Empowering small shareholders: a comparison of three instruments

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In this paper, three instruments for empowering small, individual shareholders are compared: proxy investing, proxy voting institutions and infomediaries. The working of each instrument is discussed with special emphasis on the problems of information gathering and coalition forming. Subsequently, each instrument is analysed with respect to appropriateness, costs and effectiveness. No instrument turns out to be clearly superior to the others. Although proxy investing is the most popular concept among small (individual) shareholders at present, the long-run potential of proxy voting institutions and infomediaries may be higher. Since more research could be helpful to establish which of these two options is best, both non-profit organisations and governments could in the meantime stimulate experiments with proxy voting institutions and infomediaries for small shareholders.

Keywords: Corporate governance, small shareholders, proxy voting institutions, proxy investing, infomediaries

Introduction

According to orthodox principal-agent theory, the problem of corporate governance was simple: how can a group of homogeneous shareholders, who aim at maximising financial returns only, motivate managers to do what is best for shareholders? An important solution was to convert managers, through remuneration in the form of stocks and options, into entrepreneurs who are truly interested in the firm's profits. However, the inherent problem with this approach is that managers may manipulate share prices by means of deceptive financial statements. In theory, checks and balances against such attempts can be provided by external auditors. However, recent scandals have shown that auditors do not always perform as expected.

In general, it has become clear that a model of corporate governance that focuses on two parties only (homogeneous shareholders and managers) is simplistic. Apart from analysing the role of auditors, it is also important to distinguish between small and large shareholders. Far more so than large shareholders, small shareholders lack the knowledge and power to control the behaviour of the companies they co-own.

In this paper, we focus on small, heterogeneous shareholders. A shareholder is defined to be small if she (or he) possesses less than 5 per cent of the shares of a firm.[1] We will focus on the position of small shareholders in relation to large shareholders, and also analyse the role of auditors. We will *not* discuss whether employees or other interest groups should have more or less power than shareholders in general.[2] Rather, given a corporate governance system in which it is considered desirable that shareholders have a certain amount of influence, the question is how to ensure that the desired influence of small shareholders does in fact prevail. One restriction of our approach is that we focus on small *individual* shareholders only. Of course, according to the above definition, institutional investors are also often small shareholders. However, they constitute a specific group, and their problems will not be considered in this paper.

Representation of and delegation by small, heterogeneous shareholders

According to the conventional theory of the firm, a firm's owners either manage the firm themselves or they use managers to run it

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on their behalf and for their own benefit. In the latter case, appropriate incentives are necessary to induce the managers to act in the owners' interest. To provide such incentives, managerial remuneration can be made partly dependent upon the stock price. Besides, the stock price disciplines managers through its impact on the potential for a takeover and the potential for raising additional capital.

However, this model has significant weaknesses in the case of companies with a large number of heterogeneous shareholders. Here, the problem for many shareholders is that they have neither the information nor the power to enforce the policies they prefer. This could provide both the managers and board of directors with excessive freedom. This could result in managers and possibly directors obtaining economic rent, and in general, bad management practices could continue unabated.[3] The result could be somewhat different where, for a given company, there is a combination of a small group of large shareholders and a large group of small shareholders. In such a case, the large shareholders could be well informed and powerful, enabling them to enforce policies that conform to their own interests, perhaps at the cost of small shareholders (Shleifer and Vishny, 1997; Denis and McConnell, 2003).

The question, therefore, is how to ensure that managers pursue the interests of *all* shareholders, thus avoiding the abuse of discretion and rent extraction by management, large shareholders or directors. The issue is not only to formulate the right incentive contract, but also to foster collective action. The problem remains – how can a large number of poorly informed, heterogeneous shareholders gain influence? This is essentially a three-stage principal-agent problem. In the first stage, small shareholders should define their interests and choose representatives such that their interests are represented adequately. These representatives must also have the appropriate incentives. In the second stage, these representatives should select, together with the large shareholders, a board of directors. They should also assist in making all other decisions that a shareholders' meeting is allowed to make (which depends on the prevailing laws and the corporate charter (Bebchuk, 2005)). In the third stage, the board of directors selects, evaluates and (where appropriate) replaces the chief executive officer and (possibly) other managers. It also reviews and (where appropriate) approves the financial objectives, major strategies and managerial planning processes.[4]

As discussed above, the stock price can be an instrument for disciplining managers. This price depends heavily on the firm's profit as documented in the annual report. Therefore, it is important that this report be trustworthy and reliable. In addition, such an annual report helps *directors* to discipline managers and *shareholders* to discipline both managers and directors. It also helps to reduce asymmetries of information among shareholders. In this context, auditing is of crucial importance (Bushman and Smith, 2003). Unfortunately, auditing itself poses a principal-agent problem (e.g. Loitlsberger, 1968; Antle, 1982). The auditor needs adequate incentives to do the job in the interest of shareholders. However, if the choice of an auditor is the responsibility of managers, it is to be expected that the result will be in their favour. If it is the duty of the board of directors, the result will be in the interests of the shareholders *or* of the managers, depending on whether the directors "work for" the shareholders or prefer good relations with the management. Until recently, a coalition of managers and auditors and possibly directors seemed typical in a significant number of countries, especially because management (supported by the board of directors) decided on the choice of auditors and also on the choice of external advisers who could be employed by the auditing firm. Such a coalition implies that the information provided by management (and the board of directors) may not be credible, and so the decisions of the managers (and directors) may not reflect the owners' interests. Where there are a few large shareholders, a coalition between these shareholders and the managers (and directors) is also possible. In such a case, managers and large shareholders (and directors) may also form a coalition with the auditors. In either case, the small shareholders are among the losers, while the management is on the winning side.

As we know from information economics,[5] information is an economic good, the acquisition of which costs time and money. Generally, rational investors will only acquire information until the marginal benefits equal the marginal costs. For small investors, it is generally rational not to search for much information, because most information gathering is expensive and yields little benefit. Furthermore, free-riding on the information of others may be possible. This makes it easy for the managers (and directors) to dominate the information flow by providing free information to shareholders. As a result, it is difficult for small shareholders to acquire meaningful, objective information and oppose the management of a company.[6] However, it often pays large shareholders to collect their own information. Knowing this, managers (and directors) may tend to cooperate with large

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shareholders to the detriment of small shareholders.

For small shareholders, the problem of coalition-forming is even more serious. Forming a coalition is a collective action problem (Riker, 1962). The smaller and the more homogeneous the various interest groups, the better their chances of forming coalitions capable of extracting rents or exploiting other groups (Olson, 1965). Applied to corporate governance, the large shareholders and managers (and directors) are small and homogeneous groups. Therefore, they may be able to exploit a large group of small, heterogeneous shareholders. Indeed, this has occurred in many instances throughout the world (Shleifer and Vishny, 1997).

Thus, the advantages to both management and large shareholders are overwhelming. If small shareholders are to have any chance of enforcing their interests, the forming of coalitions is a *conditio sine qua non*. To succeed in doing so, the problems of *information gathering* and *coalition forming* must be overcome. This, however, requires a certain homogenisation of interests. Only then would shareholders be willing to bear the costs of coalition forming, as the chances of influencing management decisions increase. However, if the group of small shareholders is relatively large, many may try to avoid these costs by free-riding on the activities and costs of others. Thus, *homogenisation of interests* and *control of free-riding* are necessary preconditions for coalition forming.

Proxy investing, proxy voting institutions and infomediaries

In this section, three instruments are described that may contribute towards overcoming the problems discussed above: proxy investing, proxy voting institutions and infomediaries. Some advantages of the instruments will be discussed. For a more systematic evaluation, the reader is referred to later sections.

Proxy investing

Proxy investing means that shareholders buy shares in an investment fund which, in turn, buys shares in individual companies. Thus, shareholders delegate the selection of stocks to the investment fund managers. The shareholders also delegate control of the managers of the individual companies. The fund managers can discipline these company managers through two basic methods. Firstly, the fund managers can buy, sell or not buy (additional) shares. Secondly, they can vote at shareholders meetings (AGMs), and be involved in setting the agenda of the AGM (by submitting proposals and nominating candidates for the board). Both methods can be supported by additional actions, such as informal meetings with company managers. With respect to these methods, the fund has a number of advantages compared to small individual shareholders. It has more shares, more resources, relatively low information costs (per share), more votes, and is in a better position to influence managers and directors above and beyond the AGM.

At present, most investment funds are profit-oriented. We found no evidence to suggest that the actions of most profit-oriented funds are really adequate. Indeed, a recent study of Canada’s top investment managers concluded: “In an era of increased sensitivity to corporate governance issues, many managers still voted for excessive increases in executive compensation, to appoint a board member with a record of excessive absenteeism, and voted against a proposal for independent boards of directors of controlled companies” (SHARE, 2002).

This failure has been attributed to the short-term perspective of profit-oriented funds. Furthermore, in many cases, the failure may also relate to the fact that an investment fund remains a small shareholder in individual companies. Finally, investment funds are generally associated with a bank (or similar company). Apart from their investment funds, banks are already among the large shareholders of many companies in a significant number of countries, and are also important suppliers of debt (Shleifer and Vishny, 1997). Thus, they have substantial power, and belong to the “establishment” in corporate governance. Consequently, they may not like the idea of giving small shareholders more influence at the AGMs of companies in general, and, more specifically, of the banks themselves.

A profit-oriented investment fund independent of banks might constitute a better alternative. This can be illustrated by considering a fund affiliated to an association which acts in the interests of shareholders. An example is the Dutch Association of Shareholders (“Vereniging van Effectenbezitters”), which, at AGMs, strongly criticises managers of Dutch companies.

Another, smaller element of existing investment funds is initiated by institutions that buy shares according to ethical criteria. Such an institution can send a credible signal to investors that it is able and willing to monitor individual firms, especially if it already has a good reputation. At present, ethical investment funds use both methods of disciplining managers (buying or selling shares and voting),

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with the emphasis depending on the fund in question.

Both profit-oriented and ethical investment funds can be regarded as funds that meet the specific demands of a proportion of the heterogeneous group of small investors. Profit-oriented funds meet the demands of investors interested primarily in profits. By contrast, an environmental fund meets the demand of investors who care about the environment, and other ethical funds meet other ethical demands. In principle, all kinds of combinations are possible. From the perspective of this paper, there is no fundamental difference between ethical funds and profit-oriented funds: all satisfy specific demands, which implies a certain homogenisation of interest through a particular issue/preference or combination of issues/preferences.

Proxy voting institutions

In the US, shareholders who do not attend the AGM can still vote on specific issues by filling in a proxy card. This is known as proxy voting, although a more appropriate term might be "voting at a distance". This practice will *not* be discussed in this paper. Rather, we will focus on situations where proxy solicitors have a high level of discretion to vote as they judge best.

In Germany, small shareholders often acquire and sell listed stocks through banks. Banks that hold shares "on deposit" for their customers can offer to vote on their behalf. If customers accept this offer, the bank is still obliged to send the proposals for the AGM to the shareholders who can still instruct the bank on how they wish to vote. Only when they do not make use of this opportunity – which is generally the case – can the bank vote at its own discretion in what should be the best interest of the shareholders. Unfortunately, the banks have conflicts of interests, among other things, because they are suppliers of debt and equity themselves. Consequently, they sometimes vote in a manner that serves their own interests, rather than those of the shareholders on behalf of whom they are supposed to vote (Baums and Von Randow, 1995, Brendel, 2001).

In view of this problem, Baums and Von Randow (1995) propose introducing "*proxy voting agents*" that vote on behalf of the shareholders. For each company, three agents at most can be elected by the shareholders. Each agent is supposed to work in the interest of *all* shareholders. The agents declare in advance how they plan to decide on the various issues specified in the agenda for the general meeting. If shareholders wish to vote otherwise individually, they may do so.

"*Proxy voting institutions*" are a more far-reaching alternative. Shareholders are not allowed to vote on specific issues at all. Rather, once a proxy voting institution has been elected by shareholders, it has full discretion over all issues at the AGM. The basic idea is described by Harm (2000) and Van der Burg (2002), the latter emphasising ethical considerations. The remainder of this section concerns proxy voting institutions.

To clarify further, investment funds also have full discretion to vote, but we will not discuss this under the heading of proxy voting, as we have already dealt with investment funds under the heading of *proxy investing*. Therefore, we use "proxy voting" in this paper to refer to small shareholders who use proxy voting for shares that they purchase themselves in individual companies.

More specifically, we assume that every small shareholder can choose a proxy voting institution to represent him at the AGM of all companies of which he has shares and in which he is a small shareholder. The number of votes of a proxy (voting) institution at an AGM equals the number of shares of small shareholders who have chosen this proxy institution. (Proxy institutions with only a few votes in a certain company could delegate their votes to another proxy institution of their choice.) Proxy institutions can represent a potentially large number of specific subgroups of shareholders. The institution could, for instance, be one that is oriented mainly towards shareholder value or to an environmental organisation. In principle, a wide range of proxy institutions is conceivable, each with its own aim or combination of aims. Just as with proxy investment, proxy voting overcomes collective action problems by homogenising investors by a topic or a combination of topics. Initially, we assume that every shareholder who chooses a proxy institution has to pay it a fee, the amount being proportional to the number of shares.

Since AGMs are not intended as a forum for a detailed discussion of business plans, a proxy voting institution can work in terms of general principles. These, combined with firm-specific information, enable it to decide how to vote on any proposal for a particular firm. If necessary, it can be involved in agenda-setting, i.e. it can submit proposals and nominate candidates for the board. A shareholder can select a proxy institution during specific periods of time (for example, every December). This institution then remains his delegate until the next election period. The decision to buy or sell shares remains with the shareholder.

Proxy voting institutions could become *focal points* of the coordination problem of small

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shareholders. As such, they have considerable potential for overcoming the collective action problem. As noted by Schelling (1970), focal points can solve otherwise insoluble coordination problems between people.[7] However, why should proxy institutions be able to accomplish coordination by means of focal points? We believe that shared emotions are the key.[8] They provide the basis for shared norms through shared moral sentiments. Groups of small investors have common feelings, moral sentiments and eventually norms relating to such topics as the environment or the level of profits that companies and their managers are entitled to earn. These feelings can provide a strong motivation to overcome the free-rider problem. Since emotions influencing the various relevant issues are not the same for everyone, a number of different proxy institutions are required. In this context, the attractiveness of proxy voting could, in our view, be increased significantly if social and environmental organisations became more involved in proxy voting (instead of focusing mainly on proxy *investing*), because such organisations are particularly adept at generating strong emotions.

Proxy voting institutions can, among other things, contribute to solving problems of corporate democracy in general. In the US, for instance, an important topic that could be shared by many proxy institutions is that of ensuring equal opportunities for all candidates for the board. At the same time, an individual institution could have a more specific focal point concerning the content of corporate policies (e.g. labour conditions). Together with the increased activism of institutional investors, the short-term focus on increased democracy could make board elections more democratic within a relatively short time span. Once democracy has been improved, the proxy institutions could choose additional focal points relating to the content of corporate policies (e.g. the environment). Such a use of focal points could mobilise a large number of investors.

A coalition of proxy institutions that vote for (or against) a specific proposal, and that has the majority of votes of the proxy institutions on the issue, is also likely to reflect the opinion of the majority of small shareholders. A useful analogy is a parliament with many political parties, where there is, for any specific decision, a good chance that it reflects the view of the majority of the population.

Infomediaries

There are two types of infomediaries. Proxy advising firms (PAFs) advise shareholders on how to vote on proposals for the AGM. Corporate monitoring firms (CMFs) do the same, but in addition, they help set the agenda by submitting proposals and nominating candidates for the board. With infomediaries, the responsibility for the vote remains with shareholders. If they wish, they can ignore the infomediary's advice on any issue. Infomediaries have been discussed extensively by Latham (1999a, 1999b, 2000, 2003), and the discussion below is based mainly on these references.

Presently, the US has a number of PAFs that advise institutional investors (Institutional Shareholder Services, Investor Responsibility Research Center, Glass Lewis, and Proxy Governance). They are funded by institutional investors. However, many institutional investors do not subscribe to them, and small individual investors are conspicuously absent. This greatly limits the amount of monitoring that occurs (Latham, 1999b). A positive factor is that some institutional investors have started posting some of their voting decisions on the Internet long before each voting deadline. In this sense, they can act as PAFs for small shareholders. However, small shareholders are evidently not rushing to use this service, possibly because voting is costly (primarily in terms of time) for them even with free advice (Latham, 2003). Fortunately, further cost reductions are possible. For instance, a computer program could allow all the voting rights owned by a given shareholder to be submitted automatically according to the advice of the PAF of her or his choice – unless she takes action to vote differently (Latham, 2000). Brokers and banks could provide similar cost-reducing facilities.

If, with such facilities, all voters always chose the default option of voting as advised by their PAF, PAFs would effectively function as proxy institutions. However, this does not fully explain the reasons why PAFs have been designed as they are. For instance, Latham (2000) notes that an advantage of PAFs over institutions with full voting discretion is that a PAF cannot be bribed to sell its votes, because, for any issue, the decision to vote ultimately remains with the shareholder. For this advantage to materialise, it is, of course, necessary that shareholders vote on the basis of their own judgement in a significant number of cases. Indeed, the ultimate autonomy of shareholders is one of the advantages of PAFs.

Good advice is costly, and there *is* a free-rider problem. Therefore, Latham (2003) proposes that each firm pays one PAF for its services for a certain period of time. This PAF is elected by the shareholders. Each shareholder receives the advice of this PAF. Of course, PAFs not paid by a firm may still

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Table 1: Characteristics of the instruments

Instrument	Information gathering	Coalition forming	Method of disciplining the management
Proxy investing	Investment fund	Homogenisation of interests via topic or combination of topics	Buying and selling shares, (possibly) voting and agenda-setting at AGMs
Proxy voting institutions	Proxy voting institution	Homogenisation of interests via topic or combination of topics	Voting and agenda-setting at AGMs
Infomediaries	PAFs and CMFs	Homogenisation of interests via reputation of PAF or CMF, and via the reputation of CMF candidates	Advising voters and (for CMFs only) agenda-setting at AGMs

publish advice to its shareholders. Latham suggests there could be 10–20 viable PAFs in the US, each being hired by various different companies. Given this number of PAFs, shareholders could easily learn about the reputations of the various PAFs. They would then compete with each other in order to be hired by as many companies as possible.

CMFs assume additional functions, such as nominating directors and submitting proposals on the agenda of the board. Latham (1999a, 2003) suggests that a firm's shareholders should elect one CMF for a certain period of time, to be paid by the firm. An advantage of a firm having only one CMF is that the CMF can be expected to propose a cohesive and therefore more effective board, which will then have a good chance of being elected. This prevents the loss of board collegiality that could result from free-for-all, competitive elections in which different shareholders propose different candidates. Standards could be adopted to prevent the same CMF from monitoring two firms in the same industry (Latham, 2000).

Latham (1999b) notes that in Hong Kong there typically is a dominating shareholder. In such a situation, it could be useful for a firm to hire two CMFs, so that the board also represents the minority. For instance, if more than 25 per cent of the voted shares prefer a different CMF to the majority, two CMFs could be hired. One could represent the small shareholders, and it could be elected for them in competition with other CMFs. The split of board positions between majority and minority could be determined either by cumulative voting or by the proportion of votes cast for each of the two CMFs.

PAFs can develop a good reputation by providing sound advice and by being affiliated to highly reputable organisations. Once a PAF has a good reputation, it may assume the functions of a CMF. The reputation of a CMF also benefits from the above factors, and from nominations of reputable candidates. Because an infomediary can cover more firms than a director and has a longer time horizon, it has a greater incentive to maintain its reputation by serving shareholder interests (Latham, 2003).

In the long run, the homogenisation of interests of small shareholders works via the reputation of the infomediary. In the case of CMFs, also via the reputations of its candidates. However, in the pioneering stages of infomediaries, small shareholders need to search more intensively for information, especially if infomediaries are not affiliated to reputable organisations. In such cases, they need to evaluate and compare the perspectives of the various infomediaries on specific issues. Fortunately, the media can be helpful here (as they are in the context of political elections, where similar problems arise). Furthermore, the infomediaries perform the job of information gathering and transmitting.

To conclude this section, Table 1 gives some essential aspects of the three alternatives.

Three criteria: appropriateness, costs and effectiveness

The previous section has demonstrated how each instrument can help solve the problems of information gathering and coalition forming. The following sections provide a more systematic evaluation.

The evaluation is based on the following three criteria: appropriateness, costs and effectiveness.[9] Appropriateness deals with the

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question of which problems can be addressed by the instrument of small shareholder empowering. At a general level, all concepts are appropriate for empowering small shareholders, but it will be shown that there can be limitations at a more specific level.

In order to evaluate the cost and effectiveness of proxy investing and proxy voting, we consider (1) the costs, (2) the effectiveness at a given (and significant) participation rate, (3) the participation rate and (4) the (overall) effectiveness. For proxy investing, the participation rate is defined as the percentage of the total investment budget of small (individual) shareholders (available for investments in shares of companies or of investment funds) that is invested in investment funds with the specific objective of improving corporate governance. For proxy voting, the participation rate is the percentage of this budget that is invested in shares of individual companies of which the right to vote is delegated to a proxy voting institution. The (overall) effectiveness (4) is the product of (2) and (3) to the extent that the relationship between (3) and (4) is proportional. For infomediaries, the participation rate is less relevant, and we will discuss only (1) the costs and (4) the effectiveness. Effectiveness is defined in terms of the increase in power of small shareholders.

This paper does not proceed beyond the analysis of effectiveness. Beyond effectiveness (as defined above), the empowerment of small shareholders may have benefits such as higher stock prices or social and environmental advantages. These benefits, however, will only be discussed insofar they affect the participation rate.

Proxy investment

Appropriateness

As discussed earlier, there can be many different types of investment funds, each with its own objective or combination of objectives. Thus, proxy investment can take account of many different interests of subgroups of small investors. However, the investment funds still face the problem of coalition forming among themselves. The dilemma is that the more specific the investment funds in terms of their goals, the more serious the problem of coalition forming.

Costs

An investment fund can use two basic methods of disciplining managers: firstly, buying and selling shares, and secondly, voting at AGMs. Both methods can be supplemented by other actions. The first method, of course, is not only used by investment funds, but by all investors in the stock market (either deliberately or inadvertently). Here, there are no collective action problems – a fall in the stock price as a result of bad management can also occur when companies are owned directly by small shareholders only.

At present, many investment funds discipline management by buying and selling shares according to financial criteria only. Below, these funds will not be the subject of discussion, because we do not regard them as unique instruments for disciplining managers. This paper focuses on investment funds that engage in shareholder activism, which consists of all actions intended to improve corporate governance, other than buying and selling shares according to financial criteria. Consequently, the costs borne by investment funds that discipline management through buying and selling shares according to financial criteria do not form part of the costs of shareholder activism.

What exactly are the costs of the shareholder activism of investment funds? Let us start with two cost categories that concern only ethical investment funds. Firstly, the constraint of not investing in companies that fail to meet ethical standards may lead to lower financial returns. However, these costs may be small, or even zero, because many ethical funds do not seem to perform worse than the index (Lesourd and Schilizzi, 2001). Note that this first type of cost results only from buying and selling decisions. This distinguishes it from the second type, which is related to the voting behaviour of ethical funds. Their votes can induce social and environmental measures in the companies involved. These measures can cause lower financial rates of return under certain circumstances. However, these effects may be small, again in view of the fact that ethical funds do not seem to perform worse than the index. In addition, the costs will be spread over all shareholders of the company, so that the ethical funds will bear only part of the costs.

The remaining cost categories concern all types of investment funds. The third category consists of the costs of controlling managers by means of voting, other activities within and beyond AGMs, searching for information about company policies, forming coalitions, and searching for information on selecting stocks according to ethical criteria (if applicable). Because of economies of scale, these costs will be much lower for an investment fund than for small, dispersed shareholders. In addition, the costs can be reduced if investment funds engaged in shareholder activism cooperate to reduce costs. Note that all costs

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made by an investment fund are ultimately paid by its shareholders.

Fourthly, investing in investment funds instead of in individual companies introduces an additional principal-agent problem, with the fund manager being the additional agent. Additional costs arise in this context – investors may lose money because of mismanagement or fraud. Of course, there are measures to reduce such costs, including control systems that prevent fraud and protect reputation. However, such measures also involve costs. To the extent that shareholders turn to investment funds merely because they help discipline managers, these costs can be regarded as costs of shareholder activism.

The fifth cost category concerns investors who think they can predict stock prices better than fund managers. If these investors turn to investment funds merely because this helps discipline managers, they believe that they will obtain worse financial results, so that, for them, the investment fund has (perceived) costs in this sense. Sixthly, for some people, investing is a hobby. For these individuals, turning to an investment fund with the aim of improving corporate governance may impose high costs in terms of loss of satisfaction.

At present, many investors have shares in investment funds that do not (really) engage in shareholder activism. This implies that for these investors, the sum of the (perceived) costs of the fourth, fifth and sixth categories is relatively low (for the relevant part of their portfolio), by which we mean that these costs are outweighed by the (perceived) financial benefits of investment funds in terms of rates of return (and risk profiles). At the same time, many investors do not invest at all in investment funds, or do not invest their entire budget in such funds. This implies the following with regard to the costs of the fourth, fifth or sixth categories. Firstly, for many investors, the marginal costs would be (relatively) high if they invested a proportion of their budget in investment funds (which is why they do not invest at all). Secondly, for many other investors, the marginal costs increase when they invest a larger part of their budget in investment funds (which is why they spend only part of their budget on these funds). Here, the exact shape of the cost curve clearly depends on the particular investor. Therefore, the following holds for all investors in sum: the marginal costs of the fourth, fifth and sixth categories increase when the participation rate increases. Since the costs of the first, second and third categories tend to be low, we can conclude that the (perceived) marginal costs of empowering small shareholders by means of proxy investing remain low up to a certain level of the participation rate, but increase afterwards.[10]

A counterargument is that there is also a reason for marginal costs to decrease with increasing participation rates: investment funds can achieve economies of scale in shareholder activism. However, we think the reasons for increasing marginal costs dominate, so that on balance, marginal cost increases to high levels where there are high participation rates.

As stated before, in our cost-effectiveness analysis, we will not quantify the financial, social and environmental benefits of the improvement in corporate governance resulting from shareholder activism. However, we note that such benefits generally assume the characteristics of a collective good. Investment funds that invest in specific, often underperforming firms and aim to improve their performance, constitute an exception. Apart from this exception, the improvement in corporate governance resulting from shareholder activism has one advantage only for the individual shareholder who contributes to this collective good: it may give her a psychic reward for "doing good".

Effectiveness

In order to discuss the effectiveness of proxy investing for disciplining managers, we start with *effectiveness at a given and significant participation rate*. Loosely defined, a participation rate is significant if the investment funds as a group constitute a non-negligible player at AGMs. For a given (significant) participation rate, proxy investment can be relatively effective, because the funds have two methods of disciplining managers at their disposal: buying and selling shares, and voting. Of course, these methods are not always compatible, because, amongst other factors, "exit" (i.e. selling shares) means that an opinion can no longer be expressed. Nevertheless, the two methods may sometimes reinforce each other, for instance when an investment fund with voting power threatens to sell its shares unless a certain proposal is accepted.

The participation rate is a function of the (perceived) financial costs for (individual) investors, and of both the effectiveness and psychic reward of contributing to the collective good of improved corporate governance. As stated above, the financial costs may well remain low until significant participation rates are achieved, and the level of effectiveness at a given significant participation rate can be high. From the above, it already follows that the *overall effectiveness* may be high. This implies that a valuable collective good can be

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produced. According to the literature, there is often a significant, though limited number of people willing to contribute to collective goods, as long as the costs are not too high (Guttman, 1978; Laffont, 1987; Gächter and Fehr, 1999; Falkinger *et al*., 2000). In our terms, this means that the psychic reward from doing so is significant and this positively affects the participation rate. However, in view of the rising marginal costs and fact that the number of people who voluntarily contribute to collective goods is not unlimited, the participation rate will have an upper limit. We conclude that the *overall effectiveness* of proxy investing can be large, but is nonetheless limited.

Proxy voting institutions

Appropriateness

Like proxy investment, proxy voting can take into account the specific interests of subgroups of small investors. Thus, if proxy voting were to become standard practice, investors could choose from a wide range of proxy (voting) institutions with a variety of different objectives. Like investment funds, proxy institutions face a trade-off between specificity and coalition forming.

Costs

The first cost category concerns ethical proxy institutions only. Their votes may induce social and environmental measures that have negative effects on the financial performance of the firm. However, such effects may be small. Furthermore, the related costs are spread across all shareholders, so that those who vote for ethical proxy institutions will bear part of the costs only. In addition, the negative effects of social and environmental measures for an individual firm will, essentially, boil down to a deterioration of its competitive position. However, if ethical proxy institutions become successful, they will probably have proxies for all companies. Thus, all firms will be affected similarly, so that, ultimately, no firm will have a substantially weaker competitive position.[11] All in all, small investors who give their proxies to ethical proxy institutions need not fear substantially lower stock prices.

The second cost category relates to the cost of controlling managers by means of voting, other activities at and beyond AGMs, searching for information about company policies and forming coalitions. These costs may well be low, especially if proxy institutions and investment funds coordinate their activities. Recall that shareholders engaged in proxy voting pay these costs through a fee to their proxy institution.

Thirdly, shareholders need information in order to select a proxy institution. The related costs, however, may well be low. One reason is that a significant number of reputable non-profit institutions dealing with social, environmental and financial issues may well be affiliated to a specific proxy institution. In such a situation, a proxy institution has an advantage over an investment fund, in that there is no risk of a financial scandal caused, for example, by avarice, so that non-profit organisations will be more inclined to participate. Non-profit institutions are paid considerable attention by the media, and their standing is generally high. Therefore, choosing between alternatives does not require much additional information. Fourthly, shareholders need to cast their vote, and their proxies should be conveyed to the proxy institutions. In a computerised age, the related costs may well be low.

Because of economies of scale, the cost per investor will decrease if more investors participate. To conclude, the costs need not be high, and marginal costs decrease with increasing participation rates.

Effectiveness

A proxy voting institution has, essentially one instrument only – voting at AGMs. An investment fund has an additional instrument, namely buying and selling shares. From this perspective, proxy investing can be more effective than proxy voting (at a given participation rate). On the other hand, as discussed above, reputable and established non-profit institutions may well prefer to be affiliated to proxy voting rather than to proxy investment. Therefore, the *average* proxy institution may have a better reputation than the average investment fund, which can be helpful in influencing other parties (within and beyond the AGM). Whether this advantage outweighs the disadvantage of not being able to buy and sell shares remains unclear. However, we tentatively conclude that the effectiveness of proxy voting at a given participation rate will, in any case, not be very much lower than that of proxy investment.

The participation rate is a function of the costs for investors of proxy voting, the effectiveness in terms of empowerment at a given participation rate, and the psychic reward of contributing to improved corporate management. Costs can be low, effectiveness at a given participation rate could be significant or high, and the psychic reward can be significant. Therefore, many investors may want to contribute to this

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new instrument. Of course, presently, the participation rate is lower than that of proxy investment (as a means for empowering small shareholders). This is probably related to the fact that the marginal costs of proxy investing are especially low at participation rates such as the present ones. However, from a certain participation rate onward, the marginal costs of proxy investing increase, while the marginal costs of proxy voting decrease with higher participation rates. In addition, proxy institutions can make better use of focal points, so that they have more potential for overcoming collective-action problems. Thus, once proxy voting gets going, the participation rate may quickly surpass that of proxy investing.

The government could also stipulate that every firm (and therefore *all* its shareholders, rather than only those who vote through a proxy institution), should pay the proxy institutions for their services. In such a case, the participation rate could become quite high. Consider, for instance, an environmental organisation which receives financial donations from many people, some of whom are shareholders. For these shareholders, it would, to some degree, be irrational not to be involved in proxy voting if the environmental organisation starts to act as a proxy institution.

All in all, the future participation rate of proxy voting institutions may be higher than that of proxy investment. If the government required firms to pay the proxy institutions, the participation rate of proxy voting could be much higher still. This implies that the *overall effectiveness* of proxy voting can possibly be at minimum significant, or even really high.

Infomediaries

Infomediaries resemble proxy voting institutions in many respects, so that their pros and cons, as compared to proxy investing, are often the same as those of proxy institutions. Bearing this in mind, below, we compare infomediaries to proxy voting institutions. It is initially assumed that every infomediary and proxy institution that obtains more than some rather low minimum percentage of all votes is paid by the firm, the amount being proportional to the number of votes. Given this assumption, there remains one difference only – proxy institutions have full discretion to vote, while infomediaries only provide advice.

Taking this into account, there is no difference in terms of *appropriateness*; both instruments allow the same number of subgroups of small shareholders to be represented. It is unclear which of the two systems has the lowest *costs*. On the one hand, costs may be somewhat higher in case of infomediaries, because some shareholders incur costs in deciding whether or not to follow the advice of their infomediary. On the other hand, proxy institutions incur higher costs in relation to activities such as coalition forming and negotiation. Whatever effect dominates, the initial impression is that there does not seem to be a large cost difference.

Proxy institutions can be more effective, because they know long before the AGM approximately how many votes they can cast, whereas infomediaries are never sure how many shareholders will follow their advice. Thus, with proxy institutions, the board and the various (representatives of) shareholders have a greater likelihood of making proposals that obtain a majority, and of nominating a coherent team of directors that is duly elected. In this context, it is relevant that proxy institutions can negotiate with one another, as well as with large shareholders and investment funds, and they can form coalitions (while infomediaries are not supposed to do so). On the other hand, the less powerful infomediaries are less vulnerable to bribery. From this perspective, they can be more effective in representing shareholders.

Because infomediaries decrease the costs of information gathering and enable shareholders to make informed choices, they can be expected to increase the number of shareholders that vote. How do they compare to proxy institutions in this respect? On the one hand, infomediaries could be regarded as more democratic than proxy institutions, because shareholders can vote directly on all issues. This could enhance the participation of shareholders. On the other hand, proxy institutions have more power than infomediaries. Therefore, the election of a proxy voting institution carries more weight than that of an infomediary. This will have a positive effect on election turnouts, and proxy institutions will become better known and have more chance of becoming focal points. In general, it is unclear whether or not infomediaries will be more effective in representing small shareholders and their various subgroups than proxy institutions.

Let us finally analyse the situation in which there is only one infomediary per firm. Such an infomediary will enhance the coherence of the board and its policies. In addition, a single infomediary can realise economies of scale. Yet, it is less capable of representing various subgroups of small shareholders, which has disadvantages in terms of appropriateness, popularity, participation rate and effectiveness. All in all, it remains uncertain which instrument is best.

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Conclusions

In this paper, three instruments for empowering small, heterogeneous investors have been discussed in view of the problems of information gathering and coalition forming. These instruments are proxy investing, proxy voting institutions and infomediaries.

Both proxy investing and proxy voting are appropriate for representing the specific interests of subgroups of small investors. At equal participation rates, proxy investment may be more effective than proxy voting, because it can use two methods for disciplining management: buying and selling shares, and voting. A countervailing factor is that the average proxy voting institution may have a better reputation than the average investment fund. Because the marginal costs of proxy investment increase with higher participation rates, there is an upper limit to the participation rate and therefore to the overall effectiveness of this instrument. In contrast, there is no such limit to the participation rate of proxy voting. Thus, although proxy investing is presently the most popular concept among small shareholders, the future potential of proxy voting may be higher.

Infomediaries do not possess the power to vote on behalf of all shareholders. Nonetheless, they can be effective in influencing voters, and they may also be influential through their agenda-setting activities. In many respects, the advantages and disadvantages of infomediaries *as compared to proxy investing* are essentially the same as those of proxy institutions.

In summary, each instrument has specific advantages and shortcomings. The analysis in this paper should be helpful in choosing the most adequate one. However, we cannot conclude at this stage that one instrument is superior to the other ones. Because proxy investment is currently most popular, while the future potential of proxy voting institutions and infomediaries may be large, experiments with the latter two instruments should prove useful.

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Notes

1. La Porta *et al*. (1999) define a controlling shareholder as one with over 20 per cent of the voting rights. An anonymous referee suggested defining small shareholders as those with less than 5 per cent of the voting rights, and to regard a holding between 5 per cent and 20 per cent as intermediate. One reason for this categorisation is that the level at which an investor must disclose her/his holding publicly is 5 per cent in the US. In addition, a holding of less than 5 per cent implies a free-rider factor of over 20 to 1, which intuitively seems sufficient to constitute a substantial drag through costly monitoring activities. Of course, there cannot be a sharp dividing line between "small" and "not small", so the definition is somewhat arbitrary.
2. Roe (2003) and CESifo Dice (2003) discuss corporate goverance systems in general.
3. Shleifer and Vishny (1997) present an overview of the various types of rent that managers can appropriate. For a discussion of the reasons why directors may not act in the interests of shareholders, see Monks and Minow (2001).
4. For a comprehensive survey of corporate governance and control, see Bolton *et al*. (2002).
5. Hirshleifer and Riley (1992) present an overview of the economics of information.
6. The behaviour of less-informed investors is analysed in Bloomfield *et al*. (1999).
7. Kreps notes: "The equilibria that people sometimes just naturally focus upon are called *focal points* or *focal equilibria*, and we will refer here to the organizing principle (equity, uniqueness, geography, alphabetical order) as the *focal principle*" (1990, 415; emphasis in original). See also Walzer (1999) and Bonus (1982) for the role of passions and emotions in politics. For an analysis of the coordination of large numbers of people in football stadiums when forming "La Ola" ("the wave") from the perspective of statistical physics, see Farkas *et al*. (2002).
8. Fehr and Falk (2002) analyse the psychological basis of incentives. Elster (1989) investigates the concept of emotions in social sciences.
9. See Whitley (1999) for an analysis of the factors that influence management control systems.
10. This assumes that the investors with the lowest marginal costs are the first to participate. This is not entirely correct, since ethically motivated investors with high costs may even participate at low participation rates. This qualification, however, does not invalidate the main line of the argument below.
11. If proxy voting becomes successful in one country initially, social and environmental organisations can be expected to make it successful elsewhere.

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