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PERSPECTIVES

Investor Suffrage Movement

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During the past 100 years, capitalism has been transformed. No longer is corporate America owned by Morgans, Rockefellers, and Carnegies. It is owned by average Americans through mutual funds, pension plans, and direct stock ownership. This is called "democracy of capitalism," but something is missing. For democracy to work, people must vote. In the democracy that U.S. capitalism has become, individuals do not vote the shares they own. This can be attributed to:

- *Rational apathy*. Individual holdings are too minuscule to justify the effort required to vote the shares, and most individuals lack the expertise to constructively do so anyway.
- *Institutional ownership*. Investors who beneficially own shares through mutual funds, pension plans, and other intermediaries are denied the right to vote those shares.

To reassert control over the corporations they own, shareholders must overcome these obstacles. They can do so by implementing a novel "proxy exchange" that allows them to conveniently secure, transfer, aggregate, and exercise voting rights.

A Simple Change

Imagine a woman who is a successful employee, an investor, and a mother. Between the demands of work and shuttling her kids to sports practice, she cares about her world. She worries about damage to the environment. She is troubled by explicit sex and violence portrayed on television—and the impact it has on children. Paradoxically, she owns the companies that pollute the environment and the media. During a successful career, she has accumulated savings, which she has invested in equity index funds. The woman owns a slice of corporate America—and there are a million other moms like her. Collectively, they have the economic clout to shape corporate behavior. But this is hypothetical.

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Scrambling from a planning meeting to soccer practice, the woman doesn't think such thoughts. On the car radio, an announcer describes the latest indictments in the latest corporate scandals—more names to join Enron, WorldCom, Tyco . . .

Let's change this picture. Let's make one minor modification to the woman's world and see where it leads us. Suppose the woman receives a letter from her mutual fund company reminding her that her mutual funds vote the shares they hold on her behalf. She has never had a choice about this, but the letter now offers her one. She can have the mutual funds continue to vote the shares, or the voting rights can be assigned to an organization of her choosing—perhaps a charity involved in environmental or children's issues.

The letter goes on to explain that her fund company, cooperating with other institutions, has established a "proxy exchange." This is like any other exchange except that it is not for trading stocks or futures. It is for transferring voting rights. Use of the exchange is free, and the woman can access it through a secure website. She can transfer her voting rights to anyone she chooses—anyone willing to accept them.

What will the woman do? If she and a million moms like her choose to transfer voting rights to charities, professional associations, investment advisers, advocacy groups, and other organizations, what will happen? What will those recipients do with their new economic power? How will capitalism be transformed?

Managerial Capitalism

The agency problem has existed as long as people have allowed others to act on their behalf. In corporations, it arises between shareholders and managers, and this was one of the reasons Adam Smith (1776) denounced corporations. Commenting on managers, he complained:

> . . . being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the

partners of a private copartnery frequently watch over their own. . . . (1776, Book V, ch. I, part III, article 1)

Writing 150 years later, Berle and Means (1932) noted a fundamental change in the agency problem. Stock ownership of large corporations was becoming widely dispersed. This was democracy of capitalism, but it meant that individual holdings were shrinking. Shareholders were losing influence over managers. Berle and Means wrote:

> Under such conditions, control may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding. (1932, p. 8)

Berle and Means were witnessing the beginnings of a phenomenon called "managerial capitalism."[1] In Adam Smith's day, shareholders still held sway over managers and the agency problem was a matter of managers not exercising "anxious vigilance." Under managerial capitalism, shareholders have lost control of managers and the agency problem is one of managers enriching themselves to the extent applicable laws allow. Berle and Means identified a variety of devices by which managers might enrich themselves at the expense of owners. Laws have evolved since their time, but similar methods still exist. Perhaps the most straightforward is for managers to pay themselves exorbitant compensation.[2]

Fiduciary Capitalism

In parallel with managerial capitalism, another phenomenon has emerged that we might call "fiduciary capitalism."[3] This is ownership of equities by intermediaries, such as mutual funds, pension plans, and insurance companies. As **Table 1** shows, these institutions hold about half of all U.S. equities. By inserting themselves between corporations and investors, they further isolate managers from those investors. As large shareholders, institutions could challenge managers for the benefit of investors, but few engage in such shareholder activism.

Table 1. Recent Evolution of U.S. Equity Holdings by Type of Investor

Investor Type	1995	1998	2001	2004
Individual investors	51.3%	48.1%	45.0%	39.4%
Mutual funds	12.6	16.5	19.3	23.1
Foreign investors	6.5	8.0	10.3	11.2
Private pension funds	15.1	12.5	10.2	9.8
Public pension funds	8.4	7.9	7.4	7.5
Insurance companies	5.2	5.7	6.4	7.4
Other	0.9	1.2	1.5	1.5

Notes: Calculated from Federal Reserve Board (2005, p. 82) data. Percentages indicating the fraction of U.S. equities held by each category of investor are based on market values. Because of how the Fed reports numbers, equity holdings include all U.S. company stock and foreign company stock (including American Depositary Receipts) held by U.S. investors. "Individual investors" includes bank personal trusts and estates. "Mutual funds" includes closed-end and exchange-traded funds. The "Other" category includes holdings by investment banks, brokers, and other financial institutions and domestic government holdings not included under public pension funds. The "Foreign investors" numbers are biased downward by the fact that this category does not reflect holdings of foreign stocks whereas other categories do. In 2004, foreign stocks represented 13.9 percent of the total holdings considered.

Among institutions, public pension plans—that is, plans that manage assets for the benefit of public servants—have been the most activist. They have had some success convincing boards to implement corporate governance reforms. They are respected for playing this role, but their actions have been measured—more "shareholder engagement" than "shareholder activism." As public entities, they are subject to political pressures. If they became more aggressive in shareholder activism, they might be accused of being antibusiness. Even if they were to become more activist, their impact would be limited because they hold just 7.5 percent of corporate stock.

Other institutions have exhibited little or no shareholder activism. Corporate pension plans and insurance companies are controlled by corporate managers, so most are unlikely to engage in shareholder activism.

The situation of mutual funds is more complex. During the market declines of 2000–2002, mutual fund companies lost earnings and had to lay off staff. They would welcome reforms that might avoid market turmoil in the future, but most funds hesitate to be activist themselves. The primary reason is that they do not want to jeopardize existing or potential client relationships. Many mutual fund companies sell asset management services to corporations, and they avoid shareholder activism that might antagonize managers of those corporations. Some mutual fund companies are parts of larger financial institutions, and shareholder activism on their part might imperil sales of investment banking, brokerage, insurance, custody, and other services.

At the same time, pressure is mounting on mutual funds to become more activist. Over the past 10 years, mutual funds' proportion of U.S. equity holdings has almost doubled. The U.S. SEC has implemented a new rule requiring them to disclose how they vote shares. Mutual funds have the economic power to engage in productive shareholder activism, and now the public is watching. A failure to comply poses the reputational risk of appearing to coddle entrenched corporate managers.

For mutual fund companies, having to vote shares is a lose–lose situation. They lose if they are activist; they lose if they are passive. The fund companies would like another alternative—and that is what a proxy exchange offers.

A Proxy Exchange

To understand how a proxy exchange would work, let's return to the woman who just received the letter from her mutual fund company. Intrigued, she decides to assign her voting rights to a particular charity that is involved in children's issues. At her computer, she locates the website of the proxy exchange. After entering identifying information, she is taken to her own account page. The account has already been established for her by her mutual fund and brokerage firms. Those firms have the legal right to vote shares that they hold on her behalf, but they have placed the voting rights in her account.[4] She can do with them as she pleases. If she is so inclined, she can access relevant shareholder materials online and actually vote her shares through the exchange. The exchange has an advanced set of screens that will allow her to do precisely that. More-basic screens allow the woman to simply transfer all her voting rights to a third party.

Using those screens, the woman searches for her charity and confirms that it is willing to accept voting rights. With a single mouse click, she transfers all her rights to the charity. Her selection is not permanent; she can change it at any time. Until then, the charity will continue to receive all rights deposited into her account.

What will the charity do with the rights? Actually, it is in the same position as the woman. It has an account with the exchange, and voting rights are being deposited into it—from the woman's account and perhaps from a thousand other accounts. If the charity receives a large volume of rights, it may devote resources to voting them. If not, it can transfer them on to a trusted third party. Through the exchange's intermediate-level screens, the charity has even more options. For example, it might choose to vote shares of companies whose activities affect children but transfer the rest of its rights to another charity.

Rights may pass through many hands before they end up in the account of a party with sufficient rights to justify the effort to constructively vote them. The entire process will be one of aggregation. Through an exchange, small blocks of rights will be aggregated into medium blocks, which will be aggregated into large blocks. Large blocks will be voted through the exchange.

Four classes of participants can be identified:

1. *assigners*: institutions such as mutual funds, brokerages, and pension plans that legally assign proxy rights to the exchange;
2. *beneficiaries*: the beneficial stock owners—primarily individual investors—on whose behalf those rights are assigned to the exchange;
3. *aggregators*: anyone willing to accept rights from beneficiaries or other aggregators through the exchange;
4. *voters*: parties who ultimately make voting decisions.

Some participants will be members of more than one class. For example, suppose a woman and her father are both investors in a mutual fund. The fund assigns its proxy rights to the proxy exchange and identifies the woman and her father (along with other investors) as the beneficial owners. The father transfers his rights to the woman. She then transfers their combined rights to a charity, which votes the shares. In this case, the mutual fund is an assigner; the father is a beneficiary; the woman is both a beneficiary and an aggregator; and the charity is an aggregator and a voter.

Transferring, aggregating, and/or voting rights could be done by anyone who chooses to—charities, professional associations, trade unions, advocacy groups, investment advisers, faith-based organizations, retirees who do so as a hobby—anyone. An online community may develop. Tips and ideas would be exchanged. Upcoming votes would be discussed. Referrals would be made, as in, "You want to unload your IBM? Give 'em to Joe. He knows the company inside and out, and he thinks the way you do. Check out his record."

Legal Issues

Shareholders have a legal right to appoint an agent—a proxy—to vote shares and otherwise act on their behalf. Historically, this right allowed shareholders who were unable to attend a corporation's shareholder meeting to still exercise their rights as owners.

Shareholders can dictate how a proxy is to act on their behalf, or they can leave that decision to the proxy. Today, the notion that shareholders can select their own proxy resembles the remark attributed to Henry Ford that people can buy any color of Model T they want—so long as it is black. Before each annual meeting, managers mail to shareholders proxy assignment cards allowing them to appoint those same managers[5] as their proxy. That is the only choice the cards offer—take it or leave it.

The system is so broken down that managers seek proxy rights more to ensure a quorum at the shareholder meeting than out of fear that they might actually lose a vote. Only in rare circumstances does a proxy fight arise in which a competing group also sends out a mailing to shareholders soliciting a grant of proxy rights. That situation is akin to offering automobiles that are either black or gray.

A proxy exchange will allow shareholders to select anyone they like to exercise their voting rights. It may appear that each transaction on the exchange will be a legal assignment of proxy rights. Intuitively, an exchange will work that way, but a cleaner legal mechanism is available for achieving the same result.

Legally, a proxy exchange will serve as the proxy for everyone. It will hold all proxy rights, and it will exercise those proxy rights according to the instructions of the beneficiaries. If a beneficiary chooses to vote her own shares, the exchange will vote the shares according to her instructions. If she uses the exchange to transfer her voting rights to an aggregator, the transaction will legally be nothing more than her instructing the exchange to exercise the proxy rights on her behalf according to the aggregator's instructions.[6]

Although transactions on a proxy exchange will not legally be assignments of proxy rights, exchange rules can largely treat them as if they were. Those rules may be written to comply with the spirit, if not the letter, of state and SEC regulations and case law governing assignments of proxy rights. For example, the purchase or sale of voting rights raises public policy issues, so an exchange should not facilitate such transactions.

Disclosures

In its operations, a proxy exchange will have to balance competing needs for disclosure and privacy. For example, a trade union might—with entirely good intentions—encourage its members to assign their voting rights to the union. Union members who did not comply might not want the union to know of their decision. For this and similar reasons, the exchange should not disclose to aggregators who is transferring rights to them.

Larger aggregators' voting records should be disclosed with both summary reports and details of individual votes. An aggregator might add comments to its record explaining individual voting decisions. If an aggregator transfers voting rights to another aggregator, its record can reflect how the votes were ultimately cast.

How might someone use an aggregator's record? Consider again the woman who has just assigned her rights to a charity that focuses on children's issues. Having made her selection, the woman is about to exit the exchange's website when a thought occurs to her: Sure, she cares about children's issues, but she is counting on her investments to provide income in retirement. What if the charity acts recklessly—voting shares without considering financial consequences for shareholders?

The exchange's reporting functionality is intuitive, so the woman easily calls up a summary report comparing the voting record of the charity with one of her mutual funds. She is pleased to find that they vote the same way 86 percent of the time. She calls up a list of votes on which they have acted differently. In most cases, the charity's vote has an accompanying explanatory comment in the report. Some notes relate to social issues. Many focus on financial issues; for example, the charity may have voted against a board member because of poor performance of other corporations whose boards he sits on. The mutual fund has entered few comments accompanying its votes. Reassured that the charity is acting responsibly—both socially and financially—the woman leaves her selection unchanged.

Agency Costs

Agency theory tells us that board members, managers, and aggregators will not make the personal commitment their roles require unless they get something in return. They are going to pursue, to some extent, their own private agendas. This is what economists call an agency cost.

Does it matter what the private agenda is? Often, in the case of a board member or manager, the private agenda is to secure perquisites out of corporate resources, but other agendas are possible. Is there any real difference between

- a board member who acts generally for the financial benefit of shareholders so he can pursue his own agenda of securing perks for himself and
- a board member who acts generally for the financial benefit of shareholders so he can pursue his own agenda of getting corporate money out of politics?

Both agents have private agendas that are inconsistent with maximizing shareholder value. Both strive to benefit shareholders so they can retain their positions and continue to pursue their private agendas. Their respective private agendas are agency costs.

A proxy exchange will attract numerous aggregators prepared to work diligently for the benefit of shareholders because they want to pursue their own agendas. They will compete for beneficiaries' voting rights based on *quality* (their perceived ability to maximize shareholder value) and *price* (the perceived magnitude and nature of their agency costs).

Some aggregators will have private agendas that appeal to shareholders, and they will advertise those agendas. Others will have more selfish agendas, which they will not want to advertise. All aggregators will promote their own ability to make sound decisions for the financial benefit of shareholders. Competition among aggregators will flourish. This will squeeze agency costs, minimizing the ability of aggregators to pursue their private agendas while driving all aggregators to work for the financial benefit of shareholders.

A proxy exchange will be a new market for corporate control—a market more efficient and far less costly than hostile takeovers or traditional proxy fights. Through competition, a proxy exchange will do a better job of minimizing agency costs and maximizing shareholder value than the "self-perpetuating body" of managerial capitalism ever can.

Implementation

Democracy is a controversial idea. Thomas Jefferson observed, "A democracy is nothing more than mob rule." Later, Winston Churchill would share his concern, commenting, ". . . democracy is the worst form of government except all those other forms that have been tried from time to time." This, I think, is the essential argument in favor of democracy. Giving power to the masses is frightening, but giving it to anyone else is more frightening.

Mob rule shouldn't be an issue with a proxy exchange. One reason is that the democracy of capitalism is an elitist democracy. Instead of one person, one vote, it works according to one share, one vote. With influence proportional to each person's stock holdings, the wealthy have an advantage—and they tend to be better educated than the general population.

Social agendas will be pursued through a proxy exchange, but they will be fragmented. A few with broad popular appeal may meet with some success, but they will have a moderating influence over corporations rather than a controlling one. A truism of politics is that Americans "vote their pocketbooks." If concerns ever arise about the influence interest groups are having on corporate America, we can expect average Americans to flock to a proxy exchange to "set things right."

No regulatory impediments preclude the launch of a proxy exchange. Legally, the exchange will be nothing more than an organization that makes itself available to serve as a proxy for others. Exchange rules and technology for transferring rights among participants do not need to be immediately implemented. They might evolve as the exchange grows.

A nominal exchange could be launched by activists who simply instruct their stock brokers to assign their proxy rights to the exchange. The activists could then "transfer" voting rights among themselves over hot chocolate in someone's living room. At that point, voting decisions would matter less than the fact that those decisions were actually being made through the exchange. As a novel concept unanticipated by existing regulations, such a proxy exchange would quickly introduce itself into gray areas of corporate governance regulations. It could become a useful vehicle for spawning legal test cases and highlighting the unfortunate state of shareholder rights under managerial capitalism.

There are many avenues by which a fully automated proxy exchange might be implemented. A foundation or wealthy philanthropist might donate money to launch an exchange. Various for-profit and not-for-profit organizations are involved in proxy issues and corporate governance. If they pooled their resources, they could form an exchange. A for-profit firm might launch an exchange as a business venture, earning income by charging fees from assigners. If regulators conclude that the marketplace has failed to develop a mechanism to facilitate the free granting of proxy rights, they might encourage financial institutions to form a proxy exchange.

Still another avenue would be for mutual fund companies to serve as a proxy exchange for their own clients. This would be easy because the funds already hold the proxy rights. Legally, such a proxy exchange would be nothing more than a formalized vehicle for the funds to solicit clients' advice on how to vote shares—and then act on that advice. This would be simple and inexpensive to implement. Any mutual fund company that wants to distinguish itself from competitors would be shortsighted not to implement it.

Clearly, there are many avenues for implementing a proxy exchange. If several initiatives develop, they can compete with and learn from one another. When they mature and operations become standardized, they might merge to achieve economies of scale.

Conclusion

Recent market crashes and financial scandals are symptomatic of a capitalism in which shareholders have lost control over the corporations they own. U.S. law recognizes shareholders' right to exercise control through a proxy of their choosing. But because there has been no practical way to facilitate it, shareholders have been denied this fundamental right.

The result is managerial capitalism. Its costs—fraud, diversion of resources, cronyism, and just plain mediocrity—are incalculable. Legislative responses like the Sarbanes–Oxley Act of 2002 do some good, but they also impose significant costs. Rather than reform managerial capitalism, a proxy exchange will eliminate it. It is a market-based solution that will work through the simple device of putting owners back in charge. Investors will benefit; financial institutions will benefit; and society as a whole will benefit.

Democracy of capitalism is a wonderful thing—if we can get it working. We need an investor suffrage movement. A proxy exchange will launch it.

This article qualifies for 0.5 PD credit.

Notes

1. The term was coined by Chandler (1977).
2. Bebchuk and Fried (2004) discussed management compensation specifically. Monk and Sykes (2002), MacAvoy and Millstein (2004), and Lorsch, Berlowitz, and Zelleke (2005) addressed the corporate governance problem generally.
3. Hawley and Williams (2000) used this term. See also Rubach (1999).
4. If a brokerage holds stock for investors in a street name, those investors may instruct the brokerage on how to vote the shares.
5. More precisely, the card allows shareholders to appoint a party who is *answerable* to the managers.
6. In this article, I use the expression "proxy rights" when a proxy is being assigned under applicable laws or regulations. I use the expression "voting rights" when a similar assignment is made under the exchange's rules. These rights are identical rights to act on behalf of the shareholder, which (in theory) could involve more than mere voting, but their legal bases differ.

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