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Statement of the Shadow Financial Regulatory Committee

on

SEC Proposals for More Shareholder Democracy

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The Securities and Exchange Commission ("SEC") in August of 2003 proposed, and in November adopted, new rules designed to increase shareholder (SH) participation in the corporate electoral process (the "access rules").

Since state law, and not the SEC, governs shareholder voting, the rules take the form of requiring more "disclosure" in proxy statements of certain company "policies"—or explaining why the company has not adopted the policies the SEC is promoting.

One set of such disclosures relates to the process for nominating candidates for election to the board as directors. Thus the proxy statement would have to disclose whether the board has a nominating committee, whether the nominating committee has a charter, whether its members are defined as "independent," whether it has established specific minimum qualifications for nominees, what its process is for identifying and evaluating candidates, whether it has a policy and process for considering SH-proposed candidates, and the identity of any candidate recommended by a SH or group of SHs that has owned more than 5% of the company's stock for more than a year.

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A second set of disclosures deals with the ability of SHs to communicate directly with the board and its members, in the belief that it would improve board accountability, responsiveness, and corporate governance in general. Thus there must be disclosure of the process for SHs to send communications to the board, either directly or through a company filtering mechanism—or why there is no such process. Likewise, there must be a statement of the company's policy concerning board member attendance at annual shareholder meetings, and of who attended the previous one.

In October 2003, the SEC proposed another group of rules to enable, under very limited circumstances, SHs to use company proxy statements to put forward candidates for directorship (the "nominee proposal"), meaning that the company and not the proponents would bear the mailing expense (though not the solicitation costs involved in trying to actually win election). The use of the company proxy statement would, however, be highly circumscribed:

First, there would have to be a "triggering event" that suggests SH dissatisfaction with the effectiveness of the company's proxy process: (1) A board nominee in the last election got "withhold approval" votes greater than 35% of votes cast. (2) A proposal by a SH or group (holding over 1% of shares for at least 1 year) that the company itself adopt this direct nomination procedure receives more than 50% of the votes cast. (3) A proposal by such a SH or group under rule 14a-8 has received more than 50% of votes cast, but the board has failed to implement it before the next proxy round; this is characterized not as a proposed rule but as a possibility under consideration.

Second, if a triggering event has recurred, an eligible SH could submit director nominees to be included in the company's proxy statement. However, an eligible SH or group must have owned 5% of the share for at least 2 years, as reported (on Sch. 13G) as a passive or institutional investor which does not seek to influence board control. The number of director candidates who may be nominated ranges from 1 with a board of less than 9 members to 3 for a board of 20 or more. The candidate cannot be affiliated with the nominating shareholders, as for example an employee or paid representative.

These two sets of rules represent another manifestation of the SEC's periodic advocacy of what might be termed its "town meeting" concept of SH democracy, in which what SHs want to do is discuss different points of view about company policies. Some decades ago, the SEC promulgated rule 14a-8, which enabled SHs to put proposals on the company's annual proxy statement for SH vote. For the most part, they have been used by activists owning a small number of shares to garner attention for their personal social causes.

The consequences of the new rules on access to the board members and a nominating committee can only be conjectured at this point. On the one hand, they might produce a torrent of communications and recommendations, which would have to be responded to but would likely be for the most part justifiably ignored by the board. On the other, they might be largely ignored by SHs themselves, in which case there would be few communications and little burden.

The nominee proposal is notable mainly for what it excludes. Triggering events explicitly do not include sustained dismal financial performance by the company, and the restrictions on SH nominees preclude the possibility of incumbent management's control being weakened to any appreciable degree. Again it appears the purpose is to provide critical SHs with an opportunity to speak, through nominees who do not actually represent them, but not to take any effective action.

The SEC notion of improving the governance of the modern large public company by marginally facilitating SH speech is badly out of touch with the reality of corporations with hundreds of thousands or even millions of SHs. It is an ineffectual solution to a mis-diagnosed problem. The most critical role of the board of such companies is to assess and improve the performance of top management and replace chronic underachievers, who are failing to make the most efficient or profitable use of the company's resources, before they ruin the firm or produce bankruptcy. If the board is overly deferential to the CEO or merely inattentive, though "independent" in terms of now-forbidden personal ties, a fall-back mechanism is vitally necessary.

What the SEC should focus on—instead of these trivial gestures—is the larger and much more central issue of how to facilitate through the proxy system more effective ways for SHs to oust unproductive managers. Large SHs, whether institutional or individual, who have the strong incentives and clout that few merely “independent” directors will possess, and therefore have indeed an interest in influencing control of the board, play an essential role in genuinely effective corporate governance. The Shadow Financial Regulatory Committee believes it should be a high priority for the SEC to make it easier and legally safer for such SHs to play a meaningful role in corporate control contests, even if they have no interest in assuming control themselves. The current nominee proposal is an exceedingly small step in that direction, is unlikely to have any significant effect on management accountability, and may well even be counterproductive in its timid endorsement only of “short slates” without interest in the control and direction of the firm.