Legal Studies Research Paper Series Paper No. 1397

In Search of "Absent" Shareholders: A New Solution To Retail Investors' Apathy

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IN SEARCH OF THE "ABSENT" SHAREHOLDERS: A NEW SOLUTION TO RETAIL INVESTORS' APATHY

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ABSTRACT

Corporate law scholars have taken investors' rational apathy for granted for many years, considering it a necessary evil once ownership is no longer closely held. But how significant is retail investors' apathy and what is its impact? This Article is the first to provide comprehensive data on the true magnitude of retail investors' apathy and its negative impact on corporate governance. Building on behavioral economics tools, this Article then presents a novel solution that could substantially mitigate, if not fully eliminate, this long-standing problem of investors' rational apathy, with minimal regulatory burden. The solution is based on the premise that the high economic and mental costs associated with voting could be dramatically reduced by providing retail investors with a little "nudge" in the form of highly-visible voting default arrangements that would allow (or force) them to choose from a menu of voting short-cuts. Aside from strengthening shareholder democracy, mobilizing retail investors with different voting heuristics will have other important advantages such as providing for greater accountability of companies' incumbents.

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I. INTRODUCTION

Do you vote? Yes, of course I vote, most people would answer. Let us rephrase the question: do you vote your shares? Most people, after shaking off their confusion, would say no. They may add, why should we even care? Indeed, it is no surprise to any of us who ever owned shares of a publicly-traded company. Every year we get a series of envelopes/emails from our broker, we may or may not bother opening them, but shortly thereafter they will find their way to the recycling box, left untouched.

Retail investors, who individually hold small fractions of a firm's equity capital, often lack the financial incentives to monitor management. Since the process of informing and expressing one's preferences is costly, retail investors often choose to refrain from any involvement in the governance of the corporation,[1] simply deferring to management's agenda or relying on other active, large shareholders to do the work for them. This is the essence of rational apathy in the context of corporate law discourse and it has played an integral part in the modern U.S. corporate governance paradigm for decades.[2]

Importantly, as we show in this Article, large-scale changes to the corporate governance landscape that took place over the last two decades have further aggravated the problem of investors' apathy. While these recent regulatory changes, along with the increased involvement of activist shareholders, were aimed at accomplishing a good purpose—restraining managerial entrenchment by enhancing disclosure requirement and subjecting more matters to shareholder vote—they also had an unintended consequence: increasing the costs associated with exercising an informed vote.

However, while individually it might make sense for shareholders to ignore their rights to express preferences regarding the governance of the firm, collectively, the absence of retail shareholders' voices might allocate improper weight and power to management, or to certain large shareholders, and distort the optimal decision-making process.[3] Investors' apathy could also limit the ability of shareholders to initiate efficient governance changes through private ordering, or lead to deadlock situations where low participation by investors prevents companies from amending their governing documents, even when the amendments are desirable to all shareholders.

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[1] *See* BROADRIDGE & PWC PROXYPULSE, 2013 PROXY SEASON RECAP, (3d ed. 2013) (noting that of shares held by individual or 'retail' investors, an average of 30% were voted at annual meetings in 2013).

[2] *See infra* notes 15-17 and accompanying text.

[3] *See infra* Section II.B.

Corporate governance scholars have long struggled to find ways to mitigate the agency problems caused by rational apathetic investors. Independent directors,[4] institutional investors,[5] and activist hedge funds[6] were all championed as agents that could bridge the gap between the individual shareholder apathy and the collective good. In doing so, both traditional and contemporary corporate governance discourses have taken investors' rational apathy as a constant that could not change, therefore focusing on other actors and means to mitigate investors' lack of participation.

But why should investors' apathy stay constant? Is there a way to reduce the costs of participation to a level where it is no longer rational for investors to remain passive? Indeed, first signs of a shift in the regulatory approach to retail investors' participation can be found in a roundtable that the Securities and Exchange Commission (SEC) organized in early 2015 that "focus[ed] on strategies for increasing retail shareholder participation in the proxy process."[7] The SEC and the distinguished participants in the roundtable underscored the lack of participation by retail investors as an issue that merits close attention.[8] The roundtable also highlighted market participants' and regulators' need for additional information on the subject. Its minutes are filled with anecdotal and "ball-park" estimations[9] of the magnitude of investor's apathy, but they fail to present the necessary data that is germane to the issue.

In this Article, we fill this gap by providing novel data regarding voting patterns and trends of this important class of investors and demonstrating the severity and magnitude of the problem. With a better understanding of the issue and its extent, we then suggest utilizing behavioral economic tools to solve this long-standing problem of investors' apathy. In particular, we propose to facilitate retail investors' participation in the voting process by providing them with a little "nudge" in the form of highly-visible default arrangements that would dramatically reduce the economic and mental costs associated with

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[4] *See* Jeffrey Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1478-79 (2007).

[5] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 819 (1992).

[6] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1028 (2007).

[7] SEC PRESS RELEASE, *SEC to Hold Roundtable on Proxy Voting,* (Jan. 27, 2015), http://tinyurl.com/qbe889q.

[8] *Id.*

[9] *See* SEC PROXY VOTING ROUNDTABLE, 88-90 (Feb. 19, 2015), http://tinyurl.com/sec-rountable [hereinafter: SEC PROXY VOTING ROUNDTABLE].

voting. These default arrangements would allow (or force) retail investors to choose between several available voting short-cuts, such as voting along with a specific large and sophisticated shareholder, in accordance with the majority vote of institutional investors not affiliated with management, or in accordance with the recommendation of a proxy advisor.

Imagine that you no longer need to open that heavy envelope you received in the mail. Instead, when you sign in to your brokerage account, a pop-up window (that you may or may not be able to close) would allow (force) you to make a number of short and simple voting choices. By checking a box, you would instruct that your shares be voted in the same manner as Fidelity or other large shareholder votes, with management, or based on ISS recommendation. You can always choose to opt out of all of those options, and continue to make your own decision. But, if you are unlikely to invest time and resources in making an informed decision on the merits, case by case, you may now use a short-cut, choosing an agent to make the choice for you. Making a single choice regarding an agent rather than numerous decisions on the merits of each topic, would reduce the costs associated with voting, therefore making the expression of preferences by retail investors more likely.

The rest of the Article is organized as follows: Part II reviews the prevalence and direct impact that investors' apathy has in the context of the public firm, against the backdrop of recent changes to the corporate governance landscape. Part III then details the costs of retail investors' apathy on the governance of the firm, and provides empirical and anecdotal evidence to support it. Part IV explains how behavioral law and economics can help in addressing this investors' apathy. Part V presents the general framework of our solution and the design questions that must be addressed by policy makers. Part VI reviews the benefits that would stem from the adoption of such new regime, such as providing for greater accountability by public company incumbents and improving firm value. Part VII addresses the potential concerns that might arise from the implementation of a nudging mechanism. Part VIII concludes.

II. THE PROBLEM OF INVESTORS' APATHY

This part lays out the factual backdrop to our discussion. Section A presents the key problem addressed in the Article—retail investors' limited participation in corporate decision making—and shows that it is of a large magnitude. Section B explains how recent regulatory and corporate governance changes that were originally aimed at strengthening shareholder voice have paradoxically exacerbated the concerns regarding low retail investors' participation in corporate decision-making.

A. *Investors' Apathy and Its Magnitude*

Shareholder voting is an important mechanism of accountability and a critical element of shareholders' ability to influence corporate strategy and financial policy. While the board and the management of the corporation enjoy vast authority and discretion to operate the business of the corporation,[10] such power and authority is not without limits. Corporate law provides shareholders with certain voting rights that allow shareholders, at least in theory, to keep the board accountable.[11] These voting rights include the ability to elect and remove directors, to approve amendments to the governing documents of the corporation, and to approve fundamental transactions.[12] The shareholder voting mechanism is, therefore, an important tool that provides management with *ex-ante* incentives to remain accountable to shareholders. Larry Hamermesh[13] recently iterated this topic during a roundtable organized by the SEC on the topic of retail investors' participation in the proxy process:

> So in the same way that a hospital emergency room is critically important to a seriously injured patient, the voting process is critically important to the issuers who have significant problems.[14]

However, despite the importance of voting, most retail investors are rationally apathetic.[15] A diversified investor, who holds a small stake in a large public company, knows that her vote probably will not affect the voting outcome. She, therefore has very little incentive, if at all, to invest time and efforts in the costly process of collecting information and studying the firm's affairs in order to make an intelligent voting decision

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[10] *Id.*; Christopher Gulinello, *The Retail-Investor Vote: Mobilizing Rationally Apathetic Shareholders to Preserve or Challenge the Board's Presumption of Authority,* 2010 UTAH L. REV. 547, 550-51 (2010).

[11] Gulinello, *supra* note 10, at 550-51.

[12] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 123-125 (11th ed. 2010) (discussing shareholder voting rights).

[13] Larry Hamermesh is the Ruby R. Vale Professor of Corporate and Business Law, Director, Widener's Institute of Delaware Corporate Law. http://tinyurl.com/grs322d.

[14] *See* SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 87.

[15] *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 584-91 (1990) (discussing rational apathy, and shareholder's incentives to become informed); Gulinello, *supra* note 10, at 573-74 (discussing rational apathy of retail investors).

regarding the election of directors or other corporate matters. For such a shareholder, it is simply economically rational to stay uninformed and not to vote at all.[16]

Investors' rational apathy, which is a natural result of the dispersion of ownership and diversification of investor portfolios, has been a long-standing problem of public firms.[17] Yet, one can rightfully wonder whether technological changes, such as the employment of the Internet to facilitate shareholder voting, have eliminated it. Additionally, the recent rise in shareholder activism and proxy fights that received strong media coverage, and the increased attention that companies direct to their shareholder base,[18] could have potentially mitigated shareholders' apathy—rational or behavioral—making it more likely that shareholders would exercise their right to vote. Surprisingly, however, despite these technological advances and structural changes in the corporate governance landscape, evidence we present in this Part shows that the problem of investors' apathy continues to exist in a significant manner, and it could have a substantial impact on the voting results.

So how significant is investors' apathy? For that end, we conducted an empirical research, investigating the total percentage of shares that were not voted in each of the matters standing for a vote at S&P 500 companies in the years 2008-2015 and found two significant trends.[19] First, the percentage of shares that do not vote is very significant, standing at 21.7% of the total votes in 2015. Second, we identify that non-participation rates have been trending up, further exacerbating the issue. Since 2008 the percentage of non-voting shares has jumped by 42% from 15.2% in 2008 to 21.7% in 2015.

This significant increase in non-participation could be explained, at least partially, by changes in the ability of brokers to vote shares that they received no voting instructions for (often termed as "Broker Non-votes"). Since around 85% of equity shares listed on stock exchanges are held by brokers in "street name" on behalf of clients,[20] retail investors' *true* apathy was often masked by the ability of their brokers to cast votes

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[16] *See* Black, *supra* note 15, at 584; Gulinello, *supra* note 10, at 573-74.

[17] *See* Frank H. Easterbrook & Daniel R. Fischel, THE ECON. STRUCTURE OF CORP. L. 66 (1991); Black, *supra* note 15.

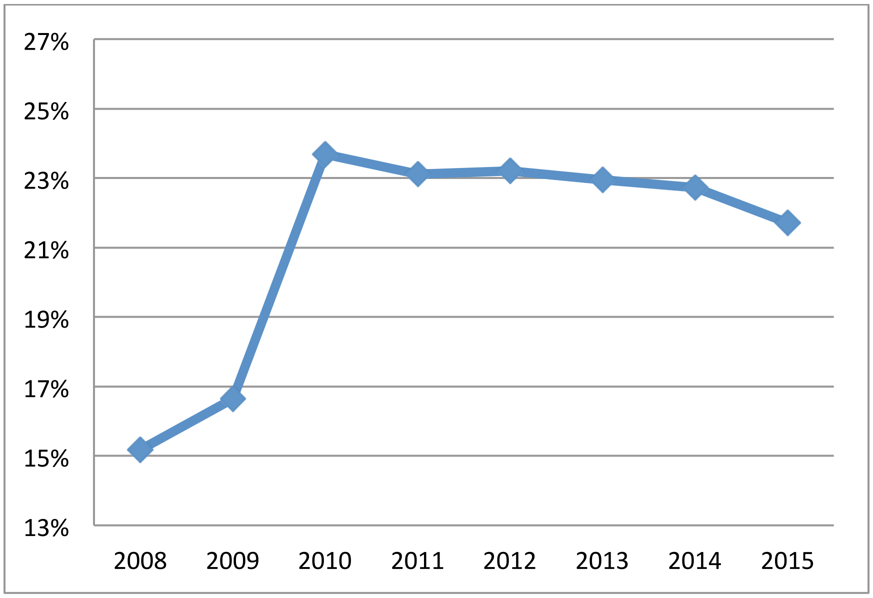
[18] *See, e.g.*, CFO Journal, *Shareholder Engagement: A New Era in Corporate Governance* (Oct. 4, 2013), *available at* http://tinyurl.com/z6kbgb9.

[19] Data was obtained from the SHARKREPELLENT database and is valid through September 2, 2016. The SHARKREPELLENT database contains various statistics on all public companies in the U.S., including broker non votes, votes cast and total votes outstanding for the years 2008-2015. Data *available at* https://sharkrepellent.net/.

[20] *See* SEC, *Roundtable on Proxy Voting Mechanics* (May 23, 2007), *available at* http://tinyurl.com/au7lv9 ("Approximately 85% of exchange-traded securities are held by securities intermediaries").

on behalf of their clients, when the latter did not provide voting instructions.[21]

Figure 1: Percentage of Non-Voting Shares in S&P 500 Companies



However, in 2009 and in 2011 the NYSE made significant changes to the ability of brokers to vote on such uninstructed votes, prohibiting brokers from casting votes in uncontested director elections starting in 2010, and further limiting their ability to cast votes on "non-routine" corporate governance matters in 2012.[22] As brokers have become more restricted in their ability to vote uninstructed shares, the true scope and impact of retail investors' apathy is finally revealed.

Indeed, as *Figure 2* further illuminates, in matters where brokers were allowed to vote uninstructed shares throughout the 2008-2015 period, such as ratifying auditors, the voting trends remained constant with total non-participation of around 13.5%. However, non-voting percentages have spiked in matters where brokers were no longer allowed to vote such shares. In uncontested elections the non-participation rate jumped from 14% to 24%, dragging with it the total

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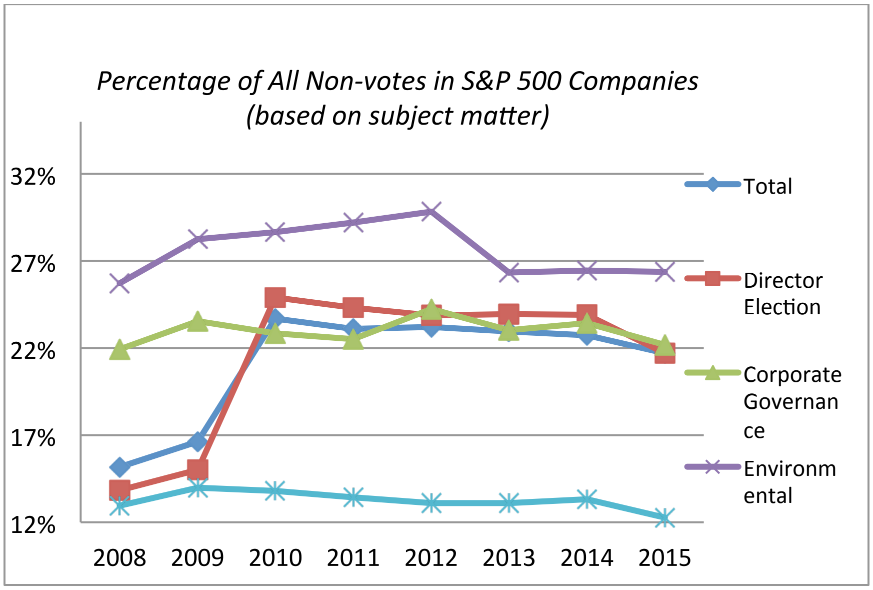
[21] Gulinello, *supra* note 10, at 563.

[22] *See* Securities and Exchange Commission Release No. 34-60215 (July 1, 2009), *available at* http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf; Update – NYSE Expands Range of "Broker May Not Vote" Matters Under Rule 452, SEC. L. ADVISORY, (Jan. 26, 2012), *available at* http://tinyurl.com/alston-bmnv.

rates that we reported in *Figure 1*. Similarly, a more nuanced increase is observable in corporate governance matters where a second wave of restrictions took place in 2012.

Figure 2: Percentage of All Non-Voting Shares in S&P 500 Companies Divided by Subject

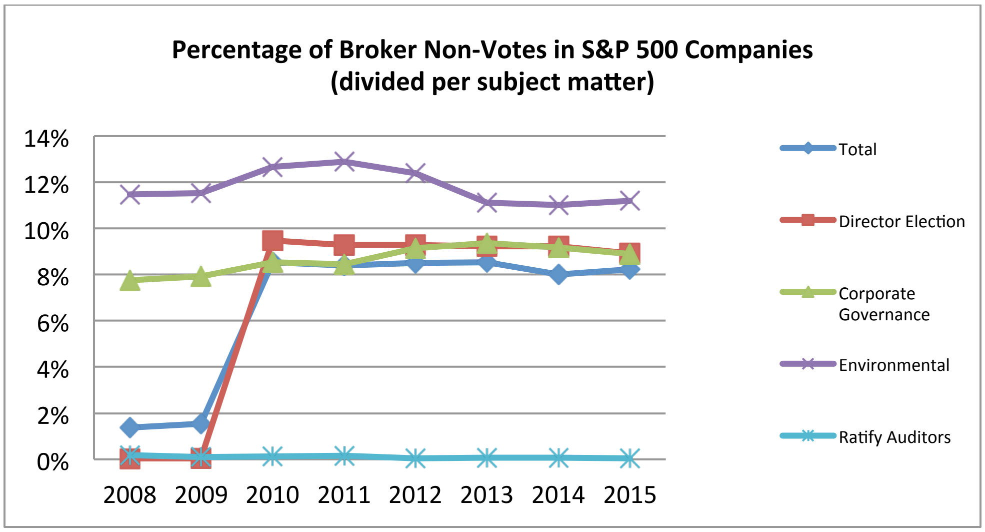


We further corroborate these trends with an examination of the broker-non-votes percentages on all matters that were brought to a shareholder vote in the S&P 500 for the years 2008-2015. Similar to existing studies,[23] we find that the level of broker-non-votes has been averaging at around 8-9% after the 2010 restriction on director election voting took force, with varying levels depending on the type of subject matter. The significant increase in the prevalence of broker-non-votes that has led to an overall increase in the ratio of shares that do not vote, coupled with the fact that retail investors' participation has remained low despite the increase in shareholder activism and the increasing requests

[23] *See* Client Alert, Wilson Sonsini Goodrich & Rosari, P.C., *SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections* 2 (July 15, 2009), *available at* http://tinyurl.com/rule452 (finding that in 2008 brokers who had not received instructions from their clients voted 16.5% of all shares voted in public corporations); *see also* Scott Hirst, *Frozen Charters*, 34 Yale J. on Reg. (forthcoming, 2017), at 24 (finding that in 2012 the average level of uninstructed broker votes was 10.4% of outstanding shares in director election of US Russell 3000 companies).

by companies for shareholder input in recent years, validate our concern that retail investors' apathy is of a large magnitude.

Figure 3: Percentage of Broker Non-votes in S&P 500 Companies Divided by Subject



One may also argue that retail investors "discriminate" in their voting behavior, showing higher participation rates in matters where their vote is important to them.[24] However, our findings dispel this hypothesis, as we find that retail investors' apathy varies little between the different types of matters brought to a vote in 2015, and that such variance is mainly explained by higher broker non-votes ratios rather than in the underlying overall participation rates.

Additionally, no significant change in retail investors' voting behavior is found when comparing total non-participation rates in 2008 with 2015 based on subject matter. As *Figure 5* below shows, non-participation rates have remained practically the same in matters where brokers are allowed to vote (such as auditors' ratification and environmental issues) and have only changed significantly in the case of director election where broker non-votes became a factor post 2010.

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[24]*See* Tara Siegel Bernard, *Voting Your Shares May Start to Matter*, N.Y. TIMES – Stocks and Bonds (Mar. 5, 2010), *available at* http://tinyurl.com/nyt-vysm; Gulinello, *supra* note 10, at 553 (discussing a situation in which a shareholder will act when the harm being done by the director outweighs the cost of replacing the director).

Figure 4: Percentage of Non-votes in S&P 500 Companies Divided by Subject for the Year 2015

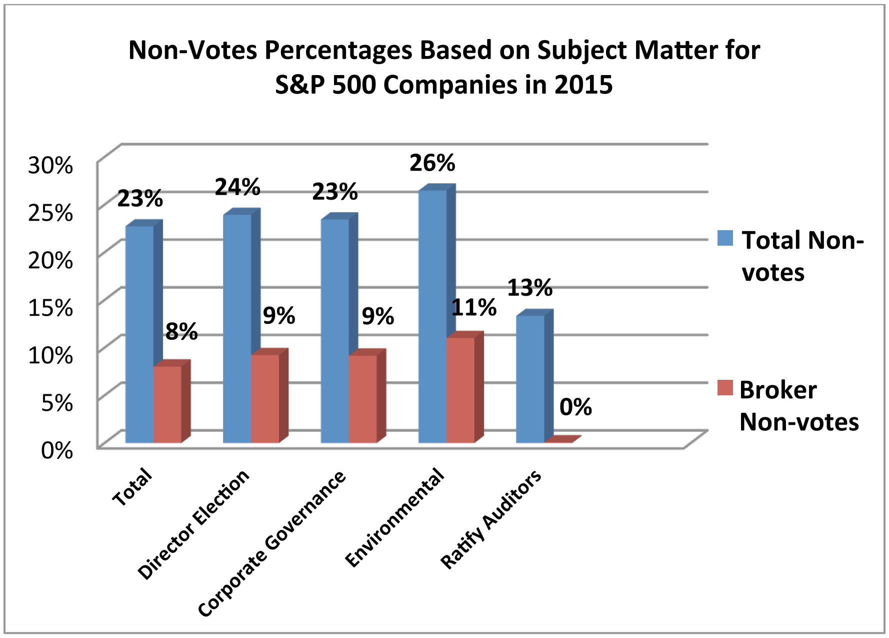
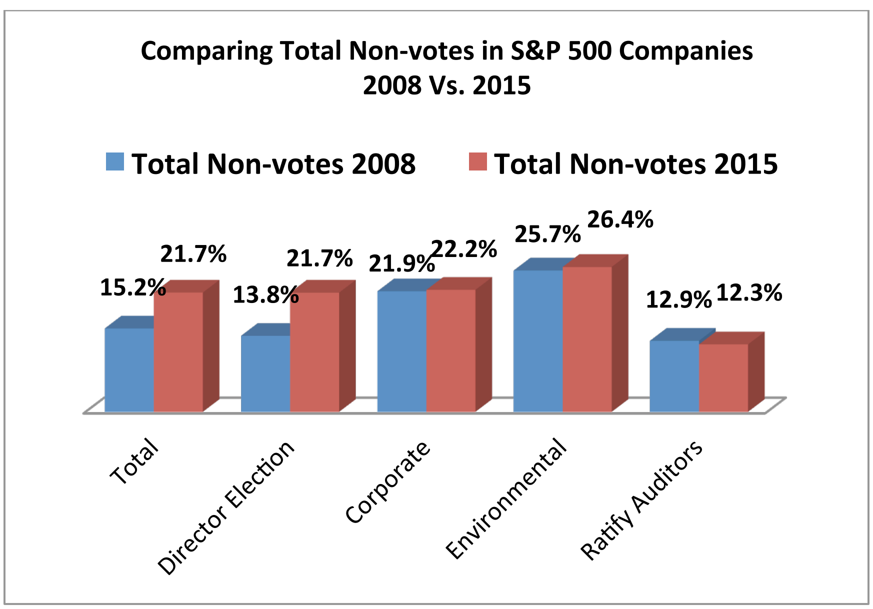


Figure 5: Comparison of Non-votes in S&P 500 Companies divided by subject matter



To sum up, our empirical findings lead to several important observations. First, retail investors' apathy, as proxied by the percentage of non-voting shares,[25] is very significant (more than 20% of all outstanding shares at the average). Second, non-participation trends have been on the rise, led by more restrictions on the ability of brokers to use their own discretion and vote uninstructed shares, fully exposing the true magnitude of retail investors' non-participation. Third, retail investors show little sensitivity to the subject matter when deciding whether to vote. Their apathy is simply exercised across the board. Finally, retail investors have not responded to movements in the corporate governance landscape or to improvements in the voting system, showing similar levels of non-participation over time (when broker non-votes are excluded).

These findings are particularly important when considering the impact that retail investors' votes may have. As we demonstrate below, full participation in the election process becomes particularly important when management faces a contested election, when a withhold campaign is organized against incumbents, or when a shareholder proposal to initiate an important governance change is brought to a vote at the annual meeting. Mobilizing 10-15% of the eligible voters could have a substantial impact on the final voting results of those campaigns or proposals, and could make the difference between having a shareholder initiative pass or fail.

B. *The Unintended Effect of Shareholder Empowerment*

The recent overall increase in the ratio of non-voted shares presented in the previous subsection, coupled with the finding that retail investors' participation has remained low over time (even when broker non-votes are excluded), is not trivial. One should expect that technological improvements (such as the implementation of online voting), as well as the recent rise in shareholder activism and the adoption of regulatory reforms that empower shareholders, all could have led to an increase in the involvement and participation of shareholders. In this section we argue that while such movement towards a shareholder franchise and the enforcement of enhanced disclosure requirements were aimed at restraining managerial entrenchment, they also had an unintended consequence: increasing the costs associated with exercising an informed vote, and thus, aggravating the problem of investors' apathy.

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[25]Note that institutional investors vote in rates of over 90% while retail investors only vote approximately 30%.

The public outcry regarding excessive executive compensation in the late 1990's, the corporate scandals of the early 2000's, and the aftermath of the financial crisis in 2008 have led to increased regulatory intervention aimed at providing additional monitoring rights and information to shareholders.[26] In particular, those regulatory changes enhanced disclosure requirements and the input given by, and expected of, shareholders regarding different corporate affairs by subjecting more issues to a shareholder vote.[27] Additionally, shareholders themselves have become more involved in the governance of the public firms by submitting a larger number of proposals and through the emergence of activist hedge funds that have raised the volume of contested elections.[28] In this Part, we discuss these regulatory changes and their unintended impact on retail investors. Specifically, we classify these changes into three main categories:

(i) *More information.* Disclosure requirements have dramatically intensified during the past 20 years, causing proxy statements to become substantially longer.[29] This new atmosphere has also increased the scope of additional voluntary disclosures by companies.[30] These regulatory and market changes, taken together, have increased complexity and sheer volume to financial and other reporting.[31] As a result, in today's proxy statements, investors are required to review a significantly larger volume of complex materials before making a decision regarding their vote.

(ii) More Input Requested. A related, yet different, aspect of the changing landscape in corporate governance is the greater power and input given to, and expected of, shareholders regarding different corporate affairs. Over the past decade there has been a pivotal shift in corporate governance thinking toward a "shareholder franchise" approach,[32] which results in the empowerment of shareholders, vis-à-vis management, in an effort to limit managerial slack.[33] This shift had two

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[26]*See infra* notes 29-35.

[27]*Id*.

[28]*See infra* notes 36-40.

[29]Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 124-25 (2004) (describing the voluminous information that U.S. public companies produce to comply with disclosure requirements); *See also* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 473-75 (2007) (describing SEC intensive disclosure requirements and noting that and that "academics have paid considerable deference to mandatory disclosure as a solution to myriad problems of corporate governance").

[30]*See* Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA L. REV. 1047, 1108-09 (2009) (noting the increase in voluntary disclosure by companies).

[31]*See supra* note 29.

[32]*See, e.g.*, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA L. REV. 675, 676 (2007).

[33]Professor Bebchuk, who is the main proponent of this approach, has published several papers advocating this change. *See generally* Lucian A. Bebchuk*, The Case for*

main manifestations. First, recent regulatory changes have eased the ability of shareholders to voice their opinions on various corporate governance matters. The adoption of a say-on-pay rule by the Congress in 2010,[34] which requires U.S. public companies to conduct an advisory shareholder vote on executive compensation proposals, has been at the forefront of these changes.[35]

Second, shareholders themselves have become more active, forcing companies to put more matters to shareholder vote.[36] As noted earlier, the number of shareholder proposals brought to a vote has increased dramatically in the past decade, allowing voting shareholders to express their views on a greater number of corporate matters at each annual meeting.[37] In addition to the plethora of non-binding matters shareholders need to decide on,[38] shareholders are now more often requested to cast a binding vote as management has been submitting its own resolutions in response to surging shareholder proposals.[39] Finally, the increasing rate of contested director elections,[40] staged by activist hedge funds, has similarly engulfed shareholders with solicitation materials by both management and the activist.

(iii) Broader Portfolios. Retail equity holdings increased by 50% from 2010 to 2014,[41] and most retail investors nowadays hold larger sets

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Increasing Shareholder Power, 118 HARV. L. REV. 833 (2005)*;* Lucian A. Bebchuk, *Response to Increasing Shareholder Power: Reply: Letting Shareholders Set the Rules,* 119 HARV. L. REV. 1784 (2006); s*ee also* Amicus Brief of Harvard Law School Faculty submitted to the Second Circuit in *AFSCME v. AIG* (along with other HLS professors), *available at* http://tinyurl.com/jdabmtj.

[34]*See* Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) (requiring that the S.E.C. will set some rules in regard to executive compensation and shareholder ratification of such compensation ("say on pay")). Section 14A of the Securities Exchange Act of 1934 and the rules thereunder subsequently adopted by the SEC, as part of the Dodd-Frank Act, implement the requirement to conduct a nonbinding vote on executive pay. 15 U.S.C.A. § 78n-1; 17 C.F.R. § 229.402. In addition, the bill regulates sophisticated financial players and thus potentially limits their incentives and tools for activism. For a review of the main provisions of the act, *see* DAVID A. SKEEL Jr., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (John Wiley & Sons, 2010). For a critical review of the act, *see* Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2010).

[35]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1900 (2010).

[36]*See infra* notes 59-61.

[37]*See supra* Part II.B.

[38]For a review of all shareholder proposals submitted in 2014, *see* Rajeev Kumar, *2014 Corporate Governance Review*, GEORGESON (Oct. 23, 2014), *available at* http://tinyurl.com/rajk-14.

[39]*Id.*

[40]*See* John Lovallo, *Proxy Contests on the Rise – Activists Emboldened by Success*, LEVICK DAILY (Oct. 28, 2013), *available at* http://tinyurl.com/lovallo-20x13.

[41]*See* Table L.213 of the Federal Flow of Funds Accounts Release, Financial Accounts of the United States*,* FEDERAL RESERVE STATISTICAL RELEASE (Dec. 11, 2014)

of companies than in the past.[42] Even if all other things are held equal, the fact that many retail investors now have larger portfolios means that shareholders are not only tasked to make an informed choice on various and growing number of matters at any given company, but that they are also required to make these choices for a growing number of companies.

While the abovementioned changes were aimed to increase shareholder power vis-à-vis management, and while they exemplify the importance of having shareholders more involved in corporate matters in order to make the board more accountable, they also had an unintended result: the creation of a chilling effect on participation by retail investors. Paradoxically, the additional control rights that are now allocated to shareholders also increase the costs associated with exercising a vote, leading retail investors to opt-out from the voting process altogether. The longer proxy statements become, the lower the chances that retail investors will actually read them. Similarly, individual investors now have to spend more time and efforts on collecting information and making informed votes on a growing number of matters, and this, in turn, reduces the chances that rational apathetic investors will exercise any vote at all.[43] Consider for instance the example of Apple. In 1994, the company proxy statement had 18 pages, and only two proposals were submitted to shareholder votes.[44] Twenty years later, the company proxy statement was more than five times longer. It held 90 pages (including appendixes), and 11 different proposals were brought to shareholder vote.[45]

Moreover, since many investors tend to diversify their portfolio, they hold stocks in numerous companies. Therefore, during each proxy season, a retail investor who is interested in exercising an informed vote has to read hundreds of disclosure pages and vote on dozens of different proposals. This information overload and the need to exercise so many votes during one single proxy season could be overwhelming for an individual investor, and she may give up on voting all together.

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http://tinyurl.com/3rs4v3; *see also* Jawad M. Addoum, *Household Portfolio Choice and Retirement* (working paper, 2014) (documenting the increasing importance of retail investment as in 2011 they directly held stocks valued at $8.1 trillion who make up an important fraction of equity holdings in the US).

[42]*See* Brad M. Barber & Terrance Odean, *The Behavior of Individual Investors*, 2 HANDBOOK OF THE ECONOMICS OF FINANCE 1533 (2011) (citing the proportion an employee invested in their company stock has declined over the past 10 years).

[43]*See generally* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets,* 95 VA. L. REV. 1025, 1047 (2009) (describing the behavioral findings that when faced with complex numerous options the bias towards indecision and the status quo is more pronounced).

[44]*See* Apple Inc., Proxy Statement (Form DEF 14A), (Dec. 12, 1994).

[45]*See* Apple Inc., Proxy Statement (Form DEF 14A), (Feb. 28, 2014).

To be clear, the view presented in this Section is not that the recent regulatory changes or the increased shareholder involvement in corporate governance are unwarranted. To the contrary, we believe that, on average, such changes promote shareholder value by keeping management more accountable to shareholders. We do, however, highlight the negative spillover impact of these changes on the problem of investors' apathy and call on regulators to consider adopting effective voting short-cuts along the lines presented in this Article, which would mobilize retail investors to vote.

III. THE STAKES

Retail investors choose not to vote. They do it in overwhelming numbers. But why should one care if shareholders choose, rationally or otherwise, to stay out of the game? This Part delineates the stakes. Section A presents the potential costs associated with investors' apathy. In contradiction to the traditional belief that retail investors' participation has marginal impact, if at all, on the vote outcome, we show that this is not the case.[46] Additionally, Section A shows that the decision of a large number of investors to remain apathetic, in the aggregate, may have significant costs. Section B explains why retail shareholders' vote and participation in corporate decision making is more important today than it has ever been in the past. Section C presents data on the potential impact of mobilizing retail investors. Finally, Section D further illustrates this impact with the recent case of retail investors' uncommon participation in the DuPont proxy fight.

A. *The Direct Costs of Investors' Apathy*

While it is economically efficient for a small, individual investor to be rationally apathetic, when a substantial number of individual investors avoid voting, this behavior, in the aggregate, negatively externalizes on other voting shareholders, and may be undesirable for the company for three reasons. First, low participation rates among retail investors may distort the voting outcomes. This distortion, as we show, often works in favor of management. Second, investors' apathy also limits the ability of shareholders to successfully initiate important governance changes. Finally, such apathy may lead to dead-lock situations where a governance amendment that is desirable to both management and shareholders would not pass due to low shareholder turnout.

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[46]SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 91-92, 97 (explaining that retail investors "don't vote because they don't really feel like their vote matters").

1. Distorting Vote Outcome

Low retail investors' participation in corporate decision making may distort the voting outcome. Such distortion is created if the voting choices of shareholders who decide not to vote are different from those who exercised votes. This distortion could work in different directions, which we discuss below:

(i) *Distortion in Favor of Management*. A distortion in favor of management occurs when shareholders who did not participate in the election were expected to vote against management in a higher proportion than shareholders who participated in the vote. There are two factors that, in our view, could increase the likelihood of a vote distortion to work in favor of management. First, broker discretionary voting along with the documented tendency of brokers to vote with management is likely to distort the voting results in favor of management in certain situations. NYSE rule 452 allows brokers who had not received instructions from their clients to vote the uninstructed shares based on their discretion if the proposal for shareholder vote is on a "routine" matter.[47] Evidence shows that brokers overwhelmingly vote in the manner recommended by management,[48] and that broker discretionary voting used to constitute a non-negligent number of all shares voted in public corporations.[49] Although the ability of brokers to exercise discretionary voting has been significantly narrowed in recent years,[50] it has not been fully eliminated,[51] and there has been a call for broadening it once again.[52]

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[47] *See* SEC Notice: Order Approving NYSE Proposed Rule Change, To Eliminate Broker Discretionary Voting for the Election of Directors, 74 F 22393-01 (July 10, 2009).

[48] *See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange,* at 14 (June 5, 2006), *available at* http://tinyurl.com/z5pbr5w; *see also* Jennifer Bethel & Stuart Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 42-45 (2002) (finding that routine management proposals, on which brokers are allowed to vote, receive 8% more votes favorable to management); Gulinello, *supra* note 10, at 563-564.

[49] In 2008, for instance, 16.5% of the brokers had not received instructions from their clients. *See* Wilson Sonsini Goodrich & Rosari, P.C., *SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections*, at 2 (July 15, 2009), *available at* http://tinyurl.com/wsgr-452.

[50] *See, e.g.*, Letter from NYSE Regulation to ALL NYSE AND NYSE AMEX EQUITIES MEMBERS AND MEMBER ORGANIZATIONS (Jan. 25, 2012), *available at* http://tinyurl.com/he3bmyn (imposing new limits on the practice of broker discretionary voting by no longer treating corporate governance matters as 'routine' for the purposes of Rule 452. In addition, an earlier amendment to rule 452 from 2009 made director voting in uncontested elections a non-routine matter); *see also* Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60215, 74 Fed. Reg. 33293, 3329395 (July 1, 2009).

[51] For instance, one matter that does appear to remain subject to broker discretionary voting is the ratification of auditors. *See* Alston and Bird LLP Memorandum, *Update – NYSE*

Second, management exclusive power over the proxy process, especially in uncontested situations, could further distort the voting results. Management exercises significant power over the design and content of the proxy materials, the agenda of the meetings, as well as the dissemination of the proxy information.[53] It is likely that through its vast control over the content of proxy materials and the voting process in general, management does as much as it can to mobilize retail investors to vote in favor of management. A striking example from past years was the use of a "Vote with Management" option by most proxy distribution service providers and transfer agents, which gave a stockholder the opportunity to vote, with one click of a button, in accordance with the recommendations of management.[54] This practice, which was subsequently abandoned after the SEC expressed concerns over its impartiality,[55] served as a form of a voting nudge, but only in favor of management.

(ii) *Distortion in Favor of Activist/Dominant Shareholders*. Vote distortion could also be in favor of an activist shareholder who advocates for a change in the business or financial strategy of the corporation that is not supported by all other investors. Activist shareholders often launch, or threaten to launch, a proxy fight against the company to exercise additional pressure on management to accept their view.[56] If usually non-participating retail investors are more likely to vote against the nominees of an activist shareholder because their interests are aligned with those of institutional shareholders opposing the activist shareholder

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Expands Range of "Broker May Not Vote" Matters Under Rule 452 (Jan. 26, 2012), *available at* http://tinyurl.com/gtwkxo2.

[52] *See, e.g.,* Hirst, *supra* note 23, at 60-61, 68-71. For additional critic of Information Memo 12-4, *See generally* Alston and Bird LLP and Bird Memorandum, *supra* note 51; Paul Hastings Memorandum, *NYSE Implements New Restrictions on Broker Discretionary Voting*, (Mar. 2012), *available at* http://tinyurl.com/j69c2bx.

[53] *See infra* notes 125-126.

[54] *See* Ross Kerber, *Proxy Sites Dump One-click Vote Button on SEC Concerns*, (Mar. 20, 2013), *available at* http://www.cnbc.com/id/100574479.

[55] In 2012, the staff of the SEC announced new interpretive guidance under Rule 14a-4 and Rule 14a-2(a)(1) under the proxy rules that impacted the "Vote With Management" button. Under the new guidance, the staff expressed the view that the presentation of a "Vote With Management" button without the presentation of a corresponding "Vote Against Management" button was inconsistent with the plain language of Rule 14a-4 and the "impartiality" requirement of Rule 14a-2(a)(1). This guidance was announced publicly by Tom Kim, the Chief Counsel of the SEC's Division of Corporation Finance, at the Annual SEC Speaks Conference in Washington D.C. in February 2013. Following the new guidance, Computershare, one of the largest transfer agents, and Broadridge, which acts as the agent for most brokers and banks, eliminated the "Vote With Management" option for the 2013 proxy season. *Id.*

[56] *See generally* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007) (discussing the use of proxy fights as a method to gain control by shareholder activists).

proposals, then their decision not to vote distorts the vote result in favor of the activist shareholder.

Similar distortions could be created when the company has a controlling shareholder who holds less than 50% of the voting rights, but still exercises an effective control over the firm by holding a substantial fraction of the firm's voting rights. In such cases, investors' apathy further facilitates the controller's effective control, and corporate decisions that benefit the controllers, but harm other shareholders, are less likely to be blocked. This is because the controller will vote her entire stake in favor of her initiative, and the avoidance of rational apathetic investors from voting will make it harder for other institutional investors who oppose the controller's proposal to obtain the requisite vote in order to block such proposal. This low (and sometimes extremely low) chance to block a controller's proposal could, in turn, provide retail investors with *ex-ante* negative incentives to not participate in the vote, causing the rational apathetic problem to be particularly severe in controlled companies.

In sum, in all of these situations, mobilizing retail investors to cast a vote will reduce the potential distortions in the voting outcome. These distortions work first and foremost against the rest of the shareholder base that does participate in the vote, but faces lower chances to block detrimental governance changes due to the problem of investors' apathy.

2. Limiting Shareholders' Ability to Initiate Governance Changes

Rule 14a-8 of the Securities Exchange Act of 1934 allows a shareholder who meets certain criteria[57] to include a shareholder proposal on the company's own proxy to be voted upon at the company annual meeting.[58] Voting on such a proposal is a major way through which shareholders could initiate, and at times approve, governance changes that were not initiated or supported by management. While shareholder proposals are usually submitted in a non-binding form, they have become an important mechanism to drive governance reforms in the past decade. The number of votes in support of shareholder proposals, and in particular proposals aiming at improving firms' corporate governance, has increased dramatically since early 2000,[59] with an average

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[57]Those criteria include holding shares worth $2000 (or 1% of the market value of equity) for at least one year. *See* Securities Exchange Act of 1934 Rule 14a-8, 17 C.F.R. § 240.14a-8 (2007).

[58]*Id.*

[59]*See* Stuart L. Gillian & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 64-66 (2007) (showing voting support for corporate governance and compensation related shareholder proposals submitted in 2005 is significantly higher as compared to the support rate in 1987-1994 period); Yonca Ertimur,

shareholder support of 45.5% in 2013 and 2014.[60] There has also been a pronounced increase in the rate of management implementation of non-binding shareholder proposals that receive majority support,[61] often due to the increased influence of proxy voting advisory firms.[62]

However, the ability of shareholders to initiate important governance changes might be restricted by the passivity of retail investors. A high shareholder support for governance changes usually increases the likelihood that the board will take steps to implement a non-binding proposal.[63] Such high support rate could serve as a more effective pressure mechanism on management, and it could also provide tangible evidence that the proposal has a real chance to meet the required voting threshold, which is at the minimum 50% of the votes outstanding, but could be even higher due to supermajority requirements. The abstention of retail investors from voting may reduce the number of votes in favor of the suggested governance changes, especially for those proposals that traditionally receive strong support from institutional investors and that retail investors could be expected to support as well if they were to participate in the vote. Investors' apathy, therefore, impairs the ability of shareholders to initiate important governance changes.

3. Creating Deadlock Situations

Retail investors' apathy and their limited participation in corporate decision making could also lead to deadlock situations. Such situations could be caused by the inability of shareholders who choose to participate in the voting process to comply with the quorum or threshold requirement for approving certain governance changes. These deadlock

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Fabrizio Ferri, & Stephen R. Stubben, *Board of Directors Responsiveness To Shareholders: Evidence From Shareholder Proposals*, 16 J. CORP. FIN. 53, 57-59 (2010) (showing the percentage of governance-related proposals receiving a majority vote jumps from 18% (1997–2001) to almost 32% (2002–2004)).

[60]Shareholder proposals that attracted particularly high rate of support in 2013 and 2014 (on average) are: board declassification (81.5%); majority voting (59.5%); eliminate super majority provisions (69.5%); right to call special meeting (51%) and proxy access proposals with 3% and 3-year thresholds (44%-65%). *See*, Sullivan & Cromwell LLP memorandum, *2014 Proxy Season Review* (Jun. 25, 2014), *available at* http://tinyurl.com/sc-p14r.

[61]Renneboog & Szilagyi, for instance, show that rate of implementation of passed proposals grew dramatically from 17.1% between 1996 and 2000, to 23.6% in 2002 and 70.1% in 2005. *See* Luc Renneboog & Peter G. Szilagyi, *The Role of Shareholder Proposals in Corporate Governance*, 17 J. CORP. FIN. 167, 173-75 (2011).

[62]For instance, when management ignores shareholder proposals that receive majority support, proxy advisory firms are likely to recommend against votes on individual directors or the entire board at future annual meetings. *See* Sullivan & Cromwell LLP memorandum, *supra* note 60, at 22-23.

[63]*Id*. at 27.

situations are particularly troubling when both management and the shareholders who participate in the vote are interested in the same outcome for a matter that is brought to a shareholder vote. However, they are unable to achieve this outcome because the vote is subject to special approval requirements that are a percentage of shares outstanding (such as special supermajority requirement or an approval of majority of minority shareholders), and the vote fails to receive such required threshold due to a low shareholder turnout. Therefore, although an outcome is desirable for both management and shareholders, the parties are unable to pass it due to investors' apathy.

One major example for a deadlock situation is the case of "frozen charters". A recent study shows that a non-negligent number of charter amendments, that by rule have to be initiated by management, have failed since 2012 despite receiving over 90% shareholder support.[64] The study also estimates that there are hundreds of U.S. public corporations that are unable to amend their charter due to the combination of low shareholder turnout and approval requirements that are a percentage of shares outstanding. The problem of deadlock situations that rational apathetic investors create is, therefore, an acute one.

B. *The Increasing Importance of Retail Investors' Vote*

In this Subsection we show that recent changes in U.S. corporate governance landscape, including the increasing frequency of proxy fights, withhold campaigns, the adoption of say-on-pay votes, and majority voting standards, have made retail investors' votes more important than they have ever been in the past. In this new reality, where just a few percentages of votes can make a big difference, and where the threshold of voting impact is not always the 50.01% majority requirement, but often much less (in the range of 30%), retail investors' lack of participation may have significant impact on the results of matters brought to a vote of shareholders.

In particular, retail investors' participation may generate greater impact due to the following reasons: First, the rise in shareholder activism over the past decade has transformed the corporate landscape by increasing the frequency and matters on which companies are challenged in the ballot or through tender offers.[65] As the recent case of DuPont discussed in Subsection D demonstrates, in a close proxy contest, retail

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[64]Hirst, s*upra* note 23, at 40-41, 75-77.

[65]*See, e.g.*, Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. (2014); Steven Davidoff Solomon, *As Activist Investors Gain Strength, Boards Surrender to Demands*, N.Y. TIMES: DEALBOOK (Oct. 14, 2014), http://tinyurl.com/nyt-db-14x14.

investors' turnout is especially important, as every vote can affect the outcome.[66] Indeed, issuers and activist hedge funds recognize the important role that retail investors play in those cases, and are willing to pay proxy solicitation firms millions of dollars to go find those retail investors, and persuade them to vote when needed.[67]

Second, the increasing importance of proxy advisers coupled with the credible threat of withhold campaigns against companies that ignore shareholder concerns have led corporations to pay closer attention to precatory shareholder proposals that receive significant support by shareholders. The guidelines of ISS and Glass Lewis, the two largest and most influential proxy advisory firms, require companies to act upon shareholder resolutions that pass.[68] If management ignores successful shareholder proposals, proxy advisory firms are likely to recommend "against votes" on individual directors (or the entire board), and such directors could be subject to potential withhold campaigns. In essence, such practice has transferred so called "precatory" shareholder proposals into "quasi-binding" resolutions. This suggests that companies nowadays face more severe sanctions if an unwelcomed shareholder proposal passes.[69] Since a few percentages of votes in favor could make the difference, especially in the context of governance proposals that traditionally receive strong shareholder support, retail investors' participation could be outcome determinative and have a real impact on directors' chances to be re-elected.

Indeed, the ability of shareholders to discipline board members through withholding votes from directors' nominees has become a major way for passive shareholders to express their voice within the current regulatory framework and to signal to the board that they are dissatisfied with its actions. Aside from the lack of responsiveness to shareholders, the guidelines of leading proxy advisory firms also recommend that shareholders withhold their vote when boards engage in problematic practices, such as: unilateral bylaw/charter amendments that materially diminish shareholder rights, problematic audit-related practices, concerning compensation practices, lack of board independence, and

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[66] *See infra* Part III.D.

[67] *See infra* notes 81-84 and accompanying text.

[68] *See, e.g.*, ISS, 2015 U.S. PROXY VOTING SUMMARY GUIDELINES 38, 41 (2015), *available at* http://tinyurl.com/iss-p15; GLASS LEWIS & CO., LLC, PROXY PAPER GUIDELINES 2015 PROXY SEASON, 1, 7-8, 28, *available at* http://tinyurl.com/g-15gus.

[69] *See* Kobi Kastiel, *Against All Odds: Shareholder Activism in Controlled Companies*, 48-49 (Olin Working Paper, 2015) (discussing the mechanism behind the increasing disciplinary effect of 14a-8 shareholder proposals); Ertimur, Ferri, & Stubben, *supra* note 59, at 60-64 (providing empirical evidence that managers and directors who ignore majority vote shareholder proposals are more likely to face sanctions in the labor market).

other general governance failures.[70] However, when a non-negligent number of shareholders avoid participating in the vote, the ability of shareholders to convey their dissatisfaction with the board's poor practices is impaired. This is because the voice of shareholders is diluted, which, in turn, reduces boards' incentives to remain accountable to shareholders. The retail investors' decision not to vote at all, nowadays, plays an important role in undermining this new balance of powers between the board and shareholders.

Relatedly, in recent years there has been a significant increase in the adoption of majority voting policies.[71] When a company adopts an effective majority voting policy, directors who receive less than a majority support of the votes casted are required to resign.[72] Here again, since a few percentages of votes in favor could make the difference for a director who faces a risk of removal, retail investors' participation could be particularly important and may determine the outcome of a vote.

Finally, even when a resolution or a matter does not receive the necessary majority vote, the ratio of shareholder support (or objection) may still have significant impact on the corporation. In that context, shareholder participation can make a difference even when it does not cross the bright line requirement many investors traditionally considered as the threshold for success. For instance, evidence shows that companies reconsider and revise their compensation packages even if their "say-on-pay" vote has passed but received a strong objection ratio of 20%-30% of all outstanding votes.[73] Similarly, recent work has found that director turnover starts happening as soon as directors are getting 30% dissent votes.[74] Shareholders no longer need to gather a majority of votes to force management's hand. And if the new 50% action-threshold

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[70] *See*, *e.g.*, ISS, 2015 U.S. PROXY VOTING SUMMARY GUIDELINES 38, 41 (2015), *available at* http://www.issgovernance.com/file/policy/2015ussummaryvotingguidelines.pdf.

[71] *See, e.g.*, Claudia H. Allen, *Study of Majority Voting in Director Elections*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 23, 2007), http://tinyurl.com/harv-23xi7 (showing that the percentage of S&P 500 that adopted a form of majority voting increased from only 16% in 2006 to 66% in 2007). *See also* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 464, 466 (2007) (noting a trend towards director voting from plurality to majority voting).

[72] Allen, *supra* note 71.

[73] SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 95. If a company receives less than a 70% favorable vote in the prior year's say-on-pay vote, ISS may not only recommend a negative say-on-pay vote but also may recommend votes against individual directors, especially those on the compensation committee, unless ISS is convinced that the company has made a satisfactory response to the negative vote. *See* ISS, *supra* note 70, at 12.

[74] SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 91-92. *See also* Peter Iliev, Karl Lins, Darius Miller & Lukas Roth, *Shareholder Voting and Corporate Governance Around the World,* 28 REV. FINANC. STUD. No. 8, 2168, 2188-89 (2015) (finding that greater dissent voting is associated with higher director turnover).

is now 25-30%, then the importance of any single retail investor vote has respectively appreciated in its value.[75]

C. *Empirical Evidence on the Impact of Retail Investors' Vote*

So far we have described the costs associated with investors' apathy by conducting a general analysis as to how the lack of retail investors' participation can distort voting results. We now turn to an empirical analysis of the potential impact of increased retail investor voting. In this Subsection, we examine how an increase in retail investors' participation will impact the potential outcome of any given vote. Our findings support our assertion that increasing retail investor participation could have great impact on the governance of U.S. firms.

Specifically, we collected voting data and results on all of the corporate governance proposals that were brought by shareholders in S&P 500 companies in 2014. We then measured their sensitivity to outcome change on three levels. The first and widest level contained all votes that received a support rate ranging between 35-65%. This 15% sensitivity level observes cases where a 15% net increase in support (objection) rates due to increased retail investors' participation would have changed the outcome of the vote. The second level ranged from 40-60%, thus requiring only 10% movement. The third and narrowest level focused on the 45-55% rate, looking at the extremely likely cases where only a 5% movement was needed. As Chart A below shows, we found that 15% of all votes on corporate governance matters ranged in the 45-55% range—meaning that mobilizing an additional 5% of the outstanding votes could have had an impact on the proposal outcome. Similarly, we found that an increase in voting rates of more than 10% (15%) could have impacted close to 25% (38%) of all corporate governance matters brought to a vote by shareholders.

In addition to examining precatory shareholder proposals, we also collected data on all cases of contested elections (proxy fights) during the 2014 calendar year in the Russell 3000 index that came to a shareholder vote[76] and found a similar, significant, potential impact. In each case we measured the minimum additional number of votes needed by the highest

[75] *See, e.g.*, SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 102 (Mr. Alan Beller stating that "What I think is changing is as some people have said, twenty or thirty is now an important number in terms of things. You didn't have Say on Pay ten years ago, you didn't have vote no campaigns ten years ago and twenty to thirty is the new fifty, and I think what we're seeing some of the developments of encouraging retail to vote more and some of this retail catching on to vote more is a recognition that, if outcome determinative is twenty-five, retail is much more important than if outcome determinative is fifty-one and that's a phenomenon that I think we're seeing so that was what I wanted to throw out.").

[76] The data are collected from SHARKREPELLENT. *See supra* note 19.

vote-receiving *losing director nominee* in order to get elected (or alternatively the number of additional votes that would cost the lowest vote receiving elected director her seat).

Chart A: Sensitivity Analysis on All S&P 500 2014 Corporate Governance Related Shareholder Proposals

Range	Number of Proposals in The Range	Total Sample Size	Percentage
45-55	30	208	**14.42%**
40-60	51	208	**24.51%**
35-65	80	208	**38.46%**

As Chart B below details, we found that in 10 cases out of a total of 21 contested elections (47.6%) a change would have been theoretically feasible if voting turnout had been higher. Such theoretical change in the election result is feasible because the percentage of shareholders that did not participate in the election is higher than percentage of additional votes needed to change the election results (and assuming that voting distribution of retail investors would have had an impact on the likelihood of such a change). More importantly, in 6 cases out of the 21 contested elections (28.5%) a change in the outcome would have been highly likely as the percentage of shareholders that do not vote is at least three times higher than the percentage of votes needed to change the election results.

In sum, our findings show that mobilizing eligible voters could have a substantial impact on the final voting results of a contested election or a shareholder proposal that is brought to a vote at the annual meeting, and could make the difference between having a shareholder initiative pass or fail.

Chart B: Sensitivity Analysis on All 2014 Russell 3000 Contested Elections

Company	Total Vote Difference	% of Outstanding	% of Total No-votes out of Outstanding Shares	Minimum % of the Non-Voting Shares Needed
Alco	441,000	13.53	41.887	32
Anworth Mortgage	48,468,115	36.56	30.7	>100
Bob Evans Farms	132,035	0.5	13.05	4
Cliffs Natural Resources	1	0.0001	34.12	0.0001
CONMED Corporation	5,589,615	20.44	10.95	>100
Darden Restaurants	45,387,102	34.23	21.1	>100
EVINE Live	970,545	1.94	12.61	15.4
Echo Therapeutics	3,783,352	31.71	34.06	93
Forward Industries	2,107,929	23.07	30.93	74
GrafTech International	76,119,002	56	10.24	>100
Griffin Land & Nurseries,	773,251	15.02	2.3	>100
Hampden Bancorp	1,132,649	20.46	26.46	77
Harvard Illinois Bancorp	149,359	17.78	8.09	>100
Hudson Global	20,659,000	62.84	10.59	>100
Morgans Hotel Group	1,269,269	3.71	12.27	30
Sensient Technologies	704,363	1.4	9.57	14.6
Spark Networks	14,068,920	59.04	16.35	>100
Superior Industries International	13,244,918	49.21	9.97	>100
Telephone and Data Systems	33,779,880	19.49	30.39	64.1
The Pantry	5,747,987	24.504	11.14	>100
XenoPort,	39,882,447	64.43	11.98	>100

D. *The Case of DuPont*

The recent high-profile proxy fight between DuPont Co., the 212-year-old chemical company, and the activist hedge fund Trian Fund Management LP further highlights our claim regarding the increasing importance of retail investors' participation in the voting process, and their ability to impact corporate America more than ever before. As a Wall Street Journal reporter familiar with the fight correctly observes:

> The proxy battle between DuPont Co. and Trian Fund Management LP pits the industrial giant against one of Wall Street's most successful activist investors, and it involves financial institutions that manage billions of dollars. But the outcome could come down to […] individual investors...[77]

Trian's engagement with DuPont first became public in September 2014, when the hedge fund disclosed that it sent a letter to the company's board. The letter criticized management's failure to meet earnings targets and urged it to initiate certain strategic changes, including a split of DuPont into two companies.[78] DuPont rejected the activist's proposal to breakup the company, claiming that it would needlessly distract management from its business plan to refocus on more-profitable products.[79] The activist engagement soon evolved into a high-profile boardroom battle after Trian announced the nomination of four director candidates for election to the board at the company's 2015 annual meeting, including Trian's Chief Executive, Nelson Peltz.[80]

DuPont, with a market capitalization of about $66 billion, has estimated it has about 600,000 retail investors that hold about 33% of its equity, which is a higher retail holding percentage than the average S&P 500 company.[81] And since both parties expected the results of the vote to be close, retail investors became critical players in one of the biggest proxy contests in history. As such, the parties and their proxy soliciting firms spent millions of dollars to go find them. According to certain estimates, DuPont paid $15.4 million to its proxy soliciting and had about 200 employees working on the fight and gathering every possible

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[77] Jacob Bunge, *DuPont's Swing Voter: The Small Investor*, WALL ST. J., (May 6, 2015), *available at* http://tinyurl.com/wsj-6v15.

[78] *See* Trian Press Release, *Trian Partners Delivers Letter and White Paper Summary to DuPont Board*, BUSINESSWIRE (Sep. 17, 2014), *available at* http://tinyurl.com/bw-17ix14.

[79] *See* Bunge, *supra* note 77.

[80] *See* Trian Press Release, Trian Partners Nominates Four Highly Qualified Candidates for Election to DuPont Board, BUSINESSWIRE (Jan. 8, 2015), *available at* http://tinyurl.com/z2kognk.

[81] *See* Bunge, *supra* note 77.

vote from retail investors.[82] Trian did not lag much behind, spending $8 million and hiring about 175 employees to solicit votes.[83] Mom-and-pop shareholders were bombarded with emails, phone calls and advertisements in local and national newspapers, and both parties also created dedicated websites for the proxy contest.[84]

In the end, and after a close vote, DuPont won the battle, having all of its candidates elected.[85] It was the first activist campaign Trian had lost since Peltz co-founded the firm a decade ago.[86] The vote results show that the parties' concentrated efforts to mobilize retail shareholders proved vital to the outcome. We found that the shareholder participation rate in the company's 2015 annual election was 11% higher than in the 2014 annual meeting (rising from 65.6% to 77.0%).[87] Since only 6% of votes (out of the company outstanding shares) separated between Nelson Peltz and DuPont's board nominees who received the lowest number of votes,[88] and since retail investors are the ones who usually refrain from voting, it is likely that the additional 11% of votes in 2015, were instrumental to the final outcome.

The actual impact of retail investors to the final result is even larger when taking into account the strong institutional support for Trian's candidates. For instance, Glass Lewis and ISS recommended shareholders vote for the election of Nelson Peltz to the DuPont board, and California State Teachers' Retirement System (CalSTRS) also announced support for candidates proposed by Trian Partners.

In sum, the case of DuPont clearly demonstrates that mobilizing retail investors is not an impossible task. When issuers and their proxy solicitors get the attention of retail investors, they could also persuade them to vote. And in certain instances, such as in hotly debated proxy fights, withhold campaigns, and close votes on governance matters, retail investors' participation could actually determine the outcome.

Yet, the DuPont case also shows that the parties' outreach activities could be extremely costly, mounting to millions of dollars for an annual meeting. The limitations of the current regime are thus exposed, as the high costs of engagement to increase retail participation substantially reduce the likelihood that all issuers will actively engage in

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[82] *See* Bunge, *supra* note 77.

[83] *Id*.

[84] *Id*.

[85] *See* E. I. du Pont de Nemours and Company, Proxy Statement (Form 8-K/A) (Jun. 9, 2015).

[86] Tim Loh & Jack Kaskey, *DuPont Retail Investors Prove Decisive in Defeat of Trian*, BLOOMBERG (May 13, 2015), *available at* http://tinyurl.com/zduld7l.

[87] E. I. du Pont de Nemours and Company, Proxy Statement (Form 8-K/A) (June 9, 2015); E. I. du Pont de Nemours and Company, Proxy Statement (Form 8-K) (Apr. 23, 2014).

[88] *See* E. I. du Pont de Nemours and Company, Proxy Statement (Form 8-K/A) (June 9, 2015).

mobilizing investors before every annual election. The solution we advance in this Article is aimed at achieving similar results, but for all public companies and with substantially lower costs.

IV. BEHAVIORAL ECONOMICS AND INVESTORS' APATHY

Behavioral law and economics (BLE) has been broadly regarded in recent years as one of the most promising developments in public policymaking.[89] Surprisingly, despite the broad implications of BLE to many fields, including retirement savings, consumer credit, health issues, and environmental protection,[90] its implication to corporate governance remains at the margin of the BLE discourse. This Part discusses the rise of behavioral economics and its different uses in the legal field. In particular, we focus on the concepts of bounded rationality and on nudging tools that BLE scholars advocate for. In our view, these tools could prove to be extremely beneficial in encouraging retail investors to vote.

A. *The Emergence of the Behavioral Law and Economics Movement*

The BLE movement has been attracting a lot of attention in recent years, as an increasing number of studies systematically documented the numerous ways that human behavior differs from the rational behavior assumed by neoclassical economics.[91] In particular, BLE literature documented that rationality is bounded. Brain and time limitations lead rational people to adopt rules of thumb as a way to economize on cognitive faculties,[92] leading in turn to mistakes in judgment and perception. By incorporating more realistic models of human behavior based on these findings, the emerging field of BLE strives to modify some of the regulatory and policy measures that were based on the neoclassical model, with ones that better account for the deviations of actors from the rational path.[93]

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[89] *See generally* Ryan Bubb & Richard Pildes, *How Behavioral Economics Trims its Sails and Why*, 127 HARV. L. REV. 1593 (2014).

[90] *Id*. at 1596.

[91] *See, e.g.*, Bubb & Pildes, *supra* note 89, at 1601; Sendhil Mullainathan & Richard Thaler, *Behavioral Economics*, *in* INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL & BEHAVIORAL SCIENCES 1094–1100 (Neil J. Smelser & Paul B. Baltes eds., 2001); Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LITERATURE 11, 11-13 (1998) (surveying the evidence of departures from the neoclassical rational actor assumption).

[92] Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998).

[93] In the U.S. the main advocate of using BLE in regulatory and policy making is Professor Cass Sunstien. *See* CASS R. SUNSTEIN, SIMPLER 100–26 (2013); Courtney Subramanian, *'Nudge' Back in Fashion at White House*, TIME.COM (2013), *available at*

Two of these modifications are particularly relevant for the purpose of our discussion. First, the replacement of the rational actor assumption with the more precise behavioral assumption has lead behavioral scholars to suggest that a whole new breed of market failures exists, one that stems from the actors irrationality, rather than from lack of information or competitiveness.[94] For instance, lack of appropriate retirement savings due to cognitive errors and self-control problems is often mentioned as a behavioral market failure.

Second, since the actions of actors might deviate from what a rational theory might predict, BLE calls for reconsideration of the regulatory tools that are currently employed by regulators. Most importantly, the behavioral approach challenges the limited toolbox to which the neoclassical theory availed itself.[95] Instead of only using rational "carrots and sticks", regulators may now use an array of other regulatory tools that the neoclassical theory could not accept. Default rules, for instance, should not matter under a rational economics-theory scenario, but have been proven to matter in significant ways in the real-world setting.[96]

While not without its critics,[97] the mainstream of the BLE movement has strived to bridge and reconcile the neoclassical model with the behavioral findings, rather than completely abandon it.[98] Several prominent scholars have advocated the use of regulatory means, often termed as "soft paternalism," that maintain the ability of rational actors to choose, while improving the likely choice of those who decide not to choose or act irrationally.[99] Professors Sunstein and Thaler have

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http://tinyurl.com/jqpursx. In The UK similar efforts have been spurring. *See* Rhys Jones, Jessica Pykett & Mark Whitehead, CHANGING BEHAVIOURS: ON THE RISE OF THE PSYCHOLOGICAL STATE 23 (2013). Similar initiatives have been adopted in the EU as a whole. European Commission, *Applying Behavioural Sciences to EU Policy-Making* (2013), *available at* http://tinyurl.com/mittle.

[94]*See* Bubb & Pildes, *supra* note 89 at 1602.

[95]*See* Jolls, Sunstein, & Thaler, *supra* note 92, at 1545.

[96]*See, e.g.*, Russell Korobkin, *Status Quo Bias nd Contract Default Rules*, 83 CORNELL L. REV. 608, 624-25 (1997).

[97]*See* Bubb & Pildes, *supra* note 89, at 1605-1610; *see also, e.g.*, Tom Baker & Peter Siegelman, *Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics*, 43 (2013) (unpublished manuscript) (on file with the University of Pennsylvania Penn Law Legal Scholarship Repository); Paul Heidhues & Botond Kőszegi, *Exploiting Naïvete About Self-Control in the Credit Market*, 100 AM. ECON. REV. 2279, 2301 (2010).

[98]*See* Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue, & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. PA. L. REV. 1211, 1214-18 (2003); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1160-61 (2003).

[99]*See* Judd F. Sneirson, *Soft Paternalism for Close Corporations: Helping Shareholders Help Themselves*, 2008 WIS. L. REV. 899, 918-23 (2008).

formally coined this as a "Nudge":[100] The use of modest regulatory means such as disclosure and default rules as ways to nudge people in the right way while maintaining their ability to opt-out if they so wish. Focusing on opt-out defaults and soft paternalism, the Nudge school of thought preserved the neoclassical model of rationality by allowing rational actors to act against the nudge if they wish.[101]

B. *The Implications of Behavioral Law and Economics for Corporate Governance*

One of the early fields challenged by the BLE movement was the field of corporate finance and particularly the Efficient Market Hypothesis[102] that stands at the epicenter of modern corporate finance discourse. Providing sharp, testable predictions about observable phenomena and high-quality data available to test these sharp predictions, the Efficient Market Hypothesis[103] was the perfect petri dish for the BLE movement to substantiate its claims.[104] Similarly, many

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[100] *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 6 (2008).

[101] *See, e.g.*, *id. at 248-49*.

[102] *See generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (providing a survey of theoretical implications of efficient markets and empirical testing of the efficient markets hypothesis). *See also* Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853-55 (1992).

[103] *See* Donald Langevoort, *Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, NW. U. L. REV. 135, 138 (2002) (stating that one important characteristic of the financial markets is that they generate extensive data and that because of this transparency, behavioral finance is somewhat better positioned to test for the real world impact of bias in market prices than research in more opaque economic settings). *See also* Richard Posner, *Rational Choice, Behavioral Economics and the Law*, 50 STAN. L. REV. 1551, 1551-52 (1998); Jennifer Arlen, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1768-69 (1998).

[104] The efficient markets theory has been attacked from multiple fronts, behavioral and others. For an extensive literature review, *see* Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. ECON. LIT. 1583, 1613-17 (1989); ROBERT J. SHILLER, MARKET VOLATILITY 432 (1989); Lawrence Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 547-51 (1994); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 1-2 (2000); John Y. Campbell, *Asset Pricing at the Millenium*, 55 J. FIN. 1515, 1551 (2000); Daniel Kahneman & Mark Riepe, *Aspects of Investor Psychology*, 24 J. PORTFOLIO MGT. 52 (1998). In addition to the finance studies there are also laboratory studies that seek to replicate features of the financial markets. *See, e.g.*, Amanda R. Ganguly, John H. Kagel, & Donald V. Moser, *Do Asset Market Prices Reflect Traders' Judgment Biases?,* 20 J. RISK & UNCERT. 219, 240 (2000). *But see* Alon Brav & J.B. Heaton, *Competing Theories of Financial Anomalies*, 15 REV. FIN. STUD. 575, 577-78 (2002) (observing that the differences between what behavioral theories predict and what models based on rationality but incomplete information predict are small).

BLE studies probed closely related financial aspects such as savings[105] and investment decisions.[106] While corporate finance and related consumer aspects were heavily investigated by the BLE, corporate governance, and in particular, shareholder participation in corporate elections did not receive similar attention. A number of studies used the BLE approach to criticize the SEC regulation,[107] or to examine issues such as IPOs,[108] auditors' work,[109] or the dissemination of information to investors,[110] but generally speaking the application of BLE to main-stream corporate governance is rare.

In particular, BLE literature that directly deals with the exercise of shareholder rights, including the participation in corporate elections, has been very limited.[111] One study, which is the closest to this Article's agenda, has focused on providing retail investors with more information as a means to increase their participation.[112] However, as we contend, the suggestion to provide more information to investors suffers from the same issues that lead to investors' apathy to begin with. This lack of attention of BLE scholars to corporate governance and retail investor participation in governance of the corporation is puzzling. As we

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[105] *See, e.g.*, James Banks, Richard Blundell and Sarah Tanner, *Is There a Retirement-Savings Puzzle?* 88 AMERICAN ECONOMIC REVIEW 769, 769 (1998); Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. OF ECON., 1149, 1149-50 (2000); Ted O'Donoghue and Matthew Rabin, *Procrastination in Preparing for Retirement*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS 125, 126 (Henry Aaron, ed., 1999); Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. OF POL. ECON. S164, S166 (2004).

[106] *See e.g.*, Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 J. FIN. 75, 76 (1991); Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. FIN. 1775, 1775-76 (1998); Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, J. FIN. 777, 777-78 (1985); Nicholas Barberis, Ming Huang & Tano Santos, *Prospect Theory and Asset Prices*, 66 Q. J. ECON. 1, 2-3 (2001); *see also* Nicholas Barberis & Ming Huang, *Mental Accounting, Loss Aversion and Individual Stock Returns*, 56 J. FIN. 1247, 1247-48 (2001).

[107] *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC,* 56 STAN. L. REV., no. 1, Oct. 2003, at 1, 42 (2003) (noting that "[o]ne response.., would be to ignore investors' behavioral biases altogether and structure regulation on the basis of the rational actor model" but also noting that "[w]e think that is an unlikely outcome"); Langevoort, *supra* note 103, at 166-67, 187-88.

[108] *See* Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 88-91 (2006).

[109] *See* A. C Pritchard, *The Irrational Auditor and Irrational Liability,* 10 LEWIS & CLARK L. REV. 19, 48-49 (2006).

[110] *See* Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57, 67-68 (2006).

[111] Some of these very few studies are not related to shareholders of public corporations. *See, e.g.,* Sneirson, *supra* note 99, at 901-02, 920, 937-38 (addressing minority shareholder protection in the context of closely held companies).

[112] *See* Gulinello, *supra* note 10, at 571.

discussed above, the apathy observed by retail investors has been both significant in magnitude as well as increasingly important, and therefore, could be an important research area for behavioral economists.

Looking at retail investors' apathy through a behavioral economics lens reveals a more nuanced picture and suggests that such apathy could stem from two main sources; the first of which is investors' traditional *rational apathy*. When an investor has limitless resources but the costs of participation in the election exceed its benefits, it will be rational for that investor to avoid voting. The second source of apathy stems from investors' inability to deal with large quantities of information, which precludes any vote even if the costs of participation do not exceed its benefits. We term the second source of investors' apathy as "*behavioral apathy*." A real solution for retail investors' apathy must therefore address both causes: the rational and the behavioral apathy.

Using BLE, and in particular some of the nudging tools it advocates for, could obviously prove to be beneficial in reducing investors' behavioral apathy by reminding investors to vote or making the voting process more accessible to them, without interfering with their rational decision to remain apathetic (by allowing them to "choose not to choose"). But among the set of nudges aimed at attracting the attention of investors, a preferable solution would be the one that also addresses investors' rational apathy by reducing the actual costs associated with exercising a vote.

Understating the distinction between investors' rational and behavioral apathy, and how BLE tools could be useful in limiting those two modes of investors' apathy is just the first step. The next question that needs to be addressed is what type of voting heuristics or short-cuts regulators could offer retail investors in order to increase their participation in the voting process. In the next Part, we dissect this exact question and put forward a general framework as to how voting nudges could serve as a means to increase shareholder participation in corporate decision-making.

V. THE PROPOSED SOLUTION

In this Part we present and advocate for a BLE-type solution to the long-standing retail investors' apathy problem. Our solution focuses on facilitating retail investors' participation by redesigning the current voting system afforded to retail investors. The redesigned voting system would provide retail investors with default short-cuts that would "nudge" them to make a choice by affording them with the ability to align their vote with the vote of other shareholders/proxy advisors with similar interests. For several reasons discussed in this Part and in Part VI, we believe that our solution has the potential to significantly limit, if not fully eliminate, the problem of investors' apathy while maintaining the ability of all investors to make their own voluntary choice.

Importantly, by allowing shareholders to make a choice, not regarding any specific issue at hand, but rather regarding the best agent to make an informed decision on their behalf, we significantly increase shareholder involvement without imposing substantial costs on the company or the market. At its essence, our proposed solution is similar to a situation where an investor delegates the voting authority to a money manager by investing through an intermediate entity (i.e., a pension fund) rather than directly holding the company's shares. Thus, our proposed solution provides retail investors with many of the benefits that investing through an actively-managed fund brings to the table (decision making regarding optimal vote), but without the costs associated with it (e.g. management fees).[113]

Choice Architecture Design: While the idea of using voting heuristics is very intuitive, the design of such a voting short-cut system is far from simple and involves different choices and considerations that regulators will have to take into account. Below we provide what we identify as several levels of design-choice that a policy maker would need to consider before adopting such a regime.

(i) Voting Options. The first design consideration revolves around the nature of the short-cuts offered to shareholders. One option is to provide retail investors with a list of large shareholders with whom they might want to align their interests and to allow them to request *ex-ante* to tag-along their vote with one of these investors. This individualized list will also include an option to vote with management. A second option is to allow shareholders to vote according to the recommendations of proxy advisors. In recent years the scope and coverage of proxy advisors' recommendations has substantially grown so that almost every issue coming to a vote carries with it a proxy advisor recommendation.[114] A third option would focus on joining the majority of the shareholders on each specific matter going to a vote (with or without including management/controlling shareholder shares), shifting the emphasis from a specific actor's vote to the consensus of shareholders. Finally, the policy-maker would need to consider whether to provide an option to not participate all together, by "choosing not to choose".

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[113] *See, e.g.*, John C. Coffee, *The SEC and The Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 837-40 (1994); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, THE NEW PALGRAVE DICTIONARY OF ECON. AND THE LAW 459, 460-61 (Peter Newman ed., 1998).

[114] *See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange,* June 5, 2006, at 14, *available at* http://tinyurl.com/nuss-erde.

(ii) An Opt-out or Opt-in Regime? Equally germane to the effectiveness of the proposed mechanism is the question of the initial default. If an opt-in regime is chosen, then shareholders would be left with the current system as a starting point, but would be offered the opportunity to enroll into these additional set of short-cuts. Importantly, they would have to make an active choice in order to exercise their vote according to a short-cut, thus potentially leading to a lower participation rate compared to an opt-out regime.[115] Under an opt-out regime, shareholders would be forced to choose a short-cut when they buy shares from a brokerage firm and make the initial investing decision (the selection phase), unless they actively chose to opt-out. The ability to opt-out can be done either initially, by providing investors a full opt-out option in the selection phase, or on an ad-hoc basis, by allowing investors to deviate from their pre-assigned designation by submitting a detailed vote when needed.

The choice between opt-in and opt-out regimes also reflects the regulator's views regarding the main issue that prevents retail investor's participation. If retail investors' participation is mainly driven by behavioral apathy, then an opt-out regime would be better suited, since the cost of decision making is not the main driving force behind the apathy. However, if the traditional rational apathy is the pivotal concern, then an opt-in regime might be better suited, since investors are more likely to recognize their need for short-cuts.

(iii) Visibility. Increasing the visibility of the voting mechanism is another key issue. Currently, shareholders have the ability to simply ignore voting materials or voting requests without incurring any costs, and this, in turn, has further contributed to their incentive to remain apathetic. By increasing the visibility of the potential choices and short-cuts, and by increasing the costs of ignoring these options, retail investors are more likely to make a voting decision. For instance, brokers may design a pop-up screen when a retail investor logs into her account, forcing her to check a box with a decision regarding the desired short-cut before proceeding to manage her account. A similar approach can be conducted with paper accounts, requiring new customers to provide a choice when opening a broker account.

(iv) The Scope and Duration of a Shareholder's Choice. When adopting a default-choice regime, a related question that would need to be addressed at the choice-design stage is the question of the duration and scope of a shareholder choice. A default mechanism could be

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[115]Investors are less likely to participate for a combination of reasons such as inertia, lack of knowledge, lack of interest, procrastination and others. *See, e.g.*, James J. Choi et al., *Optimal Defaults*, AM. ECON. REV. 180, 180 (2003); Madrian & Shea, *supra* note 105, at 1149-50, 1185.

implemented in various forms and for different durations. For instance, shareholders could have a different short-cut for each type of questions that are brought for a shareholder vote. Alternatively, they could have one short-cut for all issues raised at a specific shareholder meeting and such a short-cut could also be applicable to more than one meeting, potentially until modified. Similarly, the choice may be valid to all of the companies in the investor's portfolio, or be applied on a company-by-company basis. Designing duration and scope would ultimately reflect the policy maker's opinion on the right balance between achieving participation at "all costs" on the one hand and achieving informed participation on the other hand. Allowing the default arrangement to last for a longer duration reduces the costs of participation for retail investors, but it may lead to choices that retail investors might not prefer in the long run as their initial short-cut selections might no longer represent their current preferences.

(v) Allowing for Variance between Companies. So far we have suggested a "one size fits all" approach whereby all issuers will be required to implement the same voting short-cuts. A more nuanced approach could suggest that regulators allow for variance and differentiation between companies. Instead of a standard unified arrangement, different issuers will be allowed (or required) to present different short-cuts, if at all, based on the severity of investors' apathy in those companies. For instance, regulators could impose the voting short-cut requirements only on companies where retail investor's lack of participation has been more pronounced or could play a more significant role (e.g. high super majority, stocks from smaller indexes). To exemplify the sharp difference in investor participation between similar high profile companies, consider the examples of Bank of America and Hess Corporation. In 2013 broker non-votes have accounted for 24% of the votes outstanding in Bank of America, but for less than 0.1% points at Hess Corporation.[116] Recognizing that investors' lack of participation is much more prevalent at Bank of America than at Hess could justify a different regulatory application of the voting design for the two companies.

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In this Part we identified several levels of design-choice that a policy maker would need to consider before adopting our proposed solution for curing the problem of investors' apathy. As a general matter, a less paternalistic arrangement (such as an opt-in arrangement) is likely to have a reduced impact on shareholders' participation level, whereas a more paternalistic arrangement (such as an opt-out arrangement that

[116] *See supra* note 19 and accompanying text.

forces all shareholders to make a choice) is likely to significantly reduce, if not totally eliminate, the problem of investors' apathy. While one solution can be more effective, but also more paternalistic, than the other, we believe the decision regarding the chosen arrangement should be left in the hands of regulators. In our view, the adoption of our proposed framework, in one form or another, will already be a value-creating move. We now turn to discuss the advantages of the proposed framework.

VI. ADVANTAGES

Increasing retail investors' participation would not only mitigate the direct costs associated with retail investors apathy highlighted in Part II, but would also carry with it a number of indirect benefits for all parties involved, which are highlighted in this Part. Section A analyzes the impact of the proposed solution on the parties' incentives. As we show, the implementation of the proposed solution will provide the parties with *ex-ante* incentives to be more efficient and to make their value-increasing behavior more transparent to voting shareholders. Section B suggests that our proposed solution could counter-balance management exclusive power over the proxy process. Finally, Section C explores another important advantage of the proposed solution: its high feasibility of implementation.

A. *Positive Impact on Parties' Incentives*

1. Enhancing Transparency and Efficient Shareholder Involvement

Higher retail investors' participation is likely to provide certain shareholders and management with *ex-ante* incentives to disseminate more information to shareholders, to bring about efficient changes and to block inefficient ones, thus benefiting all shareholders. Under the proposed arrangement, both management and dominant shareholders will have increased incentives to obtain and produce information in a simplified way to retail investors, so that they will be able to digest it quickly and exercise a vote in favor of the party that produces such information. Even if one believes that retail investors are unlikely to rely on this additional information, and that they will simply follow the voting patterns of leading institutional investors, then management and activists will have an increased incentive to conduct additional engagements and discussions with these leading institutional investors. In any event, the proposed solution is likely to enhance transparency and the flow of information to shareholders, improving the governance playing field altogether.

Additionally, the decision of an activist shareholder to engage with a company and to bring about a value-increasing change depends first and foremost on its ability to receive the necessary support from other shareholders unaffiliated with management.[117] When the percentage of shareholders participating in the vote is relatively low due to investors' apathy, activists may encounter difficulties to compete with the voting block organized by management in a proxy contest situation, or to have a shareholder proposal pass by receiving a majority support of shareholder participating in the vote, or by meeting a higher threshold if supermajority requirement exists.[118] Therefore, higher retail participation could increase the chance of an activist campaign succeeding and reduce the likelihood of value-enhancing change being blocked by management just because there are not enough shareholders participating in the vote. This, in turn, would provide activist shareholders with *ex-ante* incentives to become more involved on corporate matters. Since there is compelling empirical evidence showing that hedge fund activism enhances shareholder value both in the short and long term[119] and that institutional activism also serves as an important disciplinary force,[120] increased retail investors' participation in

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[117]For a comprehensive analysis, *see generally* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 61-68 (2011). Those costs, which in the context of hedge fund activism are related to the identification of potential targets, the financing of its equity position, and the communication with the target, could be particularly high.

[118]Consider, for instance, an example where the proposal needs 50% of the votes to pass, management controls 10% of the votes, and 15% of the investors avoid voting. In such a case, only 75% of the shareholders not affiliated with management would vote on the proposal (100-10-15), and the activist needs to solicit almost 67% of the votes (50/75) in order to have a proposal passed by a simple majority. If there is supermajority requirement of 75% of the votes, the activist will have to solicit all of the votes in order to have the proposal passed.

[119]For evidence showing that interventions by activist hedge funds are accompanied by positive stock market reactions around the filing of a Schedule 13D, *see, e.g.,* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN., 187, 207-211, 225-226 (2009); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755-57 (2008); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists,* 14 J. CORP. FIN. 323, 328-333 (2008). For evidence showing the long-term benefits of hedge fund activism, *see* Lucian Bebchuk, Alon Brav, & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism,* 115 COLUM. L. REV. 1085, 1122 (2015).

[120]*See, e.g.,* Ertimur et al., *supra* note 59, at 54 (showing that the implementation of a proposal that receives majority support is associated with approximately a one-fifth reduction in both the probability of director turnover and the probability of losing other directorships); Bonnie G. Buchanan et al., *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AM. BUS. L.J. 739, 790, 74-96 (2012) (reporting that firms targeted by shareholder proposals are more likely to replace their

corporate election could further facilitate such activity to the benefit of all shareholders.

But that is only one side of the equation. Higher participation rates of shareholders can also prevent value decreasing actions by activist hedge funds. If the change that an activist shareholder tries to advance decreases the value of the corporation, then such activist investor will encounter greater difficulties to bring about this change even when management is unable to block it. As more votes are cast, the relative power of the voting block that the activist gathered is diluted, therefore forcing the activist to obtain a larger number of votes from its peer shareholder. This is a task that could become difficult if the proposed change does not benefit all shareholders, and thus the activist shareholder would be less likely to receive the necessary support for its course of action. Compare that to a case where fewer shareholders participate in the election process in which the activist would need fewer votes to succeed (note that in many corporate decisions the required majority is calculated out of votes cast and not votes outstanding). Higher retail investors' participation is, therefore, also likely to reduce the chances of value-decreasing changes to be adopted.

Finally, having more incidents of value-increasing activism as a result of higher retail investors' participation will also have a positive impact on the incentives of management. If management is more concerned about the likelihood of activist campaigns and the chances of a proponent to win, management will *ex-ante* try to avoid such campaign altogether by taking steps to increase shareholder value. In these cases, higher retail investors' participation would indirectly serve as an additional disciplinary force, benefiting all shareholders.

2. Alleviating Distortions Caused by an Effective Controller

Engaging retail investors could also alleviate some of the distortions of incentives that are created when a controlling shareholder exercises an effective control over a company while holding less than 50% of the equity rights of such company. A controlling shareholder often holds less (and sometimes substantially less) than 50% of the voting rights[121] in order to diversify its holdings, reduce its idiosyncratic

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CEOs and separate the CEO and Chairman positions, and that shareholder proposals submitted between 2000 to 2006 are followed by positive stock returns).

[121] *See, e.g.*, Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FINANC. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block is 26%); Ronald Anderson, Augustine Duru & David M. Reeb, *Founders, Heirs, and Corporate Opacity in the U.S.*, 92 J. FIN. ECON. 205, 207 (2009) (showing that in the 2,000 largest industrial U.S. firms, founder-

risk, and due to the need to raise new capital.[122] However, going below the 50% threshold does not preclude such controller from exercising an effective control over corporate affairs, and investors' apathy further facilitates such effective control and aggravates the distortion of incentives associated with it. An effective control may create a distortion of incentives since controllers who hold less (and sometimes substantially less) than 50% of the equity capital bear only a fraction of the negative effects of their actions on the firm's cash flow, but they can capture the full private benefits of their actions.[123]

To see the effect of investors' apathy on the controller's ability to exercise its effective control, consider the following example: a controller exercises an effective control by holding only 30% of the firm's voting rights. Suppose further that the shareholder proposal, to which the controller opposes, is brought to a shareholder vote, that such proposal needs a simple majority to pass, and that 15% of the investors are rational apathetic and avoid voting. In such a case, the proposal has to receive the support of more than 90% of the shareholders not affiliated with the controller in order to pass.[124] If, however, investors' apathy were eliminated, then the proposal would need only the support of approximately 70% of shareholders unaffiliated with the controller to pass.

Our proposed solution, therefore, could encourage the participation of all investors in the voting process, and an effective controller, who holds less than 50% of the voting right, would be less likely to block decisions or proxy solicitations that benefit other public shareholders.

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controlled firms constitute 22.3% and heir-controlled firms comprise 25.3%, with average equity stakes of approximately 18% and 22%, respectively).

[122] *See, e.g.*, George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 749 (1986); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VIR. L. REV. 807, 812 (1987).

[123] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 89 (2004) (explaining that asymmetric positions can produce substantial inefficiencies and may lead to expansion decision that is value decreasing for other shareholders); *see also*, Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1081-82 (2010) (evidencing that control enhancing structures, which lead to a wedge between ownership and control rights, are associated with increased agency costs).

[124] The public float after excluding the controller's stake and the shares held by shareholders who do not exercise their vote is 55%. Since the proposal has to receive at least 50.1% of the votes in order to pass, it will need the support of more than 90% of the shareholders not affiliated with the controller (50.1/55=91.09).

B. *Counter-balancing Management Exclusive Power over the Proxy Process*

Nudging retail investors to vote could also lead to an increase in the relative power institutional investors hold vis-a-vis management. This is because many investors are likely to attach their votes to those of institutional investors, augmenting their voting power. So far, we have assumed that institutional investors will not be the only beneficiaries of our proposed solution, and that retail investors will not always blindly follow the voting choices of dominant institutional investors. But, even if the implementation of our proposed solution would lead to a bias in the exercise of retail investors' vote toward institutional investors, we do not believe this is necessarily a negative outcome.

Management currently exercises fairly strong control over the voting process by controlling the dissemination of information, the design of the proxy materials, the agenda of the meetings, and the content of some of the issues brought to shareholder vote, as well as having the ability to exclude shareholder proposals from the ballot.[125] Additionally, unless there is a contested election, management also exercises significant control over the nomination of directors.[126] Therefore, designing a voting arrangement for retail investors that would empower major institutional investors would seem to provide beneficial counter balance to the tight control that management currently exercises over the proxy process.

Moreover, even if retail investors are going to blindly follow the voting choices of dominant institutional investors, this does not necessarily mean that they will end up categorically voting against management. When management makes value-enhancing proposals, sophisticated institutional investors, who can devote time and resources to closely examine the issue at stake, are likely to support management proposals, and rational apathetic retail investors who blindly follow other dominant institutional investors will simply do the same.

C. *Feasibility of Implementation*

The proposed solution of a nudge to retail investors' voting habits has one additional major advantage: it would be easy to implement. This solution does not require issuers or broker-dealers to exert special efforts,

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[125] *See, e.g.*, GIBSON DUNN, *Shareholder Proposal Developments During the 2015 Proxy Season* (Jul. 15, 2015), *available at* http://tinyurl.com/gd-proxy; Staff Legal Bulletin No. 14H (October 22, 2015), *available at* http://tinyurl.com/hxdqodu.

[126] *See* 17 C.F.R. § 240.14a-8; *see also* Gulinello, *supra* note 10, at 557 (discussing incumbent board control's over the company's proxy mechanism, and recent amendments to Rule 14a-8).

nor does it involve substantial costs or time commitment. All that issuers or broker-dealers would be required to do is request (require) their investors to make a choice regarding the different voting short-cuts. This could be done during the initial process of opening an account with a broker, or at any point thereafter, during the online activity of the investor.

Second, and more importantly, it entails minimal regulatory intervention with shareholder will, and therefore, even pure contractarians who generally oppose any mandatory intervention in the market place should be more inclined to accept it. As discussed in greater details in Section VII.A., while the proposed solution would provide shareholders with convenient voting "short-cuts," regulators adopting it would not interfere with shareholder freedom to choose the option that seems the most beneficial to them. In other words, the suggested solution does not replace shareholders' voices with the regulator's voice. It merely focuses on facilitating greater involvement of shareholders by reducing the associated costs of such involvement.

VII. POTENTIAL OBJECTIONS

This Part considers and responds to a wide range of possible objections to our suggested proposal to facilitate retail investors' participation by redesigning the voting arrangements, and providing shareholders with voting "short-cuts." We show that the objections presented in this Part do not provide a good basis for rejecting our proposed solution.

A. *Interfering with Shareholder Freedom not to Choose*

Even if regulators elect to utilize the type of suggested solution that is minimal in its effort to force a specific type of choice, one may argue that any type of nudge, does strive to force shareholders to vote, and therefore impedes their freedom to remain totally passive, or to "choose not to choose."[127] When shareholders choose not to choose, forcing them to vote counts as a form of paternalism and any insistence on active choosing, the argument goes, may reduce shareholders' welfare and impede their ability to exercise their autonomy.[128]

This argument, however, does not preclude the use of *any* type of nudge to retail investors' voting habits. To begin with, the design of a

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[127]For an elaborated discussion on this topic, *see* Cass R. Sunstein, *Choosing Not to Choose,* 64 DUKE L.J. 1, 5-6, n. 8 (2014).

[128]*Id.* at 19-20 (noting that those who reject paternalism typically invoke welfare, autonomy, or both).

nudge could maintain the freedom not to choose[129] by adding an easy opt-out or an abstain option, or by designing the voting nudge as an opt-in mechanics. Assume, for instance, the more paternalistic case where the vote nudge is designed as a pop-up window that requires shareholders to make an active choice between different voting options, such pop-up window could also include a check-the-box option which allows the investor to eliminate the use of any voting nudge in the future,[130] or to abstain from a specific vote (but keep the voting nudge in the future). Alternatively, the voting nudge could be designed in a way that does not force shareholders to make an active choice at all. When a pop-up window appears shareholders who are interested in exercising their vote could easily opt into a short-cut with their preferred voting arrangement, but those who are interested in remaining rationally apathetic could simply close the pop-up window.

Each of the above-mentioned arrangements will provide shareholders who (freely) choose not to choose with the ability not to choose (or at least it will minimally interfere with this right), while still ensuring that all other shareholders who wish to choose may be better served. Compared to other alternative solutions to the problem of investors' apathy, such as mandatory requirement to vote, the proposed solution minimally infringes, if at all, on shareholder freedom not to choose.

Second, it should be noted that even under the current voting regime, shareholder ability to choose not to vote is somewhat impaired due to broker discretionary voting on certain matters when shareholders choose to remain apathetic. As discussed above, NYSE Rule 452 permits brokers to vote on "routine matters" when the beneficial owner of the stock fails to provide specific voting instructions to the broker prior to a scheduled meeting.[131] Broker discretionary voting in fact leaves the voting decisions in the hands of brokers, and thereby potentially distorts shareholder will, as evidence shows that brokers

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[129] *See* Cass R. Sunstein & Richard H. Thaler, *supra* note 100 (arguing that some kind of paternalism is newly justified, especially if it preserves freedom of choice, as captured in the idea of "libertarian paternalism").

[130] *See* Sunstein, *supra* note 127, at 4 (arguing that if people are asked whether they want to choose, and can opt out of active choosing in favor of a default rule, this could be an especially attractive form of libertarian paternalism).

[131] Rule 452 however prohibits the use of discretionary voting on non-routine matters, and the supplementary materials to the Rule lists 21 matters on which brokers are not permitted to vote discretionarily, including contested proposals, proposals relating to mergers, proposals for the election of directors, etc. *See Giving Proxies by Member Organization*, N.Y.S.E. Guide (CCH), No. 452 (2003).

overwhelmingly vote in the manner recommended by management.[132] Although the ability of brokers to exercise a discretionary voting has been narrowed in recent years,[133] it has not been fully eliminated.[134] Moreover, recently there has been a call to broaden brokers' discretionary voting once again in order to solve problems related to the lack of shareholder participation,[135] and this suggestion, if implemented, will constitute a more severe intervention in investors' right not to choose than the Article's proposed solution.

B. *Encouraging Self-interested Behavior by Dominant Investors*

Another possible concern is that having a default arrangement that encourages retail investors to follow the voting patterns of large institutional investors will *de facto* lead to a dramatic increase in the voting power of a specific institutional investor, hedge fund or other dominant investor since rational apathetic retail investors are unlikely to divert from their initial choice or the default arrangement. This augmented voting power might cause that dominant shareholder to behave opportunistically. Institutional investors or hedge funds, whose interests are not necessarily aligned with those of other shareholders,[136] could block management initiatives, take advantage of their increased voting power to extract private benefit to themselves,[137] or promote short-term goals at the expense of long-term value creation activities.[138]

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[132] *See* The Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, at 14 (June 5, 2006), *available at* http://tinyurl.com/z5pbr5w; Bethel & Gillan, *supra* note 48, at 46.

[133] *See, e.g.,* Letter from NYSE Regulation to All NYSE And NYSE AMEX Equities Members And Member Organizations (Jan. 25, 2012), *available at* http://tinyurl.com/he3bmyn (imposing new limits on the practice of broker discretionary voting by no longer treating corporate governance matters as 'routine' for the purposes of Rule 452). In addition, an earlier amendment to rule 452 from 2009 made director voting in uncontested elections a non-routine matter. *See* Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60, 215, 74 FED. REG. 33, 293-95 (July 1, 2009).

[134] For instance, one matter that does appear to remain subject to broker discretionary voting is the ratification of auditors.

[135] *See supra* note 52.

[136] *See, e.g.*, Kahan & Rock, *supra* note 6, at 1048-57, 1070-79 (discussing the conflict of interests of institutional investors and hedge funds).

[137] *See, e.g.*, Spencer Klein & Enrico Granata, *"Greenmail" Makes a Comeback*, MORRISON & FOERSTER LLP, (Dec. 20, 2013), *available at* http://tinyurl.com/green-mofo (arguing that hedge funds could act opportunistically and extract outsized returns for themselves at the expense of other investors).

[138] *See, e.g.*, Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. TIMES: DEALBOOK (Aug. 26, 2013), http://tinyurl.com/deal-nyt; Ira M. Millstein, *Re-examining Board Priorities in an Era of Activism*, N.Y. TIMES: DEALBOOK (Mar. 8, 2013), http://tinyurl.com/nyt-act-deal.

This argument, however, could be easily addressed by the design of proposed solution. First, the voting nudge could, and in our view should, be designed in a symmetric way so that it will provide shareholders with the ability to choose to vote not only with institutional investors but with management as well. This nudge design would provide management and institutional investors with equal access to retail investors' votes. Relatedly, and to prevent placement bias, the voting short-cuts options given to investors can be randomized to prevent a concern regarding list order bias in the selection phase.

Second, the design of the applicable nudges and default arrangements could also be structured to leave the choice of retail investors undisclosed to the rest of the investors, preventing them from acting *ex-ante* based on the assumption that they would have the support of other investors. To further mitigate the concern of empowering a specific shareholder, a potential default arrangement could also allow retail investors to exercise their vote in accordance with the majority vote of all investors not affiliated with management; that is, in accordance with the majority of the "floating vote." This short-cut aligns the interest of retail investors with the majority of shareholders unaffiliated with management, but not with a specific shareholder. Therefore, it does not negatively affect the decision making of a specific investor.

The voting nudge could also be designed so that each shareholder will have to actively exercise its votes by choosing one of the short-cuts prior to each vote, instead of making an active choice the first time it has to vote and then having an automatic vote in the following annual meetings based on the initial preferences. Forcing shareholders to make an active choice before each meeting is likely to deter self-interested behavior by dominant shareholders, as they will have to regain the trust of other investors prior to each election.

C. *Distracting Management*

It could also be argued that greater participation of retail investors would encourage excessive levels of shareholder involvement in corporate affairs due to the higher chances of shareholder-led initiatives to succeed. Such excessive level of shareholder involvement in corporate matters, as may be reflected by an increased number of shareholder proposals or proxy fights, could disrupt management's ability to manage the corporation without interference. The excessive level of shareholder involvement could also make it more difficult for other shareholders to identify beneficial proposals by increasing the noisiness around shareholder activity. As a result, uninformed retail investors could also support proposals that are not beneficial to the corporation.

However, if the current level of shareholder engagement with companies is not as high as it should be, then incentivizing activist shareholders to further engage with companies could actually bring us closer to the optimal level of shareholder involvement. While answering this question is well beyond the scope of this Article, it is important to note that empirical evidence shows that contested elections do not occur often. For instance, the number of contested elections that took place in each year during the period 2011-2014 varies from 35 to 45 contested events per year.[139]

Likewise, data on corporate governance proposals voted on at S&P 1500 companies during 2011-2014 shows that the number of governance-related proposals that were voted on each year varies from 240 to 269; that is, on average, less than 0.16 governance proposal per company, per year.[140] Moreover, the proposed solution is expected to positively impact only the submission of proposals that traditionally receive strong shareholder support, such as governance related proposals.[141] Shareholder proposals that generally receive low support will have no chances to pass, even if all the votes of retail investors were counted in favor of those proposals. Therefore, the proposed solution is unlikely to increase their number.

Also, even if the level of initial activist engagements will spike, sophisticated shareholders, such as large institutional investors, would be able to identify engagements that are destructive to the company. Retail investors who will follow the sophisticated shareholders are unlikely to support those destructive engagements. This, in turn, would reduce shareholder incentives to submit inefficient proposals in the first place.

Finally, one should also remember that even under the current state-of-affairs, the ability of management to manage the corporation is often disrupted by investors' apathy. There are cases, as in the example of frozen charters,[142] where shareholder passivity and their rational decision not to vote is the main cause behind management's inability to act. Therefore, our proposed solution could increase, rather than limit, management ability to act when actions initiated by management benefit all shareholders.

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[139] *See* Georgeson, *2014 Corporate Governance Review,* 56 (Oct. 23, 2014), *available at* http://tinyurl.com/gwop3k3.

[140] *See id.* at 14.

[141] *See* SULLIVAN & CROMWELL, LLP, *2014 Proxy Season Review* 5, 11 & 14 (Jun. 25, 2014), *available at* http://tinyurl.com/sc-14-rev. (For instance, shareholder proposals that attracted particularly high rate of support in 2013 and 2014 (on average) are: board declassification (81.5%); majority voting (59.5%); eliminate super majority provisions (69.5%); right to call special meeting (51%) and proxy access proposals with 3% and 3 year thresholds (44%-65%)).

[142] *See* Hirst, *supra* note 23.

D. *Regulators and Issuers Could Adopt More Moderate Proposals*

Finally, one could argue that before adopting our proposed solution, regulators and issuers could adopt more moderate solutions, such as simplified disclosure forms intended for retail investors. Alternatively, issuers (or their proxy solicitors) could use less paternalistic "nudges" to remind retail investors to vote and make the process more appealing to them (i.e., by using reminder calls, having their votes recorded on the phone, initiating town hall meetings, sending voting materials by Federal Express packages, etc.). In our view, these other potential solutions are inferior to our proposed solution. They often entail higher costs, are more complicated for implementation, and, on the average, are expected to be less effective in mobilizing retail investors on a large-scale basis.

1. Simplifying Disclosure Requirements

In recent years, regulators and scholars have focused on the importance of providing investors with more disclosures and information.[143] However, as we noted above,[144] one of the major issues that drive retail investors out of the voting game is information overflow. Even if an investor was interested in casting a vote, the amount of information in the proxy materials is so large that apathy is indeed rational under those circumstances. A potential solution to reduce the cost of voting could be to simplify the information provided to retail investors by adding a more user-friendly, short-form version of a disclosure document intended for retail investors that would contain only the germane information pertaining to the issues on which shareholders input is directly requested.[145] While this solution may sound appealing due to its non-paternalistic nature, such solution is costly, difficult to implement, and it suffers from the following shortcomings:

First, it would increase the costs the corporation, and ultimately all shareholders, have to bear. The corporation would be required to create two sets of disclosure documents and those documents would have to conform to the SEC requirements. As such, the costs to the corporation in complying with this augmented disclosure regime would rise. Furthermore, costs might be further exacerbated if the additional disclosure requirement would encourage public corporations to go private or discourage private corporations from going public.

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[143] *See* Gulinello, *supra* note 10, at 573, 577.
[144] *See supra* Part II.B.
[145] *Cf. supra* note 9 and accompanying text.

Second, in order to provide a short-form document that is effective and concise, companies would have to exclude certain relevant information, but certain matters are so complex that they cannot easily be reduced, processed, and simplified into a short-form disclosure document. Even if such reductions were feasible, providing shareholders with prescreened information might lead to a loss of context and may negatively affect the decision-making process, especially when understating the entirety of the issues at stake and the interconnection between them is important to the overall result.

Consider the issue of say-on-pay for instance. Current proxy materials have a bounty of information about pay structure, incentives, design and so on. By minimizing the amount of information, some relevant data would be forced out, thus leaving shareholders with the incomplete information to make their voting choice. Assuming the investors identify that the information is incomplete, they could decide to vote based on the incomplete information, and thus, may make a suboptimal choice; they may, but are unlikely to, decide to revert to the full proxy materials to review the matter in detail while incurring costs they were unwilling to bear to begin with;[146] or most likely, it would lead those investors to revert back to their rational apathy.[147]

Finally, since the overarching agency concern in the United States is of managerial entrenchment, leaving the design and the content of the short-form disclosure in the hands of the management of the company would possibly push shareholders to vote in a manner that is tilted towards management's preferences, at the expenses of shareholders as a whole. While the regulatory framework could alleviate some of these concerns, in mandating the design of the short-form as discussed above, it is unlikely to provide a comprehensive solution due to the complexity and differentiation between each corporation, which would require some discretion to be left with management.

2. Using Moderate "Nudges"

Alternatively, issuers (or their proxy solicitors) could use less paternalistic "nudges" to motivate retail investors to vote, such as sending targeted reminder emails, allowing retail investors to vote on a

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[146]One can argue that the short-form could serve as a behavioral trapping device; that is, luring the investor in with the short form and once some costs are sunk, making him expand resources he would otherwise avoid. *See generally* Alexander Borsh & Nicolai Andersen, *Behavioral Traps and Innovation,* 15 DELOITTE REV. 134, 137-44 (Jul. 28, 2014), *available at* http://tinyurl.com/bf-trap (discussing behavioral traps and investors).

[147]Since this is a repeating game, even if investors spend time on the first short form proxy they may soon opt-out to not participate in future votes if they conclude they have insufficient information. *See supra* Part II.

recorded line, sending investors a recorded message by a member of senior management (robocalls), having town hall forums, creating a website with links to the actual voting sites, sending voting packages by Federal Express, adding blue polywrap to the voting package, and so on.[148]

While those alternative nudges could push retail investors toward being more active, most of them are expensive or time consuming and are unlikely to be implemented on a large-scale basis by all public companies due to the high costs they entail. Outside very specific situations, such as a hot proxy contest, where both sides are competing head to head, issuers are unlikely to spend time, efforts, and resources on individual calls with each of their retail investors or on sending them voting materials through expensive messengers (such as FedEx). As one proxy solicitor familiar with issuers' efforts to mobilize investors mentioned: "So these tools definitely work, but, again, it costs money and that's the biggest challenge that our clients face."[149]

Other proposed solutions, such as blue polywrap for voting packages that is aimed to attract the attention of investors, robocalls, or links to the voting sites are simply too "soft." While these tools could be useful in reminding shareholders to vote, they are unlikely to reduce the real costs associated with exercising such a vote, namely – the time and efforts retail shareholders have to spend in order to review and analyze the disclosure documents. If the real costs of deliberating issues at stake and exercising a vote do not go down, shareholders are unlikely to exercise a vote, even if the process itself becomes more accessible or user friendly. Our proposed solution addresses both the behavioral problem (that is retail investors' tendency to ignore long and complicated proxy materials) and the economic problem (that is investors' rational decision not to spend time and resources on a vote when they are unlikely to influence the outcome), and it does so in the most cost-effective way and without imposing heavy costs on issuers.

VIII. CONCLUSION

It is hard to find a corporate law textbook that does not mention the problem of investors' rational apathy in the public firm. This long-standing problem that corporate law scholars have taken as a given for so many years is considered a necessary evil once ownership is no longer closely held. In this Article, we expose the true magnitude and impact that retail investors' apathy has on corporate governance and present a solution, grounded in behavioral economics, that could substantially

[148] *See, e.g.*, SEC PROXY VOTING ROUNDTABLE, *supra* note 9, at 40-44.
[149] *Id*. at 41 (quoting Donna Ackerly, Senior Managing Director, Georgeson, Inc.).

reduce costs of participation to retail investors and limit, if not fully eliminate, the problem of investors' apathy with minimal regulatory burden. This novel solution is based on the premise that the economic and mental costs associated with voting could be reduced dramatically by nudging retail investors with highly-visible voting default arrangements. Nudging would allow (or force) investors to choose between several available voting options. This is likely to substantially increase retail investors' participation in the governance of the firm. Aside from strengthening shareholder democracy, mobilizing retail investors with different voting heuristics will have other important advantages, such as providing for greater accountability of the directors of public companies.

Behavioral economics has become the new hope. Regulators are making increasing use of different heuristics to increase our protection as consumers, to encourage us to save for pensions, to eat healthier, to protect the environment, and so on. Surprisingly, there have been very few applications of behavioral economics to corporate governance, and in particular to the way we, as individual investors, participate in the governance of public firms. This Article provides the first comprehensive framework as to how it could be done.

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