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The Individual's Role in Driving Corporate Governance

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Never believe that a few caring people can't change the world. For, indeed, that's all who ever have.
—Margaret Mead

Mainstream economics and many fund fiduciaries assume people are separate from nature and behave like robots. Once central to economic theory, justice and other human values appear as a foreign language. This is a call to action. We cannot depend on elites; individuals must reintroduce values to the world of commerce.

Global warming, the disappearing middle class, terrorism—we are plagued by a host of problems that seem too big for the individual to make a difference. Most of us are too focused on earning a living and raising our families to do anything other than vote and donate to a few special causes. We hope powerful elites will take more comprehensive action. But if the system is working for them—if they are already part of the proverbial 1 percent—how likely are they to work for change?

To restore a salubrious environment and to make our economy work for most of us, we need a fundamental reboot. Individuals *can* make a real difference. After all, we form the basis of society. Without real people, acting fully human, our institutions—our families, governments, schools, commercial and religious organizations—become hollow shells.

The Internet allows companies like Google, Facebook, and Airbnb to scale up quickly, with relatively few employees and little capital. When Facebook went public, they did so not to raise money for operations but to enable the founder and early investors to take cash out of the company. WhatsApp only had 70 employees when acquired by Facebook for $22 billion.

In addition to providing the infrastructure for fast-growing companies, the Internet can also provide a platform for rebuilding our institutions. Social media, open-sourcing, crowd-funding, the sharing economy, and other developments illustrate how individuals can participate in creative decision making on a grand scale without sacrificing our values—since dialogue and other substantive interaction can be baked into the process.

If PiggyBee.com can connect individuals to share transportation space in backpacks, surely someone can successfully design and host a website to facilitate cooperation among individual investors in shaping corporate governance.

Instead of asking ourselves as passive objects what the world will look like in ten years, we increasingly recognize our future world will be one of our own making. If we want a good one, we better take a greater role in shaping it.

Today's most powerful revolutionary forces are not families, governments, schools, or religious communities—although these remain important. Real power is increasingly housed in multinational corporations, building social networks at the speed of light. As power shifts to corporations, focusing on corporate governance, rather than elected officials, may be a more direct way of creating social, tangible, and financial structures aligned with our values.

However, the average individual, while growing more apathetic with the apparent futility of civil elections, has *no* idea how to influence the direction of corporations. In this chapter, I aim to identify some possibilities for individual and cooperative action.

From Robots to Democracy

Corporate governance suffers from a similar malady as economics. Seeking to create a more legitimate numbers-based hard science, economists *assumed* invisible hands and rational individuals seeking only to maximize their own benefits. While other social sciences sought to measure *actual* behavior, economists built mathematical models based on the robotic behavior of an idealized *homo economicus*. Compassion, service to others, the natural bonds between people and other less measurable realities were discounted.

As Yannis Papadogiannis writes:

> All the things that couldn't "fit" into mathematical equations (emotions, passions, social and political relations, etc.) were weeded out . . . economics managed to establish itself as a hard science, on a par with physics and biology, albeit by paying an unbearable price: being cut off from reality and the world of action.[1]

Many economists treat markets *as if* there is perfect competition and investors *as if* all they care about is maximizing short-term profits. Assumptions, initially taken as approximating reality, then in turn shape reality when cases are adjudicated on fiduciary duty, when SEC regulations are written and as a host of other activities are conducted. Short-term economic return is too frequently regarded as the highest value, even when such behavior harms the environment or society.

There is no legal duty to maximize shareholder value, except when selling the company or in a takeover situation per *Revlon.*[2] The Internet can facilitate finding out what investors actually want. Yet few, if any, companies survey shareholders on their values.

The regulatory system, once designed to ensure corporations advanced social and economic interests, is now more focused on protecting corporations from citizens and boards from shareholders. Corporations are not really independent persons with their own rights but are, instead, a legal fiction. We need to ensure they are conscientiously governed.

While many, such as Robert Reich focus on the need for government regulations to ensure corporations work "for the many, not the few," real change must be pursued on multiple fronts, including by shareholders from within corporations.

The Declaration of Independence contained aspirational phrases like "all men are created equal" that did not describe the current state of law, but a state of hope for the future. Reformers, such as Fredrick Douglas, then used these images of a future society to point out the country was not living up to its ideals.

Similarly, corporations hold elections without a choice among candidates and current practices tip the balance in favor of management. For example, opponents to board nominees generally must send out their own proxy through an expensive solicitation process, while board-endorsed candidates are included in materials paid for by the company. Shareholders are limited to 500 words in describing proposals, whereas boards have unlimited space in proxy materials to oppose such proposals or to describe their own. Boards can freely change the titles of shareholder proposals on proxy ballots to confuse or mislead voters and many companies count abstentions as "no" votes.

Still, over the last few decades, corporate elections have been moving in the direction of greater participation and democracy. Thirty years ago, no shareholder proposal had ever won a majority of votes cast at an annual meeting. Today proposals seeking governance reforms, disclosure of political contributions, sustainability reports, and other actions are passed every year. Twenty years ago, directors were nominated by CEOs; today, by independent board members. Ten years ago, unopposed directors only needed one vote to win; now they often need a majority of shares voted. The arc of history points to the spread of democracy throughout many of our institutions, including corporations.

Companies without Owners

There is debate between those who see directors and companies as having a fiduciary duty to maximize shareholder value and those who believe there must be an entry point for sustainability or other social values. Milton Friedman argued that the social responsibility of business is to increase its profits,[3] whereas Joel Bakan contends that, left unchecked, corporations will lead to ruin.[4] Such arguments are not new, but are variants of a famous set of post-Depression-era exchanges between Adolph A. Berle, Jr. and Merrick Dodd, regarding the evolving nature of corporate responsibility and accountability with the separation of ownership from control.

Traditional industrial moguls, such as Andrew Carnegie and John D. Rockefeller, as well as traditionalist contemporaries such as Bill Gates, compartmentalize life. Earn as much money as possible in business, then donate to good causes. Those who grew up with smartphones see less of a disconnect between work and leisure—between earning money and donating to good causes. Values should not be suspended in any realm of life. We don't have to create or accept a false dichotomy. Corporations are social constructs and should continually evolve through dialogue and action.

Some corporate missions are very focused, but most companies are chartered to conduct any legal business activity. Like the Declaration of Independence's "All men are created equal," Google's motto, "Do no evil," describes a principle we hope will lead to a better future. The actual strategies a corporation follows over time should be appropriately informed and influenced by its shareholders, who must have opportunities for dialogue before they can arrive at common truths.

Too many of today's companies are on autopilot. As Robert A. G. Monks points out, we, the owners of America's corporations, have abdicated our responsibility.[5] Just as most banks no longer hold actual mortgages like the building and loan in the classic movie *It's a Wonderful Life*, we have also sliced and

diced our stock holdings to the point where it is not worth monitoring the companies we own.

On the advice of John Bogle and others, we have increasingly invested in indexed funds. While that strategy works well for individual investors, collectively it means that few, or no one, in the chain of ownership has an incentive to care significantly about firm-specific corporate governance, despite good intentions. When everyone owns just a very small portion, no one takes responsibility for the whole.

For example, if Vanguard, Fidelity, and BlackRock each own 1 percent of a company, any changes Vanguard initiates at any one company will also benefit the other two funds (their competition) in proportion to their holdings, but Vanguard will incur *all* the expense. Therefore, most funds are rationally passive but not totally passive. Research has found them associated with less support for management proposals, greater support for shareholder-initiated governance proposals, reduced cash holdings, a higher dividend yield, and lower managerial pay.[6] However, none ever initiated a proxy proposal or a proxy contest, although they do tip-off activist investors to possible opportunities.

In the words of Justice Louis Brandeis,

> There is no such thing to my mind . . . as an innocent stockholder. He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of the system. It is his business and his obligation to see that those who represent him carry out a policy, which is consistent with public welfare.

Directors must be accountable to those outside their own body—to shareowners and government at least—if they are not to become insular and self-serving. But the chain of responsibility and obligation, which Brandeis spoke of, is largely broken.

Robert Monks documents this problem and its implications better than any other author.[7]

> Seven decades ago, Adolph A. Berle warned that granting managers free rein posed the "danger of a corporate oligarchy coupled with the probability of an era of corporate plundering." Both fears have been fulfilled in our own time, but this takeover hasn't happened in a vacuum. Passive index funds, algorithm trading, the incessant churn of financial markets around the world have all served to weaken the bonds of ownership and divorce shareholders from any compelling sense of responsibility for the corporations in which they have invested.

The result is what Monks calls drone corporations: in the sense that they are untethered from reality and responsibility because of their distance from

human operators. Companies without owners, that is shareowners with a large enough interest to warrant monitoring, are associated with a long litany of problematic behaviors—tax avoidance, regulatory fines, underperformance, and high CEO pay. Too many CEOs and boards are shifting the burden of externalities onto society, leaving us with the consequences of global warming, political chaos, and so on.

Taking Responsibility

Addressing the problem of passive investors will require effort from many perspectives. Monks focuses on 24 highly influential foundations and university endowments—the elites of society. However, I question how many are willing to be traitors to their class.[8] Whatever turmoil climate change brings, the sons and daughters—as well as the grandchildren and great-grandchildren—of today's elite endowment trustees are likely to remain better off. They will find higher ground. Although some may be moved by Monks's call to action, the 99 percent should not look to the 1 percent to be saved.

I also have to disagree strongly with Monks's lost hope with shareholder democracy, although I do understand his frustration after so many years of valiant effort.

> The atom of ownership is too smashed, and the proxy system through which corporate voting is carried out has been too corrupted to give any hope of a democratic resolution to the multiple ills of corporate governance today . . . Proxy voting is the moat around management, not the bridge into the castle. (2013, 132–133)

We have made substantial progress, in large part due to Monks's efforts. Most S&P 500 companies have declassified their boards, redeemed poison pills, require majority vote for directors, and no longer require supermajority votes to amend bylaws. Yes, flaws remain. However, fixes are available if individuals will just gather together and work for change.

The irony here is that Monks himself, in collaboration with Nell Minow and others, provides us with the best tools we have to bridge the moat to that metaphoric castle. His role was key in establishing that proxy votes be treated as assets. Because of Monks, pension funds must vote proxies in the best interest of plan participants. Mutual funds and investment advisors must report how they voted, which is critical if we are to hold them accountable. Proxy advisors now analyze issues and provide at least some reasonable balance to the recommendations of company management.

The Lens fund that Monks and Minow created showed there is money to be made in good governance. Their GMI Ratings helped establish a better form of index funds, based on risk and measures of good governance. And, of course, their books continue to inspire new generations to strive for a better, more sustainable world.

Like an optometrist, Robert Monks clarified our vision and highlighted the dangers of irresponsible owners. Like an architect, he presents several model reforms that could result in more profitable, responsible, and sustainable corporations. Success will require the involvement of individuals, pushing our institutions from all sides.

Most retail investors toss their proxies. Many institutional investors vote only because of their legal obligation to do so. Although funds are required to vote, all they need to do is blindly follow the herd . . . voting with as much thought and care as a prudent person would do under like circumstances. In other words, if most trustees make little or no effort, the law judges such disengagement as prudent.

Share*holders*, who ignore their obligations as share*owners* sometimes leave control in the hands of unaccountable boards with little knowledge of, or interest in knowing, what their shareowners really want. Greed is the only assumed common value.

As companies evolve, they should continually assess their mission. To do so adequately, they must know their citizens, their share*owners*. Truth can more easily be found in the process, rather than the end goal. Companies have the trappings of democracy but in the absence of public debate, private self-serving decisions too frequently prevail. Open dialogue, that includes shareholders, is more likely to include concern for the public good.

If companies are to reach their true potential, boards need to understand their investors not as abstractions but as corporate citizens. Commonalities should not be assumed but should be discovered through healthy dialogue. All investors are in the end *individual* investors, even though more and more is done through intermediaries—through our pension plans, mutual funds, ETFs, hedge and other funds. How well do those intermediaries, often built on the false dichotomies of economics, reflect our values?

Yes, most investors want a reasonable rate of return, but many also want a salubrious environment. Bringing our values to our role as owners could actually enhance the profitability of the corporations we own, especially if regulatory agencies are provided the resources to punish bad actors. It is widely recognized that companies that seek creative employees are more likely to invent and execute the next big ideas. Creative ideas can also come from customers and investors. Dialogue and debate are healthy.

Life-Affirming Foundations

John McMurtry points out, the most fundamental and significant difference between the cellular and social planes of life organization is that social bodies are not genetically determined. Social bodies, unlike cellular bodies, reproduce in every moment through underlying values and decision structures subject to conscious modification. We must, therefore, reject reductionist theories of determination based on history, economic laws, or genetic blueprints, which rule out alternatives to the status quo.[9]

Humanity's urge to overcome limits has harnessed itself to systems of corporate governance and economics that are consuming the habitat of life itself. The result is species extinction, global climate change, and the beginning of a new era of political turmoil.[10]

Economics and corporate governance can be reformulated to gauge progress against Earth's carrying capacity, biodiversity, the health of soil, air and water, nutrition and literacy levels, disease ratios, housing, freedom of expression, and so on. Are we winning or losing at life itself?

When Humans Bring Their Values to the Corporation

Studies have shown that firms highly rated on environment, social, and governance (ESG) are more profitable. Well-governed firms tend to do well in other endeavors as well.

Research found a clear relationship between ESG ratings and stock returns. High-return companies in aggregate had better ESG ratings. There was a strong negative correlation between ESG ratings and stock volatility, and this relationship was stronger when market volatility was higher. Fund managers can get diversification benefits by choosing stocks with better ESG ratings, especially when markets are more volatile. The risk-adjusted return turned significantly positive in recent years, and this positive correlation strengthens further by excluding the lowest ESG stocks.[11]

Most studies are based on after-the-fact measures, which are noisy proxies. Researchers focused on managerial incentive structures find that an emphasis on corporate social responsibility (CSR) can counterbalance the negative effects of managerial entrenchment, lead to higher shareholder value, and is consistent with shareholder-wealth maximization. "Our empirical results (based on an instrumental-variables estimation) suggest that good governance causes high CSR, and that a firm's CSR practice is consistent with shareholder wealth maximization."[12]

Current Pay Practices Work Against Creating Long-Term Value

Since firms with high ESG and CSR ratings perform better than those with lower scores, won't this drive the behavior of management and investors? Maybe the market will adjust automatically to favor companies with high ratings?

If that were the case, CEOs and other managers would get paid based on how well their companies score on these metrics. Although some do use these metrics for pay purposes, this is a rare, if perhaps slowly growing, practice. At most firms, pay is not even linked to how well executives convert invested dollars into future profits, as would be predicted by conventional economic theory.

In 1993, the U.S. Congress amended the tax code [IRC Section 162(m)] to tie executive pay to performance. To be a tax-deductible business expense, pay in excess of $1 million must be performance-based. Stock price was an easy proxy for performance and was acceptable to the IRS, although more complex measures are equally acceptable.

Before that amendment, in 1991, average CEO pay at large public firms was 140 times that of average employees. By 2003, it was approximately 500 times. Whereas equity-based compensation at such firms accounted for zero percent of the median executive's compensation in 1984, it climbed to 66 percent by 2001. The percentage of CEO pay from stock option grants rose from 35 percent in 1994, to over 85 percent by 2001.[13]

Research into CEO pay shows that total shareholder return (TSR) is, by far, the most dominant performance metric in long-term incentive plans. Yet, increased TSR often has little to do with CEO effort or actually growing a business for the long term. Stocks go up and down for many reasons, including the general direction of the market.

TSR is easily gamed through cost-cutting measures such as firing employees, reducing R&D, stock buybacks, or financial engineering. In contrast, developing new products, training staff, and increasing sales take more creativity and may take years to bear fruit. Researchers found that economic performance explains only 12 percent of variance in CEO pay, whereas more than 60 percent is explained by company size, industry, and existing company pay policy. None of those other measures are performance-driven.

Only 17 percent of companies specifically disclose return on invested capital or economic profit as a long-term performance measure for long-term executive compensation. Some 47 percent of S&P 1500 companies over the five-year period (2008–2012) did not generate a positive cumulative economic profit or return on invested capital greater than their cost of capital.

Nearly 60 percent of companies changed performance metrics for CEO compensation in 2013 alone, and one-third of companies changed at least 25 percent of the peer group used for performance benchmarking. Lack of stability of performance metrics suggests a short-term focus.[14]

A follow-up study of "say-on-pay" votes found:

The average say-on-pay support vote across the sample was 82 percent for 32 low performing companies, where return on invested capital (ROIC) was less than the cost of capital, and 84 percent for 32 high-performing companies (ROIC greater than the cost of capital and positive relative total shareholder return). The median vote was 90 percent for the low-performing companies and 96 percent for high-performing companies.

ISS recommended "for" say-on-pay at 84 percent of value-destroying companies and 81 percent of value-creating companies. Glass Lewis did slightly better, recommending "for" votes at 72 percent of the value-destroying companies and 81 percent of the value-creating companies.[15]

Another widely used method for setting pay—peer group benchmarking—has also been discredited. Theories of optimal, market-based contracting are based on the notion of competitive markets for transferable executive talent. Yet, the market for CEO's is *not* robust and executive knowledge is more firm-specific than previously assumed.

Additionally, a formulaic reliance on peer grouping leads to spiraling executive compensation, even if peer groups are well constructed and comparable. Boards generally do not want to see their CEOs as average. Every year, most boards pay their CEO at levels above average and every year the average ratchets up. In Lake Woebegon, "all the children are above average." In America, all the CEOs are above average!

Elson and Ferrere urge compensation committees to develop firm-specific pay standards based on internal pay equity and the company's competitive environment.[16]

Incentivizing workers with ownership and opportunities for participation could also drive profits. An advisory group to the Organisation for Economic Co-operation and Development (OECD), led by Ira Millstein, gave a nod to aligning the interests of employees with corporate performance through stock-based incentives. Just as cooperative relationships with investors, such as hedge funds, can generate more total wealth for those willing to share information and control, the same is true for being more inclusive with employees.

Millstein notes that, increasingly, the board becomes a "mediator of rents." "The more important human capital is to a business, the more those investors should stand to gain—or lose—and the greater voice they should have in governing it."[17]

A 1986 study by the National Center for Employee Ownership (NCEO) found that firms with significant employee ownership and participation in decision making grew 8 to 11 percent faster than their counterparts. A year later, the General Accounting Office found that such firms experienced a 52 percent higher annual productivity growth rate.

Companies with open-book management also have higher average growth rates. These are companies where employees are given the financial and performance data needed to make a good decision, as well as the training needed to understand the financial impact of their work.[18]

Status and Power

Scientists have known for decades that engaging employees in decision making generates more wealth. For example, back in the 1970s a panel of experts reviewed the extensive findings of 57 field experiments in job satisfaction and productivity for the National Science Foundation and concluded:

> Human involvement at the work place in all facets of the work is a prerequisite for the enhancement of quality life as well as performance and satisfaction . . . The organizational policy, therefore, should work toward enhancing such aspects of work which encourage people's ownership of the work place as well as the work itself, collaborative efforts among coworkers, and decision-making processes based on participate models.[19]

Other scholars have long reached the same conclusion:

> It is paradoxical that the standard justification for autocratic practice in industry is its alleged efficiency, since the empirical research results do not support that conclusion. In fact, increased rank-and-file responsibility, increased participation in decision making and increased individual autonomy are associated with greater personal involvement and productive results.[20]

Why, against the findings of so many studies, do organizations continue to allow workers so little control over their jobs? From what I studied as a Fellow with the National Institute of Mental Health, many decision-making structures are designed around status needs related to dominance and control over others, not to maximize the creation of wealth or to meet other societal needs.

In order to gain higher status, individuals seek to dominate more and more people, leading to a widespread dynamic over time, which shapes the organization so as to move the locus of control upward. In order to generate more wealth

and to meet other societal needs, we should take advantage of all the brains in our organizations. We can do so by pushing decision making down to the lowest practical level. At the same time, we need to infuse our financial decisions with all our values to ensure we are not externalizing costs and creating an unsustainable company or world.

Companies that pollute and take a callous attitude toward risk face serious fines and reputational risks. If social mechanisms are working, as they should, a virtuous circle is created. Companies are rewarded for behaving well and punished for behaving badly. Investors should seek to reinforce such mechanisms. For example, if our company is paying its employees well while the competition is using slave labor, we should seek to level the playing field by having governments sanction the competition. However, although economics is of great value, it shouldn't be the only value.

The Example of Norway

The Norwegian government took a bold step in mandating a 40 percent quota for women directors on publicly traded boards. There have been dozens of studies showing that diverse boards correlate with higher profits (see bibliography from Julie Gorte[21]). Those findings are used to support campaigns around the world to increase the proportion of women and minority directors. Of course, not all findings are supportive and I have seen no evidence that Norway transformed itself into a more dynamic economic powerhouse now that 40 percent of directors at large firms are women.

In Norway the measure was *not* justified by economic reasons. Instead, the quota was introduced to address societal needs for "justice in society, democracy, participation, equality between the genders, human rights and compliance with various conventions of the United Nations and the European Economic Area."[22]

Diversity in the workplace, treating all people as fully human . . . these values should not be dependent on arguments about enhancing return on capital. We do not have to settle for the world we are born into. We can change it.

How Much Will Government Help?

We look to government to counterbalance and regulate the excesses of market capitalism. However, as Carl Gershenson notes in "Protecting Markets from Society: Non-Pecuniary Claims in American Corporate Democracy," the

state also acts as a market protector by favoring a profit orientation over other concerns, allowing exceptions, primarily when not doing so would invite social unrest.[23]

Gershenson argues that autonomous markets "require continuous state intervention in the affairs of corporations"[24] to keep them safe from the demands of society. State managers take a longer and wider view of the economy than most businesses. State actors also serve a safety-valve effect, guiding social discontent into democratic channels and mediated change.

At its founding, the SEC was largely a champion of shareholder rights. For example, Rule 10b-5, issued by the SEC in 1942, required disclosure of material facts. *TSC Industries, Inc. v. Northway, Inc.*, later determined "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."

The SEC required companies to include proposals on any proper subject in the proxy in order to approximate the conditions of the annual meeting. The SEC even took Transamerica to court in 1947 for refusing to place shareholder proposals on their proxy—the *only* time the SEC has ever gone to court to protect the rights of shareholders to place a measure on a corporate proxy.

From that high point, the SEC began chipping away at shareholder proxy rights. The rules were amended so that shareholder proposals could only target issues *directly related* to the corporation. When grey areas arose, such as a 1951 proposal to consider the advisability of abolishing Greyhound's segregated seating system in the South, the SEC insulated management from proposals *motivated* by a general cause, even if the proposal concerned issues directly related to the corporation.

Then came the ordinary business rule, allowing exclusion of proposals concerned with day-to-day business decisions, followed by other exclusions. "The SEC had overseen the transformation of corporate democracy from the formal equivalent of open-ended face-to-face meetings to the right to propose profit-oriented general strategies."[25]

When the viability of the entire system came into question, some back-pedaling occurred. The "SEC embraced a more robust version of corporate democracy that acknowledged both profit-oriented and values-oriented investors" after Watergate, helping to "re-legitimate both the state and market," writes Gershenson.[26] Commissioners embraced an enhanced management obligation to make public all material information that might influence stock prices or influence a corporate election.

Once markets were stabilized, more expansive interpretations of materiality began to be seen as unnecessary intrusions. Gershenson reviewed historical documents and found that, for example, Commissioner Garret only objected to

corporate immorality that "might be expensive to investors." The SEC, he said, was indifferent as to how "the corporation treats the rest of the world."[27]

Shareholder rights began to erode further when, under President Reagan, the SEC excluded shareholder proposals that concerned "operations which account for less than five percent of the issuer's gross assets" and disqualified any proposals from shareholders unless they owned at least $1,000 (since raised to $2,000) of common stock for at least a year.[28] Proposals must stem from economic motives; that became the predominate philosophy at the SEC.

However, the post-Cracker Barrel SEC[29] accepted the untenability of enforcing a bright line between the market and society in 1998 when the SEC announced it would return to a case-by-case approach regarding when social policy issues fall within the scope of the ordinary business exclusion.

In 2015 the SEC took another step in the right direction. For many years SEC staff had been expanding the directly conflicts provision of Rule 14(a)-8(i)(9), which was originally added to ensure shareholders could not use proposals to circumvent solicitation rules to oppose a company proposal. Staff misinterpreted the rule to mean that companies could simply create a proposal on the same subject, even if it moved in an opposite direction, and could then get the shareholder proposal thrown out.

Abuse reached its high point in December 2014 when Whole Foods Market invoked the rule by countering my proposal with terms that could clearly never be met. My appeal to the full commission, and the subsequent protest by investors, led the SEC to clarify that the exclusion only applies "if a reasonable shareholder could not logically vote in favor of both proposals." Companies are still free to make counterproposals, but shareholders will now get a chance to vote on both.[30]

While Gershenson places some hope of a broader perspective in the courts, he also notes:

> Legal definitions of fiduciary duty also serve to reinforce market/society boundaries by keeping many of the largest institutional investors from making nonpecuniary claims on the corporation . . . Fund managers must primarily focus on fund performance.[31]

But must they do so exclusively? We turn to that issue next.

Fiduciary Duty

In 2014 a review of fiduciary duties was undertaken in the UK because it was not clear if fiduciaries were required to maximize returns or if they could also consider other factors.

The UK Law Commission's final 2014 report and guidance on fiduciary duty concluded that where trustees think ethical or environmental, social, or governance (ESG) issues are financially material, they should take them into account.

While the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, nonfinancial, concerns to be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund.[32]

So, fiduciaries *can* take *ethical principles* into account, as long as fund members share those principles and as long as acting on such principles incurs no significant financial risk. But how many funds take surveys of their members to determine ethical principles? Apparently, nonfinancial factors can come into play, as long as financial return is the highest value and members agree with the other values. Would taking into account stranded carbon assets constitute incurring a significant risk? What about *not* taking them into account? Clearly, more discussion of member values is needed.

With regard to the United States, in 1994 there was a Third Restatement of Trust Law drafted by the National Conference of Commissioners on Uniform State Laws. This is basically the current standard that fiduciaries should be following. Subdivision (c) sets out a list of the usual considerations, such as economic conditions, tax consequences, expected total return, needs for liquidity, and so on. Subdivision (c)(8) also lists: "an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."

What special value does any specific investment have to one or more of the beneficiaries? Such values could include clean air, clean water, inexpensive living quarters, healthy food, efficient public transportation, convenient places to exercise, continuing education, and a healthy local economy to grow old in. Pension funds should at least survey beneficiaries and taxpayers (in the case of public pension funds) to get some sense of these other priorities. Additionally, many now argue that consideration of environmental, social, and governance (ESG) issues is clearly permissible and is arguably required.[33]

Share*holders*, acting as share*owners*, should be able to demand that corporate directors and fund managers represent their interests as full human beings, not simply as imaginary rent-seeking robots. If that ever happens, future shareowners may spend as much time helping to govern their companies as they do now on market timing and stock picking. When that day comes—if that day comes—we could transform the corporation's pathological pursuit of profit and power. Corporations could, instead, become fully developed mediating structures that help individuals create more productive, salubrious environments. Of course,

much depends on the values of shareholders. Maybe most *are* rent-seeking robots. However, the more public those debates are, the less that seems likely.

Take Action: If you are a member of a pension fund, ask the administrator to survey members and beneficiaries for common values. Maybe most don't want their money invested in coal, tobacco products, or guns. Maybe most want transparency in political spending and proxy access for shareholder nominees for directorships. Take a look at your fund's voting policies. If you don't agree with them, work with others in the fund to change the policies.

Research Points to Public Opinion as a Driver

Research finds that news media could play a significant role in pressuring corporate managers and directors to behave in ways that are socially acceptable. Decision makers care not just about their reputation in the eyes of current and future employers but also their public image.[34]

Social media is quickly becoming the new battleground for corporate image. Appeals concerning what is socially acceptable are more likely to center on shared cultural values than on maximizing shareholder wealth. Shareholder discussions using social media are likely to broaden in scope from the current focus on market timing to corporate governance and social responsibility. Witness the debate surrounding auto emission fraud.[35]

A review of all proxy proposals for each firm in the Russell 3000 Index for the period January 2004 through November 2010 found:

> Public opinion on corporate governance issues, as reflected in media coverage and surveys, is strongly associated with investor voting, particularly mutual fund voting. In addition, even proxy advisors' recommendations are associated with public opinion . . . media coverage captures the attention of proxy advisors, institutional investors and individual investors, and is thus reflected in recommendations and votes . . .
>
> Our results suggest that public opinion, as measured through either Gallup Poll survey or media coverage at the aggregate and firm level, influences shareholder voting. The implications of these results are that financial intermediaries, such as mutual funds, pay attention to the shareholders' preferences regarding corporate governance. These results hold even after controlling for the recommendations of the proxy advisor.[36]

Since the root driver of votes against management and in favor of proposals by shareowner activists now appears to be public opinion, we expect a surge from all sides in the use of social media. See, for example, the article "Live-Tweeting for Influence, Not Disclosure."[37]

Investors can't hope to win in the court of public opinion unless more announce their votes before retail shareowners toss their proxies or simply vote by default with management.

Politics precedes economics; dialogue creates common core values. When knowledge is selected, organized, and presented, in other words curated by the masses instead of elites, power will be on the path to democracy. We see this in open-source reference material, such as Wikipedia. A 2008 report by the Standish Group estimated that adoption of open-source software resulted in savings of about $60 billion per year to consumers.[38]

Let us now shift our focus from theory to actions by individuals.

Retail Investors Who Made a Difference

As Lewis D. Gilbert tells it in his book *Dividends and Democracy*, he was instrumental in getting proxies to disclose executive pay and requiring that shareowner proposals be included in the proxy. Gilbert recognized that rules are not self-enforcing, but depend on shareowner vigilance. They are lost by default when not used.

Gilbert envisioned democratically conducted shareholder meetings "televised from coast to coast through a closed circuit" and proxy access, which he called "the most vital proxy reform, since the proxy is not "management's" and all shareowners share its cost.

Long before *Citizens United v. FEC*, Lewis Gilbert recognized that "we cannot have good political government unless we have good corporate government," since "our political leaders reflect the thinking of the corporate world."[39]

Proposals by four individuals accounted for 22 percent of the 752 proxy proposals filed overall in 2014, including those from institutional shareholders like labor unions, pensions and hedge funds.[40]

Typical corporate governance topics include declassifying boards so that all directors stand for election every year, majority vote requirements for directors, end supermajority requirements to change bylaws, allow specified shareowners to call a special meeting, and allow specified long-term shareowners to place a limited number of board nominees on the corporate proxy. The most frequent social and environmental topics include disclosure of political and lobbying expenses and reports on climate change.

Take Action: Filing shareholder proposals is relatively easy. For the basics, see my very brief "Shareowner Action Handbook."[41] File three proposals or more in a given year and you too can be among the top ten individual filers.

Know How Your Funds Vote

Although mutual funds have been required to disclose how they voted their proxies since August 31, 2004, most report only votes cast months ago. Worse, many of us own funds though our deferred compensation programs and such funds do not have to disclose their votes if they are not offered to the general public.

Pensions & Investments, an influential trade publication, ran an editorial in 2014, "Winning Over Proxy Voters," arguing institutional investors have a fiduciary duty to announce their proxy votes in advance of annual meetings, if doing so is likely to influence voters.

Votes are assets. Announcing votes in advance of meetings puts the value of those assets to their full use. Most funds that disclose in advance of meetings have also authorized ProxyDemocracy.org to scrape their data. Proxy Insight, a subscription service, now captures votes ahead of annual meetings from about 30 of the 1,500 fund managers in their coverage universe.

As a former state employee, I participate in the Savings Plus program, administered by the California Department of Human Resources. I compared the votes of Northern Trust, contracted as an S&P 500 investor, to those recommended by the AFL-CIO Key Votes Survey for 23 voting items.

Northern Trust voted with the AFL-CIO twice, against the proposals 17 times, and didn't vote four times. They voted against many of the things I fought for as a state employee, like political transparency, equal rights, sustainability, and democratic governance.[42]

Take Action: Ask your fund administrator to disclose the proxy votes for all funds offered or to post a link to where that information can be found. Then ask the funds to announce their votes in advance of annual meetings. If people see how funds are voting, they will demand changes and funds will vote more conscientiously.[43]

United Shareholders Association

There have been many attempts to unite retail shareowners in America. United Shareholders Association (USA), founded by Texas oilman T. Boone Pickens and headed by Ralph Whitworth, grew to 65,000 members while seeking to enhance the rights of shareholders. USA negotiated agreements resulting in a mean abnormal return of 0.9 percent, for a total $54 million shareholder wealth gain at targeted firms between 1990 and 1993.[44]

Take Action: More than 20 years later, the void remains, even though starting and running such an organization today would be much easier using the Internet. Perhaps The Motley Fool, Foliofn Investing, Carl Icahn, ValueAct

Capital, or others might be persuaded to help sponsor such a group. The Australian Shareholders' Association (ASA) might provide an example to copy, since they have been successful for over 50 years. In 2004, ASA company monitors voted more than $3 billion in company shares on behalf of members.[45] They not only help individual investors choose companies to invest in, they help them govern those companies as owners.

Luby's, Inc.

The Committee of Concerned Shareholders, led by Les Greenberg, was the first grass-roots shareholder group to conduct a formal proxy fight using the Internet. Shareholders met on a Yahoo! Finance Message Board in the year 2000 and went after the management of Luby's, Inc. (LUB).

Their director-nominees received 24 percent of the votes cast and two of the shareholder proposals they supported (i.e., removal of all antitakeover defenses, annual election of all directors) received support from approximately 60 percent of the votes cast. Their attention attracted a white-knight investor with restaurant experience, the CEO left, and a director with hands-on restaurant experience was added to the board.

Plan B for Yahoo!

Eric Jackson owned 96 shares, put together a Plan B for Yahoo (YHOO) in 2006, created a Facebook page, blog, wiki, and posted videos on YouTube. At the annual meeting, directors received up to 35 percent "against" votes. A week later, the CEO stepped down. Jackson's efforts made a difference for Yahoo investors, and the positive publicity helped him launch Ironfire Capital, a hedge fund.[46]

ProxyDemocracy.org

Founded by Andy Eggers in 2007 while a student at Harvard, ProxyDemocracy scrapes voting data posted on the Internet and tells users how up to ten trusted funds voted each proxy before the annual meeting. Users receive free automatic notifications of when votes have been collected for their specific portfolio companies. View voting records of mutual funds, their levels of activism, and create focus lists to compare voting records of major mutual funds. ProxyDemocracy is now part of the Sustainable Endowments Institute, a Special Project of Rockefeller Philanthropy Advisors.

Shareowners.org

Shareowners.org, incorporated as a 501c(3) nonprofit organization, was founded "to build and educate a network of shareowners who will understand and take action on their rights as owners of publicly held companies." The Facebook-like site undertook surveys, testified before Congress, and created a collective voice for lobbying. Membership grew quickly to about 1,000, but the organization died from lack of funds.

United States Proxy Exchange (USPX)

Glyn Holton, a financial risk consultant, started the United States Proxy Exchange (USPX) in 2008 around the idea of shareholders being able to easily assign their proxy votes to other individuals or entities.[47]

USPX facilitated self-organizing around core issues. Members transferred proxies and launched a Field Agents program to move proposals submitted by proponents living far from annual meeting venues. USPX members also commented on rulemakings, filed legal briefs, advocated for various reforms, facilitated cross training, and created templates in the process. Central operations ceased in 2012 for lack of funds.

Moxy Vote

Launched in 2009, Moxy Vote's mission was to increase participation by individual shareholders and give companies greater access to their shareholders. By combining their voices, shareholders would be heard in the boardrooms of the public companies they owned. Companies could use the platform to speak directly to retail investors and other stakeholders, such as human or animal rights groups.

Founders theorized that more shareowners would be attracted to vote in corporate elections if drawn to specific issues, rather than for financial reasons or an abstract interest. Site visitors were invited by PETA, the Humane Society, the Sierra Club, and other membership organizations. Once there, shareowners began to make their voices heard on a wider range of issues.

Moxy Vote enabled investors to link their brokerage accounts and vote right on the site where recommendations were provided. Users could even establish a default voting system based on disclosed fund votes. If *x* voted this item, follow their example. If not, vote with *y*. If *y* didn't vote, vote like *z*, and so on.

The more successful Moxy Vote became, the more they had to pay to process votes. Just as the Blue Marble photograph of Earth helped us see our

world in a new light, Moxy Vote helped us see corporations differently (see Moxy Vote video at, http://youtu.be/p1S0_ggNgkU). Share*holders* moved from disengaged gamblers to active participants in a community of *owners*. Again, lack of funding led to their demise.

The Phone App

One of my favorite, yet to be implemented, opportunities for a gateway to shareholder activism is a proposal by Bradley Coleman.[48] Create a phone app using an algorithm and the ProxyDemocracy.org database.

Coleman argues people are unlikely to know the predisclosers or to trust their proxy voting. Ranking predisclosers is like nonfans of baseball ranking the best pitchers. Instead, simply ask users to decide how activist or conservative they want to be in director elections, executive compensation, corporate governance, and corporate impact.

The phone app would deliver prefilled voting suggestions on each of the user's portfolio companies. The database could also push press releases of each predisclosed vote to web-based news services, such as Yahoo! Finance.

Once shareowners download and use the phone app for a few months or see the press releases of voting behavior, many will dig deeper, going to ProxyDemocracy.org, GorpGov.net, or other Internet sites. Hopefully, they will also take some of the other actions suggested in this chapter, such as contacting their deferred compensation administrator to find out how shares are voted or pressing for changes in voting policies. They might even start submitting shareholder proposals.

Conclusion

Like the managers of agency theory, many shareholders also seek to maximize their own profits by exploiting information imperfections. Neither managers nor shareholders have much incentive to stay loyal to the company. Both can move on easily.

According to Gomez and Korine, we are now entering a new corporate governance paradigm where investors are focused on the value of a portfolio of investments. They trade to optimize their portfolio and care little about the fate of any single company.

Shareowners, on the other hand, focus on individual corporations. Both are interested in profit maximization, but shareowners may also be interested in the firm's specific role in defending jobs, securing credit, consolidating business

relationships, preventing ecological risk, or increasing share price through shareowner intervention. Shareowners are more engaged in monitoring.

Management and boards become arbitrators of investor and shareowner demands. Where shares are highly dispersed and markets in those shares are liquid, investors hold sway. In the opposite case, shareowners play a more critical role. "Between the 'invisible hand' of the markets and the very visible role of management, active shareowners play the roles of catalysts and mediators."[49]

Gomez and Korine offer three primary characteristics of contemporary corporate governance.

1. Omnipresent information. Traditional family run companies operated on principles of secrecy and strict hierarchy, directed from the top. Today, markets require a permanent flow of increasingly standardized public information.
2. De-privatization of corporations. Shareowners and investors, to some extent, work for the corporation, even though formally outside of it, by contributing significantly to strategy.
3. Debate and representation of interests play an increasing role. Public opinion is the main counterweight to entrepreneurialism. Consumers, owners, workers, citizens often overlap to a great extent, enlarging the circle of discussion.[50]

A corporate governance model based only on the atomistic calculations of individual economic interests either as investors or shareowners does not maximize the true potential of society. Market self-regulation is inadequate, since markets focus almost exclusively on what can be readily priced.

Corporations have facilitated the ability of entrepreneurs to generate abundance but at a cost, which now threatens our salubrious environment. Individuals demanding, creating, and utilizing democratic mechanisms on the Internet can ensure the convergence of public and private interests *if* individuals step up and participate as full human beings, not rational economic robots, in governing corporations more democratically. Have additional ideas? Let's collaborate.

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