WHOSE PORTFOLIO IS IT, ANYWAY?

Frederick H. Alexander*

"[I]f you own something, you have a vital stake in the future of our country. The more ownership there is in America, the more vitality there is in America, and the more people have a vital stake in the future of this country."

- President George W. Bush[1]

The idea that ownership gives individuals a stake in the future can be powerful, but also misunderstood. The concept should not be taken to mean that only owners care about the future: after all, even those with no assets at all can care deeply about the future in which they and their descendants will live. Ownership does, however, provide a specific opportunity to influence and profit from the future, along with a corresponding responsibility.

Home ownership is often the first example that comes to mind when Americans think about the "ownership society" and provides a useful illustration.[2] Owning a home can lead to prosperity if the neighborhood becomes more desirable.[3] Conversely, it can lead to economic loss if that area becomes less desirable or uninhabitable.[4] But such changes don't just happen—they have causes.[5] And the

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* © 2018, Frederick H. Alexander. All rights reserved. B.A. University of Maryland, 1985; J.D. Georgetown University Law Center, 1988. I want to thank Professor Torres-Spelliscy who inspired me to write this Article, and also to extend profound gratitude to the members of *Stetson Law Review*, who meticulously conducted all of the research supporting it.

1. Press Release, Office of the Press Secretary of President George W. Bush, *Fact Sheet: America's Ownership Society: Expanding Opportunities* (Aug. 9, 2004), *available at* https://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html.

2. Dan Ackman, *The Ownership Society*, FORBES (Sept. 3, 2004), https://www.forbes.com/2004/09/03/cx_da_0903topnews.html.

3. Devon Thorsby, *What Does That New Luxury Building in Your Neighborhood Mean for Your Home's Value?*, U.S. NEWS & WORLD REPORT (Apr. 7, 2016), https://realestate.usnews.com/real-estate/articles/what-does-that-new-luxury-building-in-your-neighborhood-mean-for-your-homes-value.

4. *Id.*; Teresa Mears, *9 Factors That Can Torpedo Your Home's Selling Price*, U.S. NEWS & WORLD REPORT (July 30, 2015), https://money.usnews.com/money/personal-finance/articles/2015/07/30/9-factors-that-can-torpedo-your-homes-selling-price.

5. *See* Mears, *supra* note 4 (listing some of the causes reducing the value of a home).

homeowner, or perhaps the collective homeowners in a neighborhood, have the ability—and the corresponding responsibility—to create a valuable community.[6] That may involve taking care of the homes themselves, maintaining common areas, and investing in systems like sewers, water, and telecommunications.[7]

Thus, while homeowners are positioned to reap financial rewards, they are also stewards of their properties and the system in which the properties are embedded. These implications of ownership also apply to the owners of the corporations that play a crucial role in the economy.[8] Just like homeowners, shareholders have opportunities and obligations with respect to the corporations that they own.[9] They have the potential to earn significant financial returns, but their control over corporate assets also vests them with great responsibility for the systems those assets both depend upon and threaten.[10] This aspect of our ownership society has important implications for the citizens who are the real owners of those corporations.

I. FINANCIAL CAPITAL'S INFLUENCE

Worldwide equity markets are valued at more than seventy trillion dollars[11] and venture capital and other private equity at

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6. Thorsby, *supra* note 3; *see also* Laura Agadoni, *8 Neighborhood Features That Increase Your Home Value*, TRULIA (Apr. 12, 2017, 12:29 PM), https://www.trulia.com/blog/features-increase-property-values-in-my-neighborhood/ (explaining the role of homeowner's associations' rules in increasing the value of one's home).

7. Agadoni, *supra* note 6; Bruce Turner, *Infrastructure and Property Value – A Causal Relationship to Aid Investment Decisions and Gain Public Support?*, LINKEDIN (Dec. 6, 2015), https://www.linkedin.com/pulse/infrastructure-property-value-causal-relationship-aid-bruce-turner.

8. *See* Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARV. BUS. REV. (July–Aug. 2012), https://hbr.org/2012/07/what-good-are-shareholders (discussing the importance of information about the market and ways in which the market influences investors' decision-making).

9. Walter Johnson, *The Rights & Obligations of a Stockholder*, CHRON, http://smallbusiness.chron.com/rights-obligations-stockholder-37636.html (last visited Dec. 25, 2017).

10. *See id.* (listing shareholders' rights and responsibilities).

11. Will Martin, *The 17 Most Valuable Stock Exchanges in the World*, BUS. INSIDER (Sept. 4, 2016, 3:01 AM), http://www.businessinsider.com/most-valuable-stock-exchanges-in-the-world-2016-9.

ten trillion dollars.[12] The owners of these equity securities control much of the private economy.[13] And in much of the global financial system, the private economy allocates most of the investment capital: in the U.S., business and consumer spending account for eighty percent of GDP, while government spending accounts for just twenty percent.[14]

Thus, while we focus a huge amount of our policy energy on decisions made by governments, it is decisions made by private actors that determine how we allocate most of our resources. While governments can of course influence these decisions, the influence is, for the most part, secondary; laws and regulations establish the guardrails within which for-profit businesses are permitted to act.[15] But the primary, affirmative decision-making is left to the private sector. Generally, that decision-making is done by boards or similar bodies selected by shareholders.[16]

Consider the many economic, social, and environmental issues that must be managed. For example, financial system stability is critical to a well-functioning economy.[17] Yet, the current corporate governance system encourages financial institutions to focus on their own narrow interests, rather than on preservation of the entire financial system upon which "citizen shareholders" depend.[18] We then spend large amounts of legislative and regulatory effort seeking to prevent these institutions from taking on levels of risk that threaten the financial system.[19] But such

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12. *See Private Equity*, FS INV., https://www.fsinvestments.com/learn/articles/private-equity (last visited Dec. 29, 2017) (explaining that the private U.S. middle market generates over $10 trillion in revenue per year).

13. Brian DeChesare, *Private Equity v. Venture Capital: Why the Lines Have Blurred*, MERGERS & INQUISITIONS, https://www.mergersandinquisitions.com/private-equity-vs-venture-capital/ (last visited Dec. 25, 2017).

14. Frederick H. Alexander, *Saving Investors from Themselves: How Stockholder Primacy Harms Everyone*, 40 SEATTLE U. L. REV. 303, 303 (2017).

15. Tyler Lacoma, *Government Laws That Affect Business*, CHRON, http://smallbusiness.chron.com/government-laws-affect-businesses-25756.html (last visited Dec. 25, 2017).

16. *Board of Directors – B of D*, INVESTOPEDIA, http://www.investopedia.com/terms/b/boardofdirectors.asp (last visited Dec. 25, 2017).

17. *See* Anne Tucker, *The Citizen Shareholder: Modernizing the Agency Paradigm to Reflect How and Why a Majority of Americans Invest in the Market*, 35 SEATTLE U. L. REV. 1299, 1303 (2012) (explaining that participation in the stock market leads to financial stability).

18. *Id.* at 1307.

19. *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing for Growth and Development: Report for G20 Leaders*, ORG. FOR ECON. CO-OPERATION & DEV. 4 (Feb. 2013), http://www.oecd.org/finance/private-pensions/

legislation and regulation, while necessary, is an indirect and cumbersome way of approaching the issue because it is the banks themselves making the decisions that create the risks.

The same analysis applies with respect to environmental concerns and the treatment of workers. The corporate governance system prioritizes only parochial interests, while broad societal interests are left to regulators.[20] To fulfill the promise of an ownership society, shareholders must insist that the companies they own look beyond their narrow interests and recognize the importance of maintaining the "neighborhood."[21] Make no mistake, businesses create tremendous value by producing the goods and services we all need and often create positive social and environmental impacts while doing so.[22] However, those valuable outputs are a byproduct of a system designed to produce financial gain, and when profit can be made without producing such positive impacts, or even by creating negatives ones, that will often be the path chosen.

Talk of the corporate system and financial capital may call up images of CEOs and directors, Wall Street bankers and lawyers, private equity moguls, and Silicon Valley venture capitalists. But while there certainly is a financial and managerial class controlling much of the system's financial capital, most of it does not actually belong to them.[23] They are, for the most part, intermediaries between the capital working at the bottom of an investing web and the ordinary citizens whose capital is ultimately being put to work.[24]

A. Corporations: The Bottom of the Web

Starting at the bottom of the web, businesses obtain financial capital from various markets. First, there is public equity. As noted

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G20reportLTFinancingForGrowthRussianPresidency2013.pdf [hereinafter *The Role of Banks*].

20. *See generally* Tucker, *supra* note 17, at 1300, 1300 n.8 (discussing ways to "empower shareholders' voices in corporate governance").

21. *Id.* at 1354–55.

22. David Ingram, *The Advantages of Businesses in the Local Economy*, CHRON, http://smallbusiness.chron.com/advantages-businesses-local-economy-3289.html (last visited Dec. 25, 2017).

23. *See Private v. Institutional Investors*, ZACKS, http://finance.zacks.com/private-vs-institutional-investors-6252.html (last visited Dec. 25, 2017) (discussing the difference in investing strategies between institutional and private investors).

24. *See id.* (explaining private investors tend to engage in riskier investments).

above, there are more than seventy trillion dollars invested in public market equity.[25] Of course, those companies may well have much more than seventy trillion in assets at work, since they can finance much of their assets with debt; with reasonable debt-equity ratios, these companies likely control over one hundred trillion dollars in business assets.[26] Other companies are owned by "private equity."[27] Closely related to these private equity firms are venture capital firms, which also usually invest the money provided by limited partners.[28] They differ from private equity in the type of investments they make and tend to look for newer businesses trying to grow quickly, often creating new products and services.[29] These businesses tend to have more inherent risk, and therefore not as much debt. And, of course, many businesses are financed without outside equity capital and are owned by family or partners participating in the business.[30]

It is the directors and managers operating these companies who must decide how to allocate the capital with which they are entrusted.[31] What policies will cover wages and benefits? How much will be spent on energy efficiency or auditing supply chains for human rights violations? As noted above, government policy certainly has an effect on those issues: certain worker rights may be mandated, and emissions and other environmental effects may

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25. Martin, *supra* note 11.

26. Michael Lewis, *6 Things You Need to Know About Raising Capital for a Small Business*, HUFFINGTON POST (June 23, 2013, 6:42 PM ET), https://www.huffingtonpost.com/michael-lewis/6-things-you-need-to-know_b_3484069.html (explaining that the structure of corporate investments is "usually styled in the form of debt, equity, or a combination of each").

27. Andrew Blackman, *The Pros and Cons of Having Private Equity Firms Invest in Your Business*, BUSINESS.TUTSPLUS.COM (Mar. 18, 2014), https://business.tutsplus.com/tutorials/the-pros-and-cons-of-having-private-equity-firms-invest-in-your-business--cms-19887; *see* Allen Latta, *LP Corner: US Private Equity Fund Structure – The Limited Partnership*, ALLEN LATTA'S THOUGHTS ON PRIVATE EQUITY, ETC. (June 3, 2017), http://www.allenlatta.com/allens-blog/lp-corner-us-private-equity-fund-structure-the-limited-partnership (noting that, generally, professional investment firms are structured as limited partnerships, which acquire and run companies in all industries, and which often seek to increase return of equity by borrowing heavily).

28. Andrew Blackman, *How to Raise Money from Venture Capitalists*, BUSINESS.TUTSPLUS.COM (Mar. 11, 2014), https://business.tutsplus.com/tutorials/how-to-raise-money-from-venture-capitalists--cms-19799.

29. *Id.*

30. Doug White & Polly White, *10 Ways to Fund Your Small Business*, ENTREPRENEUR, https://www.entrepreneur.com/article/270556 (last visited Dec. 25, 2017).

31. *Capital Allocation*, INVESTOPEDIA, http://www.investopedia.com/terms/c/capitalallocation.asp (last visited Dec. 25, 2017).

be regulated.[32] But businesses have a number of strategies to maximize financial gain by limiting the effectiveness of legislation and regulation.[33] First, there is "bare compliance": doing what is required, but no more. Second, there is pushing the envelope, occurring when regulators are unlikely to want to pursue "close calls." A third strategy is regulatory arbitrage, when regulations are technically followed, but in ways that defeat their purpose.[34] Fourth, and perhaps the clearest strategy, is the ability to influence the law itself. Companies lobby the government at all levels in an attempt to ensure that laws and regulations favor them.[35] This may involve supporting candidates and political parties likely to support rules that increase profitability.

B. Up the Web: Institutional Investors and Their Beneficiaries

But where does that capital come from? A great deal of the capital invested in public companies, private equity, and venture capital comes from "institutional investors."[36] These include pension and mutual funds, insurance companies, sovereign wealth funds, endowments, foundations, and other types of entities that control assets on behalf of others.[37] Many of these asset owners rely on third-party advisers to actually manage the assets.[38]

These institutional investors essentially control the market, owning close to seventy percent of public equity, along with significant amounts of private equity and venture capital investments.[39] While there are certainly a number of wealthy families whose assets are part of this institutional wealth, the fact is that, to a large degree, these institutions control wealth that is ultimately held for the benefit of ordinary citizens.[40] Pension funds

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32. Lacoma, *supra* note 15.

33. *See* Jonathan Ernst, *How Corporations Turned into Political Beasts*, BUS. INSIDER (Apr. 25, 2015, 12:00 PM), http://www.businessinsider.com/how-corporations-turned-into-political-beasts-2015-4 (detailing the increased engagement of corporations in politics).

34. *Regulatory Arbitrage*, INVESTOPEDIA, http://www.investopedia.com/terms/r/regulatory-arbitrage.asp (last visited Dec. 25, 2017).

35. *See* Ernst, *supra* note 33 (detailing the different ways in which companies lobby the government).

36. *The Role of Banks*, *supra* note 19, at 4.

37. *Id.*

38. Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, HARV. BUS. REV. (May–June 2017), https://hbr.org/2017/05/managing-for-the-long-term.

39. *Id.*

40. *Id.*

own assets to fund workers' retirements.[41] Mutual funds are held in 401(k) or similar accounts for retirement, as well as savings for college and other life needs.[42] Insurance companies collect the premiums of insureds and invest them in order to make sure that there are funds available when citizens encounter life events that require cash.[43] Banks lend out their deposits.[44] Foundations and endowments are investing assets that fund education and other needs of the citizenry, as are sovereign wealth funds.[45]

The point is that these trillions of dollars of invested funds—while invested through a long, complicated web of institutions, advisers, and corporations—are ultimately intended to be put to work on behalf of most of the citizenry in one way or another. So, in examining this system, it is important to ask whether the citizenry's needs are in fact being served.

C. Answering the Agency Problem: Beyond the Pin Factory

In his famous *Wealth of Nations*, Adam Smith explained how the invisible hand of self-interest would create markets for goods and services, where assets and labor would find their highest and best use through such markets.[46] But the model he worked with was one where owners managed their own businesses, and he recognized that market mechanisms would break down when absentee owners left their assets to be managed by others.[47] And,

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41. *See Pension Plan*, INVESTOPEDIA, http://www.investopedia.com/terms/p/pensionplan.asp (last visited Dec. 25, 2017) (explaining that the retirement funds are invested on the employee's behalf).

42. Joshua Kennon, *The Basics of Mutual Funds: What They Are and How They Can Make You Money*, THE BALANCE (Apr. 28, 2017), https://www.thebalance.com/mutual-funds-101-356319; *see also* John Wasik, *The Five Best College Savings Strategies and Myths*, FORBES (Sept. 8, 2014), https://www.forbes.com/sites/johnwasik/2014/09/08/the-five-best-college-savings-strategies-and-myths/#390a81f15d70 (explaining that college savings are established and managed by mutual fund companies).

43. *How Do Insurance Companies Make Money?*, TRUTH ABOUT INS., http://www.thetruthaboutinsurance.com/how-do-insurance-companies-make-money/ (last visited Dec. 25, 2017).

44. Stephen D. Simpson, *The Banking System: Commercial Banking – How Banks Make Money*, INVESTOPEDIA, https://www.investopedia.com/university/banking-system/banking-system3.asp (last visited Dec. 25, 2017).

45. Meg Voorhes & Farzana Hoque, *Unleashing the Potential of US Foundation Endowments: Using Responsible Investment to Strengthen Endowment Oversight and Enhance Impact*, US SIF FOUND. 1, 2 (Jan. 27, 2014), www.ussif.org/files/Publications/unleashing_potential.pdf.

46. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 34–35 (R.H. Campbell, A.S. Skinner & W.B. Todd eds., 1976).

47. *Id.*

indeed, as the economy industrialized, and enterprises required more and more capital, absentee ownership became the rule more than the exception.[48] Trading enterprises, railroads, canals, extractive industries, telephony, steelmaking, auto manufacturing, and other industries required vast amounts of capital.[49] And, as industrializing societies grew richer, a broader group of individuals had assets to save.[50] From these circumstances, the capital investment system grew, although initially it was much simpler.[51] The early twentieth-century version of the investment web consisted mostly of investors directly investing in companies.[52]

These assets, however, unlike Adam Smith's pin factory, were managed by professional managers, who had no direct connection to the investors. In many cases, complex holding company structures also left control of these companies to shareholders with a relatively small percentage of actual ownership.[53] This led to a situation coined as the "separation of ownership and control."[54] There was concern that this separation would break down the healthy market ideas expressed by Adam Smith because the management that actually controlled the assets might be more likely to apply the capital so as to benefit themselves, and not the shareholders who contributed capital—a market failure.[55] This is sometimes called the "agency problem," highlighting the fact that whenever principals are called upon to rely on agents to act on their behalf, there is a risk that the agent will use that opportunity

48. W. ARTHUR LEWIS, THE THEORY OF ECONOMIC GROWTH 63 (2013).

49. *See* J.B. Maverick, *Which Types of Industries Have the Largest Capital Expenditures?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/020915/which-types-industries-have-largest-capital-expenditures.asp (last visited Dec. 25, 2017) (listing industries that require ongoing investments).

50. *See Industrialization*, INVESTOPEDIA, http://www.investopedia.com/terms/i/industrialization.asp (last visited Oct. 8, 2017) (noting that industrialization resulted in a higher average income).

51. *See Dictionary of American History: Foreign Investments in the United States*, ENCYCLOPEDIA.COM, http://www.encyclopedia.com/history/united-states-and-canada/us-history/foreign-investment-united-states (last visited Dec. 25, 2017) (discussing how America became a creditor nation leading foreign investments).

52. *Id.*

53. Eugene Fama & Michael Jensen, *Separation of Gun Ownership and Control*, 26 J.L. & ECON. 301, 301–04 (1983).

54. *Id.* at 301.

55. *Id.* at 304; *Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion*, ORG. FOR ECON. CO-OPERATION & DEV. 5 (Dec. 2007), https://www.oecd.org/daf/ca/40038351.pdf.

to take action that is less beneficial to the principal than the action the principal would have taken on its own.[56]

The agency problem was particularly acute with respect to widely-held corporations because the shareholder principals were disaggregated, and individually, none may have held enough shares to make close monitoring of management worthwhile.[57] Over the twentieth century, law and custom moved towards a system of "shareholder primacy" as a way to address this concern.[58] Under this doctrine, corporate directors are charged with a primary objective of satisfying the financial return to the shareholders who have contributed capital.[59] This requirement is enforced through several mechanisms, including fiduciary duties, corporate governance, and market discipline.[60]

With respect to fiduciary duties, directors are expected to act loyally and carefully, with a goal of creating an optimal financial return for shareholders.[61] This duty can be enforced with lawsuits, just as a beneficiary can enforce duties against a trustee.[62] However, corporate governance mechanisms give shareholders the ability, through director elections, to decide who manages the company and to approve certain critical transactions, such as mergers, amendments to governing documents, and dissolution.[63] Thus, when boards fail to act in ways that shareholders consider to be in their best interests, they can be replaced. Related to this governance concept is the idea of market discipline.[64] When

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56. *Agency Problem*, INVESTOPEDIA, http://www.investopedia.com/terms/a/agencyproblem.asp (last visited Dec. 25, 2017).

57. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 89 (Summer 2017).

58. Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE U. L. REV. 1169, 1169–77 (2013).

59. *Shareholder Primacy – Who Do Corporations Really Serve?*, CORP. FIN. INST., https://www.corporatefinanceinstitute.com/resources/knowledge/other/what-is-shareholder-primacy/ (last visited Dec. 25, 2017).

60. Pavel Leshchinkskiy, *Corporate Fiduciary Duties*, LEGAL MATCH L. LIBR., https://www.legalmatch.com/law-library/article/corporate-fiduciary-duties.html (last visited Dec. 25, 2017); *Fast Answers - Cumulative Voting*, SEC. & EX. COMMISSION (Oct. 14, 2014), https://www.sec.gov/fast-answers/answers-cumulativevotehtm.html; *Market Discipline*, INVESTOPEDIA, http://www.investopedia.com/terms/m/market-discipline.asp (last visited Dec. 25, 2017).

61. Leshchinkskiy, *supra* note 60.

62. *See id.* (discussing the ways in which attorneys can help ensure compliance with fiduciary duties).

63. *Fast Answers - Cumulative Voting*, *supra* note 60; *Corporate Governance Defined: Not So Easily*, CORP. GOVERNANCE, https://www.corpgov.net/library/corporate-governance-defined/ (last visited Dec. 25, 2017).

64. *Market Discipline*, *supra* note 60.

managers are doing a poor job, the theory goes, the price of shares of a company will fall because it will be less valuable to shareholders.[65] This price reduction may present an opportunity for outsiders to buy a controlling stake and use their votes to replace management and then profit from an improved share price when new management rights the ship.

It is important to note that there is not a clear statute or regulation that states that the highest duty of a director is to produce high share prices.[66] Shareholder primacy is the result of a complex confluence of multiple causes and is not a historically consistent doctrine.[67] Indeed, in the post-WWII western economies, shareholder primacy was not viewed as a bedrock doctrine for business.[68] CEOs of large U.S. corporations could publicly state that they served a number of constituencies, including their workers, their customers, and their communities, along with providing a fair return to their shareholders.[69] But a number of developments in the capital markets, economic theory, business schools, and the law led to a situation where by the late twentieth century, businesses with outside investors generally operated with a primary purpose of creating value for shareholders.[70] Of course, it is a big world, with many businesses, investors, and jurisdictions. So, there is certainly variation. But U.S. capital markets and legal structures are clearly dominated by this sort of thinking, and its influence is felt around the world.[71]

D. Shareholder Primacy in the Investing Web

As the doctrine of shareholder primacy began to take shape a century ago, the links between investor and company were mostly

65. Bill Witherell, *The Role of Market Discipline and Transparency in Corporate Governance Policy*, ORG. FOR ECON. CO-OPERATION & DEV. 1–2 (May 16, 2003), http://www.oecd.org/corporate/ ca/corporategovernanceprinciples/2717763.pdf.

66. Lynn A. Stout, *Corporations Don't Have to Maximize Profits*, N.Y. TIMES (Apr. 16, 2015, 6:46 AM), https://www.nytimes.com/roomfordebate/ 2015/04/16/what-are-corporations-obligations-to-shareholders/corporations-dont-have-to-maximize-profits.

67. *See* Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, Paper 865, CORNELL L. FAC. PUBLICATIONS 1169, 1174 (2013) (discussing the origin of shareholder primacy).

68. *Id.* at 1170–75.

69. *Id.* at 1170–71.

70. *Id.* at 1172–73.

71. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 292 (1998).

direct.[72] Since then, many connections have been added, which created a complex web.[73] It is now the case that a worker may rely upon a pension fund for her retirement.[74] The fund may contract with asset management companies that themselves hire consultants who help them invest not only in public companies, but also in private equity and venture capital funds, who in turn invest in corporations.[75] The pension fund may have other relationships that help it decide how to vote the shares in the companies it owns.[76] Each connection comprises another agency situation, with an asset manager or adviser managing financial assets for another entity in the web.[77] The ideas that underpin shareholder primacy at the corporate level guide these relationships as well because the relationship is essentially the same: a pension fund is managing capital for its pensioners, just as a corporation is managing capital for its shareholders.[78]

This impetus to maximize return has led to a mandate for managers and advisers to maximize the return from assets within any portfolio for which they have responsibility.[79] Mutual funds seek to hire managers to pick shares that will beat the market and compete for customers on that basis.[80] Then, through corporate

72. *See id.* at 296–300 (discussing the early history of shareholder primacy).

73. *See id.* at 297–98 (discussing "the detailed rules that governed corporations").

74. *See Why People Need Pensions*, PENSION RIGHTS CTR., http://www.pensionrights.org/publications/fact-sheet/why-people-need-pensions (last visited Dec. 25, 2017) (explaining that Americans have a difficult time maintaining a living off of Social Security benefits alone).

75. Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, *Evaluating Pension Fund Investments Through the Lens of Good Corporate Governance*, *transcript available at* https://www.sec.gov/ news/speech/2014-spch062714laahtm (last visited Dec. 24, 2017).

76. *See id.* (discussing interests that can undermine the relationship between pension funds and shareholders); *see also* Blair Nicholas & Brandon Marsh, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (May 17, 2017), https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/ (discussing generally the web of shareholders involved in corporate governance and decision-making).

77. *See* LearnVest, *Get the Inside Scoop from an Asset Manager*, FORBES (May 9, 2014, 3:06 PM), https://www.forbes.com/sites/learnvest/2014/05/09/get-the-inside-scoop-from-an-asset-manager/2/#2fee45d65a67 (discussing the concept of asset managers as agents).

78. *See* Nicholas & Marsh, *supra* note 76 (referring to corporate voting rights in different types of companies, including pension funds).

79. *See* Aguilar, *supra* note 75 (discussing the pressure on asset managers to select the best investments possible).

80. *See Mutual Funds*, FIN. INDUS. REG. AUTHORITY, http://www.finra.org/ investors/mutual-funds (last visited Dec. 24, 2017) (stating that "[t]he goal of an active fund manager is to beat the market"); *Fund Managers Rarely Outperform the Market for Long*, THE ECONOMIST (June 24, 2017), https://www.economist.com/news/finance-and-

governance and market discipline mechanisms, such managers push companies to maximize return.[81] A similar dynamic governs pension funds, endowments, and other institutions.[82] At each step along the way, success is measured by comparison with peers.[83] A mutual fund is successful if it does better than other mutual funds specializing in similar sectors.[84] And the financial performance of companies is, of course, measured against that of their peers.

All of this leads to a situation where the managers at each step along the way are obligated to act for the benefit of the investors above them, but success is measured by return on investment as compared to peers. This narrow view of investing is embodied in Modern Portfolio Theory (hereinafter MPT), which dominates the investing world and which has a cascade of results.[85] First, the focus of fiduciaries is on the performance of the companies or portfolios that they manage.[86] Second, success is measured relative to peers, rather than by attainment of specific goals.[87] *Finally, the system of investing financial capital is largely indifferent as to its*

economics/21723845-sheer-luck-good-past-returns-predicting-future-performance-fund (stating that clients will "pay more if that translated into better performance").

81. *See Mutual Funds*, *supra* note 80 (detailing how fund managers seek to maximize returns).

82. *See Many Unhappy Returns: Pension Funds and Endowments Are Too Optimistic*, THE ECONOMIST (Nov. 21, 2015), https://www.economist.com/news/finance-and-economics/21678812-pension-funds-and-endowments-are-too-optimistic-many-unhappy-returns (discussing generally the similar operations of pension funds and endowments and implying that investment returns are important to pension funds and endowments).

83. *See* Julian M. Regan, *Is Your Pension Plan Measuring Up?: The Effectiveness of Pension and Other Retirement Systems Can Be Measured Efficiently and Accurately*, BENEFITS MAG. 14, 17 (Apr. 2014), https://www.ifebp.org/inforequest/ifebp/0165147.pdf (explaining that trustees use comparisons to help them make decisions).

84. *See Mutual Funds Rankings*, U.S. NEWS & WORLD REPORT, https://money.usnews.com/funds/mutual-funds/sector (last updated Oct. 16, 2017) (ranking mutual funds by sector).

85. Corina S. Weigl, *Prudent Investor Rule and Modern Portfolio Theory*, 33 EST. TR. & PENSIONS J. 145, 151 (2014); *see also* William G. Droms, *Fiduciary Responsibilities of Investment Managers and Trustees*, 48 FIN. ANALYSTS J. 58, 62 (1992) (discussing how portfolio managers must operate under "Modern Portfolio Theory").

86. Weigl, *supra* note 85, at 150–51; *see also* Jay Youngdahl, *The Time Has Come for a Sustainable Theory of Fiduciary Duty in Investment*, 29 HOFSTRA LAB. & EMP. L.J. 115, 118–19 (2011) (discussing the impact of Modern Portfolio Theory on investing).

87. *See* STEPHEN DAVIS, JON LUKOMNIK & DAVID PITT-WATSON, WHAT THEY DO WITH YOUR MONEY: HOW THE FINANCIAL SYSTEM FAILS US AND HOW TO FIX IT 48 2016 (Yale University Press, New Haven and London) (asset managers "look at performance relative to a broad market benchmark such as the S&P 500, and relative to their competitors. In other words, they measure themselves against the rest of the agent universe of which they are a part.").

effect on the performance of the market as a whole, or on the systems within which that market is embedded.[88]

E. Sum Sources of Return

To emphasize the last point, from the perspective of a share value maximizer, *the strategy used to maximize value is not important*. Of course, there are many strategic choices to be made in a business, and therefore many strategic elements that a value maximizer is indifferent to. Here I want to focus on one distinction—the *sum source* of value delivered to shareholders. In this way of parceling up the world of shareholder value creation, there are three sources of value for shareholders: (1) positive; (2) zero; and (3) negative.[89]

An example of positive sum value creation is a company located in a high unemployment region that increases its profits by hiring a new group of workers to increase energy efficiency, thereby decreasing its costs and also decreasing its use of scarce resources and carbon footprint, while creating jobs for the community. Presumably, this company has made the economic pie for the world somewhat bigger, and the increased profits it enjoys will represent a portion of that increase in value.

In contrast, the same company might achieve the same cost savings by switching to a dirtier, but cheaper, fuel. This is an example of a negative sum source: by adding to the planet's carbon load, this company is actually reducing the value of the world's economic pie, but opportunistically increasing shareholder return by doing so. As discussed above, we can, as a society, attempt to legislate against such negative externalities, but that can be difficult, due to the myriad of opportunities for such rent seeking, as well as the power of corporations to influence legislation.

Finally, there are the zero-sum opportunities: situations where value is appropriated from third parties and provided to shareholders.[90] An example is high pressure sales tactics and

88. Youngdahl, *supra* note 86, at 119 (explaining that Modern Portfolio Theory "is based on a definition of success that fails to acknowledge the extent to which investments at the portfolio level can affect the overall financial markets").

89. *See generally id.* at 125–26 (discussing the negative externalities and "harmful unintended consequences" inherent in Modern Portfolio Theory).

90. *Id.* at 125. "The portfolio-level benefits that accrue from this [Modern Portfolio] [T]heory are by definition part of a zero-sum game at best and available to only a limited number of investors." (quoting STEVE LYDENBERG, *Beyond Risk: Notes Toward Responsible*

deceptive marketing campaigns: no negative externality is created, but customers and others are separated from more money than they fairly ought to be. In this situation, of course, what might be a negative externality might well be in the eye of the beholder. Depriving consumers of disposable income that they might spend on fairly priced goods and services, or invest in value producing activities, may ultimately reduce the size of the overall economic pie. Moreover, there are opportunity costs when effort is spent on zero-sum activity—all that effort might otherwise be spent on positive value creation.

The larger point, however, is that shareholder primacy, as applied throughout the investing web, is indifferent to the sum source—its mandate can be fully satisfied by negative sum value creation.[91] Indeed, it encourages negative sum value creation if the value "created" for shareholders is more than might be created in a positive sum activity.[92]

This indifference creates a primacy trap: *negative sum strategies satisfy managers' duties, creating actual incentives for our financial capital to be employed in ways that create negative externalities that can damage society and the planet as a whole*.[93] The doctrine of shareholder primacy creates this incentive at the corporate management level, and it is amplified by the application of MPT in the rest of the investment chain, which emphasizes the return of individual companies and portfolios and ignores the performance of the market as a whole.[94]

F. A Citizen Shareholder's Story

Consider Ms. Jones' family. Ms. Jones has a modest 401(k) invested in several mutual funds, and her spouse works for the local municipality and has a pension. They have children who would like to attend the same private colleges their parents did. There are also foundations that support a number of local

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Alternatives for Investment Theory, *in* CORPORATE GOVERNANCE FAILURES: THE ROLE OF INSTITUTIONAL INVESTORS IN THE GLOBAL FINANCIAL CRISIS 26 (James Hawley, Shyam Kamath & Andrew Williams, eds., 2011)).

91. Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 672–73 (Spring 2006).

92. *Id.*

93. Youngdahl, *supra* note 86, at 126–27.

94. *See* Alexander, *supra* note 14, at 315–16 (asserting that "[w]e have to change both investing concepts").

institutions from which the Jones' directly or indirectly benefit, such as hospitals, cultural institutions, and support for the underprivileged. Through all these relationships, Ms. Joneses family is invested in the equity markets—if the mutual and pension funds do well, it will mean a secure retirement. If the college endowment succeeds, the children may receive more generous financial aid. If the foundation profits, their community will be a better place to live. So, it might seem that shareholder primacy and its cousin, MPT, are exactly what the Jones' need. These doctrines should prevent all of the managers between them and the capital invested on their behalf from lining their own pockets.

Perhaps they do, but at what cost? All of those individual corporations are embedded in a complex global economy, and their actions affect the performance of other corporations. The fact is, through her various extended financial interests, Ms. Jones is likely invested across the economy. And for a diversified portfolio, most of the performance—eighty percent—is based on the return of the market.[95] Only twenty percent is based on individual stock performance.[96] Ms. Jones and her family also have many interests that are not financial. Just like the homeowners discussed at the beginning of this Article,[97] they would like to live in a nice "neighborhood"—although the neighborhood may be the planet.

What does this mean? It means that Ms. Jones—and all the managers within the investing web who are supposed to be acting in her interests—should be more concerned about the performance of the market as a whole more than they should about how any one individual company performs. But, shareholder primacy and MPT are indifferent to how companies make money, and they actually incentivize companies to engage in negative sum strategies that

95. *Id.* at 310. "It is estimated that general market performance ('beta') contributes about 80% to a diversified portfolio's performance while particular choices ('alpha') contributes only 20%." *Id.*

96. *Id.* And, of course, for those who index, 100% of return is based on the market return. *See* Lee McGowan, *What Are Index Funds?: Index Funds Definition and Basics*, THE BALANCE, https://www.thebalance.com/what-are-index-funds-2466441 (last updated May 23, 2017) (explaining that "[i]ndex funds are considered to be passively managed because the portfolio manager of each index fund is replicating the index, rather than trading securities based on his or her view of the potential risk/reward characteristics of various securities").

97. *See supra* notes 2–7 and accompanying text (examining the responsibilities of "collective owners of homes in a neighborhood").

decrease overall value in the economy.[98] *Indifference* is the key here: when there is an opportunity to make money by negative sum rent seeking, corporations are encouraged to take it, unless all of the positive sum opportunities offer superior shareholder value.[99]

All of this incentivized rent seeking creates a fierce headwind for Ms. Jones. To have enough for retirement, she needs her investments to grow significantly. But that is going to be tough in an economy where negative sum values are being constantly created. The 2008 financial crisis was caused by financial institutions taking risks that were actually quite rational from the viewpoint of their shareholders—the bets they took were classic negative sum strategies because the upside risks went entirely to the shareholders, while the downside risks were born by not just shareholders, but also by creditors and the financial system.[100] So the banks managing Ms. Jones' capital, following the dictates of modern financial theory, destroyed huge amounts of value *outside of the banks themselves, and this destruction hurt their own shareholders, who had broad interests*. The same concept holds for companies that can emit greenhouse gases without paying for the cost of increased climate risk—or companies that employ supply chains that exploit workers and the environment, adding to global instability and risk. They privatize gains from this activity, satisfying the shareholder primacy mandate but socializing the costs, thereby threatening all of the nominal gains of the citizen shareholders they are supposed to be serving.

In his foreword to the *Cambridge Handbook for Institutional Investors*, Vice President Al Gore captures the conflict between beating the market and lifting it:

> Investing is a means to ensure our future well-being. This requires a broader consideration by fiduciaries of systemic effects–for example, consideration of how investments can create better markets tomorrow, rather than simply focusing on

98. *See* Alexander, *supra* note 14, at 311 (noting that the application of these theories "benefits no one, except short-term players who siphon value from the rest of the economy").

99. *See id.* at 308 (asserting that reliance on shareholder primacy "requires asset managers to play a negative-sum game with other stakeholders, if that game will give the investors the greatest return").

100. *See generally id.* at 310 ("Companies that create systemic risks and costs are likely to damage the market in its entirety. This is precisely what the financial sector did by chasing individual returns in the mortgage market, leading to the financial crisis, which hurt the stockholders of all companies, to say nothing of the dislocation and costs suffered by homeowners.").

> "beating" the market today. Incentives that encourage fiduciaries to take advantage of asymmetries have frequently seduced fiduciaries to succumb to a self-destructive cycle of short-termism and have clearly generated unhealthy outcomes for the system as a whole.[101]

II. TIME TO RECALIBRATE

The story of how we arrived at the current system of shareholder primacy and MPT has been told elsewhere.[102] And it might be thought that, imperfect as it is, it is "good enough," and it prevents managers from usurping assets for themselves (curing the agency problem) and that other public goods will just have to be protected by law. But that is just not realistic in an increasingly interconnected world. Corporations are embedded in a complex global economy that depends on various forms of capital—human, natural, and social—that are at serious risk.[103] Climate risk, poor management of scarce resources, severe global inequality, food insecurity, and other systemic issues have real potential to destroy large amounts of value and impose tragic human costs. We cannot afford to base our entire financial system on principles that leave these concerns to governments and NGOs. Businesses must be part of the solution.

This change has to start with the institutional investor community. It controls the votes at public companies and funds private equity and venture capital around the world; it has a responsibility to all the citizen shareholders, like Ms. Jones, to do more than beat or track the market. It has the power, through security selection and proxy voting, to influence whether that market rises or falls (and whether the planet and its inhabitants thrive or wither). With that power comes responsibility.

There has certainly been movement in the institutional investor community to focus more on "environmental, social, and

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101. CAMBRIDGE HANDBOOK OF INSTITUTIONAL INVESTMENT AND FIDUCIARY DUTY xvi (James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg & Edward J. Waitzer eds., 2014).

102. Harry M. Markowitz, *The Early History of Portfolio Theory: 1600-1960*, 55 FIN. ANALYSTS J. 5, 8 (1999).

103. *See generally* William Michael Cunningham, *What Is Impact, ESG, CSR or Socially Responsible Investing?: Impact Investing*, CREATIVE INV. RES., http://www.creativeinvest.com/sri/ (last visited Dec. 24, 2017) (discussing the incorporation of "environmental, social and governance (ESG) criteria" into "investment analysis and portfolio selection").

governance" issues, "corporate social responsibility," and "socially responsible investing."[104] These are good developments, but they are often portrayed solely as strategies to increase long-term stock price—that is, as positive sum value creation techniques for individual companies and nothing more.[105] While developing techniques to systematically identify positive sum opportunities is a very welcome development, it is not enough. There will continue to be many opportunities for businesses to make money through negative sum strategies, and thus plenty of opportunities for money managers to beat the market by investing in and encouraging such behavior.

The investment community needs to realize that individual share price and portfolio value maximizing can lead to market damaging activity, and must police that activity, *even when it conflicts with shareholder primacy concerns at individual companies*.

A. Benefit Corporations: A Tool for Managing Systems

One technique for approaching this dilemma is to encourage corporations to change their governance rules to explicitly recognize that directors have an obligation to consider the effects of their decisions on all stakeholders and not just shareholders. The ability to make this change is now available in thirty-three states in the U.S., including Delaware, through the adoption of benefit corporation legislation.[106] The details of the statutes have been discussed elsewhere.[107] Here, it is enough to note that benefit corporation laws require boards to consider the interests of all stakeholders, so that in addition to creating shareholder return, they have an obligation to consider the effect of their operations on communities, the environment, workers, customers, and others.[108] However, those altered obligations exist in what remains a

104. *Id.*

105. Lynn A. Stout, *The Problem of Corporate Purpose*, BROOKINGS (June 18, 2012), https://www.brookings.edu/research/the-problem-of-corporate-purpose/.

106. *State by State Status of Legislation*, BENEFIT CORP., http://benefitcorp.net/policymakers/state-by-state-status (last visited Dec. 24, 2017).

107. *See generally The Model Legislation*, BENEFIT CORP., http://benefitcorp.net/attorneys/model-legislation (last visited Dec. 24, 2017) (listing the general components of such legislation).

108. *Model Benefit Corporation Legislation: With Explanatory Comments*, BENEFIT CORP. (Apr. 17, 2017) http://benefitcorp.net/sites/default/files/Model%20benefit%20corp%20legislation%20_4_17_17.pdf.

shareholder-centric model.[109] It is still shareholders who elect the board and have other governance rights, and it is only shareholders who can bring lawsuits challenging the board for failure to adequately consider the interests of other stakeholders.[110]

> Th[is] benefit corporation structure [thus] relies on shareholders understanding the need to value systems—if they remain in share-value mode, they will not use their power to enforce the new obligations. And while some institutional shareholders are beginning to recognize that value, it is not yet the norm. Although there certainly is increased understanding of the need to manage systems, institutions struggle to find tools to do so, and they worry about free riding and problems of collective action. Benefit corporations are one way to address those concerns. By encouraging corporations in their portfolios to change governance focus, investors can work together to make these changes.
>
> There will certainly be objections. Some will say that corporations can already do well by doing good and that creating this distinction just gives other companies further license [to continue] to exploit [the commons]. The fact is, they are already doing that. The stronger objection perhaps, is that there is just no way to make this work. There is too much opportunity for free riding and commons grazing, and there will always be non-benefit corporations that rush in to [grab the negative sum opportunities]. [From this perspective, regulation is the only way to bring about positive collective action.]
>
> I am more optimistic. There are many companies for whom benefit corporation adoption is actually a way to implement their business plan. For these companies, the ability to make authentic commitments to their stakeholders is a way to induce those stakeholders to commit back. . . . [In other words, there are many workers, customers, regulators, and communities who will prefer to deal with a for profit company that includes all stakeholders in their bottom line. For these companies, benefit conversion is an opportunity.] As these companies [are introduced] into the market, more workers and customers will

109. *See* Alexander, *supra* note 14, at 304 (discussing how "[t]he current rules for allocating private capital are based on the idea of 'stockholder primacy' and the pursuit of immediate increases to share value").

110. *See generally id.* at 313 (describing the "basic structure" of the shareholder primacy model).

> look for businesses that have stakeholder values in their DNA, and investors can contribute to this pressure.

Just as we shifted to shareholder primacy at some point in the latter half of the twentieth century, we ought to be able to move the paradigm back, reaching a tipping point where the question corporations will face isn't "why are you a benefit corporation?", but "why aren't you?"[111]

B. Principles for Responsible Investing

But benefit corporation law is only a tool. The changes that have to be made must start with investors, particularly the institutions who control so much of our financial capital. The individuals these institutions represent recognize that profits cannot come before good corporate citizenship. Publicly traded pharmaceutical companies that increase their bottom line through raising prices as much as the market will bear are coming under increasing scrutiny.[112] Consumers are demonstrating a willingness to pay for products that are responsibly produced, as organic products fill the aisles not just at Whole Foods, but at Walmart.[113] Apparel companies with irresponsible supply chains are risking their licenses to operate.[114]

These ideas need to be translated into action at the investment stewardship level. Institutional investors have to insist that companies in their portfolios stop engaging in negative sum strategies, *even if that means sacrificing individual company return*. In an ownership society, we have a responsibility to take care of our neighborhood, as well as our own homes, and we can

111. *Id.* at 161.

112. *See generally* Wesley K. Sumida, Ronald Taniguchi & Deborah Taira Juarez, *Prescription Drug Pricing*, 75 HAW. J. OF MED. & PUB. HEALTH 25 (Jan. 2016), *available at* https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4733824/pdf/hjmph7501_0025.pdf (providing a thorough explanation on the increasing drug prices which have been increasingly scrutinized).

113. Zoe Krey, Shopping for Sustainability: Whole Foods Market and the Contradictions of Corporate Organics 4 (2016) (unpublished Honors Program Thesis, DePaul University), *available at* https://academics.depaul.edu/honors/curriculum/Documents/2016%20Senior%20Theses/Krey,%20Zoe%20Senior%20Thesis%20WQ15-16.pdf.

114. *See* Tam Harbert, *Can Businesses Police the Behavior of Global Suppliers?*, BUS. RESEARCHER (Apr. 25, 2016), http://businessresearcher.sagepub.com/sbr-1775-99621-2728048/20160425/ethics-and-the-supply-chain (noting that a company's operating license is dependent on good behavior).

reap great rewards from doing so, while preserving thriving systems for future generations. Below is a set of principles that institutional investors could adopt in order to move us in that direction.

III. INVESTMENT PRINCIPLES FOR ALIGNED GOVERNANCE[115]

Preamble

Our paramount duty is to act in the best long-term interests of our investors. Our beneficiaries are invested across markets through our portfolios, through other investments, and through assets owned by other institutions that represent their interests, including defined benefit plans, insurers, endowments, and foundations.

Governance is a critical factor in determining whether firms create long-term durable value that contribute to rising markets that benefit all investors. Models that emphasize only share value and short-term profit encourage firms to impose external costs on society and the environment. This emphasis on short-term profit creates systemic risks and long-term adverse effects on the securities markets, and threatens the value of all long investment portfolios, including our own. In contrast, *purposeful* corporate governance models can create corporations that are *accountable* to shareholders for external impacts and *transparent* with respect to such impacts. Purpose, accountability, and transparency can be encouraged through corporate charters that create benefit corporations or similar entities ("mission aligned entities"). The missions of such firms are aligned with the society within which they are embedded and will lead to better long-term performance for all investors, including our own.

Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

Principle 1

We will incorporate purposeful governance principles into our policies and practices and support the creation of long-term, durable value by companies within our portfolio, including those within funds in which we invest as limited partners or otherwise.

115. The discussion within this Part can also be found at *The Six Principles: Signatories' Commitment*, PRINCIPLES FOR RESPONSIBLE INV., https://www.unpri.org/about/the-six-principles (last visited Dec. 24, 2017).

Principle 2

We will support the creation of mission aligned entities and work together with corporate managers to implement mission aligned governance, including by voting our shares in favor of charter amendments to create benefit corporations or similar entities.

Principle 3

Where otherwise consistent with our investment policies, we will invest in mission aligned entities, including benefit corporations.

Principle 4

We will work together with other asset managers and owners to create an investment environment that discourages private enterprise from creating financial returns through practices that impose adverse external costs on the markets, society, and the environment.

Principle 5

We will promote the adoption and implementation of these principles throughout the investment industry.