Shareholder Voting
and Corporate Governance

The German Experience and a New Approach

Theodor Baums
Philipp v. Randow

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The Economic Development Institute
of The World Bank
Foreword

This EDI Working Paper will be published as one of 12 chapters in a forthcoming book entitled: Corporate Governance in Transitional Economies: Insider Control and the Role of Banks edited by Masahiko Aoki and Hyung-Ki Kim. The book will have three parts:

Part 1: Generic and Comparative Issues: Theory and Policy Implications (chapters 1–3)
Part 2: Country Studies in Comparative Perspectives (chapters 4–8)
Part 3: Relevance and Lessons of the Japanese and German Experience (chapters 9–12)
A list of titles is provided on the inside back cover of this paper.

The book presents the results of a research project on corporate governance issues in transitional economies from a new perspective based on comparative institutional analysis. A concern with three issues—the emergent phenomena of insider control, the possible role of banks in corporate governance, and the desirability of the comparative analytic approach—sets the common ground for the research presented in this volume.

The coexistence of the alternative models of corporate control in the developed countries suggests that the possible "lessons" for the transitional economies may not be so obvious. It makes little sense to judge the merits of each corporate governance model and its applicability to the transitional economies without taking into account a country's stage of development and the history of its institutions and conventions. In designing corporate governance structures for the transitional economies, economists are required to identify the specific conditions under which each corporate control model (or combination of models) works, the availability of these conditions in the transitional economies, and the most efficient approach to achieve these conditions. By pooling rich individual country studies and cross-examining and comparing their implications, we may be able to avoid premature generalizations or theorizing based on the observation of a single economy. By comparing the workings of diverse systems, we may also be able to uncover latent factors that are conducive to, or constrain, the workability of particular governance structures. Comparative analysis may thus serve in the social sciences as a kind of proxy for laboratory experiments.

This work was prepared as part of EDI's multiyear Program for the Study of the Japanese Development Management Experience which is financed by the Policy and Human Resources Development Trust Fund established at the World Bank by the Government of Japan. The Program is managed by the Studies and Training Design Division of the World Bank's Economic Development Institute.

Hyung-Ki Kim, Chief
Studies and Training Design Division
Economic Development Institute
Shareholder Voting and Corporate Governance: The German Experience and a New Approach

Theodor Baums and Philipp v. Randow

The rapid expansion of the private sector in transition economies, particularly the corporatization of enterprises, poses problems of corporate governance. To provide large, publicly held corporations with equity capital, investors need assurance that they are protected against the detrimental side-effects of a separation of ownership and control. In this chapter we propose a tentative market solution to some of the governance problems in large, publicly held corporations and compare it with the “German experience”—that is, the role of banks in corporate governance.

Shareholder Voting and Collective Action

Shareholder voting is an integral part of the governance structure of publicly held corporations. Requiring shareholder consent for any fundamental change in corporate policy is a safeguard for the residual risk-bearers of a corporation against ex post expropriation by the management. The right to vote assures the shareholders that the basic terms of their investment cannot be altered without their approval. In essence, then, voting rights are to stockholders what covenants are to bondholders: by limiting managerial discretion, they serve as a protection against moral hazard (Easterbrook and Fischel 1990, p. 186). Unlike bondholders, however, shareholders receive most of the marginal costs and benefits of fundamental corporate decisions. Thus, shareholders as residual risk-bearers have the appropriate incentives to decide on those matters (Easterbrook and Fischel, 1991, pp. 67, 69). Also, vesting voting rights in shareholders is the only feasible method to implement major improvements of corporate policy that affect the terms of their investment. Because of the dispersion of equity holdings, renegotiations are impossible to organize (Bebchuk 1989). Moreover, renegotiations would require unanimity, thus giving veto power to all shareholders, including those who hold only a small fraction of shares. By allowing a majority to implement fundamental changes of corporate policy, however, veto power can only be exerted if a shareholder holds a substantial proportion of the shares—thus, a vetoing shareholder is forced to internalize at least part of the impact of his decision on firm value.

Unfortunately, voting as a decision mechanism suffers from collective action problems. Widely dispersed shareholders are likely to be “rational-apathetic” when it comes to acquiring information on changes of corporate policy proposed by management. The cost of informing oneself in order to cast an intelligent vote on a management proposal will exceed the expected benefits, even if one assumes that their own vote will be decisive. Therefore, voters that hold only a small fraction of shares will remain rationally ignorant. If the management controls the agenda, as it does in most legal systems, shareholders will give their approval, assuming that the management acts on superior knowledge (Easterbrook and Fischel 1991, p. 67). Moreover, even if some shareholders have determined that a particular proposal will result in a loss in share value, “free-rider” problems will discourage formation of an opposition.
Each shareholder may gain from opposition, but each will gain more if other shareholders bear the costs. Shareholders are not rewarded for contributing to decisionmaking. Thus, while it is better for all if everyone contributes, it is better for everyone not to contribute, with the result that the activities (information gathering, casting votes) will not be undertaken. There is no cost-sharing mechanism that forces all the shareholders who gained from the efforts of forming an opposition to pay for these activities (Gordon 1989).

As a result, changes of corporate policy might be adopted even though they are value-decreasing. Selling shares is not a viable alternative; informed traders would anticipate the approval of a value-decreasing change of corporate policy, and they would lower their willingness to pay accordingly. Thus, investors cannot escape the detrimental effects of their collective action problems by selling shares. True, if a buyer acquires large blocks of shares, he can change the course of action of a particular firm and dismiss the incumbent management. Under these circumstances, his expected payoff from informed voting may warrant efforts to evaluate the proposals of the incumbent management. Voting rights, then, help to provide incentives to the management to work hard on behalf of the shareholders because a poorly performing firm may become a target for a takeover. But large equity holdings come at a cost—they reduce liquidity in the market and thereby limit the informational content of share trading (Holmström and Tirole 1993). This cost is ultimately borne by the shareholders themselves, because reductions in market liquidity make performance evaluation of the management more difficult (Holmström and Tirole 1993).

The question we want to address is whether there exists a less costly mechanism to eliminate the collective choice problems mentioned above. We will try to evaluate the costs and benefits of a market solution where there are entrepreneurs, who can earn profits by lowering the costs that dispersed shareholders must bear to exercise informed, coordinated voting power. Allowing for entrepreneurs to cast a vote for dispersed shareholders would be advantageous to the group as a whole. The cost of informed voting by the entrepreneur would be lower than the sum of the personal costs of all shareholder monitoring as well as the costs of nonmonitoring by individual shareholders. Unlike dispersed shareholders, an entrepreneur can economize on the fixed costs of collecting information about firms. Moreover, it is plausible to assume that there are economies of scope as well if a specialist casts votes for shareholders of different firms of the same industry.

In what follows, we shall argue that it is possible to establish a market that functions well for voting services, where firms offer to engage in monitoring and voting on behalf of the equity owners of large, publicly held corporations. To accomplish this, however, a new regulatory framework for proxy voting needs to be implemented. We will outline its main components, some of its potential pitfalls, and compare it to the German experience—that is, proxy voting by universal banks. Banks' proxy voting power is often assumed to be a substitute for the activism of large shareholders because they can exploit economies of scale and scope in information collection, evaluation, and exercise of shareholder voting rights (Cable 1985, p. 121). Our analysis, however, will cast some doubts on the well-known notion that German banks act as delegated users of equity control rights.

A Market for Voting Services

To start the analysis, let us very briefly describe the main reasons why markets that function well for proxy voting services may not emerge.

First, there would be free-rider effects on the demand and the supply sides of voting services. To see this, let us assume for a moment that a voting company could collect the proxies of the majority of shareholders. While this majority would have to pay for the monitoring and voting services, its benefits would
also accrue to the minority shareholders who did not give their proxies to the voting company. Clearly then, instead of paying for the services provided, shareholders will try to take a free ride on the efforts of a voting agent. Moreover, there may be free-rider incentives on the supply side of voting services as well. The management of voting companies may want to rely on the monitoring efforts of their competitors and vice versa, resulting in under-monitoring of the company to be controlled.

Second, there is a problem of asymmetric information. Again, assume that there are competing firms, offering their monitoring and voting services to shareholders. Yet because of the small investment, a single shareholder will devote almost no resources to ascertaining the quality of their services. Voting agents that offer good quality cannot charge higher prices than those who offer voting services of inferior quality. Thus, bad firms may drive out the good (Akerlof 1970). Even if a shareholder learns that the voting services from a particular agent are of inferior quality, he will still not know whether its competitors provide quality of a higher standard. Therefore, his costs of switching to another company may be higher than the expected benefits.

We thus are led to conclude that there are major obstacles to the establishment of a well-functioning market for voting services. Because of problems of collective action and asymmetric information, there is no reason for an individual investor to hire an agent to cast an informed vote on his behalf at the shareholder's meeting. The German experience, however, tells us a different story. Equity owners in Germany give proxies to their banks and let them exercise voting rights at their discretion. Is there a German solution to the problems of collective choice in shareholder voting?

The German Experience

In Germany (Baums 1992, 1993; Kondgen 1994), private investors do not have access to the stock exchanges. Instead, listed stock is acquired and sold through intermediaries, such as banks.1 Because of high transaction costs, investors generally choose not to hold the documents themselves; in most cases they “deposit” their shares with a bank. The bank holds an account at a special deposit company (Deutscher Kassenverein), where the shares are certified in a global document.2 According to the Stock Corporation Code (Aktiengesetz 1965), banks that offer to hold shares on “deposit” for their customers are obliged to furnish them with the corporation’s information on shareholders’ meetings (for example, the agenda, the recommendations of the management board, the proposals of other shareholders as to resolutions of the meeting). Although the banks are refunded for this service by the company itself,3 they charge their customers for keeping the shares in custody; they also offer to vote these shares.4 If a bank offers to vote the shares to any shareholder of a company, it is obliged to accept each client’s request to cast their vote as well (§ 135 (10), Aktiengesetz). Banks do not, however, charge their clients an additional fee for their voting services.5 They ask for a flat rate for the depository service only. Soliciting proxies and voting their clients’ stock is one of the few financial services that German banks offer “for free.”6

The latest statistical data on shareholder representation by banks show that the main banks in Germany have acquired control of a substantial proportion of voting rights in publicly held corporations. According to a study conducted by Perlitz and Seger (forthcoming), in nine out of fifty-seven major “top one-hundred” German industrial corporations, proxy voting rights provided the main banks with the blocking minority, in another six companies with the majority, and in eleven corporations with a majority of over 75 percent of the shares present at the shareholders’ meeting, thus enabling them to change statutes (see tables 12-1 and 12-2). The voting power of the main banks is even more impressive if their own shareholdings are taken into account. The combined voting power from shareholdings and proxy voting rights amounts to a blocking minority in five companies, a majority in nine companies, and a
qualified majority (over 75 percent of the shares represented at the shareholders' meeting) of seventeen corporations (see tables 12-3 and 12-4).

According to a further study, conducted by Fraune (forthcoming), the accumulated voting power of banks from their own shareholdings, proxi votes, and shares held by investment companies where banks hold more than 50 percent of nominal equity capital, accounted in 1992, on average, for more than 82 percent of the votes present in the general meetings in 20-4, “top one-hundred” publicly owned corporations in Germany (the average presence of all shares being 58 percent). This voting power amounted to a blocking minority in all four corporations, a majority in three, and a qualified majority in seventeen corporations of the sample.

In a further study, from a list of the one hundred largest firms in 1984, Gottschalk (1988) selected firms with more than 50 percent of their stock either widely held or owned by banks. These thirty-two companies, with a (nominal) equity capital of DM 29.5 billion, represented about a quarter of the nominal capital of all German stock corporations. Gottschalk aggregated the voting power of the banks' own shares, their custodial shares, and shares held by investment companies that are bank subsidiaries. He found that, on average, banks represented more than four-fifths (82.67 percent) of all votes present at meetings (the average presence of all shares was 64 percent). With one exception, they represented at least a majority (more than half) of the votes present. Consequently, banks were able to elect the members of the supervisory board chosen by shareholders and changes in the corporate statutes could not be effected against their votes. In twenty-two, or two-thirds, of the firms, the banks voted more than three-fourths of the stock present and thus could change the statutes. No other shareholder could block these decisions. Note that many of these corporations (by the votes of the banks) have provisions in their statutes that no one shareholder may vote more than (typically) 5 percent of all shares of the company. This rule does not, however, apply to banks voting proxies. The aggregated voting power of banks, added to rights based on their own equity holdings or rights transferred to them by mutual funds run by a subsidiary, thus provide a comfortable and stable power base at shareholder meetings. Furthermore, Gottschalk's study shows that the voting power is highly concentrated in the three largest private banks (Deutsche Bank, Dresdner Bank, and Commerzbank). Together they voted an average of approximately 45 percent of the stock represented at the general meetings of the thirty-two companies. In almost half the cases (fifteen firms), they held the majority; in another third (ten firms) they had a blocking minority. In individual cases, one or another of the big banks dominates. In most cases the votes are distributed roughly equally among them, or two banks together have about the same number of votes as the third alone. Also, according to a survey conducted by the Gesellschaftskommision, the proxy rights of the three big banks together in 1974 constituted the voting majority in five companies and the blocking minority or voting majority in another sixteen companies (out of seventy-four) (Studienkommission 1979, p. 436).
Table 12-1. Proxy Votes of German Banks, 1990  
(percent of shares present)

<table>
<thead>
<tr>
<th>Proxy votes</th>
<th>Deutsche Bank AG</th>
<th>Dresdner Bank AG</th>
<th>Commerzbank AG</th>
<th>Other banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 10</td>
<td>40</td>
<td>45</td>
<td>56</td>
<td>28</td>
</tr>
<tr>
<td>10–25</td>
<td>9</td>
<td>10</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>25–50 (blocking minority)</td>
<td>6</td>
<td>2</td>
<td>0</td>
<td>11</td>
</tr>
<tr>
<td>&gt; 50 (majority)</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Total cases of bank proxies</td>
<td>57</td>
<td>57</td>
<td>57</td>
<td>57</td>
</tr>
</tbody>
</table>

Note: N = 57.  
Source: Perlitz and Seger, forthcoming, p. 16.

Table 12-2. Proxy Votes of German Banks, 1990  
(percent of shares present)

<table>
<thead>
<tr>
<th>Total bank proxies</th>
<th>Number of corporations</th>
<th>Percentage of total number of corporations</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 10</td>
<td>20</td>
<td>35.1</td>
</tr>
<tr>
<td>10–25</td>
<td>11</td>
<td>19.3</td>
</tr>
<tr>
<td>25–50 (blocking minority)</td>
<td>9</td>
<td>15.8</td>
</tr>
<tr>
<td>50–75 (majority)</td>
<td>6</td>
<td>10.5</td>
</tr>
<tr>
<td>&gt; 75 (extraordinary majority)</td>
<td>11</td>
<td>19.3</td>
</tr>
</tbody>
</table>

Note: N = 57.  
Source: Perlitz and Seger, forthcoming, p. 17.

Table 12-3. Shareholdings plus Proxy Votes of German Banks, 1990  
(percent of shares present)

<table>
<thead>
<tr>
<th>Shareholdings plus proxy voting</th>
<th>Deutsche Bank AG</th>
<th>Dresdner bank AG</th>
<th>Commerzbank AG</th>
<th>Other banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 10</td>
<td>35</td>
<td>43</td>
<td>56</td>
<td>26</td>
</tr>
<tr>
<td>10–25</td>
<td>10</td>
<td>8</td>
<td>1</td>
<td>13</td>
</tr>
<tr>
<td>25–50 (blocking minority)</td>
<td>8</td>
<td>4</td>
<td>0</td>
<td>13</td>
</tr>
<tr>
<td>50–75 (majority)</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>&gt; 75 (extraordinary majority)</td>
<td>3</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Note: N = 57.  
Source: Perlitz and Seger, forthcoming, p. 17.
Table 12-4. Total Shareholdings plus Proxy Votes of German Banks, 1990
(percent of shares present)

<table>
<thead>
<tr>
<th>Total banks' shareholdings plus proxies</th>
<th>Number of corporations</th>
<th>Percentage of total number of corporations</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 10</td>
<td>17</td>
<td>29.8</td>
</tr>
<tr>
<td>10-25</td>
<td>9</td>
<td>15.8</td>
</tr>
<tr>
<td>25-50 (blocking minority)</td>
<td>5</td>
<td>8.8</td>
</tr>
<tr>
<td>50-75 (majority)</td>
<td>9</td>
<td>15.8</td>
</tr>
<tr>
<td>&gt; 75 (extraordinary majority)</td>
<td>17</td>
<td>29.8</td>
</tr>
</tbody>
</table>

Note: N = 57.
Source: Perlitz and Seger, forthcoming, p. 18.

To sum up, our overview shows that the banks accumulate and yield considerable voting power at shareholder meetings (Baums 1992, table 1, 1994, table 12-3). This is most visible in the number of seats they hold on the supervisory boards of companies with a fragmented ownership structure. Banks sent eighty-five representatives (managers and directors) into the board rooms of the one-hundred largest industrial firms in 1990 (on personal interlocks between firms and banks, see Baums 1992, table 4), placing banks at the center of corporate interlocks. Perlitz and Seger confirm this data in their recent study: in a sample of 110 large industrial companies, the credit institutions are represented by 162 members; this accounts for 12 percent of all the 1,355 members that were chosen by the shareholders; moreover, in 29 corporations the chairman of the supervisory board is a bank representative (see tables 12-5 and 12-6; Perlitz and Seger, forthcoming). Also, according to a survey conducted by the Monopolkommission in 1978, bank representatives occupied 145 seats on the supervisory boards of the largest one-hundred publicly held corporations in Germany (Edwards and Fischer 1994). The main banks (Deutsche, Dresdner, and Commerzbank) accounted for 94 of the 145 representatives (Edwards and Fischer 1994).

Table 12-5. Banks' Representation in the Supervisory Boards of German Companies, 1990
(number)

<table>
<thead>
<tr>
<th>Bankers on supervisory boards</th>
<th>Corporations</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deutsche Bank AG</td>
<td>Dresdner bank AG</td>
<td>Commerzbank AG</td>
<td>Other banks</td>
</tr>
<tr>
<td>1</td>
<td>45</td>
<td>22</td>
<td>12</td>
<td>43</td>
</tr>
<tr>
<td>2</td>
<td>7</td>
<td>1</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Total cases of representation</td>
<td>52</td>
<td>23</td>
<td>14</td>
<td>52</td>
</tr>
<tr>
<td>Chairmanships</td>
<td>15</td>
<td>3</td>
<td>0</td>
<td>11</td>
</tr>
</tbody>
</table>

Note: N = 110.
Source: Perlitz and Seger, forthcoming, p. 18.
Table 12-6. Total Banks’ Representation in the Supervisory Boards of German Companies, 1990

<table>
<thead>
<tr>
<th>Bankers on supervisory board</th>
<th>Number of corporations</th>
<th>Percentage of corporations</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>18</td>
<td>16.4</td>
</tr>
<tr>
<td>1</td>
<td>51</td>
<td>46.4</td>
</tr>
<tr>
<td>2</td>
<td>19</td>
<td>17.3</td>
</tr>
<tr>
<td>3</td>
<td>17</td>
<td>15.4</td>
</tr>
<tr>
<td>4 or more</td>
<td>5</td>
<td>4.5</td>
</tr>
</tbody>
</table>

*Note: N = 110.*

*Source: Perlitz and Seger, forthcoming, p. 19.*

The enormous success of German banks in soliciting proxies is easy to explain: there is a factual compulsion to use the banks as trading institutions and depositories. Because banks do not charge their clients a fee for the additional service of casting votes on their behalf, it is easy for them to solicit proxies from their clients. Thus, the free-rider problem on the demand side of voting services has been overcome. The question then arises: do banks exercise their voting power in the best interest of their clients? But before we turn to this question, let us describe briefly the extent to which banks are allowed to cast the votes of their clients at their own discretion.

In order to cast a vote for its clients, the bank needs a special written power of authority or proxy, which may not be included in the general standard form contract governing the bank-customer relation. This proxy cannot be given for more than fifteen months, and it is revocable at any time (§ 135 (1), (2), Aktiengesetz). Before a shareholder meeting, banks have to recommend to their customers how to vote, and they must ask for special instructions. To enable the client to make an informed decision, the bank has to submit its own proposals of how it intends to vote in case it does not receive any instruction. In such a case the bank may then vote the client’s stock in accordance with its previous proposals (§§ 128 (2), 135 (5), Aktiengesetz). In most cases, a bank votes the proxy on the basis of a carte blanche and in accordance with proposals that are of its own making. Apart from extraordinary cases, banks usually take sides with the proposals of the management (which does not exclude the possibility that management has checked in advance with the major deposit institutions to determine if certain proposals will have a chance to pass; see Bericht der Studienkommission 1979). Banks usually content themselves with mailing a proxy form sheet, routinely suggesting that the vote should be cast in accordance with the proposals of the management if the shareholder has not given other instructions. Empirical surveys have shown that customers give directions of their own in only 2 to 3 percent of all cases (Immenga 1978, p. 103). Any vote that departs from either the customer’s guidelines or the bank’s own proposals has to be reported and accounted for to the client (§ 135 (10) Aktiengesetz). Apart from the provision that banks follow the explicit instructions of their clients, the Stock Corporation Code does not say much about the duties of the depository banks when voting their clients’ stock (Köndgen 1994). Provision § 128 (2) of the Aktiengesetz requires that the bank’s proposals for voting be in the best interest of the client-shareholder. Only two provisions address conflict of interest. First, if a bank has been given a proxy to vote the stock of its own company, it may do so only if it has been given explicit instructions regarding specified items on the agenda (§ 135 (1) Aktiengesetz). Second, the bank has to disclose if one of its managers is a member of the supervisory board of the issuing company or vice versa (§ 128 (2) Aktiengesetz).
From the above analysis it should be clear that banks have a *substantial degree of discretion* when they exercise the voting rights of shareholders. Since banks are able to vote at their discretion to a large extent, the question remains of whether this voting power is exercised exclusively in their clients' interest. Recall first that there is a problem of asymmetric information inherent in markets for voting services. Again, if shareholders that hold small equity claims do not care about their right to vote, why should they try to evaluate whether a voting agent acts to their best interest? And why then should a bank as voting agent provide for good quality?

We can look at this question from two different angles. First, potential conflicts of interest have to be identified when a bank exercises voting rights in other corporations. The multiple roles of German banks as advisers, lenders, equityholders, and voting agents have to be taken into account. This analysis, however, would rely on the assumption that the management of banks will try to maximize the value of the banking corporation. But banks very often are large, publicly held corporations themselves. Thus, we also need an understanding of the *particular objectives of bank's managers* as the decisionmakers of large publicly held corporations when they decide on how to vote their customers' shares in other companies (Edwards and Fischer 1994, p. 237). Specifically, we are led to ask whether the unique combinations of proxy voting power and equity holdings between banks and other corporations in Germany is a device that enables self-interested managers to protect each other against the threat of dismissal by dissatisfied equity owners and to establish a "cooperative shirking equilibrium." Although there is some anecdotal evidence that proxy voting power is exercised to the detriment of the clients' interests in single cases (Wenger 1992), there are no systematic studies on the voting behavior and policies of depositary banks and their managements. But if we look at the incentive structure of these intermediaries and their managements, and keep in mind that there is considerable discretion to use their positions as proxies in their own rather than in their clients' interest, the guess is certainly that this monitoring device comes at an additional agency cost for the shareholders. The agency cost of the monitoring system that we analyze is the sum of the investments borne by the shareholders in limiting shirking or opportunistic behavior of the depository, plus the costs associated with remaining or residual suboptimal behavior. Since small shareholders *are rationally apathetic as shown above*, the amount of the investment of the shareholders themselves to limit shirking or opportunistic behavior will probably be low, or even zero, whereas the residual cost may be high if there are no mechanisms to reduce this cost.

There are only a few legal provisions that address conflict of interest and try to ensure that depository banks pursue the interests of their clients. The provision that banks comply with express directions from their clients is certainly not an innovation. In addition, Aktiengesetz (§ 128 [2]) requires that the bank's own proposals for voting the proxy be in the best interest of the shareholder. This broad phrasing gives way to almost any interpretation (see Kondgen 1994, p. 552). Courts have never tried to specify the meaning of this rule because shareholders have not brought suits against depot banks so far. The provision that banks may vote their own stock only if they have been given express instructions on how to cast the vote (§ 128 [1] Aktiengesetz) covers only a small range of possible conflicts of interest. The banking supervisory authorities do control the deposit and proxy voting business of banks to a certain extent; this control, however, is merely formal. It is confined to checking whether the depository institutions complied with the provisions of the Stock Corporation Act. In addition it provides that a bank has to document the reasons and deliberations that led to its voting proposals. The most effective control is probably exerted *by the financial press and the public debate* on the role and economic power of banks. Banks are responsive to this critique because abuses could lead to adverse public or political reactions.
Now, let us look at the main reasons that banks might be interested in soliciting proxies from individual shareholders. This analysis will reveal a number of conflicts of interest for banks that might adversely affect the interests of small shareholders.

Banks could try to protect and enhance the value of their own equity investments. As we mentioned above, German banks may and may do hold, in addition to their position as proxyholders, considerable equity stakes in firms. The 4,191 banks that are supervised by the Federal Banking Supervisory Agency (Bundesaufsichtsamt für das Kreditwesen) held 4,802 direct participations in other firms of more than 10 percent of the capital of these firms in November 1993 (Federal Banking Supervisory Agency 1993). Proxy voting power may enable a bank to influence the management of a particular corporation to deal with other companies where the bank has substantial equity holdings. If these business transactions with other bank-controlled companies benefit the bank's shareholders but are not to the best interest of the shareholders of the controlled corporation, close and ongoing monitoring on behalf of these shareholders does not pay off for the bank.

Also, as a creditor commanding over half the votes at a shareholder meeting because of its own holdings and proxy voting rights, a bank can choose who manages the firm. It will choose people who implicitly promise not to harm the interests of the creditor by engaging in overly risky projects, distributing assets to shareholders, and the like, without the bank's approval. In case of misbehavior it can punish management—clearly, the incumbent management will anticipate this possibility. The addition of custodial shares to its own equity holdings seems to be a perfect arrangement to get the necessary leverage on a firm's management to protect the bank's own credit investment without sharing the risks. Because proxy voting rights yield disproportionate voting power the bank will not bear the residual losses from an overly risk-averse investment strategy commensurate with its control over the company. It does not matter that this power usually has to be shared with other banks; as creditors they have largely parallel interests in dealing with the firm's management.

A bank does have incentives to act as a depository and get as many proxies as possible in order to be able to cast votes and send representatives into board rooms, because this will increase the likelihood that the bank will get a share of the respective firm's financial business. The main banks that command the most votes at the general meeting of a given firm will most likely be among the (leading) members of an underwriting syndicate for the issuing company (Böhm 1992). There remain complaints about the stable structures of these syndicates and the low degree of competition in the market, although things seem to be changing in issues on the national market (Verband der Auslandsbanken in Deutschland 1993). Furthermore, banks may want to hold proxy voting power in order to maintain their dominant role as leaders of a syndicate when new shares are issued. Since the existing equity owners usually get the right to purchase the shares of a new issue, a bank with a great number of shares on deposit is in a good position to arrange the sale of shares to the existing shareholders (Edwards and Fischer 1994, p. 216).

Banks may also prefer projects that need (higher) external (credit) finance to projects with a comparatively higher net present value for the firm and greater benefit for the shareholders (Böhm 1992). If the assertions of the managerialists are correct, corporate managers do not pursue profit maximization, but rather seek size or growth maximization (Klein and Coffee 1990, pp. 161–62). This means that there may be a common interest between managers and custodial banks at the expense of shareholders. The evidence, however, is mixed. Credit finance does not play a more important role in firms where banks exercise substantial proxy voting power than it does in firms that do not have banks in a comparable position. Large corporations with banks as proxyholders raise significantly less bank finance than the German corporate sector as a whole ("Monatsberichte der Deutschen Bundesbank" Oct. 1992, p. 31; Mayer and Alexander 1990). A related issue concerns the dividend policy of firms. Management may prefer to retain earnings rather than distribute them to shareholders. This makes the firm less dependent
on external finance and provides a way to conceal fluctuations in future reported earnings, and thus reduces management’s accountability for losses. Banks are said to support this restrictive dividend policy when casting their clients’ votes to protect their credit extensions or to get a share of the firm’s financial business (Böhm 1992, pp. 139–40, 143, 149; Immenga 1978, p. 121). At the same time, retaining dividends means that management becomes increasingly independent and “emancipated” from external finance as the internal funds grow. But perhaps banks tend to neglect this long-term development in order to pursue their present interests.

Still another incentive to get proxies exists for management of banks that are publicly held corporations with widely distributed shares. Mutual proxy or capital interlocks between two banks, a bank and an insurance company, or a bank and an industrial firm can dilute the respective managements’ ability to control each other when exercising the voting rights of third parties. If managements can punish each other because both firms hold a sufficient amount of either the stock of the other firm or its shareholders’ proxies, they will probably refrain from being a nuisance to the other side. Such mutual proxy and capital interlocks ensure that the respective managements can support as well as punish each other. In the past, banks have helped the management of other banks and large firms whose stock they vote protect themselves against unwanted takeovers by changing the target firm’s corporate statutes to dilute the voting power of a possible challenger. Admittedly, this incentive does not play a role in cases where the ownership structure of the deposit bank looks different—as is the case, for example, at a privately held bank or at savings banks (Sparkassen) owned by a municipality. To sum up, there are a number of conflicts of interest for banks exercising proxy votes that might adversely affect the interest of small shareholders. Apparently, the German system of depositary voting is in need of a change. In the following, we will try to evaluate the costs and benefits of a market where there are entrepreneurs, who can earn profits by lowering the costs that dispersed shareholders must bear to exercise informed, coordinated voting power.

A New Approach

Let us now turn to a proposal that might help to establish a market in voting services despite the problems mentioned above. The main requirements are outlined below.

Voting agents offer their services to the corporation and declare the prices they intend to charge for their services. Eligible as voting agents are auditors and auditing companies only. Any business links between the voting agents and the corporation and/or the shareholders of the corporation are prohibited by law. These restrictions do not apply to other parties that exercise shareholder voting rights on the basis of specific instructions.

- Shareholders will be furnished with the all relevant data concerning these offers. Voting agents will be elected by the active shareholder: the votes may be cast by postal vote, by representatives on the ground of specific instructions, and by shareholders who attend the general meeting. The voting agents will be elected for a certain period of time. After each period—say, three years—there will be a new election. In this election the incumbent voting agents are not allowed to represent shareholders. Moreover, a term limit prohibits reelection of a voting agent for more than two consecutive terms. After such a break, however, voting agents are free to campaign for a new election.

- There is a limit on the number of voting agents that may be elected, depending on the ownership structure of the corporation. In corporations that are listed on a stock exchange there may be no more than three (3) voting agents at a time; unlisted corporations with a nominal equity capital
of more than DM 1 million may not have more than two (2) voting agents. Incorporations with a nominal equity capital of less than DM one million, voting agents may not be elected.

- **In order to be elected, voting agents need to get at least 5 percent of the votes cast or votes representing more than DM 500,000 of the nominal equity capital of the corporation.**

- **The voting agents represent all shareholders except those who attend the general meetings during the tenure or are represented by a person that has been given specific instructions or a special proxy.** For example: if, say, 60 percent of the shareholders attend the general meeting or are represented by third parties on instructions, the voting agents will automatically cast 40 percent of the votes not present. Thus, there will be a 100% rate of shareholder representation in any general meeting.

- **The voting agents declare in advance how they plan to decide the issues of the general meeting’s agenda.** If shareholders want to vote otherwise, they have to attend the general meeting or to send their specific instructions to the bank that holds their shares in custody.

- **The voting agents cast votes of nonactive shareholders according to their success in the election.** Thus, if two voting agents have been elected, and voting agent A received 40 percent of the votes, while voting agent B got 20 percent, A represents two-thirds and voting agent B 1-third of the inactive shareholders in the general meeting. Shareholders, of course, are free to choose whether to attend the general meeting, let third parties decide on specific instructions, or to rely on the voting agent.

- **The voting agents are paid by the corporation.**

- **Voting agents will be supervised by a regulatory authority.**

This regulatory framework should make sure that a well-functioning market for voting services will emerge. First, recall that there may be free-rider effects on the demand side if firms will offer voting services. By requiring the corporation to remunerate the voting agents, however, a cost-sharing mechanism will be introduced that forces all the shareholders who gain from the effort of informed coordinated voting to pay for this activity through the corporation. (Kallfass 1992ab). True, if the active shareholders hold only a small proportion of the shares, there will bear only a small fraction of the cost of their choice. Thus, they might be led to vote for an extensive voting agent. Hiring an unduly expensive voting agent, however, would lower the value of the shares as well. Therefore, the incentives to externalize costs on the inactive majority are mitigated.

Second, the problem of asymmetric information has to be managed. Shareholders, who hold only small fractions of shares, will devote almost no resources to ascertaining the quality of the services of a particular voting agent. Again, the cost of informing oneself will exceed the expected benefits. Thus, we need a mechanism that allows for an informed choice of voting agent. Enter the general meeting: Voting agents should be elected by active shareholders. Basically, then, **active shareholders elect voting agents on behalf of the inactive shareholders.** By allowing only active shareholders to cast a vote, the problem of asymmetric information will be overcome.

Active shareholders are—almost by definition—interested in corporate matters, and their interests, as far as profit-maximization is concerned, align with those of inactive shareholders. Therefore, they will carefully scrutinize the quality and prices of the voting companies that stand for election. This quality control by active shareholders and limited tenure will provide a voting trust with an incentive to work hard on behalf of the shareholders it represents. Only by providing monitoring efforts that benefit shareholder interests can the voting agent hope to get reelected. The role of active shareholders in electing a voting agent for inactive shareholders, however, might raise some concern. Let us address two potential objections. First, active shareholders might try to preserve their disproportionate voting power in the general meeting by refraining from casting a vote altogether. Because the election of voting agents
requires the participation of only a very small group of active shareholders (5 percent of the votes cast or votes representing more than DM 500,000 of the nominal equity capital of the corporation), however, this risk will be minimized. Second, voting agents may go with the proposals of active shareholders in order to be reelected, when these proposals are disadvantageous to the inactive equityowners. Leaving potentially adverse reputational effects of such collusive behavior aside, there is good reason to assume that active shareholders and voting agents will not collude to the detriment of the group of the inactive shareholders. If a shareholder wants value-decreasing changes of corporate policy in order to pursue his short-term interests, he will not be interested in holding the shares of the corporation for a long time. Thus, a voting agent cannot necessarily improve his chances of getting reelected by going with the short-term interests of a shareholder. Moreover, the competition between corporations for investors’ money has to be taken into account. If, for example, an influential shareholder elects a voting agent who favors his interests over those of the shareholder groups to the detriment of the corporation as a whole, then, as a consequence, investor will be reluctant to provide additional equity capital to this firm. In other words: the shareholders’ meeting choice of voting agents will become an important decision variable for (institutional) investors. Term limits and liability rules, as well as the prohibition of any business links between the voting agent and shareholders and the corporation to be controlled, should alleviate the problem. Also, by allowing for more than one voting agents at a time in bigger companies a balance of power will be reached. Agents will be watching each other, thereby reducing any risk of collusion between an active group of shareholders and one of the voting agents. Nevertheless, if we allow active shareholders to elect a voting agent for inactive shareholders, why not do away with proxy voting completely? Indeed, because our proposal relies essentially on a convergence of interests between large, active and dispersed, inactive shareholders, it seems logical that votes would only be cast by the former. But there is a significant difference: if active shareholders only are allowed to cast a vote, the extent of their control is limited to the amount of their shares; therefore, undermonitoring is inevitable. But hiring a voting agent brings another strong monitor into the governance structure of the corporation. Thus, control will increase. Moreover, this arrangement might attract institutional investors, who do attend the shareholder meetings, but do not want to engage in close monitoring of the corporation.

Summary

Allocating voting rights on fundamental corporate matters to the shareholders as the residual claimants of the firm represents a commitment by the corporations’ decisionmakers not to act to the detriment of the investors after the investment is made. Problems of collective action, however, diminish the value of this bonding device. Holders of small equity claims lack the incentive to acquire and to act on information about the impact of the management’s proposals on firm value. Proxy voting and takeovers are costly alternatives. We propose another mechanism—active shareholders should be allowed to elect a single voting agent for a specified period of time. The voting agent acts on behalf of the shareholders who do not attend the general meetings in this period. After each period there will be a new election. Because of limited tenure, a voting agent has an incentive to work hard on the behalf of the shareholders he represents. The voting agent is paid by the corporation. In order to avoid potential conflicts of interest, personal interlocks and business links between the voting agent and the corporation or the active shareholders have to be prohibited.


Perlitz, M., and F. Seger. Forthcoming. “Regarding the Particular Role of Universal Banks in German Corporate Governance.” *Journal of Business and the Contemporary World*.


Chapter 12—Footnotes

1 Wolfgang Hefermehl speaks of a monopoly position of the banks in this respect (Schlegelberger 1977).

2 Most shares of German stock corporations are bearer shares, not registered shares.


4 Apart from the depot banks, two incorporated associations of shareholders (Schutzvereinigung deutscher Wertpapierbesitz; Schutzgemeinschaft der Kleinaktionäre) act as proxies on behalf of their members.

5 Overview in Capital 7/92 at p. 100 f. The three “big” banks with the largest number of proxies do not belong to the banks with the lowest depositary fees.

6 Banks are refunded for communicating notices and so forth by the company. These refunds do not, however, cover the costs of asking for proxies and voting.

7 With only one exception; see Kondgen 1994, p. 545.


9 On December 8, 1993, the Committee on Economic Affairs of the federal parliament held a public hearing, the “Power of Banks and Insurance Companies.” Depository voting was one of the issues (some of the statements are published in Zeitschrift für Bankrecht und Bankpolitik, 1994, issue 1, p. 69.

10 For example, according to Gottschalk’s study (1988), in the shareholders’ meeting of Commerzbank in 1986. Commerzbank’s management commanded 34.58 percent, whereas 26.22 percent of the votes were cast by the other two big banks (Deutsche und Dresdner Bank). In Dresdner Bank’s general meeting the numbers were 47.08 percent and 16.98 percent, respectively. In order to get the majority of votes each side depended on the other.
See Lutter and Lammers 1990. It has to be mentioned, however, that the views on such anti-takeover provisions and the interests of the target's shareholders are not unanimous in the academic literature (see Baums 1990; for a different view see Zöllner and Noack 1991).

Kallfass (1992a,b) wants shareholders to choose voting agents on the market. Voting agents then are remunerated by the corporation according to the number of proxies they solicited. This approach, however, does not take into account the rational ignorance of small shareholders. There is no reason to assume that small shareholders will devote more resources in ascertaining the quality of voting agents than to controlling the managements' agenda.

Also, by allowing for only a limited number of voting agents, the free-rider problems of the supply side of voting services should be mitigated.
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