Shareholder Democracy and the Objective of the Firm

Proxy Voting, Investor Coalitions, and Data:
Challenges in Addressing ESG Issues

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A tale of two paradigms

- *Paradigm 1:* Homogeneous shareholders – the traditional view
  - finance textbooks
  - Jensen & Meckling (1976)
- All shareholders are the same
  - maximize the same payoff
  - “shareholder value”
  - agree on how payoffs are generated
- Sources of friction
  - agency (managers need incentives)
  - information (investors need disclosure)

- *Paradigm 2:* Shareholders are different in the way they care about
  - risk
  - time horizon (present vs. future)
  - taxes
  - the environment
  - employees
  - …
- Sources of friction
  - preferences
  - differences of opinion (views of “how the world works”)

Why do these paradigms matter?

→ *Paradigm 1:* Homogeneous shareholders

→ One dimension of conflict

- managers ↔ shareholders

→ One clear objective

- shareholder value

→ Shareholder voting

- prevents capture of the board – not about conflicts between shareholders
- need to monitor management

→ *Paradigm 2:* Heterogeneous shareholders

→ Two dimensions of conflict

- managers ↔ shareholders
- shareholders ↔ other shareholders

→ No unique common objective

- each shareholder has its own value

→ Shareholder voting

- mechanism to resolve disagreement among shareholders
- can be preferences or opinions

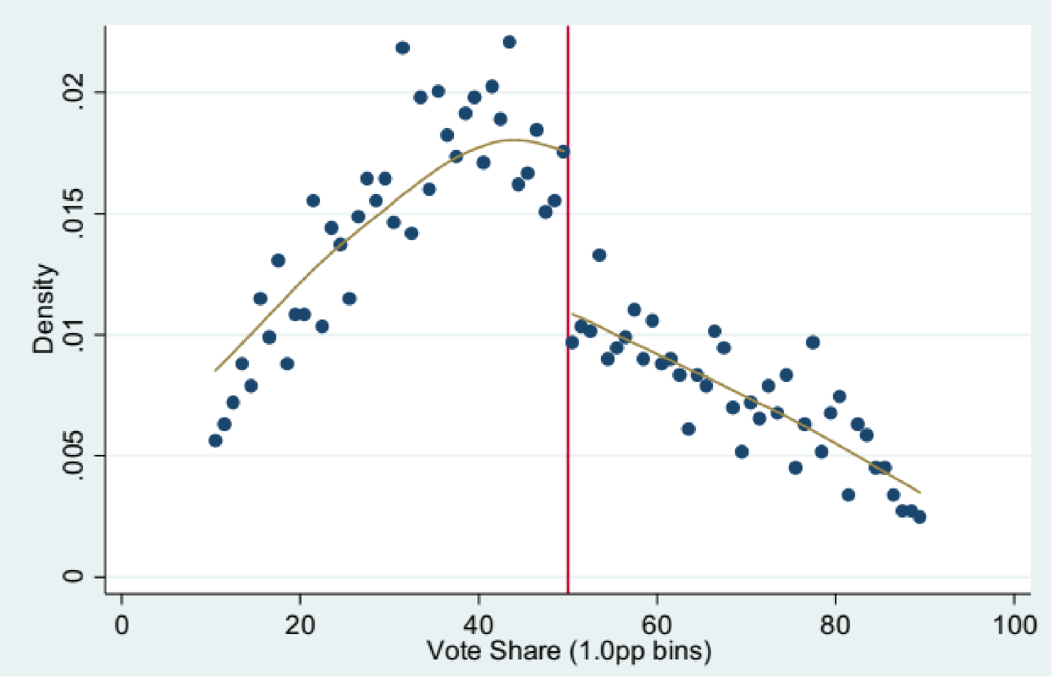
Preview of the punchline

- Regulation and the interpretation of empirical studies mostly center on the homogeneous-shareholders paradigm
  - This feeds the drive toward “shareholder democracy”
- The empirics are very much on the side of the heterogeneous-shareholders paradigm
- What does this mismatch imply?
- The lawyers’ view:

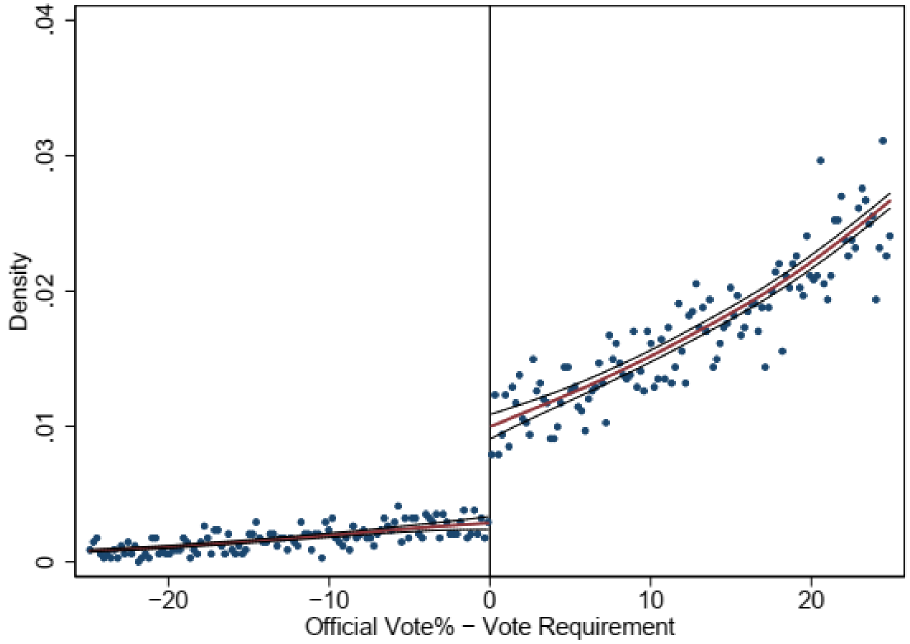
  "Shareholders express views by buying and selling shares; (...) The more shareholders govern, the more poorly the firms do in the marketplace. Shareholders' interests are protected not by voting, but by the market for stock (...)." (Easterbrook and Fischel, 1983, pp. 396-397).

What does the data say?

- If all shareholders agree – then they should vote the same way!
  - Voting outcomes should be extreme – 0% or 100% support – not in the middle



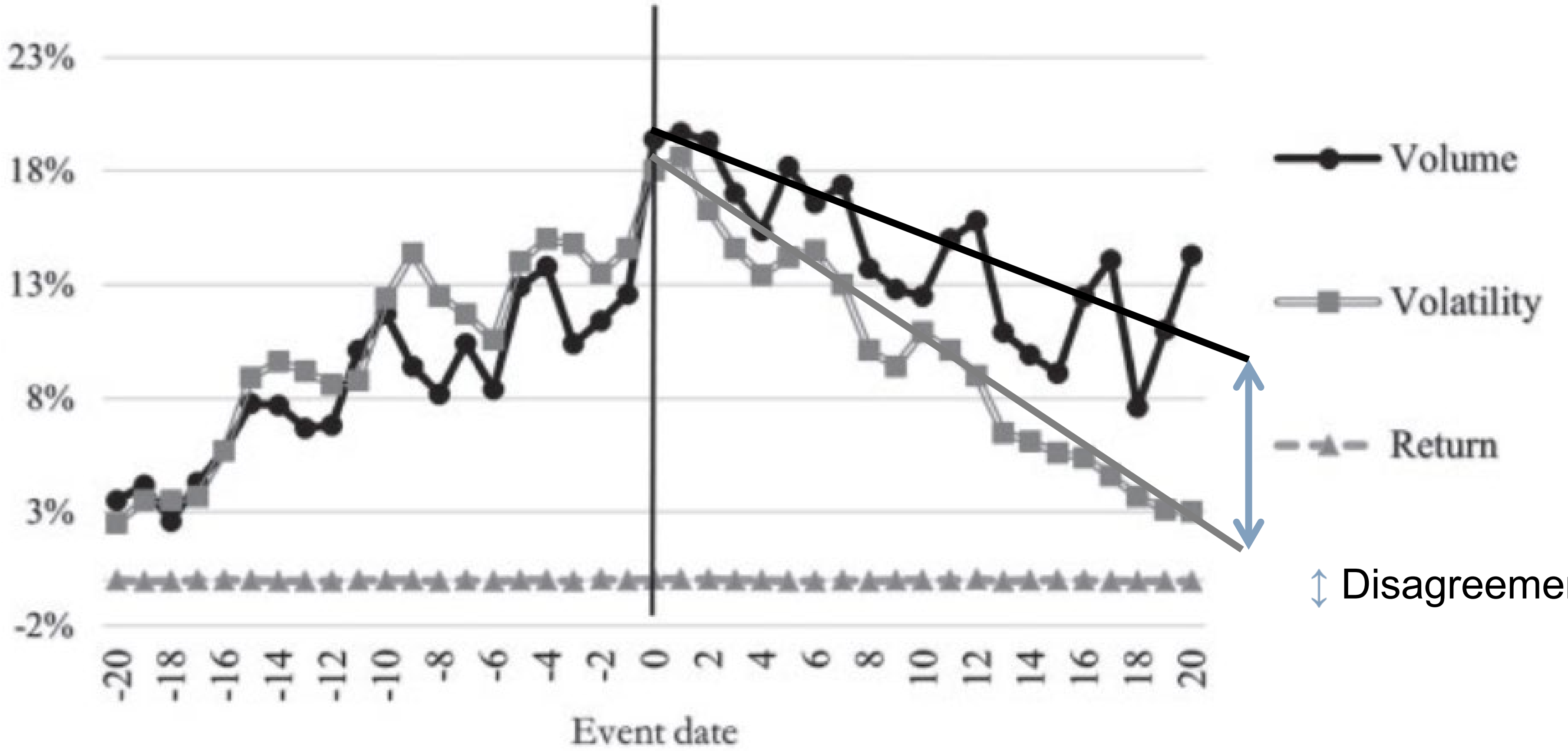
Bach, Laurent, and Daniel Metzger, 2019, How Close Are Close Shareholder Votes?, *Review of Financial Studies* 32:8, pp. 3183–3214, Figure 1.



Babenko, Ilona, et al., 2023, Management (of) Proposals, *Working Paper, Arizona State University,* Figure 2B.

What does the data say?

→ If shareholders only disagree because they have different information, then volatility should be proportional to volume



↕ Disagreement = volume - volatility

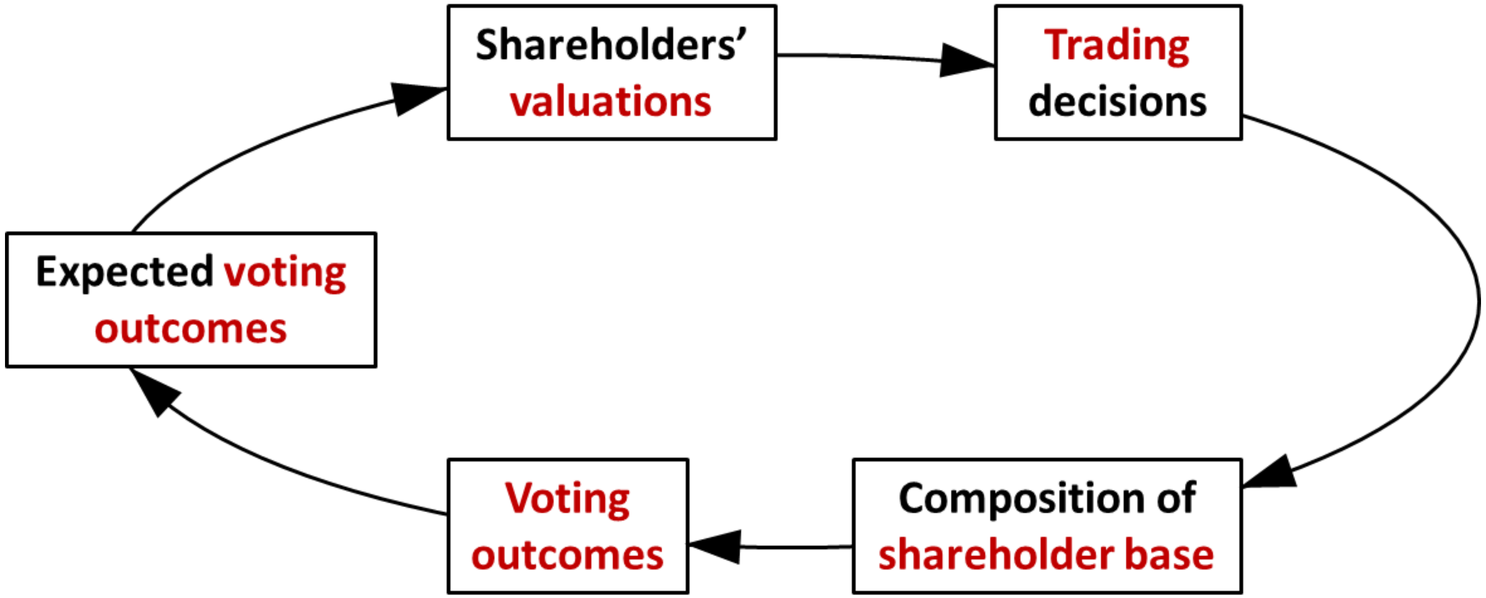
Li, Sophia Zhengzi, et al., 2022, When Shareholders Disagree: Trading after Shareholder Meetings, Review of Financial Studies 35:4, pp. 1813-1867, Figure 2A.

The case for “shareholder democracy”

- Shareholders are residual claimants
  - they are the first to lose from mistakes
  - and benefit from correct decisions
- Managers are self interested (“agency”)
  - problem of capture
- Give “power to the people”
  - those who ultimately bear the consequences should be in charge

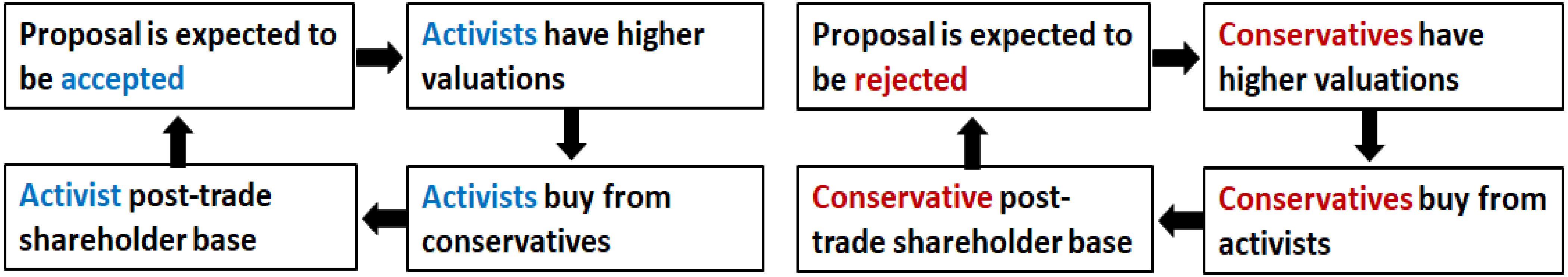
Shareholder democracy – reconsidered

- *Trading:* unlike the political setting, investors can choose their ownership stakes based on their preferences and the stock price
- *Voting rights*: can be sold ⇒ shareholder base is endogenous, results from trading
- Feedback loop between trading and voting



Implication 1: Trading and alignment of interests

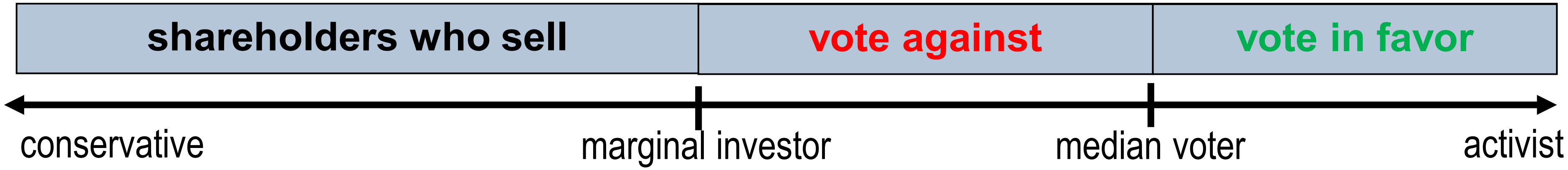
- The shareholder base aligns with the expected outcome: If the expected outcome is more activist, the shareholder base will *become* more activist, and vice versa.



- Shifts in the shareholder base make *ex-ante* expectations self-fulfilling.
- Firms with the same fundamental characteristics can have different ownership structures and voting outcomes.
- Outcomes can be inefficient: shareholders may coordinate on one outcome, but might be collectively better off with the other outcome.

Implication 2: Decision-makers are not price setters

- Stock prices are set by the marginal investor
  - The investor who is just indifferent between buying or selling the stock
  - The valuation of this investor is equal to the price
  - This investor is always the *most extreme* shareholder in the shareholder base after trading
    - In the activist scenario, this is the most conservative shareholder, all others have sold
    - In the conservative scenario, this is the most activist shareholder, all others have sold
- Decisions are taken by the median shareholder
  - The investor who is in the middle of the shareholder base after trading (with simple majority rule)



- Decision-makers (= median voters) are different from price setters (= marginal investors)

- → If the beliefs (or preferences) of the marginal investor (= most extreme shareholder) and those of the median shareholder differ
  - stock prices may increase even if shareholder welfare declines
- → Interpretation of event studies relies on the homogeneous-shareholder paradigm:
  - stock price reactions reflect shareholders’ common valuation
  - if shareholders are *heterogeneous*, stock prices *cannot* reflect the valuations of those who make decisions
  - → we cannot always trust event studies!

Implication 3: Trading on the stock market has good and bad sides

→ The good news: Trading allows the winners to buy out the losers

- e.g., conservative shareholders sell to those who are more activist
- the activists who buy pay more for the shares: they expect that the other shareholders will be supportive
- the conservative sellers benefit more from the higher price than they would from a more conservative policy

→ The bad news: more trading can make things worse

- more liquidity means that the most extreme shareholders can buy more shares
- the policies of the firm become more extreme
- the gap between the marginal investor and the median shareholder may widen: lower prices
- the gap between the marginal investor and the average shareholder may widen: lower shareholder welfare

Implication 4: The case for the business judgment rule

- Delegation to a board of directors may be good, and better than “shareholder democracy”
- Assume there is no vote, only directors decide
- The optimal board is biased
  - for example, from the point of view of initial shareholders, the board may be too activist
  - the optimal board should cater to the post-trade shareholders, not considering those who sell
  - but the sellers benefit from the higher prices the buyers are willing to pay
- Delegation to the board is (almost always) better than voting
  - if the board is chosen carefully, it maximizes the welfare of the post-trade shareholders
  - voting will rarely achieve this, because the median voter ≠ average shareholder
- Shareholders may not support a corporate charter that increases their collective welfare
  - potential buyers will strategically vote for a charter that reduces the price at which they buy
  - collective action problem from short-term trading considerations

The bottom line

- → The case for shareholder democracy rests on the homogeneous-shareholder paradigm
- → The empirics support the heterogeneous-shareholder paradigm
- → The discrepancy gives rise to a number of issues
  - distrust event studies, prices may not reflect “shareholder value”
  - trading in the stock market may be good and bad
  - with delegation to a board, this would be avoided
- → Maybe we should pause and reconsider our support for “shareholder democracy”