

# VOTE YOUR STOCK

*Mark Latham\**

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*\*Founder, Corporate Monitoring Project ([www.corpmon.com](http://www.corpmon.com)), 1755 Robson Street #469, Vancouver, B.C., Canada V6G 3B7. Tel.: (604) 608-9779; e-mail: [mark@corpmon.com](mailto:mark@corpmon.com)*

## **Abstract**

Institutional and individual investors can coordinate their proxy voting to improve corporate governance. A new funding design can increase competition and quality of professional proxy advisors. These reforms would reduce the need for the public sector to police boards of directors by onerous regulation and expensive lawsuits.

Recent corporate governance reforms have higher costs and lower potential benefits than a strategy of empowering investors to protect their own interests by more informed voting. The Sarbanes-Oxley Act shifts some power from one group of agents (CEOs and other directors) whose interests conflict with shareowners, to another group of agents (courts, lawyers, regulators, oversight boards) whose interests also conflict with shareowners.

Instead, we can substantially improve investor influence on boards by implementing three measures to raise the quality of shareowner voting:

1. Bring individual investor voters on side with institutional investors, rather than leaving their votes in management's pocket.
2. Increase competition among institutional investors to enhance their reputations for voting in shareowners' best interests, by unbundling voting from portfolio management.
3. Increase competition and quality of proxy voting advisors by paying them with investor-directed corporate funds, with the added impact of giving their advice to all shareowners.

Through voting influence on director elections, on compensation plans, on mergers and other key decisions, these reforms would make directors more loyal to shareowners, thus enhancing stock returns.

## **I. Individuals can vote by brand reputation**

Brand reputation makes it easy for individuals to vote in civic politics, by reducing the need for detailed analysis of issues and candidates every time we go to the polls. We can choose Republican, Democratic, Green or other brands based on what we have learned about those brands over the years. It's important to make voting easy, because the private incentive to vote is so weak. For voting shares in corporations, lack of brands has left individual investors out of power.

What other brands could individuals use to guide their voting of shares? Fortunately, there are already many teams of experts analyzing the corporate policy issues raised in the annual proxy voting process (director elections, management stock option plans, choice of auditor, mergers, recapitalizations and so on). These teams include the proxy voting departments of some institutional investors, and professional advisors like Institutional Shareholder Services and Glass Lewis.

Thanks to these experts some stock is now voted intelligently in the shareowners' interests, but most stock is not. For example, most individual investors either don't vote at all, or simply follow the voting recommendations of each corporation's board of directors because that is the only professional advice conveniently available. However, the interests of directors often conflict with our interests as shareowners, which is why we have an annual vote in the first place. This problem is compounded by stock exchange rules allowing brokers to vote stock owned by individuals who neglect to vote. These broker

votes overwhelmingly follow director recommendations, leading the Council of Institutional Investors to describe the practice as “ballot stuffing for management.”<sup>1</sup>

The internet can help us solve this problem. When individuals bring up their proxies at the most popular voting website, proxyvote.com, the first button they see says “Vote my shares per directors’ recommendations”. Someone could build software to give them other convenient sources of voting advice, like a button saying “Vote my shares the way CalPERS is voting its shares”.

CalPERS is the California Public Employees’ Retirement System, America’s largest public pension fund. For many years they have built a reputation for intelligent voting in the shareowners’ interests, independent of corporate management influence. Then in 1999 they started posting their voting decisions on the web ([www.calpers-governance.org/alert](http://www.calpers-governance.org/alert)) about two weeks before each voting deadline. Many other institutional investors now post their decisions on the internet promptly too. This makes professional voting guidance available to the public for free.

The SEC now requires all mutual funds to publish their voting decisions, starting August 2004. Although funds need not disclose in advance of each voting deadline, some choose to do so. In any case, with disclosure now becoming widespread, we can expect the financial community to publicly discuss and compare institutions’ reputations for intelligent voting in the shareowners’ interests. Individuals will then be able to choose voting advisors based on reputation, just as we can buy personal computers based on brand reputation without being computer experts ourselves. More and more stock will then be voted in the interests of shareowners, giving corporate management greater incentive to serve those interests. Competition for public reputation will maintain some upward pressure on the quality of voting advice even though the advice is free of charge. (Section IV below shows how to enhance quality still further by paying for it.) We can expect other organizations to enter this competition for reputation, such as environmental groups and unions, offering proxy voting advice for those who share their principles.<sup>2</sup>

Will this development be enough to get individual shareowners to vote? We’ll find out after it gets going, but there are many reasons for optimism. The biggest obstacle to voting now is not the time it takes to mail in an envelope or click on a website. Rather, it’s the time it would take to make an informed vote. Most people realize that just going along with the board of directors for lack of an easy alternative is not a meaningful vote. But understanding the proxy issues requires too much time and expertise. A voting website with competing advisors would not only remove this biggest obstacle, but could even automate voting all your stocks to follow your chosen advisor until you reset that option. Even though individuals may not understand the details of corporate policy issues, just knowing brand reputation of advisors is enough to make their votes count.

Enron and other scandals have shown us that the current governance system leaves our investments at substantial risk. That fact will encourage many to participate in an effective alternative. Just as we have done for civic voting, we can build an ethic to vote your stock as a responsible member of the financial community. To go a step further, a public website could show the names of those who vote.

Internet voting of stock using advisor brand reputation will give individual shareowners an effective vote for the first time. Although it will take years to change their voting habits (or rather, their non-voting habits), this could start a fundamental shift in corporate power and management accountability.

## **II. Secret ballots prevent vote-selling**

Taking advice on voting, even with automated software, is different from transferring your voting authority to the advisor. When you take advice, the advisor need not know how you are voting or whether you are following their advice. Our rules for voting in civic elections show the critical issues at stake here. If someone knows how you vote, then they can reward you for how you vote. In other words, you can sell them your vote. To prevent this, we require secret voting in civic elections. You must cast your ballot in person; no one else can vote for you. You are given no record proving how you voted. And you may not show anyone how you are voting, even if you want to. *Especially* if you want to.

We have never made voting your stock as confidential as voting in civic elections. You can vote from home, unsupervised, by paper mail or the internet. No one prevents you from showing others how you vote. But the potential for undermining all voters' collective interests is similar in both corporate and civic contexts.

Selling votes undermines the public interest because voting is a collective decision process. As with working on a collective farm, there is very little private incentive for you make any effort on behalf of the community. This is called the "free-rider" problem, since those who work less get a free ride on those who work more. That is why voting has to be made so easy. Fortunately most of us have enough community spirit to vote if it's easy, but allowing vote-selling would create such a direct opportunity to sell out the public interest for a small private gain that many of us would do it. The people who would pay the most for votes are those planning to use the power of elected office for their private benefit, so we would all end up losing because we sold each other out.<sup>3</sup>

There are several practical reasons for us not to require secret voting of stock. It would be costly and cumbersome to create supervised polling places as we do in civic elections. Most stock is voted by intermediary agents (such as mutual funds) on behalf of the beneficial owners, which prevents secrecy at the fundamental beneficial owner level anyway. We have developed other ways of defending against vote-selling, including explicit prohibition, detailed rules for proxy solicitation, the ability to change your vote up to the meeting date, and confidential tallying of votes at some companies.

Nonetheless, we should keep in mind the potential harm from vote-selling and the lack of secrecy which permits it. Depending on how we use the internet and other technological advances, such harm could substantially increase or decrease. Thus I emphasize that in the voting advisor brand reputation system proposed in section I above, advisors need not know who is following their advice. There is still the risk of bribing advisors, but we have similar risks of self-serving influence on those who vote stock now, without the countervailing force of competition for advisor reputation.

### III. Unbundle voting from investment management

If a new system of advisor brand competition can raise the quality of individual investor voting, it can do the same for institutional investor voting. Figure 1 summarizes statistics from the NYSE publication *Shareownership 2000*, showing that U.S. equities are owned about 41% by individuals and 59% by institutions. But actually, equities are owned 100% by individuals. This is the difference between legal ownership and economic (or “beneficial”) ownership. Although institutions legally own stock, they are merely intermediaries or conduits for the ultimate economic owners, individuals. The conflicts of interest arising from how stock is voted are a function of *economic* ownership.

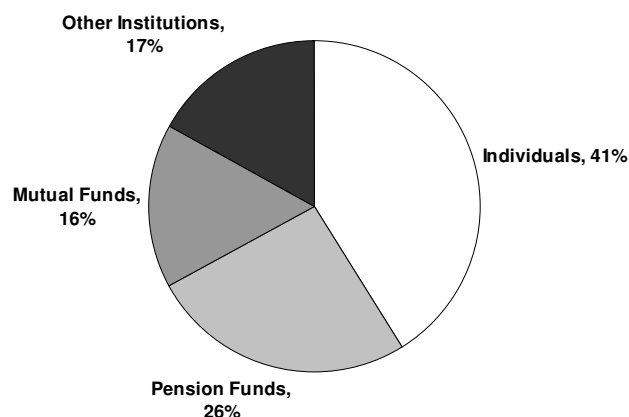


Figure 1 Share ownership (USA).

Suppose that several years from now we have succeeded in building the system proposed in section I above, and in educating most individual investors to use it for voting stock. If you invest partly in individual stocks and partly in mutual funds, you will then be able to vote your stocks following the advisor you think has the best reputation. But the stock you own through your mutual funds would still be voted by your mutual funds’ managers on your behalf.

As we know from civic politics, letting someone vote on your behalf can open the door to such mischief as vote-selling. Likewise for voting stock. A recent SEC proposal on voting disclosure explains: “...the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.”<sup>4</sup>

Awarding fund management business is not the only way corporate managers can buy mutual fund votes: “[SEC] Regulation FD is also designed to address another threat to the integrity of our markets: the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors.”<sup>5</sup>

We are fortunate that the SEC is alert to such abuses. But the private incentive to sell votes is pervasive, and merely requiring vote disclosure does not change this. Remember that your vote-selling benefits you but harms all other shareowners. Investing in a mutual fund that sells its votes can give you a private advantage over investors who shun it. The mutual fund managers can rebate some of the bribe to you by lowering their fees, so both they and you benefit at the expense of other shareowners hurt by poor voting of your stock.

The new SEC rule requiring mutual fund vote disclosure is a two-edged sword. Note that it goes in the opposite direction from how we prevent vote-selling in politics by keeping votes secret. Shareowner activists have for many years supported confidential proxy voting. CalPERS’ governance guidelines are explicit: “Proxies should be kept confidential from the company, except at the express request of shareowners.”<sup>6</sup>

The SEC’s reasoning seems to be that sunlight is the best disinfectant, that disclosing mutual fund voting will push them to vote more in their investors’ interests. But funds that sell their votes may actually be helping their own investors (while harming other shareowners). This is for the same reason why voters in civic elections can benefit by selling their votes, so that we need to prohibit it and prevent it by secret ballots. Letting people voluntarily choose whether to sell their votes is not sufficient protection. Disclosure of voting may end up facilitating vote-selling and thus increasing the entrenchment of poor corporate management.

There is a long-run solution to this problem: give individual investors the option of voting the stock they own beneficially through mutual funds. If the advisor reputation system proposed in section I enables us to vote stock we own directly as individuals, then we can use it for our mutual fund holdings too. Once we can automatically link to professional voting advice through the internet, we need no longer give voting authority to mutual fund managers. That assignment of voting rights was a compromise solution to the practical problem of voting the many fragmented shareholdings of individuals in mutual funds. That compromise will no longer be necessary once individuals can automatically copy institutional voting decisions via the internet. We can still benefit from those same mutual funds’ professional proxy voting analyses, plus improve the overall quality of voting by competition, choosing those sources of voting advice with higher reputations. This will provide some market protection against vote-selling.

This proposal can be seen as a natural complement to the new voting disclosure rules. Publishing voting policies and decisions helps the financial community assess which mutual funds are voting in the shareowners’ interests. Unbundling stock selection from voting makes it easy for individual investors to shift to higher quality voting without compromising their investment strategies. We have to make it easy because voting is a public service with minimal private incentive. An intermediate step to facilitate this

evolution will be to collect and organize voting decisions from many mutual funds in a single easily accessible website, along with some comparative discussion of voting quality and policies.

No matter how good a voting advisor's reputation is, it's a bad idea to let people hand over their voting authority to the advisor, especially when it's not necessary. In civic politics, we should not hand over our votes to the expert team at the New York Times. This should not be taken as a criticism of the New York Times' integrity, but rather as a statement of general principle on wise design of a democratic system. Likewise for shares, we should shift voting authority from institutional to individual investors. This should not be taken as a criticism of institutional investors' integrity, but rather as a statement of general principle on wise design of a democratic system.

The system development costs, education and behavioral change required for this evolution should be undertaken in stages. First, we can implement voting by advisor brand for individuals' personally owned shares, and encourage people to exercise this option. Then some mutual funds may voluntarily offer investors the option to vote their beneficially owned shares, just as some mutual funds are voluntarily disclosing their votes before the SEC requires it. Public-spirited investors may use their market power to encourage more mutual funds to follow suit. But again since voting is a public service, regulation may be needed to eventually push all funds to offer this option, just as we use regulation to outlaw transferring voting rights in civic elections.

Of course, mutual funds are not the only intermediaries invested in stock. Pension funds, insurance companies, and other corporations should also pass through voting rights to their beneficial owners. In defined-contribution pension funds, the future pension recipients bear the risk of stock price fluctuations, so they are the beneficial owners. In defined-benefit pension funds, pension recipients have a fixed-income claim against the fund, so the beneficial owners of the fund's stock investments are actually the shareowners of the corporation funding the pensions. In the case of public employee defined-benefit pension funds, those "shareowners" are the taxpayers, so in principle the stock held by CalPERS should be voted by all California taxpayers. Such a fragmented pass-through arrangement should be considered only after the simpler mutual fund pass-throughs have proven successful.

Passing through voting rights to the beneficial owners would be a neat solution to the undermining of owners' rights by cross-holding and pyramiding in such countries as Japan and Korea. Whereas American companies hold relatively little of each other's stock, in many other countries corporate managers can keep each other in power by voting stock legally owned by the firm they manage. They do not own this stock personally, but they can vote it against the beneficial owners' interests. In principle this is similar to American private pension funds voting to support management of other firms. Voting by beneficial owners can thus eliminate this pervasive underlying drag on the quality of corporate governance.

Letting individuals vote doesn't mean we will all bother to vote. We could consider creating a monetary incentive as in Australian civic elections, by paying a slightly higher dividend to those who do vote. Should mutual funds continue to vote those shares not

voted by their beneficial owners? That is the natural default policy for the early stages of this evolution. It is tempting to call for the eventual implementation of a general principle that only beneficial owners can vote stock. As in civic elections, letting someone else vote for you (or even know how you vote) would be banned. But for those shares that individuals would continue to neglect to vote, institutional investor voting can provide a valuable counterweight to the voting power of concentrated shareholdings, especially those of corporate insiders. We may learn how best to trade off these factors based on our experience in the earlier stages of this proposed evolution. But at least we should have a policy of trying to get some indication from each beneficial owner as to how their stock is to be voted.

Although shifting voting authority from institutions to individuals will reduce the opportunities and incentives for vote-selling, two types of corruption could still occur: vote-selling by individuals, and bribery of voting advisors. With individual beneficial shareownership far more fragmented than institutional legal ownership, it will be much harder for vote-buyers to organize significant influence without being caught. Making the vote tallying process confidential at all companies would further reduce the risk of such corruption.

The potential for bribery of voting advisors, however, is a substantial danger. Although I criticized disclosure for making it easier to sell votes, my proposed advisor system requires public disclosure of the advice. Whereas individual shareownership is fragmented, brand reputation is likely to concentrate influence into a handful of advisory organizations, making them a clear target for influence by corporate insiders. The ongoing market for advisor reputation in the financial community will have to guard against such corruption along with other causes of low-quality advice, such as incompetence or lack of effort. The market may develop ways of signalling integrity, including disclosure and contractual guarantees of strict penalties. The next section shows how to further enhance advisors' incentive to increase quality.

#### **IV. Pay voting advisors with corporate funds**

One powerful tool is missing from the voting reforms proposed above: money. If we want high-quality advice, we should pay for it. Especially to provide a counterweight against the temptation of bribery, we need to give voting advisors an incentive to stay honest.

The biggest obstacle to paying advisors is the shareowners' free-rider problem. Whether you are an individual or an institution, if you pay for advice to improve the quality of your voting, that helps all other shareowners even if they don't pay for or receive the advice. For example, if you own 1% of a company's shares then only 1% of the benefit from your voting comes back to you. So most shareowners have almost no incentive to pay for voting advice.

This problem limits the effectiveness of proxy advisory firms now, such as ISS (Institutional Shareholder Services, [www.issproxy.com](http://www.issproxy.com)), which depends on payments from institutional investor subscribers to their voting advice services. Even for institutions, 1% of a company is a large shareholding. Given the hundred-to-one severity of the resulting

free-rider problem, one might wonder how ISS can get enough institutions to pay for their research staff. The answer is a federal regulation that requires pension funds to vote stock in their beneficiaries' interests. Pension funds can satisfy this rule by subscribing to ISS research.

However, that only creates an incentive to pay for a minimal amount of research. "Comprehensive analyses of proxy issues and complete vote recommendations for more than 10,000 U.S. companies are delivered by ISS's seasoned U.S. research team consisting of more than 20 analysts."<sup>7</sup> We can thus estimate about four hours of analysis per proxy, costing perhaps \$2000 including ISS infrastructure costs. Considering the amount of money we shareowners pay CEOs and boards of directors who are elected and compensated based on our voting, and the amount of capital at stake in the typical company they manage for us, we should be spending more than \$2000 to guide our voting.

All shareowners of a company can solve the free-rider problem by paying for voting advice as a group instead of one investor at a time. If we can pay with company funds, then all are paying together in proportion to the number of shares owned, thus in proportion to any benefit in share value from improved voting. We can thus balance total cost and benefit, and choose to spend much more than \$2000 per proxy.

The trick is to keep the advisor selection and payment procedure free of influence from the board of directors. Otherwise, the board could bias the voting advice to benefit themselves rather than shareowners. As we will see, this proposal can be expected to attract new competitors into the proxy advice business. The mechanism for shareowners to choose an advisor from among several competitors is to include this as a new item to be voted in the annual proxy. Any proxy advisor could offer its services, specify its fee, and have its name and fee appear in the ballot. The winner would give proxy advice to all shareowners in that company for the coming year. The advice would be published on a website and in the next year's proxy. The company would pay the specified fee to that advisor.

To minimize frivolous entrants, there could be an entry fee to get onto the ballot, refundable if the advisor gets 5% of the vote. The voting could be designed to hire more than one advisor, with a separate yes/no vote on each candidate; or a single best candidate could be chosen by a vote ranking procedure to ensure it is preferred by a majority of voters. Advisor name brand reputation can make these voting decisions feasible without another level of paid voting advice.

This proposal would require a new corporate bylaw, which most boards would oppose because it reduces their power. A majority of shareowners may need to threaten to replace the board in order to get it implemented.

New advisors are likely to be created because solving the free-rider problem would dramatically increase total revenue of the advisory business, and because advisors could earn a significant fee for each company covered. They would no longer need to build a subscriber base. Experts in certain industries or countries could compete with ISS in their chosen sectors only.

By thus unbundling professional stock selection from professional voting advice and paying for each separately, we shareowners would benefit from better voting advice than any we have now. All shareowners of a company would get the advice instead of just the minority that currently subscribe to such research. Competition for advisor reputation would maintain pressure for high quality and moderate pricing.

Note that this proposal -- company-paid voting advice -- can be implemented independently of the individual investor proposals outlined earlier in this article.

## **V. Voting advisors could help set voting agenda**

Agenda-setting -- determining the issues to be voted on -- is often more important than voting. This is painfully clear in director elections, where typically the only candidates are those nominated by the incumbent board. With just one nominee for each board seat, voting hardly matters. However, the reforms proposed above can affect corporate voting agendas in two ways. First, a change in voting behavior may induce those who set the agenda to set it differently. Second, the voting advisor function could expand to include agenda-setting.

The trouble and expense of nominating board candidates to compete with the incumbent board's nominees is rarely worthwhile in our current system, where it is difficult for shareowners to determine the quality of an unknown challenger. Why bother running if you have no chance of being elected? An independent professional advisor can guide shareowners to vote for better challengers, thus encouraging the entry of such candidates.

Even without competing candidates, an independent advisor could recommend that voters withhold approval of the board's nominees. To avoid this potential embarrassment, the board may nominate a slate the advisor would support. Thus a well-paid advisor with strong reputation could negotiate with the board on nominations, and likewise on other agenda items: compensation plans, auditor selection and so on.

Shareowners could also vote for a new corporate bylaw empowering the voting advisor to directly set some agenda items. The advisor could nominate director candidates, propose a compensation plan, and recommend an auditing firm. Experiment and experience would show us over time whether brand reputation gives voting advisors a stronger incentive than boards to serve shareowner interests in these functions. If so, they would become more than mere advisors. In Latham (1998) I called this expanded entity a "corporate monitoring firm" (CMF).

Because a CMF would be selected and paid by all shareowners, it would not suffer the free-rider problem faced by any one shareowner undertaking agenda-setting. Even for large institutional investors, the free-rider drag on incentives would limit spending time and money on such critical tasks as extensive searching and screening of nominees for director positions. For this reason, the CMF system would provide more effective shareowner input to director nomination than current proposals to simply include shareowner nominees in the company-mailed proxy.<sup>8</sup>

## **VI. Shareowners would benefit from electing the auditor**

Auditor selection provides an illuminating example of how brand reputation can reduce the conflicts of interest between management and shareowners. Because they are now selected by the board of directors (with only rubber-stamp approval from shareowners), auditors have an incentive to build brand reputations for giving audits that boards like – uncritical audits. Only if auditors turn a blind eye to the most egregious misstatements will the courts eventually penalize them, so they try to play the game within that wide boundary.<sup>9</sup>

Suppose shareowners could directly elect their company's auditor, by an annual vote in which all four major audit firms are on the ballot. How would this change the auditors' incentives? What kind of audit would shareowners like?

To simplify the argument, let's suppose there are two types of auditor – easy, and tough – and two types of company – rotten, and healthy. The easy auditor will give an uncritical audit (“see no evil”) and say the company is fine regardless of its actual condition. The tough auditor will find out whether the company is rotten or healthy, and immediately tell the world about it. Let's say a rotten company has a hidden loss so big that it's actually bankrupt and the stock price would immediately go to zero.

Would shareowners vote for the easy auditor or the tough auditor? You might think they'd be afraid to choose the tough one for fear of losing their investment. But it turns out that choosing the tough auditor will give a higher stock price on average. Here's why:

Investors know all too well that there are rotten companies out there. They just don't know which ones are rotten. So they discount the prices of all companies to reflect that risk. Then any company that hires a tough auditor will see its price go back up if no bad news is found, or down further if bad news is uncovered. The amount of pre-audit discount is the market's average expectation of bad news impact, so that on average hiring a tough auditor is a wash, except for one key point: the sooner we find out about a problem the sooner we can fix it – like Enron two years before it went bankrupt. The whole idea of getting information is to act on it. Companies that hire tough auditors can achieve higher future profits by solving problems sooner, so their present values are higher. And knowing that shareowners can and will hire a tough auditor, management will change the behavior that led to hiding losses in the first place. All this logic also applies to the more realistic case of a company with various possible amounts of hidden losses, not just the simplified all-or-nothing example above.

Notice that even if the auditor will not perform the audit until two months later, a short-term trader would still benefit from voting for a tough auditor. The market will boost the stock price as soon as it's clear that the tough auditor will be elected, in anticipation of the future monitoring benefit.

Although most directors own stock in their company, that does not seem to give them enough incentive to choose tough auditors. This is because their jobs are at stake. A tough auditor could get them fired, costing them substantial future compensation. Thus the ability to choose an easy auditor is a form of directors' and officers' insurance – for their jobs.

Adding to the conflict of interest is the fact that most shareowners are outsiders with only public knowledge of their own firm, so they don't know in advance whether their firm is one of the bad apples.

The crucial link for making shareowner selection of auditors work is the financial community's ability to judge an auditor's quality. As a brand reputation system, it works best if each auditor is in business for decades, serving hundreds of corporate clients. That creates a statistical sample large enough to measure performance based on results, without having to analyze and second-guess audit decisions at individual companies. For this reason, even if we had competition in director elections it would be difficult for shareowners to choose better directors. There are too many directors for each one to be a brand. Compared with an auditing firm (or a proxy advisory firm), each director has a shorter career and serves on at most a handful of boards. It is thus much harder for the financial community to assess the quality of each director and communicate it to shareowner voters.

The recent fall of Arthur Andersen might suggest that an auditor's reputation in the financial community is a poor guide to quality. Before the Enron scandal Andersen's reputation was strong, like the other big four auditing firms. But these are reputations that help them get chosen by boards of directors, and thus may tend to include reputations for giving easy audits. Of course they are not blatantly advertised as such. This behavior need not be overt. Auditors are just responding to incentives that have shaped their culture for decades. Instead, if shareowners choose the auditor, then the investment community will develop new ways of assessing auditor reputation to fulfill the new demand for such information. Investors would like to see auditors find and reveal problems much sooner than has been the practice in the past.

The reasons for shareowners to elect the auditor are similar to the reasons for electing a company-paid voting advisor: brand reputation of an organization is a more practical guide to voting than brand reputation of individual directors. However, in the long run it is not necessary for shareowners to vote for both auditors and advisors. Electing a voting advisor may be enough, because a trusted advisor could guide the selection of a tough auditor who would serve shareowner interests.

## **VII. Better proxy advice would reduce short-termism**

The conflict of interest between shareowners and boards over auditor selection has a close parallel in management decisions that boost current income at the expense of long-term share value. Making such decisions can increase CEO pay and keep an under-performing board in power for a few more years. But if shareowners could elect a proxy advisor with a reputation for discouraging such short-termism, they could benefit from an immediate stock-price boost by doing so. Just as with lax auditing, the investor community knows that short-termism is pervasive, and has already marked down all stock prices to reflect this. This is one of the reasons why the voting enhancements proposed in sections I through V above can be expected to make stock prices go up.

Much of the harm done by corporations in the name of their shareowners is harmful to the shareowners themselves. This is because many negative externalities are caused by management short-termism, such as neglecting employees, customers and public safety, for short-term profit gain that is more than offset by subsequent harm to the value of the firm when the neglect is discovered. So these too may be corrected by an effective pro-shareowner monitor, who would not only be paid to watch for such abuses, but would also become an ideal audience for corporate whistle-blowers. (Those externalities that are not caused by short-termism are addressed in section VIII below.)

Reducing short-termism is just one example of how this improved monitoring system can improve stock returns. More broadly, it gives management and the board greater incentive to act in the shareowners' interests. We can thus expect it to enhance the key decisions where manager and shareowner interests have tended to diverge, including director selection, mergers and recapitalizations, and the design of CEO compensation.

Determining the amount and format of a chief executive's pay package (stock options, golden parachutes etc.) is a highly complex and specialized task, and thus a fine opportunity for pulling the wool over shareowners' eyes. Especially with options not exercised, CEO-friendly boards have taken advantage of this opportunity and granted compensation packages that turned out to have astronomical value, often requiring the company to issue stock, diluting the value of existing shares. Only by hiring an independent professional analyst can we shareowners have any hope of using our voting power to effectively influence CEO pay. Stock option plans now typically require approval by shareowner vote, but lacking independent guidance they are rarely voted down. A professional advisor selected by shareowners could negotiate with the board toward a compromise pay plan that both sides would support.

We should try this new monitoring system because the corporate governance mechanisms that have evolved in the USA, although helpful, have proven inadequate. And while Enron and other scandals have prompted an accelerated evolution, the fundamental weaknesses of these mechanisms remain. For example, the concept of director "independence" has been promoted as a way of reducing the CEO's influence over some directors and making them more loyal to shareowners. Independence is defined based on a lack of formal business links to the corporation. But calling some directors independent doesn't make them independent. As long as director selection is dominated by the incumbent board, they have a strong incentive to be more loyal to the incumbent board than to shareowners.

There are some useful market-based remedies for mismanagement. Shareowners can sell their stock if they think the managers are corrupt or incompetent. That does not take capital away from the bad managers however, merely transferring it to the next hapless shareowner at a price that reflects the market's assessment of management's poor performance. The managers may only get replaced after they have destroyed enough value to make a hostile takeover worthwhile. The large premium a takeover seems to require leaves room for enormous waste before the cure can take effect. This article's proposals for improving voting would be far cheaper.

Another expensive remedy is that of shareowner lawsuits. Their effectiveness is limited because they only arise after great damage is done, and the limited ex-post liability of directors and officers undermines any ex-ante deterrence.

### **VIII. Impact of corporations on politics, the environment, other externalities**

If only each corporation had to eventually pay the appropriate price (or receive the appropriate reward) for all its impacts on society, then eliminating “short-termism” as described in section VII above would also eliminate corporate disregard of social goals. But such an ideal internalization system seems out of reach. Even without that however, corporate monitoring intermediaries can help encourage managers to give greater weight to social concerns. This is because diversification of share ownership gives investors a greater self-interest than CEOs in balancing profit versus externalities. Notice that CEOs’ personal portfolios tend to be highly concentrated in the companies they manage, causing a little-recognized conflict of interest between management and shareowners.

With the widely dispersed pattern of ownership prevalent in the USA, shareowner interests correlate more closely with the public interest than is commonly believed. Stock price maximization is a reasonable primary goal, but it is not the shareowner’s only interest. Thus a shift from pursuing CEOs’ narrower interests to pursuing shareowner interests will also benefit the general public, as argued in Latham (2003).

Among negative externalities, perhaps the most damaging is political influence of corporations through campaign contributions and lobbying. Such influence is usually designed to benefit the CEO and other corporate insiders, but it often harms the majority of that company’s shareowners. An example is pressure from steel companies to raise tariff barriers on steel. That would increase their profits, but impose higher costs on the rest of the economy. Investors with portfolios highly concentrated in steel would benefit – notably CEOs of steel companies. But most steel company shareowners hold diversified portfolios, so would benefit less and be harmed more by steel tariffs than their undiversified CEO. Better proxy voting advice could help guide this “silent majority” to oppose their CEO in such conflicts of interest.<sup>10</sup>

Notice that paying voting advisors with collectively-owned company funds closely parallels the idea of federal funding for political campaigns. Bringing corporate political influence under the democratic control of shareowners by means of professional monitoring organizations could become, in effect, a new political system. The same independent monitors that guide us to vote against CEOs who would harm the public interest, could also inform civic voters about similarly harmful politicians. The brands that guide our voting of stock would then be competing with the brands that guide our political voting. If stock voting brands can take control of corporate political contributions, and if they compete in a reputation market with greater ease of entry than our political party system, we can expect them to become stronger than the Republican and Democratic brands.

Another way these corporate governance reforms could influence our political systems is by example. If a technique for paying voting advisors with collective funds proves valuable for corporate governance, we could design a similar technique for public funding of civic voting advisors such as news media and public policy research institutions. Or conversely, Latham (2004) shows how collective voter-directed funding of information organizations could start in democratic politics and spread from there to corporations.

## **IX. Conclusion**

We can improve corporate governance more by empowering shareowners than by legal oversight of CEOs and boards. Investors have the ultimate authority to replace a company's board of directors, but lack the information and insight to exercise that authority effectively. This article proposes three reforms to increase competition among and quality of professional organizations that inform and guide shareowner voting.

First, individual investors could easily raise their voting participation and quality by copying the voting decisions published by some institutional investors on the internet. All that is needed to trigger this change is for internet stock brokers and other financial websites to offer such voting options in a convenient form.<sup>11</sup>

Second, we could unbundle institutional investor voting from portfolio management, by allowing beneficial owners to choose which institution's voting advice to follow, independently of which institution picks their stocks. This would only become practical after the first step above is taken, but is an attractive long-run policy principle for reducing conflicts of interest in voting.

Third, we can solve most of the shareowners' free-rider problem by paying professional proxy voting advisors with corporate funds directed by shareowner vote. All shareowners would then receive this advice in addition to the board's voting recommendations. Boards naturally resist such competition for influencing votes, but a majority of investors who recognize the potential advantages could threaten to replace a board that refuses to implement it. This third reform can be applied one company at a time, and would be beneficial with or without the first two reforms.

By making CEOs and boards more loyal to shareowner interests, better informed voting would raise long-run stock returns. There would be fewer future Enrons, and CEO compensation would be driven more by merit and incentive than by insider power. Diversified investors would use their heightened influence to encourage companies to balance profit with environmental and social goals, thus replacing public-sector regulation with private-sector market incentives. Shareowner action campaigns to promote these ideas are described on the Corporate Monitoring website ([www.corpmon.com](http://www.corpmon.com)).<sup>12</sup>

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## Notes

1. For example, see Council of Institutional Investors press release "Auditor Reforms" (February 4, 2002) at [www.cii.org/dcwascii/web.nsf/doc/press\\_auditorreforms.cm](http://www.cii.org/dcwascii/web.nsf/doc/press_auditorreforms.cm) .
2. This proposed website could be described as "the Napster of corporate governance" because it would facilitate free sharing of information and change an important business power structure. Free sharing of information can undermine incentives to produce information, but section IV shows how we can create a better incentive to produce voting information than any we have now.
3. Having two classes of stock with different voting power is similar to vote-selling. In fact, it *is* vote-selling. The class with more votes per share will trade at a higher price, reflecting the market value of the extra votes. And the only investors willing to pay that premium will be those who plan to use the extra voting power for their private benefit.

Another transaction equivalent to vote-selling is lending stock during the voting period to a borrower who then votes the stock. However, lending to a borrower who immediately sells the stock does not have the harmful aspect of vote-selling. This is because the corresponding buyer (who can then vote the stock) does want the stock price to go up, so has the appropriate incentive to vote well. Stock derivative positions (such as options) could further complicate these voting incentive issues.

4. Securities and Exchange Commission Proposed Rule on proxy voting disclosure, September 20, 2002, [www.sec.gov/rules/proposed/33-8131.htm](http://www.sec.gov/rules/proposed/33-8131.htm) .
5. Securities and Exchange Commission, August 21, 2000, [www.sec.gov/rules/final/33-7881.htm](http://www.sec.gov/rules/final/33-7881.htm) .
6. From [www.calpers-governance.org/principles/domestic/us/page10.asp](http://www.calpers-governance.org/principles/domestic/us/page10.asp), viewed June 2, 2004.
7. From [www.issproxy.com/institutional/proxy/pas/index.asp](http://www.issproxy.com/institutional/proxy/pas/index.asp), viewed June 2, 2004.
8. See [www.sec.gov/rules/proposed/34-48626.htm](http://www.sec.gov/rules/proposed/34-48626.htm) and [www.calpers-governance.org/news/openproxy.asp](http://www.calpers-governance.org/news/openproxy.asp) .
9. Kaplan (2004) describes the causes and symptoms of conflicts of interest involving auditors, and concludes that the Sarbanes-Oxley legislation was an ineffective response.
10. Some investors are already actively opposing management decisions that benefit one company at the expense of the rest of the economy. An American company that reincorporates overseas can reduce its own taxes, imposing a tax revenue loss on the U.S. economy. A growing number of institutional investors oppose such moves – see: [www.calstrs.com/Newsroom/Archive/newsrel022503.aspx](http://www.calstrs.com/Newsroom/Archive/newsrel022503.aspx)  
[www.calpers-governance.org/tyco/default.asp](http://www.calpers-governance.org/tyco/default.asp)
11. A project is already underway to offer individuals email notification of voting decisions by their preferred institutions on stocks they both own.
12. SEC regulations let shareowners submit 500-word resolutions for inclusion in a company’s annual proxy ballot. The Corporate Monitoring Project has submitted thirty of these so far. Ten have survived legal challenges and made it into the proxy, to be voted on by all shareowners. This gets the message out to the investor community, or at least to those who vote their proxies. Support for the proxy advisor proposal exceeded 20% of the vote at Oregon Steel in 2004. Unfortunately, the SEC has consistently allowed management to omit the auditor selection proposal from the proxy, deeming this an “ordinary business” decision that shareowners should leave to the board.