The fallacy of shareholder democracy

Is there any evidence shareholders really care about the vote?
Institutional investor votes dictated by governance policies
Voting decisions separated from investment decisions
Should the annual democratic experience be retained?

By Charles Nathan

Shareholder democracy is commonly viewed as a cornerstone of the modern US corporation. Academic and legal literature is rife with this thesis, often postulating that the fundamental quid pro quo for granting private citizens the right to form limited liability corporations is providing shareholders with a franchise to elect directors and approve fundamental decisions affecting the corporation, such as mergers and acquisitions or a major sale of assets.

Like most truisms, the claim that shareholder democracy is a necessary and universal feature of corporate governance exaggerates the reality. Corporate law in most states permits companies to have more than one class of stock, grant differential voting rights to different classes of stock and issue non-voting shares. As a result, many publicly owned corporations (and a far greater number of non-public corporations) have voting arrangements that cut against the grain of almost any concept of shareholder democracy. An obvious example is public companies with two classes of otherwise identical common stock: one with one vote per share, the other with – for example – 10 votes per share. The super-vote class, of course, is intended to override a traditional democratic governance model.

Accepting that shareholder democracy is an aspirational, rather than a necessary, attribute of public company governance still begs three important questions. Two of these get frequent attention, although there is continuing debate about the answers. The first is what form of democracy is appropriate for a US corporation: a New England Town Meeting at which shareholders govern directly and collectively, or a legislative model in which the board of directors is roughly analogous to the legislature and the executive function is filled by full-time professional managers? If it’s a legislative model, should it be bicameral (consisting, for example, of a supervisory board of largely outside directors and a management board of full-time executives) or unicameral (as is common in the English and US tradition)?

The second, closely related, question is whether a democratic governance model is appropriate in the first place, even as a crude analogy. A corporation, after all, is not a polity and its goals are largely (many would say wholly) economic value creation, not the promotion of the welfare of its citizens.

A third question raised by the prevailing model of shareholder democracy has received far less attention: do the holders of the franchise – the shareowners – really...
care about the vote or is it just a necessary (and, for institutional investors, an expensive) evil, at least for matters not obviously related to shareowner wealth creation?

**Devising policies**
The answer for institutional investors is clear. It concerns the reality of an almost total split of institutional investors, regardless of their size and investment thesis, into persons responsible for making investment decisions (or for designing and applying models for quantitative investing) and those responsible for making voting decisions.

To put the phenomenon in its most basic terms, the professionals who run the investing function have, as a matter of practice and often policy, outsourced all voting decisions for portfolio stocks to an independent and largely self-contained group of corporate governance specialists. In some institutions, particularly the larger ones, the corporate governance professionals are employees who report up a different management chain from the portfolio managers and analysts, typically a non-financial function such as the general counsel or senior governance officer, not to the chief investment officer, investment committee or the like.

In many institutions, particularly medium-sized and smaller ones, many or all voting functions are outsourced to third-party, unregulated proxy advisory firms, such as RiskMetrics (formerly ISS), Glass Lewis or Proxy Governance International.

**Voting by default**
The reasons institutions have created parallel universes for investment decision making and voting decision making are simple. Approximately 20 years ago, the federal government issued regulations requiring institutional investors to vote every share of portfolio stock on each matter brought to shareholder meetings and to do so in compliance with a fiduciary duty of due care. These regulations had the intended effect of preventing institutional investors from voting in accordance with management recommendations as a matter of course, or simply not bothering to vote at all.

The obvious rub was that the large number of votes institutional investors have to cast each year makes a voting system based on hand-tailored decisions expensive and thus relevant to the investors’ profit margins. As an inexpensive ‘default’ system of not voting or routinely voting managements’ recommendations was no longer available, an alternative simple-to-administer and low-cost default system had to be developed.

Corporate governance-based voting policies were created to achieve this goal. Whether managed internally by corporate governance specialists or externally by third-party proxy advisory firms, these policies are intended to – and do – function to satisfy the federal regulations at the lowest possible cost. They are self-operative, answer the question of how to vote all portfolio shares on all matters (other than mergers and proxy contests) and supply a convenient one-size-fits-all methodology that can be managed efficiently, with minimum personnel and little or no involvement by high-priced investment decision makers.

There are several problems with the corporate governance-based voting model, however. To begin with, there is a very real lack of empirical support for the wealth-creating efficacy of many corporate governance principles espoused by the corporate governance community. Moreover, by its very nature, the corporate governance voting model cannot possibly take into account the particulars of every portfolio firm.

Even if there were, for example, strong empirical evidence that separating the CEO and chairman roles generally promoted improved wealth creation for shareholders, there are bound to be exceptions and variations. Multiply this conundrum across the entire spectrum of corporate governance ideals and more than 10,000 publicly held US corporations, and the reason for a mechanistic, one-size-fits-all system becomes clear.

Additionally, to maintain its relevance, the corporate governance community continually needs to find new principles of corporate governance to foster. Otherwise, its very success in promoting adoption of corporate governance policies will lessen its utility and ultimately its members’ employability, thus undermining its fundamental business model.

Nor is the reality of corporate democracy any more satisfying in the context of individual retail shareholders. Retail investors for many years could ignore the burden of voting their shares on most routine matters and rely on their brokers to vote on
their behalf under an NYSE rule that permitted discretionary voting by brokers that did not receive specific voting instructions from their customers.

The corporate governance community has actively and effectively lobbied for the repeal of this rule, and has largely succeeded. The result is that retail investors, like institutional investors before them, have been deprived of their long-used default voting system. Unlike institutional investors, however, individual investors have not been able to switch default systems to proxy advisers and other corporate governance specialists and, as a result, have simply stopped voting.

It’s still about the finances
There is one clear exception to the pattern of default voting at the institutional and, to a somewhat lesser extent, the retail level. Investors, for the most part, want to exercise their franchise directly on votes with clear economic or control significance: mergers, acquisitions and election contests. This suggests an interesting reexamination of the concept of shareholder democracy.

Perhaps, instead of forcing a multitude of shareholder votes every year at more than 10,000 annual meetings, we should seriously consider whether corporate governance might not be improved by moving away from annual director elections to a model of director elections only every several years, with longer terms for directors, similar to the system we use for electing members of Congress.

After all, it is doubtful any serious observer would advocate that all government legislators serve one-year terms under a mandatory annual election system. Annual elections would impair continuity and the ability of legislators to take a long-term viewpoint to legislation. When so many investors decry the lack of longer-term decision making at public companies, why should we advocate the uncertainties and short-termism created by annual elections of directors? The current system appears counter-intuitive in this regard.

Moreover, we could easily dispense with most other required shareholder votes – for example, votes on equity-based incentive plans – which these days are controversial only when the proposal trips arbitrary criteria (or a black box model) maintained by an external proxy advisory company or an internal corporate governance group on a one-size-fits-all basis. Finally, we should consider requiring a much greater stock ownership threshold than the current standard of $2,000 for shareholder-initiated votes and limit the permissible topics for shareholder-initiated votes.

The only exception to a vastly streamlined system of shareholder meetings and shareholder votes would be transformational events that would be brought to special shareholder meetings, as they largely are in our current shareholder democracy system.

A misuse of resources
In short, wouldn’t it make sense to abandon the myth that most shareholders actually want an annual democratic experience? The annual meeting could just as easily become a biennial or triennial meeting, at least from the standpoint of shareholder voting. Directors with longer than one-year terms would more easily be able to make longer-term decisions.

The costs and burdens of producing annual proxy statements, many running well in excess of 100 pages, at more than 10,000 public companies could be vastly reduced, resulting in significant cost savings for the corporation, which could result in increased shareholder value, not to mention the positive environmental effects. Institutional investors could stop what they obviously believe is the waste of money necessary to run a parallel universe to manage the annual shareholder meeting cycle.

The only loser in the reform would be the corporate governance community and certain institutions whose business it is to process votes. This also might not be a bad thing, particularly if it helped free companies and institutional investors from the current tyranny of an ever-increasing list of corporate governance ‘best practices’ that lacks an empirical base or proof these practices lead to a real increase in shareholder value.

Boards and managers could get back to what they do best – running companies and creating value – and investors could chose to invest their funds freely, without the burden of unnecessary and often unproductive voting requirements.

Charles Nathan is a partner in the New York office of Latham & Watkins

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