

Trading and Shareholder Democracy

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Shift from board primacy to shareholder democracy

Voting

Reforms and charter amendments empowered shareholders to vote not only on:

- directors, auditors, mergers, etc.

... but also on

- corporate governance
- executive compensation
- social and environmental policies

Shareholder democracy

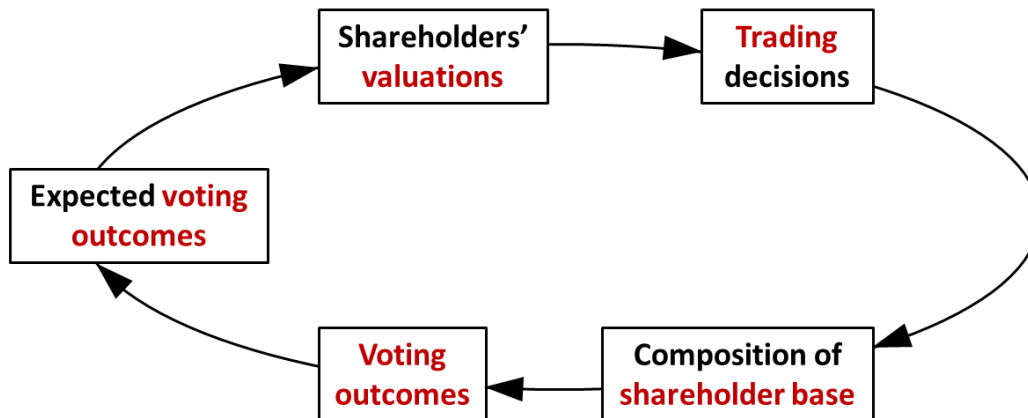
Does shareholder voting increase shareholder welfare by giving "power to the people"?

Endogenous voter base

Trading

- Unlike the political setting, **markets** allow investors to choose their ownership stakes based on their preferences and the stock price
- Voting rights can be sold \Rightarrow shareholder base is **endogenous**

Trading & Voting \Rightarrow Feedback loop



Endogenous voter base

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Trading & Voting \Rightarrow Feedback loop

The link between trading & voting is even more important given:

- **Growth in index funds:** vote but do not trade
- **Rise of E&S issues:** affect investors beyond their ownership stakes

This paper

Goal

- Examine the link between **trading** and **voting**

Implications for

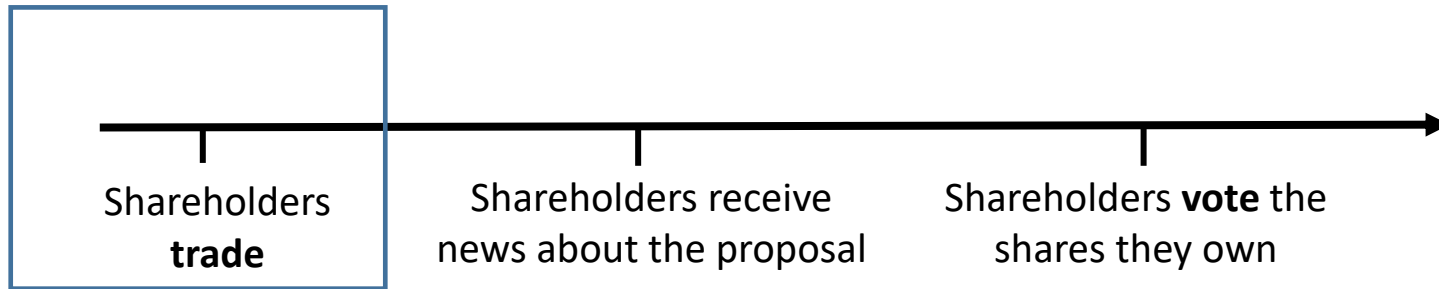
- Prices and shareholder welfare
- Shareholder voting vs. board decision-making

Theoretical framework

- Shareholders **trade** and then **vote** on a proposal
 - M&A, proxy fight, ESG issues, etc.

Theoretical framework

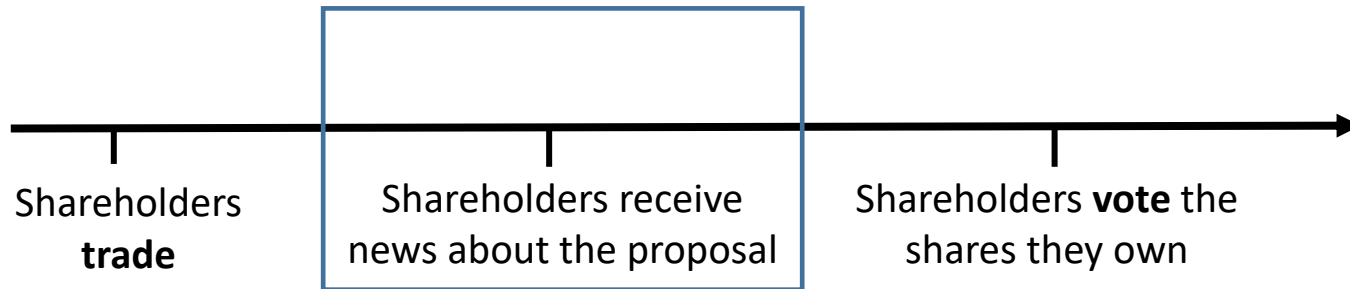
- Shareholders **trade** and then **vote** on a proposal
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- Shareholders trade in a competitive market

Theoretical framework

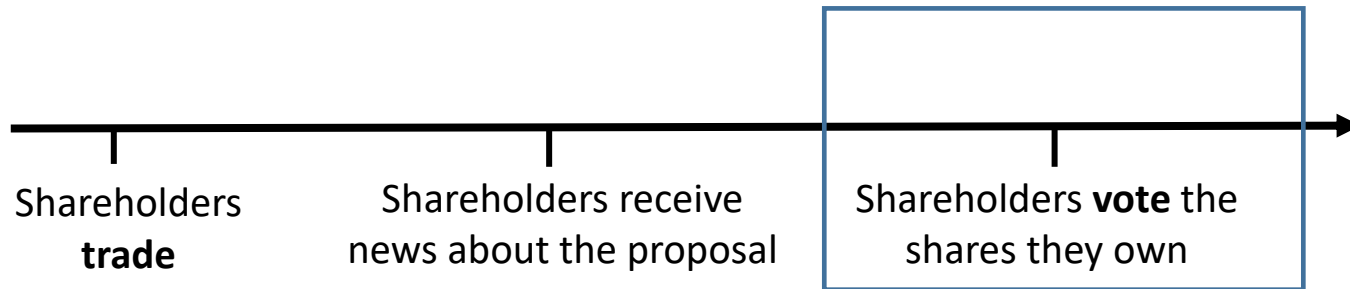
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- Disclosure by management
- Proxy advisors' recommendations

Theoretical framework

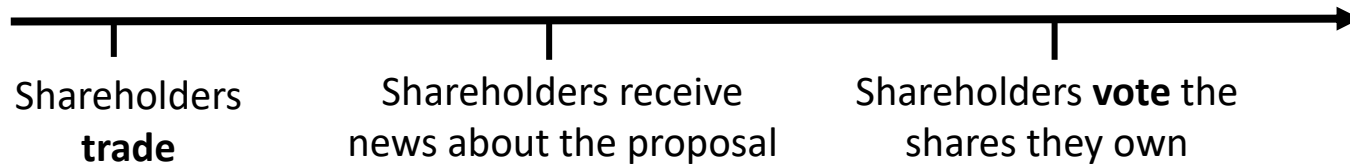
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- Proposal is approved if high enough voting support, e.g. > 50%

Theoretical framework

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- Shareholders have **heterogeneous preferences** regarding the proposal

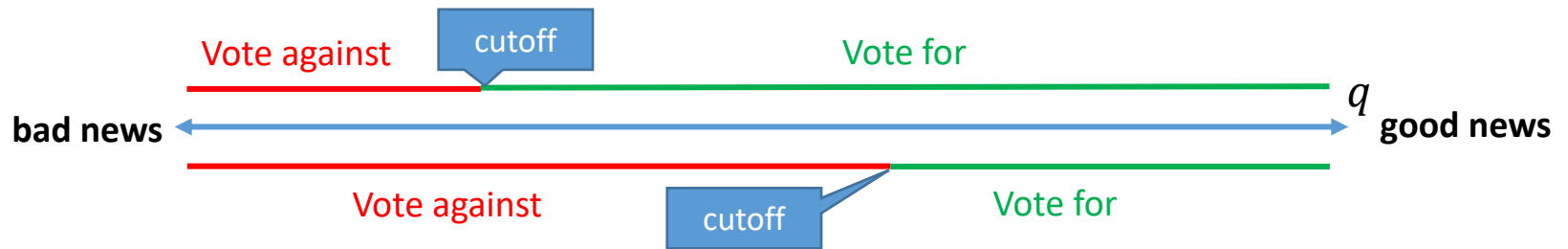
Heterogeneity of preferences

It is simply not true that the "preferences of [shareholders] are likely to be similar" (Martin & Partnoy 2005)

- **Governance philosophy:** Bubb, Catan 2020
- **Social / political ideology:** Bolton et al. 2020
- **Time horizon:** Bushee 1998; Gaspar, Massa, Matos 2005
- **Tax differences:** Desai, Jin 2011
- **Cross-ownership:** He, Huang, Zhao 2019
- **Conflicts of interest:** Cvijanovic, Dasgupta, Zachariadis 2016
- **Private benefits:** e.g., unions; family shareholders and founders
- **Differences of opinion:** Li, Maug, Schwartz-Ziv 2021

Shareholders' preferences and voting

- Shareholders receive news (q) about the proposal
- “**Activist**” shareholders
 - like the proposal
 - require little evidence to vote for proposal \Rightarrow **low cutoff** on q



- “**Conservative**” shareholders
 - like the status quo
 - require a lot of evidence to vote for proposal \Rightarrow **high cutoff** on q

Trading

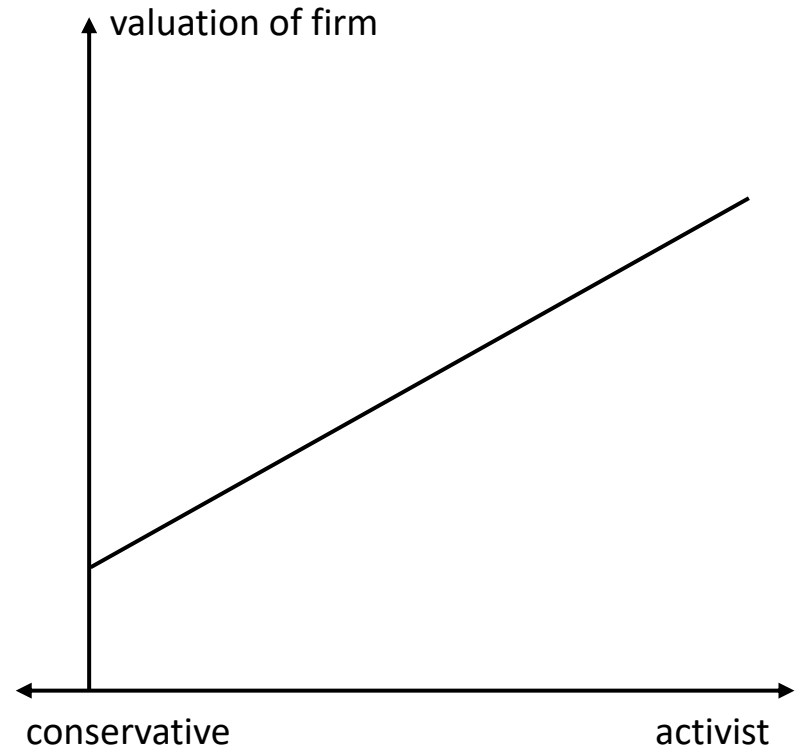
- Shareholders expect the proposal to be approved if news $q > \text{cutoff } q^*$

Trading

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- **Scenario 1:** q^* is “small”, i.e., proposal is likely to be approved

Trading

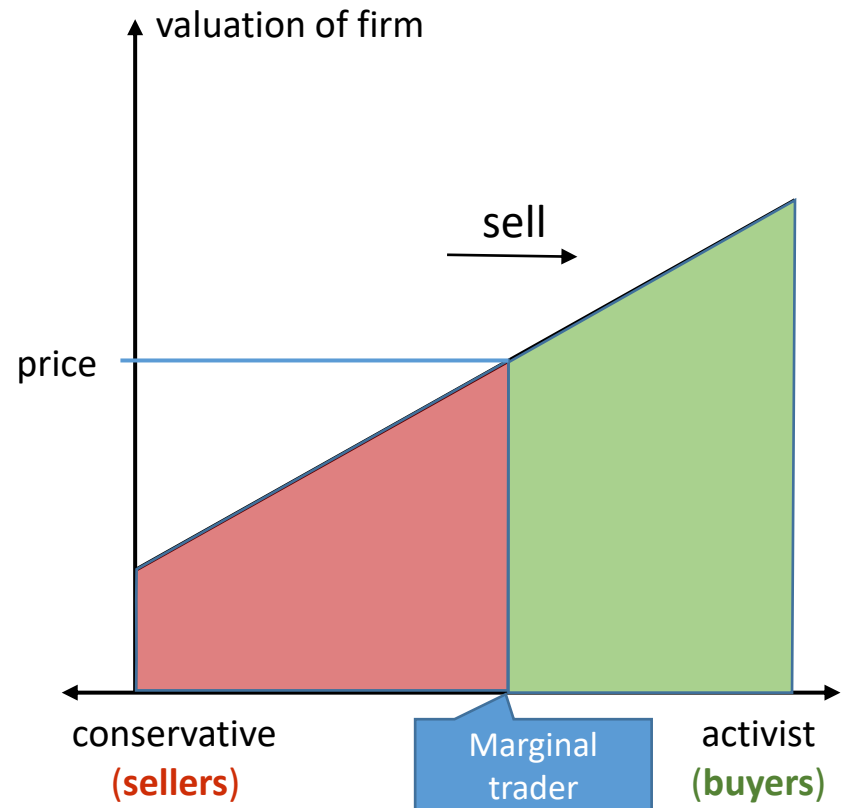
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 - activist shareholders, who like the proposal, value the firm more



Trading

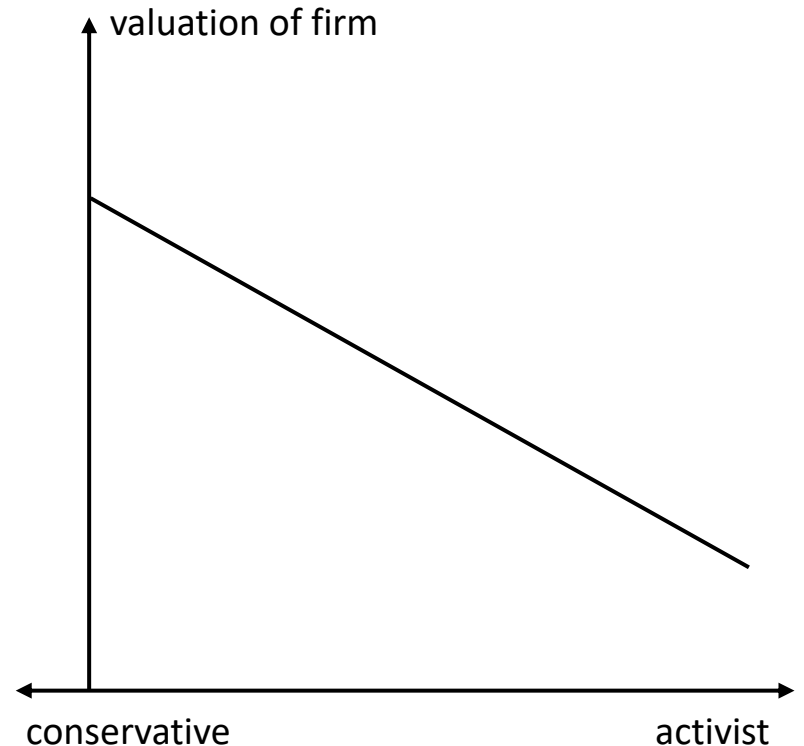
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 - **activist equilibrium:** conservatives sell to activists

Matching: shareholders who like the expected outcome own the firm



Trading

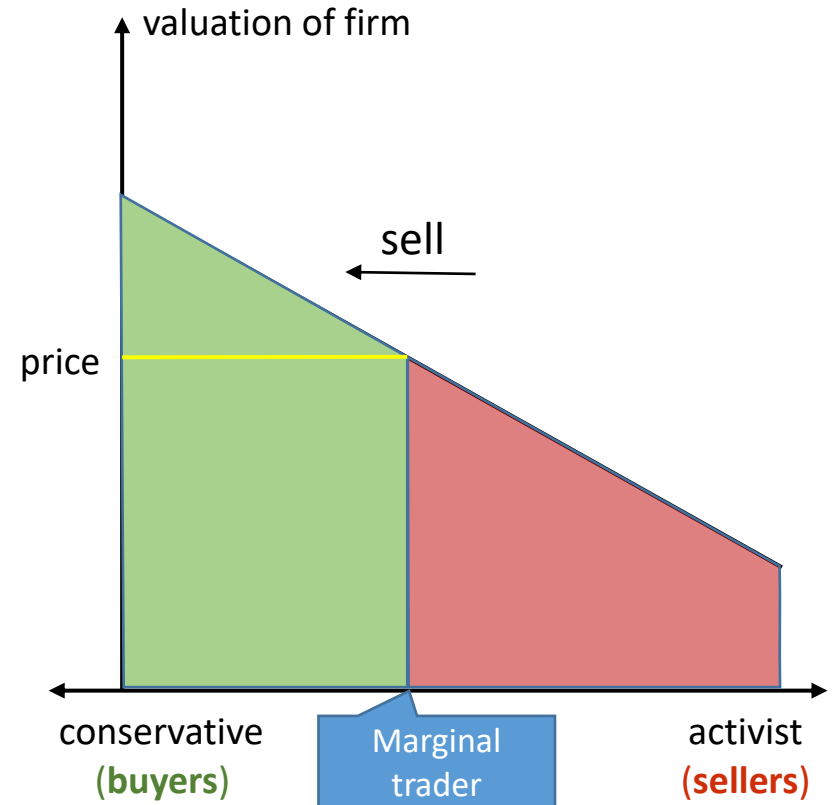
- Shareholders expect the proposal to be approved if news $q > \text{cutoff } q^*$
- **Scenario 2:** q^* is “large”, i.e., **proposal is likely to be rejected**
 - **conservative** shareholders, who dislike the proposal, **value the firm more**



Trading

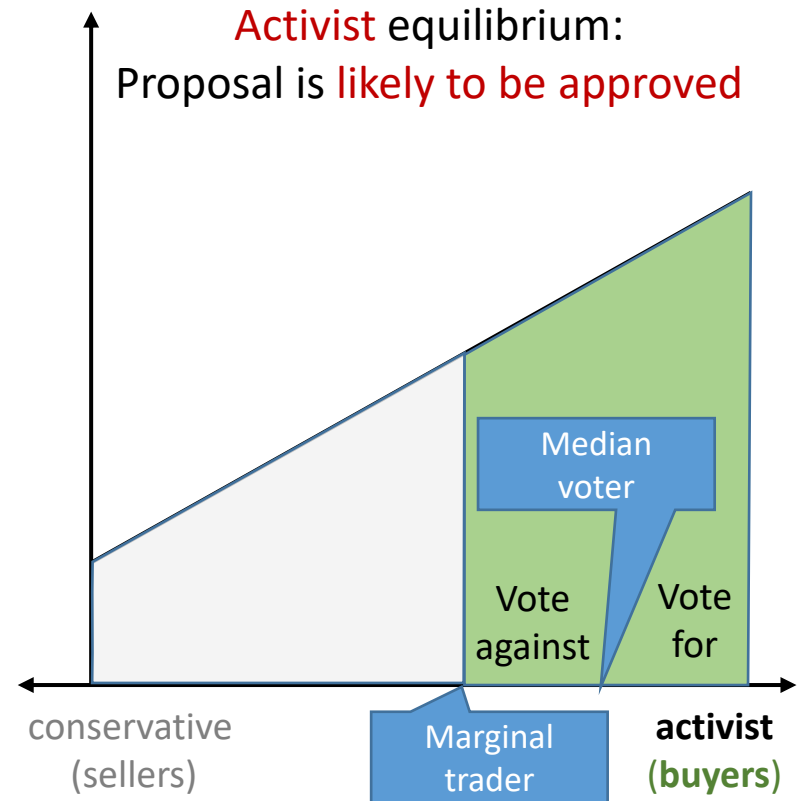
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 - **conservative equilibrium:** activists sell to conservatives

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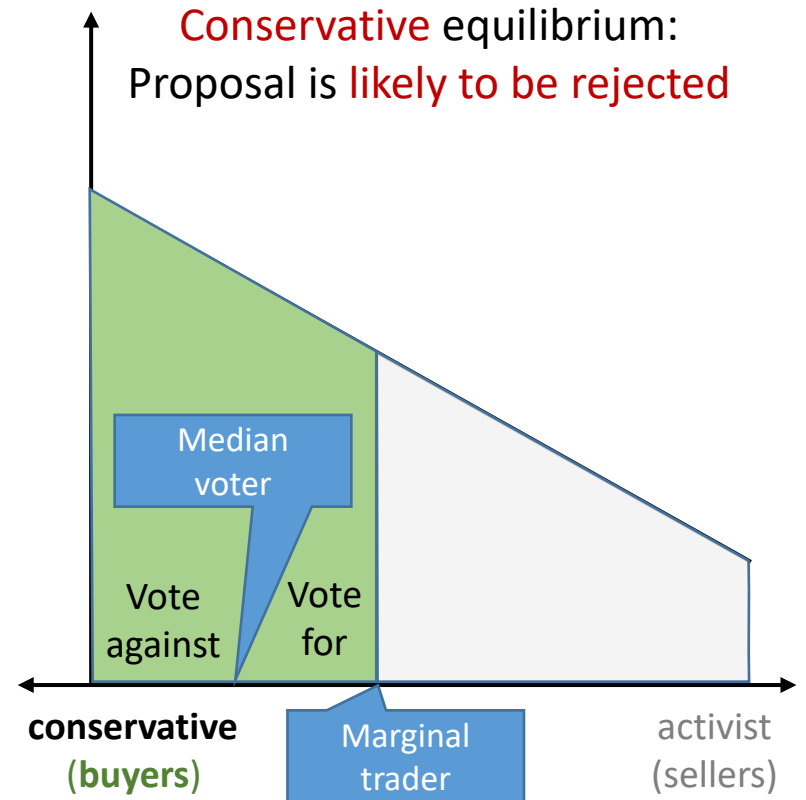
Voting after trading

- Post-trade shareholder base determines the voting outcome
- **Median voter**: whose vote determines the voting outcome



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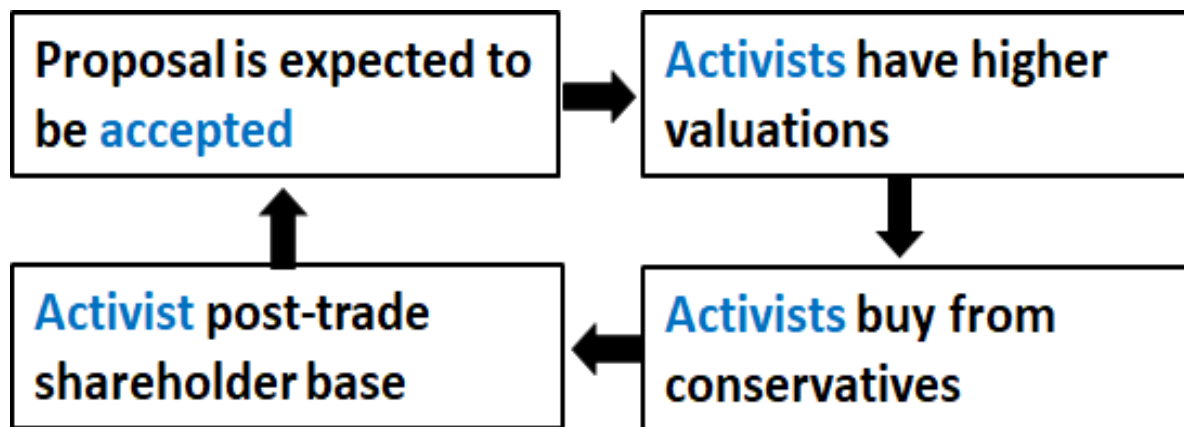


Implication 1

Non-fundamental indeterminacy

Non-fundamental indeterminacy

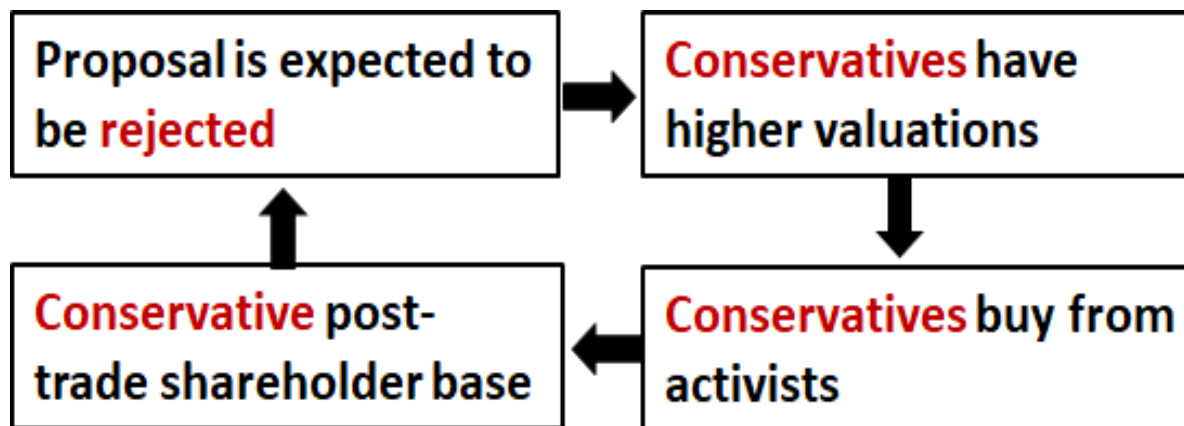
- The activist and conservative equilibria can coexist



- Due to trading, **expectations** about voting outcomes are **self-fulfilling**

Non-fundamental indeterminacy

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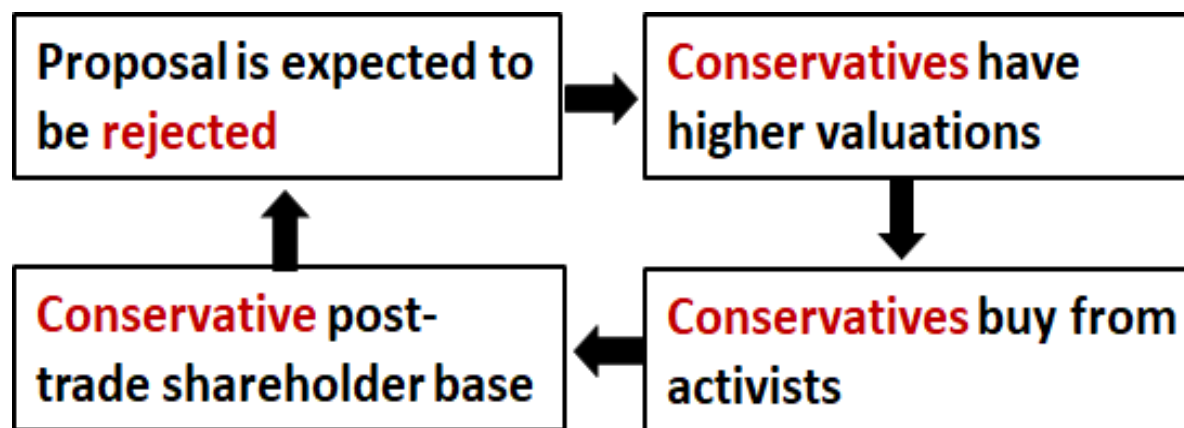
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Cox, Mondino, and Thomas (2020)

- large ownership changes in M&A targets after deal announcement
- associated with the likelihood of the deal being approved

Non-fundamental indeterminacy

- The activist and conservative equilibria can coexist



- **Empirical challenge:** Similar firms can have different ownership structures and voting outcomes
- **Indeterminacy** is more likely with **large swings in shareholder base:**
 - shares are more liquid
 - few long-term, non-transient shareholders (e.g., index funds)
 - for proposals with substantial preference heterogeneity (e.g., E&S)

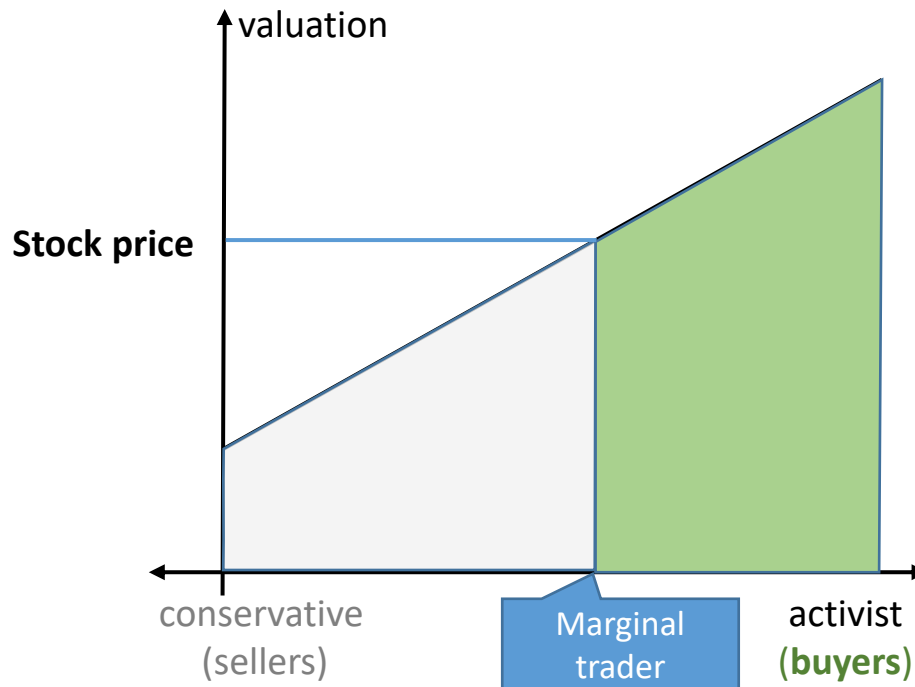
Implication 2

Stock price and shareholder welfare
can move in opposite directions

Stock price and shareholder welfare

Stock price and shareholder welfare

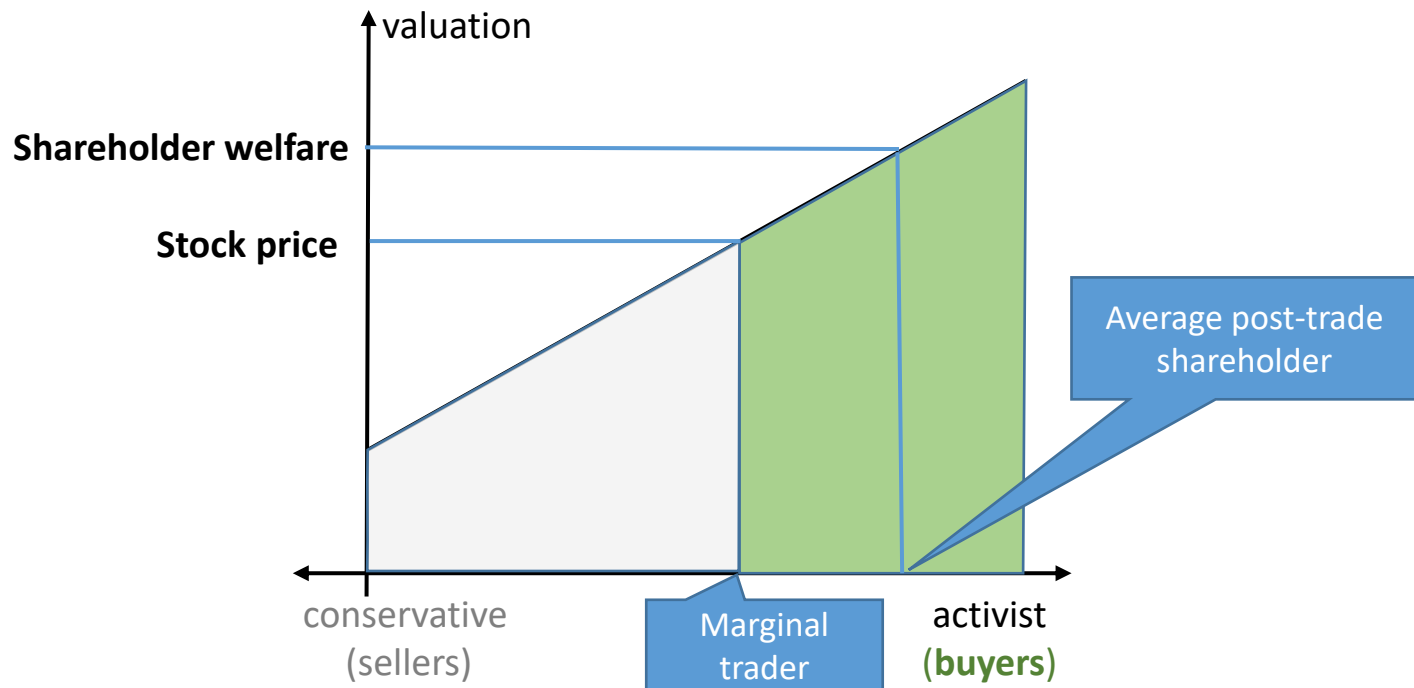
Stock price = Valuation of **marginal trader**



Stock price and shareholder welfare

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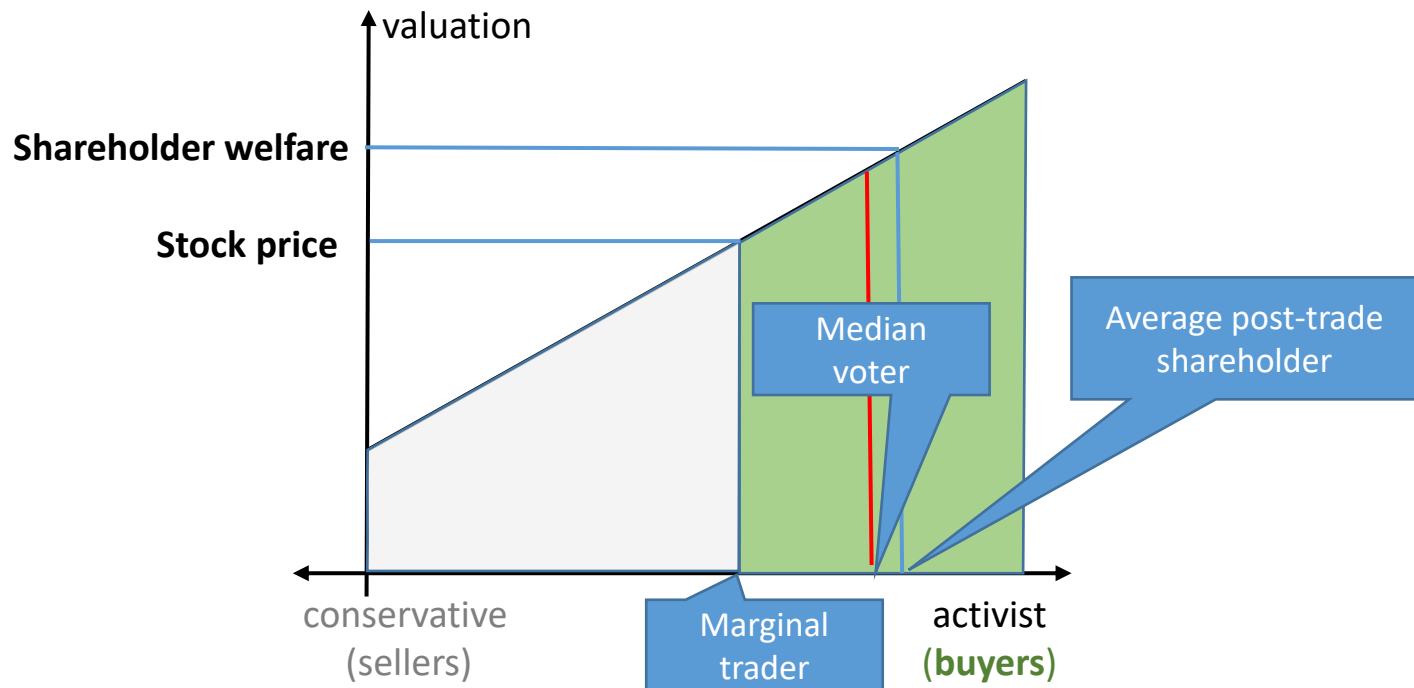
Shareholder welfare = Valuation of **average post-trade shareholder**



Stock price and shareholder welfare

Stock price = Valuation of **marginal trader** ← median voter

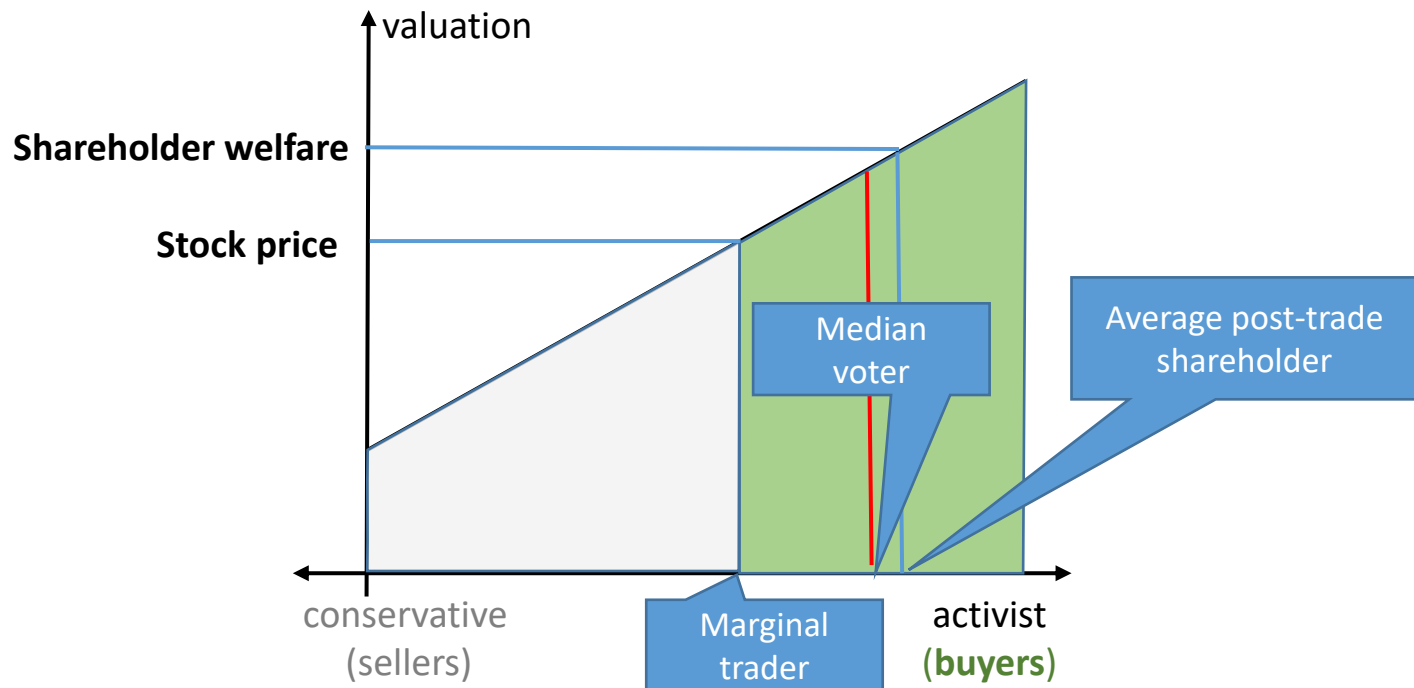
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Stock price and shareholder welfare

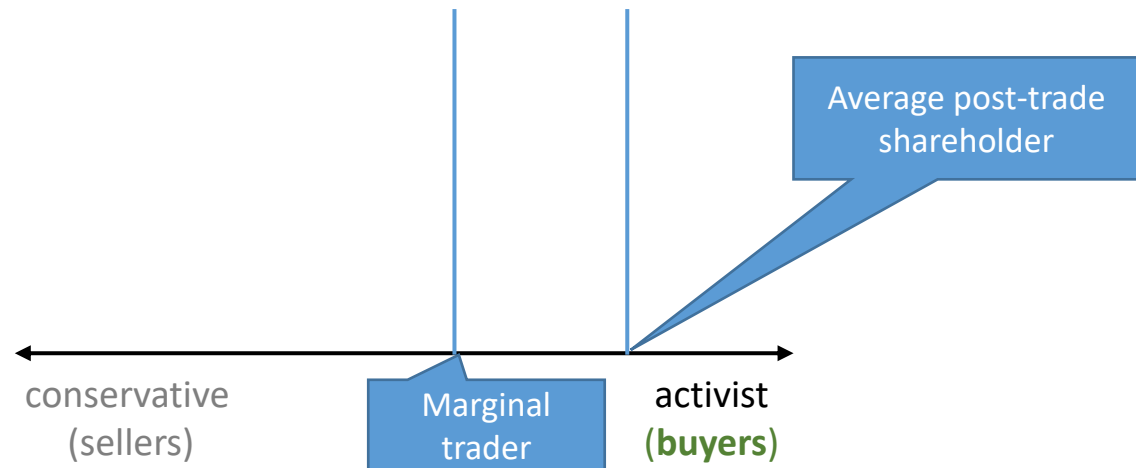
Stock price \nearrow if **median voter** is closer to **marginal trader**

Shareholder welfare \nearrow if **median voter** is closer to **average post-trade shareholder**



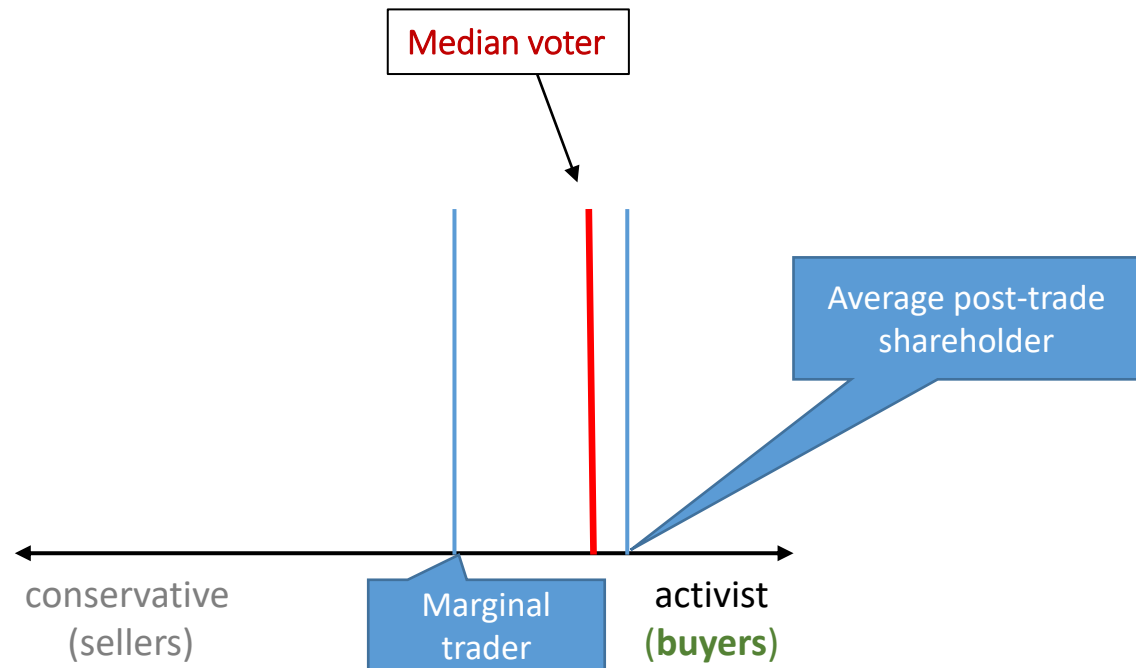
Opposing effects on price and welfare

Price and welfare can **move in opposite directions** in response to shocks



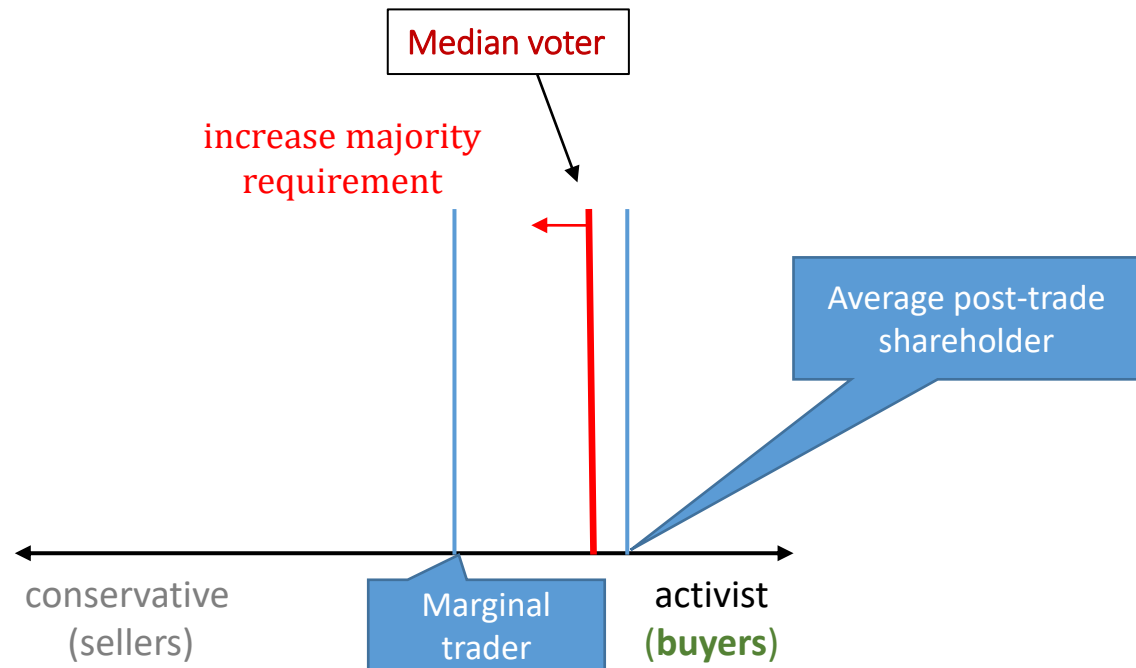
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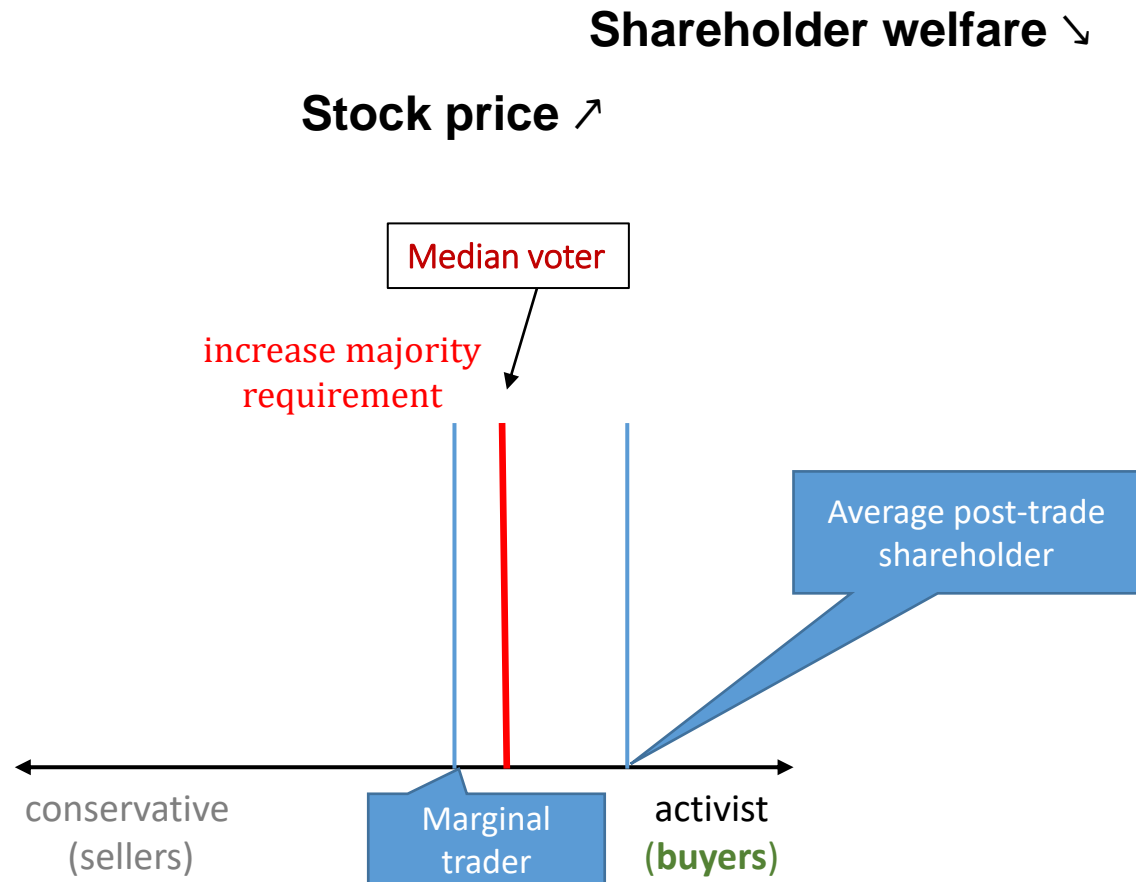
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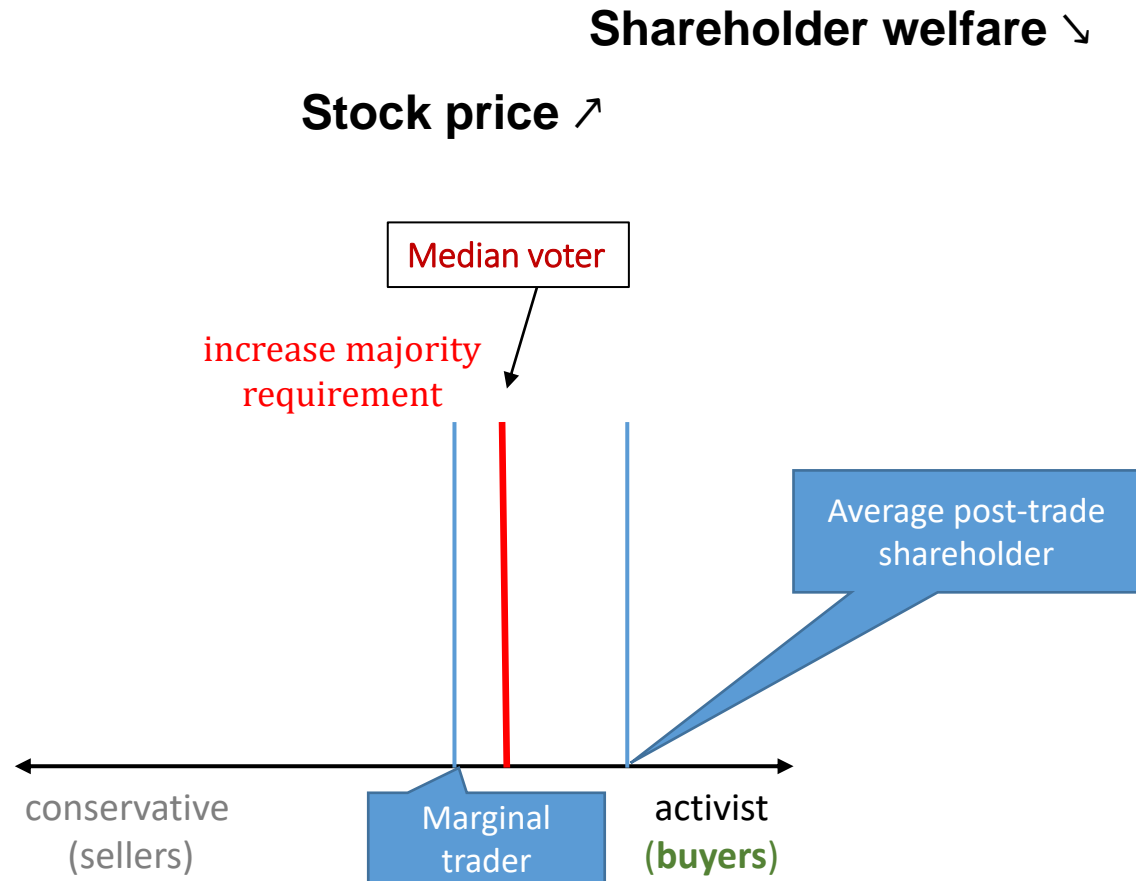
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Opposing effects on price and welfare

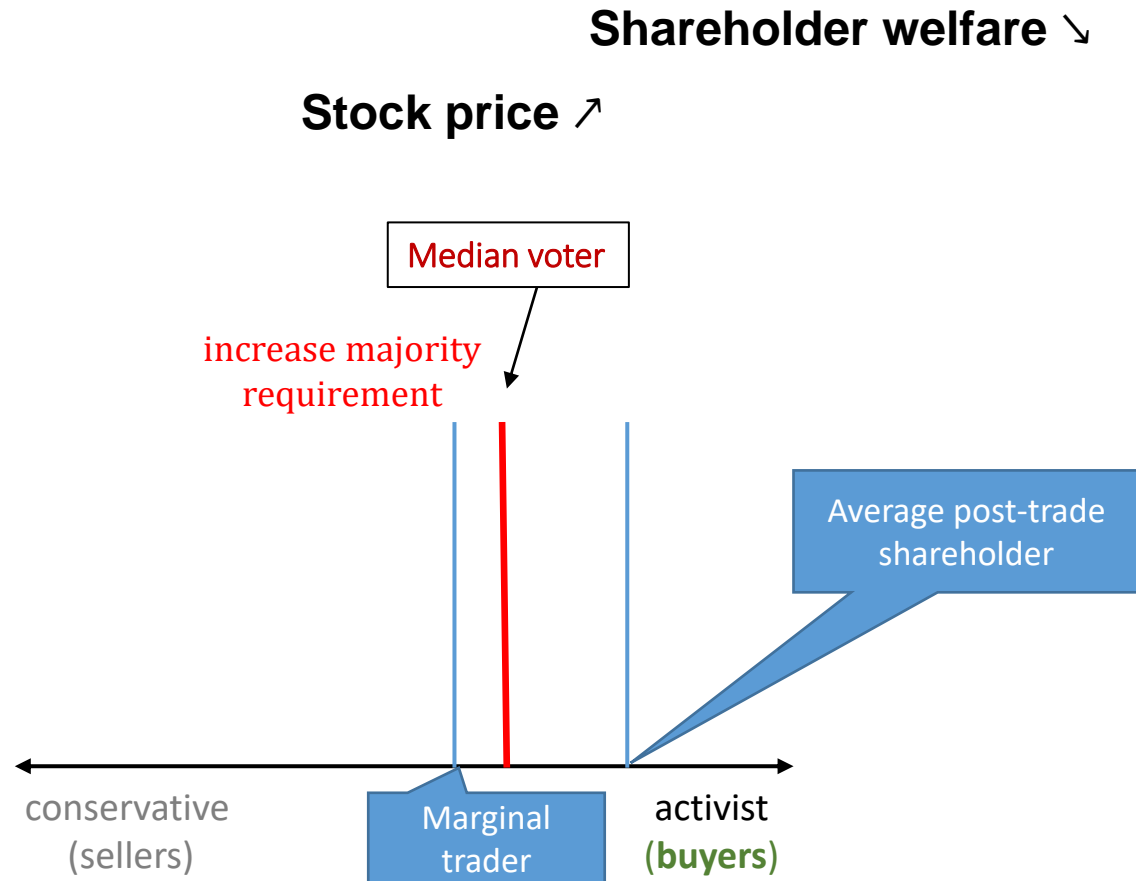
Price & welfare **reactions to vote outcomes** can also have **opposite signs**

- limits the interpretation of **event studies** of shareholder voting



When is price-welfare discrepancy larger?

- When post-trade shareholder base is more heterogeneous
- When the vote outcome is “close”



Implication 3

Trade can be harmful for prices and welfare

Trade can be harmful for prices and welfare

Intuition

- Trade allows **extreme investors** to build large positions and use their **votes** to implement their preferred policies, hurting moderates
 - as median voter becomes more extreme, gap between median voter and average shareholder can widen

Can shareholders benefit from **delegation to the board?**

Implication 4

Optimal board is biased
Nevertheless is preferred to voting

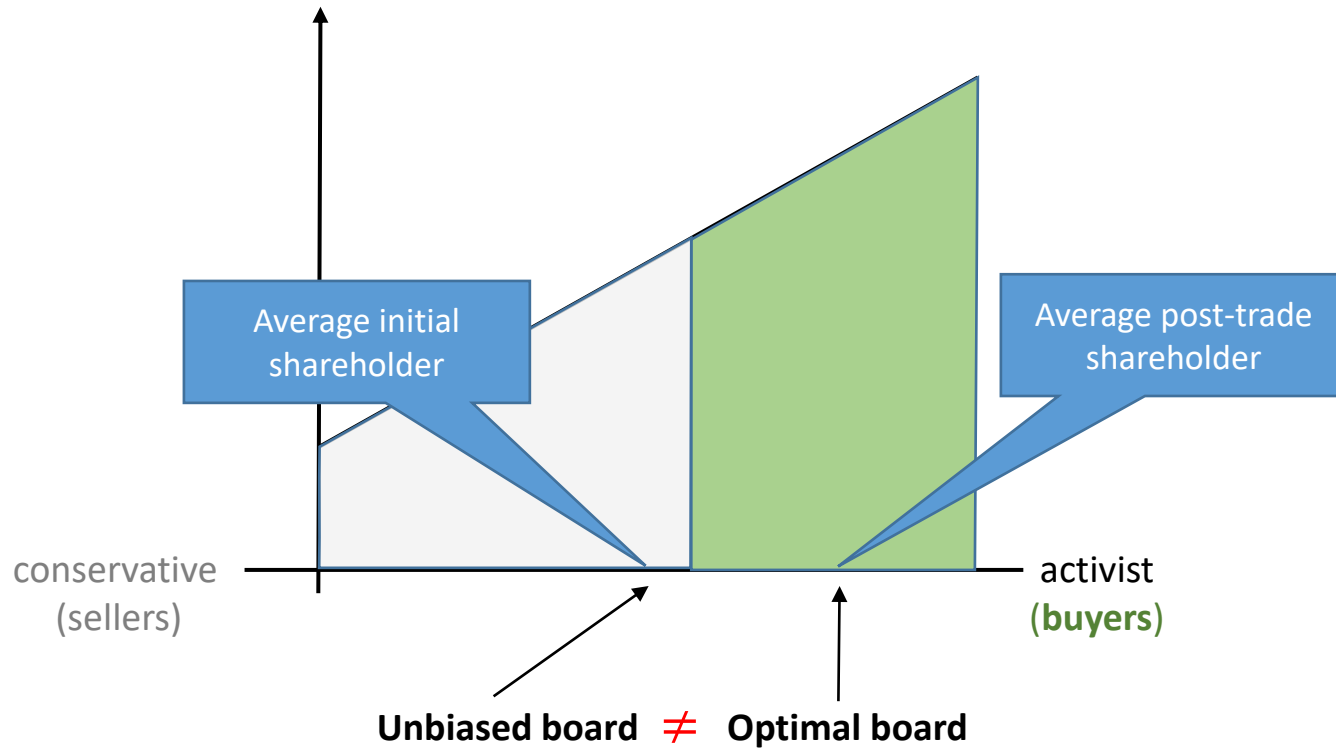
Delegation to the board

- Shareholders trade, but do not vote
- The board unilaterally decides on the proposal

Optimal board

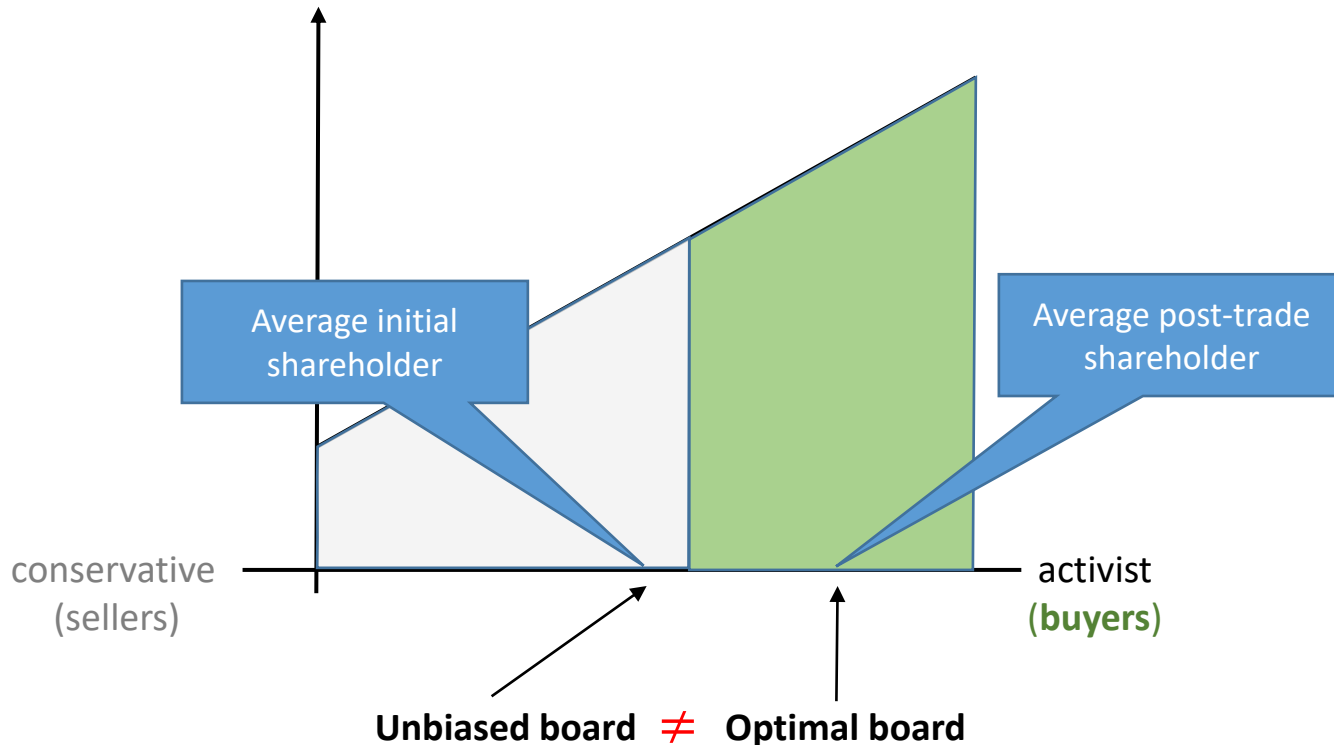
- Which board maximizes initial shareholder welfare?
= valuation of the **average post-trade** shareholder

Optimal board is biased



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1. With trade, the optimal board is always **biased**
 - caters to shareholders with the highest willingness to pay
 - moderate shareholders can sell for a higher price



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 - caters to shareholders with the highest willingness to pay
 - moderate shareholders can sell for a higher price
2. Shareholders **benefit from delegation** to the optimally **biased board**

Other implications

Shareholders may vote against delegating to optimal board

- short-term trading considerations

Index fund ownership

- mitigates non-fundamental indeterminacy

Concerns about E&S issues

- amplify non-fundamental indeterminacy
- can decrease the price

Follow-up work

- role of blockholders & voting premium

Conclusion

Link between trading & voting has important implications:

- Non-fundamental indeterminacy
- Real effects of financial markets
 - trade can be harmful due to voting externalities
 - opposing price and welfare effects

Shareholder democracy or board primacy?

- Our conclusion: **accounting for trading is crucial**
- When shareholders can trade, biased board is not automatically dominated by shareholder voting