Working draft
March 3, 2004
Comments welcome

The Case for Shareholder Access: A Response to the Business Roundtable

Lucian Arye Bebchuk*

Abstract

The Business Roundtable recently submitted to the Security and Exchange Commission an eighty-page comment letter expressing strong opposition to the Commission's proposal to provide shareholders with some access to the corporate ballot. This paper provides a detailed examination of the objections to shareholder access raised by the Business Roundtable. I conclude that none of them provides a good basis for opposing shareholder access.

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

---

* William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance, Harvard Law School; Research Associate, National Bureau of Economic research. I am grateful to Kiwi Kamara and Rob Maynes for their assistance and to the John M. Olin Center for Law, Economics, and Business for its financial support.

This draft was prepared for distribution to participants at the SEC roundtable on March 10, 2004. I plan to revise this paper during the month of March; future revisions can be downloaded at www.law.harvard.edu/faculty/bebchuk.

The proposal for shareholder access to the ballot now under SEC consideration has attracted strong opposition from the Business Roundtable ("BRT"), an influential association of CEOs of leading companies. In response to the SEC request for public comment, the BRT filed in December 2003 an eighty-page letter comment, with hundreds of pages of appendices, in opposition to the proposed shareholder access rule. [1]

I discussed in earlier work the general case for the shareholder access proposal.[2] In this paper, I reconsider the subject in light of the BRT submission, examining in detail the objections raised by the BRT. I show that none of them provides a good basis for the BRT's opposition to shareholder access.

I. NO NEED FOR REFORM?

A. The Empirical Claim

After challenging the Commission's authority to adopt the proposed rule (pp. 1- 22), the BRT proceeds to argue that there is no need for reform. [All page numbers refer, of course, to the BRT's comment letter of December 2003.] The BRT begins by suggesting that the evidence contradicts the view that reform is needed. In particular, the BRT argues that "scant evidence is given that shareholders are in fact denied meaningful participation in the proxy process under the current rules," and that "substantial evidence in the record, in fact, suggests the opposite."

In claiming that the evidence suggests the opposite, the BRT relies on the statistics concerning the incidence of "withhold" votes that the Commission reported in its release. According to these statistics, the incidence of withhold

[1] *See* Letter from Henry A. McKinell, Chairman, Business Roundtable, to Jonathan Katz, Secretary, Securities and Exchange Commission (December 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/brt122203.htm. The main arguments made in the BRT submission are also put forward in a piece by John Castellani, the President of the BRT and Amy Goodman, who participated in drafting the BRT's comment letter. See John J. Castellani and Amy L. Goodman, "The Case Against the SEC Director Election Proposal," forthcoming in Lucian Bebchuk, ed., *Shareholder Access to the Corporate Ballot* (Harvard University Press, 2004).

[2] *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 THE BUSINESS LAWYER 43 (2003).

votes for one or more of the directors exceeds 35 percent in only 1.1 percent of companies. The BRT interprets this low incidence of large withhold votes as evidence that shareholders are content with board performance in the vast majority of companies. Moreover, even for the small number of cases with withhold votes exceeding 35 percent, the BRT claims that (i) cases in which only 35 percent of the shareholders withhold their votes should not be viewed as a problem since incumbents still enjoy the support of a majority of the shareholders, and (ii) even if the withhold vote in such cases were viewed as reflecting the existence of a problem at the time of the vote, the large withhold vote might commonly lead to management action addressing the problem so that, again, no reform is needed.

Withhold votes register shareholder dissatisfaction but do not directly confront incumbents with a risk of removal. In the presence of a quorum and the absence of a competing slate, the company's slate will be elected regardless of the number of withhold votes. Incumbents face a risk of replacement only when a rival slate competes for shareholder support. The possibility of such a replacement, it is worth reminding, plays a key role in the accepted theory of the corporation. The viability of such replacement when shareholders are dissatisfied with board performance is supposed to provide a critical safety valve.

The evidence that the BRT overlooks is the negligible incidence of electoral challenges outside the hostile takeover context. The BRT seems to believe that there is a meaningful incidence of such challenges. It argues that "[I]n fact, shareholders have used the Commission's existing rules to launch election contests on numerous occasions." (p. 4) In support of this claim, the BRT lists several examples of well-known contests. (p. 4) Although such examples do exist, they are drawn from a rather small group of cases.

In a recent empirical study, whose preliminary findings I reported in my earlier article, I examined the incidence of contested solicitations in the seven-year period 1996-2002.[3] During this seven-year period, 215 contested proxy solicitations took place, about 30 per year on average. 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

[3] *See* Bebchuk, *supra* note 2, at 45-46.

contests did not involve director elections at all, but rather other matters such as proposed bylaw amendments. Among contests over the election of directors, a majority involved a fight over a possible 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 such 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. Thus, the incidence of such contests for firms with a market capitalization exceeding $200 million was remarkably small – less than two per year on average.

Of course, the BRT could respond to the above evidence in a way similar to how it reacted to the low incidence of large withhold votes reported by the Commission. The dearth of electoral challenges, the BRT might argue, simply reflects the negligible incidence of companies with widespread shareholder dissatisfaction; electoral challenges are generally not mounted, so the argument goes, simply because shareholder satisfaction with their board makes running a competing slate futile. However, while shareholder satisfaction might substantially contribute to the extreme dearth of electoral challenges, it is implausible that it fully accounts for it. With thousands of publicly traded companies, how plausible is it that widespread shareholder dissatisfaction occurs in any given year in only ten companies or so – and in only two companies or so with a market capitalization exceeding $200 million? It is highly plausible that the practically non-existent incidence of electoral challenges stems in part from the costs and impediments that challengers face even when shareholders are dissatisfied.

Imagine that you visit a country, let us call it Corporatia, and you find that it has 10,000 towns and that in almost all of them the incumbent members of the city council run unopposed in town elections, with a competing slate running in only about 10 towns in any given election year. You will be unlikely to view this state of affairs as evidence that city councils do a terrific job across the numerous towns of Corporatia. You will be more likely to suspect that the dearth of electoral challenges is at least partly due to some impediments confronting potential challengers in Corporatia.[4]

Returning from the imaginary land of Corporatia to our capital markets, an inference that the dearth of electoral challenges is due in part to the impediments facing challengers is also supported by any realistic assessment of challengers' situation. Challengers currently cannot place their candidates on the ballot sent by the company to all shareholders, but rather must incur the costs involved in getting their proxy cards to shareholders independently. Further, challengers must bear all of the "campaign" costs involved in effectively communicating their case to the shareholders, whereas incumbents may spend substantial amounts from the company treasury. The shareholder access proposal is simply a step to reduce – still falling far short of leveling the playing field – the disadvantages that challengers now face.

To conclude, the empirical evidence indicates that electoral challenges are practically non-existent. This evidence suggests, and examination of the basic features of the corporate elections system confirms, that this state of affairs is in part due to the substantial disadvantages challengers now face. The safety valve of the shareholder franchise is currently not working. As long as we continue to maintain the view that shareholder power to replace the board is an important element of corporate structure, we need reform that would turn this power from myth into reality.

B. Other Protections

The BRT also agues that, even if flaws in current arrangements make electoral threats not viable, shareholders have other adequate protections that make reform unnecessary.

[4] Would the concern of a visitor to Corporatia go away if the visitor were to learn that its citizens have the option of casting blank ballots and that in only 1.1% of the towns the percentage of blank ballots exceeds 35 percent? Such inference would be unlikely, especially if the casting of blank ballots can register dissatisfaction but cannot prevent the re-election of incumbents.

1. Voting with One's Feet

The BRT argues that shareholders dissatisfied with incumbent directors can "'vote with their feet' by selling the company's stock." (pp. 24-25) An investor dissatisfied with a corporation's board of directors," the BRT suggests, "easily can redirect his or her capital to a preferred alternative." (p. 25) This observation leads the BRT to take the view that "[T]he purest form of corporate suffrage takes place in the capital markets, not through regulatory action."(p. 25)

The ability of shareholders to sell their shares on the market, however, is hardly a substitute for a viable route for replacing directors. Consider shareholders that believe that their board is and has been under-performing and that, as a result of this poor performance, the company's stock price is only $40 per share rather than the $60 per share it would be with adequate board performance. If the board performance cannot be improved, being able to sell shares on the market would not address the shareholders' problem: selling would still provide them with only $40 per share rather than the $60 per share their stock would fetch with adequate board performance. Thus, for shareholders concerned that poor board performance is reducing the value of their investments, the freedom to sell their shares is not an adequate remedy.

2. Relying on Independent Directors

The BRT also stresses that shareholders are protected by the dominant presence of independent directors on the board. Rather than run an opposing slate, shareholders that seek to add a new director "may submit director candidates to the board's independent nominating committee." (p. 24) Like other opponents of the shareholder access proposal, the BRT stresses that recent changes in stock exchange requirements and corporate practices have increased the dominance and power of independent directors on boards and nominating committees. (pp. 26-27 & 49)

Although the recent strengthening of director independence might well be beneficial, it does not obviate the need for the safety valve of a viable mechanism for shareholder replacement of directors. The mere independence of directors from insiders ensures neither that directors are well selected nor that they have the right incentives to advance shareholder interests.

Indeed, even assuming that strengthened independence of directors will often lead to good nomination decisions, a safety valve is still necessary. Recent reforms cannot be expected to completely eliminate cases in which nominating committees fail to make desirable replacements of incumbent directors. With due respect to the benefits of director independence, it should not lead us to accept a state of affairs in which self-perpetuating boards confront no meaningful threat of replacement. The safety valve of replacement by shareholders remains indispensable notwithstanding the strengthening of directors' independence. The evidence that this safety valve is not working warrants reform.

II. ADVERSE CONSEQUENCES?

The BRT argues that, while the proposed shareholder access rule would not provide any benefits, simply because the flaws it seeks to address do not exist, it would have considerable adverse consequences.

A. The Distortion of Shareholder Access Resolutions

To begin, the BRT argues that access to the shareholder access arrangement would be triggered "far more often than the Commission supposes" (p. 27) and far more often than shareholder interests warrant. The proposed rule displays considerable caution in that it seeks to limit the availability of shareholder access to cases with clear evidence of widespread shareholder support for such an arrangement or widespread shareholder dissatisfaction. But the BRT argues that the passage of shareholder access resolutions would not reflect a judgment by most shareholders that such an arrangement would serve shareholder interests. According to the BRT, the Commission has failed to consider the presence of two factors that might lead to the adoption of shareholder access resolutions that do not serve shareholder interests: (i) the "collateral objectives" of some institutional investors who might bring and support shareholder access resolutions to advance some special interests (pp. 27-28), and (ii) the "influence of proxy advisory services" whose recommendations are followed automatically by many shareholders.

1. Barbarians at the Gate: State and Labor Union Funds

The BRT notes that "[S]tate and labor union pension funds are among the principal advocates of the proposed rule." (p. 30) It expresses concern that union pension finds are using their holdings to pressure companies on such traditional labor concerns as wages, unionization, and benefits, and that state pension funds are using their holdings to press for "social" issues (such as environmental protection). (pp. 31-32) On the view of the BRT, union and state pension funds can be expected to put forward and vote for shareholder election proposals in order to advance "special interests of their own that are unrelated to the openness of the proxy process." (p. 31)

Accepting that union and state pension funds have such "collateral objectives," however, hardly indicates that such collateral objectives would lead to the passage of shareholder resolutions that do not have widespread support among shareholders that are solely interested in enhancing share value. In the vast majority of companies, union and state pension funds have holdings that are far too small to ensure the passage of shareholder access proposals or even to have a major effect on the outcome of a vote.[5] As a result, shareholder access proposals would pass only when drawing large support from institutional and other shareholders that are solely concerned with share value.

Indeed, past voting patterns clearly indicate that shareholder resolutions that are brought because of their appeal to shareholders with special interests generally do not pass. Shareholder resolutions that focus on social or labor issues generally fail. Shareholder proposals that have attracted majority support, such as those calling for repeal of staggered boards, have generally been ones that are viewed by professional money managers (correctly or incorrectly) as clearly serving shareholder value.

---

[5] Damon Silvers and Michael Garland present some data that nicely illustrates this point. According to their data, in the eight firms that submitted comment letters opposed to shareholder access, the largest union or state pension fund holds less than .75% of the company's shares. *See* Damon A. Silvers and Michael I. Garland, "The Origins and Goals of the Fight for Proxy Access," forthcoming in Lucian Bebchuk, ed., *Shareholder Access to the Corporate Ballot* (2004).

Indeed, in many companies the fraction of shares held by union and state pension funds, which might have "collateral objectives" inducing them to vote in favor of shareholder access proposal, is smaller than the fraction of shares held by the company's insiders, who might have "collateral objectives" inducing them to vote against shareholder access proposals.

2. Barbarians at the Gate: The ISS

The BRT argues that the Commission has failed to take into account "the role of proxy voting guidelines in determining the voting practices of many institutional investors."(p. 28) Employee benefits plans, which are among the most significant investors in the capital markets, are required to vote proxies as part of their duties as plan fiduciaries. Confronting the need to make voting decisions in numerous companies, such institutional investors do not make case-by-case decisions. Rather, they largely follow voting guidelines that they develop either on their own or by using the guidelines of Institutional Shareholder Services (ISS) or some other proxy advisory service. ISS, the currently leading proxy advisory service, is viewed as having pervasive influence on the voting decisions of many institutional investors. (p. 29) Therefore, the BRT argues, a widespread adoption of shareholder access resolutions might result not from shareholders' genuine judgment that such a regime will serve their interests, but rather as a result of an ISS recommendation to support such resolutions. (p. 30)

It is difficult to predict accurately what voting policies institutions will develop following the adoption of the proposed access rule. ISS has stated that it will make recommendations on a case-by-case basis. Institutional investors, as well as their proxy advisers, may also develop voting policies that tie voting on shareholder access resolutions to some governance or performance parameters that they view as important. For example, an institutional investor may adopt a policy of voting for shareholder access proposals if and only if a board's performance is highly unsatisfactory in terms of some easily checked criterion -- e.g., the company's under-performing its peers for a sufficiently long period of time, restating its earnings, failing to tie pay to performance in any way, and so forth. After all, while institutional investors disfavor staggered boards, shareholder resolutions to repeal staggered boards have been brought and have passed in only a small fraction of the companies with staggered boards.

While it is difficult to predict how many shareholder access resolutions will pass if the proposed rule is adopted, it is safe to assume that a widespread adoption would not result from a capricious, arbitrary decision by ISS rather than from the emergence of a widespread consensus for shareholder access among institutional investors. Given the attention that the shareholder access issue has received, it is unlikely that institutional investors will not have an informed view about it but rather will feel the need to follow thoughtlessly the recommendations of a proxy advisor. Institutional investors will likely be exposed to a range of recommendations and views about the subject, and they will have little reason to adopt a policy of generally voting for access proposals unless they view such proposals as value-enhancing.

In sum, one cannot rule out the possibility that shareholders will approve a large number of shareholder access resolutions. This could happen if, as experience accumulates over time, a consensus in favor of shareholder access emerges within the investment community. What can be ruled out, however, is the possibility of widespread adoption of such arrangements without genuine and widespread support for them among shareholders concerned about increasing share value.

B. Trojan Horses: Special Interest Candidates on the Ballot

The BRT suggests that the "greatest harm threatened by the proposed rules … may well be the prospect … of 'special interest' and 'single issue' campaigns and candidates." (p. 40). On the BRT's view, candidates nominated by shareholders with a special interest will be ones that "share a common policy objective" and, once elected, these shareholder nominees will put this objective "ahead of the corporate well-being as a whole."(p. 40) Thus, the BRT raises the concern that a shareholder with interest in certain "social investment policies" will nominate a candidate with "shared sympathies" toward such policies and that, once elected, the candidate will pursue these policies in a manner that "could have a debilitating effect on … the vitality of the company as a whole."(p. 41)

The BRT suggests that the prospect of candidates nominated by union pension funds "warrants particular attention." (p. 41) The BRT worries that, in the case of a labor dispute, union pension funds will place a candidate of the ballot that will "excoriate current management and … criticize the management policies at the heart of the underlying labor dispute between the company and union." (p. 42) Worse, "if the union candidate or candidates were elected, the prospects of a bitterly divided and ultimately dysfunctional board are of course quite real."(p. 42)

The fear that shareholder access will provide unions and social activists with substantial influence over board decisions does not seem warranted. While the BRT does not seem to place much trust in the voting decisions of shareholders, it is still a stretch to expect candidates with a union or social activist agenda to have any meaningful chance of being elected. Most shareholders are primarily focused on enhancing share value, and they are highly unlikely to vote for a candidate with a labor agenda. As already noted, shareholder resolutions that focus on labor or social issues are generally defeated by substantial margins.

Nor is there basis for the fear that the shareholder access regime will provide a union with a new and powerful "bully pulpit" to attack a company with which the union has a labor dispute. To be sure, if the union succeeds in meeting the ownership and holding requirements for placing a candidate on the ballot, the union will be able to include a short statement criticizing management in the company's proxy materials. But unions already can place such statements in the proxy materials by proposing a shareholder resolution criticizing the company's labor policies. And proposing such a shareholder resolution is much simpler and easier than getting a candidate on the ballot would be under the proposed rule.

It is worth noting that the view that shareholder access will provide labor interests with more influence over the board is not shared by other opponents of shareholder access. To the contrary, Martin Lipton and Steven Rosenblum have argued that shareholder access will lead boards to give less attention to the interests of nonshareholder constituencies such as employees.[6] Lipton and Rosenblum believe that currently boards can be expected to take into account not only the interests of shareholders but also the interests of other constituencies. In their view, permitting shareholders to nominate directors would make board decisions more focused on shareholder interests, to the potential detriment of employees and other constituencies.

The prediction that shareholder access can be expected to make boards more attentive to enhancing share value is warranted because the key to director election is in the hands of shareholders that are interested in enhancing share value. The BRT is therefore not justified in making the opposite prediction.[7]

---

[6] *See* Martin Lipton & Steven A. Rosenblum, Election Contests in the Company's Proxy: An Idea Whose Time Has not Come," 59 BUSINESS LAWYER 67 (2003).

[7] As to Lipton and Rosenblum, while they are correct in predicting that shareholder access will make boards more attentive to shareholder interests, they are not on solid ground when arguing that this change will hurt employees. The problem with their argument is that, even

III. CONCLUSION

The BRT paints far too rosy a picture of the current state of affairs, failing to undermine the view that reform is needed to make shareholder power to replace director truly viable. The BRT also paints far too bleak a picture of the consequences of the proposed shareholder access rule, failing to show that it would have significant adverse consequences. Overall, the BRT's submission does not provide a good basis for its fierce opposition to the proposed rule.

without the shareholder access rule, there is little basis for expecting directors to have substantial overlap of interest with employees. Thus, board insulation form shareholders should not be expected to operate to the benefit of employees. It is merely expected to protect management slackness and under-performance, which hurt shareholders and might sometimes hurt employees as well.