Shareholder Voting and Corporate Governance

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Abstract

This article reviews recent research into corporate voting and elections. Regulatory reforms have given shareholders more voting power in the election of directors and in executive compensation issues. Shareholders use voting as a channel of communication with boards of directors, and protest voting can lead to significant changes in corporate governance and strategy. Some investors have embraced innovative empty voting strategies for decoupling voting rights from cash flow rights, enabling them to mount aggressive programs of shareholder activism. Market-based methods have been used by researchers to establish the value of voting rights and show how this value can vary in different settings.

1. INTRODUCTION

Shareholder voting lies at the foundation of a wide range of corporate governance protections. The rights of shareholders to choose members of the board of directors, approve mergers and acquisitions, authorize new equity issues, and amend the firm's articles of organization give them ultimate power over important corporate decisions. Conversely, a large concentration of voting power in the hands of management tends to negate the discipline of corporate governance and the market for corporate control, especially when management's voting rights exceed its cash flow rights due to the use of devices such as multiple classes of common stock or pyramidal business groups.

This article reviews recent research in the area of shareholder voting, focusing on cross-sectional empirical studies at the company level. In the late 1990s, commercial vendors began to market large research databases with firm-level information about voting, ownership, and corporate control. Wider availability of data has contributed to a surge of academic research in the area and also led to innovations in the business world, such as the incorporation of ownership and governance data into debt ratings. Regulators have recently taken a strong interest in shareholder voting, with proposals currently under study by the federal government to give shareholders a more direct role in approving executive compensation and nominating director candidates. Many public companies have come under shareholder pressure to modify their voting rules, causing hundreds of major firms in the past three years to switch to majority vote elections that give shareholders opportunities to block the election of objectionable director nominees.

Scholarship about shareholder voting began in earnest in the 1980s, around the time that major institutional investors started exercising their voting rights in programs of shareholder activism. An important paper by Morck et al. (1988) showed that firm value can deteriorate as the voting control of insiders rises, a result extended in a recent study by Gompers et al. (2009), though questioned by other authors who consider the relationship to be jointly determined and influenced by a multitude of outside forces. LaPorta et al.'s (1997) cross-country index of voting regulations began an active line of finance research that linked the growth, depth, and valuation of international capital markets to the strength of shareholder voting rights in different nations.

Although certain benefits of strong shareholder voting rights have become apparent from these and other studies, many commentators and theorists recognize that voting is accompanied by costly side effects. Shareholders lack specific information about the firm, and their voting decisions may depart from superior choices that managers, with better information, might make on their own. Managers facing frequent shareholder votes might spend large amounts of time campaigning and pursuing frivolous short-term policies that cater to blocs of voters but compromise the firm's long-term interests (Karpoff & Rice 1989). Aghion & Tirole's (1997) model of the delegation of authority from owners to managers illustrates that the level of managerial initiative, which encompasses aspects such as effort supply and innovation, depends on owners delegating sufficient authority and not retaining the power to second-guess the managers' business decisions. A similar theme appears in Burkhart et al. (1997), who write, "The manager is less inclined to show such initiative when shareholders are likely to interfere." These arguments parallel research into the costs and benefits of political referenda, which show that although frequent public voting will clarify the preferences of citizens, it may also affect the behavior of elected representatives, who could pursue policies further from those preferred by the median voter to influence the outcomes of future elections (Matsusaka & McCarty 2001).

Shareholder proposal: a non-binding resolution voted on at a company's annual meeting

Given the wide range of potential costs and benefits of shareholder voting, the topic has become an active research area, with most of the studies attempting to evaluate whether stronger shareholder voting rights increase or detract from firm value. The remaining sections of this review describe the contributions of important recent papers in five broad categories, as follows: Section 2 discusses studies on the design and conduct of corporate elections. Section 3 reviews cross-sectional studies of voting in elections of corporate directors. Section 4 analyzes studies of vote-buying, vote-lending, and other strategies related to the decoupling of voting rights from cash flow rights. Section 5 reviews studies on voting on various aspects of executive compensation. Section 6 discusses research into shareholder activism. Section 7 concludes the review.

2. DESIGN AND CONDUCT OF CORPORATE ELECTIONS

Until recently, most research on shareholder voting focused on episodes of conflict or activism affecting relatively small groups of firms. Mulherin & Poulsen's (1998) study of proxy fights, which includes a survey of related prior papers such as Pound (1988), indicates that direct contests for board seats occur in approximately 10 to 20 companies per year. Studies generally find that shareholder wealth increases around the time of these events, many of which lead to changes in the composition of the board. Related papers, some of which are discussed below, have focused on nonbinding shareholder resolutions and other forms of activism, usually aimed at dismantling takeover defenses, reducing executive compensation, or changing the organization of corporate governance. Although this research has provided considerable insight into the effectiveness of various governance tactics, it has overlooked the vast majority of shareholder voting, given that most firms rarely become subjects of targeted activism or corporate control challenges.

2.1. Corporate Election Administration

In all public companies, shareholders vote at annual meetings on the election of directors and a variety of other governance topics. These votes provide a channel for communication between shareholders, the board, and management. The agenda for shareholder meetings is determined partly by legal requirements, partly at the initiative of management, and occasionally by shareholder petition. In addition to director elections, shareholders may vote on such topics as the appointment of outside auditors, issuances of new shares, creation of equity-based compensation plans, amendments to the corporate charter or bylaws, major mergers and acquisitions, and ballot questions submitted in the form of advisory shareholder proposals. Shareholders may also be asked to ratify certain decisions of the board of directors, such as related-party transactions with members of management. When shareholder approval of an item such as an acquisition becomes time critical, votes may be held at special shareholder meetings called in the middle of a year.

Ground rules for routine shareholder voting follow the same basic structure at all companies, with some variation from firm to firm in electoral decision thresholds. Kahan & Rock (2008) and Listokin (2008) provide excellent overviews of this area, including the complexities and pitfalls of the vote-counting process. Nearly all shareholders vote by proxy, sending in votes by mail or Internet rather than attending meetings to vote in person.

Kahan & Rock (2008) identify numerous weaknesses and inconsistencies in election administration, including inaccurate shareholder lists, delays and omissions in ballot distribution, and incomplete vote tabulation by the subcontractor firms that run elections on behalf of public companies. The authors view many of these problems as artifacts of an archaic voting system that was created early in the twentieth century when share ownership was based on physical possession of stock certificates and nearly all elections were uncontested. When the United States reorganized the formalities of share ownership in the 1960s and 1970s, on the basis of electronic registration, voting procedures were not modernized at the same pace.

Kahan & Rock caution that without substantial improvements in election administration, growing conflict and uncertainty over the outcome of corporate elections seems inevitable, given the increasingly aggressive voting practices of major shareholders. Kahan & Rock further note that even if an election's outcome is not in doubt, managers and shareholders pay attention not only to the identity of the victor, but also to the vote totals on both sides. If votes are not counted accurately, then voting totals become noisier signals of shareholders' preferences, undermining the value of corporate elections as a form of communication. The authors' concerns about accurate administration of elections seem especially troubling when one considers the growing regulatory trends, discussed in the sections below, of extending the shareholder franchise into areas such as executive compensation and encouraging competitive elections for the board.

2.2. Empirical Research on Election Procedures

A small number of papers has evaluated aspects of the design and procedures for corporate voting. Bhagat & Brickley (1984) find negative abnormal stock returns when firms eliminate cumulative voting and also when firms classify the board of directors. Each of these actions diminishes the influence of outside shareholders' votes. Cumulative voting facilitates the election of dissident board candidates, because it permits each shareholder to concentrate all of his votes in support of a single candidate; if n board seats are open, a dissident can be elected if he receives all of the votes cast by just $1/n$ of the shareholder base. Board classification extends each director's term from one year to three years and provides for staggered elections, meaning that shareholders have fewer opportunities to remove any individual director, and no possibility of changing a majority of the board in a single election. Brickley (1986) finds positive abnormal stock returns around the mailing dates of proxy materials to shareholders for routine annual meetings, suggesting that corporate leaders behave much like politicians; they strategically disclose optimistic corporate news shortly before election day. Shivdasani & Yermack (1999) study the process for nominating candidates for the board of directors, finding that lower-quality nominees emerge when the firm's CEO has a direct role in the nominating process (a practice that has all but disappeared since 2003, due to new regulations). Other research has studied the general effects of voting restrictions on firm value and performance, often finding that firms perform worse when the shareholder franchise is curtailed due to structures such as a classified board. Notable recent papers in this large literature include Gompers et al. (2003), which examines a range of takeover defenses and voting restrictions; Bebchuk & Cohen (2005) and Faleye (2007), both of which focus on staggered boards; and

Gompers et al. (2009), which studies dual-class voting structures. A contrary result, showing superior performance of firms after dual-class recapitalizations, appears in Dimitrov & Jain (2006).

Broker vote: votes cast on behalf of management by custodian brokers, using the shares of owners that fail to vote

Some voting regulations and practices appear to tilt election outcomes in favor of management. Strong circumstantial evidence to this effect appears in Listokin (2008), which examines the margins of approval for management-initiated ballot questions, most of which are executive compensation plans that require shareholder approval. As illustrated in **Figure 1**, the study finds an overwhelming disparity between the frequency of proposals narrowly passing, with vote totals just above the 50% approval threshold, compared to the frequency of proposals narrowly failing, with vote totals just below 50%. In contrast, no sharp discontinuity exists around the 50% threshold for ballot questions initiated by outside shareholders. This pattern may partly reflect judicious timing and scaling of compensation plans by management, but it is also likely influenced by management's ability to lobby shareholders as it observes incoming vote totals (and in most firms, voter identities) during the vote-counting period and to withdraw proposals that appear to be headed for narrow defeats.

Management-sponsored ballot questions have also benefited from the so-called broker vote, which gives registered brokers the authority to vote shares held in street name on behalf of clients, if the ultimate owners fail to vote their shares. Broker voting applies a broad range of ballot questions that are classified by stock exchange regulations as routine, including uncontested director elections and, prior to 2003, issuances of new equity up to a limit of 5% of outstanding shares (these smaller share issues frequently include the funding

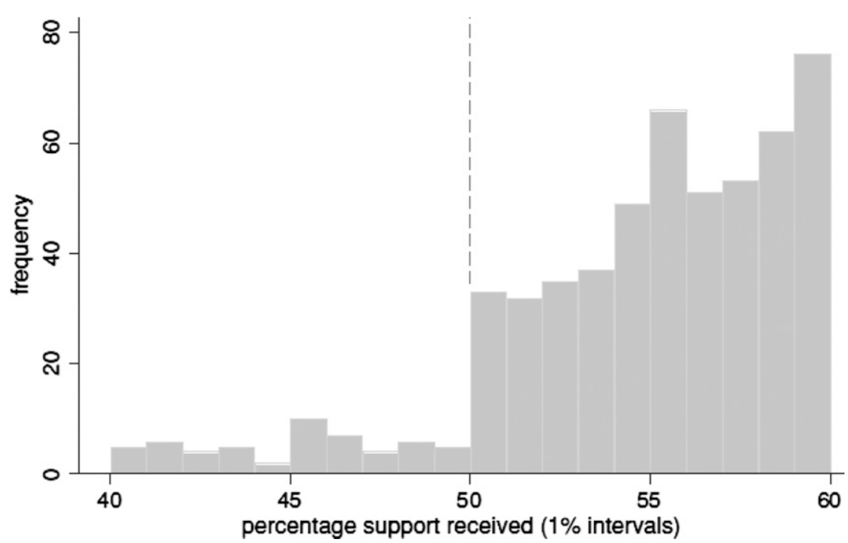

Figure 1

Histogram of vote percentages for management-sponsored proposals. The figure shows the distribution of voting outcomes for a sample of annual meeting ballot questions sponsored by management. The large majority of votes sought shareholder approval of executive compensation plans. The total sample includes more than 13,000 items voted on by shareholders at annual meetings between 1997 and 2004. The figure shows the distribution of outcomes for the 502 votes that received between 40% and 60% shareholder support, with 50% required for passage.

Proxy access: permits shareholders to nominate candidates for the board, with the candidates listed in the firm's proxy materials alongside management's nominees

for many equity-based compensation plans) (see Maug & Rydqvist 2009). Bethel & Gillan (2002) report that broker votes are invariably cast in favor of management's nominees or positions, and that they tend to increase the vote totals in favor of these questions by approximately 11 to 14 percentage points, sometimes much more. Broker voting was introduced in 1937 to boost shareholder participation at annual meetings in order to meet quorum requirements. That rationale has become archaic in today's market, with institutional investors controlling (and usually voting) the majority of outstanding shares. As a result, in 2009, the U.S. Securities Exchange Commission (SEC) repealed broker voting for director elections beginning in 2010.

3. VOTING IN DIRECTOR ELECTIONS

Although shareholder voting rights are potentially powerful, they are seldom used directly to unseat members of a board. Only a few dozen contested proxy contests are held each year in which rival candidates compete head to head. Instead, dissident shareholder votes are usually cast to signal displeasure with management indirectly, through protest votes against certain board candidates or in favor of ballot questions advocating governance reforms. As shown below, these protest votes may often intimidate management into changing the composition of the board, dismantling takeover defenses, revising executive compensation packages, and implementing other changes. In addition, when managers know that they face a large block of antimanagement votes, the threat of a proxy contest often provides an impetus for these types of reforms to bypass the cost and adverse publicity of the confrontation.

Director elections will almost certainly become more competitive and visible in the near future, due to three significant regulatory changes under way in late 2009. As noted above, the SEC has repealed broker voting in director elections beginning in 2010, depriving management-backed nominees of a cushion of approximately 10%–15% of votes cast in a typical election. The SEC also appears likely to soon liberalize its rules about proxy access despite longstanding opposition from the business community. This reform would give outside shareholders the right to nominate candidates for the board to compete with management's nominees, perhaps only under limited conditions linked to poor company performance. Firms would have to allot space within management's own proxy solicitation materials to publicize the outside candidates alongside management's own nominees. Finally, since 2006, a large number of companies, including more than two-thirds of the S&P500 firms, have responded to pressure from shareholder activists by replacing plurality voting election thresholds with some form of majority voting rules. Although the strictness of these rules varies from firm to firm, they generally require board candidates to receive at least half of all votes cast to be elected, greatly reducing the costs to shareholders of denying election to any or all of the members of a board.

3.1. Studies of Routine Director Elections

The first comprehensive analysis of voting in annual director elections appears in Cai et al. (2009). The authors study voting at 2,488 shareholder meetings between 2003 and 2005 involving the election of more than 13,000 individual directors; approximately half of directors were elected annually, and the remainder were elected once during this period for three-year terms on classified boards. According to summary statistics in the study, the typical board candidate runs unopposed and receives 94% support in favor of election or re-election. Vote totals for directors are higher when the firm has performed well, when it has high-quality corporate governance (such as few takeover defenses or many outside directors), and when the board has high ownership. Vote totals tend to fall when the firm has been sued for securities fraud or has paid its CEO more compensation than expected. The rules of voting also matter: When a firm has confidential voting (which is true only approximately 13% of the time), nominees receive slightly less support, and if the firm has multiple classes of shares with unequal voting rights, vote totals for directors are higher. All of these associations exhibit statistical significance but relatively modest economic significance.

Just-vote-no campaign: a campaign among shareholders to abstain or withhold votes for the election of certain director candidates

Although the magnitude of these effects may make most director elections appear pointless, Cai et al. (2009) document intriguing spillover effects, as does a similar study by Fischer et al. (2009). These papers show that meaningful vote totals against the election of certain directors are followed by changes in the board, management, or corporate actions within the next year. For example, Cai et al. estimate that a 1% decrease in the votes for a director who serves on the compensation committee of the board tends to reduce CEO compensation by approximately $143,000 in the next year (the estimate is developed only within the subsample of CEOs estimated to be overpaid relative to their peers). In another model, the authors find that votes against reelection of independent directors tend to increase the probability of CEO turnover in the next year, holding constant the effects of company performance and other variables. Very similar results, based on a somewhat overlapping sample, emerge from the Fischer et al. paper. An excellent recent example occurred in 2009 at Bank of America Corp., when the shareholders reelected Chairman and CEO Kenneth Lewis to his board seat with just 67% support, an abnormally low total, in the aftermath of the bank's controversial acquisition of Merrill Lynch. Lewis announced his early retirement from the company less than six months later, and many of the outside directors left as well. Related analysis from the Fischer et al. and Cai et al. studies suggest that protest votes against directors lead to director resignations, value-increasing acquisitions and divestitures, and the dismantling of takeover defenses such as poison pills and classified boards; though, the strength of these effects is ambiguous.

3.2. Influence of Shareholder Campaigns

Organized voting campaigns sponsored by dissident shareholders underlie some of the results found in the Cai et al. (2009) and Fischer et al. (2009) studies, and further research suggests that these campaigns help initiate changes in the board or corporate strategy. Since the early 1990s, institutional investors have occasionally waged just-vote-no campaigns against certain individual board members, hoping to generate a significant number of abstention votes that would motivate directors to play a more constructive role in the corporation. DelGuercio et al. (2008) study a sample of 112 publicly announced just-vote-no campaigns, which are typically targeted at directors of large capitalization, underperforming firms. Approximately two-thirds of these campaigns are mounted against most or all of the members of the board, whereas approximately one-third are aimed at individual directors. The authors find that directors targeted by such campaigns have approximately 11.4% of votes withheld for their reelection on average. Cai et al. (2009) find

Proxy advisor: a research firm that issues voting recommendations to its clients

a much lower but still significant voting effect in a regression analysis that includes a just-vote-no campaign indicator variable. The firms in the DelGuercio et al. sample appear to respond to just-vote-no campaigns, as they experience high rates of CEO replacement, improved operating performance, and a high frequency of strategic changes in the subsequent year.

3.3. Influence of Proxy Advisor Recommendations

Proxy advisory services also impact director elections, and they have become the subject of a growing literature. Institutional Shareholder Services (ISS) is the oldest and largest proxy advisor. It was founded in 1985 to provide research and advice about how institutional investors should vote in corporate elections, with the goal of improving corporate governance. Over time, ISS became the leading collector and provider of data about corporate voting, and its role in corporate elections grew to become both influential and controversial. The firm was acquired in 2007 by RiskMetrics Group, a publicly traded corporation, and it now has an active business consulting with corporations about how to improve their governance while making voting recommendations to outside investors about elections held at the same firms (and others as well).

Cai et al.'s (2009) analysis of director elections shows that ISS may have a strong impact on voting. When ISS recommends that shareholders vote against an individual director, his vote total drops by an average of eight percentage points (ISS recommendations have a high overlap with poor director attendance, and if a director meets this criterion his support drops by a further 11 percentage points). Bethel & Gillan (2002), Choi et al. (2008), Alexander et al. (2009) and Daines et al. (2009) study ISS and other corporate governance rating agencies. Choi et al. focus especially on ISS and other proxy advisors' impact on director elections. The authors present evidence that proxy advisors' recommendations are based on easily observable variables such as attendance, age, company performance, and accounting restatements. They argue that proxy advisors provide a service by aggregating information for shareholders, but that shareholders' voting decisions are based on the data rather than the recommendations of intermediaries. This conclusion, which is contrary to the views of most other studies, is based on regression analysis that shows proxy advisors' recommendations having insignificant impact on elections once other variables are included in the model.

4. DECOUPLING OF VOTING RIGHTS AND CASH FLOW RIGHTS

Equity ownership represents a bundle of two rights: the right to receive capital gains, dividends, and other distributions from the firm, and the right to participate in corporate governance by way of shareholder voting. These two components are often described in shorthand as cash flow rights and voting rights. Although we can observe the market value of most equity securities directly from stock exchange quotations, documenting the separate values of the cash flow right and voting right components has become a major empirical research question. Establishing the value of voting rights would help quantify the general importance of corporate governance as an influence on the value of the firm. As discussed below, until now, most research has indicated that the value of voting rights is quite small, at least under normal business conditions when control of the company is not at issue.

Beginning with Grossman & Hart (1988) and Harris & Raviv (1988), many theoretical papers analyze potential costs and benefits of decoupling voting rights from cash flow rights. Burkhart & Lee (2008) provide a recent overview of this literature. Almeida & Wolfenzon (2006) and Masulis et al. (2009) examine the special case of pyramidal business groups.

4.1. Premiums for High-Vote Stock

Much of the extant empirical research into the value of voting rights focuses on small samples of firms that have more than one class of common stock listed and trading on a major exchange. Typically these shares will have different voting power, with the high-vote shares under control of management and/or the firm's founding family (see sidebar on Family Business Groups). By comparing the different market prices of high-vote and low-vote shares issued by the same firm, and adjusting for any difference in dividends, these papers attempt to isolate the market price of a voting right. Kalay and Pant (2009) survey the existing studies, approximately ten of which have been published to date. In general, they find positive and statistically significant average premiums for the higher-vote shares. This conclusion is subject to numerous qualifications, including the sample selection bias inherent in the data, because firms that choose to employ dual-class equity structures may be those in which voting rights are most valuable.

Probably the two most important papers in the area are a tandem by Zingales (1994, 1995). Zingales (1994) finds that voting shares of Italian companies listed on the Milan stock exchange are priced with a premium of more than 90% above the price of nonvoting shares issued by the same firms. Zingales (1995) studies the same question for U.S. listed firms and finds that premiums for high-voting stock are much lower and often indistinguishable from zero, except in cases in which control of the firm becomes (or is likely to become) contested, when the premiums can become very large. Together these results suggest that the value of corporate votes is highly sensitive to market conditions in

FAMILY BUSINESS GROUPS

Voting structures such as pyramids or dual-class shares often perpetuate founding family control of listed companies (Villalonga & Amit 2009). In the United States, this phenomenon exists in firms such as Ford Motor Co. and The New York Times Co. Whether family control adds value has become the subject of a growing literature, beginning with the study of sudden CEO deaths by Johnson et al. (1985). Major papers include Anderson & Reeb (2003) and Villalonga & Amit (2006).

Researchers studying family companies must isolate the effects of sample selection bias arising from families' choices of whether to continue control from one generation to another. Bennedsen et al. (2007) solve this problem by merging civil census data from Denmark with the corporate registry of officers and directors of Danish corporations. They study the performance impact of intrafamily CEO succession, using as an instrumental variable the gender of the CEO's first-born child. Estimates in their paper indicate that family control exerts a severely negative impact on performance.

Related research has studied topics such as the valuation effects of marriages between offspring of business dynasties (Bunkanwanicha et al. 2008) and how inheritance laws in different countries affect the investment horizons of family firms (Ellul et al. 2009).

both the short-term and long-term. In the short-term, voting rights become valuable when control of the firm is put into play, and in the long-term the rights are valuable if the firm is chartered in a state or country that permits large extraction of private benefits of control.

4.2. Stock Lending and Empty Voting

The studies discussed above share a common limitation, in that they all present only indirect evidence about the supply of, demand for, and value of corporate votes. The first paper to advance beyond this point and provide direct insight into the trading of corporate votes is an innovative recent study by Christoffersen et al. (2007), which examines the stock lending market using a proprietary dataset of loans made by a large custodian bank.

Stock lending has existed for decades to provide a supply of shares to short sellers. A buyer who transacts with a short seller expects to obtain all the antecedents of ownership, including voting rights, so it is necessary for voting power to be transferred away from a share's true owner if the stock is lent out. However, there is no requirement for an investor who borrows shares to sell them short; the shares could simply be borrowed for voting purposes and then returned to their owner, who collects a modest amount of cash interest from the borrower during the loan period (Harris & Raviv 1988).

Christoffersen et al. (2007) provide abundant evidence that many investors follow this strategy. **Figure 2** illustrates their most dramatic point that average volume in stock lending spikes upward to a level approximately 25% higher than usual on the record date for annual shareholder meetings, and then immediately reverts to normal levels the next day (the effect is greater for large-capitalization stocks). On the basis of these volume data, the authors conclude that, "while the equity loan market exists to facilitate short selling, it also

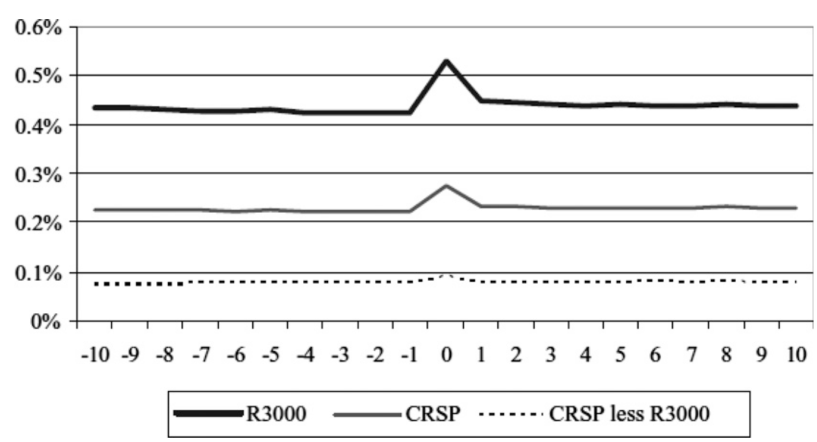

Figure 2

Loan market volume around voting record date. Loan date (record date is 0) is on the horizontal axis, and shares loaned by an undisclosed custodian bank, divided by shares outstanding, is on the vertical axis. The sample is 6,764 record dates of CRSP stocks from November 16, 1998 to October 15, 1999. The sample is broken into all shares in CRSP, all shares in the Russell 3000 (larger capitalization stocks, the top series), and those shares in CRSP, but not the Russell 3000 (smaller capitalization stocks, the bottom series). Source: Christoffersen et al. (2007). Reproduced with permission of *The Journal of Finance*.

facilitates the trading of votes" (Christoffersen et al. 2007, p. 2901). However, the increased volume of stock lending around annual meeting record dates is concentrated in a relatively small number of observations, and it may not be economically meaningful in many cases. Further evidence in the paper suggests that most of the borrowed votes are cast against management; although, these outcomes cannot be observed directly. The most surprising result in this study is the absence of any significant cost associated with borrowing votes. The authors document that the cost of carry, or specialness, that is charged to borrowers is almost trivially low and generally does not increase on the record date when voting rights can be exercised.

Empty voting: using derivative transactions to obtain the voting rights associated with shares of stock while removing economic exposure to price changes

The low cost of borrowing votes documented by Christoffersen et al. (2007) must be interpreted with great caution, because the large majority of contested elections in the paper's sample involves votes on advisory shareholder proposals only and not contests for corporate control. When the sample is restricted to a small group of events in which control-related votes are taken, estimated costs of borrowing votes rise dramatically. However, the associated standard errors are so large that the estimates are not significantly different from zero.

The study by Christoffersen et al. (2007) proved timely, because it coincided with widespread market publicity about a variety of vote-trading and vote-buying tactics used by active investors to influence corporate elections. These strategies generally rely on the use of derivative securities transactions such as stock lending, equity swaps, and forward contracts, and are described in detail in an important law review article by Hu & Black (2006). Hu & Black coined the phrase empty voting to describe the tendency of these transactions to be structured to deliver voting rights to an investor while reducing or even removing any exposure to changes in the underlying stock price.

Empty voting strategies have influenced the outcomes of a number of corporate control contests around the world, including some involving hedge funds that aggressively aggregated voting rights as part of a shareholder activism program (Klein & Zur 2009). Empty voting poses challenges to regulators, because current disclosure rules in many countries (including the United States) do not clearly require investors to report large voting positions if they are constructed synthetically and on short notice via combinations of derivative securities. In addition, empty voting may lead to problems with the fair administration of corporate elections. Phenomena such as double voting and over voting apparently occur often when the true owner of a share does not know his broker-custodian has lent out his securities and both the borrower and the ultimate owner attempt to cast votes, a surprisingly frequent phenomenon described in Christoffersen et al. (2007). Kahan & Rock (2008) discuss the ambiguous procedures for resolving these problems when tabulating the votes in actual elections.

The most troubling aspects of empty voting arise when an investor with substantial votes succeeds in removing any price risk, insulating himself from any valuation consequences that may be associated with his voting strategy, and then proceeds to vote differently than he might have in the presence of price risk. In certain scenarios, such an investor might cast votes against the best interests of the corporation to enhance the value of his positions in other securities. In a particularly well-known example in 2004, a hedge fund owned a large position in King Pharmaceuticals®, Inc., which received an attractive takeover offer from Mylan Laboratories, Inc. The offer was likely overpriced, as many of Mylan's shareholders, including activist Carl Icahn, publicized their intention to vote against their firm's proposed acquisition. Fearing that its investment in the target firm would lose value if the deal did not go through, the hedge fund acquired 9.9% of the votes in the bidder and removed any price risk by entering into equity swaps and forward contracts with investment banks. It intended to vote in favor of the transaction, even though such a vote would likely have helped drive the bidding company's share price lower (the deal was ultimately abandoned for unrelated reasons).

4.3. Contingent Claims Valuation of Votes

Two recent working papers by Kalay & Pant (2009) and Karakas (2009) employ a contingent claims approach to extending the results of this literature. In each paper, the authors exploit the concept of put-call parity and use a combination of options and bonds with identical maturities to replicate the cash flows associated with owning a share of stock. As they explain, "An investor that buys a call option, sells a put option with the same strike price and time to expiration, and, invests in a risk free asset an amount equal to the present value of the strike price, creates a synthetic stock" (Kalay & Pant 2009, p. 2). The cost of constructing this synthetic stock with traded derivative securities is then compared to the market price of a genuine share of stock that delivers not only cash flow rights but also voting rights.

Both papers find modest estimates of the average value of a voting right, on the order of approximately 0.10%–0.25% of the value of a share of stock under normal conditions. The apparent value of voting rights rises higher when control of a firm is contested, such as when companies call special shareholder meetings to vote on mergers and acquisitions. In a control-related subsample Karakas (2009) studies, the value of voting rights is estimated as high as 5% of the value of a regular share, whereas Kalay & Pant (2009) obtain estimates with much lower average magnitude. Karakas validates his higher estimates by comparing them with quotations of the cost of borrowing shares from the stock lending market. These pricing data, which are available from 2005 onwards from a publicly accessible source, indicate that the annualized cost of borrowing shares is approximately 5%–6% of the shares' face value during the period around the record date for special shareholder meetings.

Karakas's (2009) analysis calls into question the conclusion by Christoffersen et al. (2007) that voting rights have negligible cost in the stock lending market even when control of the firm is at issue. The two studies may not be in conflict, because the Christoffersen et al. paper examines only a very small sample of such events and obtains estimates with large confidence intervals. However, both papers may be estimating a relatively unimportant statistic, which is the cost of acquiring a single marginal vote. As illustrated by the King Pharmaceuticals example above, active investors sometime acquire large numbers of votes when attempting to influence corporate elections. In these situations, supply-and-demand effects should lead to marked increases in the cost of votes, as suggested by certain examples in Zingales (1995). Illustrating how the value of votes increases when shareholders demand large quantities appears to be an important question for further research.

5. VOTING ON EXECUTIVE COMPENSATION

High executive compensation, especially in poorly performing firms, has long been the subject of shareholder protests. Over time, shareholders have acquired the right to vote on a number of aspects of companies' executive remuneration, providing opportunities to influence executive pay both directly and indirectly.

5.1. Current Opportunities for Shareholder Votes on Compensation

In 1992, the SEC permitted shareholders to sponsor nonbinding resolutions about executive compensation, and over time activists have used these votes to target controversial pay practices such as golden parachutes, stock option repricing, and management perquisites. Subramaniam & Wang (2009) document the growth of these shareholder proposals since 1992; a large surge took place in 2003 after a series of accounting scandals at major firms including Enron, Tyco, and WorldCom. However, shareholder compensation proposals typically have not attracted large voting support, and their effect on compensation and company performance has been mixed at best, as discussed in Ferri & Sandino (2009).

In 1993, Congress enacted section 162(m) of the Internal Revenue Code, limiting the tax deductibility for the compensation of top executives unless their pay was delivered through a shareholder-approved incentive plan. In addition, many incentive compensation plans use stock or stock options, and exchange listing regulations have long required shareholder approval to authorize inventories of new shares (at least above certain thresholds) that are reserved for future use as restricted stock or stock option awards to managers. Although these voting requirements have had loopholes that permitted firms to avoid seeking shareholder approval under certain conditions, most of the exceptions were eliminated in a 2002 SEC reform, and today shareholder approval of equity compensation plans is almost universally sought by firms, due to these tax and exchange listing regulations.

Shareholders' votes on whether to ratify shares for executive compensation have been influential. Gillan (2001) presents data showing that the average shareholder vote against authorizing shares for equity compensation plans rose from approximately 3% in 1988 to approximately 19% by 1996, a period when stock option compensation grew very rapidly and many institutional investors adopted voting policies designed to limit their exposure to future share dilution. Martin & Thomas (2005) also report a 19% average opposition to equity compensation plans in 1998. Morgan & Poulsen (2001) find that plans with high potential dilution levels, with large amounts of shares authorized for future issuance, receive lower support; although, this may occur because stock exchanges have classified plans with dilution of 5% or more of outstanding shares as nonroutine items that the broker vote cannot support, as Bethel & Gillan (2002) discuss. Morgan et al. (2006) find that plans in 2000 to 2003 received an average opposition of 33% when a proxy advisory service recommended that shareholders withhold approval, a much higher total than in earlier years. Cai & Walkling (2009) find that negative vote totals for share authorization are associated with excessively large executive compensation. Circumstantial evidence suggests that many firms have reacted to the rising tide of negative votes by scaling back their equity compensation plans, which leveled off in size in the aggregate from 2000 onward (changing accounting rules requiring the expensing of stock option compensation probably influenced this trend as well).

In addition, shareholders can vote against reelecting those directors who have responsibility for setting executive pay, such as the members of a board's compensation committee. Results cited above in Cai et al. (2009) and Fischer et al. (2009) indicate that CEO pay falls in the aftermath of shareholder votes against these directors.

Say-on-pay vote: a shareholder vote to approve the firm's compensation policies, held by all British public companies since 2002

5.2. Say-on-Pay Votes at British Companies

Since 2002, British companies have held votes at all annual shareholder meetings to solicit approval for the firm's overall executive compensation strategy (more precisely, shareholders vote on whether to approve the report of the board's remuneration subcommittee). Although these say-on-pay votes are purely advisory, and no remedy occurs if shareholders withhold ratification, they have become widely popular among institutional investors. The advisory, rather than compulsory, nature of the votes appears to strike a balance between giving shareholders an opportunity to communicate directly with the board on a highly visible issue and not imposing potentially enormous costs (through clawbacks and rescissions of employment contracts) in those cases in which shareholders oppose management.

Four recent papers study the say-on-pay experience in the United Kingdom: Alissa (2009), Carter & Zamora (2009), Conyon & Sadler (2009), and Ferri & Maber (2009). All four papers come to the same general conclusions. Although only a small handful of say-on-pay resolutions fail to pass, negative vote totals tend to increase when executive compensation is higher than expected, given a firm's size, performance, and other relevant variables. In the aftermath of high negative votes, firms tend to reduce the size and increase the performance sensitivity of top managers' pay. In addition, episodic cases have emerged in the British news media of firms withdrawing bonus or severance packages for top managers in response to negative say-on-pay votes.

The generally favorable experience with say on pay in Britain has caught the attention of U.S. politicians, and the U.S. Congress appears very likely to adopt a parallel law by 2010 or 2011. A few U.S. firms have begun holding these advisory votes voluntarily or as a result of shareholder-sponsored proposals. Cai & Walkling (2009) conduct an event study of the reaction of U.S. firms' stock prices to the approval of say on pay by the U.S. House of Representatives in 2007. They find that firms with excessive compensation and low pay-performance sensitivity experienced stock price increases, consistent with a view that shareholders welcomed the opportunity for a more direct role in regulating these companies' compensation.

6. SHAREHOLDER ACTIVISM

Shareholder activism refers to efforts by investors to use their voting power as a catalyst for corporate change. Most activists have relatively short time horizons, generally seeking to pressure firms into immediate governance reforms but not seeking full operating control. The United States has a long history of shareholder activism dating from the eighteenth century (Wright & Sylla 2009), and examples of activism in European companies can be found at least as early as the Renaissance.

Until the 1980s, most U.S. shareholder activism occurred under the aegis of aggressive individual investors, who have operated in public stock markets for hundreds of years. A typical activist shareholder, such as Carl Icahn or Kirk Kerkorian, will acquire a significant block of stock and agitate from outside the firm for value-increasing improvements. Grossman & Hart's (1980) model of takeover bids by outside shareholders suggests that too few major blockholders may pursue this type of activism, because they bear all of the costs but obtain only a fraction of the economic benefits created.

Although individual shareholder activists continue to operate in the markets, the focus of most U.S. shareholder activism shifted to major institutional investors beginning in the late 1980s. At that time, institutions controlled approximately 47% of the equity of the 1,000 largest U.S. public corporations, a figure that increased to nearly 68% by 2005 (Brancato & Rabimov 2007). The size of this aggregate ownership implies that institutions working in concert can enact governance reforms at almost any firm they target. Maug & Rydqvist (2009) present evidence of strategic interaction among voters, suggesting that institutional investors make their voting decisions after taking account of one another's positions and also the approval thresholds for individual votes. However, institutional investors undertaking activism have an incentive mismatch similar to that facing major blockholders, because activists bear all of the costs of their efforts but must share the benefits widely with minority investors.

As discussed in Section 6.1 below, the success of institutional investor activism to date appears limited, although this conclusion may be misleading if it is based on only the share price paths of companies that institutions have targeted for reform. Activist institutions frequently state that their goal is not to improve the value of individual investment positions, but rather to create positive externalities by signaling optimal governance practices market wide, potentially improving the value of the institutions' other diversified investments. The evidence Matvos & Ostrovsky (2008) present about institutions' returns around merger and acquisition announcements appears consistent with this point. The authors find that institutions are often shareholders of both the bidder and target companies involved in any given merger. Even though bidder companies tend to overpay in acquisitions and see their stock prices drop, these losses to institutions' portfolios are cancelled out by gains in the shares of target companies that they also own. In merger situations, therefore, institutions likely focus on the joint value creation for the combined firm rather than the returns to either company individually. Similar logic would lead institutions to evaluate the success of activism programs, not by examining the returns to individual targeted firms' stocks, but rather by attempting to ascertain the impact on companies throughout their portfolios—an evaluation that might be quite difficult in practice, given the very large number of companies potentially influenced by institutional activism programs.

In the past decade, a new strain of shareholder activism sponsored by hedge funds has earned impressive returns. Hedge fund activism, discussed in Section 6.2, has succeeded partly due to the use of synthetic vote-buying strategies discussed above, as well as other structural advantages that hedge funds enjoy relative to pension funds and other institutional investors. Even if hedge funds have to share the benefits of activism with minority shareholders, their relatively inexpensive access to voting power has reduced the cost of activism to a point where the returns appear attractive. As a result, hedge fund activism has grown rapidly in recent years, at least up until the financial crisis of 2007 to 2010.

Not all major institutional investors have embraced the shareholder activism movement. Some groups, such as mutual funds and corporate pension funds, have played only limited roles as activists either because of regulatory constraints or because of business motivation. In 2002, an SEC reform required mutual funds to disclose their proxy voting, and many hoped that the new transparency would cause some mutual funds to begin working in concert with public pension funds to challenge managements in underperforming companies. Up to now, this has not happened on a large scale.

For research that evaluates the voting patterns of mutual funds, see Davis & Kim (2007) and Morgan et al. (2009).

6.1. Public Pension Fund Activism

As discussed in Gillan & Starks (2000), major public pension funds began activist programs in 1987 by sponsoring a wave of shareholder proposals advocating improved corporate governance. Liberalization of the proxy rules by the SEC in 1992 simplified the costs of communication and coalition building among institutions, leading to ever-growing numbers of shareholder proposals and gradually increasing vote totals. The 1990s also saw the advent of more aggressive institutional activism strategies, including the just-vote-no campaigns discussed above and publication of watch lists of underperforming companies singled out by institutions for intensive dialogue and negotiation.

Although public pension fund activism became the focus of copious media coverage and academic research, empirical evidence suggests that it has not had much impact. Several studies have shown that companies targeted by institutions do implement governance reforms, either as a result of back-channel negotiation (Wahal 1996, Carleton et al. 1998) or after shareholder proposals receive large voting support (Ertimur et al. 2009). Cziraki et al. (2009) discuss related European evidence. However, it is less clear that these changes lead to improved value of the targeted companies. A literature review by Karpoff (2001) studies the findings of more than 20 academic papers that analyze the effectiveness of a wide range of public pension fund activism strategies. Nearly all of these studies conclude that the impact of activism on the value of target firms has been statistically insignificant or, at best, modestly positive over very short horizons (Barber 2006). A representative study is DelGuercio & Hawkins (1999), which states, "We conclude that shareholder proposals are effective in promoting change at target companies ...[but] we find no evidence that this activity has significant effects on stock return or accounting measures of performance in the three years following an initial targeting, and only sketchy evidence of positive effects in the short term."

6.2. Hedge Fund Activism

At the beginning of the twenty-first century, hedge funds began confrontational activism strategies at selected companies. Hedge funds' methods are fundamentally different, and certainly more aggressive, than the activism programs mounted by public pension funds since the mid-1980s. As shown in a number of recent studies, early returns to hedge fund activism have been impressive. However, this activity slowed considerably in the credit crunch of 2007 to 2010, and the staying power of hedge fund activism programs remains uncertain.

Brav et al. (2008) and Klein & Zur (2009) are the first major studies of hedge fund activism in large-sample datasets. Approximately 10 additional working papers and smaller-sample studies have also been completed to date. These studies generally identify hedge fund activism events from SEC Schedule 13D filings that are mandatory when a shareholder acquires 5% or more of a public company; sometimes these filings indicate specific goals such as changing the composition of the board, paying out excess cash, rescinding takeover defenses, or seeking the sale of the firm. Brav et al. (2008) find that disclosure of these activist-oriented 13D filings lead to abnormal returns of approximately

7%–8%, whereas Klein & Zur (2009) report a slightly higher mean abnormal return of approximately 10% for their sample. Both studies also report very high success rates, with a majority of companies implementing the hedge funds' reforms within a relatively short time horizon, leading to permanent improvements in shareholder value.

As both studies discuss, hedge funds have a number of intrinsic advantages as activists when compared to pension funds, mutual funds, or other institutional investors. Hedge funds have no diversification requirement, enabling them to concentrate assets in a few target companies. Hedge funds can invest in illiquid securities, because their own investors cannot withdraw their capital on short notice, and hedge funds face less comprehensive ownership disclosure requirements than other institutions, enabling them to operating with greater secrecy and flexibility. Managers of hedge funds typically have far stronger performance incentives than managers at other types of institutional investors. Perhaps most importantly, hedge funds can build large voting positions by using leverage and empty voting strategies such as stock borrowing and equity swaps, most of which would be off-limits to pension funds and mutual funds. Together, these factors imply that the costs of activism may be lower for hedge funds than for other institutions, the opportunities may be broader, and the rewards to fund managers may be greater.

Greenwood & Schor (2009) find that most returns from hedge fund activism result from eventual takeovers of a minority of targeted companies. Even if hedge funds' original demands do not involve selling these firms, the involvement of activists tends to put them into play. Among firms that are not taken over, the authors do not find significant evidence of value improvements due to cost savings, capital structure changes, payout increases, or other adjustments in firms' operations. The authors do not provide an explanation for why takeovers appear to be a necessary condition for value creation by targeted firms, but they suggest that the real skill of hedge fund activists may lie in identifying and marketing companies as takeover targets, and possibly orchestrating their sales at prices that exceed the true value of the firms' assets.

6.3. Social Activism

Some shareholders sponsor ballot questions at annual meetings to promote social, environmental, and political agendas. This practice probably began in 1951, when shareholders of Greyhound Bus Lines submitted a proposal recommending that the company discontinue racially segregated seating on bus routes in Southern states. Greyhound successfully went to court to block a shareholder vote on this resolution. By the early 1970s, social activists began to introduce annual meeting resolutions on topics such as automobile safety (Ralph Nader's campaign against General Motors) and the manufacture of napalm for the Vietnam War (Manne 1972). Courts began permitting shareholder votes on these and other topics, and the SEC enacted procedural rules to formalize the process. The first large-scale campaign organized around a specific issue concerned divestment of major corporations from South Africa, which began with a shareholder resolution at the 1973 annual meeting of Mobil Corp. (Teoh et al. 1999).

Socially oriented shareholder proposals have been among the most controversial forms of shareholder voting, for they seem to offer only vague benefits to targeted companies while potentially imposing large costs in terms of adverse publicity and distraction of management. Most social proposals, if adopted by targeted companies, would clearly tilt against the firms' financial interests. For example, tobacco companies often receive proposals calling for studies of the health impact of the company's products, and oil companies receive proposals recommending that management prepare a report on the connection between the firms' products and global warming.

In recent years, the frequency of social ballot questions has gradually increased, as have their vote totals. The Social Investment Forum (2008) estimates that approximately 11% of professionally managed investment assets in the United States are held in socially screened funds. The group also reports that social and environmental shareholder proposals received an average of 15.4% voting support in 2007, the highest level ever. This vote total implies that social resolutions have some appeal to ordinary shareholders even when they do not use social criteria as the basis for asset selection.

Social activists' voting on shareholder proposals can publicize a firm's business practices, motivating regulators' or plaintiffs' lawyers to scrutinize a firm or industry more closely and limit its freedom of action. A good example would be General Electric Co.'s costly cleanup of pollution in the Hudson River, which began in 2009 under orders from the Environmental Protection Agency. The Environmental Protection Agency acted against the company in 2002 after a series of shareholder ballot questions had kept the issue in the public eye for years. To contain publicity risk, firms targeted with social proposals often make preemptive concessions. At ExxonMobil Corp., Chairman and CEO Rex Tillerson surprised many by publicly advocating a carbon tax in 2009, after a series of shareholder proposals related to alternative energy development and corporate governance changes received significant voting support in 2007 and 2008.

Social investors have grown enough potentially to challenge the governance and compensation practices of certain companies. Agrawal's (2008) study of proxy voting by AFL-CIO pension funds suggests that labor unions systematically vote against management's director nominees and executive compensation plans, a pattern probably shared by many socially activist institutional investors. Although organized labor's pension assets are small relative to the market capitalization of most companies, the possibility exists that a firm could one day face a concerted voting campaign from socially minded shareholders who have goals other than profit maximization. For instance, an environmentally conscious hedge fund could accumulate enough votes to unseat the directors of a high-polluting electric utility, perhaps with voting support from the endowment funds of universities and conservationist organizations. How managers would balance the interests of these voters with those of ordinary shareholders who simply seek to maximize profits would raise novel legal and ethical questions.

7. CONCLUSIONS

This review surveys recent research into corporate voting, including such topics as election administration, the impact of vote totals in director elections, strategies for decoupling voting rights from cash flow rights, and patterns of shareholder activism. For many years, these subjects received relatively little attention in the corporate governance literature, which has been dominated by topics such as executive compensation and boards of directors. However, real-world developments in corporate voting have led to new academic research that is both timely and creative. Shareholders have acquired greater power to use voting rights to unseat board members and limit executive compensation, and hedge fund activists have adopted aggressive vote-trading strategies, enabling them to push through governance reforms or strategic changes at many underperforming firms. With rich datasets on shareholder voting becoming increasingly accessible to researchers, this area promises to become a growing and important area of corporate finance scholarship.

The various developments that this review highlights seem to reflect a growing trend toward shareholder democracy in U.S. corporate governance. This pattern probably dates from the 1950s, when nonbinding shareholder proposals first appeared at annual meetings, and it has been accelerated by regulatory initiatives over the past decade, encouraging more voting in areas such as executive compensation, ratification of management's choice of auditors, and to a lesser extent, director elections and takeover defenses. Whether more shareholder democracy adds value to public corporations remains an ongoing research issue that is touched on, more or less, by many of the papers discussed above. Many studies offer indirect evidence that firm values are higher when the shareholder franchise is more easily exercised; though, much of this evidence is confined to the area of mergers and acquisitions, with relatively less research supporting the idea that firms benefit from shareholder participation in areas such as executive compensation or social activism.

Reasons for growing shareholder democracy are diverse. Leading explanations include the decreasing costs of communication and voting, especially in the Internet age; the gradual concentration of share ownership among institutional investors, such as pension funds and hedge funds, who actively seek to exploit the value of their voting power; and waves of shareholder outrage in response to corporate scandals during the post-Enron era and the financial crisis of 2007 to 2010. All of these trends—cheaper communication, rising ownership concentration, and growing public outrage—appear to be operating today as strongly as ever, implying that the trend toward more shareholder democracy is unlikely to be reversed any time soon.

SUMMARY POINTS

1. Archaic rules and procedures, many of which indirectly insulate managers from shareholder discipline, plague the administration of corporate elections in U.S. companies. Recent SEC reforms have attempted to give shareholders a more direct voice in nominating and electing directors and regulating executive compensation.
2. Shareholder voting provides an effective means for shareholders to communicate with the board of directors, and boards usually take action in response to clear protest voting.
3. A variety of empty voting tactics related to vote lending and vote trading have come into wide use in recent years, posing novel problems for regulators and targeted firms.
4. Researchers have devised several market-based and arbitrage methods of estimating the value of voting rights. This value seems small under most conditions, but it can be large when corporate control becomes contested.
5. Partly due to their mastery of voting tactics, in recent years, hedge funds have enjoyed success in shareholder activism, greatly surpassing the previous achievements of other institutional investors in this area.

6. Shareholder clienteles have become increasingly aggressive in using corporate votes to focus public attention on social issues related to the environment, employment conditions, and related topics.

FUTURE ISSUES

1. What is the value of a large block of votes in a company, as opposed to the value of a single marginal vote?
2. What consequences arise from the inconsistent and inexact administration of corporate elections?
3. What are the value consequences to the firm when directors lose their board seats under recently adopted majority voting election rules?
4. What are the costs and benefits, if any, of advisory shareholder votes on executive compensation and social issues?

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