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Designing a Shareholder Access Rule

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Abstract

This paper examines the specific features of the shareholder access rule recently proposed by the Securities and Exchange Commission. I suggests that, even accepting the Commission's generally cautious approach and its desire to limit shareholder access to cases where the need for it is evident, the restrictions included in the rule proposal are excessive and should be relaxed. In particular, I identify several changes in these restrictions that would contribute to attaining the policy goals that the proposed rule seeks to serve.

Key words: corporate governance, directors, shareholders, shareholder voting, corporate ballot, corporate elections, proxy fights, proxy contests, proxy rules, SEC.
JEL classification: D70, G30, G32, G34, G38, K22.

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The Securities & Exchange Commission's shareholder access proposal has attracted a vast number of comment letters and a heated debate. In my view, the rule proposed by the Commission is a positive step in the desirable direction of making elections more viable. It is, however, too mild. The limitations included in the proposed rule would excessively impede and delay shareholder access to the corporate ballot. I suggest that, even accepting the Commission's generally cautious approach to the subject, it would be desirable to relax or re-examine some of the proposed restrictions on direct access.

I. THE EXCESSIVELY MILD STEP UNDER CONSIDERATION

Shareholders' power to replace directors plays a critical role in the accepted theory of the corporation. While this power is not expected to be used regularly, it is supposed to provide a critical safety valve. "If the shareholders are displeased with the action of their elected representatives," stresses the Delaware Supreme Court in *Unocal*, "the powers of corporate democracy are at their disposal to turn the board out."[1]

But the safety valve is missing. Although shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth. Indeed, the incidence of attempts by shareholders to replace incumbents with a team that would do a better job running the company – the type of cases referred to in the Delaware opinions above – are even more rare than is commonly recognized.

In earlier work, I present evidence about the dearth of such contests. During the seven-year period 1996-2002, 215 contested proxy solicitations took place, about 30 per year on average.[2] The majority of the contested solicitations, however, did not involve attempts to replace the board with a new team that would run the firm differently. About a quarter of the cases did not involve the choice of directors at all, but rather other matters such as proposed bylaw amendments. Among the cases that did focus on elections for directors, a majority involved a fight over a possible

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[1] See Unocal Corp. v. Mesa Petroleum Co., 493 A. 3d 946 (Del. 1985).
[2] Lucian Bebchuk, The Case for Shareholder Access to the Ballot, 59 The Business Lawyer 43 (2003).

sale of the company or over a possible opening or restructuring of a closed-end fund. Contests over the team that would run the (stand-alone) firm in the future occurred in about 80 companies, among the thousands that are publicly traded, during the seven-year period 1996-2002.

Furthermore, most of the firms in which the considered contests occurred were small. Of the firms in which such contests occurred, only 10 firms had in the year of the contested solicitation a market capitalization exceeding $200 million. The incidence of such contests for firms with a market capitalization exceeding $200 million was hence rather small – less than two a year on average.

Thus, the safety valve of potential ouster via the ballot is currently not working. In the absence of an attempt to acquire the company, the prospect of being removed in a proxy contest is far too remote to provide the safety valve on which our corporate governance system is supposed to rely. To be sure, determining the optimal magnitude of the removal threat, and the optimal incidence of challenges to incumbent directors, is difficult. But there are strong reasons to doubt that this incidence is practically zero. The case for reforms that would make the electoral threat more viable is thus very strong.

The proposed rule is a very moderate step in this direction. To begin, under the proposed rule, a direct access procedure would be available in a corporate election only if a triggering event occurred a year earlier. Getting a triggering event would be far from trivial – it would require a majority vote in favor of a proposal to have shareholder access or a 35% vote to withhold support from one of the directors. In addition, even if a shareholder access procedure becomes operative, access would be limited to shareholders or groups of shareholders satisfying substantial ownership and holding requirements.

Furthermore, shareholders that would be able to place a candidate on the ballot would still have to bear their own "campaign costs," even if they win, whereas incumbents' costs would be fully borne by the company. This financing disadvantage would strongly discourage challenges and make those occurring less likely to succeed. For this reason, it would be desirable to put in place measures that would enable successful candidates to get some of their costs covered.[3] Without

[3] See Lucian Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," 78 California Law Review 1073 (1990).

such reimbursement, challenges to incumbents would still confront excessive impediments.

Putting the above together, shareholders dissatisfied with incumbents' performance would have to (i) get sufficiently large support to get a triggering event, (ii) wait a year, (iii) satisfy the substantial ownership and holding requirement for nominating a candidate, (iv) bear the costs involved in persuading other shareholders to vote for their candidates in a campaign against incumbents that are fully financed by the company itself, and (v) win majority support for their candidates. And in the event that they are successful in overcoming each of the above five hurdles, the shareholders would only elect directors that would constitute a relatively small minority that might have influence but far from a decisive say.

Conversely, examining the proposed change from the perspective of incumbents, the change would not expose them to a substantial risk of replacement in the event of dismal performance. Even in the face of widespread dissatisfaction, incumbents would have to fare badly in two votes spaced at least a year apart. Incumbents would have the advantage of being able to out-spend their challengers in each of these votes. And, in any event, only a limited fraction of the incumbents would be vulnerable to replacement in this way. Thus, the proposed rule would produce only limited pressure on directors to be attentive to shareholder interests.

For all of the above reasons, the proposed rule would not go far enough in the direction of making electoral challenges viable. Still, I support the proposed rule because it would clearly be superior to the current state of affairs. Although the shareholder access proposal would be only a moderate step in a desirable direction, it hopefully would facilitate additional steps in this direction in the future.

I now turn to discussing some of the specifics of the proposed rule and to responding to some of the questions raised by the Commission. In the discussion below, I accept as given the Commission's desire to follow a rather cautious approach. I start by considering the triggering event requirement, taking as a premise the Commission's desire to have a significant screening before companies become subject to a shareholder access regime.

II. ADDITIONAL TRIGGERING EVENTS

In addition to the triggers proposed by the Commission, it would be desirable to set some events that would make a shareholder access procedure available without much delay. Under the proposed rule, no matter how substantial and widespread shareholder dissatisfaction is in a given situation, and no matter how dismal or disappointing the performance of incumbents, shareholders would not have access to the ballot in the coming elections if they did not get such a procedure in place through their votes in preceding elections.

This unavoidable delay could make the proposed rule ineffective in some of the cases where shareholder intervention might be most necessary. When faced with events indicating that performance or corporate governance are especially poor, shareholders can ill afford waiting for the elections after next before they can have access to the ballot.

The Commission discussed some events that can be viewed as "red flags" – poor performance relative to peers, criminal indictments, delisting from an exchange, and so forth. The Commission opted not to use such events as triggers, however, because it wanted to tie the triggering events closely to "dissatisfaction with [the] company's proxy process." The occurrence of such events, it might be thought, does not imply that shareholders are dissatisfied with the proxy process; their occurrence does not rule out the possibility that shareholders might in fact be completely content with the process as is and with the directors currently serving on the board.

The Commission's view, however, is presumably based on a desire to provide direct access only in circumstances when there is significant likelihood that it is wanted by and valuable to shareholders. Consider the possibility of triggering a shareholder access regime for companies that are in the bottom 5% of their industry as judged by their performance in the preceding, say, three years. Wouldn't such an approach introduce shareholder access in companies where it would likely be valuable while doing so for only a small fraction of all companies?

To be sure, that the company's long-term performance is in the bottom 5% of its industry does not imply that shareholders would wish to make changes in the board. But subjecting such a company to a shareholder access regime also does not imply that a shareholder nominee would be elected (or even placed on the ballot).

What is clear is that long-term performance that is especially poor substantially increases the likelihood that shareholders might find access to the ballot useful and valuable. Furthermore, in such circumstances, if shareholders were to feel that adding some new voices to the board could improve matters, they would likely wish to have the option to do so without having to wait until the election after next.

The same can be said about other "red flags" mentioned in the Commission's release. It would be desirable to subject a company to a shareholder access regime in the coming elections if (i) the company is delisted by a market, (ii) the company or its officers are indicted on criminal charges, or (iii) the company has to restate earnings. Again, subjecting such a company to shareholder access does not require us to rule out the possibility that shareholders could be content with incumbents in the face of such events. But the occurrence of such events makes it much more likely that having access to the ballot in the coming elections could be valuable to shareholders.

As always, it is necessary to take into account the incentive effects that such a rule would have. Such triggering events would provide management with incentives to avoid falling in the bottom 5% in terms of long-term performance, having the company delisted or indicted, or having to restate earnings. These are not bad incentives at all.

Finally, as was suggested in a comment letter to the SEC by a group of Harvard faculty including,[4] it would be desirable to provide immediate access to the ballot, without a one-year delay, if the shareholder group behind a nomination is sufficiently large, say, one holding 10% of the shares. The larger the initial support of a nominee, the stronger the case for placing this nominee on the ballot. It is worth noting that, under the corporate laws of many states, as well as under the Revised Model Business Corporation Act, 10% of the shareholders can call a special meeting in the absence of charter provision to the contrary. Having a special meeting might be more distracting than placing additional candidates on the ballot in an already scheduled election.

[4] Comment letter dated Dec. 3, 2003, Re: Release No. 34-48626, File No. S7-19-03, Security Holder Director Nominations, available at www.sec.gov. The letter is also available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/news.htm.

III. The Threshold for Submitting a Direct Access Proposal

One proposed triggering event would be the passage by a majority vote of a shareholder proposal to provide direct access. The Commission proposes that only shareholders with 1% ownership would be able to make such a proposal, and seeks comments on this threshold. In my view, the 1% threshold is probably too high, especially in the case of very large companies.

The Commission estimated that in a large majority of exchange-traded companies at least one institution satisfies the above threshold requirement. The Commission should examine, however, whether the small minority of companies that do not have such an institution among their shareholders tend to be very large companies, which have economic significance greater than their numbers reflect. Further, even for companies where an institution with 1% ownership exists, the Commission should take into account that mutual funds are often reluctant to initiate and lead corporate governance initiatives even when they are willing to support those initiated by others.[5] The above suggests that, in a significant number of companies, especially large ones, the 1% ownership requirements could require shareholders to join forces even for the purpose of the very preliminary step of proposing a shareholder access resolution.

The Commission might be interested in preventing submission of proposals for direct access by shareholders with nominal holdings (as is possible for rule 14a-8 proposals). A lower threshold, however, could still ensure that proposing shareholders have a non-trivial stake. In particular, a lower threshold should be used for large or very large companies.

IV. The Period for which Access would be Triggered

The Commission proposed that, after the occurrence of a triggering event, the direct access procedure would be operative for two years. Given that the Commission's proposals would require shareholders to overcome substantial impediments to get to such a regime, limiting it to two years would be undesirable. Consider a company whose shareholders believe that having access to the ballot

[5] See Robert Pozen, Institutional Perspective on Shareholders' Nomination of Corporate Directors, 59 The Business Lawyer 95 (2003).

would be desirable in general. Why should we require these shareholders to submit and pass proposals for direct shareholder access as often as every two years?

The Commission's proposal to allow shareholders to vote to introduce direct access is presumably based on a view that accords significant weight to shareholder choice with respect to direct access. It would be desirable to provide shareholders not only with choice as to whether the company will be subject to a shareholder access regime but also with at least some choice as to the length of the period during which the regime would be operative. Thus, whatever the default length of the period, the Commission should permit the resolution introducing direct access to set the period for which it would be operative up to some limit, say, five years.

The above suggestion might be opposed on grounds that, if shareholders are allowed to and do introduce direct access for a long period, they might find themselves "stuck" with a costly and disruptive procedure which they might over time regret having adopted. To address this concern, however, all that is necessary is to enable shareholders to opt out of an established direct access regime. However long the period for which direct access was initially established, it should stop being operative if a shareholder resolution to this effect is approved by a majority vote.

V. Ownership and Holding Requirements

Under the proposed rule, a nominating shareholder would have to own more than 5% of the company's shares for more than two years. The Commission asked for comments on whether these thresholds are too low or too high.

According to the data discussed by the Commission, among firms trading on NYSE, AMEX, or NASDAQ, 58% do not have even a single institutional shareholder that satisfies the 5% threshold, and 50% have less than two institutional shareholders with more than a 2% stake. This data indicates that raising the threshold beyond 5% would clearly be unwarranted. Even under the proposed 5% threshold, the two largest institutional investors would not be able together to nominate a director in 50% of the considered firms. This would already be a substantial impediment, especially given that institutional investors would likely vary greatly in the extent to which they would be willing to take governance initiates.

Further, the above data suggests that the Commission would do well to consider whether the thresholds should be lowered, at least in the case of large companies. To this end, the Commission should examine how the number of shareholders needed to satisfy the proposed threshold is related to the size of the company. It might be that the 50% of companies that do not have even two institutional investors with more than a 2% stake are relatively larger companies that represent a substantially larger percentage of the total market capitalization. It would be interesting and useful to identify the incidence of institutional shareholders with more than 5% and with more than 2% among the top 100 and 500 companies.

The above analysis would be important to carry out, as it could conclude that the proposed threshold would produce an excessive impediment to shareholder nominations in an important subset of companies. If such a conclusion were reached, the Commission should set lower eligibility thresholds for large companies or, alternatively, make shareholders eligible also on the basis of the dollar value of their holdings and not only on the basis of percentage of total shares owned.

It is interesting to note in this connection the threshold proposed in a well-known 1991 article by Martin Lipton and Steve Rosenblum.[6] They proposed to provide eligible shareholders with access to the ballot, as well as reimbursement of campaign expenses. (In contrast to the Commission's proposed rule, the Lipton-Rosenblum proposal would provide such access every five years, rather than a year following a triggering event, but it would provide eligible shareholders with reimbursement of campaign expenses as well as access to the ballot.) Their proposed eligibility standard was ownership of shares constituting more than 5% of shares <u>or</u> having a value of more than five million dollars. The Commission should consider following an approach similar to that of Lipton-Rosenblum and set a dollar value (say, fifty million dollars) as an alternative eligibility criterion.

VI. Relationship between Nominating Shareholders and their Nominees

The proposed rule requires shareholder nominees to be independent of both the company and the nominating shareholders. The requirement of independence from the company makes sense; in any event, when mounting a challenge to incumbents, nominating shareholders would be highly unlikely to choose a candidate that is dependent on the company. A requirement that the nominee be

[6] Martin Lipton and Steven Rosenblum, "A New System of Corporate Governance: The Quinquennial Election of Directors," 58 University of Chicago Law Review 187 (1991).

independent of the nominating shareholders, however, would be consequential and counter-productive.

It is widely believed that owning a significant (but non-controlling) block could provide directors with beneficial incentives to enhance shareholder value. While the empirical evidence on the subject is not yet conclusive, there is no evidence that having a substantial interest in the company's shares adversely affects directors' performance. I thus see no reason for precluding nominees that are affiliated or even closely connected with the nominating shareholder.

Especially undesirable is the proposed rule's prohibition on compensation of the nominee by the nominating shareholder. Under the proposed rule, nomination must be accompanied by a representation that the nominee has not accepted during the then-current calendar year, or during the immediately preceding year, any fees from the nominating shareholder. Although the language of the proposed rule does not explicitly prohibit fees paid after the nomination, it appears that the Commission intends to rule out such fees as well.

Prohibiting nominees that are affiliated with or compensated by the nominating shareholders would clearly make it more difficult to induce high-quality candidates to accept nominations. It is worth noting that opponents of shareholder access have repeatedly argued that the possibility of having to face some electoral challenge down the road might deter some potentially good directors from serving on boards. High-quality directors, it is argued, would not wish to accept a nomination to a board, even in the face of no opposition at the time, if there were a risk that they would have to be part of a contested election in the future. Would high-quality candidates not be even more reluctant to accept nomination by a nominating shareholder when such a shareholder may not compensate them? After all, their nomination would, with certainty, lead them to take part in a contested election and, if elected, to serve on a board most of whose members were on the other side in that election. A prohibition on compensating nominees for the willingness to be candidates and the time spent on their candidacy would significantly and adversely narrow the pool of possible candidates.

VII. Permitting Companies to Provide More Expansive Access

The Commission's intent seems to be to establish some minimum level of direct access that companies should provide, but not to prevent companies from providing more expansive access through their charters, bylaws, or board policies. It is conceivable that some companies will seek to provide direct access that would be more expansive – say, in terms of the number of directors that shareholders may place on the ballot, the circumstances in which shareholders will be able to nominate directors, or some other dimension of the direct access arrangement. MCI and Apria Healthcare group have already been moving in this direction.

In crafting the specifics of a final rule, the Commission should make clear that companies are permitted to opt out with respect to given dimensions of the rule in a way that expands shareholders access. Thus, for example, the ownership thresholds should be the ones selected by the Commission unless the company chooses lower thresholds; the number of candidates that shareholders may place on the ballot in any given election should be the one selected by the Commission unless the company chooses a higher number; and so forth.

VIII. Conclusion

Even accepting the Commission's generally cautious approach and its desire to enable shareholder access only in those cases in which there is evidence that it is needed, the restrictions included in the rule proposal are excessive. Relaxing some of the se restrictions in the ways discussed above would contribute to attaining the policy goals that the proposed rule seeks to serve.