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The *Idealized Electoral College* voting mechanism and shareholder power

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ABSTRACT

Increasing concern over corporate governance has led to calls for more shareholder influence over corporate decisions, but allowing shareholders to vote on more issues may not affect the quality of governance. We should expect instead that, under current rules, shareholder voting will implement the preferences of the majority of large shareholders and management. This is because majority rule offers little incentive for small shareholders to vote. I offer a potential remedy in the form of a new voting rule, the *Idealized Electoral College* (IEC), modeled on the American Electoral College, that significantly increases the expected impact that a given shareholder has on election. The benefit of the mechanism is that it induces greater turnout, but the cost is that it sometimes assigns a winner that is not preferred by a majority of voters. Therefore, for issues on which management and small shareholders are likely to disagree, the IEC is superior to majority rule.

As for popular suffrage, it may be further remarked that especially in large states it leads inevitably to electoral indifference, since the casting of a single vote is of no significance where there is a multitude of electors. Even if a voting qualification is highly valued and esteemed by those who are entitled to it, they still do not enter the polling booth. Thus the result of an institution of this kind is more likely to be the opposite of what was intended; election actually falls into the power of a few, of a caucus, and so of the particular and contingent interest which is precisely what was to have been neutralized.

G.W.F. Hegel (1821)

1. Introduction

In order to improve corporate governance, academics and policy makers often suggest increasing the number of things upon which shareholders can vote. For example, new "say on pay" rules give shareholders a binding or non-binding vote on Chief Executive Officer (CEO) compensation. Governance experts hope these rules can rein in excessive pay packages but, with some notable exceptions, early evidence seems to run contrary to these aspirations.

> Except in fairly extraordinary circumstances, [shareholders] don't much care about how much people get paid…We saw it last year, the first year say-on-pay votes were required by the new Dodd-Frank financial reform law, and we're seeing it again this year. Last year, only 36 of 2,225 companies said shareholders voted down their compensation plans.[1]

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[1] http://www.huffingtonpost.com/2012/05/07/say-on-banker-pay_n_1496133.html.

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Are shareholders really accepting of these pay packages or do they lack an incentive to vote? I show below that, under majority rule, we should expect that small shareholders will abstain from voting: majority rule will implement the will of the majority of *large* shareholders, not the majority of *all* shareholders. Many large shareholders, especially financial firms, receive private benefits from management. For example, insurance firms may manage employee life or health insurance plans, mutual funds may manage employee retirement accounts, and investment banks may underwrite bond and equity offerings. Such shareholders are therefore likely to vote with management (Gordon and Pound, 1993; Gillan and Starks, 2000; Davis and Kim, 2007, Brickley, Lease, and Smith, 1988, 1994). Moreover, management itself is often a large shareholder. Because small shareholders are inclined to abstain, majority rule will implement the will of management, not shareholders. This is especially true when, as is the case in the United States, brokers are allowed to vote the shares of their clients if the clients do not submit votes.[2]

In attempting to improve corporate governance, therefore, we must either abandon the shareholder voting route, or we must reconsider the use of the majority rule mechanism. I offer in this paper an alternative mechanism, the *Idealized Electoral College* (IEC), that may induce small shareholders to vote. The benefit of the IEC is that it significantly increases the likelihood that a given voter will affect the outcome of the election, thus increasing turnout. The cost of the IEC is that the side receiving fewer votes sometimes wins the election. This means that even if all shares are voted, the majority's will may not be implemented. Therefore, the IEC is superior to majority rule if and only if the preferences of large shareholders/management differ from those of shareholders overall.

The IEC mechanism is a randomized and stylized version of the American Electoral College, in which votes for or against a proposal are organized into groups, and majority rule determines each group's choice. Groups are formed into super-groups and majority rule is again applied. This process is repeated until all votes are aggregated to a single decision. I show that individual votes are almost always far more likely to affect the outcome of an election under the IEC mechanism than under majority rule. I then introduce a model of shareholder preferences and voting, and derive properties of two important equilibria, one in which all shareholders vote (a "universal voting" equilibrium), and one in which only large shareholders vote (a "universal abstention" equilibrium). If parameters are such that a universal voting equilibrium exists for majority rule, then one exists for the IEC as well. The converse, however, is not true. There are cases in which the IEC induces all voters to vote, but majority rule does not. Moreover, of the set of parameter values such that the IEC allows a universal voting equilibrium, the fraction for which majority rule also induces universal voting goes to zero as the number of votes goes to infinity.

Universal abstention equilibria are more likely to exist under majority rule. Indeed, I would argue that these equilibria are the norm in practice. Burch, Morgan, and Wolf (2004) find that, in votes at acquiring firms concerning large stock-for-stock mergers—those mergers in which value is most likely to be destroyed—the fraction of shares voted in favor is 95–98%. They do not find a single failed vote in their sample, spanning 1990–2000. Nearly all shareholders who vote side with management, which is peculiar because the sample specifically contains only proposals that are likely to harm shareholders. It seems that shareholders lacking a private benefit to siding with management abstain. As I show, under majority rule this is to be expected; under the IEC it is less likely.

I also analyze what conditions of an electorate make the IEC or majority rule superior. Majority rule is superior when large and small shareholders have similar preferences, but the IEC is superior when they have significantly different preferences. It may be optimal, therefore, to selectively implement the IEC for certain types of votes, particularly those in which there is a concern about managerial motives (e.g., executive pay or large acquisitions).

There are alternative mechanisms that have been developed that could assign special power to small or minority shareholders. For example, dual class voting, introduced in Maug and Yilmaz (2002), could be applied to the problem in several ways, two of which I discuss. Either classes could be defined by the ownership stake of the voter—with small shareholders (e.g., $<3\%$) constituting one class and large shareholders (e.g., $>3\%$) and management constituting another—or classes could be defined by connection to management, where shareholders with a business relationship with the firm constitute one class and shareholders with no business relationship constitute another. In either case, majority rule would determine each class's choice, and each class would have veto power over a proposal. One could reasonably ask why the IEC is useful when these alternatives exist.

The IEC mechanism is inferior to these alternatives under the assumption that the class assignment is not manipulable, but manipulation may be feasible in practice. As one example, large shareholders can mimic small shareholders by splitting stakes among shell funds or corporations, each of which has a small ownership stake.[3] Firms with a business relationship could legally, but not functionally, split the investment side of the business from the pension management side. Regardless of the details, *any rule where voting rights depend upon characteristics of the voter may be subject to manipulation*. The IEC is not subject to manipulation because each share has the same rights, regardless of its ownership. In a finance setting, where voting identities can be masked, faked, or otherwise manipulated, an anonymous rule is important.

[2] For routine votes, at least, brokers may vote shares for clients (Bethel and Gillan, 2002). This fact reconciles the seemingly contrary facts that even though small shareholders do not vote, 80% of shares are typically voted on proposals at large US corporations (Maug and Rydqvist, 2009).

[3] Similarly, small shareholders could use the equity lending market to combine shares into larger holdings, in order to vote as part of the "large shareholder class."