

Restructuring the Capital Market to Protect Small Investors and More

Abstract

We question the effectiveness of shareholders' protection from the moral hazard risk that managers might make choices contrary to the shareholders' best interests. We explore the evolution of the dynamic manager-shareholder relationship and suggest a change that can be made to improve it. Specifically, a significant group of shareholders should not be viewed as "owners" because they lack effective means to protect their interests via the normal tools of ownership, i.e., voting in corporate elections. Therefore, in exchange for their voting rights, they should receive an explicit contract that spells out their specific compensations and protections.

Introduction

The agency relationship between managers and shareholders is a long-standing issue. Regulations in the U.S. and many other countries aim to protect shareholders from managers making choices contrary to the shareholders' best interests. The evolution of the manager-shareholder relationship is dynamic. It is periodically marked by events that shake investors' confidence in the information value of financial statements and the protection of shareholders' interests, often followed by actions to restore investors' confidence. We explore the evolution of this dynamic relationship and changes that can be made to improve it.

After the stock market crash of 1929, Congress passed the Securities Act of 1933, which requires uniform disclosures for initial public offerings, and the Securities Exchange Act of 1934,

which created the Securities and Exchange Commission (SEC) to oversee secondary stock trades. In 1973, the SEC created the Financial Accounting Standards Board (FASB) to replace the less politically independent Accounting Principles Board. In response to a series of accounting scandals, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), which created the Public Company Accounting Oversight Board (PCAOB) to generate new rules for improving the independence of auditors and oversight by the board of directors, certification of financial statements and internal controls by top management, and tougher penalties for fraudulent financial reporting.

As a result of these legislative reforms, public corporations are burdened with high levels of compliance costs. Whether the benefits of these regulatory acts justify the cost is a difficult question to answer. However, these regulations do little to protect shareholders from managers who put their own interests ahead of the shareholders' interests. This is evident in the continuing growth of executive compensation, which many believe is excessive. This belief is expressed in an editorial in the *New York Times* (2016), which argues that excessive executive pay hurts shareholders. Similarly, Ritholtz (2017) in an opinion piece for Bloomberg View states that the highest-paid managers tend to do the most to destroy shareholder value. This view is echoed by Lowenstein (2017) who believes that CEO pay is out of control.

While those who own large blocks of stock can express their wishes through voting, and shareholders who are insiders do not need protection from themselves, the group that has the least protection is the small, often uninformed or unsophisticated shareholders who are the focus of this article. Referring to these investors as "small" simply means that the number of shares owned by each of these investors represents only a tiny fraction of the total number of shares outstanding. Thus, these small investors have little voice in the firm's decisions. Their need for protection stems

from the fact that they do not have the time or the expertise to become involved in the affairs of the corporations in which they own stock. Even if they want to participate in firm governance or strategy, the miniscule proportion of shares owned by each small shareholder makes such involvement ineffective. In addition, small shareholders often own shares in many companies, making involvement in each company impossible. Another explanation for the silence of small shareholders may be William Forster Lloyd's theory of the "tragedy of the commons", which originated in an 1833 lecture at Oxford University, and became known through an article by Hardin (1968). While all shareholders recognize the importance of voicing their opinions in corporate matters, each small shareholder may assume that someone else will speak up, and therefore remains silent.

Given that small shareholders have virtually no influence over the firm in which they own stock, we do not consider small shareholders as "owners". Instead, they are more like consumers who pay for managerial services and have the right to expect management to operate the company according to their preferences even if that is not consistent with maximizing market value. Our focus on shareholders' interests may be challenged by those who, like Friedman (1970), believe that the ultimate objective of a public company is to maximize its market value. By contrast, our view is consistent with Hart and Zingales (2017), who argue that shareholders' welfare is not equivalent to market value and conclude that companies should maximize shareholders' welfare.

In the next, the second, section we examine the effectiveness of various ways that small shareholders are supposed to be protected from management, and conclude that small shareholders have little protection. Then in subsequent, the third, section, we propose restructuring the relationship between small shareholders and the firm by replacing their useless voting rights, which imply ownership that does not actually exist, with a contract. This contract will have explicit

provisions designed to support small investors' interests and drastically reduce management's moral hazard. In addition, well-crafted, explicit shareholder contracts may be acceptable to the SEC as a substitute for some or all of its current regulations. This would reduce the cost of compliance, which many companies view as excessive. We discuss our proposal following this section and present our concluding remarks in the final, the fifth, section.

Small Shareholders' Protections under the Current Regime

The need to protect shareholders from managers, who face the moral hazard of being able to prioritize their own benefits above those of shareholders, is the rationale for the regulatory market regime in the U.S. and abroad. In addition to monumental accounting scandals, many companies have executives who are overpaid and/or conduct transactions that benefit themselves at the expense of their shareholders. Those executives often practice "creative accounting" to give shareholders the impression that the company has better performance than it truly does.

But why can't the small shareholders protect themselves? They do have voting rights, but how much are these rights really worth? Shareholders have the right to vote on nominees to the board of directors, although nominees often run unopposed, and shareholders may lack information on the nominees' plans for the firm or their interest in overseeing management, so small shareholders rarely vote. As discussed by Hart and Zingales (2017), shareholders may have incentives to vote against their own preferences on the firm's social welfare activities because their stake is so small that they cannot affect the result by voting as they would if they could affect the result. How often such situations occur is an empirical issue, but the possibility of such a result undermines the idea of shareholder democracy. Furthermore, in order to have an impact, shareholders must be able to present proposals for consideration. Under SEC regulations, shareholders do have the right to

propose resolutions within a range of allowable topics, such as corporate governance or environmental policy, but are not permitted to make proposals related to the firm's ordinary business activities (Hart and Zingales, 2017). Even within the allowable sphere of action, it has been found that when shareholders become active and make proposals, their track record is mixed. Say-on-pay, which is arguably the most important shareholder proposal, has had some success, but little overall impact on excessive executive compensation (Mason et al., 2016). Dimitrov and Gao (2017) use data from the Institute of Shareholder Services (ISS) to track shareholder proposals made and voted on. They find that, out of 81 categories of proposals made from 2003-2013, only 11 categories received at least 50% of the vote. The eleven categories relating specifically to executive compensation contained 495 proposals, but only twenty-two of these proposals or 4.44% passed. Thus, shareholder voting seems to have little impact on corporate governance.

The main group charged with protecting shareholders' interests is the SEC. Other groups include the board of directors, managers, the FASB, auditors, the PCAOB, and financial advisors. In addition, since institutional shareholders may hold large blocks of stock, they may function as proxy guardians of the rights of smaller shareholders. Finally, shareholder activists certainly have the potential to strengthen the rights of all shareholders by removing ineffective managements or forcing management to act in the best interest of the shareholders. Of course, as a last resort, dissatisfied shareholders can seek legal remedies.

The SEC. The main regulator of public corporations, and therefore the chief protector of small shareholders, is the SEC. Its primary protective weapon is extensive disclosures. Evaluation of the SEC's effectiveness is problematic because it is impossible to know what would have happened to the capital markets and small investors if the SEC did not exist or if another regime had been in its

place. We believe that, despite current SEC regulation, the principal-agent relationship between investors and management leaves small investors with the short side of the deal.

Regulations are meaningless unless they are both well-crafted and enforced. The beauty of a regulation may be in the eye of the beholder, with different beholders coming to different conclusions as to whether and/or how vigorously it should be enforced, with perceptions by market participants as to how this will shake out helping determine the deterrent effect of both proposed and *enacted* regulations.. Enforcing a regulation is a gauge of its potential effectiveness at achieving whatever end is sought by its enactment. Enforcement effort may be compromised by the lack of resources made available to such efforts, the unwillingness of SEC commissioners to engage in active enforcement¹, and political deadlocks among subgroups of the commissioners as to the desirability of vigorous enforcement as well as what the value of regulation is.

Therefore, one way to gauge the effectiveness of the SEC is by examining the activity of its enforcement division. A midyear FY 2018 update report by Cornerstone Research shows an annual average of only 58 actions in 2010-2017. Also alarming is the Bain (2018) report that “In its determination to reverse a two-decade slump in U.S. stock listings, a regulator might offer companies an extreme incentive to go public: the ability to bar aggrieved shareholders from suing. Also, McKenna (2015) reports that “the enforcement of ... rules—meant to reclaim compensation paid executives whose companies restated financial results as a result of misconduct—has been virtually nonexistent since they were adopted in 2002.” Schmidt & Bain (8/23/2018) further note how understaffed and underfunded the SEC is, making it easier for

¹ See, for example, Temple-West (8/2/2018) interview with Republican SEC commissioner, Hester Pierce. Pierce prefers—as do many large corporations—that investors be forced to submit to mandatory arbitration, a forum for dispute resolution that has come under great criticism over the years. See, for example, Fleming (2/24/2018), who believes that it would harm capital formation in the US. His reasons for believing so are summarized in his speech of that date.

potential investor frauds to go unpunished. Ergo, how important is a regulatory framework when the regulations fail to be enforced?

A more fundamental issue is whether all public corporations must be regulated by the SEC. As Stigler (1971) explains, attempts to regulate any industry in the public interest will fail in the long-term. Firms have tremendous incentives to co-opt their regulators, since the firm's benefits are large and concentrated, whereas losses to the public are small and diffuse. Thus, regulation alone cannot protect shareholders. Consequently, we believe that our proposal to shift from a regulatory regime to a contractual system should be strongly considered.

While we are proponents of reducing regulations, others hold the opposite view. For example, under Senator Charles Schumer's proposed Shareholder Bill of Rights Act of 2009, shareholders could vote on executive pay annually and include their own board nominees in proxy statements, board members would need a majority of all votes to be elected, board elections could not be staggered, and the CEO would not be allowed to serve as board chair. However, this measure never made it to the Senate floor, possibly because it was perceived as excessive regulation with potentially undesirable, unintended consequences.

The Sarbanes-Oxley Act of 2002 (SOX). Following the public scandals of Enron, Tyco, and WorldCom, scandals that virtually destroyed investor confidence in financial reporting, Congress passed SOX with the aim of protecting investors by mandating strict reforms to improve financial disclosures and prevent accounting fraud. Coates and Srinivasan (2014) review 120 SOX-related papers in accounting, finance, and law to evaluate its impact. They conclude that SOX has produced benefits in financial reporting, but its costs of compliance are substantial and fall

disproportionately on smaller companies. Thus, research on the net benefit to social welfare remains inconclusive.

Board of Directors. Shareholders elect the board of directors as their agents to choose managers who will operate the firm in a way that will enhance shareholder value. Directors are legally charged with the duty of loyalty to shareholders and the duty of care in selecting and negotiating with top executives, overseeing how the business is being managed, reviewing the firm's financial goals, and approving the firm's external auditor and choices of accounting principles. However, the board has limited ability to protect shareholders. As with any agency relationship, directors may be effort-averse or self-dealing. This, along with such board characteristics as size, the proportion of inside and outside directors, and whether the CEO acts as its chair, may affect directors' ability and willingness to monitor managers.

As a result of SOX, boards have become more vigilant in their oversight. In particular, audit committees are now appointed based on their financial expertise and plum appointments are rare. Nevertheless, relying on audit committees to act independently was questioned in a study by Beck and Mauldin (2014) who argue that "in an environment where the CFO interacts extensively with the auditor and often influences or controls fee negotiations, it may be unrealistic and misleading to investors to indicate that audit committees are 'in charge.'"

In addition, in those cases where boards are now more independent and involved, they also undergo more scrutiny. Therefore, they hesitate to take risks. Due to SOX, boards and managers assess the cost of missing an opportunity to engage in a new high risk/high reward project as low compared to the cost they will incur if the project fails. This biased view of risk has reduced

investment, especially in research and development, and may have contributed to the slow growth of the economy in recent years.

Managers. The board of directors hires managers to protect shareholders' interests and increase their wealth. However, this separation of ownership from control creates agency problems because the interests of managers and shareholders are different. Managers can make decisions that benefit themselves, not the shareholders, and conceal their actions through information asymmetry.

The FASB. The FASB is the main manufacturer of Generally Accepted Accounting Principles (GAAP), a collection of standards that can easily be manipulated, as shown by the common practice of earnings management. In the late 1960s Abraham Briloff a Professor at City College in New York began to criticize the accounting profession's practices and standards, publishing his criticisms in books and a column in Barron's. In 1972, he published a book entitled "Unaccountable Accounting: Games Accountants Play" which includes "a collection of horror stories about the ways in which generally accepted accounting principles are used, or misused, to produce whatever kind of financial statements management finds useful, often with scant regard for reality." (Gunn 1973). In 1976 he published a second book "More Debits Than Credits" whose title also speaks for itself. The book indicts accounting and auditing firms and the prestigious American Institute of Certified Public Accountants for allying themselves with corporate management in the preparation of deceptive, inaccurate corporate financial statements. Since then, there seems to be a never-ending series of accounting and auditing scandals as well as books and articles about the very same complaints made by Briloff. And again the titles speak for themselves:

- How real are those blue chip earnings? Forbes Cover Story February 2nd, 1981
- Financial Numbers Game Detecting Creative Accounting Practices by Mulford, Charles W., Comiskey, Eugene E. (1994)
- Creative Accounting Exposed by Ignacio de la Torre (2008)
- Financial Shenanigans by Howard Schilit (2010)
- Bean Counters. The Triumph of the Accountants and How They Broke Capitalism, by Richard Brooks (2018).
- And many more.

Now about half a century later searching Google Scholar for “earnings management” yields 827 results including 352 since 2014

Perhaps even more alarming is the failure of the FASB to reflect fundamental changes in the economy. GAAP is largely based on the way that business was conducted in previous generations when most assets were tangible. However, firms are now increasingly relying on intangible assets. GAAP has been slow to catch up with the way businesses operate today, so the old rules are becoming less effective over time. As Lev and Gu (2016) point out in their book, *The End of Accounting*, financial statements, the main product of corporate disclosure, are arcane and offer little value to shareholders. The growing trend of firms reporting on a non-GAAP basis highlights GAAP’s ineffectiveness (McCann, 2017). The potential unreliability of non-GAAP numbers, of course, numbers governed by no standards in their derivation nor capable of being meaningfully compared to other firms’ calculations (e.g., King, 2017), underlines even further the need for a change in how the small shareholder-firm relationship is conducted.

Auditors. One of the board's responsibilities is to hire the external auditor to assess whether managers have (a) followed GAAP in preparing the firm's external financial reports and (b) maintained sufficient internal controls over financial reporting to prevent or detect and correct material misstatements. The auditor's ability to protect investors is limited because they are not required to look for potential frauds. In addition, the effectiveness of audits depends on whether the auditor is truly independent of management. Many accounting scandals have shown that this is not always true, and the PCAOB was designed, in part, to mitigate the problem of auditor independence (Anandarajan et al., 2008). The fact that auditors are hired, paid, and can be fired by the firm that they audit casts doubt on the proposition that auditors are independent. In addition, the potential punishment for auditors who do not maintain independence from management may not be sufficient to deter this behavior (Davies, 2018). Brooks (2018) provides an extensive discussion of the ways that the validity of auditing results are imperiled by the temptations available from corporate management.

The PCAOB. The PCAOB was created to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. It may be somewhat effective in reducing the magnitude and frequency of accounting scandals, but is unlikely to improve the informativeness of financial statements, which, as mentioned before, are of little value to investors.

Financial Analysts. Small investors can find financial advice on the Internet, in the financial press, and on television. However, information asymmetry limits an advisor's ability to detect situations in which managers promote their own interest instead of their shareholders' interests. In addition, some advisors are unfortunately guilty of making stock recommendations that favor themselves at the expense of the investors. This problem is well-captured in recent discussion of

the US Department of Labor's fiduciary responsibility rule for financial advisors (e.g., Hopkins, 6/4/2017).

Institutional Investors. Institutional investors, such as pension funds, mutual funds, and insurance companies that own large blocks of stock, could be effective monitors for all shareholders. According to Hart and Zingales (2017), 60% of stocks are owned by institutional investors and only 27% by households. The impact of institutional investors can be more powerful when they seek the advice of organizations such as the ISS and act together. While Fox and Lorsch (2012) argue that most institutional investors lack the motivation to discipline or otherwise oversee management there is recent trend of increased involvement (Jahnke 2017). However, even when they do get involved, their ability to help small shareholders is limited because they face the same information asymmetry under Regulation FD of 2000 as the small shareholders. Thus, like all non-controlling shareholders, they are also unprotected from opportunistic management. It is also likely that institutional investors might vote against small individual shareholders' interests if they have economic or social relationships with management. In addition, as Hart and Zingales (2017) note, management of institutional investor organizations may not know the preferences of the individual investors whose assets the institutional investors manage. Also, the notion that all individual investors have a single, shared, set of preferences is problematic in itself. Certainly for larger corporations with large, in absolute numbers, numbers of shareholders, preferences as to corporate action may be diverse. Some may favor pro-sustainability decision making, others pro-labor policies, and still others sheer profit maximization. For whom, therefore, will institutional shareholders act? Given these things, institutional investors necessarily turn out to be ineffective defenders of individual shareholders' rights.

Shareholder Activists. A shareholder activist can put considerable pressure on management using a variety of tools including publicity, letters or petitions to top management or the board of directors, shareholder resolutions, proxy battles, or litigation. Once called corporate raiders, activists see economic opportunities to make changes at firms that are performing at suboptimal levels. Activists often improve the performance of weak firms by removing ineffective executives and directors. Their action can benefit all shareholders, including small shareholders. However, activists fail in many cases because companies have instituted anti-takeover measures. In addition, once activists become part of management, there is no guarantee that they will not fall into the moral hazard trap.

Legal Remedies. Dissatisfied shareholders can sue the firm for damages resulting from securities fraud. However, the legal standards are strict, lawyers' fees are high, settlements are too small to compensate shareholders or deter self-interested managers, and significant portions of the funds are never claimed. Class action lawsuits have long been a possibility. Filing a class action lawsuit enables the leveraging of a few law firms (typically) to act on behalf of a large group of individual claimants, many of whom will have been minimally hurt by the alleged malfeasance. The ability to do so, though, is under severe challenge—most recently with regard to class action lawsuits against financial industry firms (e.g., McCoy, 10/25/2017.) Forcing individuals qua individuals into arbitration is often argued to work against the latter and in favor of the allegedly malfeasant firm. Arbitration can be costly on its own given the need to marshal evidence and perhaps retain an attorney. For individuals, this can be prohibitive. So-called low-cost arbitration under the 1925 Federal Arbitration Act has been resisted by the SEC, forcing purported victims of firm malfeasance into processual difficulties. That is, how should they proceed? . Furthermore, Harte and Zingales (2017) note that it is very difficult to use the courts to attack decisions made

by the board of directors since most of these decisions are protected by the “business judgment rule”.

If all else fails, what to do?

Proposed Contract-Based Relationship between Small Shareholders and Public Corporations

Rationale. The essence of ownership is control. Yet small shareholders have no control over the activities of the company they “own” and lack protection from managers who put their own interest ahead of the shareholders’ interests. As argued in the previous section, the SEC and other groups concerned with shareholder’s rights are ineffective when it comes to protecting small shareholders.

Perhaps the problem lies in thinking of small shareholders as owners when, in fact, they are “owners” in name only. Small shareholders are actually participants in an ill-defined contractual relationship with their corporations. Once they invest their hard-earned money in common stocks, they become completely dependent on the ethical values of management and the effectiveness of protection by the SEC and other groups.

Rather than considering small shareholders to be owners of the firm, we view them as consumers paying for managerial services. Similar to the rights they have to know the ingredients of the tomato soup they buy in the supermarket they should have the right to know the “ingredients” of how management is committed to operate the company.

Proposal. To remediate this problem, we suggest treating the relationship between the firm and small shareholders as an explicit contract that grants specific protections and compensations

to shareholders in exchange for their investment. Our idea of a contract is based on Jensen and Meckling (1976), who viewed the corporate organization as a “nexus of contracts.” Under the contract, firms can offer any terms they think will attract investment capital. As long as the terms are transparent, legal, enforceable, and non-conflicting, the market should allocate capital efficiently. Such a contract would state specific, enforceable benefits and protections in the form of covenants designed to meet potential investors’ financial goals, societal concerns, risk tolerance, and/or information needs. Except for issues related to changes in the contract, it should not include voting rights, since votes offer small shareholders little benefit. Thus, the current system in which small investors hold common stock with useless voting rights and little protection from managers’ self-serving behaviors would be replaced by a regime in which they are protected by a contract and, if needed, a specialized court to adjudicate contractual disputes between the firm and the contract holders. We suggest using the term “capital contract holder” instead of “shareholder” to describe these investors.

Under the proposed new regime, the corporation will have two types of equity investors: 1) common stockholders who protect themselves through their voting rights; and 2) capital contract holders who are protected by the contract, but whose voting rights are limited to changes in the contract. Both types of equity could be traded on stock exchanges although the volume of trading in the voting stock may require a different trading vehicle than listing on a major stock exchange.

Both the holder of the voting stock class and the holders of the capital contract stock class have a shared objective of making the company more profitable. Each however would like more of those profits to be distributed to its class rather than to the other creating a conflict of interest which suggests banning owning both classes simultaneously. So management, controlling

investors and other insiders will own the voting stock while all other investors whether individuals or institutions will own the capital contract stock.

Release from SEC Regulations. In our scenario, the SEC would examine each contract to determine whether it offers sufficient shareholder protections to release the company from some or all of its regulations. Such a release may have major benefits to public corporations that have complained for years about the high cost of complying with SEC regulations. Moreover, the high cost of SEC compliance has been a significant obstacle for companies that want to go public and may be one reason why some public companies decide to go private. Taylor (2017) argues that “the drop in public companies tells us something about the costs and benefits of becoming a public company: specifically, it suggests that the costs are higher and the benefits are lower. Those who wish to impose greater costs on public companies should consider the tradeoff that is taking place.” A similar argument is made by Wursthorn and Zukerman (2018), who point out that small companies are staying private longer and relying on private capital to avoid the more stringent regulatory requirements of public companies. As a result, many small shareholders who do have access to private equity face fewer investment opportunities.

Elements of the Capital Contract. We suggest that a firm’s capital contract with non-voting investors should specify six key elements: 1) the basis for compensating capital contract holders for their investment; 2) reporting requirements for the firm; 3) any special covenants related to the capital contract; 4) the role of the auditor in this new scenario; 5) a way to adjudicate disputes between capital contract holders and the firm; and 6) procedures for changing the terms of the contract as the firm evolves. We describe each of these in turn.

Compensation for capital contract holders. Dividends for holders of voting common shares of stock will continue to be determined by the board of directors. By contrast, payments for capital contract holders will be determined by a formula explicitly stated in the contract. One possibility is to pay capital contract holders a percentage of the firm's revenue, operating income, net income, or any other basis. The contract will have to specify the formula for determining the payments to the capital contract holders, related measurement rules, and the specific procedures instituted to assure the capital contract holders that the contract is executed faithfully. In addition, covenants may also specify any distributions to capital contract holders upon the sale of major productive assets, such as a division, and in the case of liquidation.

Assuming that a main concern of small investors is excessive executive compensation, a possible remedy can be a formula in which the contract holders' compensation is a function of executives' compensation or a function of their bonuses. This will put pressure on the voting shareholders and the board of directors they elect to align those compensations with the firm's performance.

Reporting requirements. Current disclosure/reporting rules are highly standardized. Under a system of capital contracts, each firm can match its reporting to the nature of its operations, resulting in information that is more relevant for current/future capital contract holders. The content of the reports may vary according to the industry. For example, a real estate firm may report rent per square foot, whereas an airline may disclose information regarding its hedging on oil prices. Additionally, some companies may choose to withhold reporting of sensitive information to protect their competitive advantage.

Furthermore, in the digital era, companies could elect to disclose raw data and allow the capital contract holders or financial analysts to pull the data they need according to their preferences. We believe that an information “pull” approach, as opposed to the current information “push” system, is the way of the future. Unlike current one-size-fits-all reporting requirements, any of these covenants could be part of the contract with the firm’s capital contract holders. In a competitive market for investor capital, small investors can choose to invest in firms that provide disclosures that suit their needs.

Another timely issue is reporting frequency. Currently, there is growing concern about short-termism caused by excessive focus on quarterly reporting. The latter discourages investments in innovation and long-term profitability. Kraft et al. (2017) provide evidence that “increased reporting frequency is associated with an economically large decline in investments” and state that this is “most consistent with frequent financial reporting inducing myopic management behavior.” A 2015 *Wall Street Journal* article reported that the influential law firm of Wachtell, Lipton, Rosen & Katz proposes eliminating the SEC requirements for quarterly reporting. Under the capital contract, the reporting frequency could be designed to match the firm’s strategic plans and the capital contract holders’ information needs. Some companies, especially those with very long business cycles, may report every year or even two or three years, which would allow management to focus on the long run, benefiting both the common stock shareholders and the capital contract holders. Depending on the importance of liquidity to the capital contract holders, less frequent reporting might be combined with restrictions on trading, especially high frequency trading.

A covenant could also require the firm to provide prospective financial and/or non-financial reports about its plans for the coming period. This would allow companies to tailor their reports to the specific information needs of their capital contract holders. For example, a retailer may plan to

close 20 unprofitable stores, a food company may plan to reduce the sugar in its cereals by 25%, or a real estate company may plan to increase foreign sales by 15%. At the end of the period, each company would have to present an audited comparison of the plan's expected result to the actual result of its execution, and explain any variances. What the plan should be, of course, is a function of circumstances specific to the company. Such circumstances (e.g., more labor friendly versus more cost-containment/profit friendly, etc.) may be partially spelled out in special covenants. These circumstances thus affect how the company would report its comparison of actual to planned outcomes and procedures.

Special covenants. Covenants can be used to reduce moral hazard and to satisfy the specific interests of the capital contract holders. For example, one covenant might limit executive compensation or tie it to an auditable measure of firm profitability. Other covenants might relate to corporate social responsibility, such as requiring workers to be paid a certain minimum wage and be treated with a certain amount of respect and care, using sustainable energy, or not doing business with countries that use child labor. Another critical covenant could ban anti-takeover measures, such as golden parachutes, which make replacing failed management expensive or impossible. Political contributions may be another area in which contractual specifications may be deemed important. Bebchuk and Jackson (2014) present empirical evidence indicating that a substantial amount of corporate spending on politics occurs under investors' radar screens. A special covenant specifying procedures for such contributions may be an important element of the contract. While our general approach here is to minimize the need to ask the contract holders for approvals, in the special case of political contributions, the capital contract holders may want to voice their opinion, so voting on this issue may be desirable.

The role of the auditor. Making such a material change in the relationship between the firm and its investors would affect the nature of audit and the role of the auditor. Assuming that firms are released from most SEC regulations, the auditor's role will be to assess whether the firm has complied with the terms of the contract that it issued, including auditing all financial and non-financial reports required by the contract. While the contract may require assurance from a CPA firm, it may be more efficient for the corporation to buy commercial insurance that will protect the capital contract holders against the possibility that management's reporting is materially misstated and against other fraudulent management behavior. As suggested by Palmon and Sudit (2009), CPA firms could become the insurance companies for financial disclosure and contract compliance or alternatively CPAs will work for insurance companies. While auditors currently operate according to one-size-fits-all audit rules, once they work for or as insurance companies, the magnitude, specific areas, and frequency of their engagement will be a function of the risks involved in each specific audit. A benefit of this change would be that audit frequency could become a function of the quality of a firm's internal controls. For example, a company that has strong internal control systems might be audited only once every three years, whereas another company that has issues with its uncollectible accounts could be subject to a special engagement every month.

A specialized accounting court. What happens when capital contract holders detect a violation of the contract? We suggest resurrecting the concept of a specialized accounting court that Spacek first proposed in 1958. Like a specialized tax court for handling IRS disputes, the accounting court would be designed to address the unique issues associated with capital contracts, any disputes between the capital contract holders and the corporation related to their contract, and lawsuits concerning possible reporting fraud.

Procedures for changing the terms of the contract. As the firm evolves, there may be a need to make changes in the contract. Examples include a need to raise more equity, merge with another company, terminate the contract, or simply make a change in a specific covenant. Changes in the contract should require a vote from the capital contract holders, and the contract should specify the specific rules for each case. Given that we live in a digital world, voting can be conducted on-line or from a smart phone the way Estonians have been voting for more than a decade.

Discussion

SEC commissioner Kara M. Stein in a speech (January 19, 2018) in the SEC - NYU Dialogue on Shareholder Engagement questioned if today's shareholders are "simply the extras in a corporate movie. They have a role but no meaningful speaking part". While she did not provide a clear answer to her question she did emphasize the critical importance of retail shareholders' engagement to whom she referred as "owners" and mentioned distributed ledger technology as a way to enhance such engagement. While sincere, she, like many others, missed the point that retail shareholder's ownership is a myth. Shareholders engagement sounds wonderful but the typical retail shareholder has no time and no expertise to effectively engage with the corporation in which he or she owns a miniscule proportion of shares. And if she holds a portfolio of many stocks the extremely low incentive to engage becomes infinitesimal. We need to face reality and stop applying the term owner to extras in the corporate movie. Instead, compensate them fairly for showing up.

Our proposal to remove voting rights from the "non-owner" small shareholders may, at first, be rejected by those who advocate increasing power for shareholders. One such advocate is

Bebchuk (2005 and 2006) who makes a strong case for a regime in which shareholders can effectively exercise their voting rights in a way that will allow them to initiate and adopt rules-of-the-game decisions to change the company's charter or state of incorporation. In addition, Bebchuk argues that shareholders should be able to adopt provisions that would subsequently give them a specified power to intervene in additional corporate decisions. Power to intervene in game-ending decisions (to merge, sell all assets, or dissolve) could address management's bias in favor of the company's continued existence. Power to intervene in scaling-down decisions (to make cash or in-kind distributions) could address management's tendency to retain excessive funds and engage in empire-building. Thus, shareholders' ability to adopt provisions when necessary to give themselves a specified additional power to intervene could produce benefits in many companies.

Bebchuk argues that shareholders have incentives to get involved, and he may be right when it comes to some shareholders, especially institutional investors. However, we doubt that the small, passive investors will participate in this process because they lack time and knowhow, and they hold shares in too many corporations to become involved. Yet our proposed regime is actually consistent with Bebchuk's idea of shareholder participation. Individual or institutional investors who want to have a voice in firm governance will buy the voting shares, whereas those who prefer to remain silent will opt for the capital contract shares. In addition, some capital contracts might grant voting rights for specific rules-of-the-game. Given the option to invest in the capital contract, those who hold the voting equity should be viewed as the real equity owners of the firm who are willing and able to participate in the governing process. As long as the equity owners do not violate the contract with the capital contract holders, they should be given and should exercise the kind of shareholder power proposed by Bebchuk.

Reacting to the recent surge in dual-class initial offerings in which one class typically has little or no voting rights, S&P Dow Jones now excludes such dual class companies from its major U.S. stock indexes unless public shareholders have at least 5% of the voting rights. The concern is that the public shareholders might be left unprotected from opportunistic insiders. In a September 6, 2017 commentary in the *Wall Street Journal*, Dorothy Shapiro Lund, a teaching fellow at the University of Chicago Law School, makes the case for issuing non-voting stock by pointing out that it leaves decisions to those who are informed. We concur and point out that the concern of S&P Dow Jones would be eliminated by the existence of a contract under our proposed regime.

In a November 15, 2017 interview on CNBC, Nobel Prize winning economist Robert Shiller argues that passive investing is a dangerous form of freeloading. We believe that one reason for the surge in index funds is investors' difficulties in distinguishing between potential winners and losers. Those difficulties are caused by arcane and one-size-fits-all accounting rules that distort the allocation of resources in the economy. Under our proposed regime, we expect that investing will become more efficient due to improved reporting that matches the specific characteristics of each company. However, the complexities involved in analyzing such improved reporting may require a level of financial sophistication that only financial advisors, institutions, and a few individual investors possess. Consequently, unsophisticated individual investors may be forced to rely more on financial advisors. Under our proposal, each company issues its own unique contract, so these advisors can help investors by sorting out the differences among the unique features of each contract. Improving the ability to distinguish between winners and losers is not cost-free. While we expect a much richer information environment, the cost of analyzing the information cannot be ignored.

If the SEC agrees to accept the protections offered under the capital contract as a substitute for many of its regulations, the lower cost of SEC compliance would help private companies that want to go public and reduce incentives for public companies to go private. Identifying specific SEC regulations that could be eliminated under capital contracts and designing the covenants to replace those regulations should be the subject of future research. The possibility of exempting companies from SOX regulations if their small investors are protected by a solid contract needs to be explored as well. Of course, this type of revolutionary change may take time, but reducing managers' ability to engage in opportunistic behavior and removing obstacles to takeovers of companies with failed management would be beneficial to small, uninformed investors, and justify implementing this proposal. Moreover, as more companies offer contracts in lieu of voting rights, and such arrangements prove to successfully secure the wellbeing of the contract holders, the greater the chance that the SEC will allow contract terms to substitute for regulations.

Eliminating compliance costs is not cost-free though. We essentially replace the cost of complying to external regulators with the costs of contracting and monitoring the contract. We believe that such a substitution makes sense and that the benefits of switching to our proposed regime would outweigh those costs. In addition, with the help of new technologies such as blockchain the contract can be designed as "smart" assuring high level of compliance with agreed upon regulation rather than an imposed one.

Implementation

Our proposal is likely to be viewed as somewhat revolutionary. Nevertheless, there is some historical precedent for a major change in the nature of equity. For example, Evans (1929) points

out the fact that railroads first issued shares of preferred stock when their planned expansions of train tracks were considered too risky to be funded by traditional bank loans or common stock.

Since our proposal aims to prevent management from benefiting themselves at the expense of the small investor, management is unlikely to support such an idea unless the benefits of our proposed paradigm will outweigh management's loss of opportunities to take advantage of the powerless small investor. One main such benefit is a significant decrease in the cost of compliance. Other benefits would vary as a function of each contract. However, those benefits may not be sufficiently high for opportunistic managements who are likely to reject our proposal. Can small investors fight back or will they continue to have highly useless voting rights with little protection from managements?

Viewing the issue as a conflict between two groups, it is not the first time management was engaged in a conflict with an unorganized group. Recall the prelabor union era. At that time managements took advantage of unorganized labor while now they do the same to unorganized small shareholders. Perhaps it is time for small shareholders to form a union that will negotiate with management a contract which specifies their rights. The mechanism, legal and regulatory issues for the establishment of such a union are complex and but we believe that given that we live in the digital era organizing many small investors into a union is very feasible. At the very least, the idea should be considered and studied.

To mitigate the dominance of managements and large investors the first step should be to give a legal definition to the term small investors, by an act of Congress. The act should also give them basic rights, such as the right to organize to the extent that organizing to challenge or negotiate with corporate management(s) may be problematic due to SEC regulations or other.

Ideally such an act should include the formation of a court specialized in dealing with disputes between small investors and management.

Another option to ease implementation of our proposal stems from the necessary requirement of banning holding voting stock and capital contract stock by the same investor at the same time. Institutional investors who are investing on behalf of individual investors (mutual funds) employees (pension funds) and policy holders (insurance companies) are now equipped with better ammunition, namely the contract, to better represent the small investors' interest. Not only that, they can serve as watchdogs to detect when management violates the contract that they may have been instrumental in negotiating to begin with. Indeed, under our proposed paradigm their interest should be very consistent with that of the small investor and therefore whether as leaders of our proposed union of investors or under a different legal form they are the natural candidates to lead.

The macroeconomic consequences of adopting our new proposed paradigm are hard to predict. However, some wealth of management and large shareholders is likely to be transferred to small investors. This is a desirable outcome for those who believe that wealth inequality in the U.S. is too extreme and that the preferable way to decrease it is without taxation. In addition, the added benefits to small investors may attract more people of the middle class to invest in corporate equity and enjoy the fruits of capitalism. This is a desirable outcome for those who believe in the virtues of capitalism.

We suggest that the best way to introduce the idea of explicit contracts would be through the IPOs of firms that are going public. Competition for investor capital would encourage these firms to offer attractive contracts, and the explicit terms of these capital contracts might encourage

small investors to invest in risky new ventures. Implementation of capital contracts in existing companies would require offering shareholders a contract in exchange for their voting rights. This seems feasible only if the SEC accepts the offered contract as a substitute for its regulations, perhaps with a required minimum percentage of shareholders converting to the new contract-based instrument.

Concluding Remarks

Stock ownership gives individuals a way to participate in the economic opportunities provided by corporations. However, small shareholders are virtually unprotected from opportunistic management. We advocate replacing the voting rights of small shareholders with a contract that clearly specifies what they get in return for their investment. Our proposed new regime would mitigate the agency problem between management and small shareholders and make it easier for voting shareholders to replace failed management. Other benefits of this proposal include a possible shift in management focus from short-term to long-term performance, more efficient and effective audits, and the possibility of insurance to protect capital contract holders against fraud.

Most importantly, as much as we like our proposal, our main goal and hope is to generate a spirited discussion not just on the merits of our proposal, but also on other ideas to replace our current regime with a superior paradigm. For example, Palmon and Sudit (2011) proposed a reform in the structure of corporate ownership that would require public companies to unbundle their common stock into separately traded voting rights and monetary rights. The more ideas we get, including “out-of-the-box” ideas, the better.

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