

THE CORPORATE MONITORING FIRM

Mark Latham

Published in

Corporate Governance - An International Review

January 1999 (volume 7 number 1)

Abstract

Shareholders can gain effective control over their firm's management by voting to choose an outside agency to nominate director candidates. This would give the board and management a greater incentive to serve the owners' interests, resulting in higher productivity of capital, more realistic levels of executive pay, less short-termism, and a moderation of the corporate bloat that tends to necessitate drastic cuts. Such a system would further improve corporate governance in western countries, and provide a much needed "quick fix" for governance problems in Asia.

Mark Latham is a financial economist and consultant. Contact by e-mail: mlatham@corpmon.com; phone: (415) 786-5583; fax/voicemail: (415) 680-1521; or post: 268 Bush Street #3934, San Francisco, CA 94104, USA. See www.corpmon.com for discussion and further information on corporate monitoring. I gratefully acknowledge helpful comments from Charles Elson, Richard Homonoff, David Pyle, and especially Mark Rubinstein.

1. The Manager-Shareholder Agency Problem

The corporate governance systems of all major countries are fundamentally flawed, because the connection between shareholders and the board of directors is broken. For example in America, as Figure 1 illustrates, in theory shareholders elect the board to oversee the CEO on their behalf. But in practice (Figure 2), this "election" is typically a rubber-stamp approval of the unopposed slate chosen by the existing board. This system enables the CEO, who chairs the board in most U.S. firms, to populate it with friends who will not challenge his authority even when he manages the firm to suit his own interests at the owners' expense. Perhaps the clearest example of this conflict of interest is that when managers can influence their own compensation, they naturally tend to be overpaid. Other often-cited examples include empire-building (expanding businesses beyond what is economically justified), opposing hostile takeovers, and paying greenmail.

In the U.S., to compensate for this fundamental flaw several mechanisms have evolved, including

disclosure requirements, takeovers, minority shareholder protection and fiduciary duty laws, incentive compensation, pressure from large shareholders, and director independence. These measures all promote economic efficiency and responsiveness to shareholders interests, to the point where America is justly viewed as the world leader in corporate governance, with a bull market to prove it.

But the fundamental flaw remains. Each of the aforementioned devices solves only part of the agency problem, still leaving substantial inefficiencies. For example, disclosure requirements make other mechanisms (plus embarrassment) more effective, but exert no direct influence themselves. Limitations of the other mechanisms are discussed below in turn.

Takeovers are an expensive disciplining tool, entailing costs of the premium over market price paid by an acquirer, legal costs, restructuring costs of returning the firm to efficient operation, and compensation for the acquirer's efforts and risk exposure. There are substantial costs of poor diversification when an entrepreneur owns the whole enterprise. So the acquirer wants to whip the firm into shape quickly and then resell it, which may well be followed by a gradual slide back into inefficiency.

Ill-treated shareholders can sue management and the board for breach of fiduciary duties. In practice though, it is so difficult for a court to distinguish self-serving from incompetence and bad luck, that lawsuits can guard against only the most flagrant abuses of management power.

Managers and directors can not be expected to neglect their own economic interests, but making them shareholders can align their interests with those of the other shareholders. Elson (1995) and others argue for paying directors in stock. Recent years have seen widespread adoption of compensation schemes involving stock, options, and other formulas giving higher pay when a firm's stock does well. While this certainly helps alleviate the conflict of interest, it can only be a partial solution. Some divergence of interests will always remain unless those who run the firm own 100% of the equity, which is rarely practical because they are not wealthy enough and would be taking too much risk.

Shareholder activism has become the dominant disciplining mechanism in the last ten years. Large public pension funds, especially the California Public Employees Retirement System (CalPERS), have put pressure on boards and management of underperforming firms to shape up or lose shareholder votes. But even large investors are necessarily limited by lack of knowledge of how the firm should be run - one of the reasons for hiring management in the first place. The more knowledge owners can acquire, the better they can oversee management, but the time and effort involved are monitoring costs that can only be recovered by a rise in the value of their shareholdings. Since each owner holds only a small percentage of the firm, they face a substantial free-rider problem: the benefits of any owner's efforts to oversee are reaped by all shareholders; so there will be a lack of such efforts. Thus the pioneers of this approach have been large institutional investors, especially those with no ties to any private-sector corporation. But even they rarely hold more than 5% of a firm's stock, which limits the amount of monitoring that is worth their while to undertake.

1. In theory, monitoring of management by the board of directors should avoid the free-rider problem, since they are paid by the firm, and thus by all shareholders. The challenge is to make them loyal to owners and independent of management. The need for outside directors is widely recognized in the academic literature, in the law, and in statements of good board practice such as those of the

National Association of Corporate Directors. But even though these directors may have no other formal ties to the firm, candidates can still be screened to ensure friendliness to the CEO, and those who rock the boat can be omitted from nomination next time. For such reasons, several authors have focused on the nomination mechanism as the key point for improving corporate governance.

Gilson and Kraakman (1991) recommend that institutional investors create a clearinghouse to nominate independent directors from a pool of full-time professionals, who would thus be motivated to favor shareholder interests. The main drawback of this plan is the free-rider problem resulting from voluntary participation of investors in funding the clearinghouse. The selection and, more importantly, the subsequent monitoring of directors is itself a costly process requiring expensive expertise. Free-riding on monitoring costs prevents an organization like Institutional Shareholder Services from resolving much more of the shareholder-manager agency problem. Tosi, Gomez-Mejia and Moody (1991) similarly propose that directors be nominated by an independent entity, although in their paper each firm would choose its own nominating entity. However, they advocate federal legislation to make it happen, and lack a mechanism for shareholders to choose the entity directly.

This paper proposes a system for shareholders to directly choose among competing nominating agencies, without interference from management.

2. Solution: A Monitoring Intermediary

Shareholders should vote to choose an independent agency for nominating director candidates. This will make directors responsive to owners rather than to management, while avoiding the free-rider problem that limits the effectiveness of other solutions. Furthermore, adopting this mechanism may well be the thin end of a wedge, which will fundamentally alter the role of the board.

The nominating entity will need to monitor director performance in order to decide whether to nominate a given candidate again, for the board of the same or another firm. Furthermore, it could perform additional monitoring functions if requested by a majority of shareholders. This intermediary can be called a Corporate Monitoring Firm (CMF), illustrated in Figure 3.

An annual shareholder ballot will choose the CMF for the following year's director elections. It may be best to offset these by six months, for example voting in November to choose the entity who will nominate director candidates the following May. But who nominates the nominators? To forestall management and the board from restricting owners' choices, any shareholder could name an entity to go on the ballot.

Frivolous entries seeking free advertising can be prevented by an up-front fee. The number of candidate intermediaries on the ballot would ideally be between two and ten.

A shareholder vote to choose one CMF from ten competitors on the ballot raises the problem of vote-splitting. For example, what if there are nine candidate firms known to be good shareholder advocates, and one candidate that is overly friendly to this corporation's management? If a management clique owns 25% of the shares, their shill may win. Preferential voting can solve this problem: rather than voting for just one candidate firm, shareholders rank the firms, indicating their first, second, third choices and so on, and a computer finds the most preferred candidate. In the

example with nine good candidates versus a single bad one, the 75% of the shares outside management control would tend to rank the management skill last, so that one of the nine will win.

Having an outside entity nominate directors need not preclude nominations via the existing mechanisms of the board's nominating committee, and the occasional opposing slate from a dissident shareholder group.

However, when shareholders vote to choose among these nominees, it is important that the ballots indicate who nominated which ones. Given the complexity of evaluating director candidates, shareholders are likely to simply vote for those nominated by the CMF they have chosen.

Monitoring by intermediary firms will enable shareholders to make powerful monitoring decisions with minimal information costs, thus avoiding the free-rider problem. Choosing good candidates for the board of directors is generally too complex for meaningful input from many shareholders, one reason why nominating is done by a board committee, and why there are rarely competing slates. But ten or twenty firms providing monitoring services nationwide can build reputations sufficient to inform intelligent choices among them, with only a casual reading of a newspaper's business section. Think of accounting firms as having similar investments in reputation. The typical shareholder would be hard pressed to name a good director candidate, but most can name a good accounting firm.

The task of voting to choose CMFs for the hundreds of firms held by well-diversified investors may be daunting. But they can simplify it using software that takes an investor's master ranking of all monitoring firms and applies it to rank the candidates for each election.

Each monitoring firm will strive to build a reputation for sound business judgment and independence from the managers of the corporations it monitors. Compared to an individual director, such a firm will provide services to many more client companies over many more years, permitting a far more accurate assessment of its capability. Statistical tests could compare the impact of various monitoring intermediaries on their clients' stock returns.

3. Potential Benefits of Monitoring Intermediaries

The primary goal for improving monitoring of management is to enhance shareholder returns. This can be achieved by a more judicious deployment of capital. CEOs have been known to enter, maintain, or expand favorite businesses even when it is not economic to do so. A strong independent board can prevent this.

With effective shareholder representation at the bargaining table, compensation of top executives will be closer to the market value of each manager's contribution to the value of the company. Oversight of the process of training and promoting middle managers can prevent a clique from monopolizing the knowledge of how best to run the firm.

Diffusing the intense focus of power in the position of CEO should have a pervasive effect of making the whole firm less hierarchical. It will no longer be worthwhile for the CEO to spend much effort maintaining a tight grip on power. Instead, a good CEO will benefit from no longer being surrounded by yes-men.

American companies are often accused of "short-termism": favoring current profits at the expense of the long-run value of the firm. This can lead to neglect of such things as investment in R&D, plant modernization, employee training and morale, product quality, customer satisfaction, firm reputation, and risk management. Near-term profits can often be enhanced by strategies involving long-run environmental damage; cooperation with repressive foreign governments can similarly boost the bottom line temporarily but devastate the firm's reputation in the long run. Such a tendency is often blamed on management being pressured to focus on the firm's stock price, which responds strongly to current earnings and dividends. In theory the current stock price should reflect all expected future earnings from investment in R&D, reputation etc., so that emphasizing stock price should not induce short-termism. However, if investors lack information about these long-term investments, and do not trust management to invest optimally, they will favor the benefits they can verify – current earnings and dividends.

A monitoring intermediary answerable directly to shareholders can reduce short-termism. Compared to the average CEO or director, the CMF will provide its services to many more companies and for many more years. This will enable the stock market to learn whether this monitor encourages the pursuit of short-term profits at the expense of long-term share value. If the market can learn that, then the incentive for short-termism is gone, since share prices will no longer respond as desired. The monitor will build its reputation for promoting the true value of the client company, and shareholders will have greater trust in long-term investments approved by its appointees. Enhancing its long-term reputation should also induce monitors to encourage more informative accounting practices, rather than creative methods designed to paint management's desired picture.

One can see how a lack of information limits the effectiveness of monitoring, by looking at how CalPERS, the leading activist investor, chooses the targets of its pressure. They focus on underperforming firms, those whose market value has lagged in recent years. Yet the firms most likely to waste resources are those that have the most to waste – companies that have been generating substantial cash flow. It would be better to forestall waste before it leads to loss of market value, rather than just locking the door after the burglary.

However, effective monitoring when there is no obvious problem, requires an investment in more inside knowledge of the firm. Partly because shareholders lack such knowledge, the existing system tends to shift some power from managers to shareholders only when market values have already suffered and the damage has become apparent. Even then the losses may be bad luck, not bad management, but the free-rider problem makes it uneconomic for shareholders learn enough to make that distinction. So a monitoring intermediary funded by all shareholders promises to be an effective remedy.

The use of CMFs is likely to dampen the painful cycles of overexpansion followed by mass layoffs that characterize existing mechanisms of corporate economic discipline. Hostile takeovers are an effective way to cut corporate flab, but they are costly both to owners and especially to employees who lose their jobs. A daily regime of discipline to stay lean is far preferable to crash diets and liposuction.

The monitoring system proposed here harnesses competition and the profit motive for the benefit of many. Share ownership is broadly distributed, especially through pension funds, and the changes advocated promise to shift more of the fruits of capitalism from a management elite to the population

of working people and retirees. And since shareholders represent a much broader public spectrum than managers, not only will long-term profits be enhanced, but the corporation's treatment of its other stakeholders can also be expected to improve. These include employees, customers, and the general public who live with the corporation's environmental impact. If an improved monitoring system can earn shareholders' trust, they may be more willing to encourage management to pursue public interest goals in addition to making money.

Moreover, removing the incentive for empire-building would, over time, decrease monopoly power, enhancing competition to the benefit of consumers. Indeed, if investors diversify to the point of holding index-fund portfolios, their self-interested trade-off between maximizing share value and pursuing other, social goals, will approach the socially optimal trade-off. An interesting test case for this proposition would be Microsoft: how would monitoring change its corporate policies if the majority of its owners considered social impact as important as profit?

The advent of monitoring intermediaries will diminish the importance of large shareholders. To the small shareholder, large shareholders are a mixed blessing. They may undertake costly monitoring of management, to the benefit of all owners. They may pay a premium to buy out all the shares. But they may extract value from the firm to the detriment of other owners, such as by receiving greenmail, "white knight" deals, inside information, or by in effect joining the management team and benefiting in various ways from non-arm's-length transactions with the firm.⁵ If shareholders vote to hire a CMF, they will no longer need large shareholders to go to bat for them. A shareholder or group holding close to half the shares could control the choice of monitoring firm, however, and exploit that power at the expense of minority owners.

Thus agency costs may be reduced by imposing restrictions on accumulating large blocks of shares, since the monitoring benefits are no longer needed. So as not to lose the potential efficiency gains from a complete overhaul, sale of the entire firm to a single acquirer could still take place if approved by majority shareholder vote.

Large investors too can benefit from having a third party take over the monitoring function. A professional monitor can afford to spend the time to learn more about the firm than any one investor. To be most effective, a monitor should go beyond publicly available information, to the point where they would be legally considered insiders. Investors must avoid this or risk having to restrict their trading activity.

On the other hand, firms are justifiably concerned about leakage of proprietary information to competitors, and if an outside entity is peering into several firms, this risk may be exacerbated. The principal defense against this is the need for the monitoring firm to maintain its reputation. If there is evidence of substantial leakage, it will lose shareholder votes. This may well be a better protection for proprietary information than under the existing system of directors, who have less of a long-term reputation to protect, and are less answerable to owners. Once owners are confident that monitoring will not leak proprietary information, they can mandate full access to inside information.

Shareholder lawsuits are a necessary but expensive last resort for preventing abuse of power by directors and management. Might not the introduction of a monitoring firm increase this expense? Certainly there will be one more target for lawsuits. However, the fundamental need for the courts to protect powerless shareholders will be gone. Shareholders will no longer be powerless. Each year,

they can fire the monitor, and the monitor can fire the board. The CMF's great investment in reputation provides a deep pocket that will be drained without court action if they lower their standards. The investors' option to sue will still be a necessary backstop, but the business judgment rule can be invoked much more readily to defend monitors, directors, and management, given a power structure with effective accountability to the owners.

Developing a system of monitoring intermediaries must be expected to do some harm, but far less harm than good. There are two main reasons for this. First, mishaps are inevitable when exploring new territory. If shareholders try a new oversight structure that turns out badly, they can vote to amend or rescind it. Second, benefits should be pursued until they are outweighed by costs at the margin. The monitoring firm's power and budget should be expanded until there is evidence of some waste or other negative effects.

Concentration of power in monitoring firms may have social and economic costs. The obvious example of anti-trust concerns can be mitigated by ensuring no firm monitors two clients in the same industry. Beyond that, the effects of such a power shift are so hard to forecast that we can only learn by advancing down that path.

4. International Applications

The proposed system will increase shareholder power beyond the level it has reached in the U.S., where it is perhaps the highest in the world. For that reason, monitoring is likely to be implemented there soonest, where it is needed least. The ongoing bull market has been buoyed by continuing advances in corporate governance, and has probably anticipated further such advances, much as a futures market for computer memory would extrapolate price trends without knowing what specific technology will drive them. So the U.S. stock market could fall if anticipated governance improvements are not forthcoming.

Effective corporate governance systems are urgently needed in South Korea, Japan, and Russia, as well as in China and other Asian countries. It is natural for them to look to the proven successes of the U.S., the U.K. and Europe as models. Why should they implement a proposal that never been tried elsewhere? The problem is that it may take years to evolve the various mechanisms (discussed in section 1, above) that compensate for the lack of direct shareholder power in western countries. Instead, creating a monitoring link between owners and the board would solve the fundamental problem directly, and may enable governance laggards to catch up quickly.

Of course, there are considerable differences among the corporate governance systems currently used in western countries. For example, British firms tend to separate the CEO and board chair roles, while in the U.S. they are usually held by one person. While separating the roles tends to enhance monitoring of the CEO, without meaningful shareholder input in choosing directors it guarantees neither independence nor accountability to owners. A board of directors chosen by a monitoring firm, however, would likely choose an outside director as chairperson, extending the recent trend in the U.S. and the U.K. toward strengthening the presence of outside directors. This trend is even now bringing their governance systems closer to the two-tier boards of Germany and the Netherlands.

Suppose Country A has a two-tier system, with a supervisory board of outsiders and an executive board of insiders, who sometimes meet separately and sometimes together. Country B has a unitary

board system, with both insiders and outsiders on the board; but these two groups sometimes also meet separately. So far, the difference between A and B is merely semantic. What matters is who has the power to make crucial decisions, such as whether to fire the CEO. If that is decided only by outside directors, then the CEO's power is held in check much more than if the CEO and other inside directors can vote on it too. For that reason, a system designed to give shareholders an effective choice in choosing outside directors would be better served by reserving such decisions to those outsiders.

This is part of the broader question of co-determination: should employees, whether CEO or any other level, be represented on the board? Gerum and Wagner (1998) survey this debate in the context of European integration, generally favoring free competition among governance systems rather than mandated standards.⁶ Note however, that these arguments and systems have evolved in a context where the owners had little influence, because we lacked a mechanism for general shareholder participation. Until now. A CMF representing the firm's owners changes several key elements of the co-determination debate.

The monitoring firm's reputation is based on serving many client firms for many years. This gives a stronger incentive to refrain from such employer behavior as post-contractual opportunism, lessening the agency costs that co-determination is purported to help resolve. Other arguments for employee representation are based on claims of positive externalities. But as mentioned in section 3 above, well-diversified shareholders will internalize much of the social effect of their decisions. As an antidote to managerial elitism, the ideal of industrial democracy can be advanced by giving a voice to all shareholders, while promoting economic efficiency through reduced agency costs. Letting employees vote on how owners will spend their money risks inefficiency by increasing agency costs. Likewise, allowing CEOs to vote on whether they themselves should be fired would be unimaginable were it not commonplace (in the U.S. and the U.K.).

Perhaps most importantly, an effective voice for owners will make employee stock ownership a far better tool for lessening the conflicts between employers and employees. If employees own over half of the shares however, they could expropriate value from the minority shareholders by the non-arm's-length transaction of overpaying themselves. But at lower ownership levels, the equity stake encourages employees to behave more like owners, and gives them real influence over the firm's policies. Prospective monitoring firms competing for votes will be induced to find an efficient balance between employee and non-employee owner interests. Thus there will be less need for separate formal labor representation.

There is no question of whether the board should meet regularly with employees, as well as with customers, suppliers, and so on. Such exchanges of views certainly benefit the firm. It is true that board decisions affect employee welfare, so the argument that employees should be represented on the board is, on its face, plausible. But when a union takes a strike vote, that decision affects shareholder welfare. So by the same argument, shareholders should also be allowed to participate in that vote. When a buyer and a seller are negotiating over price, should they be given any influence over each other besides the option of trading with competitors instead? In the case of corporate governance, this debate can ultimately be settled by competition among firms with different structures. European union presents a unique opportunity for this experiment, as long as a level and open playing field is maintained and standardization of governance forms is avoided. Perhaps a

balance will be found with one board member chosen by rank-and-file employees, one member chosen by upper management, and the remainder by shareholders via a CMF. This would keep the owners in control of their purse strings, while guaranteeing openness and a voice to all employees. In any case, an evolutionary process can determine the ultimate form and role of monitoring firms in the corporate power structure.

5. How To Start the Corporate Monitoring System

CEOs and their loyal directors will oppose hiring monitoring intermediaries, but they cannot prevent it if a majority of shares are voted in favor. Public discussion and debate will shape shareholder opinion on the merits of this idea and the specific form in which it should be first attempted. Then a shareholder proposal to retain such an intermediary should be put forward at a firm where it has the best chance of winning a majority of votes, where owners believe they would benefit from a truly independent board. This could be accelerated by like-minded investors buying shares in such companies.

How can shareholders hire a CMF when no such thing exists? The market will create them once there is demand. By the time a majority of some corporation's owners decide they want such services, someone will offer them. Assuming the first proposals are for independent nomination of director candidates, the first to step up are likely to be existing executive search firms. But because all their present business involves being retained by management, they would face two immediate problems: being deserted by their existing customers, for disloyalty; and being perceived by shareholders as lacking independence from management. So a stronger contender may be proxy advisory firms, who have already built reputations for serving owners rather than managers. In addition, individuals with experience in related fields would start new firms specializing in the corporate monitoring role, and build their reputations from the ground up.

Unfortunately, even if a majority of a firm's owners vote to hire a monitor, their decision can be blocked by cross-holdings controlled by management. These are shares in other companies, owned not by management but rather by the firm, and thus in effect by its shareholders. The problem is that such shares are voted by management, not by the beneficial owners.

Cross-holdings take different forms in different countries. In America, explicit cross-holding of one company's shares by another is limited. But private pension funds have the same effect, since they hold and vote shares of companies, and the fund manager is hired by management of the sponsoring firm. The fund manager is thus likely to be influenced by management's opposition to monitoring, at their own or any other firm. One way to prevent this is by legal pressure based on the fiduciary duty of pension fund managers to vote in the best interests of the fund beneficiaries. Another solution would be to pass through voting power from the pension fund to its residual claimants: beneficiaries for defined-contribution plans, and the firm's owners for defined-benefit plans. The resulting complexity can be reduced by the software proposed in section 2, which requires only that an investor rank all monitoring firms once.

In Korea, cross-holdings are used to keep voting control of a company in the hands of a small group, often

a family, who own only a minority of the shares. This enables them to exploit the majority owners by such means as non-arm's-length transactions. In order for monitoring to be an effective remedy for this, the voting control based on cross-holdings must first be broken, by legal pressure or requiring votes to be passed through to beneficial owners.

In Japan, cross-holdings often take the form of holding a few percent of the stock of several other firms in a keiretsu (conglomerate-like group), which cumulatively could become a block of votes controlled by management and voted against monitoring, to the detriment of economic efficiency and shareholders' interests. Similarly here, pressure from government or revision of laws may be needed to enable owners to exercise their property rights.

If there is any chance that monitoring may bring economic benefits, then there will be huge positive externalities generated by the first firms to try it, because all other firms and investors will learn from that experience. Therefore there is a strong case for government legal support for the first moves toward creating a monitoring system. But the primary impetus should come from shareholders, since monitoring is in their interests and they have the fundamental legal right to control the firms they own.

6. Conclusion

Shareholders of large firms should vote to choose an outside agency to nominate directors. This would improve corporate governance in western countries, and provide an urgently needed remedy to governance problems in Asian economies. It would enhance stock returns, reduce short-termism, promote an efficient balance between profit and social goals, and create a system of democratic capitalism where even small shareholders participate meaningfully.

References

Elson, Charles M. (1995): "The Duty of Care, Compensation, and Stock Ownership," *University of Cincinnati Law Review* 63:649.

Gerum, Elmar, and Helmut Wagner (1998): "Economics of Labor Co-Determination in View of Corporate Governance," in *Comparative Corporate Governance*, edited by K. J. Hopt et al., Oxford University Press.

Gilson, Ronald J., and Reinier Kraakman (1991): "Reinventing the Outside Director: An Agenda for Institutional Investors," *Stanford Law Review* 43:863.

Maug, Ernst (1995): "Institutional Investors as Monitors: On the Impact of Insider Trading Legislation on Large Shareholder Activism," *Institute of Finance and Accounting, London Business School*, 7/15/95.

Tosi, Henry L., Luis R. Gomez-Mejia, and Debra L. Moody (1991): "The Separation of Ownership and Control: Increasing the Responsiveness of Boards of Directors to Shareholders' Interests?," *University of Florida Journal of Law & Public Policy* 4:39.