PERSPECTIVES

Corporate Monitoring: New Shareholder Power Tool

Mark Latham

Activist investors may be missing a trick. In an era when shareholder power in the United States has already risen to the point of replacing an entire board of directors in one stroke, shareholders should further this advance by taking control of the director nomination process.

The way to achieve this value-enhancing goal is through the use of an agency outside the company to nominate company directors. The agency would be paid a fee by the client company, so all shareholders would pay for the service. Such an arrangement would avoid the free-rider problem now facing activist investors, who bear the full costs of their efforts to reform a company while sharing the benefits with all shareholders.

The nominating agency would need to monitor director performance in order to decide whether to nominate a given candidate again for the board of the same (or another) company. It might thus be more broadly described as a monitoring intermediary. Call it a "corporate monitoring firm" (CMF).

How a CMF Would Work

The shareholders of a company using this system would hold an annual shareholder ballot to choose the CMF. To prevent management and the board from controlling the CMF nominations and restricting owners' choices, the system should allow any shareholder to name a CMF to go on the ballot. A proliferation of frivolous entries seeking free advertising could be prevented by charging an up-front fee for each nomination. I suggest that the number of candidate CMFs on the ballot would ideally be between 2 and 10.

Having an outside entity nominate directors need not preclude nominations via the existing mechanisms of the board's nominating committee and the occasional opposing slate from a dissident shareholder group, but shareholders need to know the source of the nominations to decide which of them to support. With that information, shareholders are likely to favor those nominated by the CMF they have chosen.

Why a CMF Would Work

Choosing good directors is too difficult for most shareholders, which is why owners have so little influence in the current system. There are too many potential candidates for director—hundreds for a well-diversified investor—for an investor to keep track of them. But 10 or 20 CMFs providing monitoring services nationwide could build reputations that would permit intelligent choices among them after only a casual reading of a newspaper's business section.

Shareholders voting to choose 1 CMF from 10 competitors on the ballot introduces the problem of vote splitting. For example, what if nine candidate firms are known to be good shareholder advocates and one candidate firm is known to be overly friendly to this corporation's management? If a management clique in the corporation owns 25 percent of the shares, its shill could win because the antimanagement votes would be split up among the other nine. Preferential voting could solve this problem: Rather than voting for only one candidate firm, shareholders could rank the firms, indicating their first, second, third choices and so on, and a computer could find the most preferred candidate. In the example of nine versus one, the 75 percent of the shares outside management control would tend to rank the management shill last, so one of the nine would win.

For shareholders to rank all CMFs competing to serve each firm in their portfolio might seem onerous, but it could be greatly simplified by software and electronic communication. For example, if 20 CMFs were available in the United States, an investor could rank all of them once (or once every couple of years) and have that master ranking applied to each stock in his or her portfolio.

The Need for CMFs

The U.S. corporate governance system is one of the world's best,

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but even in the United States, boards of directors are not sufficiently accountable to shareholders. The annual "election" of directors is typically a rubber-stamp approval of the unopposed slate chosen by the incumbent board. This system enables the CEO, who usually also chairs the board, to populate it with friends who will not rock the boat and to take advantage of the owners.

Perhaps the clearest example of the conflict is that when managers can influence their own compensation, they naturally tend to be overpaid. Other frequently cited examples are empire building (expanding businesses beyond what is economically justified), opposing hostile takeovers, and paying greenmail.

Several mechanisms have evolved to mitigate the lack of shareholder influence on director selection. They include disclosure requirements, takeovers, lawsuits, pressure from large shareholders, incentive compensation, and insistence on director independence. But each mechanism solves only part of the problem, leaving substantial inefficiencies.

Takeovers. Takeovers are an expensive way of influencing management. The acquirer pays a premium over market price; both sides face legal costs; returning the company to efficient operation involves restructuring costs; and the expected profit must be enough to compensate for the acquirer's efforts and risk exposure. Having bought an entire firm, the acquirer is poorly diversified and thus wants to whip the company into shape quickly and then resell it. This pattern may well be followed by a gradual slide of the company back into inefficiency.

Lawsuits. Theoretically, shareholders can sue management and the board for breach of fiduciary duties. In practice, it is so difficult for a court to distinguish self-serving from incompetence and bad luck that lawsuits can guard against only the most flagrant abuses of management power.

Shareholder Pressure. Shareholder activism has become the dominant disciplining mechanism in the past 10 years. Large public pension funds, especially the California Public Employees Retirement System (CalPERS), have put pressure on boards and managers of underperforming firms to shape up or lose shareholder votes. Even large investors, however, are limited by lack of knowledge of how the firm should be run—one of the reasons for hiring managers in the first place.

The more knowledge owners can acquire, the better they can oversee company managers, but the time and effort involved in acquiring knowledge are monitoring costs that an owner can recover only by a rise in the value of its shareholdings. Because each owner holds only a small percentage of the firm, each faces a substantial free-rider problem: The benefits of any owner's efforts to oversee are reaped by all shareholders but the costs are paid by the activist owner who makes the effort. Because of the free-rider problem, the pioneers in shareholder activism have been large institutional investors, especially those with no ties to any private-sector corporation. Even they rarely hold more than 5 percent of a company's stock, however, so much monitoring remains to be done.[1]

Incentive Compensation. Managers and directors cannot be expected to neglect their selfish economic interests, but making them shareholders can align their interests with those of the other shareholders. Therefore, Elson (1995) and others have argued for paying directors in stock.

Recent years have seen widespread adoption of compensation schemes involving stock, options, and other combinations of compensation that award higher pay when a company's stock does well. Such approaches certainly alleviate the conflict of interest between managers and owners, but they can be only a partial solution. Some divergence of interests will always remain unless those who run the company own 100 percent of the equity, which is rarely practical because they are not wealthy enough and would be taking too much risk.[2]

Ironically, the laudable principle of aligning economic interests has become a smoke screen for a new wave of overpayments to executives; just because compensation is tied to performance does not mean it is fair. No doubt, many CEOs are worth their multimillion-dollar compensation packages for the value they alone can add to a multibillion-dollar enterprise. They are among the most energetic, visionary, and productive contributors to our economy. But fair-market compensation can be expected to result only if both sides, payer and receiver, are effectively represented at the bargaining table, which is not the case when shareholders (payers) have no independent representatives on the board.

Director Independence. The need for outside directors, directors independent of management, has been widely recognized in the academic

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literature, in the law, and in statements of good board practice, such as those of the National Association of Corporate Directors. Even when directors have no other formal ties to a company, however, company managers can still screen candidates to ensure friendliness to the CEO. And those board members who rock the boat can be omitted from nomination next time. For such reasons, several analysts have focused on the nomination mechanism as the key point for improving corporate governance.

Suggestions for assuring the independence of corporate directors have come from a number of authors. Gilson and Kraakman (1991) recommended that institutional investors create a clearinghouse to nominate independent directors from a pool of full-time professionals who would be motivated to favor shareholder interests. The main drawback to this scheme is the free-rider problem resulting from the voluntary nature of investor participation in funding the clearinghouse. The selection and, more importantly, the subsequent monitoring of directors is a costly process requiring expensive expertise. Free riding on monitoring costs prevents a single organization such as Institutional Shareholder Services from resolving much more of the shareholder–manager agency problem.

Tosi, Gomez-Mejia, and Moody (1991) also proposed that directors be nominated by an independent entity, but in their proposal, each company would choose its own nominating entity. They advocated federal legislation to mandate such a process, and their proposal lacks a mechanism for shareholders to choose the entity directly.

Benefits of Corporate Monitoring

Hiring a CMF can be viewed as the next step in investor activism and director independence. It would solve the free-rider problem and ensure true independence of outside directors.

Enhancing Shareholder Return. The primary goal for improving monitoring of management is enhanced shareholder returns. This goal can be achieved if monitoring leads to more judicious deployment of capital than was the case without monitoring. For example, CEOs have been known to enter, maintain, or expand favorite businesses even when doing so is not sensible economically. A strong, independent board can prevent such behavior. In addition, with effective shareholder representation at the bargaining table, compensation of top executives should more closely match the market value of each manager's contribution to the value of the company. Approval of executive pay by truly independent shareholder representatives would enable highly paid CEOs to hold their heads higher before the public, which would be confident that they are indeed worth the money. Moreover, board oversight of the process of training and promoting middle managers can prevent a clique from monopolizing the knowledge of how best to run the firm and using their monopoly position to overcharge for their services.

Lack of information deters shareholders from preventing wasteful use of resources. One can see how a lack of information limits the effectiveness of monitoring by looking at how CalPERS, the leading activist investor, chooses the targets of its pressure. CalPERS focuses on underperforming firms, those whose market value has lagged in recent years. The firms most likely to waste resources, however, are those that have the most to waste—companies that have been generating substantial cash flow. If CalPERS could monitor those firms, waste could be forestalled *before* it led to loss of market value. Effective monitoring in the absence of an obvious problem, however, would require a substantial investment to gain inside knowledge of the firm. In short, the existing system tends to shift some power from managers to shareholders only when market values have already suffered and the damage has become apparent. Even then, the cause of the losses may not be known. The losses may be the result of bad luck, not bad management, but the free-rider problem makes learning enough to make that distinction uneconomical for shareholders. A monitoring intermediary funded by all shareholders could be an effective remedy.

Limiting CEO Power. Diffusing the power that has been intensely focused in the CEO position should make the whole company less hierarchical. Spending a great deal of effort maintaining a tight grip on power will no longer be worthwhile to the CEO. And a good CEO will benefit from no longer being surrounded by yes-men.

Fighting "Short-Termism." U.S. companies are often accused of "short-termism"—that is, favoring current profits at the expense of the long-run value of the company. Short-termism can lead to neglect of investment in research and development, plant modernization, employee training and morale, product quality, customer satisfaction, company reputation, and risk management. The tendency to think

short term is often blamed on managers being pressured to focus on the company's stock price, which responds strongly to current earnings and dividends.[3] But, in theory, the current stock price should reflect all expected future earnings from investment in R&D, reputation, and so on, so emphasizing stock price should not induce short-termism. If investors lack information about these long-term investments, however, or do not trust the company managers to invest optimally, they will favor the benefits they can verify—current earnings and dividends.

A monitoring intermediary answerable directly to shareholders can reduce short-termism. A monitoring firm would provide its services to many more companies and for many more years than the average CEO or director. So, it would have a stronger incentive and opportunity to build a reputation for promoting the true value of client companies, and shareholders should have trust in the long-term investments approved by its appointees.

Improving on Current Mechanisms. Corporate monitoring is likely to dampen the painful cycles of overexpansion followed by mass layoffs that characterize existing mechanisms of corporate economic discipline. Hostile takeovers are an effective way to cut corporate flab, but they are costly to owners and to employees who lose their jobs. A daily regime of discipline to stay lean is far preferable to crash diets and liposuction.

In addition, hiring an external monitor should lessen the need for shareholder lawsuits. Because shareholders can fire the CMF, which can fire the directors, who can fire the managers, the managers would have a greater incentive than in the present system to serve owner interests and abuses could be forestalled without resorting to the courts.

Promoting Social Welfare. The monitoring system proposed here would promote social goals, especially among well-diversified investors. Indexing has often been touted as furnishing the ideal degree of diversification. Many analysts worry, however, that the more investors diversify, the less attention they will pay to how each firm is managed; so, efficiency and stock returns will suffer as indexing grows. The CMF system would not only alleviate this potential problem but would also create incentives for balancing profits against broader social goals. The reason is that a well-diversified investor shares the profits of a company in about the same proportion as the investor shares in the company's social and environmental effects, such as pollution, community service, creating employment or unemployment, and influence on politics and markets. To vote for a CMF that pursues a policy of balancing all these effects would thus be in the selfish interests of investors.

The CMF's incentives contrast sharply with the incentives of a CEO, whose career and wealth are tied to the financial performance of a single firm. The potential for CMF balancing of social and economic goals also provides an optimistic contrast to the more typical prescriptions, which require altruism or government regulation to promote the common good.

The CMF proposal is that rare economic prescription that improves both equity and efficiency rather than trading one off against the other. In the CMF system, by exercising their property rights, owners can improve efficiency and shift more of the fruits of capitalism from a management elite to the broadly distributed population of shareholders.

Discouraging Monopolies. Corporate monitoring would reduce two motives for building a company's monopoly power. As noted, control of negative social effects would be internalized and traded off against the profit opportunities. The higher prices and restricted output of a monopolistic firm are one such social effect. Additionally, managers would lose the empire-building incentive that encourages growth beyond the point of maximizing profits.

Reducing Large Shareholders' Influence. To the small shareholder, large shareholders are a mixed blessing. They may undertake costly monitoring of management to the benefit of all owners. They may pay a premium to buy out all the shares. But they may extract value from the company to the detriment of other owners. Examples of value extraction are receiving greenmail, "white knight" deals, trading on inside information, and in effect, joining the management team and benefiting in various ways from non-arm's-length transactions with the firm.[4]

The advent of monitoring intermediaries would diminish the importance of large shareholders. Shareholders voting to hire a CMF would no longer need large shareholders to go to bat for them. Of course, a shareholder or group holding close to half the shares could control the choice of monitoring firm and exploit that power at the expense of minority owners. Thus, because the monitoring benefits of large shareholder

groups would no longer be needed, agency costs could be reduced if restrictions were also imposed on accumulating large blocks of shares.

So as not to lose the potential efficiency gains from a complete overhaul, sale of the entire company to a single acquirer would still be allowed if approved by majority shareholder vote.

CMF Reputation and Variety

A monitoring firm could provide services to many more client companies for many more years than an individual director can, which would permit a far more accurate assessment of its capabilities than investors can give individual directors. A monitoring firm would thus strive to build a reputation for sound business judgment and independence from the managers of the corporations it monitors.

Like political parties, the intermediaries would be constantly reviewed, discussed, and compared by experts and journalists. Statistical tests could be used to compare the effect of various CMFs on their clients' stock returns. When discovered, misbehavior would result in scandal and loss of reputation.

Because time is needed to build a reputation, the first intermediaries to offer monitoring services are likely to be firms with established reputations in related fields, such as Institutional Shareholder Services (proxy advice), Heidrick and Struggles (executive search), McKinsey (consulting), or Price Waterhouse (accounting).

CMFs would come in different flavors—for example, cooperative versus in management's face; strictly emphasizing the bottom line versus promoting employee satisfaction, environmental preservation, or corporate citizenship. Collective experience and competition for shareholder votes would determine the dominant styles.

Learning on the Way

The CMF system has some potential drawbacks that would require solution. And many aspects of their most effective operation would need to be worked out over time.

For example, companies are justifiably concerned about leaks of proprietary information to competitors, and if an outside entity is peering into several firms, this risk may be exacerbated. The principal defense against this risk in the CMF system would be the need for the monitoring firm to maintain its reputation. If evidence of substantial leaks were traced to a firm, it would lose shareholder votes. Indeed, the CMF system might well be a better protection for proprietary information than the existing system of directors, who have less of a long-term reputation to protect and are less answerable to owners.

The CMF system also raises potential antitrust issues—relating to, for example, collusion. Antitrust concerns can be mitigated by ensuring that no firm monitors two clients in the same industry.

Introducing monitoring intermediaries into a corporation's power structure is such a fundamental change that it is difficult to anticipate all the eventual results. Learning from experience with a step-by-step approach should enable shareholders to find the best use of this tool. Once the procedure for direct shareholder selection of a monitoring intermediary has been established, various monitoring functions could conceivably be assigned by majority shareholder vote. Nomination of directors is the natural starting point because starting there will break the existing incestuous cycle of directors nominating directors.

Boards of most U.S. companies are chaired by the CEO, which enhances the CEO's control over board deliberations. Many people have advocated separating the two roles as an important way to improve monitoring of management. If the so-called outside directors are not truly independent of the CEO, however, making one of them chair of the board will merely be cumbersome window-dressing. On the other hand, once the board has some members that have been selected truly independently, they could reduce management dominance of the board by taking over the chair. Indeed, for such crucial decisions as replacing the CEO, the owners would be best served by having only outside directors vote—having, in effect, a two-tier board system.

Monitoring may induce shifts generally in the boundaries between the CMF, the board, the CEO, and other top managers. Suppose the monitoring firm routinely nominates a full slate of board candidates who routinely get elected. Then, shareholders might decide that board elections could be eliminated and they need vote only on their annual choice of a monitoring firm, which would populate the board as it sees fit. Board members would then become, in a sense, employees of the CMF, which would thus become less an executive search firm than a management consulting firm. It would be paid a headhunting fee plus the directors' fees in return for oversight services that it supplies in whatever way it finds most effective.

This evolution in the CMF system might seem to give the monitoring firm too much power, but it could actually give the client company's owners more control by enabling them to set the total budget for one large package of monitoring services. As with preferential voting for the monitoring firm, intelligent design of a computerized ballot would permit shareholders to easily vote on a complex issue. Each voter would write on the ballot the annual monitoring budget the investor considered appropriate. Then, the fee paid to the monitoring firm would be the share-weighted median of all the shareholders' chosen budgets. (Using the median would avoid the problem of paying the average fee, which could be manipulated by voting for extreme amounts.) Note that the fee would be paid by the client company and thus would be shared equally by all shareholders (pro rata) regardless of who voted for how much, so shareholders would have no inducement to vote for too low a fee (which would eliminate any free-rider problem).

Time, experience, and discussion in the media would guide shareholders in determining ideal levels for the monitoring budget, which would be a function of firm size, industry, and other factors. The budget would probably be greater than what a company now spends on finding and paying directors, because the increased accountability of directors would increase their power and responsibility. Paying directors thousands of dollars to oversee CEOs making millions of dollars may have made some sense when a board seat was a sinecure, but greater demands for board effectiveness have already left directors underpaid for what they are supposed to do. Increased spending on the monitoring role should be more than offset by decreased spending on top management, because the shift in compensation would reflect a shift in responsibility plus a gain in efficiency. Monitoring would also replace some hiring of management consultants. Furthermore, discretion in how to spend its budget would enable the monitoring firm to choose an efficient mix of staff support for its top professionals, something that today's directors lack.[5]

Other functional configurations involving CMFs are possible. Even if the board continues to exist separately, the monitoring firm could provide it with management consulting and staff services. It could also give advice directly to owners when they face decisions involving takeovers and other proposals put to shareholder vote.

CMFs could also evolve in the direction of monitoring the management of other types of organizations, such as mutual funds and mutual life insurance companies, which have similar problems of diffuse ownership, conflicts of interest, and lack of accountability.

CMFs could prove a particular boon in Asia. The Asian economies have suffered greatly from poor corporate governance, so they might gain the most from implementing corporate monitoring. Although Asia might prefer to let the United States lead the way with such an innovation, CMFs could provide a quicker fix than developing the various mechanisms that compensate in the United States for a lack of shareholder power, which would take years to develop.

Just Say Yes

To start the corporate monitoring system, shareholders need to take the plunge and monitoring firms need to accept the challenge. CEOs and their loyal directors will oppose hiring monitoring intermediaries, but they cannot prevent it if a majority of the company's owners are in favor. Public discussion will shape shareholder opinion about the merits of this idea and the specific form in which it should be first attempted. Then, a binding shareholder proposal to retain such an intermediary should be put forward at a company where it has the best chance of winning a majority of votes. This process could be accelerated by like-minded investors buying shares in such companies.

Public employee pension funds are more activist than their private-sector counterparts. The private funds are run by management appointees and are thus likely to side with managers—both of their own funds and of the companies in their portfolios. Therefore, they can be expected to oppose the hiring of monitoring intermediaries. The private funds are a web of cross-holdings that may obstruct the residual claimants, who are the true shareholders of companies held in a fund's portfolio, from exercising control over the companies. In principle, one could argue for passing through voting power from the pension fund to its residual claimants—the fund beneficiaries or the company's owners. In practice, passing voting power through would be cumbersome. Legal pressure, based on fiduciary duty, is a more likely way to get pension funds to vote for better monitoring.

The question of whether to pass voting rights through to individual investors can be raised for any institutional investor. Once the public has learned about intermediary monitoring firms, mutual fund investors could be given the

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option of specifying which monitoring firms they want their shares voted for. Market forces will determine whether such a process develops; if investors want such a voice, the mutual funds will have an incentive to arrange it.

The final question is how shareholders can hire a CMF when no such thing exists. The market will create CMFs once demand exists. When a majority of some corporation's owners decide they want such services, someone will offer them.

Conclusion

The CMF is a mechanism for enabling shareholders to exercise their property rights by influencing how their companies are managed through control of board of director nominations. It would avoid the free-rider problem, and its cost would be more than offset by savings and efficiency gains. It promises to raise the productivity of capital, reduce the short-termism of U.S. managers, promote a sensible balance between profit and social goals, and reduce the frequency of mass layoffs. It might solve the Asian economies' corporate governance problems faster than emulation of the current U.S. system.

The system would work because competitive forces would impel monitoring firms to build public reputations for sound business judgment, orientation favorable to owners, and independence of management. Shareholders should, therefore, enact such a system.

I gratefully acknowledge helpful comments from Charles Elson, Richard Homonoff, David Pyle, and especially Mark Rubinstein. See www.corpmon.com for further information on corporate monitoring.

Notes

1. Another limitation on monitoring by institutional investors is the risk they incur of running afoul of insider-trading laws when they become more informed than the investing public.
2. This problem is the major roadblock to the leveraged buy-out, which otherwise would solve the owner–manager agency problem by uniting the two roles.
3. Some of this kind of mismanagement is also blamed on paying executives with call options or option-like contracts, such as paying more when the firm does well but without symmetrical pay cuts when the firm does poorly—a description that fits virtually all pay arrangements. This approach encourages the CEO not to worry enough about low-probability disaster scenarios. Board monitoring can reduce such behavior.
4. Such conflicts are discussed in detail in Coffee (1991). Managers and other employees who own shares in the company they work for can also use their voting influence to favor themselves at the expense of other shareholders—for example, by enhancing their compensation. The mechanism of a monitoring intermediary should be able, unless such holdings approach or exceed 50 percent of the shares, to prevent such non-arm's-length behavior.
5. Like managers and directors, monitoring firms might perform better if their fees were linked to performance of their client companies. Perhaps, they too should be paid in stock and required to hold it for several years so as to reap the long-term effects of their influence.

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