The Road to Shareowner Power

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Abstract

A dramatic rise in shareowner power and improvements in corporate governance can be achieved in the next few years by expanding the role of proxy advisory firms. This will require changing the way such firms are paid. They are now paid directly by investors who buy their advice; but this arrangement suffers from a free-rider problem. Instead, they should be paid by each corporation about which they are advising, in accordance with shareholder vote so as to preclude management influence. This arrangement would make it economically feasible for advisory firms to expand their services, becoming proactive like relational investors. Any proxy advisor other than the market leader stands to gain tremendously by initiating this new system. It would eliminate the natural monopoly feature of the current system, and spread the cost more equitably across all shareowners. It would also enable proxy advisory firms to market their Services to individual investors via the internet.

Mark Latham is a financial economisf, consultant, and coordinator of the Corporate Monitoring Project. Contact by e-mail: mlatham@corpmon.com; phone: (415) 391-7198; fax: (415) 680-1521; or post: 10 Miller Place #1701, San Francisco, CA 94108, USA. See www.corpmon.com/publications.htm for future Versions of this paper, discussion and further information. I gratefully acknowledge helpful comments from Mark Rubinstein.

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1. Introduction

Managers of large corporations sometimes do not act in the best interests of their employers, the shareowners. This problem has troubled economists and business people for centuries, and although progress has been made, the costs of this conflict of interests remain substantial.[1] Especially when no shareholder owns more than 5 per cent of the firm, no one has enough incentive to monitor management, because the private benefit is small – the “free rider” problem.

Proxy advisory firms provide some monitoring services to shareowners. They advise institutional investors on how to vote their shares, regarding director elections, executive compensation, mergers and acquisitions, capital structure changes, social issues, and other corporate policy matters. Each investor chooses its advisor(s), and pays a fee of $3 or more per meeting (normally one meeting per year per stock held). While this arrangement lets investors share the costs of monitoring, a free-rider problem remains because hiring a proxy advisor is voluntary and has some cost.

Investors face a free-rider problem when deciding whether and how much advice to buy, because advice helps them vote intelligently, which helps all shareholders. Baums and von Randow[2] proposed a solution to essentially this same problem in a German context: having “voting agents” (much like proxy advisory firms) paid by the corporation, but selected by shareowner vote.

This paper shows how to apply their solution to proxy advisors, and explores some attractive developments that may result. Section 2 explains the free-rider problem. Section 3 proposes a solution to the free-rider problem for advisory firms. Section 4 describes the likely expansion from advising to a more proactive role. Section 5 shows the potential for proxy advising to become a retail internet business. Section 6 discusses the legal steps required to implement the proposed system. Section 7 concludes the paper.

2. The Free-Rider Problem and Its Solution

“Let George do it.” In situations where there is a task to be performed for the public good, rationally selfish individuals will tend to do less than their share, resulting in inadequate performance of the task. Any work you do for the public good benefits you only slightly, while everyone else gets a “free ride” on your efforts. If we relied on residents to voluntarily clean city streets, we would be walking through trash every day. instead, we levy taxes and pay professional cleaners.

Likewise, a shareholder making an effort to vote intelligently benefits all shareholders, since voting affects corporate policy which affects profits. Therefore a rationally selfish shareowner owning less than 100 per cent of the firm, will make less effort than is optimal in terms of cost versus total benefit. Most shareowners of large American firms own less than 1 per cent of the firm, making this rational voter apathy extreme. That is why as much decision-making as possible is delegated to professional corporate managers. Some issues, however, are so important or so fraught with conflict of interest that they must be put to shareholder vote.

While most individual investors do not even bother voting their stock, institutional investors do vote, partly because their larger holdings give them more of the benefit of their intelligent voting, and partly because of laws obliging them to vote. Intelligent voting on corporate policy requires study of the company's situation to form an opinion independent of management. Institutional investors do some of the necessary research themselves, but also hire proxy advisory firms to do it for them. This makes economic sense, because with hundreds of institutional investors holding shares in a given company, it is not worth the cost to generate hundreds of independent opinions on each policy proposal. It is more efficient to pool the cost of research by hiring a proxy advisory firm, as long as it is independent of the company being voted on.

Nonetheless, the free-rider problem remains. Even the largest institutional investors rarely hold as much as 5 per cent of a company's stock, so they get less than 1/20 of the benefit of the time and money they spend on voting intelligently. Therefore the proxy advisory industry today must be smaller than would be best for investors. Investors would buy more advice if they could get 100 per cent of the benefit to balance against their cost. For example, when shareowners vote for directors, advisory firms let them know which directors have missed more than 25 per cent of the past year's board meetings. This is a very crude measure of effectiveness. A director can warm that seat every meeting but still be ineffective. However, more accurate assessments, such as by interviewing directors, require more time, more expertise, and thus more money.

The existing proxy advisory system is like having each city resident decide whether to contribute to the fund for hiring professionals to clean all city streets. There is still a strong incentive to choose to contribute very little, leaving plenty of dirt on the streets. But we can create a payment system analogous to a citywide tax. It makes sense to pay as a group for something that benefits the whole group.

3. Competition for Proxy Advisory Fees

It is easier to think about these issues in terms of specific numbers. The example presented in this section is illustrative but fictional.

The leading American proxy advisory firms are Institutional Shareholder Services (ISS), Proxy Monitor (PM), and Investor Responsibility Research Center (IRRC). ISS has by far the greatest market share.[3] Suppose ISS and PM are both covering proposals to be voted on by IBM shareowners. ISS has 1000 clients paying $3 each per meeting (think of one shareholder meeting per year), collecting $3000 for its advice. PM has 60 clients paying $3 each, collecting $180 for its advice.

What's wrong with this picture? The problem is that this business is a natural monopoly. Once an advisory firm covers a company and does the work to decide how best to vote, it can sell that advice to as many clients as possible, with minimal further cost. Since the per-client fee is $3 for both ISS and PM, ISS is not pressed to provide better advice even though it is collecting much more in fees. With that structure of costs and revenues, once an advisory firm has a commanding lead in market share, it is difficult for competitors to have a viable business. PM has a long way to come from behind, and will have difficulty offering a competitive product because it is funded by so little revenue.

Here is a radically different business strategy for PM: First, it gives away some advice for free, both on the worldwide web and by dial-up link to its computer. It chooses a few high-profile companies like RJR-Nabisco, where there is some controversy between management and shareowners. It also chooses a few of the companies for which proxies can now be voted on the web. Before the annual shareholders' meeting of each chosen company, PM puts out its voting recommendations for anyone to read.

Second, PM announces that it will provide similar public voting advice for any company for a fee of $200, provided that the fee is paid by the company with the approval of a majority of its shareowners. If the company pays, then in effect all shareowners are paying, with the extra benefit of reducing corporate taxes.

Would anyone take PM's offer? Management is likely to oppose the idea, because they prefer not to be monitored. It would require a binding shareholder proposal, leaving management no discretion. The $200 spread across all shareowners is a trivial cost, while providing substantial benefits. Institutions that had been buying ISS's advice could switch to PM for those firms covered publicly by PM, saving some fees. Those who were not buying professional advice could then have access to some. Even those who have no intention to use the PM advice would still benefit from the improved quality of voting by others. What good does it do for institutions to pay for advice on contentious issues, only to lose those contests because many unadvised shares are blindly voted with management in the current system? Therefore shareholders generally can be expected to support this new proposal.

$200 is of course a special introductory offer, a loss-leader price to launch this new market channel. Once the channel is opened and investors learn how it works, many rapid developments will follow. PM will raise the price. Competitors will start using the channel. Quality and range of services will expand, and spread globally. ISS, PM, other existing advisors and new entrants would compete on a more equal footing, because the company-pay fee structure gives each the same number of clients -- all the shareowners of the given company. This will solve the natural monopoly problem without government intrusion.

A corporation's shareholders could vote to hire more than one proxy advisor.[6] All shareowners would be able to learn from the advice of all advisors so hired, thus maximizing the use of information. The cost of informed voting would be distributed equally across all shareholders, along with the benefit. Investors would benefit from competition to offer higher quality at a lower total cost. Shareowners who want to buy advice from firms not selected would still be free to do so.

Perhaps most important, such a payment structure would open up the advisory business to expansion in two new directions: proactive monitoring (drafting proposals and nominating directors), and advising individual investors via the internet. These are explored in the next two sections.

4. From Advising to Proactive Monitoring

Section 2 argued that solving the free-rider problem would result in expansion of the proxy advisory business. Section 3 pointed out that having advisors paid by the corporation would result in greater competition to increase the quality of advising. Those two are essentially the same point.

What could advisory firms do to help shareholders besides recommend the wisest choices for proxy voting? They could make proposals, and they could nominate directors. Even more than advising, these two functions affect a company's value, and they too suffer from the free-rider problem. In recent years, governance activist investors like CalPERS (California Public Employees Retirement System) have undertaken such actions. But any shareowner making the effort to draft proposals or influence the choice of directors must share any benefit with all other shareowners. Therefore not enough value-maximizing effort is directed at these methods.

Once a competitive system for hiring advisers has been operating for a few years, shareholders can decide if they have enough confidence in it to expand the advisor role. For a higher fee, an advisor could take on some of the functions of activist shareowners: critiquing management's policies, and drafting proposals it considers to be in the owners' interests. (No doubt it would confer with shareowners in the process.) Perhaps only one advisor would be assigned this capacity in a given year.

If the advisory business were a near-monopoly, investors might be reluctant to expand the advisor's power. But the company-pay system will bring more entrants and level the playing field so that no single player would dominate. Advisors will compete to build reputations for helping investors through sound business judgement and independence from management.

If shareholders believe that the director nomination process would benefit from oversight by an advisory firm, that function could also be added, the advisor chosen by vote and paid a specified fee by the company. This would make directors loyal to the company's owners, enabling directors to ask management difficult questions when appropriate without fear of being dropped from nomination next time. Thus for example, the audit committee could be staffed with truly independent directors, to decrease the risk of allowing excessive earnings management. The resultant benefits of higher profitability, more realistic management pay, and balanced treatment of social goals are extensively discussed in Latham[4,5] where the proxy advisory firm in its expanded role is called a "Corporate Monitoring Firm" (CMF).[6]

5. Advising as a Retail Internet Business

Individual investors have enthusiastically embraced the internet, both as an industry and as a medium. They trade internet stocks on the internet. The company-pay system for proxy advice proposed above could trigger a sharp rise in voting by individuals, once they can vote conveniently on the net.

You can already vote some proxies on the worldwide web, at www.proxyvote.com and www.vote-by-net.com. The company-pay advisor system will put professionally researched voting advice on the web for all shareowners to use freely. You can then surf to your favorite proxy advisor's site, read the voting recommendations for your stocks, go to www.proxyvote.com and vote your shares. Will you bother? Or is all that surfing, reading and typing still too much, given rational voter apathy?

The right software can make it as easy as a mouse-click. Personal financial management software like Quicken can already be automated to log in to your broker's computer, get your latest trade and position data, and calculate your profit.[7] Next it can be automated to read proxy advice and vote accordingly, if you check the appropriate box. Surely that makes it easy enough for you to want to take back control of your companies from management, who always got your proxies before by default. If you prefer to make your own decisions, the software can let you pull up each proposal and the relevant research, then vote it your way. Voting with management would still be an option, and free advice from other sources would no doubt also become available.[8] In fact, CalPERS has recently started posting its voting decisions on the web, at www.calpers-governance.org/alert/proxy/ . Other web resources are linked from www.corpmon.com/Vote.htm .

There are many motives for investors to vote. Some have views on environmental, social and political issues that could be advanced by influencing corporate policy. Many investors want any information that bears on the value of the stock. Once they read about matters being put to shareholder vote, they can then vote their views with one mouse-click.

If voting by individuals becomes widespread, they will influence corporate policy to an unprecedented extent. Proxy advisory firms will have to consider how their reputations influence whether they get chosen by individuals, as well as by institutions. Advisors could themselves become the next hot internet stocks.

6. Legal Hurdles

To keep this monitoring process independent of management, it must be conducted by shareowner vote. The usual shareowner proposal process enacts precatory proposals, leaving the board discretion as to whether to obey them, thus allowing too much management influence. Instead, it would probably have to be established by a binding bylaw amendment. These are overseen by state law, and the degree to which shareowners can enact such amendments in the face of management opposition is being debated this year in Delaware, where most large U.S. firms are incorporated. There may be significant legal obstacles to proposals authorizing expenditures without review by the board of directors, as discussed in Hamermesh (1998).[9] It would be unfortunate if such a law were to block the creation of a mechanism beneficial to investors and the economy as a whole. Possible remedies include revision of the law, and incorporation in another state.

Hamermesh points out that shareowner proposals have only recently become popular, the legal rules have not yet been clearly delineated, and there are reasons to suspect that allowing broader use of this tool may actually harm investors. Given rational voter apathy induced by the free-rider problem, a small group of investors may try to use the proposal mechanism to advance their interests at the expense of the majority, by greenmail or other means. As amateur attempts to usurp professional managerial authority, resolutions may be poorly written, confusing, and in conflict with each other.

While these problems may hamper some proposals, they are actually arguments in favor of the type of proposal advocated in this paper. Having the company pay for proxy advice for all shareholders removes most of the free-rider problem, making it easier for all investors to vote intelligently, diminishing the clout of activist minorities with diverging interests. As suggested in section 4 above, an advisory firm can help write future proposals, bringing greater professionalism to that process. Thus investors can have both "voice" and "exit". Even those with small holdings and short holding periods can vote meaningfully with minimal effort, based only on the reputations of competing advisory firms.

7. Conclusion

Proxy Monitor and other advisory firms competing with Institutional Shareholder Services should offer their services on a "company-pay" basis. Shareowners should vote to institute a system of having the corporation pay for their proxy advice. This would solve both the free-rider problem and the natural monopoly problem for advisory services. It would pave the way for an expanded role for advisory firms, bringing substantial improvements in corporate governance. Freely available professional advice would enable individual investors to vote intelligently via the internet, thus participating in determining corporate policies.

Notes

1. There are many surveys on this subject. See, for example, the extensive reading list at http://www.corpgov.net/library/library.html, and Monks, Robert A. G., and Nell Minow (1998): Watching the Watchers, Blackwell Publishers.

2. Baums, Theodor, and Phillip von Randow (1995): "Shareholder Voting and Corporate Governance: The German Experience and a New Approach," in *Corporate Governance in Transitional Economies,* edited by Masahiko Aoki and Hyung-Ki Kim, The World Bank.

3. European competitors include Institutional Voting Information Service, Manifest Voting Agency Ltd and Pensions & Investment Research Consultants Ltd in the UK, and Proxinvest in France. Fairvest Securities is a Canadian proxy advisor. ISS has extensive international coverage, with offices in London and Australia.

4. Latham, Mark (1998): "Corporate Monitoring: New Shareholder Power Tool," *Financial Analysts* Journal 54:5 (September/October).

5. Latham, Mark (1999): "The Corporate Monitoring Firm," Corporate *Governance - An International Review* 7:1 (January); http://www.corpmon.com/CorpMonFirm.htm.

6. There are so many possible configurations of shareowner voting mechanisms, functions of a monitoring agency, and resultant adaptations of a corporation's power structure, that the eventual evolution of this system is hard to predict. But putting more power in the hands of shareholders should ensure that the results are broadly beneficial.

7. Quicken is a registered trademark of Intuit Inc. Internet brokers might also enable customers to vote their stock conveniently at the brokers' websites.

8. For example, these other sources could include journalists, political, environmental and religious groups.

9. Hamermesh, Lawrence A. (1998): "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?" *Tulane Law Review* 73:2 (December).