

Collective Action for Dispersed Shareowners

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Small investors are being robbed, by managers in the United States, and by controlling shareowners in Hong Kong. Here I will show how they can protect themselves by changing the way they pay proxy advisory firms, a monitoring intermediary that has evolved recently in the U.S.

Dispersed ownership in the U.S. and in Hong Kong

The typical large U.S. company is widely held, with no one investor holding a controlling stake. In contrast, Hong Kong companies tend to be controlled by a family with a large percentage of the shares, the remainder being held by many small investors. Detailed statistics on these and other countries are in La Porta et al (1998).¹ To keep the numbers simple for this conceptual discussion, let us consider an archetypal U.S. firm with 100 shareowners each holding 1% of the shares, and an archetypal Hong Kong firm with one owner of 60% and 40 owners of 1% of the shares.²

Lack of a controlling owner leaves a power vacuum at the top of the U.S. firm, a vacuum quickly filled by the Chief Executive Officer (CEO), who is also chairman of the board of directors. He can maintain control of the board by populating it with his friends, because the board's nominees for its own successors are generally elected unopposed. CEOs commonly sit on each other's boards. The board sets the CEO's pay, so he can use his effective control to pay himself more than what market forces would determine. There is an extensive literature on such abuses of management power.³

Likewise, the 60% owner of a Hong Kong firm, who also manages it, can divert company funds to herself by excessive remuneration and other non-arm's-length transactions. She only profits by 40 cents per dollar diverted, versus close to 100 cents in the U.S. case, but on the other hand her control is stronger with that 60% stake.

I will propose a method for the 100 U.S. shareowners to prevent abuses by their CEO, and then consider how to adapt this solution to help the 40 Hong Kong minority shareowners protect their interests.

The "free-rider" problem and proxy advisory firms in the U.S.

The 100 shareowners in the U.S. firm have a common interest in overseeing their CEO, but no one owner has enough private incentive to do it herself, since she only gets 1% of any benefit she creates, and overseeing takes time and money. The

other 99 owners would “free-ride” on her efforts. So this monitoring job tends not to get done.

A firm’s board of directors is supposed to perform the monitoring function on behalf of owners. The board is paid from company funds, so that all owners pay in proportion to their benefit – no free riding there. However, a free-rider problem arises in the process of selecting directors. That too takes time and money, no one owner has enough incentive to do it, so the task falls to the board itself. Opposition to the board-nominated slate is rare, and the shareowner vote for directors becomes a rubber stamp. With more influence from the CEO than the owners, directors tend to be chosen loyal to the CEO.

Shareowner influence over management is primarily exerted by proxy votes cast at the annual general meeting (AGM). Owners vote on directors and on various corporate policy proposals, most put forward by management and some by shareowners. Notice the two stages in this process: agenda-setting (i.e. nominating directors and writing proposals) and then voting. Both stages take time and money to do well, but agenda-setting takes more than voting, so owners leave most agenda-setting to management and the board.

U.S. law requires pension funds to vote, in the interests of their beneficiaries. To accomplish this, instead of each fund maintaining its own costly staff to research the issues put to shareholder vote in each of its portfolio holdings, many funds subscribe to research from proxy advisory firms (PAFs). The leading American PAFs are Institutional Shareholder Services (ISS) with the largest market share, Proxy Monitor, and Investor Responsibility Research Center (IRRC). They have built reputations for serving investor interests, especially on issues like managerial pay and poison pills where managers have conflicts of interest.

The free-rider problem remains however, because PAF research costs money, and not all investors subscribe. This greatly limits the amount of monitoring PAFs can provide, and reduces the impact of PAF recommendations to the minority of shares voted by their subscribers.

Proposal: owners vote to have company pay for proxy advice

Owners of a company have a collective interest in effective monitoring of management, so they should pay *as a group* for that monitoring. They can arrange this by having their company pay for proxy voting advice, just as their company pays for the board of directors. They can create a new company bylaw requiring an annual shareowner vote to choose which PAF(s) to hire. Before the vote, each PAF can submit its annual fee and a description of its services.⁴ A separate yes/no vote is taken for each PAF on the ballot. Any PAF winning over 50% yes votes is hired: the company pays them their fee, and they make their research on that company

available to all shareowners for the coming year. Notice that company management has no influence on the selection or payment of PAFs.⁵

Compared with the existing system of voting for directors, this proposal gives shareowners a much simpler decision. In theory, shareowners can nominate director candidates to compete with the slate nominated by the incumbent board. But in practice there are too many potential candidates for shareowners to bother thinking about – hundreds of names to consider for companies in a typical diversified portfolio. By contrast, there would only be a handful of PAFs, and their reputations could be learned by a quick perusal of the financial press.

Shareowners would then be free to take the advice of any PAF, or ignore it as they choose. But this mechanism would enable them to vote their shares intelligently, while minimizing the private cost of doing so.

Investors will reap many benefits from this change, both short-term and long-term. First, all shares can then be voted based on professional research independent of management; so proposals that favor the owners' interests (primarily, maximizing share value) are more likely to pass. Having solved the free-rider problem in paying for proxy advice, that industry will grow, offering more and better information to shareowners. The PAF business will become more competitive. Perhaps most important, the new 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.

From advising to proactive monitoring

What could advisory firms do to help shareholders besides recommend the wisest choices for proxy voting? Agenda-setting is often more important than voting. Independent agents chosen by shareowner vote 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^{6,7} where the proxy advisory firm in its expanded role is called a "Corporate Monitoring Firm" (CMF).

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.⁸ 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.⁹ 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.

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).¹⁰ 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. 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.

Adapting this proposal to Hong Kong

There are two ways this proposal can be applied to Hong Kong companies: an incremental way, and a fundamental way. The incremental approach takes the prevailing ownership structure as given. The fundamental approach recognises that ownership structures can change as new institutional arrangements evolve.

Given a company with a controlling 60% owner and forty 1% owners, creating a corporate monitoring firm (CMF) system as described above would not help the minority owners. The 60% owner would completely determine the choice of monitor, making the monitor loyal to her. The CMF system was designed for the U.S. ownership structure, with no controlling shareowner. Instead, the system would need to be adapted to protect the interests of the minority.

Consider first the advice-only system, in which proxy advisory firms (PAFs) are paid with company funds, but do not nominate directors or write proposals. If the enabling bylaw were written so that a threshold of only 25% approval were enough to hire a PAF, that would enable minority shareowners to at least have independent professional voting advice. But they still only vote a minority of the shares. Also, to get such a bylaw passed would require cooperation from the controlling owner, or a government-imposed requirement.

Minority shareowner interests would be better protected by the vigilance of a professional insider loyal to them, rather than just advice from an outsider. The CMF system can be adapted to give board representation to the minority. The enabling bylaw can provide that if 25% of shares voted prefer a different CMF than the majority, then two CMFs can be hired, both of whom would nominate directors. The split of board seats between majority and minority can then be determined either by cumulative voting or by the proportion of votes cast for each of the two CMFs.

Even with such representation of course, if board decisions are determined by majority vote of the board, the controlling owner still calls the shots. But at least the minority would have professional informed advocates who can blow the whistle on abuses, resorting ultimately to the courts if necessary.

Perhaps it would be better to avoid this power struggle altogether, by not having a controlling owner; in other words, by adopting the American ownership structure, at least for some companies. This is the more fundamental way to apply a CMF system in Hong Kong.

Before making my pitch for such a fundamental change, let me clarify to whom I am making it. I am pitching to investors, not to legislators. If these ideas are correct, it will be in the investors' interests to implement them; legislation to force implementation should not be necessary. All the government need do is enforce the

contracts that people choose to create.¹¹ I would rather depend on economic Darwinism than on legislators, however benevolent.

It may be that minority shareowners of existing Hong Kong companies are doomed to exploitation by controlling owners for the remaining life of those firms. That is not my main concern. If we can design a more efficient governance structure, then newly formed public companies that adopt such a structure will outperform the old companies and, over time, dominate the business world. There is likely to be a long interim period when firms of various structures coexist and compete. That is how we will find out which models work best for which types of firm.

The ideal case for applying these competing models is a company 100% owned by someone who wants to sell out and retire. Suppose it is a growing business that needs more capital. The owner will sell at least 95% of her shares, and issue more stock to permit expansion of the business. Would she get a higher price by selling 100% to one investor, or 60% to one and the rest dispersed, or selling all shares to dispersed investors? Furthermore, would she get a higher price by first creating bylaws that protect dispersed investors?

I believe that when a company grows too large to be 100% owned by one investor, the highest IPO (initial public offering) price will usually be obtained by creating a CMF bylaw, then selling all shares to dispersed investors.¹² The dispersed-investor IPO is the norm for growing companies in the U.S. Although the CMF system (and the company-pay PAF system from which it will evolve) has not yet been tried anywhere, it promises to correct several excesses of American firms – overpayment of CEOs, short-termism, mass layoffs, and shareholder lawsuits.¹³ More importantly for Hong Kong, the CMF system can substitute for the legal and regulatory framework that protects dispersed shareowners in America – accounting, auditing and disclosure laws, oversight by the Securities and Exchange Commission (SEC), state corporation laws etc., which could take decades to replicate in another country. Dispersed ownership is rare in Hong Kong because such protection is lacking.

If a CMF system can indeed cure the weaknesses inherent in dispersed ownership, then investors will enjoy the benefits of diversification and liquid markets for their shares, while firms will find it easier to raise equity capital for expansion. Even the controlling owners of existing Hong Kong firms may find it advantageous to shift to a dispersed ownership structure, for example when the head of a family retires. Finally, judicial interpretation of corporation law will be influenced by the success of new governance structures. If investors in existing firms had known that such structures were possible, they would at least have built in a mechanism allowing shareowners to switch to a new structure in the future. This can become an argument for removing obstacles preventing such transitions, thus rescuing minority shareowners from exploitation after all.¹⁴

Conclusion

Investors in the U.S., Hong Kong and other countries can create a more efficient corporate governance structure by having their company pay for independent proxy voting advice. This will eventually lead to director nominations by an agency external to the firm. Benefits will include higher stock returns, more realistic levels of CEO pay, and an end to exploitation of minority shareowners. The new structure will support American-style dispersed ownership, so is likely to be created first in the U.S., where proxy advisory firms have already built reputations for serving investor interests. The ideal opportunity for applying this idea in Hong Kong will be when a firm's 100% or controlling owner wants to sell out her stake. She is likely to get the highest price by creating such a company-pay bylaw, then selling to dispersed investors.

The internet will play a major role in this transition – see www.corpmon.com and my next article in this journal.

Notes

1. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer (May 1998): "Corporate Ownership Around the World", Harvard University working paper. They define a shareholder to be controlling if she holds more than 20% of the voting power. However, small investors can use proxy advisory firms to overpower any investor with less than 50% of the votes.
2. Even a multi-billion-dollar institution becomes a "small" investor when it owns only 1% of a company. Competition forces it to severely limit monitoring activity for which it pays 100% of the cost but reaps only 1% of the benefit.
3. See, for example, the extensive reading list at <http://www.corpgov.net/library/library.html>; also Robert A. G. Monks and Nell Minow (1996): *Watching the Watchers*, Blackwell Publishers.
4. To avoid management influence, any PAF could put its name forward (open nominations). To prevent a proliferation of frivolous candidates, a fee of \$10,000 could be charged for a PAF to nominate itself, then refunded if they win at least 10% of the vote.
5. A similar proposal was made in 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.

6. Mark Latham (1998): "Corporate Monitoring: New Shareholder Power Tool," *Financial Analysts Journal* 54:5 (September/October). An earlier version – Mark Latham (1997): "Proposed: A Governance 'Monitor'," *The Corporate Board* (September/October) – was published in Chinese translation in Shanghai University of Finance and Economics' *Foreign Economies and Management* (September/October 1998).

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

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

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

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

11. This is simplistic. The complexity and costs of enforcing contracts call for some standardization; but not uniformity.

12. At least two additional bylaws are needed to minimize future conflicts of interest: To prevent accumulation of a controlling block, anyone reaching a 30% holding must offer to buy out all other shareholders. And vote-selling must be prohibited (more on this in a future article).

13. Latham (1998 and 1999), *op. cit.*

14. This type of argument is the main thesis of Frank Easterbrook and Daniel Fischel (1991): *The Economic Structure of Corporate Law*, Harvard University Press.