

COMMON OWNERSHIP:  
SHAREHOLDERS WIN AND EMPLOYEES LOSE

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ABSTRACT

*In the last forty years, wages in the United States have stalled and income inequality has increased, despite a tripling of the gross domestic product. During the same period, corporate America's equity markets have gone through a compositional shift. The once-prevalent "dispersed ownership" of corporations by retail investors was replaced by "common ownership": a few powerful institutional investors holding large stakes in most U.S. corporations. It is not a coincidence that at the same time American workers got a new set of bosses, their wages stopped growing and shareholders' returns went up. This Article argues that common owners are a driving force behind stalled wages and increasing income inequality.*

*Powerful institutional investors' policy of pushing public corporations to adopt strong corporate governance has an inherent, painful tradeoff. While strong governance can improve corporate efficiency—by reducing management agency costs—it can also reduce social welfare—by reducing investment and depressing the labor market. Indeed, common owners create a labor monopsony that increases the return on capital at the expense of reduced return on labor, thereby increasing income inequality. Importantly, common owners exert labor monopsony power not by exercising control in a certain way (as existing literature argues) but rather by allocating control to shareholders—pushing toward strong governance—which can then be exercised by other shareholders, such as activist hedge funds.*

*If policymakers wish to restore the equilibrium that existed before common ownership dominated the market, they should break up institutional investors along type (separating active from passive investments) and size (limiting assets under management).*

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## INTRODUCTION

Wages have stagnated for forty years, despite a tripling of the gross domestic product.<sup>1</sup> While firms have enjoyed blockbuster profits and increasing profitability,<sup>2</sup> most American households have not shared in this increasing prosperity, resulting in rising income inequality.<sup>3</sup> Causes like deunionization,<sup>4</sup> globalization,<sup>5</sup> immigration,<sup>6</sup> and technology<sup>7</sup> have been blamed for wage stagnation and increasing income inequality. But so far, a major culprit has

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<sup>1</sup> Drew Desilver, *For Most U.S. Workers, Real Wages Have Barely Budged in Decades*, PEW RSCH. CTR. (Aug. 7, 2018), <https://www.pewresearch.org/fact-tank/2018/08/07/for-most-us-workers-real-wages-have-barely-budged-for-decades/>. World Bank, *GDP (Constant 2010 US\$)—United States*, <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD?locations=US> (last visited Apr. 28, 2020); *See Estimating the U.S. Labor Share* fig.1, U.S. BUREAU LABOR STATS. (Feb. 2017), <https://www.bls.gov/opub/mlr/2017/article/estimating-the-us-labor-share.htm>, (finding that the labor share of output has declined from 64% in 1982 to a low of 56% in 2011); JOSH BIVENS ET AL., ECON. POL'Y INST., *Raising America's Pay* 10 fig.a (2014), <https://www.epi.org/publication/raising-americas-pay/> (finding that while productivity and compensation grew in tandem from 1948 until 1979, thereafter the typical rate of compensation lagged – between 1979 and 2013 productivity grew 64.9% while hourly compensation grew only 8.2%).

<sup>2</sup> *See* Robert Hughes, *Corporate Profits Hit a New Record as GDP Growth Is Revised Higher*, AIER (2018), <https://www.aier.org/article/corporate-profits-hit-a-new-record-as-gdp-growth-is-revised-higher/>; Nir Kaissar, *The Hard Part of Ending Inequality Is Paying for It*, BLOOMBERG OPINION (Sep. 2, 2019) (reporting that corporate profits as a percentage of GDP hit the highest on record in 2012 and remained elevated, according to the U.S. Bureau of Economic Analysis), available at: <https://www.bloomberg.com/opinion/articles/2019-09-02/hard-part-of-ending-inequality-is-paying-for-it>; JAN DE LOECKER ET AL., *THE RISE OF MARKET POWER AND THE MACROECONOMIC IMPLICATIONS* 10 (2018), <http://www.janececkhout.com/wp-content/uploads/RMP.pdf> (finding that in 2016, the average markup charged was 61% over marginal cost, compared to 21% in 1980).

<sup>3</sup> Upper-income households now claim half of economic wealth, up from a third in 1980. Juliana Menasce Horowitz et al., *Trends in Income and Wealth Inequality*, PEW RSCH. CTR (Jan. 9, 2020) <https://www.pewsocialtrends.org/2020/01/09/trends-in-income-and-wealth-inequality/>.

<sup>4</sup> *See, e.g.*, Lawrence Mishel, *Unions, Inequality, and Faltering Middle-Class Wages*, ECON. POL'Y INST. (Aug. 29, 2012), <https://www.epi.org/publication/ib342-unions-inequality-faltering-middle-class/>; *see also* Henry S. Farber et al., *Unions and Inequality over The Twentieth Century: New Evidence From Survey Data*, (Nat'l Bureau Econ. Rsch., NBER Working Paper 24587, May 2018), <http://www.nber.org/papers/w24587>.

<sup>5</sup> *See, e.g.*, Guido Cozzi & Giammarco Impullitti, *Globalization and Wage Polarization*, 98 REV. ECON & STAT. 984, 999 (2016); Jonathan Haskel et. al., *Globalization and U.S. Wages: Modifying Classic Theory to Explain Recent Facts*, 26 J. ECON. PERS. 119 (2012).

<sup>6</sup> Jason Anastopoulos et al., *Job Vacancies and Immigration: Evidence From Pre- and Post-Mariel Miami* 4 (Nat'l Bureau Econ. Rsch., NBER Working Paper 24580, May 2018), <https://economics.yale.edu/sites/default/files/w24580.pdf>; George Borjas, *The Labor Demand Curve Is Downward Sloping: Reexamining the Impacts of Immigration on the Labor Market*, 118 Q.J. ECON. 1355 (2003).

<sup>7</sup> *See, e.g.*, Daron Acemoglu & Pascual Restrepo, *Robots and Jobs: Evidence from US Labor Markets*, 128 J. POL. ECON. 2188 (2020) (showing that automation may reduce employment and wages); Clemens Lankisch et al., *How Can Robots Affect Wage Inequality?*, 81 ECON. MODELLING 161 (2019) (finding that automation contributes to rising inequality).

escaped detection: *common ownership*—a few powerful institutional investors controlling large stakes in most US corporations.<sup>8</sup>

Since the 1980s, control of the American stock markets has shifted from individual retail investors to an interlocking set of powerful financial institutions who own shares in practically all public corporations. Scholars have dubbed these institutions as *common owners*.<sup>9</sup> Today, these highly diversified institutional investors own more than 70% of American publicly traded equity, up from less than 25% in the 1980s.<sup>10</sup> The new ownership structure is highly concentrated: the three largest asset managers—BlackRock, Vanguard, and State Street—collectively constitute the largest shareholder in nine out of ten S&P500 firms.<sup>11</sup> The once-prevalent dispersed ownership structure<sup>12</sup> has now been replaced by common ownership.<sup>13</sup>

Effectively, common owners have hung an “Under New Management” sign over corporate America, a sector that employs about one-third of the American workforce.<sup>14</sup> It would be an astounding coincidence that, at the same time

<sup>8</sup> See Matthew Backus et al., *Common Ownership in America: 1980-2017* 1, (Nat'l Bureau Econ Rsch., NBER Working Paper 25454, Jan. 2019), <https://www.nber.org/papers/w25454> (documenting the increase in common ownership); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519 (1997) (identifying the trend of wage stagnation and higher shareholder returns as early as 1997).

This Article explains that the wage and inequality effects are driven by reduced investments caused by common ownership, *see infra* Section II, and a study has found that the aggregate-level investment gap is mostly explained by low competition and high common ownership, *see* Germán Gutiérrez & Thomas Philippon, *Investmentless Growth: An Empirical Investigation*, Brooking Papers on Econ. Activities, page 30 (Fall 2017), available at <https://www.brookings.edu/wp-content/uploads/2018/02/gutierreztextfa17bpea.pdf> [hereinafter Gutiérrez & Philippon, *Investmentless Growth*].

<sup>9</sup> See, e.g., Edward B. Rock, *Institutional Investors in Corporate Governance* 4-5 (Univ. Penn. Carey L. Sch., Penn L.: Legal Scholarship Repository Paper 1458, July 21, 2015), [https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2459&context=faculty\\_scholarship](https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2459&context=faculty_scholarship) (describing the “de-retailization of the capital markets” as a result of labor regulations and market forces). According to the Bank for International Settlements, “passive funds managed about . . . 20% of aggregate investment fund assets as of June 2017, up from 8% a decade earlier” and now make up “43% of total U.S. equity fund assets.” See, Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, 113 BIS Q. REV. 114 (2018).

<sup>10</sup> Jose Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. OF FIN. 1513, 1514 (2018).

<sup>11</sup> Jan Fichtner et al., *Hidden Power of the Big Three?*, 19 BUS. & POLS. 298, 313 (2017).

<sup>12</sup> A dispersed ownership structure of a publicly traded corporation means that there is no individual shareholder or a group of shareholders with sufficient voting power and an incentive to exercise control over management. For the historic evolution of dispersed ownership, *see generally* John C. Coffee Jr., *Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension between “Lumpers” and “Splitters”*, in THE OXFORD HANDBOOK OF CAPITALISM 463 (Dennis C. Mueller ed., 2012).

<sup>13</sup> Backus et al., *supra* note 8, at 15 fig.4 (showing the rise in S&P ownership by common owners).

<sup>14</sup> This estimate is based on data from Compustat. The total number of employees in public companies in North America (including Canada) is 79,642,332. This number includes: (1) all employees of consolidated subsidiaries, both domestic and foreign; (2) all part-time and seasonal employees; (3) full-time equivalent employees; and (4) officers. This number excludes: (1)

American workers got a new set of bosses, their wages stopped growing. To the contrary, this Article argues that common owners are the driving force behind stalled wages and increasing income inequality.

This view runs counter to conventional wisdom in corporate law. There, common owners are thought to bring savvy to the boardroom that retail owners lack, and draw praise for strengthening corporate governance in publicly traded corporations.<sup>15</sup> Strong governance—that is, more power to shareholders—supposedly improves corporate efficiency by deterring disloyal managers from overinvesting and wasting resources on pet projects.<sup>16</sup> Such *overinvestments* are a type of management agency cost that strong governance is believed to reduce.<sup>17</sup> Moreover, scholars have heralded institutional investors as guardians of shareholder rights, whose ability to monitor corporations and hold disloyal managers accountable creates a net social benefit.<sup>18</sup>

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consultants; (2) contract workers; (3) directors; and (4) employees of unconsolidated subsidiaries. Excluding Canadian public companies' employees, which we estimate at six million (out of total 15.5M Canadian employees), and foreign and part-time employees, which we estimate at thirty million, we are left with forty-three million employees in publicly traded U.S. corporations. The total number of employees in the private sector in the U.S. in August 2019 (pre-COVID-19) was 128,523,000, according to the Bureau of Labor Statistics. *Employees on Nonfarm Payrolls by Industry Sector and Selected Industry Detail*, BUREAU LAB. STATS. <https://www.bls.gov/news.release/empsit.t17.htm> (last visited Sep. 20, 2020). Thus, 43 million divided by 128 million is about 34%.

<sup>15</sup> See, e.g., Lucian A. Bebchuck et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 93 (2017) (“large institutional shareholders hold sufficiently sizable positions in each large corporation to have a non-negligible effect on the outcomes of shareholder votes.”); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507 (2020) (showing the benefits of common ownership in improving compliance).

<sup>16</sup> See Zohar Goshen & Doron Levit, *Irrelevance of Governance Structure at 7–8* (European Corp. Governance Institute, Finance Working Paper No. 606/2019, May 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3340912](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3340912) (modelling the choice facing managers between whether to invest in pet projects or value-creating investment projects).

<sup>17</sup> Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) (introducing the problem of management overinvestment, and takeovers as the solution); Steven Kaplan,

*The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (offering evidence in support of the empire-building hypothesis by showing that performance increases and investment decreases after management buyouts); Scott Richardson, *Over-Investment of Free Cash Flow*, 11 REV. ACC. STUDS. 159 (2006) (finding that strong governance reduces overinvestment of free cash-flow).

<sup>18</sup> See, e.g., Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1643–44 (2013) (arguing that empirical evidence shows that expected benefits from shareholder activism exceed expected costs, and therefore “shareholder ability to intervene . . . provides long-term benefits to companies, shareholders, and the economy”); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Voice*, 39 UCLA L. REV. 811, 815 (1992) (“The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available.”); Audra L. Boone & Joshua T. White, *The Effect of Institutional Ownership on Firm Transparency and Information Production*, 117 J. FIN. ECON. 508 (2015) (finding that institutional investors facilitate information production, which enhances monitoring); Alan D. Crane et al., *The Effect of Institutional Ownership on Payout Policy: Evidence from Index Thresholds*, 29 REV. FIN. STUDS.

Indeed, strong governance improves corporate efficiency by curtailing overinvestment by disloyal managers,<sup>19</sup> but it also deters *loyal* managers from investing in value-increasing projects. A loyal manager risks discipline and dismissal by investing in innovative, complex, or long-term investments that shareholders might misevaluate or misunderstand.<sup>20</sup> Therefore, both loyal and disloyal managers are likely to refrain from investing under a strong-governance regime. This *underinvestment* is an inefficient effect of strong governance. It is debatable whether, between these two opposing effects—decreasing management agency costs while discouraging value-creating investments—strong governance is, on average, socially beneficial.<sup>21</sup> Importantly, however, both effects of strong governance decrease corporate investment.

As this Article will show, decreasing investment lowers demand for employees and creates a labor monopsony. A monopsony is a firm (or set of firms) with sufficient market power that it can and does cut back on its purchases of an input—in this case, labor—to reduce its price and enjoy a discount.<sup>22</sup> By switching firms *en masse* to strong governance regimes, common owners create a labor market monopsony without resorting to collusion,<sup>23</sup> and indeed, likely

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1377 (2016) (finding that even non-activist institutions play an important role in monitoring firm behavior, leading to increased dividends); MIGUEL ANTON ET AL., INNOVATION: THE BRIGHT SIDE OF COMMON OWNERSHIP? (2018), <https://ssrn.com/abstract=3099578> (finding that common ownership encourages innovation);

<sup>19</sup> See, e.g., Micah S. Officer, *Overinvestment, Corporate Governance, and Dividend Initiations*, 17 J. CORP. FIN. 710 (2011) (finding that reductions in the agency costs of overinvestment at firms with poor investment opportunities and ample cash flow are reflected in higher dividend initiation announcement returns).

<sup>20</sup> Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE. L.J. 560 (2016).

<sup>21</sup> The empirical findings are inconclusive. For a review of these studies, see Goshen and Squire, *supra* note 20, at 814–25.

<sup>22</sup> COUNCIL ECON. ADVISORS, LABOR MARKET MONOPSONY: TRENDS, CONSEQUENCES, AND POLICY RESPONSES 2 (2016), [https://obamawhitehouse.archives.gov/sites/default/files/page/files/20161025\\_monopsony\\_labor\\_mrkt\\_cea.pdf](https://obamawhitehouse.archives.gov/sites/default/files/page/files/20161025_monopsony_labor_mrkt_cea.pdf) (“[A] firm with monopsony power has the ability to pay lower prices for its inputs.”). While monopolies use their market power to set the price of goods and services they sell to consumers, *monopsonies* use market power to affect the price of goods they *purchase* from suppliers. See *id.* Although common owners, working together, might be more properly termed as an oligopsony, this Article elects to use the somewhat more palatable term “monopsony” as a matter of style. See *Oligopsony*, *Merriam-Webster.com*, <https://www.merriam-webster.com/dictionary/oligopsony> (last visited Apr. 28, 2020) (defining “oligopsony” as “a market situation in which each of a few buyers exerts a disproportionate influence on the market”).

<sup>23</sup> While this Article’s thesis—that common owners create a monopsony on inputs—applies to *all* inputs—such as materials and equipment—we focus on labor for two reasons. First, when the inputs in question are goods and services rather than labor, common owners benefit less from monopsony pricing. Because they likely also own stakes in the suppliers, common owners are on both sides of the monopsony effect, meaning their gains via the buyer firms are offset by losses in the seller firms. However, when the resource in question is labor, common owners capture the economic value that otherwise would be reflected in wages and salaries, in which they have no stake. Second, workers tend to have less discretion to withhold their services from the market, and so bolster prices, as they need to earn a living. Thus, workers wield even less bargaining power than

without intending to create one.<sup>24</sup> This unique type of labor monopsony is driven by *shareholders' market power* over management rather than, as in standard labor economics, by *firms' market power* over employees.<sup>25</sup>

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providers of goods and services. Orley C. Ashenfelter et al., *A Shred of Credible Evidence on the Long Run Elasticity of Labor Supply* (Nat'l Bureau Econ. Rsch, NBER Working Paper 15746, Feb. 2010), <https://www.nber.org/papers/w15746.pdf> (noting the “relatively broad consensus that the long run elasticity of labor supply is not likely to be large”).

<sup>24</sup> As explained *infra* in Section III.D., pushing firms toward stronger governance manifest itself in higher profits, making common owners believe they are reducing agency costs. Unfortunately, the true effect of high profitability is driven by the depressed wages.

<sup>25</sup> Commonly, the theory of labor monopsony focuses on firms' market power over labor. See Orley Ashenfelter et al., *Labor Market Monopsony*, 28 J. LABOR ECON. 203 (2010) (explaining the theories of labor market monopsony); V. Bhaskar et al., *Oligopsony and Monopsonistic Competition in Labor Markets*, 16 J. ECON. PERSP., 155 (2002) (reviewing models and empirical studies of labor monopsony).

A firm's market power is achieved mostly through market concentration, either in a geographic area or in the product market. See, e.g., José Azar et al., *Labor Market Concentration* (Nat'l Bureau Econ. Rsch., NBER Working Paper 24147, Feb. 2019), <https://www.nber.org/papers/w24147.pdf> (finding geographic concentration in labor markets throughout the U.S.); Efraim Benmelech et al., *Strong Employers and Weak Employees: How Does Employer Concentration Affect Wages?* (Nat'l Bureau Econ. Rsch., NBER Working Paper 24307, Feb. 2018), <http://www.nber.org/papers/w24307> (exploring the sources of firms' market power over labor). Thus, mergers have been a major focus as the driving force behind concentration that leads to labor monopsony. See, e.g., DAVID ARNOLD, MERGERS AND ACQUISITIONS, LOCAL LABOR MARKET CONCENTRATION, AND WORKER OUTCOMES (Jan. 13, 2020), <https://scholar.princeton.edu/sites/default/files/dharnold/files/jmp.pdf> (finding that mergers that increase concentration also decrease wages); Suresh Naidu et al., *Antitrust Remedies for Labor Market Power*, 132 HARV. L. REV. 536 (2018) (reviewing the empirical data on mergers and suggesting an antitrust remedy).

Consequently, the studies challenging the labor monopsony hypothesis tend to focus on contesting the market-concentration claim. See, e.g., Brad Hershbein et al., *Concentration in U.S. Local Labor Markets: Evidence from Vacancy and Employment Data* 33 (Soc'y Econ. Dynamics, 2019 Meeting Papers No. 1336, Feb. 15, 2019) [https://economicdynamics.org/meetpapers/2019/paper\\_1336.pdf](https://economicdynamics.org/meetpapers/2019/paper_1336.pdf) (finding that in the last decade, at most 5% of new U.S. jobs are in moderately concentrated local markets, and that local labor market concentration has decreased by at least 25% since 1976); Kevin Rinz, *Labor Market Concentration, Earnings Inequality, and Earnings Mobility* (Ctr. Admin. Recs. Rsch. & Applications, CARRA Working Paper Series 2018-10, Sep. 2018), <https://kevinrinz.github.io/concentration.pdf> (finding that local industrial concentration has generally been declining from 1976–2016); Esteban Rossi-Hansberg et al., *Diverging Trends in National and Local Concentration* (Fed. Rsrv. Bank Richmond, Working Paper Series 18-15R, 2018-09-24), <https://ssrn.com/abstract=3258967> (finding that labor market concentration is falling in the U.S. economy).

By contrast, since this Article contends that monopsony is driven by shareholders' market power (common ownership), market concentration (geographic or product) is unnecessary for the labor monopsony to work. Indeed, as expected by our model, common ownership has the greatest effect of lowering investments in industries that are less concentrated. See, Germán Gutiérrez and Thomas Philippon, *Ownership, Governance and Investment*, page 3 (March 2017), available at: [https://www.semanticscholar.org/paper/Ownership%2C-Governance-and-Investment\\*-Guti%C3%A9rrez-Philippon/8e9ac9cc8a5d90ec0e90deb2d780479b63755159](https://www.semanticscholar.org/paper/Ownership%2C-Governance-and-Investment*-Guti%C3%A9rrez-Philippon/8e9ac9cc8a5d90ec0e90deb2d780479b63755159) (finding that common ownership has a limited effect on industries that are noncompetitive according to traditional measures; but a substantial effect on industries that appear competitive according to traditional measures but have large amounts of common ownership).

This Article’s main contribution is showing that common owners exert labor monopsony power not by *exercising* control in a certain way (as existing literature argues<sup>26</sup>) but rather by *allocating* control to shareholders—pushing toward strong governance<sup>27</sup>—which can then be exercised by other shareholders, such as activist hedge funds.<sup>28</sup> Moreover, by adopting one-size-fits-all governance policies,<sup>29</sup> common owners can push for stronger governance without needing to gather nuanced information about the market strategies of their portfolio companies.<sup>30</sup> And, importantly, the activist shareholders that do eventually exercise control do not need to engage in any illegal anticompetitive conspiracy—such as communicating with multiple managers and coordinating across firms<sup>31</sup>—to enjoy a labor discount. They only need to strive to maximize the value of their shares in each corporation.

Unsurprisingly, managers’ career concerns are the driving force behind this monopsony effect. When both job security and future career paths depend on pleasing a company’s shareholders—as in strong governance firms—disloyal managers will avoid inefficient investments and loyal managers will shy away from efficient investments that shareholders might misperceive as inefficient ones.<sup>32</sup> Instead, they will choose to distribute excess profits directly to shareholders through share buybacks or dividends, rather than creating shareholder (and social) value by reinvesting in the business.<sup>33</sup> As investment falls, so too will hiring: companies no longer require the labor forces to operate new factories, staff new divisions, and run new offices and locations.<sup>34</sup> In other words, common owners implicitly—and, we believe, inadvertently—act as a

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<sup>26</sup> For description and analysis of these studies, see generally C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392 (2020).

<sup>27</sup> See *infra* section B.

<sup>28</sup> See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Cost of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013).

<sup>29</sup> See, e.g., ISG, Corporate Governance Principles for US Listed Companies, available at: <https://isgframework.org/corporate-governance-principles/>

<sup>30</sup> See, e.g., Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2104 (2019) (documenting that the Big Three institutional investors “have been very active in supporting [shareholders] proposals advocating governance changes favored by their governance principles.”); Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 101 (2007) (explaining the flaws of one-size-fits-all policies).

<sup>31</sup> When organizing a cartel, each corporation affects the other corporations, requiring the cartel to allocate quotas and monitor against defections. See Joseph E. Harrington & Andrzej Skrzypacz, *Private Monitoring and Communication in Cartels: Explaining Recent Collusive Practices*, 101 AM. ECON. REV. 2425 (2011).

<sup>32</sup> See Goshen & Squire, *supra* note 20, at 803 (“Anticipating the risk of false negatives—of being fired despite their competence—managers could respond in a variety of ways. They could demand a higher salary as compensation for the risk. They also could avoid profitable but complex business strategies that are prone to mismeasurement.”).

<sup>33</sup> See *infra* notes 164–165 and accompanying text.

<sup>34</sup> See Frederico Belo et al., *Labor Hiring, Investment, and Stock Return Predictability in the Cross Section*, 122 J. POL. ECON. 129, 131–32 (2014) (examining the relationship between hiring and investment).



labor market cartel, incentivizing their portfolio firms all at once to cut back on hiring. While corporations invest less, each unit of investment is more lucrative because of the wage discount, meaning that, on the whole, portfolio profits rise.<sup>35</sup> And while shareholders are better off under the labor market monopsony, workers suffer. This mechanism thus explains not only increasing corporate profits and decreasing investment, but also wage stagnation and mounting income inequality.

Key to the monopsony effect are the strong-governance measures that common owners impose on their portfolio firms. Take, for example, the demise of antitakeover protections such as staggered boards and poison pills.<sup>36</sup> The conventional wisdom behind removing antitakeover protections is that it will be easier for shareholders to hold managers accountable.<sup>37</sup> A disloyal manager who makes inefficient investments will cause share prices to decline, and in the absence of takeover protections, a hostile bidder will eventually appeal directly to the shareholders to tender their shares, acquire the corporation, and fire the inefficient managers.<sup>38</sup> As a result, common owners generally support removing antitakeover protection in order to deter disloyal managers from making inefficient investments.

But this common wisdom is only one part of the story. The fear of takeover also deters loyal managers from making *efficient* investments.<sup>39</sup> While share-price underperformance can indeed reflect inefficient investments, it can also be the result of market mispricing.<sup>40</sup> Some visionary, hard-to-understand, or long-term investments are underpriced by the market, exposing talented loyal managers to unjustified hostile takeovers.<sup>41</sup> Without antitakeover protections,

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<sup>35</sup> See David W. Berger et al., *Labor Market Power* (Nat'l Bureau Econ. Rsch, NBER Working Paper No. 25719, Oct. 2019), [nber.org/papers/w25719.pdf](https://nber.org/papers/w25719.pdf) (explaining that monopsonies enjoy a wage discount by paying workers less than the marginal revenue product of their labor).

<sup>36</sup> See *infra* sections I.B.2 and I.B.3.

<sup>37</sup> See, e.g., Lucian Aryeh Bebchuck, *The Case Against Board Veto in Corporate Takeovers*, 69 U. Chi. L. Rev. 973, 994 (arguing that “takeover threat provides managers with an important source of incentives to serve shareholders”).

<sup>38</sup> See John H. Matheson, *Corporate Governance at the Millennium: The Decline of the Poison Pill Antitakeover Defense*, 22 HAMLINE L. REV. 703, 704 n.7 (1999).

<sup>39</sup> See, e.g., Julian Atanassov, *Do Hostile Takeovers Stifle Innovation? Evidence from Antitakeover Legislation and Corporate Patenting*, 68 J. FIN. 1097 (2013) (finding a significant decline in the number of patents and citations per patent for firms incorporated in states that pass antitakeover laws relative to firms incorporated in states that do not); Thomas J. Chemmanur & Xuan Tian, *Do Antitakeover Provisions Spur Corporate Innovation? A Regression Discontinuity Analysis*, 53 J. FIN. & QUANTITATIVE ANALYSIS 1163 (2018) (finding a positive, causal effect of antitakeover provisions on innovation).

<sup>40</sup> Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Dead Hand Pills, and Shareholder-Adopted Bylaws*, 19 CARDOZO L. REV. 511, 513 (1997) (arguing that a market for corporate control that is unconstrained by antitakeover mechanisms like poison pills risks “hair-trigger arbitrage transactions based on the gap between stock prices and alternative measures of value”).

<sup>41</sup> See Eitan Arom, *Hidden Value Injury*, 120 COLUM. L. REV. (forthcoming 2021) (manuscript at 14–16), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3533411&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3533411&download=yes) (arguing that markets may fail to factor long-term value information into short-term prices).

loyal managers are less likely to make this type of (beneficial) investment, choosing instead to keep the company running as usual while distributing free cash flows to shareholders, thus protecting themselves against being unjustifiably fired.<sup>42</sup> Antitakeover protections are a double-edged sword: they provide cover for disloyal managers and loyal managers, encouraging both efficient and inefficient investments.<sup>43</sup>

Common owners have more or less eliminated the use of antitakeover protections, such as staggered boards and poison pills, in major American corporations.<sup>44</sup> Managers who invest in projects shareholders do not understand or approve of may find themselves on the wrong end of a hostile takeover.<sup>45</sup> The demise of antitakeover protections across thousands of companies, including most of the 500 largest American corporations, has had a chilling effect on investment levels. And removing antitakeover protections is only one of the strong-governance measures that common owners favor.<sup>46</sup> Applying the whole arsenal of strong-governance measures across corporate America has generated a significant and systematic decrease in corporate investment and an anticompetitive labor market, despite common owners having undertaken these measures in the name of good corporate governance. That is, institutional investors have increased corporate profits not necessarily by improving the quality of investments but rather by taking wealth away from employees and giving it to shareholders.

In addition to providing the existing empirical evidence, this Article presents an economic model that supports the link between governance structure

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<sup>42</sup> See Pornsit Jiraporn et al. *Dividend Payout and Corporate Governance Quality: An Empirical Investigation*, 46 FIN. REV. 251, 275 (2011) (showing empirically that firms with “better governance quality”—that is, strong governance—disproportionately distribute profits instead of reinvesting them).

<sup>43</sup> The total social benefit of antitakeover protections remains inconclusive. See Miroslava Straska & H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J. Fin. & Quantitative Analysis 933, 950 (2014) (reviewing forty years of studies and concluding that “[d]espite the considerable amount of time and attention devoted to examining how antitakeover provisions affect shareholders, the net effects of these provisions on shareholder wealth remain uncertain”).

<sup>44</sup> As early as 1999, corporate law scholars noted that “institutional investors had gone from expressing intense criticism of this device [the poison pill] to challenging particular aspects of its operation, in addition to seeking mandatory removal of it from the arsenal of corporate defenses.” See Matheson, *supra* note 38, at 704; see also Francis J. Aquila, *Adopting a Poison Pill in Response to Shareholder Activism*, PRACTICAL LAW: THE JOURNAL 22, 24–25 (Apr. 2016), [https://www.sullcrom.com/files/upload/Apr16\\_InTheBoardroom.pdf](https://www.sullcrom.com/files/upload/Apr16_InTheBoardroom.pdf).

<sup>45</sup> In today’s market, such a takeover would likely be dress-up as a “friendly” acquisition. See, e.g., Best Hostile Takeover Disguised as a Friendly Acquisition, BALTIMORE SUN (Sep. 16, 2014), <https://www.baltimoresun.com/citypaper/bcp-best-hostile-takeover-disguised-as-a-friendly-merger-20140916-story.html> (describing how Men’s Warehouse attempted to play down its bitter battle to acquire Jos. A. Bank after the \$1.8 billion deal went through); see also Roberta Romano, *The Future of Hostile Takeovers*, 57 U. CINN. L. REV. 457, 496, 497 (1988) (explaining that the associations around hostile takeovers—like layoffs—give companies an incentive to dress up hostile takeovers as friendly ones).

<sup>46</sup> See *infra* section I.B.

and stagnant wages, outlining the social consequences of the labor monopsony.<sup>47</sup> Simply put, the model predicts that when wages are abnormally low, shareholders will prefer weak governance to incentivize managers to take advantage of the discounted labor prices by investing. As more firms switch to weak governance and increase their investments, increased hiring will push wages up. A symmetric process kicks in when wages are abnormally high. Wages and governance structure thus form a feedback loop, resulting in a competitive equilibrium where a certain number of strong- and weak-governance corporations coexist and are equally profitable—and, importantly, where wages are determined competitively.<sup>48</sup>

Unlike in the competitive equilibrium, common owners push firms toward strong governance *regardless of prevailing labor prices*. Fewer firms with weak governance leads to lower investment, reduced demand for labor, and decreased wages.<sup>49</sup> Those firms that continue to invest (the remaining weak-governance firms) see increased profits due to the labor discount. And because common owners hold the entire portfolio of strong- and weak-governance firms, their portfolio value goes up. Importantly, common owners disable the mechanism—choice of governance structure—that normally drives wages back up when they are below their competitive rate. As a result, under common ownership, the model predicts wages will be persistently low without the need for collusion among firms. Finally, the labor monopsony means lower wages for employees and higher profits for shareholders, resulting in a wealth transfer from typically lower-income bracket wage-earners to higher bracket shareholders, thereby exacerbating income inequality.

This Article reframes the debate around common ownership and institutional investors by exposing this previously unremarked cost of common ownership. To be sure, while the existing literature lauds common ownership for reducing management agency costs, several scholars have argued that common owners engage in anticompetitive behavior in the *product* market (rather than the labor market), thereby harming *consumers*.<sup>50</sup> Because common owners hold stakes in competing corporations, they could allegedly benefit by incentivizing their portfolio companies to raise consumer prices by not competing with one another.<sup>51</sup> For instance, economists have noted anticompetitive effects of common ownership on the prices of airline tickets.<sup>52</sup> Such anticompetitive

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<sup>47</sup> See *infra* Part 0.

<sup>48</sup> See *infra* section III.C.

<sup>49</sup> See *infra* section III.D.

<sup>50</sup> See *infra* note 199 and accompanying text.

<sup>51</sup> See Hemphill & Kahan, *supra* note 26, at 1402–1403 (describing how common owners stand to gain by discouraging portfolio companies from competing with one another).

<sup>52</sup> The airline example is a loaded one, as the most significant empirical analysis tending to show monopolistic behavior among institutional owners studied the airline industry, concluding that common ownership was correlated with higher-than-average ticket prices on a route-level basis. See Azar et al., *supra* note 10, at 1518. But this study has been strongly challenged. See generally, e.g., Patrick Dennis et al., *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* (2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3063465](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3063465); Hemphill & Kahan, *supra* note 26, at 1397.

behavior would increase profits for shareholders, but would be costly for consumers and socially inefficient. However, the monopoly theory faces a key limitation: it requires common owners—like Blackrock and Vanguard—to take explicit or implicit steps to facilitate an illegal monopoly in the product markets.<sup>53</sup> As Professors Hemphill and Kahan showed, “for most [anticompetitive] mechanisms, there is either no strong theoretical basis for believing that institutional [common owners] could or would want to employ them, no significant evidence suggesting that they do employ them, or both.”<sup>54</sup> Absent the necessary evidence, it is difficult to conclude that institutional investors would or could rig the product markets for several decades without attracting regulatory or academic notice.

Instead, this Article argues that framing the costs and benefits of common ownership as the product of two distinct activities—promoting strong governance versus facilitating anticompetitive behavior—obscures the real costs of common ownership. Strong governance is not the benefit of common ownership against which we must weigh the anticompetitive costs. Rather, the costs and benefits of common ownership are *both* generated by institutional investors’ policy of pushing public corporations to adopt strong governance.

Viewed in this light, it is clear that the monopsony effect does not share the limitations of the monopoly theory. Common owners still increase shareholder profits at the expense of other stakeholders—not through illegal coordination in the pricing of products (output), but rather through strong governance resulting in monopsony pricing of labor (input).

Acknowledging the inherent tradeoff of strong governance—reducing management agency costs while creating a labor monopsony—present a difficult dilemma for policymakers. Should they side with employees or shareholders? If shareholders’ interests are the sole concern, nothing should be done. The power of common owners would continue to grow, and with it the effects of strong governance. If the interests of employees are the concern, however, then policymakers should act. To return markets to their previous competitive

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<sup>53</sup> See, e.g., Erik Gilje et al., *Who’s Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, 137 J. Fin. Econ. 152 (2020) (showing that properly measured, common ownership does not affect managers’ incentives to consider employing anticompetitive devices); Hemphill & Kahan, *supra* note 26, at 1402–1403 (2020) (providing a comprehensive challenge and criticism of the studies suggesting anticompetitive behavior by common owners); Edward Rock and Daniel Rubinfeld, *Does Common Ownership Explain Higher Oligopolistic Profits?* (June 15, 2020). Available at SSRN: <https://ssrn.com/abstract=3627474> (criticizing the anticompetitive monopolies claim and offering alternative explanations for the data); Thomas A. Lambert & Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors’ Common Ownership of Small Stakes in Competing Firms* (U. Mo. Sch L., Legal Studs. Rsch. Paper No. 2018-21, May 4, 2018), <https://ssrn.com/abstract=3173787> (criticizing the studies claiming that common ownership leads to anticompetitive monopolies); Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (N.Y.U. Sch. L. & Econ. Rsch. Paper Series No. 17-05, March 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2925855](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2925855) (criticizing the economic analysis and findings of the anticompetitive monopolies claim); John Morley, *Too Big to Be Activist*, 92 S. Cal. L. Rev. 1407 (2019) (explaining why large institutional investors cannot be activists).

<sup>54</sup> See Hemphill & Kahan, *supra* note 26, at 1400.

equilibrium, where labor and capital shared more equitably in corporate value, they should eliminate the monopsony effect of common owners.

To achieve this goal, this Article suggests breaking up the large institutional investors along two dimensions: type and size. Regarding type, institutional investors manage both passive and active investment funds. While passive investment funds are the classic common owners, buying and holding diversified portfolios, their power is increased by the shareholding of active funds under the same management. Separating passive and active funds' management would decrease the power of common owners and release active funds to generate competition. Turning to size, several institutional investors have assets under management (AUM) in the trillions of dollars. Limiting investors to holding no more than a half-trillion dollars in AUM would increase the number of institutional investors, encourage competition in the market, and readjust the balance of power between managers and shareholders as to governance structure. These shifts would reignite the incentives for corporate managers to increase corporate investment and labor demand, restoring the competitive equilibrium in the labor markets and leading to higher wages and greater economic equality.

This Article proceeds as follows. Part I describes the rise of common ownership and the shift toward strong governance. Part II presents the empirical evidence that the shift to strong governance has resulted in decreased investment and stagnant wages. Part III sets out an economic model that explains the link between governance structure and wages, and shows how common owners break the governance equilibrium by altering the balance of strong and weak governance companies. Part IV outlines the policy implications of the monopsony effect. Finally, the Conclusion will summarize.

## I. THE RISE OF COMMON OWNERSHIP

The move from retail to common ownership dramatically changed not only how corporations are owned, but how they are run. Retail shareholders—everyday folk holding stock in pensions or investment accounts—could not meaningfully participate in boardroom affairs or police corporate conduct.<sup>55</sup> By contrast, large asset managers like BlackRock and State Street have the power and sophistication to influence their portfolio companies.<sup>56</sup> Common owners have used this newfound influence to usher in an era of strong governance, pushing for measures that empower shareholders over managers.<sup>57</sup> As this Article will show, the shift from weak to strong governance, precipitated by the rise of common ownership, has had far-ranging consequences.

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<sup>55</sup> See Barbara Black, *Are Retail Investors Better Off Today*, 2 BROOK. J. CORP. FIN & COM. L. 303 (defining retail investors as “individual investors who, compared to institutional investors or wealthy individual investors, have modest portfolios, a lesser degree of investment acumen and less individualized attention from professional advisors”).

<sup>56</sup> See *supra* note 18 and accompanying text.

<sup>57</sup> See *infra* section I.B.

Section I.A describes how common owners unseated retail investors as the dominant force in the American equity markets. Section I.B. shows how common owners have used this influence to institute strong-governance measures that make directors and officers responsive to shareholders’ desires—and dependent on shareholders for their jobs.

#### A. *From Dispersed to Common Ownership*

The rise of common owners fundamentally changed the structure of the modern corporation. Under the classic Berle-Means model—where individual investors held just a few shares each—shareholders were a nonentity in the boardroom, and directors and officers ran corporations more or less exactly how they saw fit.<sup>58</sup> The posterchildren of this era were domineering corporate leaders like longtime Chrysler chief Lee Iacocca, whose initials were famously said to spell out “I am Chairman of Chrysler Corporation Always.”<sup>59</sup> Managers like Iacocca were free to build empires and hoard the private benefits of control, or otherwise, nurture bold visions of the future and undertake daring investments.<sup>60</sup> Common owners brought an end to the era of dominant and domineering managers by concentrating ownership in the hands of just a few financial institutions with the means and the inclination to involve themselves in corporate affairs.<sup>61</sup>

Despite their enormous size and influence, common owners are a relatively new invention. Sixty years ago, the three largest asset managers—BlackRock, State Street, and Vanguard, the so-called “Big Three”—did not exist.<sup>62</sup> Today,

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<sup>58</sup> See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (10th ed. Transaction Publishers, 2009) (describing the then-modern corporation as one owned by “a large body of security holders . . . who exercise virtually no control over the wealth which they or their predecessors in interest have contributed to the enterprise”). See generally Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (coining the term “Berle-Means corporation” and defining it as one with “fragmented shareholders buying and selling on the stock exchange”).

<sup>59</sup> *I Am Chairman Of Chrysler Corporation Always’: 8 Facts About Lee Iacocca*, REUTERS (July 2, 2019) <https://www.reuters.com/article/us-people-lee-iacocca-facts/i-am-chairman-of-chrysler-corporation-always-8-facts-about-lee-iacocca-idUSKCN1TY06X>.

<sup>60</sup> See Roe, *supra* note 58, at 14 (describing the criticism that, under dispersed ownership, “[m]anagers build empires and pursue bad strategies without shareholder intervention until matters are so out-of-hand that the violence of the hostile takeover or the instability of the leveraged buyout results”).

<sup>61</sup> See Gilson & Gordon, *supra* note 28, at 865 (noting that, because of the concentration of ownership in the hands of a few financial institutions, “the Berle-Means premise of dispersed share ownership is now wrong”).

<sup>62</sup> See *A Remarkable History*, VANGUARD, <https://about.vanguard.com/who-we-are/a-remarkable-history/> (last visited April 6, 2020) (noting that Vanguard was founded in 1975); *History*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/blackrock-history> (last visited Apr. 6, 2020) (noting that Blackrock was founded in 1988); *Our History*, STATE STREET GLOBAL ADVISORS, <https://www.ssga.com/us/en/individual/etfs/about-us/our-history> (last visited Apr. 6, 2020) (noting that State Street Global Advisors, the asset management arm of State Street, was founded in 1978).

their AUM exceed the GDP of China.<sup>63</sup> A few figures regarding types of common owners—mutual funds, pension funds, and insurance companies—help put the magnitude of this change into perspective. In 1965, American mutual funds, pension funds, and insurance companies held a relatively small fraction of the stock market: 5%, 6%, and 3% respectively, for a total of about 14%.<sup>64</sup> By 1980, these groups controlled about a quarter of the stock market, with pension funds alone holding 17.4%.<sup>65</sup> But by 2016, these three groups of institutional investors collectively held \$25 trillion, or over 50% of the market,<sup>66</sup> with mutual funds eclipsing the other groups at \$9.1 trillion in assets.<sup>67</sup> In other words, since 1965, institutional investors have gone from a relatively marginal percentage of the American stock market to holding most of the publicly traded stocks in the country.

Within this group of institutional investors, a few money managers wield especially significant influence.<sup>68</sup> For instance, in the commercial sector,

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<sup>63</sup> Blackrock, State Street, and Vanguard have \$7 trillion, \$5.6 trillion, and \$2.9 trillion in assets under management respectively, for a total of \$15.5 trillion. See David McLaughlin and Annie Massa, *The Hidden Dangers of the Great Index Fund Takeover*, BLOOMBERG BUSINESSWEEK (Jan. 9, 2020), <https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover>. The gross domestic product of China as of 2018 was \$13.6 trillion. *GDP (Current US\$)*, THE WORLD BANK, [https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?most\\_recent\\_value\\_desc=true](https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?most_recent_value_desc=true) (last visited Apr. 28, 2020).

<sup>64</sup> See BD. GOVERNORS FED. RSRV. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 1965–1974 at 95 tbl.L.213 (2014) [hereinafter Federal Reserve Tables 1965–1974], <http://www.federalreserve.gov/releases/z1/20140306/annuals/a1965-1974.pdf> (showing that the entire equity market of all U.S. public shares was worth less than \$750 billion at the time). Shares of U.S. corporations not held by institutional investors were held directly by the public or by large shareholders, including controlling shareholders. See John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?* 24 J. CORP. L. 837, 848 (1999) (discussing ownership patterns of U.S. corporations and noting the presence of controlling shareholders in an appreciable segment of the economy).

<sup>65</sup> James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, in 2 BROOK. PAPERS ON ECON. ACTIVITY 295, 313 tbl.5 (William C. Brainard & George L. Perry eds., 1995) (describing the changing pattern of stock ownership during the previous three decades, and the association between share price movements and consumption).

<sup>66</sup> See BD. GOVERNORS FED. RSRV. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 2005–2015 at 123 tbl.L.223 (2016), <https://www.federalreserve.gov/releases/z1/current/annuals/a2005-2015.pdf>.

<sup>67</sup> See Bespoke Investment Group, *U.S. Stock Market Tops \$25 Trillion - Up \$1.9 Trillion Since Election*, SEEKING ALPHA (Jan. 27, 2017), <https://seekingalpha.com/article/4040012-u-s-stock-market-tops-25-trillion-1-9-trillion-since-election> (detailing the total stock market capitalization for stocks in the Russell 2000 since 2002). As of September 2018, the total market capitalization of the S&P 500 companies was \$25.8 trillion. *S&P 500 Historical Total Market Cap & Float Adjusted Cap*, SIBLIS RSCH., <http://siblisresearch.com/data/total-market-cap-sp-500/> (last visited Oct. 21, 2018).

<sup>68</sup> See Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 55 (2013) (stating that three specific mutual funds dominate other mutual funds in terms of the size of assets under management).

BlackRock Funds holds approximately \$6.8 trillion in AUM,<sup>69</sup> Vanguard Group holds \$6.2 trillion,<sup>70</sup> State Street Global Advisors holds \$2.7 trillion,<sup>71</sup> Fidelity Investments holds \$3.3 trillion,<sup>72</sup> and Prudential Financial holds \$1.6 trillion.<sup>73</sup> The largest public pension funds are also, by any measure, enormous.<sup>74</sup> The Teachers Insurance and Annuity Association has over \$1 trillion in AUM,<sup>75</sup> and the California Public Employees' Retirement System's investment fund is valued at over \$355 billion.<sup>76</sup> Even *among* institutional investors, then, the market is highly concentrated. The largest twenty-five institutions hold more than 30% of all U.S. corporate shares,<sup>77</sup> and the largest ten managers hold the vast majority of those assets.<sup>78</sup>

As a result of their expansive holdings, institutional investors hold a dominant position in most public firms.<sup>79</sup> Their presence, considered in terms of ownership concentration, is even more pronounced in the largest corporations, with institutional shareholders owning on average over 70% of the stock in the 1000 biggest (by market cap) firms.<sup>80</sup> Here again, the largest institutions are the

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<sup>69</sup> *Introduction to BlackRock*, BLACKROCK, <https://www.blackrock.com/sg/en/introduction-to-blackrock> (last visited Sep. 17, 2020).

<sup>70</sup> *Fast Facts About Vanguard*, VANGUARD, <https://about.vanguard.com/who-we-are/fast-facts/> (last visited Sep. 17, 2020).

<sup>71</sup> *Who We Are*, STATE ST. GLOBAL ADVISORS, <https://www.ssga.com/na/us/institutional-investor/en/home.html> (last visited Oct. 21, 2018).

<sup>72</sup> *Fidelity by the Numbers: Asset Management*, FIDELITY, <https://www.fidelity.com/about-fidelity/our-company/asset-management> (last visited Sep. 17, 2020).

<sup>73</sup> *Prudential Financial Fact Sheet*, PRUDENTIAL, [http://www.news.prudential.com/press\\_file.cfm?presskit\\_id=68](http://www.news.prudential.com/press_file.cfm?presskit_id=68) (last visited Sep. 17, 2020).

<sup>74</sup> See Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 266–67 (2009) (describing public pension funds).

<sup>75</sup> *Who We Are*, TIAA, <https://www.tiaa.org/public/plansponsors/who-we-are> (last visited Sep. 17, 2020).

<sup>76</sup> *CalPERS Investment Fund Values*, CALPERS, <https://www.calpers.ca.gov/page/investments/asset-classes/trust-level-portfolio-management/investment-fund-values> (last visited Sep. 17, 2020). It is noteworthy that there were similar developments in the United Kingdom. See OFFICE FOR NAT'L STATISTICS, STATISTICAL BULLETIN: SHARE OWNERSHIP SURVEY 2008, at 4 tbl.A, 5 tbl.B (Jan. 27, 2010), <https://www.ons.gov.uk/ons/rel/pnfc1/share-ownership—share-register-survey-report/2008/share-ownership—share-register-survey-report—share-ownership.pdf> (suggesting that there is a growing presence of institutional investors).

<sup>77</sup> See Marcel Kahan & Edward B. Rock, *Anti-Activist Poison Pills* 20 (N.Y. Univ. Sch. L. & Econ. Rsch. Paper Series, Working Paper No. 17-08, 2017), <https://ssrn.com/abstract=2928883>.

<sup>78</sup> As of December 2016. Itzhak Ben-David et al., *The Granular Nature of Large Institutional Investors* 1 (Nat'l Bureau Econ. Rsch, NBER Working Paper No. 22247, 2017), <http://www.nber.org/papers/w22247.pdf>.

<sup>79</sup> See *id.*; Luis A. Aguilar, Commissioner, Sec. & Exch. Comm'n, Institutional Investors: Powers and Responsibilities, Speech at the Center for the Economic Analysis of Risk Workshop (Apr. 19 2013) (transcript available at <https://www.sec.gov/news/speech/2013-spch041913laahm>) (“Simply stated, institutional investors are dominant market players . . .”).

<sup>80</sup> See Matteo Tonello & Stephan Rabimov, THE CONF. BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 (2010), [http://shareholderforum.com/e-mtg/Library/20101111\\_ConferenceBoard.pdf](http://shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf) (showing that in



most prominently represented. The Big Three, when considered collectively, are the “single” largest shareholder in almost half of all publicly listed U.S. companies (1,662 out of approximately 3,900 firms), and most of the S&P 500 (438 out of 500 firms).<sup>81</sup> Institutional investors have thus consolidated their hold on the American stock market.

These institutions are big not only in terms of the size of their holdings, but also in terms of their breadth. To begin, the largest asset managers have between 80 and 97% of their equity invested in index funds, which necessarily hold wide-ranging portfolios.<sup>82</sup> But the holdings of large common owners are much broader even than that, encompassing mid-and small-cap companies including large ones. BlackRock, for instance, has a 5% or greater stake in more than 2,000 of the 3,900 publicly traded American corporations,<sup>83</sup> in addition to a robust private equity arm.<sup>84</sup> As a result, common owners act as “horizontal shareholders,” holding portfolios that span the entire economy.<sup>85</sup>

The dominance of horizontal shareholders has resulted in increasing overlap in the ownership of all major American corporations. For instance, in 1999, the odds that two public companies in the same industries shared a 5% owner were one in five. By 2014, that figure was nine out of ten—that is, 90% of public companies shared an owner that held at least 5% of each company.<sup>86</sup> The portfolios of common owners sometimes encompass entire industries; for example, horizontal shareholding is prevalent in the airline, banking, technology, and retail sectors.<sup>87</sup>

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2009, ownership concentration of institutional investors in the top 1000 U.S. corporations by market value was 73%). For instance, institutional investors currently hold 61.3% of Apple. *Apple Inc. (AAPL): Major Holders*, YAHOO! FIN., <https://finance.yahoo.com/q/mh?s=AAPL+Major+Holders> (last visited Oct. 21, 2018). Institutional investors also currently hold 74.6% of Microsoft. *See Microsoft Corporation (MSFT): Major Holders*, YAHOO! FIN., <https://finance.yahoo.com/quote/MSFT/holders?p=MSFT&.tsrc=fin-srch> (last visited Oct. 23, 2018).

<sup>81</sup> Jan Fichtner et al., *supra* note 11 at 311–13.

<sup>82</sup> *See id.* at 304. For example, funds that track the S&P 500 hold 500 of largest publicly traded American corporations representing some 80% of available market capitalization. *See S&P 500, S&P DOW JONES INDICES*, <https://us.spindices.com/indices/equity/sp-500> (last visited Apr. 28, 2020).

<sup>83</sup> Giovanni Stampelli, *Are Passive Index Funds Active Owners?*, 55 SAN DIEGO L. REV. 803, 811 (2018).

<sup>84</sup> *Private Equity*, BLACKROCK, <https://www.blackrock.com/institutions/en-us/strategies/alternatives/private-equity> (last visited Apr. 28, 2020).

<sup>85</sup> *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (describing “horizontal shareholding,” where large financial institutions hold significant shares in competing corporations, as pervasive).

<sup>86</sup> *See* José Azar, *Portfolio Diversification, Market Power, and the Theory of the Firm 2* (Univ. Navarro Bus. Sch., Working Paper No. 1170-E, Mar. 2017), <https://media.iese.edu/research/pdfs/WP-1170-E.pdf>. One study found that the level of overlap in stock ownership grew by more than fifteen times between 1980 and 2012. *See* Erik P. Gilje et al., *The Rise of Common Ownership* 19 (Apr. 19, 2018), [http://gccc.global/wp-content/uploads/2018/05/6.-Levit\\_The\\_Rise\\_of\\_Common\\_Ownership\\_June\\_6\\_2017P-1.pdf](http://gccc.global/wp-content/uploads/2018/05/6.-Levit_The_Rise_of_Common_Ownership_June_6_2017P-1.pdf).

<sup>87</sup> *See* Elhauge, *supra* note 85, at 1267–68.

Crucially, common owners do not content themselves to merely sit back and hold stocks on behalf of the clients who invest with them. While most of the funds held by common owners are invested in “passive” funds, common owners are far from passive when it comes to engaging with their portfolio companies.<sup>88</sup> Rather, they employ professionals such as portfolio managers and investment analysts to manage their holdings.<sup>89</sup> Moreover, they almost uniformly make a point of investment stewardship, making sure their investors’ money is safely parked in corporations that are, to their minds, effectively governed.<sup>90</sup> Scholars have noted the active engagement—both formal and informal—between the officers of asset managers and their portfolio companies.<sup>91</sup> One of the most prominent outcomes of this engagement has been the campaign for strong governance.<sup>92</sup>

### B. *The Push for Strong Governance*

While corporate law scholars have sometimes described institutional investors as “rationally reticent” to take an active approach to governing their portfolio companies,<sup>93</sup> common owners themselves sing a different tune. For example, William McNabb, Vanguard’s chief executive, commented in a letter to Vanguard’s portfolio corporations, “[S]ome have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth . . . We have no interest in telling companies how to run their businesses, but we have valuable governance insights to share with the board of directors.”<sup>94</sup> McNabb’s letter illustrates how, over the past four decades, common owners have reshaped the

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<sup>88</sup> See Hemphill & Kahan, *supra* note 26, at 1498 & n.139 (2020).

<sup>89</sup> See *id.* at 1421–22 (describing asset managers as agglomerations of different funds, with separate portfolio managers and investment advisors).

<sup>90</sup> See, e.g., *Principles and Policies*, VANGUARD, <https://about.vanguard.com/investment-stewardship/principles-policies/> (last visited Apr. 28, 2020) (“We engage company executives and directors in open dialogue to promote governance principles that support long-term value for our shareholders.”)

<sup>91</sup> See, e.g., Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2912 (2016) (surveying institutional investor personnel and finding “widespread use of private discussions [with portfolio firms] support[ing] the view that investors try to engage firms behind the scenes through direct negotiations, and take public measures (e.g., shareholder proposals, public criticism) only if these private interventions fail”).

<sup>92</sup> See Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 425 (2009) (“[I]nstitutional investors tend to acquire a significant portion of stock in a corporation to gain a measure of control in the corporation.”).

<sup>93</sup> For example, Gilson and Gordon argue that because institutional investors are designed to provide their clients with low-cost diversification, they will assign relatively low value to governance rights, and therefore will be “rationally reticent” toward the governance of their portfolio companies. See Gilson & Gordon, *supra* note 28 at 895.

<sup>94</sup> Letter from F. William McNabb III, Chairman & CEO, Vanguard, to Bds. Dirs. Vanguard Portfolio Cos. 1 (Feb. 27, 2015), [https://pcg.law.harvard.edu/wp-content/uploads/2016/09/7-CEO\\_Letter\\_03\\_02\\_ext.pdf](https://pcg.law.harvard.edu/wp-content/uploads/2016/09/7-CEO_Letter_03_02_ext.pdf).

corporate governance paradigm by pushing for strong-governance measures that give shareholders substantial control over corporate managers.<sup>95</sup>

Even the most “passive” of investors—index funds that mimic market portfolios such as the S&P 500—actively agitate for strong governance. One study found that companies with higher levels of index fund ownership were less likely to have takeover defenses or dual-class structures.<sup>96</sup> That is, increased index fund ownership, in this instance, leads to stronger governance. Of course, index funds cannot express dissent by selling, as they are constrained to maintain a market portfolio. However, they can—and do—vote, disproportionately in favor of measures that empower shareholders,<sup>97</sup> and mostly as part of one-size-fit-all voting policies.<sup>98</sup>

On the other hand, active funds, unconstrained in their trading, use the threat of exit—that is, selling—to influence corporate decisions.<sup>99</sup> When these funds use these tools, they also tend to use them to influence governance structure rather than short-term, operational goals.<sup>100</sup> In this way, passive and active common owners use different techniques to achieve the same strong governance shifts.

Common owners push firms towards increased shareholder rights, in particular advocating for governance mechanisms that allow shareholders to remove and discipline managers. The following measures are by no means exhaustive, but illustrate the broad governance changes common owners push on their wide-ranging portfolios.

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<sup>95</sup> See Zohar Goshen & Sharon Hanes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 277–82 (2019) (explaining how institutional investors have pushed for strong governance and shareholder empowerment, obviating to a large degree the need for courts to protect shareholders’ rights); Barry Burr, *Money Managers Increasing Activism on Governance—But Quietly*, Pensions & Investments (March 19, 2012), available at <https://www.pionline.com/article/20120319/PRINT/303199980/money-managers-increasing-activism-on-governance-but-quietly>.

<sup>96</sup> Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 114 (2016) [hereinafter, Appel et al., *Passive Investors*].

<sup>97</sup> *Id.* at 113–14.

<sup>98</sup> See, e.g., The voting guidelines of The Big Three. BlackRock, *Proxy Voting Guidelines for U.S. Securities*, BlackRock (Jan. 2019), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; Vanguard, *Vanguard Funds Proxy Voting Guidelines for U.S. Portfolio Companies*, Vanguard (April 1, 2019), [https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy\\_voting\\_guidelines.pdf](https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf); and State Street, Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, Harv. L. Sch. Forum. Corp. Gov. (Mar. 27, 2019), <https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america/>

<sup>99</sup> See generally McCahery et al., *supra* note 91 (surveying institutional investors and documenting their use of exit, the threat of exit, and “behind the scenes” discussions with boards and management to achieve governance goals).

<sup>100</sup> *Id.* at 2906.

### 1. Dual Class Structures.

Common owners oppose issuing classes of stock that create disparate voting rights.<sup>101</sup> Dual- or multi-class stock structures tend to entrench control in a few shareholders, often aligned with management.<sup>102</sup> For instance, using a dual-class structure, Mark Zuckerberg holds majority voting rights in Facebook even though institutional investors hold nearly 80% of its equity.<sup>103</sup> In this way, dual-class structures can block a firm’s equity majority owners—those holding more than half of the economic stake—from removing its managers; they are thus strong-governance kryptonite.<sup>104</sup>

Common owners have vocally—and successfully—lobbied against multi-class structures. For example, after Snap Inc.’s controversial decision to issue only stock with no voting rights in its 2017 initial public offering, institutional investors convinced stock indices to exclude dual-class firms altogether.<sup>105</sup> More recently, the Council of Institutional Investors, an industry group representing asset managers, has petitioned the New York Stock Exchange to require all dual-class firms already listed to transition over a period of seven years to a one-share one-vote model.<sup>106</sup>

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<sup>101</sup> See, e.g., Council of Institutional Investors, Dual-Class Enablers, available at: <https://www.cii.org/dualclassenablers>.

<sup>102</sup> See Blair Nicholas & Brandon Marsh, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 17, 2017), <https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/> (describing how dual-class structures “create a bulwark for managerial entrenchment”). Institutional Shareholder Services, an influential advisor to common owners, recommends voting down proposals to create new classes of stock with disparate voting rights. INSTITUTIONAL S’HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES: BENCHMARK POLICY RECOMMENDATIONS 30 (2019) <https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf>.

<sup>103</sup> Facebook Inc, CNN BUS., <https://money.cnn.com/quote/shareholders/shareholders.html?symb=FB&subView=institutional> (last viewed Mar. 19, 2020); see also *supra* notes 153–155 and accompanying text.

<sup>104</sup> A number of studies have found that a dual-class structure encourages management to invest in innovation. See Lindsay Baran et al., *Dual Class Share Structure and Innovation* (U. Tex. Rio Grande Valley Robert C. Vacker Coll. Bus. & Entrepreneurship, Acct. Fac. Publ’ns & Presentations, December 8, 2019), [https://scholarworks.utrgv.edu/cgi/viewcontent.cgi?article=1005&context=account\\_fac](https://scholarworks.utrgv.edu/cgi/viewcontent.cgi?article=1005&context=account_fac) (finding a positive association between disproportionate insider control and patent output, quality, and creativity; the efficient use of R&D in innovation; and patent filings by managers, representing personal innovative risk); Xiaoyan Cheng et al., *Investment Efficiency: Dual-Class vs. Single-Class Firms*, 45 GLOBAL FIN. J. 1 (2020) (finding that dual-class firms invest more efficiently than single-class peers); Xiaping Cao, et al., *The Innovation Effect of Dual-Class Shares: New Evidence from U.S. Firms*, 91 ECON. MODELLING 347 (2020) (finding dual-class shares have significant innovation effect in high-tech sectors, hard-to-innovate industries, firms with higher external takeover threat, and firms heavily dependent on external equity financing).

<sup>105</sup> See Goshen & Hannes, *supra* note 95, at 281–82.

<sup>106</sup> Letter from Council Institutional Invs. to Elizabeth King, Chief Regul. Off., Intercontinental Exch. Inc. 1 (Oct. 24, 2018), [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf).

## 2. *Poison Pills.*

Poison pills restrict shareholders' right to sell to a hostile buyer, preventing potential raiders from taking over a company without board approval.<sup>107</sup> Practically, selling to a raider who intends to replace the board amounts to a shareholder vote to fire the management. Thus, common owners see poison pills as entrenching boards and preventing shareholders from holding corporate managers accountable by selling.<sup>108</sup> Indeed, while poison pills became widely popular after they were invented by Marty Lipton in the 1980s,<sup>109</sup> they have since come under fire from institutional investors. Not only do proxy advisors suggest voting against poison pills, they recommend voting against any *director* who votes to adopt one without shareholder approval.<sup>110</sup> Consequently, the 299 S&P 500 companies that maintained poison pills in 2000 dwindled to 17 by 2017.<sup>111</sup>

## 3. *Staggered Boards.*

Staggered or classified boards are elected in classes: a third of the board comes up for election each year, rather than all at once.<sup>112</sup> As such, they entrench corporate managers by preventing shareholders from replacing the entire board at once.<sup>113</sup> A shareholder that gains control of a company with a staggered board must wait for two rounds of annual elections of directors to gain a board majority.<sup>114</sup> Because of their entrenching effect, staggered boards have drawn

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<sup>107</sup> Effectively, poison pills stand between a willing seller—the shareholder—and a willing buyer—the tender offeror. See Scott Hirst, *The Wrong Prescription? Revisiting the Justification for Poison Pills*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 18, 2009), <https://corpgov.law.harvard.edu/2009/11/18/the-wrong-prescription-revisiting-the-justification-for-poison-pills/>.

<sup>108</sup> See Aquila, *supra* note 44, at 24–25.

<sup>109</sup> David Futrelle, *Corporate Raiders Beware: A Short History of the “Poison Pill” Takeover Defense*, TIME (Nov. 7 2012) <https://business.time.com/2012/11/07/corporate-raiders-beware-a-short-history-of-the-poison-pill-takeover-defense/>.

<sup>110</sup> See Aquila, *supra* note 44, at 25.

<sup>111</sup> Michael Useem, *The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board*, in THE SAGE HANDBOOK OF CORPORATE GOVERNANCE 136, 143 (Thomas Clarke & Douglas Branson eds., 2012).

<sup>112</sup> See THOMSON REUTERS, *Staggered Board of Directors* (Practical Law Glossary Item 7-382-383, 2020) (defining a staggered or classified board as a “board which is comprised of directors that have different overlapping, multi-year terms, so that not all of the directors' terms expire in the same year.”).

<sup>113</sup> See Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 528 (2007) (concluding that “classified boards benefit management at the expense of shareholders” and “a movement toward greater accountability demands the destaggering of corporate boards”).

<sup>114</sup> See *Carmody v. Toll Bros.*, 723 A.2d 1180, 1186 (Del. Ch. 1998) (noting that “a classified board would delay—but not prevent—a hostile acquiror from obtaining control of the board”).

the ire of common owners.<sup>115</sup> Consequently, institutional investors provided the momentum for the “de-staggering movement”<sup>116</sup> that left fewer than 10% of the S&P 500 corporations with staggered boards in 2017,<sup>117</sup> compared to 60% in 2002. This made the boards and management of major companies more exposed to shareholders’ discontent.<sup>118</sup>

#### 4. Support for Activist Investors.

Activist hedge funds, which have gained dominance in the market over the last two decades,<sup>119</sup> have carved out a market niche by acquiring stakes in underperforming firms and implementing measures to boost performance.<sup>120</sup> While common owners do not normally agitate for operational change at their portfolio firms, activist owners do—and common owners tend to support them, especially when the proposed changes align with their governance agenda.<sup>121</sup> The presence of common owners makes it more likely that an activist hedge fund will (successfully) try to replace a company’s managers.<sup>122</sup> Support for hedge

<sup>115</sup> See Guhan Subramanian, *Delaware’s Choice*, 39 DEL. J. CORP. L. 1, 13 (2014) (claiming that institutional investors dislike staggering boards because it leaves them with “‘little recourse’ in the everyday course of business against specific directors that they wish to punish”).

<sup>116</sup> Lucian Bebchuk et al., *Toward Board Declassification in 100 S&P 500 and Fortune 500 Companies: The SRP’s Report for the 2012 and 2013 Proxy Seasons*, Harv. L. Sch. F. on Corp. Governance (Feb. 25, 2014), <https://corpgov.law.harvard.edu/2014/02/25/toward-board-declassification-in-100-sp-500-and-fortune-500-companies-the-srps-report-for-the-2012-and-2013-proxy-seasons/>.

<sup>117</sup> *Governance Trends at Russell 2000 Companies*, BOARD MATTERS Q., Jan. 2017, at 4 [https://www.ey.com/publication/vwluassetsdld/boardmattersquarterly\\_04552-161us\\_january2017/\\$file/boardmattersquarterly\\_04552-161us\\_january2017.pdf](https://www.ey.com/publication/vwluassetsdld/boardmattersquarterly_04552-161us_january2017/$file/boardmattersquarterly_04552-161us_january2017.pdf) (91% of S&P 500 companies have annual elections rather than staggered elections).

<sup>118</sup> Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422 (2017) (finding that staggered boards promote value creation for some firms by committing the firms to undertaking long-term projects and bonding them to the relationship-specific investments of their stakeholders).

<sup>119</sup> Activist hedge funds grew from less than three billion dollars in AUM in 2000 to almost \$200 billion in 2015. See AIMA & SIMMONS & SIMMONS, UNLOCKING VALUE: THE ROLE OF ACTIVIST ALTERNATIVE INVESTMENT MANAGERS 12, <http://www.sewkis.com/wp-content/uploads/9386e594-838e-46c0-a842-3d914714aee3.pdf>; Paula Loop, et al., *The Changing Face of Shareholder Activism*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Feb. 1, 2018), <https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/>. Meanwhile, activist events increased from less than fifty in 1999 to almost 500 in 2007. J.P.MORGAN, *Shareholder Activism and the Implications for Investors* 1 (Feb. 12, 2014), <https://www.jpmorgan.com/jpmpdf/1320668288894.pdf>

<sup>120</sup> See generally Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (using a novel data set to chronicle the acquisition and proxy behavior of activist hedge funds).

<sup>121</sup> See Ian R. Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 REV. FIN. STUDS. 2720, 2752 (2019) [hereinafter Appel et al., *Giants*] (“[W]e only find . . . increased activists’ successes in areas that passive investors view as beneficial for their long-term interests; in particular, effective boards, good governance, and a strong market for corporate control.”).

<sup>122</sup> *Id.*

fund activists is therefore a strong governance mechanism in its own right, putting managers at the mercy of their shareholders.

However, hedge fund activism—and its support among common owners—has a more direct impact on governance. Hedge funds often use weak governance as an excuse to mount activist campaigns against corporate management.<sup>123</sup> Activist campaigns are more likely to succeed when they align themselves with common owners, particularly by advocating for board efficiency and independence and against takeover defenses.<sup>124</sup> In other words, hedge funds do the work of fighting for stronger shareholder rights, with passive owners supporting them from the sidelines.

The four mechanisms detailed above are by no means exhaustive of common owners' campaign for strong governance.<sup>125</sup> However, these mechanisms and many others—pushed as part of a one-size-fits-all policy to strengthen corporate governance across the board<sup>126</sup>—serve to subject managers to their shareholders' will. Consequently, it is no exaggeration to say that common owners have reshaped the corporate hierarchy, putting shareholders at the top. Part II shows how this fundamental shift has led to a downturn in investment, with inauspicious effects for American workers.

## II. STRONG GOVERNANCE AND LABOR MARKET MONOPSONY

The rise of common ownership coincided with a troubling shift in the American labor market. While workers became more and more productive, wages stopped growing.<sup>127</sup> Even as firms enjoyed blockbuster profits and

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<sup>123</sup> See Brav et al., *supra* note 120, at 1744–45 (“Governance issues, including rescinding takeover defenses, ousting CEOs, promoting board independence, and curtailing executive compensation, are also commonly cited as reasons for activism.”).

<sup>124</sup> See *supra* note 121 and accompanying text.

<sup>125</sup> For example, “[a]nnual director elections, majority vote rules for director elections, shareholder approval for poison pills, and proxy access bylaws are some of the critical governance practices that have become common practice thanks to investor support,” as one booster put it. See, Kosmas Papadopoulos, *The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 6, 2019). A more skeptical observer described how activists have used the “rhetorical high ground” of director accountability to push for special meetings power, the ability to act through majority consents, the elimination of supermajority requirements, and more. Latham & Watkins LLP, *Future of Institutional Share Voting: Three Paradigms*, CORP. GOVERNANCE COMMENT. (July 2010), [https://www.lw.com/upload/pubcontent/\\_pdf/pub3617\\_1.pdf](https://www.lw.com/upload/pubcontent/_pdf/pub3617_1.pdf). The larger point is that institutional investors support a diverse and rapidly evolving group of strong-governance measures including those mentioned here, the effect of which is to put the fate of directors more and more into the hands of their shareholders.

<sup>126</sup> See Rose, *supra* note 30 at page 917 (describing how institutional shareholders, with the help of governance advisory firms, have developed a “one-size-fits-all model [that] essentially standardizes corporate governance and discourages company-specific (or even industry-specific) governance policies”).

<sup>127</sup> Simcha Barkai, *Declining Labor and Capital Shares*, 75 J. FIN. 2421, 2454 (2020) (“The decline in the labor share since the early 1980s measures the growing gap between labor productivity (which has continued to grow) and compensation (which has stagnated).”).

growing profit margins,<sup>128</sup> income inequality climbed to its highest levels since the Roaring Twenties.<sup>129</sup> Moreover, wage elasticity—a measure of labor market competitiveness—has fallen over recent decades, suggesting that employers have cartelized the labor market.<sup>130</sup> So far, scholars who have pointed to common ownership as a cause of stagnating wages and rising income inequality focused on product market monopolies and concentration.<sup>131</sup> A theory which is highly debated.<sup>132</sup> Thus, despite the magnitude of the shift to common ownership, observers have failed to find convincing explanation linking it to the struggling labor market.<sup>133</sup> After all, if common owners were rigging the market—against either workers or consumers—one would think they would leave some traces.<sup>134</sup> If common owners are indeed the source of labor market malaise, where is the evidence?

This Article provides a simple answer: Because of their size and influence, common owners need not *act* like a cartel in order to bring about a cartel’s effects. Instead, those effects flow naturally from common owners’ push for strong governance. Under strong governance, both loyal and disloyal managers will refrain from investing, for fear that shareholders will (mis)perceive their investments as inefficient pet projects.<sup>135</sup> A rational manager—regardless of loyalty— will distribute profits instead of investing under a strong-governance regime, so as to avoid running afoul of shareholders and risking termination.<sup>136</sup> By pushing firms toward strong governance, then, common owners create an investment shortfall.<sup>137</sup> Less investment means less hiring,<sup>138</sup> less hiring means

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<sup>128</sup> See *id.* at 2434 fig.3 (modeling firms “profit share”—profits over gross value added—to show it has grown at least since the 1980s). “The profit margin for the S&P 500 Index, or income as a percentage of revenue, swelled to 10.2% in 2018, the highest since 1990. The ratio of corporate profits as a percentage of GDP hit the highest on record in 2012, according to the U.S. Bureau of Economic Analysis, and that ratio has remained elevated.” Kaissar, *supra* note 2.

<sup>129</sup> See *infra* note 191 and accompanying text.

<sup>130</sup> One set of researchers surveyed recent scholarship of wage elasticity and found that “even if one takes a conservative approach and believes the studies with weaker findings, it remains clear that monopsony causes considerable harm both to the economy and to workers.” See, Suresh Naidu et al., *supra* note 25, at 568.

<sup>131</sup> See, Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8, and Azar et al, *supra* note 10.

<sup>132</sup> See the studies cited *supra* note 53.

<sup>133</sup> See, Gutiérrez and Philippon, *supra* note 25, page 8 (noting that “the exact mechanisms through which common ownership reduces competition remain to be identified”).

<sup>134</sup> See Hemphill & Kahan, *supra* note 26, at 1426 (noting that the anticompetitive effects of common ownership, “if important in practice, would leave a visible trace.”).

<sup>135</sup> See *infra* notes 143–147 and accompanying text.

<sup>136</sup> *Id.*

<sup>137</sup> See, e.g., Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8 (finding that the lack of investment represents a reluctance to invest despite high Tobin’s Q (a measure of profitability) and that the investment wedge is linked to the rise of intangibles, decreased competition and changes in governance that encourage payouts instead of investment).

<sup>138</sup> See *supra* note 34 and accompanying text. Indeed, investment in technology and innovation can decrease employment (say, a development of a robot). This is the essence of the theory associating technology to the decreased investment and labor share. However, an empirical study has found that this effect can only explain 25-35% of the drop in investment. See Gutiérrez



lower labor demand,<sup>139</sup> and lower labor demand leads to stagnant wages.<sup>140</sup> Thus, common owners' push for strong governance exacerbates—if it does not altogether cause—the labor market stagnation of the last forty years.

The previous Part showed how the market has shifted from retail to primarily common ownership, and how common owners have brought on an era of strong governance. This Part marshals empirical evidence to argue that strong governance holds wages below their competitive level, effectively denying workers the fruits of their labor. The empirical evidence for the monopsony effect can be broken into two categories: evidence that strong governance has led to an investment shortfall, and evidence that the labor market has become less competitive due to the influence of common owners. Section II.A looks at the former, first explaining the mechanism by which strong governance reduces investment, and then looking at empirical evidence that proves common owners have indeed had this effect. Section II.B. looks at the latter category of evidence, showing how stagnant wages and rising income inequality can be attributed directly to common owners. Finally, Section II.C details how common owners benefit from the wage discount, and why their presence is necessary to explain the monopsony effect. Together, these observations supply a coherent explanation for rising inequality and stagnating wages over the past four decades: by pushing for strong governance, common owners have created a sluggish labor market that allows shareholders to capture increases in productivity, causing profits to soar even as wages stall.

#### A. *Strong Governance and Investment*

With shareholders essentially absent from the boardroom prior to the 1980s, managers could invest as if nobody was watching.<sup>141</sup> Loyal managers would invest in good projects that increase firm value, and disloyal managers in bad ones that shower them with private benefits. Now, however, shareholders are watching closely, meaning managers are less likely to invest.<sup>142</sup> Empirical evidence shows that strong governance has indeed resulted in a serious investment shortfall, which in turn hamstring wages and redirects wealth from labor to capital.

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& Philippon, *Investmentless Growth*, *supra* note 8. The rest is explained by common ownership and governance.

<sup>139</sup> See generally Daniel S. Hamermesh, *New Measures of Labor Cost: Implications for Demand Elasticities and Nominal Wage Growth*, (Nat'l Bureau Econ. Rsch., NBER Working Paper No. 821, Dec. 1981), <https://www.nber.org/papers/w0821.pdf> (measuring labor elasticity, or the responsiveness of labor prices to labor demand).

<sup>140</sup> See *infra* section II.B.

<sup>141</sup> See *supra* notes 58–61 and accompanying text.

<sup>142</sup> See *supra* note 32 and accompanying text.

1. *The Manager's Dilemma: To Invest, or Not to Invest?*

Managers, broadly, face a choice between two options: reinvest any surplus cash in projects that will hopefully pay off later, or distribute that surplus to shareholders in the form of dividends and buybacks.<sup>143</sup> When shareholders do not interfere, managers can make this decision based on their best judgment and conscience: loyal managers will make beneficial, efficient investments and disloyal managers will make destructive, inefficient investments and consume private benefits.<sup>144</sup> However, when shareholders are breathing down managers' necks, this choice is much more fraught. An investment that causes shareholders to doubt a CEO's loyalty could cost the CEO's job.<sup>145</sup> Under strong governance, then, managers will disproportionately choose to distribute profits.<sup>146</sup>

Key to this insight is the fact that shareholders are imperfect judges of manager performance and loyalty: being human, they will sometimes make mistakes.<sup>147</sup> Even sophisticated investors can mistake a loyal manager for a disloyal one. Steve Jobs' early tenure at Apple is illustrative.<sup>148</sup> Jobs was the company's visionary, but was notoriously difficult to work with, and lost his job after the board of directors sided against him and with the CEO. More than a decade later, he took back the helm of the company as it teetered on the edge of bankruptcy and reasserted Apple's tech dominance by releasing the iMac.<sup>149</sup>

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<sup>143</sup> See William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (Sept. 2014), <https://hbr.org/2014/09/profits-without-prosperity> (describing how the "retain-and-reinvest" approach to corporate resource allocation gave way to a "distribute-and-downsize" approach in the 1970s).

<sup>144</sup> See, e.g., Jarrad Harford, et al., Corporate Governance and Firm Cash Holdings in the US, 87 J. Fin. Econ. 535 (2008) (finding that in the US, weakly controlled managers choose to spend cash quickly on acquisitions and capital expenditures, rather than hoard it); Matthew T. Billett et al., *The Influence of Governance On Investment: Evidence from A Hazard Model*, 102 J. Fin. Econ. 643 (2011) (findings that poor governance associates with overinvestment).

<sup>145</sup> See, e.g., Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, *The Real Effects of Share Repurchases*, 119 J. Fin. Econ. 168 (2016) (finding that managers are willing to trade off investments and employment for stock repurchases that allow them to meet analyst earning per share forecasts); Huasheng Gao, Jarrad Harford, and Kai Li, *CEO Turnover-Performance Sensitivity in Private Firms*, 52 J. Fin. & Quant. Anal. 583 (2017) (finding that CEOs in public firms have higher turnover rates and exhibit greater turnover-performance sensitivity than private firms, mainly due to investors' myopia).

<sup>146</sup> See, Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8, page 4 (showing that firms with higher passive institutional ownership have higher payouts and lower investment); Todd A. Gormley & David A. Matsa, *Playing It Safe? Managerial Preferences, Risk, and Agency Conflicts*, 122 J. FIN. ECON. 431, 432 (2016) (arguing that managers are motivated by their career concerns to "play it safe" by taking on less risk—and thus lower return—than shareholders would prefer in order to avoid being fired).

<sup>147</sup> See Goshen & Squire, *supra* note 20, at 803 ("[I]nvestors could misattribute disloyalty, bad measurements, or bad luck to incompetence, and then generate principal costs by firing a competent manager."); Roe, *supra* note 58, at 13–14 ("[D]ispersed investors cannot cheaply distinguish egoistic empire-building from a high net present value project.").

<sup>148</sup> See Matt Weinberger, *This Is Why Steve Jobs Got Fired from Apple—and How He Came Back to Save the Company*, BUSINESS INSIDER (July 31, 2017), <https://www.businessinsider.com/steve-jobs-apple-fired-returned-2017-7>.

<sup>149</sup> *Id.*

Even sophisticated and deeply informed directors with a real stake in Apple's continuing performance were wrong about Jobs: in spite of his domineering attitude and exacting attention to detail, he was a good bet.<sup>150</sup> Managers of institutional investors, in their capacity as shareholders, spread their attention across hundreds or thousands of portfolio corporations, and consequently are perhaps even more likely to make these types of mistakes than Apple's onetime directors.<sup>151</sup>

By maintaining the status quo, disloyal (loyal) managers eliminate the possibility they will be perceived (misperceived) as disloyal and fired. Even for loyal managers, undertaking a complex, long-term, or innovative investment project introduces a chance of failure, reprimand, and removal.<sup>152</sup> Thus, under strong governance, CEOs will rationally choose to distribute profits instead of taking a career risk by reinvesting them.

By contrast, the managers of weak-governance firms do not have to worry about being removed by shareholders, whether in response to an inefficient investment or to a bold, visionary one. Another tech company—Facebook—illustrates the point. In 2019, Facebook's Chairman and CEO Mark Zuckerberg introduced the cryptocurrency project Libra as an important new objective for the company and a revolution in digital finance. Critics saw it as a pet project with no apparent benefits to the company.<sup>153</sup> The same month that Facebook announced Libra, outside investors attempted to strip Zuckerberg of the chairmanship as a check on his leadership. More than two-thirds of outside investors voted in favor of the move.<sup>154</sup> However, while Zuckerberg owned only a small minority of Facebook's economic value, he held 58% of its voting power by virtue of a dual-class structure, and he easily blocked the measure.<sup>155</sup> Of course, only time will reveal who was right, but the Libra saga illustrates that in weak-governance firms such as Facebook, managers can invest in projects they see as worthwhile, without worrying that shareholders might disagree—and fire them.

In sum, because shareholders can remove managers under strong governance, those managers generally will refrain from investing, and choose

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<sup>150</sup> See Goshen & Hamdani, *supra* note 20 at 580 (citing Jobs as an example of idiosyncratic vision being inefficiently disrupted by shareholders).

<sup>151</sup> John C. Wilcox & Morrow Sodali, *Getting Along with BlackRock*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 6, 2017), <https://corpgov.law.harvard.edu/2017/11/06/getting-along-with-blackrock/> (noting that BlackRock's "Investment Stewardship" team of thirty employees votes in about 17,000 shareholder elections and meets with 1,500 companies each year).

<sup>152</sup> See Goshen & Squire, *supra* note 20, at 786–87.

<sup>153</sup> See Lionel Laurent, *Facebook's Answer to Bitcoin Poses a Double Threat*, BLOOMBERG OPINION (June 17, 2019), <https://www.bloomberg.com/opinion/articles/2019-06-17/facebook-libra-crypto-currency-is-another-zuckerberg-threat> (nothing that the "bid to launch an online payments revolution carries plenty of risks, from antitrust concerns to the threat that it might pose to financial stability").

<sup>154</sup> See Betsy Atkins, *Facebook Strong Arms Investors Who Want Zuckerberg Out*, FORBES (June 7, 2019) <https://www.forbes.com/sites/betsyatkins/2019/06/07/facebook-strong-arms-investors-who-want-zuckerberg-out/#37f0d85b5901>.

<sup>155</sup> *Id.*

instead to distribute any excess cash. In weak-governance companies, managers can invest according to their business sense and conscience (loyal or disloyal) without worrying about discipline from shareholders, and are likely to invest more. This logic predicts that, by moving firms *en masse* towards strong governance, common owners will create an investment shortfall. Indeed, the following section shows that they have done just that.

## 2. Strong Governance and the Investment Shortfall

Since the 1980s, investment as a portion of the U.S. gross domestic product has fallen, even as the rest of the world continues to invest at or near historic levels.<sup>156</sup> The nature of this downturn suggests that strong governance is to blame; consistent with the monopsony effect, firms are funneling free cash to shareholders instead of investing it. Moreover, strong-governance firms invest less than their counterparts.

The form of the investment shortfall suggests that common owners are in fact its cause.<sup>157</sup> Firstly, the timing works out: investment as a share of GDP has declined at least since the early 2000s,<sup>158</sup> as common ownership steadily grew,<sup>159</sup> and hedge fund activism has gained dominance in the market.<sup>160</sup> Rather than reinvest profits, firms in the past two decades have increasingly distributed them to shareholders, including through share buybacks.<sup>161</sup> Moreover, in industries with high proportions of common ownership, one study found, “firms

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<sup>156</sup> *Total Investment (% of GDP)*, THE WORLD BANK, [https://tdata360.worldbank.org/indicators/inv.all.pct?country=USA&indicator=345&viz=line\\_chart&years=1980,2024](https://tdata360.worldbank.org/indicators/inv.all.pct?country=USA&indicator=345&viz=line_chart&years=1980,2024) (last visited Apr. 14, 2020).

<sup>157</sup> See, Gutiérrez and Philippon, *supra* note 25, (finding that higher quasi-indexer, common owners, ownership *leads* to higher buybacks and less investment).

<sup>158</sup> Lee et. al. find the decline already started in the middle of the 1990s. See, Dong Lee, Hyun-Han Shin, and Rene Stulz, *Why Does Capital No Longer Flow More to the Industries with the Best Growth Opportunities?* (December 4, 2016). Available at SSRN: <https://ssrn.com/abstract=2839832> (showing that since the middle of the 1990s, firms in high q industries increasingly repurchase shares and decrease capital expenditures).

<sup>159</sup> See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8.

<sup>160</sup> Brian Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds* 34 (U. Cambridge Fac. L., Legal Studs. Rsch. Paper Series No. 38/2011, Sep. 2011) (addressing the rise to prominence of hedge fund activism in the 2000s), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1932805](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1932805).

<sup>161</sup> See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8; Kathleen Kahle and René M. Stulz, *Why Are Corporate Payouts So High in the 2000s?* NBER Working Paper No. 26958, (August 2020), available at <https://www.nber.org/papers/w26958> (finding that inflation-adjusted amount paid out through dividends and repurchases by public industrial firms is three times larger from 2000 to 2018 than from 1971 to 1999); Ilan Strauss and Jangho Yang, *The Global Investment Slowdown: Corporate Secular Stagnation and the Draining of the Cash Flow Swamp*, OMPTEC Working Paper No. 2019-5 (2019) available at <https://www.oxfordmartin.ox.ac.uk/downloads/academic/The-Global-Investment-Slowdown.pdf> (finding that firms are increasingly net external ‘releasers’ of funds to shareholders, creditors, and bondholders, reflecting cross-cutting exogenous factors creating a chronic excess of cash flow over weakening investment opportunities).

spend a disproportionate amount of free cash flows buying back their shares.”<sup>162</sup> That is, firms in industries with more concentrated ownership invest even less than the norm. In sum, economic trends suggest that firms are investing less than they once did *because of the influence of common owners*.

Indeed, empirical studies support the claim that companies are reducing investments because of the influence of strong governance.<sup>163</sup> Increased shareholder rights are associated with lower capital expenditures,<sup>164</sup> and less R&D spending.<sup>165</sup> More recent studies have confirmed the negative correlation between strong governance and investment, finding, as one example, that strong-governance firms less frequently make large investments.<sup>166</sup> In short, firms with more empowered shareholders invest less, supporting the hypothesis that strong governance is to blame for the investment shortfall.<sup>167</sup>

The fact that investment has declined even as profits-per-worker have increased provides further evidence that common owners are to blame. In 2019, companies captured \$15,000 *more* in profits for each worker than they did in 1980—an increase in corporate profits totaling \$13 trillion.<sup>168</sup> With labor so profitable, firms in a competitive economy would hire more workers and undertake additional investment projects; investment would be going *up*, not down. Instead, investment has trended steadily downward since the 2000s.<sup>169</sup> This Article offers a simple explanation: regardless of the opportunities available, few managers will reinvest profits if the risk for being misperceived as building empires or undertaking pet projects is termination.<sup>170</sup>

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<sup>162</sup> GERMÁN GUTIÉRREZ & THOMAS PHILIPPON, DECLINING COMPETITION AND INVESTMENT IN THE U.S. 1 n.1 (March 2017), [https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Macro%20Lunch/IK\\_Comp\\_v1.pdf](https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Macro%20Lunch/IK_Comp_v1.pdf) [hereinafter Gutiérrez & Philippon, Declining Competition].

<sup>163</sup> The discussion above excludes the effects of governance on mergers and acquisitions because while strong governance decreases inefficient *buying* of other corporations (a demand side effect) it increases efficient *selling* of corporations (a supply side effect). It is inconclusive which effect dominates. Moreover, the welfare effects of merger are also unresolved. See, Bronwyn H. Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 69, 70 (Alan J. Auerbach, ed., 1988) (available online at <https://www.nber.org/chapters/c2053.pdf>) (“The question whether increased merger activity is a good thing for the economy in general remains unresolved and unlikely to be resolved by focusing solely on the experience of the firms involved.”).

<sup>164</sup> Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 133–34.

<sup>165</sup> See Tao-Hsien Dolly King & Min-Ming Wen, *Shareholder Governance, Bondholder Governance, and Managerial Risk-Taking*, 35 J. BANKING & FIN. 512, 513 (2011), and the studies cited *supra* note 39.

<sup>166</sup> Matthew T. Billet et al., *The Influence of Governance on Investment: Evidence from a Hazard Model*, 102 J. FIN. ECON 643, 644 (2011) (“[W]eak shareholder protection (managerial entrenchment)[] associates with more frequent investment spikes”).

<sup>167</sup> See Gutiérrez & Philippon, *Investmentless Growth*, *supra* note 8, page 30 (estimating that common ownership and governance explain 80% of the reduced investment effects).

<sup>168</sup> See Barkai, *supra* note 127, at 2.

<sup>169</sup> See *supra* note 156 and accompanying text.

<sup>170</sup> See *supra* section 1.

Declining investment has had profound economic consequences. Lower investment across the board means less hiring, and less hiring means lower wages. The following section shows how reduced investment has created a wage monopsony, taking money out of the pockets of workers and putting it in the hands of shareholders.

### B. *Strong Governance and Wage Stagnation*

The previous section shows how strong governance has created an investment shortfall, which naturally reduces hiring. This section looks at direct evidence linking wage stagnation to common ownership. Because firms do not have to pay workers their competitive rates, shareholders are taking a greater cut of the revenues, causing corporate profits to soar even as employee earnings fail to budge. Consistent with the monopsony effect, these trends suggest a cartelization of the labor market that shifts wealth from labor to capital.

Notably, the monopsony effect makes a powerful set of predictions that are borne out in labor market data.<sup>171</sup> In particular, it predicts that pay will remain fixed even as worker productivity rises, resulting in stagnant wages and increasing income inequality. Under common ownership, even when workers become more productive—that is, when their marginal productivity increases—firms will *still* refrain from increased hiring because the strong-governance regime makes investing (hiring) risky for managers.<sup>172</sup> Hiring and wages will remain fixed even as marginal productivity rises, with shareholders capturing the difference. The monopsony effect thus offers a single, coherent explanation for decreasing investment, rising corporate profits, sluggish wage growth, and the widening gap between productivity and pay.

The so-called “productivity-pay gap” provides perhaps the most damning evidence of the monopsony effect.<sup>173</sup> Before the 1980s, the higher their marginal output, the more workers were paid.<sup>174</sup> Since then, wages and productivity have drifted apart, a telltale sign of anticompetitive pricing.<sup>175</sup> At about the same time common owners came on the scene, productivity and wages began to diverge.<sup>176</sup>

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<sup>171</sup> One study offering an alternative explanation of the data focused on the decline of “worker power,” *see*, Anna Stansbury, Lawrence H. Summers, The Declining Worker Power Hypothesis: An Explanation for the Recent Evolution of the American Economy, NBER WP No. 27193 (May 2020) available at <https://www.nber.org/papers/w27193>. However, since the study defined “worker power” as the product of de-unionization and changes in *corporate ownership*, it partially overlaps with the explanation of this Article.

<sup>172</sup> *See supra* section 1.

<sup>173</sup> *The Productivity–Pay Gap*, ECON. POL’Y INST., <https://www.epi.org/productivity-pay-gap/> (last updated July 2019).

<sup>174</sup> Barkai, *supra* note 127, at 36 (“A decline in the demand for labor inputs (which results in a decline in the labor share) and a simultaneous decline in the demand for capital inputs (which results in under-investment) are distinctive traits of declining competition.”).

<sup>175</sup> *Id.* at 36.

<sup>176</sup> *Id.* For a discussion of market concentration as a possible cause of the productivity-pay gap, *see supra* note 25.

even as they became increasingly productive, workers took home the same wages.<sup>177</sup> In the last forty years, one study estimates, labor has become four-and-a-half times more productive, while wages stalled.<sup>178</sup> With wages having flat lined and workers continuing to become more productive, common owners are taking a bigger and bigger cut of corporate revenue. Profits-per-worker have grown year-over-year since at least the 1980s.<sup>179</sup> Workers, however, have not shared in these gains. In the early 1980s, workers took home about eighty cents of every dollar earned by the corporate sector. By the mid-2010s, that figure was down to seventy cents.<sup>180</sup> In short, while workers are bringing greater returns to their employers, shareholders are taking a larger and larger cut of each corporate dollar, suggesting that investors (common owners) are exercising market power to reduce hiring and keep wages down.<sup>181</sup>

To see how a rising pay-productivity gap suggests a labor monopsony,<sup>182</sup> imagine a market where wages and marginal productivity are initially equal at  $x$ , but productivity rises to  $2x$ . In a competitive economy, firms would compete to hire up workers until wages rose to  $2x$ , at which point wages would equal to marginal product, and firms would stop hiring.<sup>183</sup> However, under a monopsony, firms could refrain from hiring in order to keep wages at or near  $x$  and pocket the difference.

Hedge fund activism provides a vivid view into how strong governance mechanisms allow shareholders to capture value from workers. Being a strong-governance mechanism,<sup>184</sup> hedge-fund activism campaigns supported by institutional investors reduce investments, either by cutting inefficient investments of disloyal managers<sup>185</sup> or deterring efficient investments of loyal

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<sup>177</sup> *Id.*

<sup>178</sup> Abdul A. Erumban & Klaas de Vries, *Wage-Productivity Growth Gap: An Analysis of Industry Data 14–15* (The Conf. Bd., Econ. Program Working Paper Series 16-01, Jan. 2016), [https://www.conference-board.org/pdf\\_free/workingpapers/EPWP1601.pdf](https://www.conference-board.org/pdf_free/workingpapers/EPWP1601.pdf).

<sup>179</sup> See *supra* note 168 and accompanying text.

<sup>180</sup> Elise Gould, *The State of American Wages 2017*, ECON. POL'Y INST. (Mar. 1, 2018), <https://www.epi.org/publication/the-state-of-american-wages-2017-wages-have-finally-recovered-from-the-blow-of-the-great-recession-but-are-still-growing-too-slowly-and-unequally/>.

<sup>181</sup> In aggregate, this trend is captured by the labor share of income—the portion of annual economic output that goes to labor as opposed to capital. After holding more or less steady since World War II, that figure saw a significant decline since the 1980s, from near 60% to closer to 50%, driven by a decrease in earnings for the lowest earners. Michael W. L. Elsby et al., *The Decline of the U.S. Labor Share*, Brookings Paper on Economic Activity 2013, Fall 2013, 1,2, <https://www.brookings.edu/bpea-articles/the-decline-of-the-u-s-labor-share/>.

<sup>182</sup> See Naidu et al., *supra* note 25, at 556 (explaining that a monopsonist will set wages below marginal revenue).

<sup>183</sup> *Id.* (“In a competitive labor market, firms equate the going wage of workers to their ‘marginal revenue product,’ the amount of additional revenue the worker can generate.”)

<sup>184</sup> See *supra* section 0

<sup>185</sup> See, Lucian A. Bebchuk, et al., *The Long-Term Effects of Hedge Fund Activism*, 115 Colum. L. Rev. 1085 (2015).

managers.<sup>186</sup> These campaigns often lead to layoffs and other spending cuts,<sup>187</sup> and even as productivity increases wages at target firms stagnates.<sup>188</sup> That is, the firm gets more profitable, shareholders get richer, and workers get—you guessed it—*nothing*.

The monopsony theory makes one final prediction: rising income inequality.<sup>189</sup> By holding wages below their competitive rates, the labor monopsony shifts wealth from labor-earners to capital-earners, who tend to already be wealthier.<sup>190</sup> Thus, in reverse of Robin Hood, it steals from the poor and gives to the rich. Indeed, it hardly needs to be recounted here that income inequality has reached historic rates. The wealth-to-income ratio—a measure of economic wealth captured by the highest earners—has skewed sharply upward, doubling between 1970 and 2010 and appearing to return to its 1920 level.<sup>191</sup> Similarly, the income Gini index, which measures the degree of income inequality, has consistently risen from 36.5% in 1980 to more than 45% in 2016, a record high.<sup>192</sup>

This section and the previous one outlined how the monopsony effect explains trends in investment and pay. The next section addresses competing explanations and shows how common ownership is necessary to these results.

### C. Monopoly, Monopsony, and Common Owners

To be sure, competing theories have arisen to explain the same macroeconomic trends described above. However, those theories tend to face a key limitation: they require active and likely illegal coordination on the part of investors. This section explains why the monopsony theory faces no such limitation, and why common owners are necessary to the monopsony result.

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<sup>186</sup> See, e.g., John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. Corp. L. 545, 603–07 (2016) (describing the activist hedge-fund practice of slashing research and development in pharmaceutical industry targets).

<sup>187</sup> Mark R. Desjardines & Rodolphe Durand, *Disentangling the Effects of Hedge Fund Activism on Firm Financial and Social Performance*, 41 STRATEGIC MGMT. J. 1054, 1070–71 (2020).

<sup>188</sup> Alon Brav et al., *The Real Effects of Hedge Fund Activism*, 28 REV. FIN. STUDS. 2723, 2753 (2015) (“[O]n average, workers at target firms do not share in the improvements associated with hedge fund activism. They experience stagnation in wages, while their productivity improves significantly.”).

<sup>189</sup> The focus of this Article is on inequality between wage-earners and capital-earners and not between different classes of wage-earners. For the latter, see, Jae Song, et al., *Firming Up Inequality*, 134 Q. J. Econ. 1 (2019).

<sup>190</sup> See Naidu et al., *supra* note 25, at 537 (arguing that labor monopsony “reduces the incomes of workers relative to those of people who live off capital, and the latter are almost uniformly higher earners than the former”).

<sup>191</sup> Thomas Piketty & Gabriel Zucman, *Capital is Back: Wealth-Income Ratios in Rich Countries 1700-2010*, 129 Q.J. ECON. 1255, 1257 (2014).

<sup>192</sup> Kaissar, *supra* note 2.



### 1. *Monopoly, Monopsony, or Both?*

An emerging literature links common owners to anticompetitive markets by suggesting that common owners influence *product markets*, rather than labor markets.<sup>193</sup> The most influential paper to this effect, by Professor Azar et al., studied the impact of common ownership on the airline industry, finding that ticket prices are up to 12% higher than they would be under dispersed ownership.<sup>194</sup> These authors—and other similarly inclined scholars—argue that common owners, through means both explicit and implicit, block their portfolio firms from competing with one another in order to increase prices and enjoy greater portfolio values.<sup>195</sup> To be sure, this theory would also explain the declining investment and stagnant wages: by decreasing output in order to raise prices on products, common owners would also incidentally reduce investment, hiring, and wages. Monopsony and monopoly, after all, “are two sides of the same coin, and both harm labor and product markets.”<sup>196</sup>

However, the monopoly theory faces a key limitation not shared by the monopsony theory: it requires common owners to take explicit or implicit steps to facilitate a monopoly in the product markets. In other words, household names, such as Blackrock and Vanguard, would stand accused of participating in an illegal conspiracy to raise prices, a proposition strongly challenged on both its theoretical premise and empirical proof.<sup>197</sup> So far, scholars have not provided convincing evidence that such systematic anticompetitive behavior exists,<sup>198</sup> and absent this evidence, it is difficult to believe that common owners would or could rig the product markets for four decades without attracting notice.<sup>199</sup> By contrast, the monopsony theory explains wage stagnation and income inequality without pointing to collusion. The mechanism proposed by this Article only relies on common owners to act as they normally do: pushing for strong governance and punishing managers whom they perceive to be disloyal.

<sup>193</sup> See Hemphill & Kahan, *supra* note 26, at 1401–08 (outlining the theories regarding the anticompetitive effects of common ownership and reviewing the evidence supporting them).

<sup>194</sup> See Azar et al., *supra* note 52, at 1559.

<sup>195</sup> *Id.* at 1552–54.

<sup>196</sup> Naidu et al., *supra* note 25, at 559.

<sup>197</sup> See DANIEL P. O’BRIEN & KEITH WAEHRER, THE COMPETITIVE EFFECTS OF COMMON OWNERSHIP: WE KNOW LESS THAN WE THINK (Feb. 22, 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2922677](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922677) (“[T]he emerging research at present does not scientifically establish that an increase in common ownership involving minority shareholdings causes higher prices in the industries examined.”); see also *Common Ownership*, EUR. COR. GOVERNANCE INST., <https://ecgi.global/content/common-ownership> (last visited Sep. 21, 2020) (tracking the ongoing debate on the anticompetitive effects of common ownership).

<sup>198</sup> See Hemphill & Kahan, *supra* note 51, at 1400 (“[F]or most [anticompetitive] mechanisms, there is either no strong theoretical basis for believing that institutional CCOs could or would want to employ them, no significant evidence suggesting that they do employ them, or both.”).

<sup>199</sup> In particular, researchers and regulators have been more focused on anticompetitive behavior in the product markets than the labor markets. Naidu et al., *supra* note 25, at 539–40. Thus, it seems more likely that if common owners were adopting anticompetitive strategies in the product markets, these strategies will be discovered, as opposed to comparable behavior in the labor markets.

This Article does not contend that other factors like automation, globalization, and de-unionization have no impact on wage stagnation and income inequality. Instead, it shines a spotlight on a major culprit that has so far gone unmentioned: common owners. It is no coincidence that as BlackRock, State Street, and Vanguard came to dominate the American stock market, wage growth stalled and inequality has risen.<sup>200</sup>

## 2. *The Invisible—and Inadvertent—Cartel*

Key to understanding the monopsony effect is that even though they may not intend to generate a wage discount, common owners are a necessary precondition for wage stagnation. Without large common owners to internalize the profits of low wages, the monopsony effect would require extensive collusion. Even if firms colluded to reduce investment, those that continued to invest would need to pay off those that refrained to maintain the arrangement. That is, if a group of weak-governance firms switched to strong governance in order to reduce investment levels and undercut wages, they would not benefit themselves because the CEOs of the new strong-governance corporations would cease investing (even while the cheaper labor makes investments more profitable). Rather, these firms would need to be paid off by the remaining weak governance firms out of their new, monopsony-boosted profits. Even then, the remaining strong-governance firms—those that maintained strong governance from the beginning—would *also* need to be paid off so that they too would refrain from switching to weak governance and driving up labor prices. In other words, absent the influence of common owners, an extensive and unrealistic amount of illegal coordination and payoffs would be necessary to achieve the monopsony result. Indeed, neither antitrust regulators nor industry observers have found evidence of such staggering collusion.<sup>201</sup>

This Part has outlined the broad macroeconomic effects of common ownership. The following Part uses a stylized economic model to illustrate the choice of governance structure and how it impacts wages, in order to demonstrate exactly how common owners reduce pay. The model not only explains the monopsony effect of strong governance, but also provides a nuanced template for understanding shareholders' choice of governance structure, and its macroeconomic implications.

### III. WAGES AND GOVERNANCE: THE COMPETITIVE EQUILIBRIUM

This Part shows how wages and governance structures interact—and how common owners disrupt that interaction. To better understand common ownership and the monopsony effect, it is helpful to understand what a world

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<sup>200</sup> See *supra* note 62–63 and accompanying text.

<sup>201</sup> See Hemphill & Kahan, *supra* note 26, at 1441 (“The absence of any direct evidence of the use of targeted active strategies [for collusion]—where the direct evidence should be plentiful—casts significant doubt on whether these strategies are actually used.”).

without common ownership looks like. In a competitive market, the choice of governance structure depends in part on wages: low wages make investment more profitable and therefore make weak governance more attractive, and vice versa for high wages. But wages depend on whether companies choose to invest—because investment means hiring—and companies choose whether to invest based on their governance structures. Thus, even as wages influence governance structure, governance structures influence wages. This Part shows how, without the influence of common owners, wages and the choice of governance structures would reach an equilibrium that splits wealth competitively between shareholders and workers. Even with some inefficiencies remaining, such as higher management agency costs, this competitive-determined outcome results in higher social welfare and better distribution.

Section A models how the choice between weak and strong governance depends on the wage rate. Section B explains how the wage rate depends on which governance structures shareholders choose. Section C outlines the competitive equilibrium and explains that even though it imposes management agency costs on shareholders, this equilibrium generates higher social welfare. Section D explain how common owners break the competitive equilibrium and create a labor monopsony.

#### A. *Corporate Governance: Managing the Risk of Management Disloyalty*

Shareholder exposure to manager disloyalty depends on the governance structure they choose. Weak governance increases the risk of manager disloyalty, as managers can invest inefficiently and expropriate private benefits without being disciplined by shareholders. Strong governance minimizes this risk, as shareholders can hold disloyal managers accountable.<sup>202</sup> But, as explained above, weak or strong governance will have parallel effects on *loyal* managers.<sup>203</sup> Weak governance increases the incentive for both loyal and disloyal managers to invest, while strong governance minimizes that incentive. The choice between strong and weak governance thus depends both on the probability and cost of management disloyalty and the relative gains from investing.

In the absence of common ownership, then, each firm's shareholders will make governance choices the same way they would make any other decision: which option will maximize the corporation's value? In other words, shareholders will choose between weak and strong governance based on which structure increases their expected returns. A stylized economic model serves to illustrate this choice.<sup>204</sup> Assume a market with 100 corporations where none of

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<sup>202</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 327–328 (1976) (describing how shareholders can invest in monitoring and bonding in order to reduce the cost of manager disloyalty).

<sup>203</sup> See *supra* section 1.

<sup>204</sup> The model presented here is based on the work of Goshen & Levit, *supra* note 16.

the corporations has market power over either products or resources.<sup>205</sup> Shareholders—without market power over ownership of firms<sup>206</sup>—must choose a corporate governance structure for their respective corporations. Of course, corporate governance is a spectrum of structures allocating various levels of control between shareholders and managers.<sup>207</sup> However, for simplicity, assume that only two poles of governance structures are available for shareholders:<sup>208</sup> either they can easily fire a manager (“strong governance”), as in dispersed-ownership firms without staggered boards or poison pills,<sup>209</sup> or they cannot fire a manager (“weak governance”), as in dual-class firms<sup>210</sup> where public shareholders own only non-voting or low-vote shares.<sup>211</sup> Shareholders want to hire only loyal managers, but are unable to distinguish beforehand between a loyal and a disloyal CEO.<sup>212</sup> Suppose, further, that half of all candidates for the CEO job are loyal and the rest are disloyal.<sup>213</sup>

Managers, once hired, face a discrete set of investment decisions. They can either choose project A or project B. Both require the firm to spend \$1,000,000 to hire a team of workers. Project A is a good investment. At the end of the project, it will yield \$1,500,000, representing \$500,000 in profits after accounting for the \$1,000,000 in labor costs. Project B is a pet project that allows the manager to travel in style, hire relatives, elevate their social status, and so on. It will yield an expected value of \$500,000, representing \$500,000 in losses after accounting for the \$1,000,000 investment. However, these investments take time to pan out, and shareholders, at least initially, cannot easily tell the difference between the two. Both cost \$1,000,000 and otherwise resemble each other, so shareholders cannot tell whether managers have invested in the good project A or the bad project B until it is too late.

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<sup>205</sup> That is, firms are price takers inasmuch as they hire at the competitive rate determined by the market. See Berger, *supra* note 35, at 34 (noting that all firms in a competitive equilibrium are price takers).

<sup>206</sup> See *Market Power*, OECD GLOSSARY OF STATISTICAL TERMS, <https://stats.oecd.org/glossary/detail.asp?ID=3256> (last updated March 16, 2002) (“Market power refers to the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition . . .”).

<sup>207</sup> See Goshen & Squire, *supra* note 20, at 802–04 (explaining the concept of corporate governance as a spectrum, rather than a binary).

<sup>208</sup> The model’s conclusions will not change if shareholders can choose any governance structure along the spectrum between weak and strong governance. See Goshen & Levit, *supra* note 16, at 27–28.

<sup>209</sup> See *supra* section 2 and I.B.3.

<sup>210</sup> See *supra* section 1.

<sup>211</sup> For simplicity, we use the two poles of the governance spectrum. However, as mentioned, the model’s conclusions will not change if shareholders can choose any governance structure along the spectrum between weak and strong governance. See *supra* note 208.

<sup>212</sup> See Goshen & Squire, *supra* note 20, at 770–71 (“When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs.”).

<sup>213</sup> Of course, this represents an uncharitable view of human nature. As will be shown in the following section, the model will work the same way with any proportion. See *infra* section III.B.

Managers face a third option: do nothing. They can sit back and run the company as usual, make no new investments, and distribute to the shareholders the \$1,000,000 that would otherwise be spent on labor. While shareholders cannot distinguish between project A and project B, they can between a manager that invests and one that does not.

Shareholders now must choose between strong and weak governance given the risk of disloyalty—that is, the risk that they will hire a disloyal manager who will choose project B. As mentioned, shareholders that choose weak governance face a 50% chance of disloyalty: If they hire a loyal manager, he or she will invest in project A, generating \$500,000 in profits for the firm. If they hire a disloyal manager, he or she will invest in project B, generating \$500,000 in losses. The expected value<sup>214</sup> of choosing weak governance, then, is zero.<sup>215</sup>

If shareholders choose strong governance, however, managers are not likely to invest. Disloyal managers will not invest for fear that shareholders will recognize the investment as project B, while loyal managers will not invest in project A, because shareholders may misperceive it as project B, in either case potentially resulting in termination.<sup>216</sup> Thus, managers will distribute any free cash through dividends and buybacks, rather than investing it.<sup>217</sup> On the margin, they will neither make nor lose money. The expected value of choosing strong governance, then, is also zero.

Under these conditions, shareholders will be indifferent between strong and weak governance. Strong governance yields an expected return of zero because managers will have an incentive to not invest. Weak governance also produces zero expected returns, because the potential gains from a loyal manager are wiped out by the risk of losses from a disloyal one. Either way, shareholders realize an expected value of zero, and will thus be indifferent between strong- and weak- governance.<sup>218</sup>

Of course, the indifference here is only due to the assumptions made: 50% loyal managers, with losses and gains that cancel one another out. The following sections account for what happens when these inputs change. The key insight

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<sup>214</sup> Expected value is calculated by multiplying the value of any given outcome by its probability, and totaling the weighted outcomes. So here, \$500,000 times 50% plus negative \$500,000 times 50% is zero. For an explanation of how to calculate expected value, see Will Kenton, *Expected Value*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/expected-value.asp> (last updated Jun. 27, 2020).

<sup>215</sup> The assumption is that the expected return on project A provides an appropriate return to compensate for both the investment risk of project A and the risk of hiring a disloyal manager who will invest in project B.

<sup>216</sup> See Goshen & Levit, *supra* note 16, at 14 (modeling the possibility that shareholders will “get the wrong signal” from investments and mistakenly fire a manager).

<sup>217</sup> *Id.* at 22–23 (showing that as long as they care about their jobs, managers will refrain from investing in strong-governance corporations).

<sup>218</sup> The assumption is that for every level of risk an investment yields the appropriate return to compensate for that level of risk. In other words, all investments yield market returns (zero NPV). This is true for the current investments already undertaken by strong governance firms and for the new investments contemplated by weak governance firms.

will be that the choice of governance structure is contingent: shareholders can—and do—change it in response to market conditions.

### B. *The Feedback Between Wages and Governance Structure*

Previously, we assumed that both investment projects—A and B—cost \$1,000,000 in outlays on labor. Suppose, for example, that each project demands ten employees be hired at \$100,000 per employee. This rate, given the other market conditions, makes strong and weak governance equivalent in terms of expected return. Suppose, however, that wages decline to \$80,000 per employee. Each investment project will now cost \$800,000, but will still yield the same returns. Project A will yield \$1,500,000, and subtracting \$800,000 in labor costs leaves a profit of \$700,000 (as opposed to \$500,000 before). Project B will yield \$500,000; subtracting \$800,000 in labor costs leaves a loss of \$300,000 (as opposed to \$500,000 before).

Shareholders now face a different choice when making decisions about governance structure. Under strong governance, loyal and disloyal managers will continue to refrain from investing.<sup>219</sup> The expected value of strong governance therefore remains zero. Weak governance, however, now yields a positive expected value. Shareholders stand a 50% chance of making \$700,000 with a loyal manager, and a 50% chance of losing \$300,000 with a disloyal manager, for an expected return of \$200,000 in profits. When wages are low, then, we can expect that shareholders will prefer weak governance to strong governance.

At first, this result seems counterintuitive. Typically, shareholders prize the right to fire and replace corporate managers.<sup>220</sup> However, when wages are low, they may wish to tie their own hands through weak-governance measures, allowing managers to capitalize on discounted wages without fear of being fired.<sup>221</sup> In other words, manager entrenchment makes good business sense if the goal is to encourage investment.

Notice that, under these conditions, shareholders would prefer weak governance *in spite of* the management agency costs it generates. While half of the weak governance companies will make \$700,000 due to loyal managers investing in project A, the other half will lose \$300,000 from disloyal managers investing in project B. This \$300,000 loss represents the management agency cost of weak governance. However, where investment is particularly attractive—as here, with discounted wages—weak governance is *still* preferable to strong governance due to the outsized gains from investing. Thus, rational shareholders

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<sup>219</sup> See Goshen & Levit, *supra* note 16, at 13–16 (showing that managers will maintain the status quo as long as shareholders have the right to fire them).

<sup>220</sup> Simone M. Sepe, *Board and Shareholder Power, Revisited*, 101 MINN. L. REV. 1377, 1380 (2017) (“Shareholder advocates, in particular, defend the need for a strong shareholders’ power of removal—exercisable virtually at any time—in order to ensure that the exercise of this power (or even just the threat of it) can serve an effective disciplinary function.”).

<sup>221</sup> See Ray Fisman et al., *Governance and CEO Turnover: Do Something or Do the Right Thing?*, at 14 (Harv. Bus. Sch. Working Paper No. 05-066, 2005) (“Entrenchment is likely to increase the costs of firing and simultaneously insulate the board from shareholders bad ideas. This suggests a tradeoff—some amount of entrenchment may be optimal.”).

may want to cede control to encourage managers to make investments where they otherwise would refrain—even though some companies will lose money because of management agency costs.

A depressed labor market thus makes governance choices *relevant*: weak governance is preferable under low wages. Therefore, in a depressed labor market we expect shareholders in at least some strong-governance companies to switch to weak-governance so that their managers have the freedom to invest. As the number of weak governance companies rises, investment levels will increase, pushing up wages. Firms will continue to move to weak governance until wages rise to \$100,000 per employee, where, as shown above, weak and strong governance have the same expected value. Once wages reach this rate, firms will once again be indifferent between weak and strong governance, and stop switching. In other words, they will have reached equilibrium.<sup>222</sup>

To be sure, the number of weak-governance firms will be higher in this new equilibrium than beforehand. Suppose that before, in the market of 100 firms, fifty had weak-governance structures and fifty had strong governance. Suppose further that twenty firms switched from strong to weak governance in response to low wages. Now, the number of weak-governance companies is seventy, higher than in the previous equilibrium. However, though there are more weak-governance firms now, weak and strong governance will have the same expected value. Ex ante, either structure will yield an expected value of zero, and no firm can gain by switching in either direction.

Conversely, strong governance is preferable when wages are high. Suppose that wages rise to \$120,000 per employee, for an aggregate labor cost of \$1,200,000 for each project. Now, the potential profits and losses will flip: project A yields only \$300,000 in profits while project B yields \$700,000 in losses, on average. While the expected return of strong governance remains zero, as above, the expected return of weak governance is now \$200,000 in losses. The feedback loop works just as well in this scenario. In this market, strong governance is preferable and firms will switch to strong governance, causing investment levels and hiring to fall and consequently lowering wages. Firms will continue to switch, and labor prices will continue to decrease until wages fall to \$100,000 per employee, making shareholders indifferent between strong and weak governance. At this point, there will be more strong-governance companies than before, but both governance structures will yield an expected value of zero, and so shareholders will again be indifferent.

In equilibrium, then, shareholders will be indifferent between weak and strong governance regardless of the wage rate. The same can be said of the distribution between loyal and disloyal managers: shareholders will adjust until they are indifferent between governance structures. For instance, assume that 70% of managers are loyal and 30% are disloyal (as opposed to fifty-fifty

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<sup>222</sup> See Goshen & Levit, *supra* note 16, at 17 (“Essentially, the irrelevance is obtained because in equilibrium market clearing requires the price of resources to be fair in the sense that a change to the status quo is a zero net present value (NPV) investment from the shareholders perspective.”).

before), and the wage level is \$100,000 per employee. Under these conditions, weak governance will be more profitable: 70% of managers (the loyal ones) will invest in project A and make \$500,000 in profit, while 30% (the disloyal ones) will invest in project B and lose \$500,000. The expected value of weak governance would then be a profit of \$200,000. Companies would switch to weak governance, pushing up wages, as above. Wages would once again rise until they cancel out any gains from weak governance. Thus, in a world with a higher proportion of loyal managers, we can expect that there to be more weak-governance corporations, but the expected value of either governance choice will remain zero.<sup>223</sup>

To summarize, just as wages impact the choice of governance structure, governance structure impacts wage rates. Strong governance discourages investment, whereas weak governance incentivizes investment. Investment requires labor in order to build factories, launch divisions, open stores, build supply chains, and conduct research.<sup>224</sup> Thus, if many companies move towards weak governance, investment and hiring will rise, increasing wages. Conversely, if many firms switch to strong governance, investment will fall, and wages along with it. These symmetrical forces push wages to a competitive level. Next, we will explore the parameters of the equilibrium reached and its social welfare effects.

### C. *The Competitive Equilibrium and its Parameters*

The above discussion illustrates that governance structure and labor prices will reach an equilibrium where shareholders are indifferent as to governance structure. In this equilibrium, some number of weak- and strong-governance companies will coexist, with none gaining an upper hand by switching from one governance structure to another. Because this equilibrium reflects a labor price determined through competition among hiring firms—where none of the players, corporations, shareholders, and employees, enjoy market power—it generates higher social welfare reflected in the distribution of wealth between labor and capital.<sup>225</sup>

To be sure, this equilibrium imposes certain inefficiencies on corporations and their shareholders. Because some proportion of firms will adopt weak governance, the entire universe of firms is more susceptible to management agency costs than it otherwise would be.<sup>226</sup> Returning to the model where 50%

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<sup>223</sup> For instance, one could set the prior probability that a manager is disloyal equal to a generic variable between zero and one, and obtain the irrelevance result regardless. See *id.* at 8–9.

<sup>224</sup> For example, labor costs amount to 13% of the revenue of S&P 500 companies. Connor Smith, *Higher Pay is a Rising Threat to Stocks, Goldman Sachs Says*, BARONS (July 10 2019), <https://www.barrons.com/articles/higher-pay-is-a-rising-threat-to-stocks-goldman-sachs-says-51562752800>.

<sup>225</sup> See Berger, *supra* note 35, at 44 (concluding that households are worse off in a anticompetitive labor market where firms wield market power than in a competitive labor market).

<sup>226</sup> See, e.g., Kevin C. W. Chen et al., *Agency Costs of Free Cash Flow and the Effect of Shareholder Rights on the Implied Cost of Equity Capital*, 46 J. FIN. & QUANTITATIVE ANALYSIS



of firms had weak-governance structures and 50% of managers were disloyal, probabilistically twenty-five firms would hire disloyal managers who will destroy value by investing in pet projects (project B). In this case, \$500,000 in losses per firm at twenty-five firms would total \$12.5 million in management agency costs.

Importantly, the shareholders in this model are aiming to maximize the value of their shares,<sup>227</sup> so if they could tell in advance which managers were loyal and which were not, they could avert these losses. Because shareholders lack perfect competence, however, these management agency costs cannot be mitigated without reverting to strong governance.<sup>228</sup> Under the competitive allocation, then, some shareholders will lose money due to the agency cost of disloyal management. Nevertheless, they will be indifferent between strong governance and weak governance *despite* the management agency costs that the latter engenders, because on average, both will yield the same returns.

These costs to shareholders, unavoidable in a competitive equilibrium, can be thought of as an inadvertent subsidy to workers. If shareholders could avoid management agency costs by switching to strong governance *only* in the firms with disloyal managers, they could prevent those managers from making outlays on labor. In other words, disloyal managers—twenty-five in our example—invest in pet projects when shareholders would prefer that they do not invest at all. This investment represents a benefit to workers, as it increases hiring and bolsters wages. Because shareholders are unable to preempt only disloyal managers, corporations spend more on labor than their owners would prefer.<sup>229</sup>

While this balance is not optimal from the shareholders' point of view, from a social perspective it represents a competitive allocation of wealth between labor and capital. Importantly, the equilibrium with the higher social welfare includes some level of inefficient management agency costs.<sup>230</sup> But, as long as shareholders cannot perfectly identify management's loyalty, management agency costs can only be reduced by creating a greater detriment to some other group of stakeholders.<sup>231</sup>

So far, this Part has demonstrated that in the absence of common owners, labor prices and governance structure will counterbalance one another to reach a

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171, 200–01 (2011) (concluding that firms that employ takeover defenses—a weak governance measure—experience higher costs of equity capital).

<sup>227</sup> In other words, maximizing shareholder value, as opposed to maximizing value for all stakeholders, is not the reason for the monopsony effect. Rather it is common owners' market power in the ownership of firms.

<sup>228</sup> See Jensen & Meckling, *supra* note 202, at 327–28 (noting how firms can choose an “optimal” level of different *types* of agency costs, but arguing that the costs themselves are “an unavoidable result of the agency relationship”).

<sup>229</sup> See Goshen & Hamdani, *supra* note 20, at 566–67 (outlining the information and competence problems that prevent shareholders from being perfect arbiters of managerial effectiveness and loyalty).

<sup>230</sup> See Goshen & Levit, *supra* note 16, at 18 (showing mathematically that a competitive equilibrium of control rights maximizes social welfare).

<sup>231</sup> See *id.*

competitive equilibrium. The following section describes how common owners alter this balance by increasing the number of strong-governance companies, resulting in a new and less efficient equilibrium.

#### *D. Breaking the Competitive Governance Equilibrium*

Common owners and the push for strong governance represent a departure from the equilibrium described in the economic model above, where governance structure and wages interact in a *competitive* market. With competition, the number of strong governance companies is determined by the prevailing market wage. However, common owners push for strong governance *regardless of market wages*. As a result, the number of companies adhering to either governance structure—and thus, the wage rate—is determined not by competition, but by the preferences of a handful of asset managers.

Recall that in our model, we assumed the market contained fifty strong-governance and fifty weak-governance firms, half of potential managers were disloyal, and none of the players had market power to unilaterally change the equilibrium.<sup>232</sup> As demonstrated, labor prices reach a level such that no firm can boost profits by switching from weak to strong governance, or vice versa.<sup>233</sup> Now assume that a handful of common owners hold large stakes in each of the 100 companies in the model.<sup>234</sup> No single owner needs to hold a control stake in all the relevant companies so long as together, common owners wield significant influence. Suppose that, at the urging of common owners, twenty firms switch from weak to strong governance.<sup>235</sup> From fifty–fifty, then, the market will now consist of seventy strong-governance and thirty weak-governance firms.

Before, managers could choose to invest in project A and project B, either creating or destroying \$500,000 in value, such that the expected value of weak governance after labor costs was zero. However, as common owners switch more firms to strong governance, investment will fall and the labor market will slacken, causing wages to decrease. Suppose that now each employee costs \$80,000 instead of \$100,000, for an aggregate labor cost of \$800,000 for either project. Strong governance continues to net an expected value of zero, since managers will continue to refrain from investing. However, weak governance will now yield an expected return of \$200,000 in profits.<sup>236</sup>

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<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

<sup>234</sup> The number of common owners is irrelevant for our purposes. However, if we were to set the number at three, for instance, it would be a good approximation of the American equity markets. Recall that three firms, BlackRock, Vanguard, and State Street together form the largest stockholder in nine out of ten S&P 500 companies. *See supra* note 11 and accompanying text.

<sup>235</sup> This is not an unrealistic assumption: common owners tend to endorse shareholder rights for their portfolio companies regardless of market conditions. *See supra* section I.B.

<sup>236</sup> Half the time, the weak-governance companies will hire a disloyal manager who invests in project B for a gross return of \$500,000, netting a loss of \$300,000. The other half of the weak-governance companies, headed by loyal managers, will make a gross return of \$1,500,000, for a net profit of \$700,000. Thus, the expected value of choosing weak governance is a gain of \$200,000.

In a competitive market, shareholders would adjust to these abnormal returns by switching their companies to weak governance to take advantage of low wages, eventually pushing wages back up to equilibrium.<sup>237</sup> However, in this new market, shareholders (common owners) prefer strong governance in spite of the wage rate. Regardless of abnormal returns, common owners will oppose any move to weak governance, meaning that wages will remain consistently low. In effect, common owners have deactivated the market mechanism—choice of governance structure—that previously corrected any imbalance in the labor market. Common owners will therefore have created a new equilibrium with lower investment and lower wages, or in other words, a labor market monopsony.<sup>238</sup>

The model above predicts that when the dust settles on this new world of common ownership, there will be more strong governance firms, a lower level of investment, and lower wages. Strong-governance firms will refrain from investing while weak governance firms will continue to invest—except now, the latter will enjoy a substantial labor discount. Because common owners own a market portfolio, they enjoy the extra profits accrued by weak-governance firms.

Note that strong-governance firms are not likely to benefit in this new equilibrium. Even in the face of low wages, loyal and disloyal managers of strong-governance companies still face a risk of being fired if they invest, correctly or incorrectly. Thus, in spite of the abnormally positive returns to investment, strong-governance firms will still refrain from investing and will not enjoy the benefit of below-market labor prices.<sup>239</sup> Strong-governance firms neither lose nor gain any revenue: they did not invest before, and do not invest now. However, the remaining thirty weak-governance firms in this economy will

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<sup>237</sup> See Goshen & Levit, *supra* note 16, at 4–5.

<sup>238</sup> Importantly, although our model is told in terms of firms adopting either weak governance or strong governance, the model's conclusions are valid even if firms can choose governance structures along a spectrum. Assume governance can range from weak to strong along a spectrum, according to the managerial freedom to invest. On the limited managerial freedom end, investment is zero, and on the unlimited managerial freedom end, investment is at its maximum. In this structure, firms can adopt any governance on the spectrum, with the corresponding level of investment. For instance, if a firm is on the middle of the spectrum, its manager will invest half of the maximum investment. In such a case, if all firms increase the strength of their corporate governance, the aggregate level of investment will decrease and each firm will increase its profitability on the investments it is still making. In short, the monopsony effect will work the same way.

<sup>239</sup> The abnormal profitability implies that there will be incentives for firms to go private or stay private and avoid the public market in order to enjoy the abnormal profitability from investments. Indeed, these two phenomena are empirically documented. See, *The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities*, Credit Suisse Report (2017) available at: [https://www.cmgwealth.com/wp-content/uploads/2017/03/document\\_1072753661.pdf](https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf) (providing the data on the growth of the private market); and John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?* 28 Rev. Fin. Stud. 342 (2015) (finding that compared to private firms, public firms invest substantially less and are less responsive to changes in investment opportunities). Given the empirical findings that investment levels are still low, it is reasonable to assume that there are frictions in the private market that prevent this market from returning the economy to the competitive equilibrium.

now benefit from anticompetitive wages. Each firm will net, on average, an extra \$200,000, or an extra \$6 million in the aggregate. Because common owners hold a stake in each company—while strong-governance companies lose nothing—their portfolio value will rise as the weak-governance firms become more profitable. However, this money did not appear out of thin air, but rather came out of workers' paychecks: it represents a \$6 million subsidy from workers to the shareholders of the companies that employ them. In general, then, it is a \$6 million transfer from the lower and middle classes to the rich.

Notice that in this model, common owners have expropriated value from the labor market without resorting to any collusion, unlawful or otherwise. Rather, the monopsony results from shareholders behaving as they otherwise would: firing disloyal managers, as they perceive them, and retaining loyal ones. However, because of the increased number of strong-governance firms, this everyday behavior results in underinvestment relative to a competitive market, and thus in lower wages.

By shifting value from the labor market to the capital market, common owners create a new, less efficient equilibrium.<sup>240</sup> As noted, the equilibrium determined by competitive markets maximizes social welfare,<sup>241</sup> while the new market order imposed by common owners diverges from the maximally efficient distribution. Thus, not only do common owners divert value from the labor market to the capital markets, but they do so at the cost of reducing aggregate social welfare in the economy at large.

Essentially, common owners have externalized some of their management agency costs to employees. Management agency costs are minimized because fewer disloyal managers are investing in inefficient projects, and the loss from these inefficient projects is smaller given the labor discount. Moreover, the efficient investments of the remaining loyal managers will be disproportionately profitable. However, what shareholders experience as management agency costs, workers experience as a boost to hiring and wages. By cutting these management agency costs, common owners have made the market work more efficiently for them—but less efficiently for everyone else.

To add a note of absurdity, the common owners that create this monopsony effect are the same institutions that champion “ESG investments” (Environmental, Social, and Governance).<sup>242</sup> It is hard to miss the irony in pushing ESG as a *unified strategy* across all corporations in order to mediate the harmful effects on workers and communities of maximizing shareholder value. While the “ES” aspects are indeed a response to the problem—asking managers to consider the effects of their business decisions on the environment and the welfare and diversity of their employees—the “G” is the source of the problem,

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<sup>240</sup> See Goshen and Levit, *supra* note 16, at 19 (showing that “any deviation from the competitive allocation is socially inefficient”)

<sup>241</sup> See *supra* note 225–231 and accompanying text.

<sup>242</sup> See Arom, *supra* note 41, at 10–12 (documenting the push by institutional investors for increased sustainability disclosure and performance).

continuing to push toward restricting managerial freedom and bolstering the negative effects of the monopsony on the economy.

The detrimental effect of common ownership on labor markets and the economy as a whole require a rethinking of how the law treats common owners and strong governance. The following Part begins to analyze the policy implications of the monopsony effect.

#### IV. REVERSING THE MONOPSONY EFFECT: BREAK UP BLACKROCK?

Given the inherent tradeoff of strong governance—reducing management agency costs while creating a labor monopsony—policymakers face a dilemma. Should they side with employees or shareholders? If shareholders' interests are their concern, nothing should be done. The power of common owners will continue to grow, and with it, the destructive effects of strong governance. If the interests of employees are the primary concern, however, policymakers should act.

To restore markets to their previous equilibrium—one without concentrated shareholders having market power over the ownership of multiple firms, and where labor and capital shared more equitably in the value they jointly created—the monopsony effect of common owners should be eliminated. This goal can be achieved by increasing the number of market players—and reducing the clout that each one can wield—thereby shifting the balance back toward weak governance and managerial freedom, and counteracting the monopsony effect.<sup>243</sup> That is, to solve the problems associated with common ownership, the answer is to break up common owners. This Article presents two breakup alternatives and their expected effects.<sup>244</sup>

Section A outlines the two alternatives for restricting AUM in order to limit the monopsony effect. Section B shows how breaking up multitrillion dollar asset managers will affect the relationship between shareholders and management, thereby increasing managerial freedom. Section C shows how

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<sup>243</sup> See, e.g., José Azar & Xavier Vives, *Oligopoly, Macroeconomic Performance, and Competition Policy* 4 (Working Paper, Dec. 18, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3177079](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3177079) (“[I]ncreased market concentration—due either to fewer firms or to more common ownership—depresses the economy by reducing employment, output, real wages, and the labor share . . . .”). A small but growing literature has begun to examine the effect of oligopolistic (and, by the same token, oligopsonistic) control of the capital markets. Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026, 2032 (2018). To be sure, however, the idea that concentration of ownership has negative economic effects still draws fierce criticism. See Douglas H. Ginsburg, *Why Common Ownership Is Not an Antitrust Problem*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 4, 2018), <https://corpgov.law.harvard.edu/2018/12/04/why-common-ownership-is-not-an-antitrust-problem/> (“[T]he current empirical evidence that common ownership causes anticompetitive harm is limited and hotly disputed.”).

<sup>244</sup> We are not the first to suggest that antitrust law could be applied to common owners. See, Elhauge, *supra* note 85. However, this Article is the first to suggest capping assets under management as a solution to the ills of common ownership.

these changes would disrupt the monopsony effect by tipping the market away from strong governance and restoring the competitive equilibrium. Finally, section D will address counterarguments.

#### A. Break Up BlackRock?

Common owners create a labor monopsony by moving firms *en masse* toward strong governance, depressing the price of labor.<sup>245</sup> Theoretically, any one firm could take advantage of the depressed labor market by switching to weak governance, increasing managers' freedom to invest. Practically, however, the small group of common owners that control the vast majority of publicly traded firms maintain the status quo by opposing any move toward weak governance.<sup>246</sup> Capping the AUM that any one firm can manage would require the breakup of large common owners into smaller owners, limiting the extent to which they can influence the governance structure.<sup>247</sup> Corporations would have the freedom and incentive to shift back to weak governance regimes, disrupting the monopsony effect.<sup>248</sup>

In other words, to counteract the monopsony effect of common ownership, policymakers should limit the *power* of common owners by reducing their size, as power is the crucial variable. It is important to emphasize that even under dispersed ownership, with millions of retail investors investing in diversified portfolios, each small diversified shareholder would benefit from the current monopsony effect. That is, even a small shareholder who owned a cross-section of the market would still benefit from the monopsony effect of strong governance, as it would increase their portfolio value by reducing wages. However, such small shareholders do not have the power to push corporations to adopt strong governance, and even when corporations have strong governance, it is often too expensive to coordinate the many shareholders to actually exercise control. In other words, *diversification* creates the *incentive* to push for stronger governance, but it is *size* that provides the *power* to achieve it.

This section explores two measures to mitigate the monopsony effect by breaking up common owners. First, funds must choose between management of active or passive funds; indexers and active investors should not be allowed to coexist under the same roof. Second, asset managers should be limited by a size threshold to reduce their dominance over the market.

##### 1. Separating Active and Passive Funds

A huge and growing portion of AUM at the largest investors are housed in passive index funds that hold cross-sections of the market, such as the S&P

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<sup>245</sup> See *supra* Part I.

<sup>246</sup> *Id.*

<sup>247</sup> See *infra*, section IV.A.2.

<sup>248</sup> See *infra*, section IV.C.

500.<sup>249</sup> Currently, index funds can be held by the same institution alongside actively managed funds.<sup>250</sup> Active funds try to buy winners and sell losers instead of mimicking an index or the entire market,<sup>251</sup> meaning they are much less likely to contribute to the ills of common ownership than passive funds.<sup>252</sup> That is, because they buy only select companies within each industry, active funds do not hold the market-wide portfolio that makes the monopsony effect possible and profitable. Indeed, in a monopsony environment, an active fund would likely encourage *weak* governance in order to take advantage of depressed wages, thus pushing wages back toward competitive equilibrium.<sup>253</sup> However, because institutional investors vote their shares together,<sup>254</sup> subscribing to the common policy that *strong* governance equals *good* governance, the different voice that active funds would otherwise exercise is now replaced by joining the tune of index funds.<sup>255</sup> Separating active from passive funds would allow active funds to sound an independent voice and reduce the power of passive funds (common owners).

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<sup>249</sup> See, e.g., Mark Gilbert, *BlackRock's Climate Activism Has a Passive Problem*, WASH. POST: BUSINESS (Jan. 15, 2020) (noting that “two-thirds of the money it [BlackRock] manages [is] allocated to index-tracking funds”).

<sup>250</sup> See, e.g., *Active and Passive Investing*, BLACKROCK, <https://www.blackrock.com/au/individual/learning-centre/active-and-passive-investing?switchLocale=y&siteEntryPassthrough=true> (last visited Sep. 18, 2020) (“At BlackRock, we believe that both active and passive investment strategies can be complementary to each other and are frequently used together by investors.”).

<sup>251</sup> Ian Appel, *Research: Index Funds Are Improving Corporate Governance*, HARV. BUS. REV. (May 9, 2016), <https://hbr.org/2016/05/research-index-funds-are-improving-corporate-governance> (“Unlike high-profile activist hedge funds, which attempt to outperform the market, the primary goal of passive investors is to deliver returns that match a market index.”).

<sup>252</sup> See Hemphill & Kahan, *supra* note 26, at 1400 (finding that index funds are “the most plausible culprits” for anticompetitive behavior but concluding that they are not likely to engage in the type of strategies that the authors focus on).

<sup>253</sup> While activist funds can improve their performance by increasing the value of firms within their portfolios, “index funds would improve their relative performance if the price of a portfolio company increases only if, and only to the extent that, the index fund is overweight in the portfolio company.” Rock & Kahan, *supra* note 254, at 27.

<sup>254</sup> See Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders*

*Be Shareholders* 8 (N.Y.U. Sch. of L., L. & Econ Working Paper No. 18-39, July 2019), [https://ecgi.global/sites/default/files/working\\_papers/documents/finalkahanrock.pdf](https://ecgi.global/sites/default/files/working_papers/documents/finalkahanrock.pdf) (“[L]arge investment advisers typically centralize the voting function in a ‘stewardship’ or ‘proxy voting’ group.”).

<sup>255</sup> See Alicia Adamczyk, *Index Funds Are More Popular than Ever—Here’s Why They’re a Smart Investment*, CNBC (Sept. 19, 2019), <https://www.cnbc.com/2019/09/19/why-index-funds-are-a-smart-investment.html> (citing a Morningstar report that noted “U.S. stock index funds are more popular than actively managed funds for the first time ever”). While index funds have only a slight edge over active funds in the market overall, *see id.*, they are particularly dominant at Big Three firms. Hortense Bioy et al., *Passive Fund Providers and Investment Stewardship*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 21, 2017), <https://corpgov.law.harvard.edu/2017/12/21/passive-fund-providers-and-investment-stewardship/> (showing that large majorities of the assets managed by BlackRock, Vanguard, and State Street were comprised of index funds).

## 2. Capping Size

Limiting the AUM of any one institution would force large asset managers to break up into smaller ones. For example, capping the AUM of asset managers at half-trillion dollars would require BlackRock—which holds nearly seven trillion dollars in AUM<sup>256</sup>—to break up into fourteen different fund families and State Street and Vanguard to split into an additional twenty fund families.<sup>257</sup> Such a breakup would transform three big players into thirty medium-sized players that would then compete with each other. With smaller AUM, no single fund or group of funds could gain dominance over the entire market.<sup>258</sup> A fund might be able to attain the status of common owner, but could no longer act as the kind of market-wide common owner that has led to the monopsony effect.<sup>259</sup>

This Article does not propose any particular amount to cap size of AUM, as this is a decision that should take into account the minimum size to achieve economies of scale in investing—requiring a study which is beyond the scope of this article.<sup>260</sup> However, the fact that the median AUM of the top 500 asset managers globally is below \$50 billion<sup>261</sup> suggests that AUM does not need to be in the trillions to achieve economies of scale. For the purposes of discussion, half a trillion dollars is a convenient cap—but clearly, as the cap lowers, the number of players in the stock markets increases and the size of each player decreases.<sup>262</sup> To maintain the same relative size over time, the AUM cap could also be indexed to the increases in the value of the stock market as a whole.<sup>263</sup> While the appropriate cap needs to be determined, the monopsony effect

<sup>256</sup> See *supra* note 69 and accompanying text.

<sup>257</sup> See *supra* notes 70–71 and accompanying text.

<sup>258</sup> The sum of all American public equities (all the companies listed on the New York Stock Exchange plus the NASDAQ and OQTQX Market) is valued at about \$35 trillion. *Total Market Value of the U.S. Stock Market*, SIBLIS RESEARCH, <https://siblisresearch.com/data/us-stock-market-value/> (last visited Sep. 18, 2020).

<sup>259</sup> Investors of a certain absolute size are mathematically able to capture significant shares in *every firm*, allowing them to influence governance decisions across the board. See *supra*, section A. Hence, under a breakup, asset managers could become common owners but could not have the same influence over the whole market.

<sup>260</sup> For a small cross-section of the scholarly discussion on this topic, see, e.g., Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 729 (2019); Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 BUS. & POL. 327, 335 (2019) Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PENN. L. REV. 17, 26 (2019).

<sup>261</sup> BOB COLLIE ET AL., THINKING AHEAD INST., THE WORLD'S LARGEST 500 ASSET MANAGERS 11 (2019) [https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/10/P\\_I\\_500\\_2019\\_Survey](https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/10/P_I_500_2019_Survey).

<sup>262</sup> For instance, the breakup of AT&T in 1984 resulted in a number of smaller, leaner “Baby Bells” coming into existence. See George B. Shepherd et al., *Antitrust and Market Dominance*, 2001 THE ANTIRUST BULL. 835, 860.

<sup>263</sup> For an explanation of the relationship between firm size and market concentration, see, e.g., Lina M. Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontents*, 11 HARV. L. & POL'Y REV. 235, 266 (2017).



demonstrates that over the last four decades the balance has tipped toward *too few* powerful owners. Thus, moving toward *more, smaller* owners—as regulations have historically sought<sup>264</sup>—would reduce labor market monopsony.

Notably, capping the amount that an asset manager could hold *in any one industry or corporation* could achieve similar effects: fund families would be prevented from holding huge stakes in competing businesses.<sup>265</sup> Such a scheme would preclude common owners within industries, as well as across the entire market. However, capping the amount that institutions could hold in any one corporation would be more disruptive than a global cap. Funds would be forced to sell off huge blocks of stock to get below holding limits,<sup>266</sup> and to diligently maintain their holdings within those limits forever after.<sup>267</sup> This is a more complicated task than it seems: since institutional investors are composed of multiple funds,<sup>268</sup> and assuming holding caps would apply to the entire institution, asset managers would have to dole out allowance to each funds and ensure the sum of their holdings do not exceed the aggregate limits.<sup>269</sup> Moreover,

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<sup>264</sup> Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991) (explaining the historical dispersed ownership structure of US corporations as reflecting Americans mistrust of large powerful financial institutions and the political response of enacting rules restricting private accumulations of power by financial institution).

<sup>265</sup> This proposal has most prominently been championed by Posner, Morgan, and Weyl. See generally Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017). Under their proposal, asset managers could hold at most 1% of the shares in any given industry or one company in each industry. *Id.* at 678.

<sup>266</sup> For example, as of a few years ago, BlackRock owned about 8% of United, 7% of JetBlue, and 5% each of Delta and Southwest. Steven Davidoff Solomon, *Rise of Institutional Investors Raises Questions of Collusion*, N.Y. TIMES: DEALBOOK (Apr. 12, 2016) <https://www.nytimes.com/2016/04/13/business/dealbook/rise-of-institutional-investors-raisesquestions-of-collusion.html>. Under the Posner et al. proposal, see *supra* note 265 and accompanying text, it would have to sell of 7% of United (market capitalization of \$11.3 billion), 6% of JetBlue (\$3.2 billion), and 4% of each Delta and Southwest (\$19.4 billion and \$21.4 billion respectively). See *Airlines*, NEW YORK TIMES: MARKETS, <https://markets.nytimes.com/research/markets/usmarkets/industry.asp?industry=52421> (last visited June 16, 2020) (listing the market capitalization of firms in the airline industry). Otherwise, it would else divest all of its stock in all but one of those airlines. Note, of course, that we are assuming it owned stock in *no other airlines*. Assuming it took the former route, BlackRock would have to liquidate, conservatively, \$2.6 billion in holdings *in the airline industry alone*.

<sup>267</sup> For a review of the transaction costs on both the regulatory and the corporate ends of such a proposal, see Thomas A. Lambert & Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms* 44–47 (U. Mo. Sch. Law Legal Studies Research Paper, No. 2018-21, May 4, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3173787](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173787). While Lambert and Sykuta's concerns that curtailing the influence of institutional investors would increase agency costs is addressed later, see *id.* at 49–50, see *infra* section D, they outline the extensive regulation that would go into a proposal like Posner et al.'s. Of course, with increased regulation comes increased compliance costs.

<sup>268</sup> Hemphill and Kahan explain that any single institutional investor represents a multiplicity of groups and funds. See Hemphill & Kahan, *supra* note 26, at 1421–23.

<sup>269</sup> In order for any of the funds to increase its stake in one industry, another fund would have to sell some of its holding, requiring an extensive amount of coordination between large number of funds. For instance, BlackRock maintained 927 funds. *Investment Funds*, BLACKROCK, <https://www.blackrock.com/sg/en/products/products-list> (last visited June 15, 2020).

such a proposal would restrict the strategies that institutional investors could use, for example by preventing them from building large positions in companies or industries with perceived upside. Thus, capping the amount any asset manager could hold in any particular corporation would create more transaction costs than simply capping the absolute amount of AUM of each asset manager.

To be sure, breaking up diversified asset managers into smaller institutions would not change their investment strategy of investing across wide segments of the market, and they might still advocate for strong governance to maintain the profitability of the monopsony effect. However, as the next section explains, although the *incentive* of the newly created passive funds will stay the same, their *power vis-à-vis* management will decrease.

### B. *The Impact of Breakup on Common Ownership*

A large number of small shareholders cannot wield the same power as a few large blockholders. The monopsony effect arises because common owners can impose their governance agenda on essentially the entire market, impacting the balance of strong- and weak-governance companies.<sup>270</sup> A larger group of smaller investors would not have the power to assert similar dominance over the corporate sector. Particularly, smaller asset managers operating under an asset cap could not generate a monopsony effect for at least three reasons: (1) they would lack the incentives to directly participate in corporate democracy; (2) activist investors would face greater transaction costs in pushing for strong governance; and (3) directors would be free to act independently without worrying about the “800-pound gorilla” of institutional investor voice.

#### 1. *Incentive to Vote*

The incentive of a shareholder to vote depends on the expected value of voting: the cost of being informed about voting options relative to the expected benefit from a successful vote. Because of fixed information costs, smaller asset managers would have less incentives to participate in corporate voting than larger asset managers do.

Start with the fixed cost of being informed about upcoming corporate votes. Voting in a particular way may or may not increase a company’s value: to decide whether or not to support an activist campaign or an insurgent board candidate, shareholders must invest in gathering the necessary information.<sup>271</sup> For large common owners, this investment might be worthwhile, but for smaller institutions, the cost of being informed could become insurmountable.<sup>272</sup> That is,

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<sup>270</sup> See *supra* section D.

<sup>271</sup> Michael C. Schouten, *The Mechanisms of Voting Efficiency*, 2010 COLUM. BUS. L. REV. 763, 773 (2010) (“[S]hareholders need to have at least some information to ensure that they are more likely to be right than wrong.”).

<sup>272</sup> John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (analyzing the incentives to vote); Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1300 (2013) (“Information is costly, but the returns

both large and small owners face the same cost of becoming informed,<sup>273</sup> so whether or not it makes sense to vote in an informed way depends on AUM. It may make sense for a family of index funds with cumulative assets in the trillions to invest in the human resources and technology to make informed decisions.<sup>274</sup> But for a smaller fund, there would be no way to recoup that investment. Thus, the fixed investment in becoming informed only pays off past a certain size.<sup>275</sup> The fixed cost of information, surely, is one reason why fund families pool their resources into teams that conduct “engagements” with portfolio companies.<sup>276</sup>

Now, consider the expected value of a successful vote. Scholars often reference relatively low management fees (especially for index funds) to explain why asset managers *already* have little interest in participating in shareholder democracy.<sup>277</sup> However, the sheer size of their holdings—and the associated upside potential of voting in a way that increases corporate value<sup>278</sup>—makes participating in corporate governance worthwhile,<sup>279</sup> explaining why “passive” asset managers do in fact actively participate in the affairs of their portfolio companies.<sup>280</sup>

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to the individual shareholder for improving corporate performance are distributed pro rata, such that shareholders rarely have individual economic incentive to engage more than casually on questions of corporate management.”).

<sup>273</sup> Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 536 n.19 (2018) (“[R]esearch that adds value is expensive and its fixed cost is best spread across large portfolios. These insights were a boon to the mutual funds and index funds offered by institutional investors.”).

<sup>274</sup> Chester S. Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 25, 2019) (noting that “asset managers and proxy advisory firms benefit from considerable economies of scale as information production and decision-making scale upward with relatively little additional cost”).

<sup>275</sup> See Rock and Kahan, *supra* note 254, at 25–26 (arguing that while the incentives for smaller fund families lean against acquiring the data necessary to make informed decisions, the math may work out differently for larger funds).

<sup>276</sup> See, e.g., Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 395 (2016).

<sup>277</sup> See *supra* note 93 and accompanying text. For fund families focused on passive investments spending the resources to become informed is contrary to their very nature and business plan: index funds offer their services for low management fees precisely because they shy away from careful analysis of the companies in which they invest. See Lizzy Gurdus, *The Success of Passive Investing Comes Down to One Thing, Experts Say: Fees*, CNBC (Nov. 6, 2019), <https://www.cnbc.com/2019/11/06/passive-investings-success-comes-down-to-fees-experts-say.html>.

<sup>278</sup> Rock & Kahan, *supra* note 254, at 12–13.

<sup>279</sup> See Rock & Kahan, *supra* note 254, at 14. Rock and Kahan point out that there are at least two reasons why larger asset managers have incentives to govern that smaller ones do not: First, a large common owner is much more likely than almost any other shareholder to be able to swing a corporate election (higher probability of a successful vote). Second, common owners are the largest beneficiaries of any stock price increase, giving them a concrete reason to exercise their influence (higher upside of a successful vote). *Id.*

<sup>280</sup> See, e.g. Einer Elhauge, *The Greatest Anticompetitive Threat of Our Time: Fixing the Horizontal Shareholding Problem*, PROMARKET (Jan. 7, 2019), <https://promarket.org/2019/01/07/greatest-anticompetitive-threat-horizontal-shareholding/>.

Following a breakup, the incentives to participate in corporate governance would quickly erode. For smaller asset managers, the upside of informed voting falls while the cost of becoming informed stays the same.<sup>281</sup> While the cost of being informed stays fixed, the increase in management fees as a result of stock price increases from a successful vote would become insignificant,<sup>282</sup> along with the chance that any one investor's votes would be pivotal.<sup>283</sup> As smaller asset managers face diminished incentives to interfere with corporate management, their effect on the labor monopsony would diminish.

## 2. Increased Transaction Costs for Proxy Fights.

Increasing the number of asset managers would also make it more difficult for activist investors to build the coalitions necessary to wage proxy campaigns, limiting one of the central tools common owners use to restrict managerial freedom. Instead of working with the same few repeat players in every proxy fight, activists would have to engage many more shareholders<sup>284</sup> and win over a much larger cadre of investors.<sup>285</sup> A larger number of investors presents not only a challenge in terms of time, energy and communication costs, but also a strategic difficulty in forming a coalition.<sup>286</sup> The larger the number of asset managers, the greater the divergence of opinions among them as to both the appropriate governance structure and the quality of investments undertaken by managers.<sup>287</sup> A larger number of asset managers with differing opinions will also allow managers to counteract activists by persuading a substantial number of

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<sup>281</sup> See Spatt, *supra* note 274 (noting the “fixed costs to the underlying information” in shareholder voting).

<sup>282</sup> For this reason, smaller fund families typically do not actively vote their shares at all, instead deferring to proxy advisers. See Rock and Kahan, *supra* note 254, at 7.

<sup>283</sup> See, Rock and Kahan *id.* at 14.

<sup>284</sup> See generally, John C. Coffee, Jr. *The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* (Eur. Corp. Governance Inst., ECGI Working Paper Series in L. No. 373/2017, Nov. 2017), [https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3058&context=faculty\\_scholarship](https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3058&context=faculty_scholarship) (outlining the relationship between activist hedge funds and “permanent shareholders”—BlackRock, Vanguard, and StateStreet).

<sup>285</sup> John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds* (Eur. Corp. Governance Inst., ECGI Working Paper Series in L. No. 136/2009), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1489336](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489336) (describing the “various types of transaction costs” that arise from an activist bid, including “communication costs,” or the costs of communicating with shareholders).

<sup>286</sup> See Kahn & Vaheesan, *supra* note 263, at 266 (“In short, concentration increases the likelihood that actors will share interests and decreases the costs of organizing to advocate for their agenda.”).

<sup>287</sup> See Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 B.Y.U. L. Rev. 1015, 1019 (2015) (observing that widespread shareholder activism is possible only because the rise of institutional investors have reduced collective action problems in assembling a winning coalition); Amir N. Licht, *Corporate Governance*, in HANDBOOK OF KEY GLOBAL FINANCIAL MARKETS, INSTITUTIONS, AND INFRASTRUCTURE 369, 375 (Gerard Caprio, Jr. et al. eds., 2012) (noting that in dispersed-ownership firms, “[m]ounting a proxy fight to promote a proposal not sponsored by the board is a cumbersome, expensive exercise that may be reserved for special occasions”).

shareholders to support management over the activist.<sup>288</sup> Consequently, even in corporations with strong governance, the probability of mistakenly firing loyal managers will decrease.<sup>289</sup>

### 3. *The 800-Pound Gorilla.*

Negotiating the needs and preferences of a controlling shareholder has been colorfully described as struggling with an 800-pound gorilla.<sup>290</sup> While the Big Three institutional investors rarely exert outright control over their portfolio corporations, together, they are the largest shareholder in 90% of the S&P 500.<sup>291</sup> Breaking up the largest asset managers would go a long way toward sidelining the King Kong of the stock markets, allowing directors to exercise greater independence in investing and hiring.<sup>292</sup>

Consider, for example, how a director who favors a new investment project is likely to respond if BlackRock announces that it opposes the project. In the current interconnected market, there is no way to quarrel with a common owner without fear of significant reprisal. For example, that same director might also serve as a director<sup>293</sup> or executive<sup>294</sup> at another firm where BlackRock holds a large stake. Now, multiply that effect by three if *all* the Big Three oppose a move. Directors with career and reputation concerns cannot risk their relationship with the Big Three or other major asset managers, because these same key investors wield influence throughout the corporate sector.<sup>295</sup> Disappointing a controlling shareholder may lead to dismissal from a single board, but a run-in with a giant institutional investor could have more far-reaching consequences.<sup>296</sup>

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<sup>288</sup> DELOITTE, *ACTIVIST SHAREHOLDERS: HOW WILL YOU RESPOND?* 3 (2015), <https://www2.deloitte.com/us/en/pages/finance/articles/cfo-insights-shareholder-investor-activism.html> (encouraging management to fend off activists by “proactively engaging with investors,” and especially with “major shareholders, who can be cornerstones of an activist defense.”).

<sup>289</sup> As well as the probability of correctly firing disloyal managers.

<sup>290</sup> Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002) (describing the controlling shareholder as “an 800-pound gorilla [that] wants the rest of the bananas”).

<sup>291</sup> See Fichtner, *supra* note 11, at 313.

<sup>292</sup> See Kara Haar, *King Kong Through the Years: How the Giant Gorilla Has Evolved Since 1933*, THE HOLLYWOOD REPORTER (Mar. 9, 2017) <https://www.hollywoodreporter.com/lists/king-kong-years-how-giant-gorilla-has-evolved-1933-982360/item/king-kong-1933-983416>.

<sup>293</sup> In 2019, most S&P 500 independent directors sat on more than one board, with 33% sitting on three or more. SPENCER STUART, 2019 U.S. SPENCER STUART BOARD INDEX 17, [https://www.spencerstuart.com/-/media/2019/ssbi-2019/us\\_board\\_index\\_2019.pdf](https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf).

<sup>294</sup> A large proportion (41%) of CEOs sit on boards outside their own companies. *Id.* at 22.

<sup>295</sup> This argument is a variation of the same argument that applies to *managers*. See *supra* section 1. Of course, if directors had no career or reputational concern, this would be a non-issue.

<sup>296</sup> See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1488 (2007) (arguing that directorial independence is limited by the career concerns of directors); see also Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. Rev. 971, 983 n.60

A smaller asset manager cannot engender the same career and reputation concerns. Opposing a half trillion-dollar asset manager is less risky than challenging a seven-trillion-dollar asset manager. For instance, industry leaders devote time to decoding Blackrock CEO and Chairperson Larry Fink’s famous annual letter.<sup>297</sup> There would be no great need to decode, analyze, and ultimately act on the annual letter of an asset manager one-fourteenth the size. As such, breaking up the largest institutional investors would allay director concerns and allow them to act independently and according to their best judgment, without significant fear of reprisal.

Together, these effects explain why a smaller asset manager lacks the means and incentive to influence corporate governance in the same way that mega-managers such as BlackRock and Vanguard do. The sum of a smaller set of large voices is *greater than* the sum of a larger set of small ones. In short, following a breakup, common owners would no longer have the ability to impact corporate governance to the extent of creating a monopsony effect.

### C. *The Monopsony Model Revisited*

The monopsony model above demonstrates how common owners push the corporate governance balance away from its equilibrium, resulting in a disproportionate number of strong-governance firms.<sup>298</sup> After a mandated breakup, common owners would no longer have the same power to influence governance decisions *en masse*. Their ability to create a monopsony effect would be impaired or disrupted altogether. As such, after a mandated breakup, investment would rise, stimulating hiring and pushing labor prices back to equilibrium.

Consider again the model introduced above, where, due to the influence of common owners, wages are \$20,000 below equilibrium.<sup>299</sup> Employees earn \$80,000 a year despite producing marginal revenue of \$100,000. From an equilibrium of fifty-fifty strong and weak-governance firms, common owners have created a market of seventy strong-governance firms and thirty weak-governance firms. Previously, common owners opposed any attempt to move corporations back toward weak governance, resulting in higher returns to their portfolios due to the below-market wages.<sup>300</sup>

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(noting that directors’ career concerns are magnified because “they are likely to meet the same money managers at other public companies”).

<sup>297</sup> See Larry Fink, *A Fundamental Reshaping of Finance*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> (last visited Sep. 18, 2020); Dan Pontefract, *Decoding BlackRock Chairman Larry Fink’s Letter To CEOs On The Importance Of Purpose*, FORBES, <https://www.forbes.com/sites/danpontefract/2019/01/26/decoding-blackrock-chairman-larry-finks-letter-to-ceos-on-the-importance-of-purpose/#749bf2aa2995>.

<sup>298</sup> See *supra* section D.

<sup>299</sup> See *id.*

<sup>300</sup> See *supra* notes 237—238.

Now, however, suppose that common owners have been sidelined by a mandated breakup. Firms are once again free to make governance decisions that maximize profits. In order to benefit from the \$20,000 marginal profit from each employee hired, some of the strong-governance firms will switch to weak governance so that managers will be empowered to hire up workers and generate abnormal returns.<sup>301</sup> As more and more firms switch to weak governance, wages will rise until they equal the marginal revenue of each new hire.<sup>302</sup> That is, wages will bounce back to \$100,000. Moreover, as productivity increases over time, so too will wages, eliminating the monopsony effect in the long run.

A mandated breakup prevents common owners from forcing firms toward strong governance, thus disrupting the central mechanism of the monopsony effect. Without common owners looking over their shoulders, directors and officers are free to make bold or risky long-term investments that require large investments in labor.<sup>303</sup> Capping AUM and separating passive and active investing would restore competition and equilibrium to both the labor market and the corporate governance balance. Breaking up large asset managers is thus a significant step policymakers could take to eliminate the monopsony effect and return wages to their competitive levels.

#### *D. Breakup, Agency Costs, and Inequality*

The breakup proposal goes against the view of agency-costs essentialists that strong governance is an unmitigated good.<sup>304</sup> This Article advocates for breaking up major asset managers for precisely the reasons that other scholars have lauded their interventions. To take one example, scholars have praised institutional investors for providing the support for activist hedge funds to implement cost-saving and shareholder-empowering measures.<sup>305</sup> Meanwhile, this Article views the “one-two punch” of institutions and activists as a threat to competitive labor markets, leaving directors and managers less willing to invest in hiring workers.<sup>306</sup>

Key to allaying these concerns is the realization that while agents introduce costs, so too do principals. Empowering agents increases agent costs, while

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<sup>301</sup> See *supra* section B.

<sup>302</sup> Under classical economic competitive conditions wages are said to track productivity. Roy J. Rotheim, *Keynes and the Marginalist Theory of Distribution*, 355 J. POST KEYNESIAN ECON. 356–57 (1998) (describing the “orthodox theory of distribution” where the “factors of production receive unique rewards equal to the value of their respective marginal products”).

<sup>303</sup> See *supra* section 1.

<sup>304</sup> See Goshen & Squire, *supra* note 20, at 775 (describing agency-cost essentialism as the belief that “the reduction of agency costs is the essential role of corporate law and of related fields such as securities regulation”).

<sup>305</sup> For example, Gilson and Gordon describe activist investors as “governance arbitrageurs” who work alongside institutional investors in the service of “maximizing performance.” Gilson & Gordon, *supra* note 28, at 898–97.

<sup>306</sup> See *supra* section 0

empowering principals results in principal costs.<sup>307</sup> For the past several decades, scholars have focused on how to ameliorate agent costs by empowering principals—that is, how to police corporate malfeasance by empowering shareholders to hold disloyal managers accountable.<sup>308</sup> This Article argues that the fight against agent costs has neglected to consider the principal costs it inflicts in the form of a labor market monopsony.<sup>309</sup> Capping AUM—thus disempowering principals to a certain extent from influencing their agents—would shift the balance in the other direction. While agent costs would surely increase, this Article submits that the reduction in principal costs would outweigh the increase in agent costs.

To be sure, a return to more dispersed ownership world would mean greater management agency costs. If activist investors were hamstrung in their ability to wage proxy fights against disloyal managers, more inefficient investments would follow. However, there would also be fewer downsizings,<sup>310</sup> fewer mass layoffs,<sup>311</sup> and fewer managers *mistakenly* fired for being disloyal.<sup>312</sup> Managers, loyal or disloyal, would be freer to invest in aggregate. Indeed, shareholders would suffer a loss from more inefficient investments by disloyal managers, but shareholders would only be losing the value previously taken from employees.<sup>313</sup> The result would not be a windfall to employees, but rather a return to a more efficient and equitable balance between labor and capital.<sup>314</sup>

In short, agent costs have fallen *too much* and principal costs have increased too much. In a competitive equilibrium, investors bear some *efficient* level of inefficient investments due to agent costs.<sup>315</sup> Under the present equilibrium, those agent costs are *too low*, coming at the expense of lower wages.<sup>316</sup> The claim that muffling institutional voices would increase management agency costs is correct, but it misses the point. Indeed, smaller, weaker asset managers would be less able to promote the interest of shareholders in minimizing agent costs. But other interests—particularly those of

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<sup>307</sup> Goshen & Squire, *supra* note 20, at 771 (“Principal costs and agent costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other.”).

<sup>308</sup> See, John Armour et al., *What Is Corporate Law?*, in *THE ANATOMY OF CORPORATE LAW* 1, 2 (Reinier Kraakman et al. eds., 2d ed. 2009).

<sup>309</sup> See *supra* section C.

<sup>310</sup> See Lazonick, *supra* note 143 (arguing that the new mantra of activist hedge funds has become “downsize and divest”).

<sup>311</sup> See Brav, *supra* note 188, at 2764 (finding that employees at target firms experience hour cuts and stagnating wages). Mariah Summers, *Employees Often End Up the Losers In Activist Investing Campaigns*, BUZZFEED NEWS (Apr. 21, 2014), <https://www.buzzfeednews.com/article/mariahsummers/employees-often-end-up-the-losers-in-activist-investing-camp>.

<sup>312</sup> See *supra* notes 145–147.

<sup>313</sup> See *supra* notes 229–231 and accompanying text.

<sup>314</sup> See *supra* section III.C (arguing that the competitive distribution of wealth between labor and capital maximizes social welfare).

<sup>315</sup> See *supra* note 230 and accompanying text.

<sup>316</sup> *Id.*



employees—would be better served, as would the interests of the market as a whole.

#### CONCLUSION

In addition to explaining macroeconomic trends like wage stagnation and growing income inequality, the monopsony effect challenges the conventional wisdom in corporate law scholarship that strong governance is a net economic good. This Article identified the long-suspected—but until now, evasive—inherent anticompetitive implications of common ownership and strong governance. While strong governance reduces management agency costs, it simultaneously discourages investment and hiring. Common ownership brings about a new equilibrium, with higher corporate profits and lower wages, that increases income inequality. The inherent tradeoff of strong governance suggests that policymakers must choose between siding with shareholders or employees. If they choose employees, policymakers should consider breaking up common owners.