Sebi Devlin-Foltz, Ron Donado, Carly Eckstrom, Ryan Ethington, Tamara Fucile, Devin Gould, Owen Haaga, Erica Handloff, Colleen Healy, Jeremy Johnson, Adam Michel, Michael Pearson, Elisabeth Raczek, Alexander Schunk, Nita Somasundaram, Sydney Thomas, Ivan Torrez, Emily Volk, Brian Wemple, and Katie Winham.

## OPENING STATEMENT OF HON. DONALD BEYER JR., CHAIRMAN, A U.S. REPRESENTATIVE FROM THE COMMONWEALTH OF VIRGINIA

**Chairman Beyer.** Our hearing is titled “Examining the Impact of Shareholder Primacy: What it Means to Put Stock Prices First.”

Thanks to all of our distinguished witnesses for sharing their expertise today. It is an exceptional panel of experts, and I am looking forward to hearing from you. And I want to apologize from the start that the House and Senate leadership seemed to have determined to augment our hearings with votes. So we will do our best to manage that back and forth.

This hearing will examine how the shareholder primacy model of corporate governance has impacted the economy and how Congress can help address the problems it has created.

Shareholder primacy is a corporate model that focuses mainly or exclusively on increasing stock prices to generate value for its shareholders. This approach, which has gained a lot of favor just in the last few decades, encourages corporations and their executives to spend a larger share of profits on stock buybacks to reward investors in the short term.

Who are the winners when corporations put stock prices first? In the United States, shareholders are a relatively small group. The top one percent owns roughly 50 percent of all corporate equities,

and only about half of the U.S. households own any stock at all. As a result, the singular focus on stock prices concentrates wealth at the very top, while leaving less for companies to reinvest in their workers and innovative technologies and in long-term growth.

For example, the seven largest publicly traded oil corporations recently announced a near-record \$41 billion stock buyback program, on top of \$50 billion in shareholder dividends. While everyday American workers and families bear the burden of higher gas prices, big oil is raking in record profits and prioritizing padding the pockets of the wealthy shareholders. It has not always been this way, though.

From the 1930s to the mid-1970s, American corporations largely followed a retain-and-reinvest strategy to focus on long-term innovation and job security for workers. Workers were seen as an asset and a long-term investment, not a liability. Managers viewed well-paid cared-for workers as vital to their success. They primarily used profits to pay workers, provide benefits, and make productive investments. Shareholders received the residual after companies paid workers, invested for the future, and paid down debt. Not accidentally, American productivity had unprecedented growth during this period.

During this time, economic growth was strong and broad-based. As the economy grew, workers saw their wages rise and on the whole were more financially secure. They had access to pensions and pathways to the middle class.

Since the 1970s, however, as shareholder primacy has become more dominant, boards have put shareholders at the front of the line for corporate profits, leaving everyone else behind. While CEOs and executives at the top have seen their incomes go up, 940 percent over the last four years, the bottom half of earners have seen their wages virtually flatline. These are all in constant dollars.

Across the board, the share of domestic product, gross domestic product going to employee wages and benefits has been declining for decades. The increased corporate focus on raising stock prices has driven this trend which in turn has deprived workers of the gains from economic growth.

Because the corporate executives and shareholders who benefit from this model are overwhelmingly and disproportionately wealthy and white, this further reinforces the widening wealth disparities across income and racial groups. For 2019, the top 10 percent of American households held 70 percent of all U.S. wealth, and the total wealth owned by the entire bottom half of America dropped to just 2 percent.

The impact of shareholder primacy goes beyond the widening difference between winners and losers. It is impacting our economy at almost every level. Short-sighted decisions to help companies hit short-term earnings for products can explain the just-in-time inventory and staffing approaches that left U.S. supply chains vulnerable to pandemic-related disruptions.

Shareholder primacy also hinders investment and innovation and sustainability, the driving crux of economic growth and are necessary to address threats by climate change. For example, despite growing risks from climate change, corporations have continued to

make decisions that prioritize short-run profitability at the expense of broad sustainability and climate resilience.

Surprisingly, investors themselves also lose under shareholder primacy. Families investing money in diversified stock portfolios for college or retirement suffer when individual companies put their short-term profits over their long-term investments. It is no coincidence that widening the economic inequality in this country, which began in the 1970s, coincides with the increased dominance of shareholder primacy. It has helped to concentrate economic power among the privileged few.

But this is not how we as a Nation have always done things. There are other paths forward that maintain firm profitability and promote economic growth that is stronger, stabler, and more broadly shared.

For example, incentivizing business to invest in innovation, sustainability, and enhanced productivity, would boost competition, workers wages, and economy-wide returns. Legislative proposals that place limits and tax share buybacks would help realign corporate incentives away from short-term stock prices and toward long-term pro-growth investments. And legislation that strengthens collective bargaining and raises wages, like the PRO Act and the Raise the Wage Act would ensure workers take home a larger share of the gains that public companies and their executives have been keeping for themselves.

As we dive deeper and deeper into these issues, we look forward to the testimonies of our expert witnesses, and I would like to turn it over to Senator Lee. Thank you for your flexibility and for your opening statement.

[The prepared statement of Chairman Beyer appears in the Submissions for the Record on page 32.]

**OPENING STATEMENT OF HON. MIKE LEE, RANKING MEMBER,  
A U.S. SENATOR FROM UTAH**

**Senator Lee.** Thanks so much, Mr. Chairman. Thanks to all of you for joining us today. Last week we learned that inflation has reached a new 40-year high, a new 40-year high of 7.9 percent. That means that inflation is costing the average American family \$435 a month more each month, every month, for the things that they ordinarily buy.

Given this new economic reality, I hope we keep in mind the severe price increases that are facing American families right now, as we hear about foisting environmental and other political goals onto private businesses.

Americans are hurting. Low and middle class Americans are the ones who pay the price for uprooting our market economy in favor of a political agenda. This agenda will not only compound inflation making Americans poor, and our businesses less dynamic, less capable of offering products that people need to buy, less capable of offering jobs that people want to have. But the American people have reached the benefits of free markets and of robust competition.

This free market system that has lifted Americans to the highest standard of living ever achieved by a major economy. Yet today the free market system that enables American prosperity is under at-

tack by bureaucrats, politicians, and regulators who seek to impose their personal political goals onto private parties, on businesses, and consumers alike. They seek to override the competitive forces that grow workers wages and keep prices low. They seek to make private companies beholden to politicians rather than to the shareholders who invest in companies in the first place.

When we hear the word “shareholder,” we do not usually think about the average American, but that is exactly who they are. Shareholders are the more than 180 million Americans who live in a household with a 401(k), a pension, or some other form of stockholdings. Shareholders are an ever-growing majority of households who invest in the economy. They use the return on that investment to save for retirement, buy a home, or send their kids to college.

When the government tells companies not to listen to shareholders, it is really telling companies not to listen to the American people. When the government tells companies to divert their hard-earned resources into work policy goals like environmental and social justice, the government is taking power and taking wealth out of the hands of the American people and consolidating it in Washington.

When the government interferes with the private sector, businesses stop serving their workers and customers. They instead serve the bureaucrats who set the rules. We already see this happening.

President Biden recently directed his Administration to assess companies’ progress on environmental and social justice goals. A step toward requiring them to abandon their core responsibilities to the school teachers, the firefighters, and other everyday Americans who invested in them, and who buy their products.

These actions ignore centuries of evidence that the free market system is the best way to create prosperity for workers and families and communities. Now America has always been a place where the most effective common action occurs in the space between the individual and the State. A Federal Government that attempts to replace free enterprise is a Federal Government that has overstepped its bounds. It has started to diminish the very interests it was designed to protect.

We ought to ensure that businesses are free to serve their communities by remaining at the forefront of innovation and creating value for the American families who invest in them and are served by them. In today’s environment of surging inflation, we can afford nothing less.

Thank you.

[The prepared statement of Senator Lee appears in the Submissions for the Record on page 33.]

**Chairman Beyer.** Senator Lee, thank you very much. I would like to introduce our four distinguished witnesses.

Dr. Lenore Palladino is an Assistant Professor of Economics and Public Policy at the University of Massachusetts Amherst, Research Associate at the Political Economy Research Institute, and a Fellow at the Roosevelt Institute. Dr. Palladino researches corporate power, corporate innovation, shareholder primacy, and the relationship between corporate governance and the labor market, with a specific focus on economic policies for innovation and the

cost of shareholder primacy and stock buybacks. Dr. Palladino holds a Ph.D. in Economics from the New School University, and received her J.D. from Fordham Law School.

Ms. Judy Samuelson is the Founder and Executive Director of the Aspen Institute and Business and Society Program, which works to align business and their investments to the long-term health of society. Her work is focused on redefining the understanding of the purpose of corporations, and shifting the focus away from short-termism toward practices that maintain long-term economic and societal well-being. She is the author of *The Six New Rules of Business: Creating Real Value in A Changing World*. Ms. Samuelson holds a B.A. from the University of California Los Angeles, and a Masters Degree from the Yale School of Management.

Mr. Rick Alexander is the Founder and CEO of The Shareholder Commons. He founded the organization and for four years as the Head of Legal Policy at B Lab. Over three decades he served as a corporate attorney and managing partner at a leading Wilmington-based firm where he was selected as one of the ten most highly regarded corporate governance lawyers worldwide, and is one of the 500 leading lawyers in the country. Mr. Alexander's work with the Shareholder Commons examines the significant economic risk presented by the current practice of shareholder primacy. Mr. Alexander holds a B.A. from the University of Maryland, and a J.D. from Georgetown University.

Dr. Joshua Rauh is a Finance Professor at Stanford University's Graduate School of Business, and a Senior Fellow at the Hoover Institution. His studies focus on government pension liabilities, corporate investment, business taxation and investment management. Dr. Rauh was formerly the principal chief economist on the President's Council of Economic Advisors under President Trump. He taught at the University of Chicago's Booth School of Business and Kellogg's School of Management.

Dr. Rauh holds a B.A. in Economics from Yale University, and a Ph.D. in Economics from the Massachusetts Institute of Technology.

Welcome all of you, and, Dr. Palladino, let's begin with your testimony and then we will continue in the order of introductions. Dr. Palladino, the floor is yours.

**STATEMENT OF DR. LENORE PALLADINO, ASSISTANT PROFESSOR OF ECONOMICS & PUBLIC POLICY, UNIVERSITY OF MASSACHUSETTS AMHERST, AMHERST, MA**

**Dr. Palladino.** Chairman Beyer, Ranking Member Lee, Members of the Committee, thank you for the invitation to be here today.

Policymakers have a critical opportunity to strengthen American innovation and resilience as we emerge from the pandemic. The economic and geopolitical challenges that face us are not going to stop. That is why it is time to strengthen our commitment to American productivity by reorienting our corporate governance policies toward innovation and away from the single-minded focus on share prices.

To truly understand the harms of shareholder primacy, we must start by understanding what makes the company an innovative en-

terprise? What are the structures within the company that enable innovation? And what are the social conditions for innovation that policymakers can support?

Corporations are engines of production. It is inside corporations that decisions are made about what gets produced, by whom, and how companies can succeed in producing higher quality socially beneficial products at lower unit costs over time.

We know from history that innovation comes about from long-term risk taking by businesses, enabled by collective and cumulative learning. It requires complex organization, investment in and retention of a committed workforce, and long-term financial commitments based on retained earnings and leveraged by debt.

This brings us to shareholder primacy and how its sole focus on share prices hurts the production process, and by extension our whole economy. When corporate leaders mainly focus on raising share prices, there are lost opportunities to invest in the tangible and intangible assets that power innovation, including in the American workforce.

Shareholder primacy is a flawed theory of the corporation because it makes three incorrect assumptions about the role of shareholders and other corporate stakeholders in the process of production.

First, shareholders are not the owners of corporations. Shareholders own their shares. They own the corporate securities that they have purchased and that they are free to sell. In fact, what distinguishes a corporation from a partnership or a small business is that shareholders do not own the assets of the company, nor are they responsible for its liabilities.

Second, shareholder primacy is usually framed as necessary for corporate financing. Shareholders must have authority in corporate decisionmaking and see their share prices increase in order for operating companies to have financing available. However, most shareholders are traders. When I purchase financial assets to save for retirement, the funds that I spend do not go to the operating company whose stock is now in my portfolio. The money I spend goes to the entity that sells me the shares.

Lastly, the theory of shareholder primacy fundamentally misunderstands the role of other corporate stakeholders and the risks that they take. Business success hinges not only on the actions of management and holders of stock, but the hard work of employees, customer interests, and public infrastructure supported by long-term financial commitments.

In practice, the orientation of our corporate governance system toward ever-increasing share prices has created constant pressure to pay shareholders or face activist shareholder wrath. We have to distinguish activist shareholders from households holding stock as a financial asset for life cycle needs, and remember that corporations that focus on innovation are actually best for shareholders who depend on the stock market for their retirement, because their retirement security depends on the success of the entire economy.

A key component of shareholder primacy is stock buybacks. They benefit those who sell their shares. They manipulate stock prices and they benefit corporate insiders.

U.S. corporations spent \$6.3 trillion dollars, with a “t,” on stock buybacks in the last decade, and are on track to spend \$1 trillion in 2022. We have to ask what is the opportunity cost for this use of corporate funds?

There are countless examples where the focus on spending corporate funds on shareholders has left companies ill-equipped to face shocks, not focused enough on long-term investment, or using shareholder payments as an excuse for holding down labor costs. For example, oil companies announced nearly \$40 billion in stock buybacks this year.

Proponents of stock buybacks say that companies conduct them when they have no other use for corporate funds, but this is plainly not the case for so many companies spending billions on buybacks today. There are signs of progress. Intel, for example, use to spend tens of billions of dollars on stock buybacks every year. However, Intel’s new CEO, Pat Gelsinger, recently stated publicly that Intel would reduce its stock buyback activity drastically in order to engage in long-term investment in innovation.

There are a range of policies that Congress should take up to re-orient corporate governance. I appreciate the committee’s attention to these issues and look forward to discussing the policies in our discussion. Thank you.

[The prepared statement of Dr. Palladino appears in the Submissions for the Record on page 35.]

**Chairman Beyer.** Thank you, Dr. Palladino, very much. Next we will hear from Ms. Samuelson.

**STATEMENT OF MS. JUDY SAMUELSON, VICE PRESIDENT OF THE ASPEN INSTITUTE, FOUNDER AND EXECUTIVE DIRECTOR, ASPEN INSTITUTE BUSINESS AND SOCIETY PROGRAM, NEW YORK, NY**

**Ms. Samuelson.** Judy Samuelson with the Aspen Institute, Business and Society Program. Mr. Chairman, thank you for having us today, and Members of the Committee.

For close to 25 years the Business and Society Program has been engaging business executives, directors, scholars, leaders in labor and corporate governance in both critics and those who advise business. In pursuit of our mission, which is about how do we align business decisionmaking with the long-term health of the economy?

We believe this probably animates our work the most, that business today is simply among maybe the most important and influential institution of our day. It has extraordinary capacity, especially global, international, multi-national corporations, remarkable capacity and talent and problem solving skills to address the most important problem.

We the people of course grant the license to operate. I think the question that is really behind this hearing today is: Are we harnessing that capacity for the public good? Who does that license actually benefit?

I want to clarify one point that I think that my colleague made this point, but let me just say again, the point about governance and share ownership, but when it comes to redressing shareholder primacy, it is important to note that shareholders do not own the corporation itself.

Shareholders own certificates of stock. And, yes, they come with very discrete and important rights. But the assets and the liabilities are not the property of the shareholders. The corporation owns itself. Shareholders do not own corporations, and we do not need to treat them as such.

One thing that is kind of curious, if you will, is that we spend this much time talking about the stock market at all. When General Motors was at the top of the league tables and was the largest corporation in the country back in the 1950s and 1960s, it had maybe a million employees just in the United States of America, and it was constantly accessing the capital markets to raise capital for factories, and to hold the employee base, and to fill the need and desire of consumers for automobiles.

But if you look at the situation today, many companies when they access the public markets, when they initially go for their IPO, if they are actually going to raise any money in the market. They raise the money privately, and the opportunity to go public is really about just providing their early investors an exit in the stock.

In essence, the company receives the money at the IPO. Why do you spend so much time talking about the stock market? The question was raised about who owns stock. The wealthiest 10 percent of Americans own between 84 and 89 percent of publicly traded stock—10 percent. Seventy seven percent of all U.S. stock is held by white college graduates, and we must remember that only 33 percent of white Americans have a college degree. Only 50 percent of U.S. households own any stock at all, and only 30 percent of Black and Hispanic households own stock.

Stock ownership among Black and Hispanic elites is also tiny. Shareholder primacy, putting the shareholders at the center of the metrics and of the belief system of the corporation, ensures that our economy places the elite and the wealthiest first.

I would like to end with making three discrete points:

The first is the tremendous cost that shareholder primacy brings to the system. We have already spoken about inequality and I mentioned it as well. But we also have to look at the cost of capital allocation, which the Chairman has already raised. The pressure to divert earnings and profits to the shareholders has tremendous consequences and places limits on investment infrastructure, research and development, innovation, and it explains a lot about our tepid response to climate change.

The barriers to addressing climate change of course are about the cost of operation. And the Chairman has already spoken to the tremendous amount that the high avengers are actually placing through share buybacks rather than investing.

The second point is that shareholder primacy is built not just in law, it is built through a set of incentives, and practices, and protocols. It is really not a law at all. It is baked into assumptions that are not very easy to unwind. It is the scaffolding that keeps their whole share of primacy in place.

Finally, in spite of the ESG, environment, society, governance, in spite of the ESG narrative and the promise about doing well by doing good, this is no longer a win/win world. There are real trade-offs involved, and the solutions, if you want to address the solu-

tions, may take us into some uncomfortable places. It requires us to think about innovation in employees voice and in governance, and it requires us to once again really reward long-term investing. Just the capital gains tax, for example, to go way beyond one year as a recognition of what constitutes long term.

And finally, we will take a closer look at private capital markets. That is really where a lot of the action is today, and is growing in importance. It is not all bad news out there. There are any number of companies that we could talk about today, but to put employees at the center of their market and of their enterprise because of the belief that that is how they will perform best over the long haul. That is where the employees gain their most important income and revenue, and that then works for the employees and it works for the customers as well.

[The prepared statement of Ms. Samuelson appears in the Submissions for the Record on page 48.]

**Chairman Beyer.** Ms. Samuelson, thank you very much. We will now hear from Mr. Rick Alexander.

**STATEMENT OF MR. FREDERICK ALEXANDER, CEO, THE  
SHAREHOLDER COMMONS, WILMINGTON, DE**

**Mr. Alexander.** Chairman Beyer, Ranking Member Lee, Members of the Committee, thank you so much. It is truly an honor to be here today.

My name is Rick Alexander and I serve as the CEO of The Shareholder Commons, a nonprofit that focuses on the issues we are discussing here today. But my views on this subject developed over a 25-year career of private legal practice, advising directors, executives, shareholders, and others on the rights and responsibilities under corporate law. Essentially, I practiced shareholder primacy for 25 years.

I was often the person in the room telling the directors that, no, they could not take the bid that considered the American workers at their company. They had to take the highest bid that paid the most to shareholders. That was my job for 25 years.

Turning to the subject at hand, I want to say that I do not believe that shareholder primacy is all bad. I just believe that it is a good idea that has become perverted over the last 50 years.

Shareholder primacy is the idea that a company is run primarily for the benefit of its shareholders. There are two reasons that this idea has developed such a following and really dominates our economic life.

The first goes all the way back to Adam Smith. When a business maximizes profits, it is creating value. You know, profits are just buying inputs at X and then through hard work and innovation, and maybe a little luck, selling at X plus, creating value. In an economy like ours, that is not controlled from the top, this is not just a way of protecting shareholders, it is the way we allocate scarce resources and determine prices.

The second reason that shareholder primacy is important is that it allows enterprises to raise the large amounts of capital necessary to do the work of a modern economy. Think about the billions raised by a startup EV or biotech company. This risk capital—this is kind of like the magic of capitalism—this risk capital receives no

contractual rights to any return. All they get is a promise that if there's value left over after everyone is paid, they will get that value. It would be extremely difficult to raise this capital if the company did not have a loyalty to those investors, if they could decide to shift that profit to someone else.

I believe these two reasons still hold and do not argue for the abandonment of the principal of shareholder primacy. However, what I want to suggest today is that we are doing shareholder primacy all wrong. We are not protecting shareholders, and we are not allocating resources well. In short, the problem is that primacy is exercised today with an expectation that all investors care about is the enterprise value of the individual company at which a decision is being made.

This is agnostic to the kind of sustainability issues that we are concerned about sometimes. It might lead a company to treat its workers very well in order to induce loyalty. On the other hand, it might lead another company to outsource or offshore work if that allows the company to increase its profits after having thought about loyalty and reputation and all those issues. Like I say, it is agnostic.

But here is the problem with that indifference to social, environmental, and economic effects of the decision. Investors do not just own one company. Modern portfolio theory teaches us that to achieve the best return with the lowest risk, you have to own lots of companies. In fact, fiduciaries like pension fund managers are required by law to be diversified. And for a diversified investor, 75 percent to 100 percent of return is based not on returns of individual companies or what they produce or on performance, but rather on the performance of the market.

So this means that if you are a shareholder, what is most important to you is how the economy does, how the market does. So think about the example of the outsourcing company. The first question from the perspective of a shareholder ought to be not how this will affect the company, but how will the outsourcing affect the economy overall, and thus my diversified portfolio? I do not have the answer to that question, but a lot of people believe that lower paying jobs lead to less social stability, less resilience, poor public health. And if that is true, a diversified holder is receiving a bad bargain when a company in his or her portfolio increases its own return by externalizing this cost onto the economy.

If that is true, we should make sure that the rules that govern investing allow investors to take that broader perspective and not just think about individual enterprise value. How does that translate into policy? Well, currently disclosure rules and fiduciary rules, are interpreted as focusing on enterprise value. Congress and the Federal agencies have the ability to influence the way shareholder primacy is practiced, and change these rules, or clarify them to be clear that shareholders are empowered to influence the companies in their portfolio to be more responsible with respect to the entire economy, even if that might cost the individual company a little bit of profit.

Thank you. I look forward to talking more about these questions today.

[The prepared statement of Mr. Alexander appears in the Submissions for the Record on page 57.]

**Chairman Beyer.** Mr. Alexander, thank you very much. Now we will hear from Dr. Rauh.

**STATEMENT OF DR. JOSHUA D. RAUH, ORMOND FAMILY PROFESSOR OF FINANCE AND SENIOR FELLOW AT THE HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CA**

**Dr. Rauh.** Chairman Beyer, Ranking Member Lee, Members of the Committee:

In a competitive market, companies must serve their customers, employees, and communities well, otherwise they go out of business. Companies cannot sell products to consumers who do not trust them, and they cannot hire and retain employees who prefer other jobs.

Yet, clearly the interests of shareholders are not always aligned with those of other stakeholders. For example, cutting prices to levels below cost would be well received by consumers, but bad for shareholders who are, after all, the owners of the corporation in the traditional sense that they control the corporation.

The CEOs who have claimed corporate purpose in the Business Roundtable statement are not the owners of the corporation, they are employees appointed by shareholder-elected boards. A CEO announcing that shareholders are no longer in charge is not far from a government official telling the American people that they are no longer in charge.

So who are the shareholders? Most of the benefits of strong stock returns accrue to U.S. households. U.S. households own 38 percent of the U.S. stock market directly, and most of an additional 28 percent of the market through mutual funds and ETFs. And then you have pension funds that own another 11 percent of the stock market. The benefits there also accrue to households. And equity ownership is broad-based. Fifty three percent of all U.S. households own publicly traded stock. When you add on households that do not and are relying on a pension, or own a private business where your principles also would apply, or nonresidential real estate, over 68 percent of households are in some sense shareholders.

So what do shareholders want? While I sense that other witnesses here want some authority to prescribe what firms should do, I would contend that Milton Friedman in 1970 basically got it right. He said shareholders want “generally to make as much money as possible while conforming to the basic rules of the society, both law and ethical customs.”

So under shareholder capitalism, executives have a strong incentive to make ethical decisions and plenty of leeway under the business judgment rule to do so even if it does not maximize the returns on the company’s stock in all cases.

Regarding conflicts between short-term and long-term value, more than 80 percent of companies that do IPOs in the U.S. have negative earnings, yet they raise hundreds of billions of dollars a year for investors, plus the venture capital referred to by Mr. Alexander. So it is hard to see excessive short-termism here. Still, in case of conflicts, the solution is simple. It is to structure executive compensation to reward long-term performance. It is not to give

managers free reign to make decisions in the interest of any stakeholders they want.

Of course some shareholders may and do have a taste for investments that achieve non-financial goals. Chairman Beyer, your description of this hearing says this hearing is supposed to, quote, “Examine the Rise in the recent decade of shareholder primacy,” unquote, but the hearing really should be examining the erosion of shareholder primacy. Over 33 percent of total managed financial assets in the U.S. as of 2020 are now in sustainable investments, broadly defined. This is the new phenomenon of recent decades.

Now if shareholders want to achieve social goals, even at the expense of financial ones, should companies act accordingly? Yes. But the difficulty comes if there is lots of passive capital such as in the massive market tracking index funds that many Americans own in their 401(k) plans. Large numbers of smaller investors just want a good return on their investments.

Meanwhile, powerful managers of the index funds they hold impose ESG on corporate America as they vote on behalf of trillions of dollars of other people’s money. And investors may be at risk. The surveyed evidence in over a thousand papers in the performance of ESG investments in public markets is quite varied. In my own work on private markets, I find that preferences for ESG are related to significantly lower rates of return.

In 2020, the Department of Labor protected investors from arbitrary actions in the name of social responsibility when it limited the extent to which ESG funds can be offered in 401(k)s and other plans. The Biden administration’s lack of enforcement of that rule, and the new proposed ESG rule of Fall 2021, threatened to undermine that.

In many cases, the majority views of the American people do not even line up with the received wisdom of the ESG. For example, Gallup polls from last year showed that only 39 percent of Americans want less emphasis on producing energy from oil, and only 19 percent want less emphasis on producing energy from natural gas. That is not good support for shaming companies into pursuing these actions.

Finally, it is misleading to focus on bad examples without considering the good of the entire system. Over the past 50 years, real per capita GDP in the United States increased 132 percent to \$64,000 per person, the highest among all countries with a population of at least 10 million people. Since 1959, incomes for the bottom fifth of the income distribution increased by 262 percent, the highest of all income quintiles. Those are the fruits of shareholder capital.

In conclusion, the focus now should be how to protect regular investors from the potential financial harms of arbitrary decisions under the guise of ESG and financial responsibility. And for fund management, we should return to a default of shareholder value maximization within the bounds of law and ethics, unless an individual shareholder actively specifies otherwise.

Thank you very much.

[The prepared statement of Dr. Rauh appears in the Submissions for the Record on page 69.]

**Chairman Beyer.** Dr. Rauh, thank you very much. We will now begin with questions for our witnesses. I will begin with Dr. Palladino.

Proponents of stock buybacks have argued this practice serves the stock market by moving capital from firms that have no use for it into companies with a higher need for new funds. Why doesn't this hold true, in your opinion?

**Dr. Palladino.** Thank you very much for the question. That is a great question that I will break into two parts. The first is what I mentioned in my testimony. The argument for stock buybacks often is that it is a way to efficiently move financial assets or capital from a company that no longer needs it to other companies.

So when we look at examples like for example Amazon who just announced \$10 billion in stock buybacks this past week, and we look at the fact that Amazon workers have been protesting and organizing for decent living wages for years, we see there is availability for investment in the workforce.

When we look at Exxon and we see that they have invested very little in the low carbon transition, we see that there is opportunity for investment. So I look at the opportunity costs as critical.

The other answer to your question is that we actually need more information about the private markets to understand the flow of funds that go from an operating company that repurchases stock to an asset manager, and then back out into the market. We know that net equity issuance has been negative for the last two decades, meaning that publicly traded companies are issuing less stock than they are repurchasing. We need more disclosure and data for the private markets to fully understand the flow of funds, but I believe that these arguments are mainly misguided. Thank you.

**Chairman Beyer.** Ms. Samuelson, proponents of shareholder primacy contend that shareholders own the company. We just heard this from Dr. Rauh. And yet you have argued that the corporations are actually owned by the corporations themselves. Can you expand on this, and why we should not think that the shareholder through their 401(k) or whatever, own the corporation?

**Ms. Samuelson.** Well, the corporation owns itself. When the corporation legally incorporates, it becomes legally a, you know, fictitious person. And a person owns its assets and liabilities just like any of us do.

The shareholder has the certificate of stock, but what that certificate of stock enables the shareholder to do is to vote for the board of directors, a critically important right. It gets to do things like weigh in on whether or not the executive is appropriately paid. And then of course, you know, it can put votes on the ballot. It can ask, you know, at the annual meeting for certain things to be taken up and considered. But it does not add up to controlling or running the corporation, as might have been the case if we went back a hundred and some odd years in terms of how it was structured then.

So the situation has changed a lot. And if we kind of look at the results of the incredible dependence on the shareholder as to the organizing principles of the corporation today, we would wind up with things like, another example, she talked about Amazon. I will tell you about Target. Target got a lot of great press a couple of

weeks ago because it announced that it was going to be doing about \$300 million of investment in its employees, with some wage increases in Targets across the country, greater access to health care.

We can debate whether or not those things add up to much, but if you kind of roll back in time, six months ago, this is a \$300 million investment announced on their employees, six months ago they announced \$15 billion in share buybacks. If you go back over the last 10 years, something like 93 percent of profits have been returned or, I do not even like to use the “return,” because I am not so sure they were necessarily due to begin with, but were paid out to shareholders, 93 percent.

The factor that is most important in this environment is what we are doing to reward executives. And the executives today are being paid in stock, as well. So all of this is consistent with their worldview and what they are being paid to do. But, no, the shareholders do not own the corporation. They own shares of stock that give them some rights.

The last thing I would just say is that if you look at the stay on pay votes, they correlate with the stock price. As long as the stock price is going up, the stay on pay votes largely go with saying the pay is fine. It is only when the stock price is going down that someone may raise an objection, the shareholders raise an objection to how the CEO is paid.

So the system is kind of reinforcing of where we are now.

**Chairman Beyer.** Thank you, Ms. Samuelson, very much. We will now introduce Senator Lee for his questions.

**Senator Lee.** Thank you very much, Mr. Chairman.

Dr. Rauh, I would like to start with you. We have heard a lot today about reform proposals, and critiques of the way the market works. I am concerned that in many cases when the Federal Government gets involved in order to make the world appear to be a more equitable place, or to enhance the fairness of the marketplace, which can end up not only not achieving that but having the opposite effect. It is particularly dangerous in an environment like this one in which you see that inflation—what we are experiencing today relative to a year ago, the average family in Utah is spending an additional \$582 a month every single month, just on the things that they already have to buy. It is just higher prices on the things they have already got to buy, relative to a year ago.

This is about \$7,000 a year that they are having to cough up just to buy the same stuff that they bought a year ago. Gas prices are striking well over \$4 a gallon, and just in this last week alone the prices at the pump in Utah reached their highest levels ever on record.

And so if we do these things right now, when we try to do something like pursue the SEC’s current plan to mandate climate-related ESG disclosures, I feel it would undercut the very interests that that they are supposed to serve. These sorts of things inevitably hurt the poor and middle class. They do so in a few ways.

Number one, I think they tend to entrench market incumbence, well-funded market incumbence, who are in a better position to absorb the compliance costs that startups would not have to deal with. They also have superior access. You can further degrade the ability of a startup to gain access to capital when you do this.

And then, but across the board you are increasing compliance costs. And so the cost of goods is going to become higher, and made higher still by the relative lack of competition from new entrants into the marketplace.

So tell me what your perspective is on this, on whether mandatory ESG reporting, how that might impact ordinary Americans?

**Dr. Rauh.** Well thank you for the question, Senator. I think there is little question that ESG action, including both reporting and ESG activism, has reduced production of oil and gas in ways that are impacting regular Americans.

You know, Exxon Mobile lost four board seats last year to Engine Number One, an ESG activist fund, and Chevron's board forced them to commit to reducing their indirect emissions, meaning the emissions from people buying their products. And there has been a litany of sustainability statements from many of the energy companies they have released recently, I sense under ESG duress.

Commitment to—BP's commitment to decarbonize, that involved the premise for new exploration, a decline in production of 40 percent by 2030. Other oil and gas companies have made similar statements. And so this must be affecting production.

And actually another point, which is the companies that are not subject to as much ESG pressure because they are private as opposed to publicly traded and may not be subject to as many regulations, they are now the ones who are stating that they are going to do the most, the majority or more, of more capital expenditures this year, 2022, than publicly owned companies, particularly in the shale sector.

There is no question in my mind: ESG pressure has been substantial and has had effects on production, driving down quantity, and driving up prices.

**Senator Lee.** Thank you. That is very helpful. It seems to me the last thing we ought to be doing in the name of making a more competitive environment, an environment in which poor economic mobility remains part of the American dream, the last thing we would want to do is adopt a series of policies that will further entrench elites, those who are already wealthy and well connected, making them wealthier and more well connected altogether at the expense of poor and middle class Americans.

Tell us a little bit from the investor standpoint, a little bit about how you might create risks that would go to poor and middle class Americans, today's workers, tomorrow's retirees, those saving for retirement, or saving to buy a home or what have you. How might that be affected by any system that would prioritize political, social, environmental goals above and beyond those required by existing environmental laws, instead of growing their company and answering directly to their shareholders?

**Dr. Rauh.** Well, Senator, in order to implement those requirements, the money has got to come from somewhere. And so that means it either has to come from customers in the form of higher prices the consumers are going to pay, or it would have to come from workers in the form of lower wages that we pay to workers, or it is going to come out from shareholder returns.

And, you know, while there has been a lot of talk of how much the top one percent owns of the stock market, and so on, the fact

is that we have a society where there is broad ownership, where many, many Americans, 53 percent of Americans own some stock, and a lot of people are relying on the stock market for their retirement.

And it seems rather problematic to require companies to do things that would reduce the returns that individual investors are expecting and are relying on in the interest of goals that are not actually part of the law. And it is an interesting question to wonder why are these requirements not part of the law?

I think part of it is because these requirements are just not very popular, according to polling data. So the bottom line is that whenever you put these types of requirements on companies, it has to come out of something. There are tradeoffs. There are conflicts. There are conflicts and tradeoffs. And the market system has done a good job with managing these over many decades.

**Senator Lee.** Thank you.

**Representative Peters** [presiding]. Thank you, Senator. In the absence of the Chair, I will recognize myself.

Mr. Alexander, you have noted how shareholder primacy is not the only doctrine that companies have used in the past to inform their operations because it has become more standard recently.

Can you tell us how companies operated before shareholder primacy became the dominant doctrine, and how model companies might take a different approach that would better align their incentives, in your view, with what is the common good?

**Mr. Alexander.** So I would say that—thanks for the question. I would say that, you know, in some sense there has been a pretty direct line of shareholder primacy throughout the 20th and 21st centuries. As shareholders became more diffuse, as there was more separation of ownership from control, and the real issue has been in sort of, you know, what does it mean to sort of represent the residual risk there to the equity holder.

And I think an important thing to think about, as we talk today, is that the question of shareholder primacy or not, or how we practice it, it is not a question of whether we practice ESG or not. ESG is practiced today. It actually buys into the shareholder primacy thing.

If you think about the Exxon Mobil, the Engine Number One campaign last year, that was a campaign based on sort of the ESG principles, shareholders saying, you know, the company has not done a good enough job addressing climate change issues. But the point they made was that the company had misallocated capital in anticipating the switch to more renewable, and that therefore they had done poorly for their shareholders.

Engine Number One is a hedge fund that was concentrated in company stock, and they just wanted the company to do better, and that was their theme. They were not asking the company to make sacrifices in order to benefit, you know, the greater good. You know, the question I think we are wrestling with is whether, when a management team says we are going to put the shareholders first, are they doing so in a way that externalizes costs that hurts society as a whole, that hurts the market, and in my mind that is not a good practice of shareholder primacy because it is very likely

that your shareholders are invested in other companies who are hurt when the economy is hurting. Thank you.

**Representative Peters.** Yes. I was sort of asking about whether the perspective of companies has changed with respect to shareholder primacy over time. You said it has been different?

**Mr. Alexander.** So I will confess not being enough of a historian to really answer that question well. But I don't—you know, in the New Deal era this question was really wrestled with. There was the Berle-Dodd debate that asked are companies run for the benefit of society, or are they run for the benefit of their shareholders?

And I think what happened post-War was there was not a conflict. Companies were able to pay their employees well, do well by their shareholders, and they just were not thinking about, I would say, some of the debts that they were incurring to the future in terms of what was happening to the environment, what was happening to society. And what happened I think in the last 50 years was, as we approached certain planetary and social boundaries, management had to begin focusing on the real tradeoffs that existed. And that is what sort of called the question.

**Representative Peters.** Ms. Samuelson, when we talk about the role that shareholder primacy plays in global climate change, how do you think that companies can move beyond paying lip service to sustainability and commit real resources to help fight that particular cause?

**Ms. Samuelson.** Well these are definitely creative, but can I steal a little time to respond to your earlier question?

**Representative Peters.** You have 45 seconds.

**Ms. Samuelson.** When the shareholder primacy really took off, it was in the early 1980s. And what happened is, you asked if it was a masked idea that we needed to put shareholders. The single objective function is we needed to wake up corporations, and they will then listen, perhaps.

But what happened is, in the 1980s we started connecting the CEO pay back, to start. So they could hire people cheap and promise them stock, and things really then began to take off. It also happened in 1993 when Clinton put a one million dollar cap on what could be deducted of the CEO's pay. And that's when it really took off, stock options really took off at that point.

You have really got to go back to that point of when this whole thing started to launch and really took on steam.

**Representative Peters.** Maybe we can explore that later. We will turn now to Mr. Schweikert for five minutes.

**Representative Schweikert.** Thank you. Just for the fun of it, what was the second half of Milton Friedman's sort of treatise from, what was it, 1970? "So as long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud," we always seem to forget that second half of the 1970 treatise from Milton Friedman.

I actually have a slightly different view. In many ways, this hearing actually bothers me from the standpoint of we should have done something much more global with what is going on in the economy and our world, and right now, and then this sort of soft, nationalization of corporate boards, which is functionally what it is,

let's be honest, and the last witness just said something that actually I think rings quite true.

Much of what is going on that the left considers bad is our fault. We have made it so expensive that many companies are choosing to go private. You know, in many ways would you take a company public in this environment right now, if there is enough liquidity in the market to stay private and not have to deal with this sort of stuff? Our tax policy. In many ways we drove this by our own tax policy.

And for Mr. Rauh, I really want you to touch on two things. Because there is one thing in your written testimony about rates of return, how many companies really do not have rate of return, but people are willing to invest in it because it is a new drug, but we are not going to see it for 15 years, or sort of that hope. And also touching on the fact of the incentives as we have so screwed up the market. How few companies come public today to be available for society to invest in, and we are creating a world where the haves, through family offices, through others, get to own shares. But the availability to the public keeps shrinking in many ways because of what we in Congress do, which is making it miserable, difficult, and expensive to go public.

**Dr. Rauh.** Thank you. Thanks for the question, Congressman Schweikert.

Yes, there has clearly been a major trend over the past couple decades toward companies remaining private. And going public introduces a number—has always introduced various government requirements, disclosure requirements.

And now with the advent of the ESG requirements, and now with the SEC potentially getting involved and potentially regulating what those requirements would be, that adds another layer on top of this that adds further disincentives to go public.

And firms not going public have major consequences. You know, in a 401(k) individual investors do not have access to private companies. They have to invest in publicly traded companies. And so it is incredibly important that we have a robust setting where firms are going public, and where individual investors have access to invest in them. And it is also important to ensure that the individual investors know that the mutual fund managers who are managing their money on behalf of them in Index Funds—that is when you buy, when an investor just, you know, checks the default option in their 401(k) invested in the stock market broadly—that those investors are going to be concerned with maximizing the returns that the investor can get, not with some considerations that are non-financial, but that the individual investor may simply not share.

**Representative Schweikert.** Doctor, if I came to you right now and said we do not like some of the corporate governances. Would a much more egalitarian solution be to create an environment where you minimize these sort of oligopolies, which are essentially what we have created in our corporate world, whether it be airlines, and you know, banks, so regulatory constructs: We have made monster companies. To actually create an environment where lots of disruptors, whether it be their business model, the business plan, the technology, but it is time to actually have the disruptive

business environment where you, if you want to invest in social good, that is the model you choose.

My fear is, we are trying to change our own sort of almost oligopolic, if that is a word, model right now instead of doing a much more egalitarian holistic solution of screw it, we want lots of competition out there.

**Dr. Rauh.** Well, regulation creates, as you say, benefits for incumbents are able to make investments necessary to comply. And it harms competition. And more competition means more price competition for consumers and the products that consumers buy, and it is better for the end consumer at the end of the day.

**Representative Schweikert.** Thank you for your tolerance, Mr. Chairman.

**Representative Peters.** Thank you. I will go to Mr. Estes.

**Representative Estes.** Well thank you, Mr. Chairman. And thank you to all the witnesses for joining us today. I think many Americans are right to be alarmed at the rapid increase of political activism and bullying among our Nation's top corporations. Rather than focusing on the well-being of their employees, customers, and shareholders, there have been a notable number of examples of large companies using their market power to push far left political causes at the expense of everything else.

Predictably, this has led to discrimination against hard working families who disagree with those causes being pushed. And whatever your political views, I think we can all agree that it is not good for American capitalism to have our most known brands bullying certain Americans for holding mainstream beliefs.

I believe many of the current proposals from the left involving stakeholder primacy would make this problem even worse, mandating that companies partake in these unfair activities. When it comes to the different metrics being proposed, like environmental impact, or some of the ESG scores, I am concerned about how these will be implemented. And if 53 percent of the U.S. households that own publicly traded stock are best served when companies focus on building good companies that are profitable not by getting investments into profitable companies through ambiguous ESG scores.

To recover from our current economic catastrophe that the Democrats and President Biden have steered us into over the last year, we need permanent policies that encourage active participation by U.S. investors to drive economic progress rather than divisive policies like stakeholder primacy that would put American families last and special interest groups first.

Dr. Rauh, do you think stakeholder primacy would lead to companies implementing private ESG scores for customers, similar to a credit score but instead of rating travel worthiness, rating a person's, a customer's so-called ESG risk?

**Dr. Rauh.** Thank you very much for the question. That is an interesting idea. Just so I understand, are you referring to the idea that the companies would then rate their customers on alignment with certain values, and then would potentially exclude or discriminate against those customers.

**Representative Estes** [continuing]. or avoid doing business with them at all if they did not match the score that may come back to reflect on them?

**Dr. Rauh.** Well that is an interesting idea, and it would be certainly a very, very dangerous trend if that were to happen. The idea that a company would discriminate against an individual because of the political beliefs that they hold would be quite concerning.

One place where you could imagine that happening at another level would be with suppliers. I am going to choose to buy only from companies that sign on to a certain statement of ethical values that I also agree with.

I think this is all very detrimental to the forces that have made the United States' economy the strongest economy in the world, and one that has also delivered extremely broad-based growth to after-tax, after-transfer incomes for individuals. And it also would be extremely disturbing.

Now I would wonder if such practices would actually be thought of as being legal—is the company allowed to discriminate against the customer? I do not know. I would have to turn to legal experts on that. And at least one thing that can potentially constrain companies is the law.

**Representative Estes.** Do you think that the U.S. companies could use ESG to maybe discriminate against Americans in general for lack of political belief, or their affiliations?

**Dr. Rauh.** It is not impossible. You know, certainly it seems that one could have a situation where companies could attempt to only work together with people who sign on to certain values that they hold on the front of the ESG. And if they did so, it would be quite a disturbing development.

I will say, one constraint would be do companies really want to give up potential customers? Are they willing to hold on to these beliefs so badly that they are willing to give up potential customers? I do not know. One of the forces that has produced good ethics from companies in many setting is actually the force of knowing that they want their product to be bought by as many people as possible, and they want to have a good reputation among the American public in general. It is pretty costly to shut off your potential customer base by some pretty large percentage by shutting off people who do not agree with some of these principles. Which as I mentioned in my testimony, it seems to me that there are many of these inherited wisdom ESG principles that are not actually well supported in polling data.

**Representative Estes.** Yes, I mean we have had a lot of discussion lately about banks and others that may not do business with certain companies, or certain industries.

At the end of the day, stockholders own the company, whether their moms and dads or retirees, or pensions, and they deserve to be able to manage the productive use of their property. So thank you, and I yield back, Mr. Chairman.

**Representative Peters.** Thank you. We will turn now to Senator Cruz.

**Senator Cruz.** Thank you, Mr. Chairman. Welcome to each of the witnesses.

Dr. Rauh, more and more we are seeing a dangerous shift in America where woke corporations are acting as the political enforcers for partisan Democrats. And we are seeing more and more

CEOs weigh in on political matters, and use their corporate power to try to punish anyone who does not agree with a radical policy agenda.

In your judgment, is it in the shareholders' interests for woke corporations and their CEOs to use their market power not to provide the goods and services the company is focused on, but instead to enforce a partisan political agenda?

**Dr. Rauh.** Well I think this is a classic case of what we call in economics a principal-agent problem. The shareholders are the principals, and they hire the managers, CEOs, as their agents to act on their behalf. This is no different in a startup or a private company. People on the committee have business experience, of starting their own businesses. If you hire a manager, that manager is your agent and works on your behalf. And so when you have a situation where the manager, the CEO, the executive who does not own the company, who is an agent of the owners of the company, is taking actions to impose their own political agenda, then I think that is a major failure of governance and a major failure of accountability. And I think that that is actually quite a dangerous—quite a dangerous thing.

**Senator Cruz.** Well I agree with you. And there is not only a principal agent problem with the shareholders versus their woke CEOs who are not actually focused on increasing shareholder value. But there is a principal agent problem with regard to the voters, because these CEOs are not accountable to the voters. And in my experience, most of them are profoundly ignorant about the topics they are trying to regulate, that they do so as a mild virtue signal without even doing the barest of due diligence.

I can tell you major banks that try to legislate gun control by saying we are going to cut off financial services to companies either that do not sell firearms to people unless they are 21 and over—which is not the law—or that bans so-called assault weapons. I can tell you I had the senior leadership of a bank that insisted it was going to cut off capital to anyone selling assault weapons, and I asked the leadership, I actually asked the person who designed the policy, a simple question. What is an assault weapon? She had no idea. She told me it was a machine gun, which is not what an assault weapon is. And pause for a second to think that she is writing a policy without even knowing what the hell she is talking about.

Likewise, there were numerous corporations that took political positions about election integrity laws in Georgia and Texas. The CEOs of one of those corporations sat in my office and I asked a very simple question: Name one provision in the bill that you denounce as racist, name one provision that is problematic? The CEO could not name a single provision and put out a public statement saying it was racist and had no idea what was in the bill.

Dr. Rauh, do these CEOs, do these corporations have any meaningful expertise in political matters? Is there anything about the companies that actually reflect the Democratic wishes of the electorate?

**Dr. Rauh.** Well on the first point, if I might say, at the Stanford Graduate School of Business we do attempt to give them a broad education.

Now on some of the specific matters at hand, and also what Americans believe, I think you really there identified one of the main problems, which is that I suspect that part of the reason that gun laws in America are not different from what they are now is that in the latest Gallup Poll from 2022, 41 percent of Americans were satisfied with U.S. gun policy, and 13 percent were dissatisfied but wanted less strict laws. So that is 54 percent of people who want either the same degree of strictness or less strict gun laws.

So, plus, you know, given the Second Amendment of the United States Constitution—

**Senator Cruz.** So let me ask you briefly, just because time is expiring, what can Congress do, or what can Federal regulators do to ensure a robust system of shareholder capitalism in which shareholders can expect executives to actually focus on the bottom line, rather than engaging in political adventurism and pursuing their own partisan agenda at the expense of shareholder values?

**Dr. Rauh.** I would say two things. First of all, you know, step back from mandating ESG type of regulations, or trying to regulate that sector in a do-no-harm kind of way. But secondly, the government should also be considering actions that could protect shareholders from their agents, you know, owners of index mutual funds, from their agents voting against shareholder maximization without the explicit permission of the shareholders.

And I will tell you, there are many shareholders out there, or just regular owners of 401(k) funds, who are relying on index funds, the performance of the U.S. stock market for their retirement. They are not interested in CEOs pushing their personal political agendas. They are interested in getting a fair return on their investments.

**Senator Cruz.** Well thank you. And I think those are good and helpful suggestions.

**Chairman Beyer** [presiding]. Senator, thank you very much. Now we will begin a second round of questioning. Forgive my absence, since I had to go vote for myself and four other members by proxy, people affected by COVID.

Let me go to Mr. Alexander. You had written that the assumption of the interest of shareholders in the economy are best served by using the financial returns of the company as a sole measure of success. Why is that not the sole measure of success?

**Mr. Alexander.** Thanks for that question. The reason it is not the sole—and again, I differ from some of the other witnesses here today in that I actually do not have an issue with running a company for the benefit of shareholders. I just would say shareholders are not benefited—shareholders with a broad portfolio are not benefited when each company within that portfolio struggles to increase its own bottom line without regard to the effect of doing so. It is just a category error.

If you want to have a portfolio that performs the best, you do not want each individual company within that portfolio trying to be the best because they will interfere with one another.

There is an economist, Thomas Schelling, who won a Nobel Prize for this idea—the ecology micromotives. It is just like when you drive. If everybody in the city wants to get to their destination as soon as possible, you do not just put them all out in their cars on

the street and say, “go get there as soon as possible.” You establish rules of the road, and stop signs, and stop lights, and all those sorts of things. And it is the same thing.

If a company, attempts to maximize its value, by paying its workers significantly less than a living wage, and that leads to poverty and, poor social determinants of health and things like that; it is going to drag the economy down and when you drag down the economy, you drag down the performance of portfolios because the performance of a diversified portfolio relates directly to the performance of the economy.

And what I would also say is I have heard some questions today that sort of talk about putting handcuffs on corporations. Let me just say that what I would like to do is remove the handcuffs from shareholders.

Currently, disclosure from the SEC is built around one idea: let’s look at the ESG matters, social and environmental matters. Will social and environmental matters affect the performance of the company? But how about the SEC giving shareholders information about how a company’s social and environmental performance affects the economy, and thus the other companies within that economy? Swiss Re estimates that if we stay on the carbon trajectory we are on, rather than a Paris-aligned trajectory, then global GDP will be 10 percent less in 2050 than it would otherwise be.

Swiss Re. This is not a radical institution: It is one of the largest reinsurers in the world. Well, if GDP is 10 percent less in 2050, then all the young teachers today who are in retirement plans that have diversified portfolios are going to have 10 percent less for their retirement.

So that is what I am talking about when I say from the shareholders’ perspective you cannot just look at individual company enterprise value. You have to ask the question how will my company’s performance affect the economy? And right now, and it is not just disclosure rules by the way, it is fiduciary duties—particularly at the company level but also at the trustee level—that make trustees and directors feel as if all they can focus on is enterprise value. And there is a lot of work that could be done to clarify those rules to make it clear that acting in the interest of shareholders, or acting in the interest of pension fund beneficiaries, incorporates this broader idea of what shareholder value is.

**Chairman Beyer.** Thank you. Dr. Palladino, I actually do not remember ESG being in the title of the sharing, but certainly shareholder primacy was.

What has been the tradeoff in terms of corporate investment and research and development over the last 10 or 20 years with the rise of shareholder primacy?

**Dr. Palladino.** It is a great question. We know overall that there is opportunity cost when corporations are focusing their financial assets and their energies on raising share prices. We know that CEOs today, many of themselves say that they feel hamstrung by the need to constantly appease outside activist investors who are demanding constantly higher share prices.

They would rather be focusing on the types of innovations that their companies are best able to achieve. So I will just give you a quick example.

GE is a prismatic example from the 20th century of an innovative company. It is personal to me because it is where my grandfather worked. He was a prisoner of war who then returned to work as a—in aviation at GE in Massachusetts. He never had a chance to go to college but had a good job in which he was part of the process of innovation at his firm.

GE turned toward Wall Street, turned toward maximizing shareholder value, as its main focus in the 1980s. And I think probably may people know the story from there. The focus on share prices caused the innovative potential that was there within the company to decline. Ultimately we know that GE lost \$400 billion in market value over the—over a decade, since 2000, leading to 2010, and we know that that focus on shareholder value ultimately took them away from what they should have been doing, because it focused on producing more innovative products over time.

**Chairman Beyer.** Dr. Palladino, is it fair to link the dismal productivity increase rate of the last 10 years, 2010 to 2020, with the share buyback and the supremacy of stockholder value?

**Dr. Palladino.** Absolutely. I think that while there are of course many factors because the economy is complicated, I think that the fact that we have not seen investment in the workforce, in the American people who actually produce the goods and services that our leading companies make, that investment is what will increase productivity over time. We know that from history. We know that empirically. And that lack of investment is, in my view, the most important opportunity cost of shareholder primacy.

**Chairman Beyer.** Thank you very much. Ms. Samuelson, you wrote that—and I think this is a really important point, because I want to suggest that corporations are not inherently evil. You know, it sounds like we are bashing them for rebuying of stock, repurchases and the like, but let me say. You said corporations are amoral. There are the rules and protocols in the Senate that drive behavior, and we license corporations to create goods and services.

Deeper than that, and I know you are a student of this, the creation of the corporation was to limit the liability of the people that were investing in it. There were all kinds of benefits that flowed from the rule of law around the corporation that implied a tradeoff between their special status, their special protection, and their responsibility to society at large.

Can you talk about those rules and protocols?

**Ms. Samuelson.** Well the most dominant one I spoke about a little bit earlier, I cannot remember whether you were in the room or out of the room when I did, but it is really about how were tethered CEOs pay to the stock price. So the dominant measure today that is used in the market is TSR, Total Shareholder Return, and it is basically made up of two things, dividends. And then these share buybacks. The repurchase of shares, which means some shareholders exit, and the ones who are left it pops up the stock price by reducing the number of shares outstanding. The valuation is still the same, but the ones who are still there glean a lot of the gain. And that is what these investors want.

I think the tricky part about this is not—the public company is in massive decline. I think we have 50 percent as many public companies as we did, something like 10 or 15 years ago. And they are

in decline not because of kind of ESG investors, so-called ESG investors, but it is really just this heightened moment now where investors of all kinds are starting to raise fundamental questions about risk and expressing, if you will, their desire for kind of clarity about what they are investing in. What is it actually realizing? And is it addressing, are these companies addressing the kinds of concerns that people have as investors, as well as citizens.

I just think this question takes us back to who will hold the system accountable? Corporations, as you said, corporations were created initially to do the kinds of things you cannot do with just your family's resources, or those of your best friend. It is essentially a way of kind of a bundle of contracts, or it is a way to hold together relationships. And yes, ultimately they were also given limited liability so that they are not vulnerable to the same kinds of demands as executives would have been otherwise.

And so we are back to the question of kind of really who holds these powerful institutions accountable? I am a big believer in business. I truly do not believe that we can solve our most complex problems without business at the table.

I believe in what Mr. Alexander has been talking about in terms of the need of a whole market to work well, not just creating the space where individual companies excel. But I think it gets back to the question of who is really holding the system accountable. And frankly investors are not going to do it. Investors are very, very inclined toward, you know, price and convenience, just like, you know, just like the consumer is. They want it both ways. And I think today what is interesting, what is the most interesting thing on the kind of horizon is the degree to which employees have become a force here. Where they are actually raising their voice and asking questions about what are we actually in the business to do? Are we doing it well? What does it look like? And what is my piece of this kind of puzzle?

And so I think it is an interesting time to be having this conversation, and we are hopeful that some of these questions that we are asking today will start to kind of align with the questions that executives themselves are asking about what job they have, you know, as well as the investors, the questions the investors are asking and employees themselves are asking.

**Chairman Beyer.** Thank you. Dr. Rauh, in your testimony you talked about the surge in average household income since 1950, or whatever. And then you followed it up with the increase, the percentage increase in the average income for the lowest quintile or the lowest quartile. I am sort of impressed with numbers.

How do you reconcile that with the alternative reality that our income and wealth and inequality has not been this great in 100 years? And that many, many sociologists and others suggest that the deep divides in our country, this country today is driven more by income and wealth inequality than anything else?

**Dr. Rauh.** Thank you for the question. So I think that income inequality is often overstated by academics. I trust people who have direct access to all the data in government. Auten and Splinter, Auten at the Office of OTA, U.S. Treasury, and Splinter at the Joint Committee on Taxation, JCT, right here. And so when you incorporate additional assumptions like changing marriage rates, and

also various alternative sources of income, including transfers from the government, the top one percent share of pre-tax income has only increased 3 percent since 1962. So primarily I believe it is not an accurate narrative, and these are also figures from the CBO. It is actually interesting that most of the studies that show that income inequality has not increased that much actually comes from government sources, whereas the ones that say it has increased by a lot more are coming from academics. So that is how I would reconcile those things.

**Chairman Beyer.** Okay, thank you. It is certainly an interesting lone voice, but thank you.

Mr. Alexander, having come out of corporate law and for all that time, one of the things that we have talked about was the notion that the SEC for years and years and years had regulated whether a corporation could use its excess capital for stock buybacks. And some years ago, my history is not good enough to tell you, it was early 1990s, whenever, that rule was changed and thrown out so that corporations were given essentially a free decision to own buybacks.

Does it make any sense, would it help us at all to restate that SEC regulation?

**Mr. Alexander.** Thanks for the question. I am not going to guess at the year because there is a real expert on stock order buybacks on the panel, so I do not want to be embarrassed. We can yield to her. But I will say absolutely, you know, here is the way I express the problem of the buyback, and again I will put this in the terms of thinking about the shareholder as a single company versus thinking about the fact that shareholders are actually diversified and what they care about is how a company's decisions affect the entire market.

And if you think about companies that value only the enterprise it is easy to just return cash to your shareholders because they get 100 percent of the cash, and they can do what they want with it. Whereas, if you reinvest in your workforce, in R&D, in new drugs, in electric vehicles, whatever, your shareholders benefit from that, but so does the economy. It is what economists call spillover effect, and some people say, two-thirds of the benefit of reinvesting goes to spillover effect.

So it is harder for a company to do that. And I think, as regulators, as policymakers, you have to be cognizant of that risk. For my part, I think a lot of this can be solved by changing—and this is what I have been talking about today—changing the rules to make investors and shareholders think more broadly and not sort of allow them to just focus on single companies, or at least to give them the tools to not just focus on single companies, because that is kind of what they are forced to do today. And that will help with the buyback issue. But I would also just say, because of the natural tendency of a company to do a buyback because 100 percent of the value flows to that single company, it is important for all the policies, be it tax, securities regulation, to be very cognizant of that issue, as well as—and this is a different issue but also an important issue, the potential for corporate insiders to manipulate the market because they may know when the buyback is coming and they have lots and lots of stock and they can sort of play games.

**Chairman Beyer.** Great. Thank you. Dr. Palladino, among the many things written about shareholder primacy is the idea that CEOs and C-suite folks are rewarded in their pay plans. I think you actually write that one of the ways that shareholder primacy is maximized is to make sure that top management's pay is driven by shareholder price.

And Elizabeth Warren has an interesting bill, one she introduced it in this session, that would postpone the ability of top management to cash out their options until they had left the corporation by three years, five years, something like that. So essentially they were not dependent on stock price buyback today, a share price surge tomorrow, and divesting of their stock the day after.

Is this meaningful? Is this fair? Is this good policy?

**Dr. Palladino.** Absolutely. Thank you for the question. So just on the point of stock buybacks, you know, one of the harms that they pose is that they do create disincentives structurally for corporate insiders to personally profit, as you have said and as Rick said.

And I think that the broader story that we have seen over the last several decades of executives being rewarded by stock. And then the stock sort of compensation becoming more and more complex, and more and more able therefore to be manipulated by different types of corporate financing the nippers. It is a huge problem. And I do think that it is important to reiterate, this is a type of problem that can be easily solved by rules.

Corporate executives are not, you know, this is not a story of one single sort of greedy executive over here. This a problem that we have created through, for example, Rule 10(b)(18), which is the Securities and Exchange Commission rule that was passed in November 1982, that essentially allows stock buybacks to happen at essentially an unlimited rate because the SEC does not collect the type of data that would allow them to actually know if companies are staying inside what they have constructed as a safe harbor. And it does not presume any liability for stock buybacks outside of that safe harbor, in any case.

Before 1982, stock buybacks did not happen that much because they were presumptively understood as manipulating the stock price of the company, which we would see as reasonably problematic in securities markets that we want to be operating and efficient.

So I think this disincentives that stock buybacks have created for corporate executives to be able to, and incentivized to really use short-term choices, or directions of corporate fund in order to reward themselves has turned us again away from innovation, which I think should be our North Star. And I also think that the rules that govern stock buybacks, I am really happy to see the Securities and Exchange Commission propose Rule SR, which will be a good first step toward disclosure of stock buybacks. And I really encourage them and the Congress deciding to go further and join other advanced capital markets around the world, and have common sense rules in place because of this fundamental risk of market manipulation and incentives for management.

**Chairman Beyer.** Thank you very much. I think this question is for Ms. Samuelson, but if you want to defer, we had a hearing

some time ago, or maybe it was a conversation with one of our many, many terrific economists, that essentially the seven people that ran the seven largest Index Funds—think Fidelity, Vanguard, or the like—were running our country, that they had an enormous number of the stocks under their direct control.

Clearly they may be the people that have a responsibility to maximize shareholder price, or not. How can we change the incentive system for them? Or is the incentive system right for them? Are they part of the solution?

**Ms. Samuelson.** I think I would address first the assumption of what are they actually doing with this incredible market power that they have. I think the number that is usually tossed around that Black Rock, which is the largest of the large, they own something like 7 or 8 percent of virtually every publicly traded security. They are the ultimate universal investor. They cannot exit. They have to own the market.

And so they have actually limited ability to influence corporations directly because they have thousands—you know, they have probably hundreds of annual meetings during the season every day, and they have a limited number of staff who are really detailed to kind of directly engage with corporations. So I think in some respects they mostly—Black Rock is one that would have been criticized. But it mostly just dealt with management. They vote what whatever management wants on proxy votes.

They have started to step back from that on some issues that, you know, kind are critically important. Climate change being one of them. But it is not obvious what they can do as an indexer. And so I think it takes us back to kind of saying what are the expectations of investors?

And it takes me back also to this other question about how we pay executives, and what the expectations there are, because, you know, Elizabeth Warren's proposal would suggest that it is just a matter of timeframe, and that loading up executives with stock, which in some respects the Black Rocks of the world like, right? Because that means that their, in theory that those CEOs are very, very attuned to pumping up the stock price. And of course there is an awful lot of that going on. But if you are a Black Rock or a Vanguard, you want the whole portfolio to do well. It does not really do this good just as Rick said, playing it out to kind of focus in on one stock or the other.

If I were writing that law, I would be pulling back, not that Congress necessarily has the power to do this, by the way, there is more power that resides within executives to fix their own stuff, maybe than Congress doing it directly. We have learned this from past experience.

But I pulled back from the emphasis on stock. I do not think it is doing us any good. When you hire these executives, they are people that have to exercise extraordinary judgment. They do not need incentives to take seriously the kind of risks that they are facing in this remarkably complicated day, and remarkably complicated market. And I do not know why we have to kind of load them up with stock in order to head them in the right direction. They care ultimately about the health of their enterprise, as they should, and they should care about, if not everything that one might call a

stakeholder—I do not particularly like that term. They have to get the formula right. They have got to manage their enterprise to the long haul, and that means being very attuned to what is the input that matters the most if I am in Intel? Or what is the input that matters the most if I am Chevron, or Exxon. Those are going to come up with different answers, and what we want is executives who actually are well compensated, that is fine, but who have kind of the sense of where they fit into the larger market, not doubling down, tripling down, quadrupling down, to have them just focused on the stocks.

**Chairman Beyer.** Thank you. Let me ask one more question, and I think it is for Mr. Alexander from your corporate legal background. I am a big fan of Thomas Philippon who wrote *The Great Reversal*, which is the best damning indictment I have seen yet of the corporate concentration, which I think Ms. Samuelson mentioned earlier. Hasn't the stock buybacks, dampened corporate concentration? Would it not be worse if corporations were forced to hold their capital and simply buy other smaller companies with it? Or how do those interact? Or is it too complicated to talk about?

**Mr. Alexander.** I think I am going to say that I am probably not a good person to answer that question. I would love to talk a little bit about Black Rock, but you are the Chair, so I—

**Chairman Beyer.** Dr. Palladino, any insight into the interaction between shareholder primacy and the failure of antitrust since Milton Friedman?

**Dr. Palladino.** Absolutely. I think, you know, we could have a whole other hearing on this question and maybe we should. I think that within the theory that says that we need competitive markets, we have forgotten that—you know, I teach introductory micro economics, probably Dr. Rauh does sometimes too—we have to talk about questions of market power. We have to talk about questions of externalities. These are the assumptions that we wave our hands and say do not exist when we are coming to this point of believing that perfect market clearing will simply occur.

I think that the rules that have been set in place that have enabled shareholder primacy are fundamentally related to the same drivers that have increased corporate concentration, the same interests that have driven us away from a focus on innovation, and has made some of our largest companies focus as well on maintaining market power through the exact types of practices that our antitrust laws were first set up to take on. So while there is a lot of difference in terms of the regulatory structures that govern State corporate governance law and Federal antitrust law, I believe it is really in the interest of the American people for regulators and those of us, scholars and others on the panel, to think more about the right balance between innovation and really constrain the types of anticompetitive behaviors that our largest corporations have unfortunately too often been practicing.

**Chairman Beyer.** Thank you very much. They have called the second vote over in the House. I want to thank you for letting me ask rounds two, three, four and five. I sort of like this. In any way case, thank you all very much for being here. And I want to thank you for joining me in this vital conversation about the economic cost of shareholder primacy.

As was discussed today, increased corporate focus on short-term value prices is a recent development. Given the right model of corporate governance to put shareholders before workers and innovation in the climate. And this recent pursuit of short-term gains has eroded the voice of the workers, many of whom have seen their earnings as a share of GDP diminish over the years, while also exacerbating income, wealth, racial and geographic inequality at least with respect to Dr. Rauh, and according to many economists. Focused on stock buybacks and the executive compensation, companies are investing less per dollar of profit in long-term growth and sustainability than they did in the past. And this is along with the competitiveness and overall productivity of our economy, even the average investor is left worse off.

The good news is that this is not the only way to do business. Hearing from these experts today, I am confident that we can once again prioritize investment that drives inclusive economic growth and address complex existential challenges like the threat posed by climate change.

We can do this by strengthening the bargaining power of workers, and realigning the incentives to reward long-term pro-growth investments that generate society and economy-wide returns. And we can do this together.

So thank you to each of our panelists for your contributions in this timely ongoing discussion. As we do this important work, we rely on your expertise and good faith. And thank you to my colleagues who came and went about their business for being part of this discussion and sharing their wisdom.

The record will remain open for three days. The hearing is now adjourned.

[Whereupon, at 4 p.m., Wednesday, March 16, 2022, the hearing was adjourned.]

## **SUBMISSIONS FOR THE RECORD**

PREPARED STATEMENT OF HON. DONALD BEYER JR., CHAIRMAN,  
JOINT ECONOMIC COMMITTEE

RECOGNITIONS

This hearing will come to order. I would like to welcome everyone to the Joint Economic Committee's hearing "Examining the Impact of Shareholder Primacy: What it Means to Put Stock Prices First."

I want to thank each of our distinguished witnesses for sharing their expertise today. We have an exceptional panel of experts, and I'm looking forward to hearing from them.

OPENING STATEMENT

This hearing will examine how the shareholder primacy model of corporate governance has impacted the economy and how Congress can help address the problems it has created.

Shareholder primacy is a corporate model that focuses mainly or exclusively on increasing stock prices to generate value for its shareholders.

This approach, which gained favor in just the last few decades, encourages corporations and their executives to spend a larger share of profits on stock buybacks to reward investors in the short-term.

Who are the winners when corporations put stock prices first?

In the United States, shareholders are a relatively small group: The top 1 percent owns roughly 50 percent of all corporate equities, and only about half of U.S. households own any stock at all.

As a result, the singular focus on stock prices concentrates wealth at the very top, while leaving less for companies to re-invest in their workers, in innovative technologies and in long-term growth.

For example, the seven largest publicly traded oil corporations recently announced a near-record \$41 billion dollar stock buyback program on top of \$50 billion dollars in shareholder dividends.

While everyday American workers and families bear the burden of higher gas prices, Big Oil is raking in record profits and prioritizing padding the pockets of their wealthy shareholders.

But it has not always been this way. From the 1930s to the mid-1970s, American corporations largely followed a "retain and reinvest" strategy that focused on long-term innovation and job security for workers.

Workers were seen as an asset and a long-term investment, not a liability. Managers viewed well-paid, cared-for workers as vital to their success and primarily used profits to pay workers, provide benefits and make productive investments. Shareholders received the residual after companies paid workers, invested for the future and paid down debt.

During this time, economic growth was strong and broad-based: As the economy grew, workers saw their wages rise and, on the whole, were more financially secure. They had access to pensions and pathways to the middle class.

Since the 1970s, however, as shareholder primacy has become more dominant, boards have put shareholders at the front of the line for corporate profits, leaving everyone else behind.

While CEOs and executives at the top have seen their incomes go up 940 percent over the last 40 years, the bottom half of earners have seen their wages virtually flatline.

Across the board, the share of Gross Domestic Product going to employee wages and benefits has been declining for decades. The increased corporate focus on raising stock prices has driven this trend, which in turn has deprived workers of the gains from economic growth.

Because the corporate executives and shareholders who benefit from this model are overwhelmingly and disproportionately wealthy and white, this further reinforces the widening wealth disparities across income and racial groups. By 2019, the top 10 percent of American households held 70 percent of all U.S. wealth, and the total wealth owned by the entire bottom half of Americans dropped to just 2 percent.

The impact of shareholder primacy goes beyond the widening differences between winners and losers; it is impacting our economy at almost every level.

Short-sighted decisions to help companies hit short-term earnings targets can help explain the "just-in-time" inventory and staffing approaches that left U.S. supply chains vulnerable to pandemic-related disruptions.

Shareholder primacy also hinders investments in innovation and sustainability that drive inclusive economic growth and are necessary to address threats like climate change.

For example, despite growing risks from climate change, corporations have continued to make decisions that prioritize short-run profitability at the expense of broad sustainability and climate resilience.

Surprisingly, investors themselves also lose under shareholder primacy. Families investing money in diversified stock portfolios for college or retirement suffer when individual companies put their short-term profits over long-term investments.

It's no coincidence that widening economic inequality in this country, which began in the 1970s, coincides with the increased dominance of shareholder primacy.

It has helped concentrate economic power among a privileged few.

But this is not how we, as a Nation, have always done things. There are other paths forward that maintain firm profitability and promote economic growth that is stronger, stable and more broadly shared.

For example, incentivizing business to invest in innovation, sustainability and enhanced productivity would boost competition, workers' wages and economy-wide returns.

Legislative proposals that place limits and tax share buybacks would help realign corporate incentives away from short-term stock prices and toward long-term, pro-growth investments.

Legislation that strengthens collective bargaining and raises wages, like the PRO Act and the Raise the Wage Act, would ensure workers take home a larger share of the gains that public companies and their executives have been keeping for themselves.

TURN IT OVER TO SENATOR LEE

As we dive deeper into these issues, I look forward to the testimonies of our expert witnesses. Now I would like to turn it over to Senator Lee for his opening statement.

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PREPARED STATEMENT OF HON. MIKE LEE, RANKING MEMBER,  
JOINT ECONOMIC COMMITTEE

Last week, we learned that inflation reached a new 40-year high of 7.9 percent. This means that inflation is costing the average American household \$435 more each month for the things they ordinarily buy.

Given this new economic reality, I hope we keep in mind the severe price increases facing American families right now as we hear about foisting environmental and other political goals onto private businesses. Americans are hurting. Poor and middle-class Americans are the ones who will pay the price for uprooting our market economy in favor of a woke political agenda. This agenda will only compound inflation—making Americans poorer and our businesses less dynamic.

For centuries, Americans have reaped the benefits of free markets and competition. It is this free market system that has lifted Americans to the highest standard of living ever achieved by a major economy.

Yet today, the free market system that enables American prosperity is under attack by bureaucrats, politicians, and regulators who seek to impose their personal political goals on private businesses. They seek to override the competitive forces that grow workers' wages and keep prices low. They seek to make private companies beholden to politicians, rather than to the shareholders who invest in companies in the first place.

When we hear the word shareholder, we don't usually think of the average American. But that's exactly who they are. Shareholders are the more than 180 million Americans who live in a household with a 401(k), pension, or other stock holdings. Shareholders are an ever-growing majority of households who invest in the economy and use the return on that investment to save for retirement, buy a home, or send their kids to college.

When the government tells companies not to listen to shareholders, it is really telling companies not to listen to the American people. When the government tells companies to divert their hard-earned resources into woke policy goals like environmental and social justice, the government is taking power and wealth out of the hands of the people and consolidating it in Washington.

When the government interferes with the private sector, businesses stop serving their workers and customers, and instead serve the bureaucrats who set the rules.

We already see this happening. President Biden recently directed his administration to assess companies' progress on environmental and social justice goals—a step toward requiring them to abandon their core responsibilities to the school teachers, firefighters, and everyday Americans who invest in them and buy their products.

These actions ignore centuries of evidence that the free market system is the best way to create prosperity for workers, families, and communities.

America has always been a place where the most effective common action occurs in the space between the individual and the State. A Federal Government that attempts to replace free enterprise is a Federal Government that has overstepped its bounds.

We ought to ensure that businesses are free to serve their communities by remaining at the forefront of innovation and creating value for the American families who invest in and are served by them. In today's environment of surging inflation, we can afford nothing less.

Thank you.

Statement by Lenore Palladino, Ph.D., J.D.  
Assistant Professor of Economics & Public Policy  
University of Massachusetts Amherst  
Fellow, Roosevelt Institute

Testimony before the U.S. Joint Economic Committee: Hearing on “Examining  
the Impact of Shareholder Primacy: What it Means to Put Stock Prices First”

March 16, 2022

Chairman Beyer, Ranking Member Lee, Members of the Joint Economic Committee, thank you so much for the invitation. I am honored to be here today.

My name is Lenore Palladino, and I am an Assistant Professor of Economics and Public Policy at the University of Massachusetts Amherst. My research focuses on large corporations and their critical role in generating innovation, as well as how public policy can enable sustainable prosperity.

I see shareholder primacy as a flawed theory of the corporation because it makes incorrect assumptions about the role of both shareholders and other corporate stakeholders in the process of production. The arguments from scholars of law and economics that shareholders are ‘residual claimants’ and thus the only group who should have power in corporate governance is silent on how companies actually produce better-quality products over time (i.e., how they make use of their inputs to produce better outputs). The theory of shareholder primacy misunderstands the role of shareholders trading on secondary markets and assumes that employees and other stakeholders take less risk than such shareholders, even though most of us have only one job, and if we’re lucky enough to hold corporate equity, we hold it in completely diversified portfolios—our risk comes from the stressors the entire economy faces, not just one company. My work is rooted in the economics of innovation as developed by economists like Schumpeter and Chandler, and today, William Lazonick.

In practice, the orientation towards ever-increasing share prices by corporate and financial leaders has created constant pressures to pay shareholders or face activist shareholder wrath<sup>1</sup>. The gains from spending corporate funds on financial practices like stock buybacks disproportionately benefit white, wealthy American households, because these are the households who hold the vast majority of corporate securities.<sup>2</sup> Federal Reserve data tells us that only half of U.S. households hold any

<sup>1</sup> My message is summed up by this quote from former Chief Justice from the State of Delaware, Justice Leo Strine: “Corporations have created financial returns for shareholders, but largely at the expense of other constituencies like workers. The imbalances in our current system have also left it brittle and less capable of avoiding or responding to crisis.” Kovvali A., Strine, L. (2022) “The Win-Win That Wasn’t.” Harvard Law School Discussion Paper 2022-1.

<sup>2</sup> The Federal Reserve’s Survey of Consumer Finances tells us that only half of U.S. households hold any stock at all, directly or indirectly<sup>2</sup>. For corporate equity and mutual funds, the top 1 percent of households by wealth holds 53.8 percent of stock and the next nine percent hold thirty five percent; what this means is that the other 90 percent of households hold 11 percent. Pension entitlements, which include corporate equity and other financial assets, are less concentrated, but the bottom fifty percent of households by wealth still holds just three percent. Black households hold 1 percent of non-retirement corporate equity, while Latino households hold half a percent; in terms of pension

stock at all. Meanwhile, there are countless examples where the focus on spending corporate funds on shareholders has left companies ill-equipped to face shocks and been used as a justification for holding down labor costs.

Policymakers have a critical opportunity to strengthen American innovation and resilience as we emerge from the pandemic. The economic and geopolitical challenges that face us are not going to stop. That is why it is time to strengthen our commitment to American productivity by reorienting our public policy away from enabling a single-minded focus on share prices and towards enabling innovation.

My testimony today focuses on three key points:

1. First, defining the key components of economic innovation and resilience in the 21<sup>st</sup> century;
2. Then, where corporations and finance have gotten off track – what the harms have been of the prioritization of shareholder primacy and “putting stock prices first;”
3. Finally, what the opportunities are today to rewrite the rules to orient our economy towards innovation and shared prosperity.

1. What Drives Innovation

What are the requirements for innovation, sustainability, and good jobs in America? Only by understanding what enables innovation and resilient economies will we have a clear framework for understanding the challenges of shareholder primacy. Corporations are the hot-blooded engines of *production*: it is inside corporations that the decisions are made about what gets produced, by whom, and how firms collaborate and compete to innovate and market.

We know from the history of successful companies that innovation comes about from long-term risk-taking by businesses, enabled by collective and cumulative learning<sup>3</sup>. It requires complex

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entitlements, Black households hold ten percent while Latino households hold 3.5 percent, disproportionately less than their share of the population<sup>2</sup>.

<sup>3</sup> Lazonick, W. (2017) *Innovative Enterprise Solves the Agency Problem: The Theory of the Firm, Financial Flows, and Economic Performance*.

organization, investment and retention of the workforce, and long-term financial commitments. The theory of the corporation as an innovative enterprise—engaged in productive innovation by producing higher-quality goods and services for lower unit costs—explains what makes corporations successful producers. In the formal language of economics, innovative corporations seek to reduce both fixed and variable costs of production, and do not take fixed costs as a given. Both fixed and variable inputs-or "resources"-- are not just lying around waiting to be used: the alchemy of innovation is in trying new ways to utilize such resources, even though some new methods will succeed while some will fail. In other words, innovation depends on both resource development and utilization, neither of which can be accomplished a single time and never again<sup>4</sup>.

Innovation requires a committed workforce that is engaged in improving the production process over time. Its financial base has been retained earnings leveraged by debt (and, in some sectors, a base of public investment): while corporate equity issuances bring financial resources into the firm when firms go public, subsequent trading of equity does not directly support innovation.

Theories of innovation should guide economic policymaking. However, over the last forty years, instead the theory and practice of shareholder primacy has come to dominate the American business landscape. Shareholder primacy is a flawed theory of corporate purpose and corporate governance, as it posits that shareholders take a certain kind of risk while no other corporate stakeholders do--including the workforce, customers, suppliers, and the taxpaying public—and that putting the power of corporate governance in the hands of shareholders will best maximize social welfare. I have written at length about the flaws of shareholder primacy as a theory in addition to in practice<sup>5</sup>. Let me make a few points in that regard; first, I will offer a quote from Judge Leo Strine Jr., commenting on the concept that shareholder primacy will benefit social welfare:

“The argued ‘win-win’ has been a win for one constituency—stockholders-- and at best another — top management — to the detriment of those most responsible for corporate success: the workers.” (Kovvali and Strine 2022, p. 5).

<sup>4</sup> O’Sullivan, M. (2000) The innovative enterprise and corporate governance. *Cambridge Journal of Economics*, **24**, 393-416. See also Penrose, E. (1959) *The Theory of the Growth of the Firm*. Wiley, New York.

<sup>5</sup> Palladino, L. (2020) Financialization at work: Shareholder primacy and stagnant wages in the United States. *Competition & Change*. 25(3-4), 382-400. See also Kassoy, A. et al. (2020) From Shareholder Primacy to Stakeholder Capitalism; Lazonick, W. & O’Sullivan, M. (2000) Maximizing shareholder value: a new ideology for corporate governance. *Economy and Society*, **29**, 13-35.

Shareholder primacy is usually framed as necessary – i.e., shareholders must have authority in corporate decision-making, and see their share prices rising, in order for the companies that produce our goods and services to have the financing available that they need to innovate. Yet it is the hard work of employees, customer needs and interests, and public infrastructure that determine today whether businesses succeed. This theory misunderstands the role of shareholders of publicly traded corporations who are *traders* – meaning that when I purchase financial assets to save for retirement, the funds that I spend do not go to the operating companies whose stock is now in my portfolio—the money I spend goes to the entity that sells me the shares.

The argument that shareholders should supervise corporate decisions because they take more risks and therefore care more about the actual decisions of a given company than other corporate stakeholders is especially flawed in the 2020s, as most households today hold fully diversified portfolios, meaning that we do not even know what individual stocks we hold. Put simply, there is no reason for second-by-second stock price fluctuations to be more important to corporate leaders than long-term innovation and resilience in production and supply chains, along with the well-being of the workforce required to produce.

What we need fundamentally is a full-scale reorientation towards innovation, which I know this committee and the Biden-Harris Administration has prioritized. We have seen leading organizations like the Business Roundtable call for a reorientation away from a sole focus on financial metrics, and some companies, such as Intel, start to move in that direction. We've also seen some Republicans understand the need for this reorientation<sup>6</sup>. Yet financial sector pressure for short-term returns will continue unless structural reforms are made.

## 2. How Corporations & Finance Have Gotten off Track

Shareholder primacy and the relentless focus on short-term share price increases by "activist" investors has changed the priorities within American businesses. Let me give some examples.

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<sup>6</sup> Rubio, M. (2019) *American Investment in the 21st Century*. Office of Senator Marco Rubio. [https://www.rubio.senate.gov/public/\\_cache/files/9f25139a-6039-465a-9cf1-feb5567aebb7/4526E9620A9A7DB74267ABEA5881022F.5.15.2019.-final-project-report-american-investment.pdf](https://www.rubio.senate.gov/public/_cache/files/9f25139a-6039-465a-9cf1-feb5567aebb7/4526E9620A9A7DB74267ABEA5881022F.5.15.2019.-final-project-report-american-investment.pdf)

My research has focused on open-market share repurchases, or “stock buybacks”<sup>7</sup>. U.S. corporations spent \$6.3 trillion on stock buybacks in the decade from 2010-2019 and are on track for record spending in 2022<sup>8</sup>. Stock buybacks harm the economy broadly because they benefit mainly the share-sellers, not those households holding stock for long-term lifecycle needs, and they have the potential to manipulate stock prices while benefitting corporate insiders because of the way they are currently regulated<sup>9</sup>.

It is the single-minded commitment to raising share prices that have driven the explosion of stock buybacks. Buybacks raise price *mechanically* by raising the value of the shares that remain outstanding and the all-important Earnings-Per-Share metric<sup>10</sup>. They are announced by corporate leaders as an explicit mechanism to raise share prices and satisfy share-sellers who are anxious for gain. Because they are such a high percentage of corporate net income, they have an *opportunity cost*—improving innovation and productivity across the American economy, strengthening our capacity to produce and support a broad-based middle class. In addition, it is perfectly legal for corporate insiders to personally benefit from conducting stock buybacks and then turning around and selling their own personal shares—all before disclosing such activity to shareholders. This is an example of the kind of incentives that ties the fortunes of executives and shareholders that distort corporate decision-making away from its true purpose: innovative production.

Let me give an egregious example is reporting that the Oil Majors will spend nearly \$40 billion on stock buybacks this year<sup>11</sup>. While the need to transition to a net zero economy grows more and more urgent, oil companies are prioritizing keeping their share prices up through mechanically affecting the math of earnings per share (despite rising pressure from certain shareholders for a faster move to invest in renewables)<sup>12</sup>. US companies such as ExxonMobil and Chevron are far behind European competitors when it comes to low-carbon expenditures; researchers estimate that ExxonMobil spent

<sup>7</sup> Lazonick, W. (2014) Profits without prosperity. *Harvard Business Review*, **92**, 46-55.

<sup>8</sup> Palladino, L. & Lazonick, W. (2021) Regulating Stock Buybacks. *Roosevelt Institute*.  
<https://rooseveltinstitute.org/publications/regulating-stock-buybacks-the-6-3-trillion-question/>

<sup>9</sup> Palladino, L. (2020) Do corporate insiders use stock buybacks for personal gain? *International Review of Applied Economics*, **34**, 152-174.

<sup>10</sup> Almeida, H., Fos, V. & Kronlund, M. (2016) The real effects of share repurchases. *Journal of Financial Economics*, **119**, 168-185.

<sup>11</sup> Wilson, T. (2022) Big Oil on course for near-record \$38bn in share buybacks. *Financial Times*.

<https://www.ft.com/content/2852b800-4a03-4cf6-a47f-65c306a22657>

<sup>12</sup> <https://www.ft.com/content/0e5a0373-ee69-438a-9026-4588338f6ee4>

\$19.3 billion on low-carbon investment, while they spent \$15.1 billion on dividends and stock buybacks.<sup>13</sup>

Stock buybacks are the tip of the spear; I am not claiming that simply eliminating them would not automatically reorient the economy. However, I think they are a useful issue for policy intervention right away as they clearly demonstrate the harms of relentless prioritization of shareholder payments, and the lack of guardrails has been a competitive disadvantage for some of our critical industries<sup>14</sup>. My research documents the set of available policy interventions for Congress and the Securities and Exchange Commission<sup>15</sup>.

Many economists have been documenting the negative effects of shareholder primacy on corporate investment and innovation. Studies at the aggregate, sectoral, and firm level have demonstrated a relationship between rising shareholder payments—primarily stock buybacks—and stagnant innovative investment<sup>16</sup>. Descriptive data analysis at the firm level for publicly traded firms shows a major transition towards shareholder payments and away from net new investment over the last few decades. For example, one study shows that business net investment fell as a percentage of operating surplus from 20% in the late 20<sup>th</sup> century to ten percent in the 21<sup>st</sup><sup>17</sup>. While it is hard to estimate counterfactuals with precision, it is critical for policymakers to reduce the incentives that currently exist for corporate leaders to prioritize financial metrics over sustainable investment and prosperity.

There are myriad other effects of shareholder primacy, including its contribution to rising income and wealth inequality and the racial wealth gap; its effect on climate change; and the current lack of resiliency in our supply chains. However, its effects are not inevitable, and in fact, policymakers have many approaches available to them to strengthen the U.S. economy.

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<sup>13</sup> Baines, J. & Hager, S.B. (2022) Performing Without Transforming: The Case for a Windfall Tax in the United States. *Common Wealth*. <https://www.common-wealth.co.uk/reports/performing-without-transforming-the-case-for-a-windfall-tax-in-the-united-states#footnotes2>

<sup>14</sup> One important example is the semiconductor industry. See, for example, Lazonick, W. & Hopkins, M. (2021) Why the CHIPS Are Down: Stock Buybacks and Subsidies in the U.S. Semiconductor Industry.

<sup>15</sup> Palladino, L. (2018) The \$1 Trillion Question: New Approaches to Regulating Stock Buybacks. *Yale Journal on Regulation Bulletin*, 36, 89-106.

<sup>16</sup> See Appendix I.

<sup>17</sup> Philippon, T. (2019) *The Great Reversal: How America Gave Up on Free Markets*. Belknap Press.

### 3. Opportunities for Reform

Congress can lead a reorientation towards innovation. This is the moment to focus on re-shoring of crucial productive capacities and to put in place guardrails so that public investment serves the public good. For example, we are all aware of the challenges of chip shortages and the semiconductor sector. The Department of Commerce recently noted in its report on supply chains in the Information, Communication and Technology (ICT) sector how innovation is “the foundation for a thriving ICT industry.”<sup>18</sup> Economist William Lazonick and co-authors have documented in detail how the focus on share price derailed U.S. semiconductor companies, along with sectors like pharma and PPE, which became more critical than ever during the pandemic<sup>19</sup>. As we emerge from the pandemic, it is incumbent upon policymakers to rewrite the rules that have enabled shareholder primacy. It is worth noting that Intel’s new CEO, Pat Gelsinger, has made clear that Intel is focusing on investing in innovation, stating clearly that this means less of a focus on stock buybacks and short-term share prices<sup>20</sup>.

One place to start is by reining in open-market share repurchases through putting in place bans or common-sense limits to the volume of such activity, which is the approach taken in peer financial markets<sup>21</sup>. Another area for urgent reform is the set of policies contained within the Accountable Capitalism Act, with its focus on worker voice in corporate decision-making and limiting incentives for short-termism. There is no corporate productivity without the workforce, and passage of the PRO Act is the best way to ensure a level playing field for workers to have dignity and respect at work. My research has also shown the potential for worker representation on corporate boards and broadening employee access to equity in the United States<sup>22</sup>. Reshaping how decisions are made

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<sup>18</sup> “Innovation through research and development (R&D) efforts is the foundation for a thriving ICT industry. While the United States remains the global leader in the research and development of cutting-edge technologies, continued investment is needed to sustain a prosperous R&D ecosystem and remain globally competitive.” P. 79<sup>18</sup>

<sup>19</sup> See <https://www.ineteconomics.org/research/experts/wlazonick> for extensive research on the semiconductor industry, pharmaceuticals, and PPE and ventilators.

<sup>20</sup> Intel CEO stresses more U.S. chip production, fewer stock buybacks. Marketwatch. May 2, 2021. <https://www.marketwatch.com/story/intel-ceo-stresses-more-u-s-chip-production-fewer-stock-buybacks-11620001650>

<sup>21</sup> Chen, N.-Y. & Liu, C.-C. (2021) The effect of repurchase regulations on actual share reacquisitions and cost of debt. *The North American Journal of Economics and Finance*, **55**, 101298.

<sup>22</sup> Palladino, L. (2021) Economic Democracy at Work: Why (and How) Workers Should Be Represented on US Corporate Boards. *Journal of Law and Political Economy*, **1**, 373-396. Palladino, L. (2021) The potential benefits of employee equity funds in the United States. *Journal of Participation and Employee Ownership*.

within the corporation must go hand-in-hand with the important work to take on outsized market dominance and to ensure that asset managers and financial institutions are acting in the interest of the economic beneficiaries of the shares they hold—U.S. households who have long-term interests in a healthy economy and planet, rather than short-term share price fluctuations<sup>23</sup>. Disclosure is a critical first step: I support real-time disclosure of stock buybacks, as proposed recently in the Securities and Exchange Commission’s “Proposed Rule SR,” regarding stock buybacks, and company disclosure of workforce investments, as proposed in the *Workforce Investment Disclosure Act*.

Let me end with several stories that illustrate the transition over the past forty years from innovation to shareholder primacy: the story of GE; and then two examples of companies making different choices in 2022: Amazon and Intel.

GE was a paradigmatic innovative company for much of the 20<sup>th</sup> century. My grandfather Arthur Palladino Sr. worked for GE for several decades after World War II. Even though he had served in the Air Force and been a Prisoner of War, he was unable to take advantage of the GI Bill because he had a young family. He had the brains of an engineer, and even with no college degree, he still had a good job that provided for his family, enabled my father to go to college. He participated in the innovations in aviation that were occurring at the GE plant in Lynn, Massachusetts. In other words, he was part of the process of collective and cumulative learning necessary for innovation, supported by a company whose financial commitment was to improving production over the long-term, not constantly manipulating short-term financial metrics.

GE’s turn towards prioritizing Wall Street payments under Jack Welch in the 1980s is one of the best-known examples of where American ingenuity went off the rails<sup>24</sup>. But by 2009, it is worth noting, Jack Welch proclaimed shareholder value maximization “the dumbest idea in the world.”<sup>25</sup> No less than Vanguard founder Jack Bogle wrote in 2018 that, “the outcome of the GE story of financial engineering and faulty management decisions is not a happy one... The net loss in market

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<sup>23</sup> Palladino, L. & Alexander, F. (2021) Responsible Asset Managers: New Fiduciary Rules for the Asset Manager Industry.

<sup>24</sup> Kay, J. (2019) The concept of the corporation. *Business History*, **61**, 1129-1143.

<sup>25</sup> Kay, J. (2019) The concept of the corporation. *Business History*, **61**, 1129-1143.

cap since 2000 is \$440 billion—likely the largest decline in a company’s market valuation in history.<sup>26</sup>

In this first quarter of 2022, we are seeing examples of the power of shareholder primacy, but also corporate leaders standing up and being willing to say that innovation is more important than short-term fluctuations in share prices. Amazon, which for decades has not focused on its share price, authorized \$10bn in stock buybacks on March 9<sup>th</sup>, 2022; Amazon had previously authorized just a \$5 billion stock repurchase authorization in 2016, of which it had executed \$2.12 bn, of which \$1.3 bn was spent in January 2022<sup>27</sup>. The *Financial Times* Lex columnist noted that “the company’s long-term investment in infrastructure is a better use of its funds.”<sup>28</sup> Meanwhile Amazon workers, which now number over 1 million in the United States, have themselves clearly raised myriad ways in which cost-cutting is affecting their health and well-being<sup>29</sup>. Amazon’s high turnover rate and difficult working conditions at Amazon warehouses have only intensified during the pandemic, and Amazon should invest in its workforce rather than spending \$10bn on stock buybacks<sup>30</sup>.

Intel, the global revenue leader in the semiconductor industry, spent \$80bn on stock buybacks from 2011-2020, and \$128 bn on shareholder distributions, while during the same decade they lost Apple as a customer, who instead turned to TSMC<sup>31</sup>. However, Intel’s new CEO, Pat Gelsinger, stated publicly in May 2021 that Intel would reduce its stock buyback activity in order to engage in long-term investment and innovation, adding that this decision had the support of his board<sup>32</sup>. This is a hopeful sign that leading American corporate leaders are starting themselves to recognize the harms of shareholder primacy and turning towards a renewed focus on innovation and resilience.

<sup>26</sup> Bogle, J.C. (2018) The Modern Corporation and the Public Interest. *Financial Analysts Journal*, **74**, 8-17.

<sup>27</sup> “Amazon Board Approves 20-for-1 Stock Split, \$10 Billion Share Repurchase.” *Wall Street Journal*, March 9<sup>th</sup>, 2022. <https://www.wsj.com/articles/amazon-board-approves-20-for-1-stock-split-10-billion-share-repurchase-11646863156>

<sup>28</sup> “Amazon: stock splits and buybacks equal short-term thinking.” *Financial Times*, March 10, 2022.

<https://www.ft.com/content/bb9f3927-d30d-4f8c-a612-5132dacbb7fb>

<sup>29</sup> Kelly, J. (2021). “A Hard-Hitting Investigative Report into Amazon.” *Forbes.com*.

<https://www.forbes.com/sites/jackkelly/2021/10/25/a-hard-hitting-investigative-report-into-amazon-shows-that-workers-needs-were-neglected-in-favor-of-getting-goods-delivered-quickly/?sh=20efdf7b51f5>

<sup>30</sup> “Amazon Leave Errors.” (2021). *New York Times*. <https://www.nytimes.com/2021/10/24/technology/amazon-employee-leave-errors.html>

<sup>31</sup> Lazonick W and Hopkins H. (2021) How Intel Financialized and Lost Leadership in Semiconductor Fabrication. *Institute for New Economic Thinking*. <https://www.ineteconomics.org/perspectives/blog/how-intel-financialized-and-lost-leadership-in-semiconductor-fabrication>

<sup>32</sup> Intel CEO stresses more U.S. chip production, fewer stock buybacks. Marketwatch. May 2, 2021.

<https://www.marketwatch.com/story/intel-ceo-stresses-more-u-s-chip-production-fewer-stock-buybacks-11620001650>

It is my hope that the JEC, Congress, and the Administration will continue this important focus on shareholder primacy. Thank you and I look forward to our discussion.

## Appendix I

- Gutierrez and Philippon have produced a series of studies documenting the weakness of private fixed investment relative to measures of profitability and valuation. For example, in *Investment-less Growth*, they find that industries with higher concentration and common ownership by asset managers invest less, while spending a disproportionately high level of free cash flows on stock buybacks<sup>33</sup>.
- Asker et. al compared corporations that are publicly traded versus privately held and found that “private firms invest substantially more than do public ones on average, holding firm size, industry and investment opportunities constant,<sup>34</sup>” and that privately-held firms are more responsive to changes in investment opportunities (their study is for the period 2001-2011).
- Cass (2021) categorized U.S. firms in terms of whether or not they replenished their capital stock out of earnings (EBITDA) and found that “firms that consume their fixed capital faster than [they] make new capital expenditures, while still returning cash to shareholders, though EBITDA would be sufficient to replenish their capital base” rose from 1% of all firms listed on NYSE & NASDAQ in 1980 to 49% in 2017. He also found that 37 of the 60 largest firms by market capitalization fall into this category, of making shareholder payments without investing in net new investment (that is, above that which is required for depreciation)<sup>35</sup>.
- Davis (2018) estimates a significant relationship between declining NFC investment rates and shareholder value orientation for non-financial corporations, most notably for the largest U.S. corporations<sup>36</sup>.

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<sup>33</sup> Gutiérrez, G. & Philippon, T. (2016) Investment-less growth: An empirical investigation.

<sup>34</sup> Asker, J., Farre-Mensa, J. & Ljungqvist, A. (2014) Corporate Investment and Stock Market Listing: A Puzzle? *The Review of Financial Studies*, **28**, 342-390.

<sup>35</sup> Cass, O. (2021) The Corporate Erosion of Capitalism. American Compass. <https://americancompass.org/essays/the-corporate-erosion-of-capitalism/>

<sup>36</sup> Davis, L.E. (2018) Financialization and the non-financial corporation: An investigation of firm-level investment behavior in the United States. *Metroeconomica*, **69**, 270-307.

- Davis & McCormack (2021) show that the average share of surplus allocated towards investment in an industry has been declining since 1980. They then find that firms in such industries are more likely to engage in a higher magnitude of share repurchases<sup>37</sup>.

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<sup>37</sup> Davis, L. & McCormack, S. (2021) Industrial stagnation and the financialization of nonfinancial corporations. *Review of Evolutionary Political Economy*, 1-33.



**The Impact of Shareholder Primacy: What it Means to put the Stock Price First**

Hearing of the Joint Economic Committee

March 16<sup>th</sup>, 2022

Mr. Chairman and Members of the Committee, I am Judy Samuelson, Executive Director of the Aspen Institute's Business and Society Program. Thanks for the opportunity to join you today as you delve into a topic that I care a lot about, and that will benefit from more exposure.

For close to twenty-five years, the Business and Society Program at the Aspen Institute has engaged business executives, directors, scholars, leaders in labor and corporate governance and those who both advise and critique business in pursuit of our mission: **to align business decisions with the long-term health of society.**

We believe that businesses—especially globe-hopping, talent-rich corporations, from consumer products companies to financial institutions (and the deep infrastructure of B2B companies that produce critical goods and services in support of the big brands)—embrace the capacity and problem-solving skills needed to address the most pressing problems in the modern world. Corporations are important and influential institutions, akin to the power of the Church in the middle-ages.

*How can we harness this capacity for the public good?*

In 2001, in the wake of the sudden and shocking implosion of Enron Corporation, we began series of conversations among business leaders that ultimately led to a set of principles dubbed the Aspen Principles on Long Term Value Creation. The principles were designed to unpack how Enron, then a high-flying stock, could practically disappear overnight. The Conference Board, our partner in the early rounds of dialogue, had used the term "short-termism" in the report of a Blue-Ribbon Commission on the failure of the company. We convened around this idea, engaging hundreds of individuals over the course of five years, as we dug into the management practices and protocols and narrative about corporate purpose that contributed to such a spectacular failure of a global enterprise, and significant employer.

This business failure disrupted many lives and the retirement savings of thousands of employees. It also ultimately sent the most senior executives to prison. It reminds us that the problems we are confronting in this hearing have been building over decades. Yes, shareholders expect and deserve a return on their investments, and of course companies need profits to survive and thrive, but our obsession with shareholder return—measured ultimately by the stock price—squeezes out common sense principles of management and critical investment in our future.

And while stockholder primacy has been criticized by many, it remains the dominant view in the financial community and much of the business world and return to shareholders—now measured as

Total Shareholder Return, or TSR<sup>1</sup>—is the primary way we (1) measure corporate performance, (2) structure executive compensation<sup>2</sup>, and (3) perceive the role of directors<sup>3</sup>. Even in the current and growing conversation over a corporation’s responsibilities to others, the pretense is that the actions taken must serve both the constituent and the shareholder. If there are tradeoffs involved, and there most always are, the shareholder is considered the most important to appease.

We-the-people grant corporation the license to operate. We are back to first principles. Whom does that license benefit?

It is fair to say that in a company that is truly managing for the long haul, the lines converge, and everyone can or will benefit from wise stewardship of a corporation’s capacities and resources and labor and talent, but the obsession with the stock price and short-termism are intertwined. A board’s definition of “long-term” today is about three years. We are eating our seed corn.

The nature of the conversation about shareholder primacy concerns the conduct of publicly traded companies, but as Senator Baldwin and others have pointed out, the short-term pressures to enrich investors first and foremost are also present in private capital markets, a growth area as more companies rely on private investors and never truly go public or rely on public markets.

I want to share some examples of how shareholder primacy plays out in the markets and the costs to the health of business and to wider society, starting with the growth in inequality, but moving on to broader concerns. Though these examples I also hope to explain how the system of rewards, incentives, assumptions and common-practices keep Shareholder Primacy in place.

The consequences of our focus on the stock price—return to shareholders—aka, shareholder primacy—play out in multiple domains. These problems are on the minds of business executives as well as members of this body.

#### **Growing Inequality:**

In the last decade, business leaders have joined the chorus of those who observe and are deeply concerned about the unsustainable level and growth of economic inequality in the United States. The Business Roundtable’s 2019 restatement of the purpose of the corporation is a case in point.

When the BRT restated its mission with great fanfare In August 2019, the then-Chairman of the BRT, Jamie Dimon, Chairman and CEO of JP Morgan Chase, observed, “The American dream is alive but

<sup>1</sup> The dominant measure of shareholder return is Total Shareholder Return—or TSR—dividends plus increases in the stock price. The increases in the stock price come about because investors like what they see, but also when the company decides to repurchase its own shares to reduce the shares outstanding and increase the value of the stock to those investors who remain in the stock.

For a public company to repurchase its own stock was viewed as stock manipulation and was illegal in the US until 1982. <https://corpgov.law.harvard.edu/2020/10/23/the-dangers-of-buybacks-mitigating-common-pitfalls/#:~:text=Buybacks%20were%20largely%20illegal%20until,over%20the%20next%2020%20years.>

<sup>2</sup> The top executives in public companies and many directors continue to receive the overwhelming amount of their compensation in stock.

<sup>3</sup> The primary reason directors are challenged by shareholder activists, or the company earns a ‘no’ vote in the so-called Say on Pay vote is because the company’s stock price is considered inadequate when measured against certain of its peers and/or the company’s “intrinsic” value.

fraying.” The BRT statement on the Purpose of the Corporation affirmed the commitment of nearly 200 CEOs of America’s largest companies to deliver more inclusive prosperity. Notably, the new statement of Corporate Purpose **overturned** a 22-year-old mission statement that defined a corporation’s principal purpose as maximizing shareholder return. (The idea that we are all better off if the shareholder is placed at the center of the business is still taught in finance classrooms as good management practice.)

We praised the BRT’s statement at the time. It felt like a watershed moment. It also felt to me like a return to common sense: executives of large corporations with tens of thousands or even hundreds of thousands of employees, operating across dozens or hundreds of regions and countries around the globe, cannot succeed with a single objective function. To succeed requires an extremely long-term view, strategy, complex relationships up and down the supply chain and an array of management objectives that respond to changing circumstances and are critical to survive, compete, and attract talent—and to earn public trust, and the license to operate wherever the company hopes to operate.

And yet, despite our early enthusiasm, and work behind the scenes to encourage the BRT to take a fresh look at their commitment to so-called Shareholder Value as the organizing principle for the firm, the most common question I continue to be asked is whether business is in fact living up to its commitments. And the answer to that question, clearly, is no.

Despite the public declaration of many of the most powerful business leaders in the world, and the importance of business as the wealth creators, and especially, despite having business executives enjoying many levers to influence the distribution of wealth, economic inequality has continued to get worse. Indeed, in the two years after the BRT statement, for the top 1% in the U.S., wealth grew by over \$11.5 trillion versus \$1.6 trillion for the bottom 50%.<sup>4</sup>

In the battle against inequality, inequality is winning in a rout.

And how is this possible? Many of us see headlines about wages growing as companies compete to attract and retain workers. For example, Target just received praise for a commitment to invest \$300 million in wages and benefits for employees. Isn’t this evidence of progress? Shouldn’t such an investment combat inequality? The answer, unfortunately, is no.

If we look a little deeper—we see that just six months ago, before the announcement about committing \$300 million (including bumping the minimum wage as high as \$15/hour and up to \$24/hour in some parts of the country and increasing access to health care) Target announced a \$15 *BILLION* program of stock buybacks. This use of cash to raise the stock price through the repurchase of shares was lauded by Wall Street analysts—even though it is *fifty times* the investment in the workforce. (At the end of the day, maybe 20% of the workforce will have access to healthcare as it initially only applies to those who work at least 30 hours a week.)

This is the flywheel that drives inequality.

And Target is hardly an exception or rogue player. Checking the morning newsfeed as I was about to hit send on the written form of this testimony, I saw that Amazon had announced a 20-for-1 stock split that would mean distributing \$10 billion to shareholders. The move, which is subject to shareholder approval in May, would be Amazon’s first stock split in more than 20 years, and is taking place as the company continues to resist the creation of a union at a plant in Alabama.

<sup>4</sup> <https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/table/>

These companies require scrutiny. **But they are also following the logic and incentives of our current model of capitalism.** Over the last decade, 93% of all corporate profits of the S&P 500 have been returned to shareholders via stock buybacks and dividends.<sup>5</sup> *This is what boards, CFOs and CEOs are incentivized to do.* And the only people that have formal power to challenge these decisions are the shareholders themselves, who are obviously complicit in the use of profits that we have come to expect from public companies.

Buybacks are a symptom of the short-term focus on the stock price—shareholder primacy.

Compounding this picture is the fact that **inequality is baked into the stock market itself** since the vast holdings of the market are highly concentrated — held by a tiny fraction of shareholders.<sup>6</sup> Simply stated, shareholder primacy fuels greater income inequality *because gains in stock prices benefit those who own stocks, and most stocks are owned by the wealthy*—in fact, the biggest share of stocks are owned by people who are already extremely wealthy.

**Shareholder primacy also drives inequality by actively discouraging wage growth.** Consider the market reaction to Walmart’s announcement back in 2015 that it planned to increase its minimum wage to \$10/hour. (It now pays \$12/hour and is moving to \$15/hour over time.) In addition to the raise, the company would invest in worker training, and technology to improve jobs and productivity. In response to these plans, investors punished the company with a \$20 billion dollar loss in stock value.

At \$10/hour, a full-time employee was making \$20,800 a year—well below the federal poverty line. But the commitment to increase wages at the time, and for the largest retailer in the world, was at odds with a system that *expects* companies to minimize labor costs. Fortunately, Walmart persisted, bolstered by family control of most of the company’s stock but even with that buffer, the message from the stock market was clear.

With all the hype today about so-called ESG investment, i.e., the attention paid to “environmental, social and governance” practices of companies, the reality is that the market still rewards actions like laying off workers or putting jobs out to contract—and punishes companies that do the reverse—invest in their workforce.

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<sup>5</sup> [The \\$5.3 Trillion Question Behind America’s COVID-19 Failure - The American Prospect](#)

<sup>6</sup> Note: from David Berger, Esq, Wilson, Sonsoni: According to the latest study by the Federal Reserve, the bottom 50% of American families owned 1% of overall equities (and 0% of direct stocks), while those in the 50%-80% of net worth held just 6% of overall equities. In contrast, the top 1% held 38% of overall equities and 51% of direct ownership of stock. <https://www.nytimes.com/2021/01/26/upshot/stocks-pandemic-inequality.html>. This has three very practical effects. First, it means that while the S&P 500 increased by over \$4 trillion in value in 2020 and even more in 2021, essentially none of this wealth went to the poorest half of Americans who own essentially no equity, and just about 6% went to 80% of Americans. Second, the top 1% increased their wealth by trillions of dollars, as they controlled not just 38% of the value of all stock accounts but also 51% of the value of accounts that directly hold stocks. Third, a major reason why the stock market continues to grow regardless of events in the real world—whether covid, economic growth, political gridlock or even war—is that over the last 40 years, consistent with and fueled by the theory of shareholder primacy, there has been a shift in the share of corporate profits given to capital versus the amount given to labor. (link to a recent paper demonstrating this practice: [https://www.nber.org/system/files/working\\_papers/w25769/w25769.pdf](https://www.nber.org/system/files/working_papers/w25769/w25769.pdf)).

This problem is not limited to retail. It happens across the economy. In 2017, several years after emerging from bankruptcy and a reorganization to reduce costs, American Airlines announced raises for its employees to bring their pay back in line with competitors. In response Wall St. analysts slammed the company. One analyst from JP Morgan bemoaned it as a “transfer of wealth from shareholders to labor groups,” labeling it “a worrying precedent, in our view, both for America and the industry.” Major investors agreed and airline stocks across the board took a hit on the fear that increasing wages would make airline stocks bad investments.<sup>7</sup>

In 2011, when Google announced its intention to create 1,600 new jobs, the stock price fell 5% overnight.

In the tech sector, it is now commonplace to reduce costs by replacing employees with contractor laborers, at lower wages and benefits, but also with less security, economic mobility and rights. Lower cost contract workers are a way of life. Google’s ‘shadow’ work force tops 130,000, and by most measures is greater than the employee base. It is estimated that ~10% of this number may eventually make it on to the payroll, to realize the kinds of opportunity for advancement that come with a regular job.

With employment models like this, it is no coincidence that tech companies like Apple, Microsoft, Alphabet, Amazon have among the highest stock market valuations in the world.

This incongruity, the failure of the market to reward a company’s investment in its own workforce, or to recognize these investments in employees as good for the economy, is in and of itself sufficient reason to continue to hammer away at the scaffolding that keeps the shareholder at the top of the company’s priorities. If we want to address the root causes of inequality—and other externalities of the form of capitalism in play today—we must unwind the system of incentives, informal norms and nudges, and formal rules that keep corporate shareholders as the center of attention.

For example, when it comes to rule-making, it is worth noting that the SEC just closed a comment period on the idea that the SEC should be even more insistent that senior executives be principally rewarded for Total Shareholder Return.

While we must ensure that investing institutions and the many intermediaries in the financial system are as accountable to the interests of society as we expect corporations to be, the pressure in public companies to continue to pump up the stock price is real, incredibly short-term oriented, and unrelenting.

I wish to clarify one point about governance and share ownership that is commonly misunderstood. When it comes to redressing shareholder primacy—it is important to note that **shareholders don’t own the corporation itself**. They own shares of stock that come with discrete and important rights and privileges, but the company, its assets and its liabilities, are not the property of shareholders. To unwind shareholder primacy has nothing to do with property rights. The corporation owns itself; shareholders don’t own the corporation, and we don’t need to treat them as such.

What’s holding us back from a real renaissance in business—from seeing the Business Roundtable’s restatement of corporate purpose catalyze a real change in behaviors in boardrooms and the C-suite—is

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<sup>7</sup> <https://www.cnbc.com/2017/04/27/airline-shares-decline-amid-worries-the-stocks-will-become-a-poor-investment-again.html>

a set of practices and protocols that dominate public companies—and that keep shareholders in a favored position.

Through years of dialogue and the work of networks of scholars, business leaders, some investors and governance experts, we have succeeded at disrupting the narrative that took hold in the 1980s and continues to dominate finance classrooms and law schools, aka, “The purpose of the corporation is to maximize shareholder value.” But the *scaffolding of shareholder primacy* is still firmly in place.

To question the common belief in shareholder primacy, as the BRT has done, is a critically important first step, but the system is complicated to unwind. There are winners and losers when real change takes place, and the losers would include wealthy investors who benefit from the status quo, i.e., who have massive holdings in the public markets and are loathe to give up their primary position. To continue to challenge the narrative about corporate purpose remains important, especially to challenge the assumption that shareholder primacy is embedded in law—and is a core principle of good management.

Shareholder-first thinking also persists because of the practice of “aligning” the CEO with the shareholders—a tenant of the design of Pay practices in almost all public companies.<sup>8</sup> These practices make many CEOs extremely wealthy and contribute to growing inequality within companies and within markets.<sup>9</sup>

Despite the myth that CEOs are just trying to keep up with baseball players and Hollywood stars, the data is clear. There are many social factors and other contributors to the growth of inequality, but the most obvious is that a small number of people make large amounts of money.

These so-called “mega-rich”—the top .1 of 1 percent earners—drive most of the inequality; between 1980 and 2014, they represented three-fifths of the income growth within the top 1%, and 40% of all income growth. (And the growth in inequality continues.) What might come as a surprise is that **business executives constitute most of this class of earners**—CEOs, certainly, but also other executives and professionals in finance and beyond.

And no surprise, there’s not a lot of motivation among CEOs or boards to change the system that has made them so wealthy. Further, Boards—even if they began to contend with their own role in perpetuating a massively unfair and inequitable system—are disinclined to disrupt the status quo; they fear putting their own CEO in a bad light by suggesting their CEO is less worthy than his or her peers.<sup>10</sup>

But the motivation to change is also strong—and growing. The costs of shareholder primacy are steep, and they are shouldered by all of us. Inequality is corrosive, and too many citizens have lost faith in “the system.” Employees are making their voices heard and are able connectors between internal policy and external costs and realities. Executives are listening to them. And there are many reasons beyond

<sup>8</sup> that is reinforced by proxy advisory firms like ISS, that advise mutual funds and large investors on how to vote their shares at the annual meeting

<sup>9</sup> —given the high concentration of holdings in the hands of a tiny percentage of stockholders. [I will not address the latter issue – wealth concentration in the public markets, but

<sup>10</sup> <https://www.aspeninstitute.org/programs/principles-of-pay/> See the Aspen Principles for Sensible and Effective CEO Pay, developed in partnership with Korn Ferry. The [Modern Principles for Sensible and Effective Pay](#) are the product of over two years of research and dialogue among board directors, investors, scholars and experts in governance and compensation working to assure the long term health of business and capital markets.

concern for inequality and, even the state of our democracy, for righting the ship and unwinding the obsession with return to shareholders.

**Capital Allocation:**

A critically important cost of the status quo is about capital allocation, or the pressure to divert capital to shareholders over other important investments—yes, to the employees that create the wealth, but well beyond to include under investment in infrastructure, R&D, innovation, and climate change, and the kinds of reserves that are helpful in a time of crisis, like the pandemic. Instead, we witness companies investing precious management time and money on tax avoidance and seeking protection for an industry or enterprise.

Corporations earn accolades for philanthropy and public commitments on all kinds of causes, while deploying tax subsidiaries across the globe to avoid paying taxes for these same needs at home and using their voice in Washington and at the state level to keep it that way.<sup>11</sup> The bottom line is that CEOs can appear to offer what BlackRock’s CEO Larry Fink seems to call for—serve a public purpose, execute against a well-thought strategy, and a long-term view—while still deploying extreme measures to avoid taxes and dodge the cost of public goods, including infrastructure and decarbonizing the energy mix to avoid a climate catastrophe.

The fixation on Total Shareholder Return—TSR—distracts from the actual job of corporate executives: the exercise of good judgment across a complex and constantly shifting set of relationships (especially including your own employees)—not merely to focus on the demands or expectations of shareholders.<sup>12</sup>

If the market has already priced a company’s stock appropriately, even the best and most responsible CEOs may find it hard to generate more TSR. Pressuring them to do so invites risky or nefarious behavior.

Narrowly focusing executives on TSR was at the heart of the most dangerous of corporate scandals from Boeing’s 737 Max tragedies to Wells Fargo’s fraudulent sales practices.

When corporations put the return to the shareholder at the center of the business model, it leads to diminished investment in other critical needs—investment in both workplace and product safety (think Boeing), climate change and conservation of vital resources (think VW and the “dieselgate” scandal), and R&D and innovation and skills transfer for the workforce.

It also contributes to our tepid response to climate change.

Members of this committee are surely grappling with how to fund important investments in our country’s future. Take the threat of climate change as one example. One of the barriers to addressing climate change has been the price tag. It is telling that data on share repurchases for S&P 500

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<sup>11</sup> Per [the Joint Committee on Taxation](#), the average effective tax rate of US multinational corporations in 2018 on US profits was 7.8%, down from 16% in 2017, a result of the 2017 tax cuts.

companies exceeds annual climate related spending in the Bipartisan Infrastructure Bill several times over.<sup>13</sup>

Over the last five years, repurchases for high carbon emitters exceeded \$400 billion. For the last decade, share repurchases are over five times the next ten years of the climate centered investment planned for in the BIB (II&JA).

In theory, long term investors—including large institutional investors like Blackrock and Vanguard that invest the capital of pensioners and those saving for retirement—balance out the impulses of short-term traders, who only think of today, but the reality is we are all complicit. Investors want return and pensions are under the gun to maximize return as well. Consumers are bound by price and convenience, and both carry extraordinary externalities. The stock price goes up when the company reduces costs and goes down when it invests capital in the company for the future or prioritizes the broader system or public goods on which the company depends.<sup>14</sup>

It's not all bad news out there; there are many companies, some private, some public, that manage to do things differently. Often their business model resides on the primacy of employees in order to achieve a superior customer service model, like the one that secured Southwest's reputation as a disrupter, or Delta's decision to create a bonus plan for all employees to advance their prospects coming off bankruptcy, or the legendary example of Herman Miller, that put design, and the designer, at the center, and then positioned the company to advance sustainability in design as a competitive advantage.

But these are the exceptions that buck the system as it operates now. To combat inequality—and climate change—we need a system that shares prosperity and invests in the future *by design*.

A society and economy need more than hyper-efficiency in the present. We need stability in the face of shocks. We need to be equipped for proverbial “rainy days” and downturns. We need to prepare and invest in changes that correct for past mistakes and to enable a brighter future. But the logic of shareholder primacy—extracting maximum returns for shareholders—isn't designed for balance, stability, or to reward risky long-term investment in an uncertain future, or to cushion us through the hard times.

Let me end with this thought: Despite public cynicism, business corporations are neither bad, nor good. They are not moral, or immoral. *Corporations are amoral*—a function of the rules and protocols and incentives that drive behavior. We the people license corporations to create goods and services—and when done well, wealth is created, and ideally is shared with the wealth creators along with those who have wisely invested with a long-term view of performance.

We, as a country, have remarkable talent, and tremendous resources. We have what is needed to do great things. The way forward requires a closer look at the “G” of ESG – to what end boards and executives allocate capital in support of human endeavor and our collective future. [See next page]

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<sup>13</sup> For high carbon emitters within the S&P 500, annual share repurchases by higher emitting sectors are multiples of the annual climate related spending proposed in Infrastructure Investment and Jobs Act—\$77 billion versus ~\$15 billion.

<sup>14</sup> <https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off> This article uses a research framework that enables investors to identify companies that are short term oriented.

**Resources and Policy Recommendations:**

[The Aspen Business & Society Program](#) focuses on **business** as the agent of change – and we are thus particularly interested in actions and choices that lie within the control of executives and boards.

However, over the course of two decades we have produced policy-oriented recommendations that are consistent with the need to rethink corporate purpose, reward long-term thinking and assure that boards and executives listen to and embrace those who bear the consequences of their decisions.

**Products of dialogue and business engagement include:****2009: The Aspen Principles of Long-Term Value Creation**

<https://www.aspeninstitute.org/publications/aspen-principles-long-term-value-creation-guiding-principles-corporations-investors/>

**2016: The American Prosperity Project: A Non-partisan Framework for Long-Term Investment**

<https://www.aspeninstitute.org/programs/business-and-society-program/american-prosperity-project/>

**2019: The Aspen Principle for Sensible and Effective**

**Pay**<https://www.aspeninstitute.org/programs/principles-of-pay/>

**2021: A Policy Foundation to Revive Worker**

**Voice**<https://www.aspeninstitute.org/publications/policy-foundation-worker-voice/>

*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*

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#### **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.

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### 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 owned 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

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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

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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.<sup>1</sup> More immediately, the difference between an efficient response to COVID-19 and an inefficient one could create a \$9 trillion swing in GDP.<sup>2</sup> 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.<sup>3</sup> Antimicrobial resistance may cost the world economy \$100 trillion between now and 2050 according to some estimates.<sup>4</sup> 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.<sup>5</sup> Thus, as shown in Figure 1, diversified shareholders internalize costs that individual companies can profitably externalize:

<sup>1</sup> 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>;

<sup>2</sup> 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>.

<sup>3</sup> 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%2BsKbjJbJSaTOSdw2DF4xynPwFB8a2jV1FaA3ldy7vY59bOtN2lxVQM%3D;Inequality is Slowing U.S. Economic Growth](https://ir.citi.com/%2FPRxPvgNWu319AU1ajGf%2BsKbjJbJSaTOSdw2DF4xynPwFB8a2jV1FaA3ldy7vY59bOtN2lxVQM%3D;Inequality%20is%20slowing%20U.S.%20economic%20growth), Economic Policy Institute (December 12, 2017) (Inequality reduces demand by 2-4% annually) available at <https://www.epi.org/publication/secular-stagnation>).

<sup>4</sup> *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](https://amr-review.org/sites/default/files/AMR%20Review%20Paper%20-%20Tackling%20a%20crisis%20for%20the%20health%20and%20wealth%20of%20nations_1.pdf).

<sup>5</sup> 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](https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf).

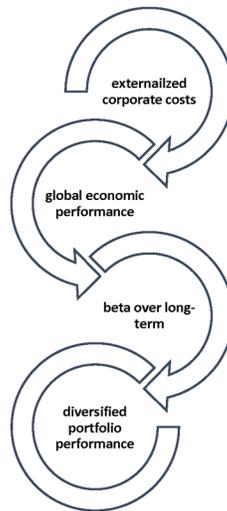


Figure 1

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

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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 its 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.*

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*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 . . . .<sup>6</sup>*

##### 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."<sup>7</sup>*

<sup>6</sup> eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).

<sup>7</sup> Available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/mcritchblackrock012422-14a8-incoming.pdf>

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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.

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### **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.")

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**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.

### Why We Should Preserve Shareholder Capitalism

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Testimony Before the Joint Economic Committee

March 16, 2022

In August 2019, the Business Roundtable stated that it no longer defines a corporation's principal purpose as maximizing shareholder value. In the Roundtable's *Statement on the Purpose of a Corporation*, 181 CEOs wrote: "companies should serve not only their shareholders, but also deliver value to their customers, invest in employees, deal fairly with suppliers and support the communities in which they operate."<sup>1</sup> These CEOs include the leaders of many of America's largest companies, like Jeff Bezos of Amazon, Tim Cook of Apple, and Satya Nadella of Microsoft. Many observers viewed this as a seismic shift away from shareholder capitalism and to a broader stakeholder-focused vision.

As has long been pointed out, in a competitive market, firms wishing to maximize shareholder value must to a great extent serve their customers, employees, and communities well. Otherwise, they will go out of business, unable to sell products to consumers who do not trust them, and unable to hire employees in a competitive labor market where workers have options. Any assertion of the need for a stakeholder paradigm as opposed to a shareholder paradigm necessarily assumes that the interests of shareholders and other stakeholders are in conflict. In fact, the shareholder versus stakeholder debate ultimately boils down to situations where a firm can take actions that would benefit shareholders while harming other stakeholders, or vice versa.<sup>2</sup>

It is remarkable that a group of business executives made the Business Roundtable declaration. Business executives are not the owners of corporations. They are employees of the corporations, appointed by shareholder-elected boards. The shareholders are the owners.<sup>3</sup> So in the Business Roundtable's declaration CEOs have stated that the owners of corporations should no longer be the ones determining corporate goals, and that instead that they (the CEOs) should determine which interests the firm will serve. A CEO announcing that the shareholders are no longer solely in charge is not far from a government official telling the American people that they are no longer solely in charge.

In this testimony, I will make five main points:

- 1.) The shareholders whose interests are served by shareholder capitalism represent a broad segment of the population, which relies on the performance of the stock market for its financial well-being, including for retirement. To a large extent, their desires as investors are those described by Friedman (1970): "generally ... to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."
- 2.) The rise of an investing approach that advertises sustainable investment reflects the fact that some investors have nonfinancial as well as financial objectives. Challenges arise if there is a tradeoff between financial and nonfinancial goals, or if there is disagreement among shareholders about what is socially desirable, or in a setting where powerful fund managers, entrusted with the

<sup>1</sup> Press Release, Business Roundtable, Business Roundtable Redefines Purpose of Corporation to Promote "An Economy That Serves All Americans" (Aug. 19, 2019)

<sup>2</sup> Sanjai Bhagat & R. Glenn Hubbard, *Should the Modern Corporation Maximize Shareholder Value?*, AEI ECON. PERSP., (Am. Enter. Inst., D.C.), Sep. 2020, at 5.

<sup>3</sup> Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L., FIN., & ACCT. 247, 263 (2017).

management of passive capital (index funds), vote in corporate matters on behalf of the individual shareholders. Given these issues, returning to a default of shareholder value maximization within the bounds of law and ethics would be the best approach to protect individual shareholders.

- 3.) The current Environmental-Social-Governance (ESG) investment space is plagued by inconsistent and changing definitions that ultimately have reduced managerial accountability to shareholders. Caution is required before investors are led to believe they should invest in ESG funds, since there is still essentially no clarity on the risk-return profile of ESG funds relative to non-ESG funds. The Department of Labor's decision in November 2020 to prohibit private retirement plans taking on financial risk in order to advance political or other goals was an important step in safeguarding the fiduciary role of retirement plan sponsors, and the Biden Administration should reverse its decision not to enforce this rule.
- 4.) The version of the socially responsible investing model that the federal government is pursuing, both in proposed legislation (such as the Corporate Governance Improvement and Investor Protection Act - H.R. 1187, or the Accountable Capitalism Act introduced in the 115<sup>th</sup> Congress) and executive order (President Biden's Executive Order on Climate-Related Finance Risk), runs the risk of circumventing the will of the people. In some cases, what appears to be inherited wisdom about what corporate actions would be valuable to society are not views held by a majority of the general public. In other cases where companies have engaged in actions that have been harmful, government policy has enabled their actions, in which case Congress should focus on changing such policy rather than trying to assert that "unethical capitalism" is the prime culprit.
- 5.) Shareholder capitalism has brought tremendous prosperity to US households, including those in the lower part of the income distribution. If anything, the financial system and financial regulators should focus on ensuring a robust system of shareholder capitalism in which shareholders can hold executives accountable for growing the value of their investments.

#### 1. Who Are the Shareholders?

To understand who the shareholders are, it is first important to review the structure of the corporation as reflected in US state corporate law and common business practice. As shown in Figure 1, shareholders elect a board of directors who then appoint officers. As such, the separation of ownership and control establishes a principal-agent relationship between shareholders (the principals) on the one hand, and the directors and their appointed executives (the agents) on the other.<sup>4</sup>

In 1993, Congress amended the Internal Revenue Code to limit deductible executive compensation to \$1 million per year unless that compensation was performance-based, which generally means tied to the share price. Under this provision, the federal tax code would favor stock options and similar securities linked to the share price over other forms of compensation. This action in a sense "enshrined" the notion of shareholder primacy into federal law.<sup>5</sup>

As is clearly seen in Figure 1, the CEOs who signed the Business Roundtable's statement are not the owners of corporations, but rather they are employees, appointed by shareholder-elected boards. The shareholders are the owners. While there has been a shift in sentiment of the executive class and some investors towards a release of directors and CEOs from their fiduciary duty to shareholders, there is little

<sup>4</sup> Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

<sup>5</sup> Mark Lowenstein & Jay Geyer, *Shareholder Primacy and the Moral Obligation of Directors*, 26 FORDHAM J. CORP. & FIN. L. 105, 113 (2021).

that justifies this shift, other than, as stated in a recent article, that “the proponents justify the result because it is the result they want.”<sup>6</sup>

It is important to understand who a shift away from shareholder primacy harms. According to the Securities Industry and Financial Markets Association (SIFMA), and as summarized in Figure 2, US households own 38% of the US stock market in the form of direct ownership.<sup>7</sup> An additional 22% of the US stock market is owned by mutual funds, 89.2% of which are owned by households. An additional 6% of the US stock market is owned by Exchange Traded Funds (ETFs), a good share of which are also owned by households. And then 11% of the stock market is owned by US public or private pension funds, which provide defined benefit retirement pensions to US workers, largely those in the state and local government sector or those in older and heavily unionized industries. In sum, the data show clearly that households own the majority of the stock market, either via direct holdings of individual securities or by mutual funds, especially those in 401(k) plans and IRAs, or by defined benefit pension plans, which are in turn directly benefiting regular households.

While it is certainly true that wealthier households have greater stock holdings, stock ownership is pervasive among US households. According to the Survey of Consumer Finances of the Federal Reserve, as of 2019, 53% of all US households owned publicly traded stock in some form. As shown in Figure 3, this share rose dramatically in the 1990s and has been roughly stable for the past two decades. An additional 10% of households have no stock or mutual fund holdings, but participate in a defined benefit pension plan. The shares owned by the median household that owns stock have a value of \$40,000. The average shareholder is much poorer than the average CEO who signed the Business Roundtable statement and asserted that they are no longer solely beholden to shareholders. A move to stakeholder capitalism represents a loss of accountability, particularly for smaller investors who are too dispersed even to monitor and influence the actions of the fund managers managing on their behalf, let alone CEOs directly.

## 2. What do shareholders want?

According to Milton Friedman’s famous 1970 article, shareholders’ desire “generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.” In the long run, a firm’s reputation and bottom line will suffer if they do not, so under shareholder capitalism, executives already have a strong incentive to make ethical decisions, and plenty of leeway under the business judgment rule to do so even if it doesn’t maximize the returns on the company’s stock.

One often-raised concern is the idea that there could be deviations between short-term and long-term shareholder value in equity markets.<sup>8</sup> It is important to note that it is nowhere close to established fact that corporate short-termism is really a problem. Studies on possible deviations between short-term and long-term value are inconclusive, and it is possible that actions justified in the interest of creating long-term shareholder value may be simply wasteful spending.<sup>9</sup> It is also difficult to see widespread evidence of market short-termism when more than 80% of the IPOs in the US have negative earnings during the 12 months leading up to their listing; these companies are going public at valuations in some cases

<sup>6</sup> *Id.* at 107.

<sup>7</sup> SIFMA INSIGHTS, A CHART BOOK ON STOCK OWNERSHIP 14 (2019), <https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Who-Owns-Stocks-in-America.pdf>.

<sup>8</sup> See McKinsey Global Institute, *Measuring the Impact of Short-Termism*, Discussion Paper, February 2017.

<sup>9</sup> Lawrence Summers, *Is Corporate Short-Termism Really a Problem? The Jury’s Still Out*, HARV. BUS. REV. (Feb. 16, 2017), <https://hbr.org/2017/02/is-corporate-short-termism-really-a-problem-the-jurys-still-out>.

exceeding \$1 billion.<sup>10</sup> Investors as a whole would have to place substantial emphasis on long-term value to support these valuations. Nevertheless, improperly structured incentives for management can bring too much focus to the short-term. In that case, the solution to that is to structure compensation to reward long term performance. It is not to give managers free reign to make decisions in the interest of any arbitrary stakeholders they want.<sup>11</sup>

Of course, some shareholders of some companies may have a taste for investments that achieve other goals, such as environmental, social, and governance (ESG) objectives. According to GSIA over 33% of total managed assets in the US today are in “sustainable investments” broadly defined,<sup>12</sup> although as shown in Figure 4, at least 5 percentage points of that is arguably more directly related to shareholder value maximization (the G in ESG). As shown in Figure 5, the share of total managed assets in the US in sustainable investments has risen dramatically over just the past six years, since the beginning of the series in 2014 when it stood at 18%. Figure 6 shows an even stronger trend over a longer period of time, with the total dollar value of ESG integrated investments spiking up since 2012, but shareholder advocacy and strategies that overlap shareholder advocacy with ESG integration essentially stagnating.

In contrast to the stated goal of this hearing to “examine the rise in recent decades of shareholder primacy,” the real issue that needs to be addressed is the *erosion* in recent in recent decades of shareholder primacy, as evidenced by the above-mentioned trends. A recent paper on the National Bureau of Economic Research website finds that (i) the average number of stated purposes of corporations have increased five-fold over the period 1955 to 2020, amounting to only two in 1955 to ten in 2020; and (ii) there has been a rise in bonus payments that are contingent on environmental and social objectives, especially among the signatories of the Business Roundtable statement.<sup>13</sup> The goal of this hearing should really be to examine the consequences of this shift and what policy measures might be taken to ensure the safety of investors in such an environment, as well as the maintenance of a strong market economy that is attractive to investors.

Oliver Hart of Harvard University and Luigi Zingales of the University of Chicago have pointed out that if the shareholders of a company clearly want to achieve social goals – even at the expense of financial ones – there is every reason for companies to comply.<sup>14</sup> In that case, if investors are “prosocial”, then maximization of shareholder value per se is not the same as maximizing shareholder welfare. Arguably this idea was also encompassed in Milton Friedman’s 1970 article on shareholder capitalism, as the fundamental point of shareholder capitalism is that shareholders are the bosses, although Friedman did not directly address the idea of shareholders with hybrid objectives (financial and non-financial).<sup>15</sup>

There are two main difficulties, however, that arise with this approach.

<sup>10</sup> Sanjai Bhagat et al., *IPO Valuation: The International Evidence*, in OXFORD HANDBOOK OF IPOs 108, 121-123 (Douglas Cumming ed., 2019).

<sup>9</sup> Sanjai Bhagat & R. Glenn Hubbard, *Should the Modern Corporation Maximize Shareholder Value?*, AEI ECON. PERSP., (Am. Enter. Inst., D.C.), Sep. 2020, at 7.

<sup>11</sup> *Id.* at 4.

<sup>12</sup> GLOB. SUSTAINABLE INV. ALL., GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020 5 (2021), <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf>.

<sup>13</sup> Raghuram Rajan et al., *What Purpose Do Corporations Purport? Evidence from Letters to Shareholders 1* (Feb. 2022) (working paper) (on file with author).

<sup>14</sup> Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L., FIN., & ACCT. 247, 263 (2017).

<sup>15</sup> Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, NEW YORK TIMES MAG., Sep. 13, 1970, at 17.

First, if investing in funds with non-financial objectives means accepting lower risk-adjusted returns, potential investors must receive a specific warning to this effect. Looking at publicly traded stocks, a meta-analysis that studied over 1,100 primary peer-reviewed papers finds that it is completely inconclusive whether ESG investing has better, the same, or worse performance than conventional investing.<sup>16</sup> As shown in Figure 7, 60% of studies that took a firm-level perspective found that firms implementing ESG have better financial performance than firms that do not. Research standards require overwhelming evidence, so a 10% majority of studies is hardly meaningful. Instead, this is evidence that the research is completely inconclusive, and admits a substantial possibility that ESG investing might involve sacrificing returns. For individual investors to be encouraged to invest in ESG funds under the presumption that they do not sacrifice returns, one would want to see a statistical rejection of the return reduction hypothesis at a 95% confidence level.

In addition, these corporate studies do not aim to address the problem of selection, or the possibility that firms adopting ESG might have had better performance anyway, with no causal effect of the ESG adoption. Investors chasing the fad of ESG funds may be pushing prices of ESG investments higher in the near term, biasing upwards studies that claim to find a positive relationship between ESG and returns over the available time horizon. Furthermore, Figure 7 shows that the majority of studies that aim to examine the effects of ESG from an investor perspective find a neutral, mixed, or negative effect on performance. The inconclusiveness of these empirical studies on the link between ESG and performance may be due to the questionable information content of ESG ratings (see the following section).<sup>17</sup>

Research on private markets, including my own work, is more conclusive that ESG preferences and local and Economically Targeted Investments (ETIs) are in fact related to underperformance in the form of significantly lower annualized rates of return. In one paper, my coauthors and I found that ESG preferences and regulations explain 25%–40% of public pension funds' increased allocation to private infrastructure funds and 30% of their underperformance in that asset class (see Figure 8).<sup>18</sup> In another, we found that Economically-targeted investments (ETIs) in private equity have six percentage points lower net internal rates of return (IRRs). We found that investments in local real estate and venture capital PE funds deliver significantly lower net IRR and multiples of invested capital, and these local investments explain part of the underperformance by pension funds governed by boards with strong political representation.<sup>19</sup> Finally, other researchers have found that social impact funds earn 4.7 percentage points lower IRRs ex-post than traditional VC funds.<sup>20</sup>

Whether investors are fully aware of the financial risk they are entering into when investing money with fund managers and firms that have non-financial objectives is unclear. There are many irresponsible industry assertions that investing with non-financial objectives comes with no financial penalties in terms of risk-adjusted returns.<sup>21</sup> Furthermore, investors may also not be aware that a strategy of “negative

<sup>16</sup> Ulrich Atz et al., “Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions” (Sep. 10, 2021) (working paper) (on file with the Social Science Research Network).

<sup>17</sup> David Larcker et al., *Seven Myths of ESG*, STAN. CLOSER LOOK SERIES, (Stan. Graduate Sch. of Bus., Palo Alto, CA), Nov. 2021, at 2.

<sup>18</sup> Aleksander Andonov et al., *Institutional Investors and Infrastructure Investing*, 34 REV. FIN. STUD. 3881, 3884 (2022)

<sup>19</sup> Aleksander Andonov et al., *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041, 2041 (2018).

<sup>20</sup> Brad Barber et al., *Impact Investing*, 139 J. FIN. ECON. 162, 163-164 (2021).

<sup>21</sup> For example: “Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors.” In “A Fundamental Reshaping of Finance” by Larry Fink, Blackrock, Chairman and Chief Executive Officer, 2020.

selection”, such as avoiding firms with aspects of their business that the investors find undesirable, does little to change those businesses – another investor will simply buy the shares at a lower price. It is likely that if the company were making more money engaging in the activity the investor finds unethical, the only way for an investor to alter that would be in fact to own shares in the company and participate in proxy contest voting that would alter its practices and reduce its profitability.

A second problem with firms managing in the interest of shareholders with non-financial objectives arises if there is extensive disagreement among shareholders about what is desirable policy. In this case, smaller shareholders may find themselves harmed by the actions of larger shareholders, which weakens the system and reduces the incentives of non-majority shareholders to provide capital. This is particularly a problem if there is a large quantity of passive capital such as in the massive market-tracking index funds. In effect, large numbers of smaller investors who might simply want a good return on their investments are under-represented, while powerful firms that manage index funds impose ESG on corporate America as they vote on behalf of trillions of dollars of other people’s money.<sup>22</sup>

Some managers of index funds have stated that they will pass the vote along to their larger clients.<sup>23</sup> This is a start, but it does not address the complexities of soliciting the views of highly fragmented smaller clients. The administrative complexity of implementing passing the vote along to index fund investors would itself be substantial, and it is also not clear how non-professional individual investors could possibly respond to the requests to vote on hundreds if not thousands of proxy questions that might come up for the companies in index funds they own. Investors in index mutual funds should be entitled to some assurance that a mutual fund manager will not cast votes that reduce shareholder value in the interest of non-financial preferences that the investors may not share with the fund manager.

### 3. ESG Definitions are Fluid and Inconsistent

According to the MIT Sloan Sustainability Initiative, ESG ratings are “noisy and unreliable” and the correlation across rating agencies is much weaker than that of other ratings such as credit ratings.<sup>24</sup> Specifically, the correlation among the main ESG rating agencies’ ESG ratings of firms was 0.61, compared to the correlation of credit ratings between Moody’s and Standard & Poors at 0.92. Rewriting and revising old ESG ratings is a common practice by at least one of the key ESG ratings providers, Refinitiv. To be clear, this does not simply mean changing an existing rating, an understandable practice as new information becomes available. Rather, it actually refers to altering historical ratings databases. Authors at this MIT initiative write: “The ESG data rewriting is an ongoing rather than a one-off phenomenon.”<sup>25</sup>

The fluidity of ESG ratings is not surprising in light of recent news about how the ESG sector has responded to the conflict in Ukraine. Reports in March 2022 have highlighted the fact that for some funds, Russian oil and gas firms had previously received positive ESG ratings, while European rating agencies are now considering reclassifying the ESG ratings of weapons manufacturers from negative to positive.<sup>26</sup> Given

<sup>22</sup> Wall Street Journal Editorial Board, “Calling Out ‘Emperor’ Larry Fink,” WALL ST. J., Feb. 17, 2022, at A21.

<sup>23</sup> Sandra Boss, “BlackRock Responds on Proxy Voting and Capitalism,” WALL ST. J., Feb. 23, 2022

<sup>24</sup> *The Aggregate Confusion Project*, MIT SLOAN SCH. MGMT., <https://mitsloan.mit.edu/sustainability-initiative/aggregate-confusion-project> (last visited Mar. 11, 2022).

<sup>25</sup> Florian Berg et al., *Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings 1* (Eur. Corp. Governance Inst., Finance Working Paper No. 708/2020, 2021).

<sup>26</sup> Matt Levine, *ESG Goes to War*, BLOOMBERG: OP. (Mar. 9, 2022, 11:05 AM),

<https://www.bloomberg.com/opinion/articles/2022-03-09/esg-goes-to-war>.

Sajjel Kishan et al., *ESG Finds Itself at Crossroads After Investing in Putin’s Russia*, BLOOMBERG, <https://www.bloomberg.com/news/articles/2022-03-06/esg-finds-itself-at-crossroads-after-investing-in-putin-russia> (Mar. 7, 2022, 4:39 AM).

the arbitrary nature of this process, returning to a default of shareholder value maximization within the bounds of law and ethics would be the best approach to protect individual shareholders.

Furthermore, combined with the uncertainty about the relative performance of ESG assets, caution is required before investors are led to believe they should invest in ESG funds. The Department of Labor made a well-founded decision in November 2020 when it prohibited private retirement plans taking on financial risk in order to advance political or other goals, limiting the extent to which ESG funds can be offered in 401(k)'s and other plans. The Biden Administration, by announcing that it would not enforce this rule, absolved plan sponsors of considerable accountability.

#### 4. Public Opinion and The Role of Government

In some cases, the majority views of the American people do not even line up with alleged ESG principles. Recent Gallup polls show that while 60% of Americans would favor policies aimed at reducing the use of fossil fuels (latest data 2019), 2021 figures show that only 39% of Americans would like to see less emphasis on producing domestic energy from oil and only 19% would like to see less emphasis on producing domestic energy from natural gas (see Figure 9).<sup>27</sup> Calling for a pro-stakeholder approach that limits oil and gas production, as in the proposed Corporate Governance Improvement and Investor Protection Act, or President Biden's Executive Order on Climate-Related Finance Risk, would appear to be something of a circumvention of the democratic process. Apparently, the American people do not clearly want what powerful parts of the political and managerial class want.

In other cases where companies made money and behaved unethically, government could have limited the incentives to do so by taking a hard look at its own policies. Consider for example the executives who profited from the opioid epidemic. To be clear, there is no dispute that their actions were highly unethical. But it was a government failure that federal programs were heavily subsidizing their product – according to University of Chicago economist Casey Mulligan, Medicare Part D reduced the annual cost of a 0.75 gram daily opioid habit from over \$39,000 to under \$3,000.<sup>28</sup> Figure 10 shows that the vast majority of the increase in morphine gram equivalents per capita during the decade after 2005 was in fact paid for by the federal government. Congress should focus as a first priority on the role its laws play in distorting markets, as that is most clearly the domain of government policy.

Several government proposals mentioned previously would interfere with free market principles by mandating corporations in the United States adhere to government-imposed goals that deviate from shareholder primacy. Consider the Accountable Capitalism Act from the 115<sup>th</sup> Congress. This legislation would have obligated company directors to consider all stakeholders (workers, customers, shareholders, and communities) in their decision making and give company directors a duty to “create general public benefit.” But general public benefit is a completely arbitrary concept, and the bill would require CEOs to make decisions that are beyond their competencies. As explained via example in a recent commentary by the American Enterprise Institute, “doubling workers’ wages would make them better off, but it would require raising prices, making customers worse off.”<sup>29</sup> It is not feasible or appropriate to ask (let alone require) a CEO to decide whether such a decision would be in the general public benefit.

<sup>27</sup> *In Depth: Topics A to Z, Energy*, GALLUP, <https://news.gallup.com/poll/2167/energy.aspx> (last visited Mar. 11, 2022)

<sup>28</sup> Casey Mulligan, *You're Hired! Untold Successes and Failures of a Populist President*, REPUBLIC BOOK PUBLISHERS (2020). “Medicare part D ... reduced the annual cost of a ... 0.75-gram daily habit from \$39,420 to \$2,677.”

<sup>29</sup> Michael Strain, *Milton Friedman was Right about Shareholder Capitalism*, AEI: OP. (Sep. 18, 2020), <https://www.aei.org/op-eds/milton-friedman-was-right-about-shareholder-capitalism>

The Corporate Governance Improvement and Investor Protection Act (H.R. 1187) would among other actions establish the Sustainable Finance Advisory Committee, which would recommend policies to the SEC to induce environmentally sustainable investments. The Executive Order on Climate-Related Finance Risk will order agencies to collect data and issue rules that address climate-related financial risk. The SEC has also issued various proposed climate and ESG disclosures, mandates, and created a climate and ESG task force, signaling at more ESG-related rulemaking to come in the near future. Yet how can such structures ensure that the actual desires of the electorate on these policies are appropriately represented, as opposed to a ruling government or managerial class? Given the fluidity in the definition of ESG, it seems that imposing these requirements would greatly limit accountability to both shareholders and the general public.

### 5. The Positive Effects of Shareholder Capitalism

Finally, it is highly misleading to focus on examples of unethical actions taken by specific companies without considering the good of the entire system. For-profit firms create enormous value for workers, customers and the communities in which they operate. The free market system has generated unprecedented prosperity in the United States. Over the past 50 years, real per capita GDP in the United States increased 132 percent to \$64,000 per person, the highest level among all countries in the world with a population of at least 10 million people.<sup>30</sup> As shown in Figure 11, since 1959, incomes for the bottom fifth of the income distribution increased by 262%, the largest of all the quintiles.<sup>31</sup> U.S. real GDP per capita since 1980 has risen by 89.5%, the highest of any of the G7 countries, as shown in Figure 12.<sup>32</sup> These successes represent the fruits of shareholder capitalism in the United States.

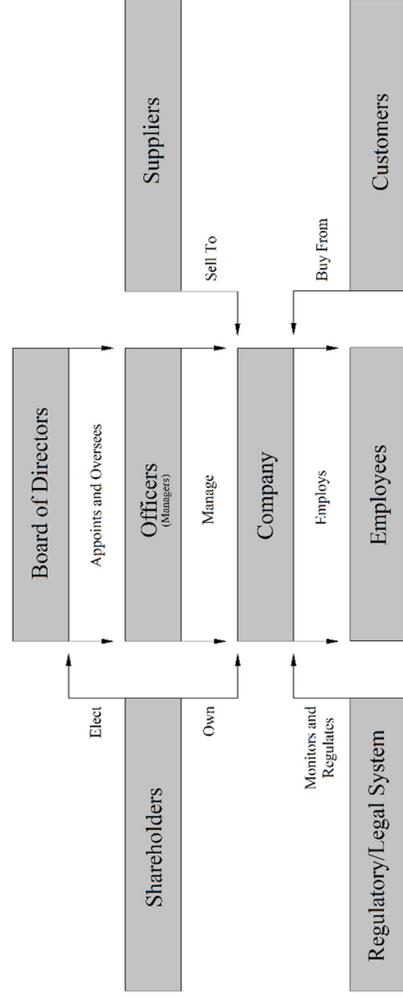
In conclusion, policies that mandate corporations in the United States adhere to government-imposed goals that remove decision rights from shareholders would interfere with a free market system that has generated widespread prosperity for Americans. If anything, the financial system and financial regulators should focus on ensuring a robust system of shareholder capitalism in which shareholders can hold executives accountable for growing the value of their investments. And given the issues with representation by large managers of mutual funds of their smaller clients in proxy voting, returning to a default of shareholder value maximization within the bounds of law and ethics, unless otherwise actively specified by the shareholder, would be the best approach to protect individual shareholders.

<sup>30</sup> *GDP per Capita (constant 2015 US\$) - United States*, WORLD BANK, [https://data.worldbank.org/indicator/NY.GDP.PCAP.KD?locations=US&most\\_recent\\_value\\_desc=true](https://data.worldbank.org/indicator/NY.GDP.PCAP.KD?locations=US&most_recent_value_desc=true).

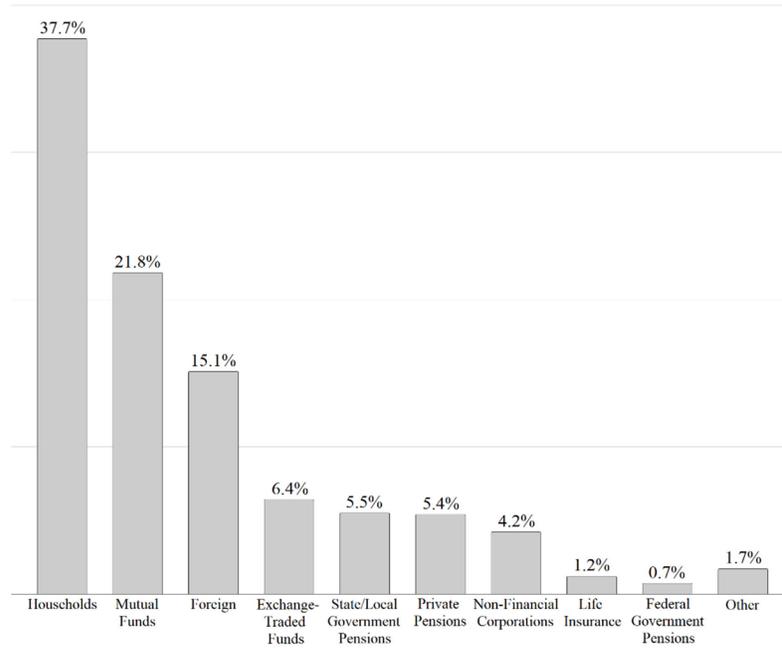
<sup>31</sup> James Elwell et al., *Income Growth and its Distribution from Eisenhower to Obama: The Growing Importance of In-Kind Transfers (1959-2016)* 42 (National Bureau of Economic Research, Working Paper No. 26439, 2019).

<sup>32</sup> Data from UN Conference on Trade and Development, Statistics Division (UNCTAD-STAT)

Figure 1: Structure of the Corporation Under the US Model

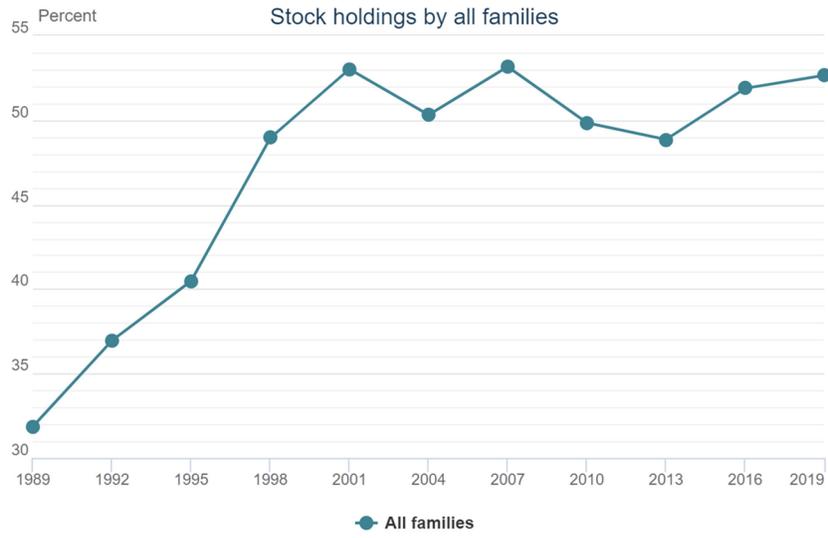


Note: Adapted from *Business Ethics and Corporate Governance* by A.C. Fernando, 2012

**Figure 2: Holders of US Equities, 2019**

*Note: Adapted from A Chart Book on Stock Ownership by SIFMA Insights, Oct. 2019*

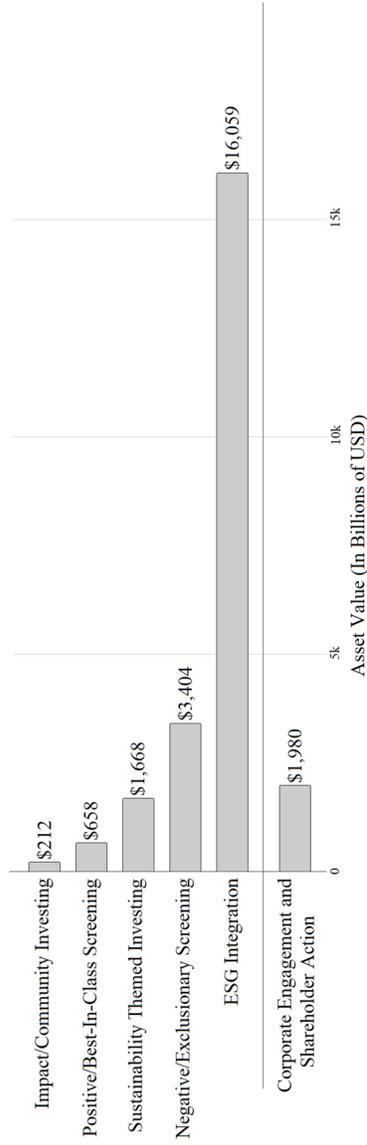
**Figure 3: Percent of Households Who Own Stock Directly or Indirectly**



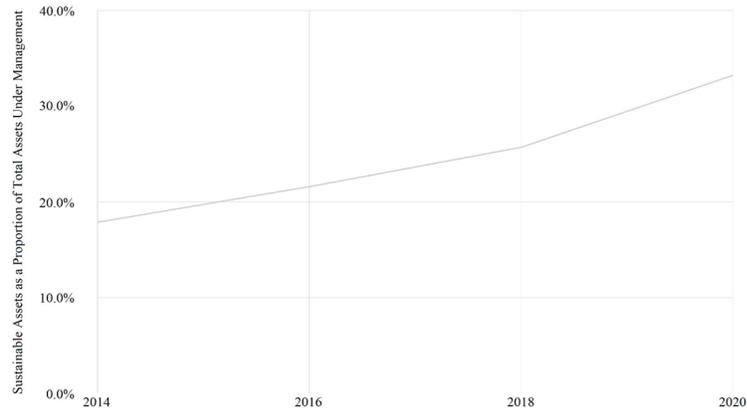
Source: Survey of Consumer Finances

Note: Obtained from *Survey of Consumer Finances, 1989-2019* by the Federal Reserve, 2020

Figure 4: “Sustainable Investing” Assets in the US by Strategy, 2020

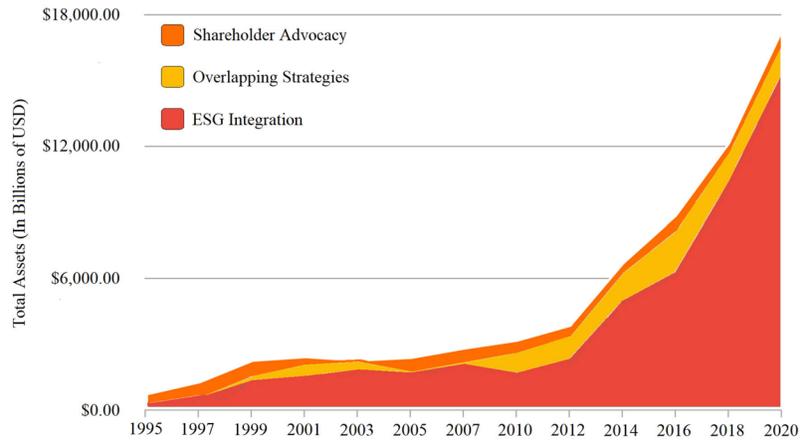


Note: *Impact/Community Investing* is investment designed to achieve positive social and environmental impacts, especially in traditionally underserved or overlooked communities; *Positive/Best-In-Class Screening* is investment in sectors or firms that have outpaced industry peers in their ESG performance by a defined threshold; *Sustainability Themed Investing* is investment in those assets that specifically contribute to sustainable solutions (such as green buildings, diversity, environmentally-friendly agriculture, etc.); *Negative/Exclusionary Screening* is excluding investment from sectors or firms based on the product produced (such as tobacco, alcohol, weapons, etc.) or behavior (such as corruption, human rights abuses, etc.); *ESG Integration* is investment that takes into account environmental, social, and governance factors into the financial analysis which governs said investment; *Corporate Engagement and Shareholder Action* is investing targeted at influencing the behavior of the corporation, including officers and shareholders. Adapted from *Global Sustainable Investment Review 2020* by GSI Alliance, 2021.

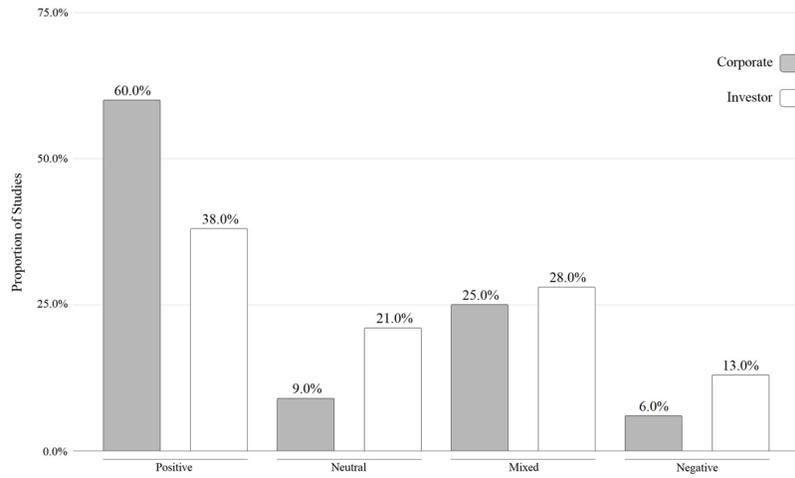
**Figure 5: “Sustainable Investing” Assets as Share of Total Assets Under Management**

Source: Global Sustainable Investment Alliance (GSIA), *Global Sustainable Investment Review 2020*. Sustainable investing assets are defined by the GSIA as an approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. According to GSIA, “The term sustainable investment may be used interchangeably with responsible investment and socially responsible investment, among other terms, whilst recognizing there are distinctions and regional variations in its meaning and use.”

**Figure 6: Growth of ESG-related Investments (1995-2020)**

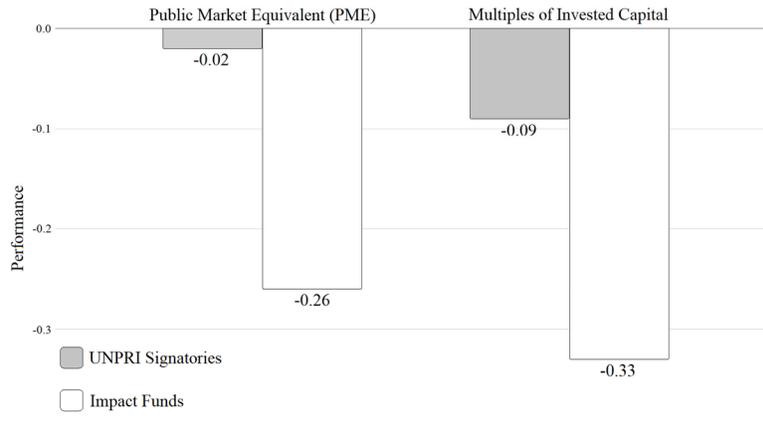


Note: Adapted from *Report on US Sustainable and Impact Investing Trends: 2020* by US SIF Foundation, 2021

**Figure 7: Disparity Between Corporate and Investor Studies on ESG Strategies**

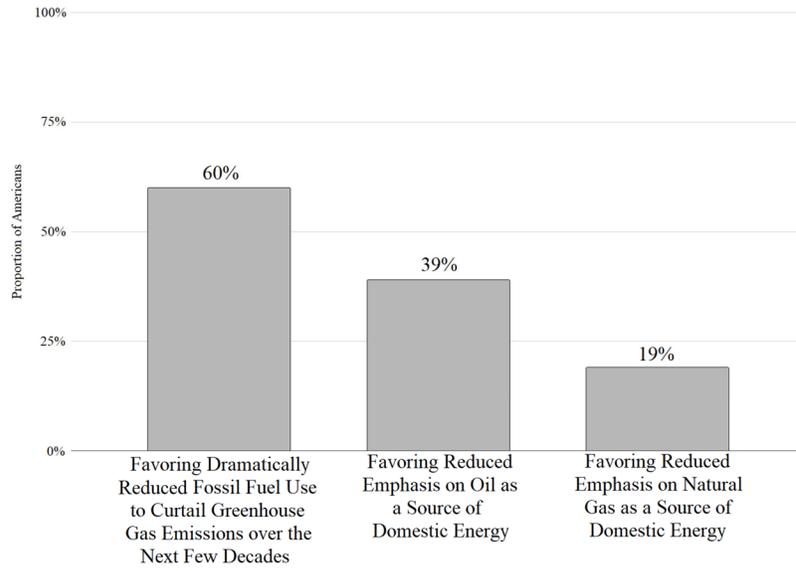
Note: Figures from *Does Sustainability Generate Better Financial Performance? Review, Meta-Analysis, and Propositions* by Atz et al., 2021

**Figure 8: Evidence of ESG Underperformance in Private Markets: Infrastructure Funds**



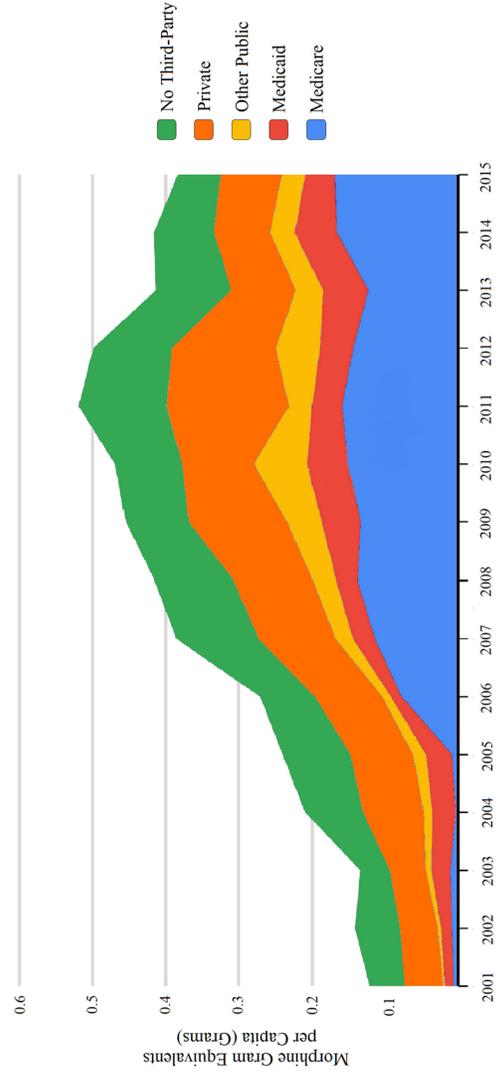
*Note:* Based on Aleksander Andonov et al., *Institutional Investors and Infrastructure Investing*, 34 REV. FIN. STUD. 3881, 3884 (2022). The PME compares the cash flows generated by the private investments to those of a benchmark asset such as the stock market, by dividing the present discounted value of fund distribution plus any remaining residual value by the present discounted value of capital calls, while the multiple of invested capital looks at an investment's current value compared to the initial amount of money put into an investment.

**Figure 9: Gallup Poll Survey on Energy**

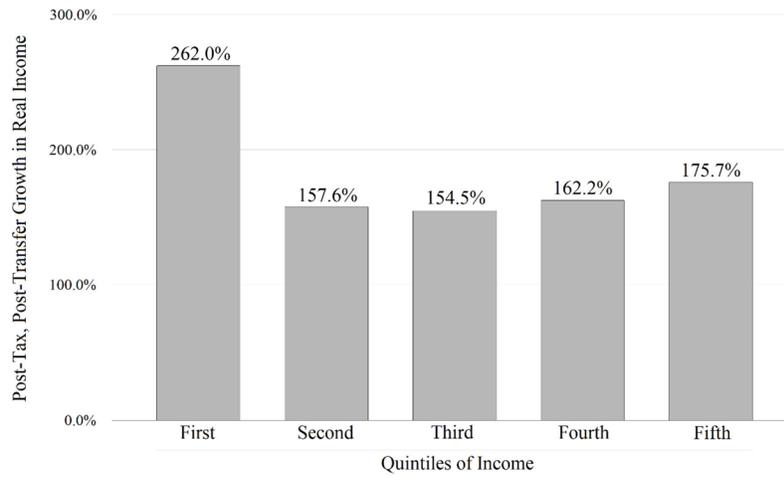


*Note: Figures from In Depth: Topics A to Z, Energy by Gallup, 2022*

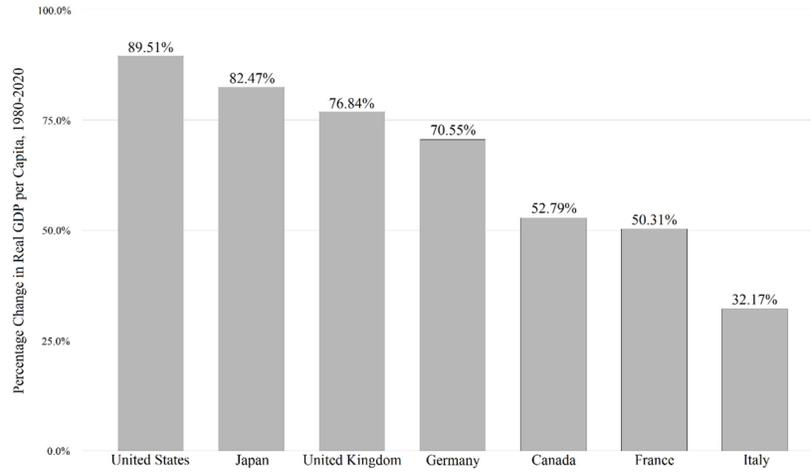
Figure 10: The Role of Medicare Financing in the U.S. Opioid Prevalence



Note: Adapted from *The Role of Opioid Prices in the Evolving Opioid Crisis* by the Council of Economic Advisors, 2019

**Figure 11: The Post-tax, Post-transfer Growth in Real Income by Quintile Between 1959 and 2016**

Note: Figures from *Income Growth and its Distribution from Eisenhower to Obama: The Growing Importance of In-Kind Transfers (1959-2016)* by Elwell et al., 2019. <https://www.nber.org/papers/w26439>

**Figure 12: Real GDP Per Capita in 2020 Compared to 1980**

Source: Data from *UN Conference on Trade and Development, Statistics Division (UNCTAD-STAT)*

RESPONSE FROM MR. FREDERICK ALEXANDER TO QUESTION FOR THE RECORD  
SUBMITTED BY SENATOR KLOBUCHAR

Mr. Alexander, in your testimony you stated that “the laws and regulations that support shareholder primacy” should encourage companies to “appropriately prioritize the impact they have on the social and environmental systems that undergird the economy.”

- **How does this recommendation relate to actions the Federal Government is currently taking to encourage investment in domestic manufacturing and spur investments to mitigate climate change?**

The laws and regulations referred to in the question include current interpretations of (1) the fiduciary laws that govern corporations and investment fiduciaries (such as pension trustees) and (2) the laws that require companies to make certain disclosures to investors. These interpretations focus on the enterprise value of each individual company and assume that the primary role of fiduciaries is to ensure that investors’ capital is managed in a manner that optimizes the value of each company.

My testimony details the good reasons to provide that the primary loyalty of corporate directors and investment fund trustees runs to the investors who provide capital. However, it also points out that most investors are broadly diversified, and that they are best served when individual companies refrain from behavior that threatens the long-term health of our economy. Thus, it is better for most shareholders if individual companies make choices that preserve and improve vital social and environmental systems, even if doing so does not maximize financial return at the individual company.

Encouraging private industry and the financial industry to adopt this broader notion of shareholder primacy—one that puts the collective success of our economy at its center—is key to the success of Federal policies encouraging investment in domestic industry and climate change mitigation.

Both of these objectives have the potential to improve the performance of the Nation’s economy over long time frames, by creating a resilient economy, reducing inequality, and preserving the value of the ecosystem services that undergird the economy.

However, if companies’ primary focus remains on increasing their own future cash flows to shareholders, there will be a great temptation to manipulate these programs in a manner that makes them profitable for companies, while not addressing the underlying policy concern.

For example, a company operating under the current interpretation of shareholder primacy might use tax credits to increase its domestic manufacturing capability but nevertheless seek to increase margins by outsourcing critical components, defeating the resiliency goals of the program. If the company were operating under an expanded understanding of shareholder primacy, it would be more likely to account for the fact that using the credits to create a dependable, authentically domestic supply chain would protect the economy, and thus the portfolios of its diversified shareholders.

Similar concerns would apply to programs that encourage investment in climate mitigation. The mitigation technologies that are most likely to reduce overall carbon concentration may not be the technologies that are most likely to increase cash flow at an individual corporation; policies that encourage a more expansive view of shareholder primacy would make it more likely for companies to adopt the former, because their decision could account for the positive “spillover” effects of adopting the technology that is best for the planet.

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RESPONSE FROM DR. JOSHUA D. RAUH TO QUESTIONS FOR THE RECORD  
SUBMITTED BY SENATOR LEE

- **Q1: What effects do stock buybacks have on innovation and other economic outcomes?**

The purpose of a stock buyback is to take a company’s cash on-hand, which its management determines does not have a productive outlet (otherwise it would be invested), and to put it in the hands of shareholders, who will in turn invest the cash from the sale of shares into other investments, including in more innovative companies with a demand for investment capital. So, while it is certainly true that repurchases have become more common in the last decade or so, with \$4.2 trillion in stocks bought by S&P 500 corporations between 2007 and 2016, this ignores that much of the buyback is reinvested in the same group of companies, with \$3.1 trillion

in new shares issued by S&P 500 companies in the same time period,<sup>1</sup> and a further \$250 billion flowing into non-S&P 500 companies annually between 2009 and 2019.<sup>2</sup> Other investor proceeds from buybacks likely flow into private equity markets or venture capital, whose assets under management have grown substantially. In short, investors are using their buybacks to finance corporations that have legitimately productive ideas, which desperately need new investors. If anything, advocates of innovation ought to be encouraging buybacks as a means of getting cash in the hands of innovative firms.

This innovation has wide-reaching implications for the rest of the economy, too. For one, it means that private enterprise invests more in R&D. Since 2001, R&D investment has grown at an annual rate of nearly 4.9 percent every year,<sup>3</sup> far outpacing annual GDP growth in the same period. Given that businesses make over 70 percent of total R&D expenditures in the United States,<sup>4</sup> policies that incentivize this sort of investment impact the rest of the country in a significant way. When corporations increase their productivity through research investment, their workers become now more valuable to the corporation than they were previously. These firms must then compete in labor markets for these more lucrative workers with other firms, raising wages. Research has demonstrated that this is no different for the investment that comes from buybacks. A 2022 study found that the 1983 rule change by the Reagan administration making buybacks easier to execute directly led to a 5.9 percent increase in labor wages.<sup>5</sup> Critics would like to argue that buybacks are a zero-sum game between employees and shareholders, but this simply is not the case. When the market directs investment toward opportunities which are legitimately productive, it turns out that everyone can benefit.

• **Q2: What does academic research find about the effects of capitalism and shareholder activism on productivity and innovation?**

A shareholder engages in activist behavior when they put pressure on the officers of the firm to change their management practices, often in the name of increasing returns. Despite the derision from critics of shareholder capitalism, in reality, shareholder activism increases the efficiency of a firm, and ultimately makes it more productive in the long run. For example, although it is true that shareholder activism can reduce investment in research, this is often a reduction in ineffective investment. Subsequent to a shareholder activist event, the number of patents filed by a target firm increases by 15.1 percent, and the citations those patents garnered increases by 15.5 percent.<sup>6</sup> The type of research investment encouraged by shareholder activism thus not only increases volume of research, but also increases the usefulness of research being produced. This has systemic effects on the rest of the firm, too. The labor productivity of the firm's employees increases, on average, by 8.4 percent to 9.2 percent.<sup>7</sup> The evidence, therefore, points toward shareholder capitalism encouraging firms to be more productive in the deployment of their limited resources.

The link between shareholder capitalism, and the activism it engenders by investors, is strongly linked to rising productivity and innovation in the economy. In the last forty years of American history, a period in which shareholder capitalism has been the guiding principle of corporate governance, the economy has increased its productivity by nearly 118 percent, meaning that the average worker today is more than twice as productive as his or her counterpart in 1979.<sup>8</sup> This increased productivity, in turn, makes workers more competitive in labor markets, raising wages. Since 1979, the Congressional Budget Office estimates that the post-tax, post-trans-

<sup>1</sup>Jesse Fried & Charles Wang, *Are Buybacks Really Shortchanging Investment?*, HARV. L. SCH. FORUM CORP. GOV. (Mar. 19, 2018), <https://corpgov.law.harvard.edu/2018/03/19/are-buybacks-really-shortchanging-investment/>.

<sup>2</sup>Greg Milano and Michael Chew, *Save the Buyback, Save Jobs*, 31 J. APPLIED CORP. FIN. 126, 127 (2019).

<sup>3</sup>*Business Enterprise Research Development Survey (BERD)*, U.S. CENSUS BUREAU, 2000–2019.

<sup>4</sup>John Sargent, *U.S. Research and Development Funding and Performance: Fact Sheet*, CONG. RSCH. SERVICE, 2021.

<sup>5</sup>Ricardo De La O, *The Effect of Buybacks on Capital Allocation* 34 (Mar. 3, 2022) (working paper) (on file with author)

<sup>6</sup>Alon Brav et al., *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. ECON. 237, 244–245 (2018).

<sup>7</sup>Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723, 2749 (2015).

<sup>8</sup>*Nonfarm Business Sector: Labor Productivity (Output per Hour) for All Employed Persons*, FED. RES. ECON. DATA (FRED), <https://fred.stlouisfed.org/series/OPHNFB> (last visited Mar. 18, 2022).

fer median income of the average American has risen by nearly 91 percent,<sup>9</sup> demonstrating that the benefits of such increased productivity are not just felt by the wealthiest Americans. Rather, by incentivizing the sort of investments that increase long-term efficiency, shareholder capitalism creates a more vibrant and productive economy, the rewards of which are felt by investors and workers alike.

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QUESTION FOR THE RECORD FOR DR. LENORE PALLADINO  
SUBMITTED BY SENATOR KLOBUCHAR

**Dr. Palladino, you testified that innovation depends upon “both resource development and utilization” and discussed the need to bridge the divide between academic innovation and commercialization.**

- **In your view, what is the proper role of academic research in driving innovation?**



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<sup>9</sup> *The Distribution of Household Income, 2018*, Cong. Budget Office (CBO) (Aug. 2021), <https://www.cbo.gov/publication/57404>.