Toward Democratic Board Elections

by James McRitchie

Imagine a political system in which the incumbents get to select all election candidates, and voters have no choice but to vote for these nominees, or not vote at all. Such "democracy" rules the U.S. proxy process by which investors elect corporate board members. Now, an "open ballot" movement among big shareholders is working to shake up how your board is elected.

On April 14, 2003, the Securities and Exchange Commission (SEC) announced it would consider possible changes to proxy regulations "to improve corporate democracy." Alan Beller, director of the Division of Corporation Finance will examine "procedures for the election of corporate directors" and issue a report by July 15th, after consulting with "pension funds, shareholder advocacy groups, business and legal communities." New rules could be in place by next year's proxy season.

Soon after Les Greenberg, of the Committee of Concerned Shareholders, and I petitioned the SEC last August for just this kind of rulemaking, Patrick McGurn, special counsel at proxy advisor Institutional Shareholder Services (ISS), called the movement for an open ballot the "Holy Grail of corporate governance."

Sarah Teslik, executive director of the $3 trillion Council of Institutional Investors (CII), which primarily represents large pension funds, called the SEC's announcement "the biggest thing that has come out of the commission in my 20-year career." According to CII, the petition "re-energized" the "debate over shareholder access to management proxy cards to nominate directors and raise other issues."

What led the SEC to make such an announcement? How are corporate governance and management likely to change?

Although the possible rulemaking has received little press, its implications could be dramatic, something akin to a corporate governance Magna Carta. The Magna Carta was drafted in response to the excessive use of royal power, while the rulemaking stems from the abuse of power by management at Enron, WorldCom, Tyco and others.

The first clause of the Magna Carta guarantees "freedom of elections" to clerical offices of the English church to prevent the king from making appointments and siphoning off church revenues. A *shareholder's* Magna Carta would prevent managers from having undue influence over corporate boards and will prevent them from using corporate coffers as their personal bank accounts.

"Captains of industry" once retained both ownership and control over corporations. In the 20th century, though, power shifted to professional managers.

At the turn of the 20th century, "captains of industry" like Carnegie, du Pont, Mellon, Morgan, and Rockefeller owned large blocks of stock and exercised direct control over their investments. Ownership and control were embodied in the same people. Corporations were accountable to their owners, who also managed them.

By 1932, Adolph Berle and Gardiner Means documented a significant shift in ownership, which had become so dispersed that control shifted from owners to managers. The framework of corporate law, much of which developed in reaction to the stock market crash of 1929, restored public confidence by separating or limiting the power of bankers, insurance companies and mutual funds. It also gave broad powers to the SEC to develop rules "under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders."

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That framework has the appearance of being democratic (one share, one vote) but the basic mechanisms to carry out more than an illusion were never developed. While nominally empowered to elect directors to oversee management, shareholders lack mechanisms allowing them to participate in either the nomination of candidates or their election. The corporation laws of every state solemnly recite that shareholders elect the board of directors, but each year shareholders participate in an exercise which bears little resemblance to the word "election" as commonly used in any democratic country.

The real election for directors occurs within the boardroom. Shareholders become a rubber stamp of affirmation.

Shareholders are free to vote but generally have no real choice in the election of directors. Even if an overwhelming majority opposes a corporate-sponsored nominee, that person will serve as director, unless an expensive proxy contest is undertaken. The real election for directors occurs within the boardroom. Shareholders become a rubber stamp of affirmation. The vast majority of board vacancies are traditionally filled via recommendations from chief executives. Requirements for an "independent" nominating committee provide little assurance against continued management domination.

The current "open ballot" movement in corporate elections seeks to address this failure by empowering shareholders with the most fundamental right: nominating and electing their own representatives to the board of directors.

Other potential means to achieve accountability of directors are ineffective. The threat of litigation, through class-action lawsuits or derivative actions brought by shareholders, is highly overrated as a deterrent to corporate malfeasance. Corporations themselves or the SEC generally reveal corporate improper acts before civil litigation is commenced. Shareholder lawsuits rarely result in the perpetrators themselves paying damages. If damages are recovered, they are paid out of insurance policies and corporate assets. In the end, shareholders bear the cost of both sides and must cover the expenses of both plaintiff and defense attorneys, diluting the value of their shares.

Proxy contests to *force* change are hardly ideal. In the process, shareholders can see considerable wealth destroyed by inept management and defensive measures. Even after much of the wealth has been destroyed, the takeover and transition back to profitability is also expensive, generally estimated to range between two to four percent of the value of the firm. There may be very heavy transaction costs for employees through layoffs, lost wages, increased divorce and suicide rates, as well as to communities in the form of lost taxes and charitable contributions.

In contrast, the cost of proxy driven *changeovers* have run considerably below one percent, according to Patrick McGurn of ISS. In civil society, democratic transitions have long been recognized as preferable to war. Yet, SEC rules discourage peaceful transitions in corporate governance.

The largest hurdle to peaceful transitions in corporate governance is current SEC regulations denying shareholders the right to place the names of their board nominees or resolutions concerning the election process on the corporate ballot. Additionally, the assets of all shareholders are expended by management to distribute those ballots and to campaign for the company's candidates. Dissident shareholders can expect to expend anywhere from $250,000 to millions running even a single candidate. They must locate other nominees, conduct due diligence, draft a committee charter, and digest corporate bylaws, articles of incorporation, applicable state and federal laws and regulations.

Since corporations and their transfer agents will often stall and request thousands of dollars for a copy of the shareholders list, shareholders must be willing to file a legal action in court, or defend against frivolous legal actions. They must also lobby proxy advisors and institutional investors. Then they need to verify that proxy statements have actually been mailed to "beneficial holders" of the stock and that votes have been counted properly.

Today, the only way shareholders can access man-

agement's proxy card is by filing a shareholder resolution. The shareholder proposal rule, which has been in place since 1942, sets eligibility requirements ($2,000 in stock or one percent of stock held continuously for at least a year), limits the length of resolutions (500 words, including supporting statement), restricts subject matter and stipulates resubmission requirements.

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The SEC allows companies to omit resolutions that would let shareholders list candidates for directors, change the way elections are held or even hire an independent monitor to advise them on elections. Shareholder resolutions are unlikely to bring fundamental management change because they are nearly all "precatory," or nonbonding under SEC rules. However, because they are a highly public way for shareholders to register displeasure, more than 1,000 will appear on ballots this year alone.

The issue of an open ballot has been acknowledged since at least 1942, when the SEC proposed giving shareholders proxy access to nominate directors. The language they proposed was confusing and poorly drafted. Additionally, the country was going to war. The SEC said they dropped the proposal because "unqualified persons might be nominated, that too many candidates might be nominated, and that the shareholders would become confused and improperly mark their proxies."

By 1947, the SEC enacted regulations providing director elections as a basis for exclusion for shareholder resolutions. The Commission apparently believed that dissidents seeking access to the board should be forced to run their own slates.

In 1977 the SEC responded to a series of corporate scandals and bankruptcies by holding public hearings on shareholder communications and participation in the electoral process. In August of that year, the Business Roundtable recommended "amendments to Rule 14a-8 that would permit shareholders to propose amendments to corporate bylaws, which would provide for shareholder nominations of candidates for election to boards of directors." Their memo noted such amendments "would do no more than allow the establishment of machinery to enable shareholders to exercise rights acknowledged to exist under state law."

The SEC passed rules requiring board candidates to provide information in the proxy regarding conflict of interest transactions. They also required the corporation to disclose additional information regarding executive compensation, standing board committees, board member attendance records and resignations. However, nothing was done to facilitate an open ballot.

About two years later the SEC proposed "further study" of the use of nominating committees to empower shareholders. Staff recommended that if sufficient progress by companies in considering shareholder nominations was not made in two years, the Commission should adopt "procedures for shareholder access to issuer proxy material for the purpose of making shareholder nominations."

However, in reviewing the SEC proposal, Professor Jayne W. Barnard found "no evidence exists that the Commission staff followed up on the staff report after its issuance or that it reviewed the 1980 proxy materials to measure the effectiveness of corporate nominating committees."

In 1980 a shareholder of Unicare Services placed a proposal on their ballot permitting any three shareholders to nominate board candidates and have their names placed on the proxy. A similar proposal allowed a "reasonable number of stockholders" to place candidates on the proxy statement of Mobil. In 1981 Union Oil had to include a proposal permitting 500 or more shareholders to place nominees on the corporate ballot, with no threshold on the number of shares they held individually or collectively.

Interestingly, during this period at least one corporation argued that placing a minimum threshold on access to the company's proxy would discriminate "in favor of large stockholders and to the detriment of small stockholders," causing the company to violate the equal treatment principle.

In 1988, CalPERS submitted a shareholder proposal to Texaco providing for the establishment of a Stockholder's Advisory Committee of the company's largest shareholders. CalPERS withdrew the proposal when Texaco's management agreed to nominate a candidate recommended by CalPERS.

After years of allowing shareholder proposals concerning elections, the SEC in 1990 issued a series of no-action letters ruling that proposals concerning board nominations could be excluded. Proposals by institutional investors were beginning to win majority votes. Perhaps the SEC realized failing to issue no-action letters could soon have consequences.

On August 1, 2002, Les Greenberg, of the Committee of Concerned Shareholders, and I submitted petition file 4-461 to the SEC. It would allow shareholders to place board nominees in corporate proxies under the same provisions that apply to the submission of shareholder resolutions discussed above. We also sought to disallow counting votes cast by brokers not directed by beneficial owners.

Today, I would include provisions to narrow the field of candidates by:

☐ Limiting the number of candidates for each position (using something like the "lead plaintiff" provisions in the Private Securities Litigation Act of 1995;

☐ Requiring a "good faith" deposit of a few thousand dollars, refunded if the candidates reach minimum thresholds; and

☐ Instant runoff voting, which requires voters to rank candidates by preference. I would also include provisions holding all candidates to relatively modest spending limits.

An Uphill Battle
The Proxy Campaign At Sears

In 1991, business leaders surveyed by *Fortune* magazine rated Sears 487th out of 500 companies for the reputation of its management. Dale Hanson, then chief of the California Public Employees Retirement System (CalPERS) said, "from 1984 on, Sears went to hell in a handbag."

In May 1991, activist investor Robert A. G. Monks indicated he would engage in a proxy contest for a single seat on the board, something no one had ever done before at any company. Sears hired renowned takeover lawyer Marty Lipton, brought a lawsuit to stop Monks and budgeted $5.5 million dollars over and above Sears' usual solicitation expenses to ensure his defeat. That allocation represented one out of every seven dollars made by the retail operation during the previous year. Sears also assigned 30 employees to defeating Monks.

With cumulative voting and five directors up for election, Monks might have won a seat. However, Sears shrunk its board by eliminating three director seats, which meant that Monks needed a higher proportion of the vote to win. About 25 percent of the vote was held by Sears employees (and voted by Sears trustees); much of the rest was held by individuals, who were impossible to solicit without spending millions of dollars.

In 1992, Sears shrunk their board again. Instead of running for the board again, Monks supported shareholder proposals submitted by others. His now famous full-page ad in *The Wall Street Journal* declared the board "nonperforming assets." Two of the resolutions he supported, confidential voting and annual election of directors, got over 40 percent of the vote. The proposal to separate the CEO and chairman positions got 27 percent.

Sears went on to implement several of the reforms that Monks had advocated, including restructuring its operations, which helped it rebound financially, but management retained full control.

In March of 2003, CalPERS voted to pursue an SEC rule for greater shareholder access to proxies for nomination of directors.

At the end of September 2002, e-Raider, an Internet investors group, submitted a similar petition to the SEC. Their petition additionally seeks to ban the use of corporate funds for campaigning and to "strike down unreasonable qualification tests for director candidates." The AFL-CIO also announced they would submit a rulemaking petition asking the SEC to create an absolute right to allow shareholders direct access to the proxy.

In March 2003, CalPERS voted to pursue an SEC rule aimed at gaining greater shareholder access to management's proxy for the nomination of directors. Shareholders would have to hold an aggregate of at least five percent of outstanding shares. Only shareholders of at least one year would be permitted

to nominate candidates, but that time constraint would not apply to those providing a second to the nomination to reach the five percent threshold.

In an effort to minimize takeover concerns, CalPERS would permit shareholders to nominate less than a majority of the entire board's occupied seats in any single year. They also called for some reimbursement provisions to stem wasteful spending by companies and provisions to keep the campaign expenditure process fair.

Later that same month, CII voted to ask the SEC to enact similar rules that would allow shareholder nominees for directorships to be listed on corporate proxies.

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Upon learning of our "open ballot" petition, an investor from Germany said he was disappointed to learn that elections of directors of U.S. public companies are not democratic. "This is exactly how voting in communist countries worked. Everyone could vote, but there was just no choice of candidates. The point was not how to be elected, but how to get on the election list. With this system no changes were possible, so there was no motivation to improve the governance." Dozens of comments on the petition, almost all supportive, have been posted to the SEC's Internet site.

In January 2003 the Conference Board's Commission on Public Trust and Private Enterprise decried the current process whereby "shareholders have no meaningful way to nominate or to elect candidates short of waging a costly proxy contest."

A month later, Delaware Chancery Court Chancellor William B. Chandler III and Vice-Chancellor Leo E. Strine, Jr. described the election process as a "forgotten element of reform." They suggested that policy makers take up the issue of management biased elections and require equal access to "the proxy machinery between incumbents and insurgents with significant nominating support."

"As of now, incumbent slates are able to spend their companies' money in an almost unlimited way in order to get themselves reelected, they wrote. This renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate."

The American Federation of State, County and Municipal Employees (AFSCME) submitted binding and nonbinding proposals at several firms, including Citigroup to "in effect take a fake democratic process and make it real," according to Michael Zuker, director of corporate affairs. The SEC let stand a no-action letter on Citigroup, even as they announced ordering staff to review the rules to possibly "improve corporate democracy."

However, not all the leaders in corporate governance have come out in support of an open ballot. In April 2003, Peter Clapman, chief counsel of corporate governance at Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), announced the SEC ought to focus on how companies nominate directors—not on giving shareholders nominating power. "We want to work very hard to improve the quality of nominating and corporate governance committees."

Expect any reform recommended by SEC staff to limit the proportion of board members that can be nominated by shareholders to less than half, in order to prevent use by short-term corporate raiders. If the threshold is set relatively high, for example, three percent of outstanding shares or $1 million worth of stock, most corporate elections will probably remain uncontested. Even activist pension funds like CalPERS are unlikely to mount candidates at more than a few poorly performing companies at once. When they do, it will probably be through partnerships with activist "relationship" investors to avoid any "controlling person" liabilities.

Even where contests exist, management selected candidates would retain a number of advantages over challengers such as incumbency, ballot position within management's slate and, most likely, resources. Yet even the possibility of director contests will lead nominating committees to search out more diverse candidates with new ideas, including

those recommended by investors. Outside directors who own or represent the ownership of substantial stock in companies are more likely to ask discerning questions. This allows a more realistic appraisal of alternative actions and in challenging management, especially during a crisis.

Competition for board positions has traditionally stimulated share value. Researchers have found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and fewer corporate acquisitions. Investors who bought firms with the strongest democratic rights and sold those with the weakest rights would have earned abnormal returns of 8.5 percent per year during the sample period.

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Opening the corporate ballot will increase market mechanisms for corporate control through gradual takeovers and disarmament of management entrenchment devices, such as poison pills. Yet directors nominated by shareholders are likely to take a long-term view of the firm because the most active large shareholders have been those with the longest time horizon, pension funds.

As early as 1988 the Department of Labor set forth their opinion that, since proxy voting can add value, pension fund voting rights are subject to the same fiduciary standards as other plan assets. Last year, former SEC Chair Harvey Pitt said the same standards apply to mutual funds and in 2003 the SEC ruled that proxy votes made by mutual funds and investment advisors must be disclosed.Pension and mutual funds will face increasing pressure from beneficial owners to ensure votes are cast in a manner they agree with. Opening the corporate ballot will further increase monitoring by shareholders.

The most vigilant shareholders, especially those submitting resolutions, have been those who profess to be "socially responsible." That includes mutual funds, as well as labor and public pension funds, which seek to increase triple-bottom-line returns (adding economic, environmental and social value). Public employees do not want to work during the day to protect the environment, only to find their pension funds invested in polluting it. Those trends will continue to accelerate.

Experience with more democracy at the top, especially when found profitable, may lead companies to also try more democratic management. Firms with significant employee ownership and participation in decision-making grow 8 to 11 percent faster than their counterparts. Companies practicing "open-book" management also have higher average growth rates.

Scientists have known for years that such organizations would generate more wealth. It is paradoxical that the standard justification for autocratic practices in industry is its alleged efficiency, since empirical research results do not support that conclusion. Increased rank-and-file responsibility, increased participation in decision-making and increased individual autonomy are all associated with greater personal involvement and productive results.

The keys to creating wealth and maintaining a free society lie primarily in the same direction. Both require that broad-based systems of accountability be built into the governance structures of corporations themselves. By accepting the responsibilities that come with ownership, pension funds and other institutional investors have the potential to act as important mediators between the individual and the modern corporation. ■