SHAREHOLDERS & SHAREHOLDER ACTIVISM
THE ROLE OF SHAREHOLDERS

- The shareholder-centric view holds that the primary purpose of the corporation is to maximize wealth for owners.

- From this perspective, effective governance aligns the interests of managers and shareholders, reducing agency costs and increasing value.

- However, deciding what elements or features result in an “effective” system is not always easy.

Disagreements arise because investors have different viewpoints and objectives.
• **Investment horizon**
  Short-term investors prefer that management focus on quarterly results. Long-term investors might tolerate volatility if they believe value is being created.

• **Objectives**
  Some investors care primarily about economic returns. Others might emphasize how results are achieved and the impact on stakeholders.

• **Activity**
  Active investors care greatly about individual firms. Passive investors might focus on index returns and pay less attention to individual outcomes.

• **Size**
  Large funds can dedicate significant resources to governance matters. Small funds lack these resources.
• **Free-rider problem**
  Shareholder actions are expensive. Although all shareholders enjoy the benefits, a few bear the costs. This provides a disincentive to act.

• **Indirect influence**
  Shareholders do not have direct control over the corporation. They influence firms by:
  - Communicating concerns
  - Withholding votes
  - Waging proxy contests
  - Sponsoring proxy items
  - Selling shares
A blockholder is an investor (individual, institutional, or corporate) with a large ownership position in a company.

INSTITUTIONAL BLOCKHOLDERS AMONG U.S. CORPORATIONS

<table>
<thead>
<tr>
<th>FIRM SIZE</th>
<th>MARKET VALUE</th>
<th># OF INSTITUTIONAL INVESTORS</th>
<th>AVG # OF BLOCKHOLDERS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>TOP 1000</td>
<td>7,453,500,000</td>
<td>400</td>
<td>15</td>
</tr>
<tr>
<td>1,001 to 2,000</td>
<td>1,141,400,000</td>
<td>163</td>
<td>17</td>
</tr>
<tr>
<td>2,001 to 3,000</td>
<td>237,200,000</td>
<td>66</td>
<td>10</td>
</tr>
<tr>
<td>3,001 to 4,000</td>
<td>32,400,000</td>
<td>14</td>
<td>2</td>
</tr>
<tr>
<td>1 to 4,000</td>
<td>500,300,000</td>
<td>105</td>
<td>11</td>
</tr>
</tbody>
</table>

Median values. Based on data from Thomson Reuters. Sample includes 4,070 firms, with fiscal years ending 2019.
Because of their size, blockholders can influence the governance of a firm.
- Determine outcome of director election or proxy contest.
- Determine outcome of takeover battle.
- Encourage company to change management, strategy, or sell itself.
- Gain direct board representation.

The actions they take depend on the nature of their investment and relationship to the firm.

- Firms that have a blockholder at one point in time tend to have one 5 years later.
- No clear evidence that blockholders boost firm value; they might be subject to their own agency problems if their interests are not the same as other investors’.
- External blockholders have greater influence when they hold a board seat.

Barclay and Holderness (1989); Holderness (2003); Core, Holthausen, and Larcker (1999); Edmans and Holderness (2017)
The proxy voting process is an important mechanism for shareholders to influence the corporation.

Publicly traded companies are required by state law to hold an annual meeting to elect the board and transact other business that requires shareholder approval.

Shareholders are provided advanced notice through a written proxy statement and vote their shares on ballot items in person or by proxy.

Institutional investors voting record
- “For” a proposal 86% of the time when management is also “for.”
- “Against” a proposal 89% of the time when management is also “against.”

ISS Voting Analytics (2017)
• **Management proposals** are those sponsored by the company, including:
  – Election of directors
  – Ratification of the auditor
  – Approval of equity-compensation plans
  – Say-on-pay
  – Bylaw changes

• **Shareholder proposals** are those sponsored by investors, generally relating to bylaw changes, social policy, and compensation.

• Companies may exclude shareholder proposals if they violate the law, deal with management functions, capital distributions, or other substantive matters.
Shareholder proposals are primarily sponsored by individual, religious, social responsibility, or union-affiliated investors, with mixed results.

**SHAREHOLDER PROPOSAL SPONSORS**

- Individual: 70%
- Labor affiliated: 15%
- Religious/social: 14%
- Other institutional: 1%

**AVERAGE SUPPORT**

- Declassify board: 76%
- Eliminate supermajority: 68%
- Majority voting uncontested election: 58%
- Special meeting: 44%
- Act by written consent: 39%
- Proxy access: 33%
- Independent chair: 29%
- Dual class voting: 27%
- Board diversity: 8%

Sullivan & Cromwell (2019); Georgeson (2019)
• An activist investor is a shareholder who uses an ownership position to actively pursue governance changes. Examples might include:
  – Labor-affiliated pension fund
  – Social responsibility investment fund
  – Hedge fund
  – Individual investor

• Activist investors play a prominent role in the governance process, sometimes for the better and sometimes not.
Public pension funds manage retirement assets on behalf of state, county, and municipal government employees.

Private pension funds manage assets on behalf of trade union members.

Pensions are active in the proxy voting process. However, their activism has not been shown to have a positive impact on shareholder value or governance outcomes.

Unions increase the number of proposals they sponsor in contract expiration years, and these proposals appear to be designed to benefit labor rather than shareholders.

Matsusaka, Ozbas, and Yi (2017).
ESG AND SOCIAL RESPONSIBILITY FUNDS

• Socially responsibility funds cater to investors who want to invest only in companies whose practices are consistent with specific objectives.
  – Environmental sustainability
  – Social responsibility
  – Employee practices and human rights

• The process for determining a “socially responsible investment” from one that is not is highly discretionary.

• Socially responsible funds are active sponsors of proxy proposals. These proposals rarely pass, but fund managers also undertake direct engagement with company to argue for change.

  In 2019, only 9% of proposals passed; average support was 29%.

Sullivant & Cromwell (2019)
Individual investors are the largest sponsors of proxy proposals; these proposals rarely receive majority approval.

Critics contend individual activism is a waste of corporate resources.

Defenders argue that every shareholder is a legitimate participant in the governance process. Although individuals lack the size, they still have voting and economic rights.

The SEC has moved to increase ownership thresholds to decrease individual proposals, while trying not to exclude them entirely.

“Every material issue was once an immaterial issue brought by some shareholder of some company that said that this was important.”

Hedge funds are private pools of capital that engage in a variety of trading strategies to generate excess returns.

Hedge funds are known for their high fee structure (2% management fee, 20% carry).

They face pressure from clients to generate superior performance to justify these fees. This pressure might encourage activism.

- Target companies with high cash flow and below market values.
- Create positive short-term stock price performance.
- Tend to achieve the objective of activism: resignation of CEO, sale of company, increased buybacks, etc.
- Long-term financial impact is uncertain.

Brav, Jiang, Thomas, and Partnoy (2008); Klein and Zur (2009); Bebchuk, Brav, and Jiang (2015); deHaan, Larcker, and McClure (2019)
Index (passive) investing: shareholders invest in funds whose objective is to match benchmark indices at very low cost.

Index funds have little incentive to improve governance at individual firms, although they benefit from market-wide improvements in governance quality.

Ownership of assets has concentrated in the hands of a small number of index providers (Vanguard, BlackRock, and State Street).

These firms have considerable influence over voting outcomes; the economic implications of concentrated ownership are unclear.

Concentration of ownership and voting power introduces new agency risks.

SHAREHOLDER DEMOCRACY

• In recent years, there has been a push by Congress, the SEC, and others to increase the influence that shareholders have over governance systems ("shareholder democracy").

• Advocates believe that it will make board members more accountable to shareholder concerns.

• Elements of shareholder democracy include:
  – Majority voting in uncontested elections.
  – Investor right to nominate directors ("proxy access").
  – Investor vote on executive compensation ("say on pay").
  – Engagement with the board.

• Shareholders react negatively to these requirements.

Larcker, Ormazabal, and Taylor (2011)
Many institutions rely on the recommendations of a third-party advisory firm to assist them in voting the proxy.

(+) Proxy firms examine all issues on the proxy.
(+) Small investors lack the resources to do this in-house.
(+) Large investors might want a second opinion.

(-) No evidence that their recommendations increase value.
(-) Guidelines tend to apply a one-size-fits-all approach.
(-) Proxy firms might not have sufficient staff or expertise.
The largest proxy advisory firms are Institutional Shareholder Services (ISS) and Glass Lewis, whose clients manage $35 trillion.

An unfavorable recommendation by ISS can reduce support by 10% to 30%, depending on the nature of the proposal.

Companies adapt policies to gain proxy advisory support.

No evidence that proxy advisor recommendations improve performance; some evidence that they hurt performance.

SEC Commissioner

“It is important to ensure that advisers to institutional investors . . . are not over-relying on analyses by proxy advisory firms. No one should be able to outsource their fiduciary duties.”

Copland, Larcker, and Tayan (2018); Gallagher (2015).
CONCLUSION

• In theory, shareholders should be in a strong position to influence the structure of governance systems.

• In practice, shareholders have limited influence, and in some cases they have conflicting agendas.

• Regulators have attempted to increase the influence of shareholders by mandating elements of “shareholder democracy.”

• However, shareholders tend to react negatively to these regulations. A positive impact on governance quality has not yet been demonstrated.
BIBLIOGRAPHY


