Institutional Perspective on Shareholder Nominations of Corporate Directors

*By Robert C. Pozen**

In two other articles in this issue of *The Business Lawyer*, Lucian Bebchuk and Martin Lipton argue respectively for and against shareholder nominations of corporate directors. Given the eloquence of both these authors, this Article will not attempt to restate or criticize their arguments. Instead, this Article will review the practical issues that the Securities and Exchange Commission (SEC) would have to resolve in order to make workable any system for shareholder nomination of directors.

In particular, this Article takes the viewpoint of institutional investors, such as mutual funds and pension funds,[1] which control over half of the publicly-traded equities in the United States.[2] As explained almost a decade ago,[3] institutional investors are "reluctant" activists that almost never seek to obtain control of the board of a publicly-traded company because of legal restrictions or practical constraints. Thus, this Article addresses situations where shareholders are seeking to nominate only one or two directors to the board of a publicly-held company.

This Article will begin by presenting the cost-benefit framework utilized by most institutional investors in evaluating whether to be "activist"—defined to mean doing something more than voting proxies in a diligent fashion. Although this review will touch upon various categories of costs and benefits, it will focus on those most relevant to shareholders nominations of directors. Then this Article will apply this cost-benefit framework to the five alternative methods, suggested by the American Bar Association Task Force on Shareholder Proposals ("ABA Task Force"), for increasing shareholder participation in nominating corporate directors, as well as the sixth alternative of cumulative voting. These five alternatives are:

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1. I was Vice Chairman of Fidelity Investments until the end of 2001. During most of my fifteen years working there, I had supervisory responsibility for proxy voting by the mutual funds and pension accounts managed by Fidelity Investments. This Article represents my personal views, however, and not those of Fidelity Investments.

2. In 2001, institutional investors held 55.8% of the publicly-traded equities in the U.S. The Conference Board: INSTITUTIONAL INVESTMENT REPORT, Mar. 2003, at 32.

3. Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.–Feb. 1994, at 140, 140–49.

i. enhancing the input of shareholders into the processes of the nominating committee of the company's board,
ii. allotting specific board positions for nomination by shareholders through the nominating committee of the company's board,
iii. simplifying independent proxy solicitations for so-called short lists of shareholder-nominated directors,
iv. permitting shareholders to use the company's proxy machinery to solicit proxies for their own nominees, and
v. allowing more leeway for shareholder proposals defining the process of nominating directors for a specific company.

Cost-Benefit Framework

The Wall Street Rule is alive and well. In most cases when institutional investors are dissatisfied with the performance of a company's directors or executives, these investors simply sell the stock. Selling the stock sends a signal to the company, yet does not impose any costs (other than trading costs) on institutional investors.

In a small number of cases, however, institutional investors may consider whether to sell the stock or, alternatively, to hold the stock and engage in activism in an effort to change a significant policy or strategy of the company at issue.[4] As mentioned above, activism means more than voting proxies diligently. Activism can take many forms—for example, waging a proxy fight, submitting a shareholder proposal or simply publishing a list of so-called corporate underperformers. In deciding whether to engage in any form of activism, institutions usually weigh the various costs likely to be incurred in activist activities against the magnitude and probability of expected benefits of such activism.

Costs

The various categories of costs involved with institutional activism include some items that are relatively easy to calculate and other items that are extremely difficult to estimate. The easily calculable items are the out-of-pocket costs associated with the particular form of activism selected—for example, the printing and mailing costs incurred with a proxy solicitation for a shareholder nominee, or the advertising expenses associated with publishing lists of so-called corporate underperformers.

One difficult expense to estimate is the time of senior executives and investment personnel who participate in an institution's activism. When a large manager of mutual funds or pension assets actively promotes a change in a company's business strategy, a senior executive of the manager must spend considerable time making sure that the right message is conveyed to the company, that press

4. These are not mutually exclusive alternatives. An institutional investor may also sell down to an underweighted position; in that case, it would still be interested in improving the company's financial performance.

relations are handled properly, and that the trustees of the mutual fund or pension plan are kept apprised of the activism. Similarly, although investment professionals generally do not participate in routine proxy votes (which are typically handled by an internal proxy voting team), they must take the time to provide guidance to the proxy voting team when a substantial holding in their portfolio becomes the subject of activism by their own manager (or by another institution). The time of senior executives and investment professionals is very expensive, and the amount of time necessary to implement or support an activist strategy is almost impossible to predict.

Another difficult expense to predict is litigation cost because it is unclear whether institutional activism will stimulate litigation by company management or other opponents of the strategy pursued by the institution.[5] Of course, the SEC's rules now permit an unlimited number of institutional investors to communicate among themselves about a proxy item, such as the election of a director, without the filing of proxy solicitation materials.[6] This SEC exemption is subject to many conditions, however—most importantly, that the institution continues to qualify as a 13G filer, rather than a 13D filer, under the Securities Exchange Act of 1934. In turn, an institution may qualify as a 13G filer only if it, acting alone or in concert with others, has neither the purpose nor the effect of changing or "influencing the control" of the company at issue.[7] These phrases, as the ABA Task Force points out, are crying out for clarification in the context of shareholder nominations for directors. Unfortunately, the SEC has been intentionally vague about what constitutes "acting in concert" under section 13(d) and what constitutes "influencing the control" of a company under section 13(g).

A different type of cost for engaging in institutional activism, as opposed to selling the stock, is the time delay in waiting for the annual shareholders' meeting to nominate directors or make other types of shareholder proposals. Of course, the institution could go through the process of calling a special meeting of shareholders, but this is a cumbersome and expensive process.

Finally, one potential cost of any institutional activism is that a company may cut off access to the analysts of the institution, or threaten to terminate the institution as a manager of the company's pension plans. Such retaliation has occurred as a result of much lesser sins than mounting public opposition to sitting corporate directors—for example, company retaliation against Wall Street research analysts who issue negative recommendations on a company's stock.[8] Advisors to mutual funds may be particularly reluctant to support another institutional activist be-

5. *See* Letter from Robert Todd Lang et al, Co-Chair, Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, ABA Section of Business Law, to Jonathan G. Katz, Secretary, Securities and Exchange Commission 6 (June 13, 2003) [hereinafter ABA Task Force Letter].

6. Commodity and Securities Exchanges, 17 C.F.R. § 240.14a-2(b)(1)(vi) (2003).

7. *See id.* § 240.13d-1(b)(1)(i).

8. The SEC recently requested the NYSE and NASDAQ to consider adopting new rules designed to prevent listed companies from cutting off an analyst's access to top executives if they do not like the analyst's report on the company. Deborah Solomon & Robert Frank, *'You Don't Like Our Stock? You Are Off the List': SEC Sets New Front on Conflicts By Taking Aim at Companies That Retaliate Against Analysts*, WALL ST. J., June 19, 2003, at C1.

cause of the SEC's new disclosure rules for investment advisors to mutual funds.[9] These advisors must now disclose to the public not only the advisor's general guidelines for the voting process, but also every vote on every proxy item cast by the advisor, including any vote for any director nominee other than a member of the management-backed slate.

Benefits

Although certain categories of costs incurred by institutional activism are hard to estimate, the magnitude and probability of benefits from activism are even more difficult to predict. For this reason, institutional investors are best advised to concentrate their activism on situations where the price of a company's stock is at issue, like a merger proposal, if the target's shareholders believe the price being offered is inadequate. In such situations, successful institutional activism is likely to lead to a higher stock price, which directly benefits the clients of the institutional investor. On the other hand, institutional investors should not become activists in situations promoting corporate governance procedures that, although advocated by some theoretician, are not significantly correlated with increases in the price of a company's stock or its net income (e.g., splitting the board chairman and Chief Executive Officer (CEO) positions).[10] In the middle are the most challenging situations involving corporate governance procedures that are not likely to increase a company's stock price or earnings in normal times, but are likely to do so if the company becomes enmeshed in a crisis situation like a hostile takeover. The composition of the board is one of these challenging situations in the middle of the benefit spectrum.

The overwhelming majority of empirical studies show no significant correlation between the percentage of independent directors on the board and the performance of the company (measured by stock price or earnings), except if the company becomes the target of a hostile takeover.[11] In that event, a higher percentage of independent directors is positively correlated with a higher takeover price received by target shareholders. Of course, none of these studies was done under the new regulatory framework established by the Sarbanes-Oxley Act. Nevertheless, these empirical studies make sense to anyone who has served on a corporate

9. *See* Securities and Exchange Commission, *Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 17 C.F.R. Parts 239, 249, 270 and 274* (2003), *available at* http://www.sec.gov/rules/final/33-8188.htm (last visited Oct. 17, 2003). For critical comments on the scope of this Rule, see Letter from Robert C. Pozen & Lucian Bebchuk, Professors, Harvard Law School, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 4, 2002), *available at* http://www.sec.gov/rules/proposed/s73302/rcpozen1.htm (last visited Oct. 7, 2003).

10. *See* James A. Brickley et al., *Leadership structure: Separating the CEO and Chairman of the Board*, 3 J. Corp. Fin. 189 (1997); B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 Strategic Mgmt. J. 41 (1996). The separation of the CEO and board chairman, however, may make sense in a specific company—for example, when a new CEO has relatively little foreign experience in a global company.

11. The extensive literature is reviewed in Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1999) and Roberta Romano, *Corporate Law and Corporate Governance*, 5 Indus. & Corp. Change 277, 284–90 (1996).

board—it is the knowledge and diligence of the person, rather than his or her formal affiliation to the company, that determines the quality of a director.[12] Some of the best directors are "interested," and some of the worst directors are "disinterested." Thus, institutional investors will not be likely to nominate an independent director for a company merely because it ranks relatively low on one of the several published indices of good corporate governance.[13]

The necessary, but not sufficient, condition for the institutional nomination of an independent director is that the company at issue is performing poorly as measured by stock price or earnings relative to an appropriate peer group of companies. In addition, most institutions will not nominate a company director unless they believe that an independent voice is very likely to result in a substantial increase in the financial value of the company.[14] For instance, suppose a public company is engaging in a series of transactions at inflated prices in favor of a private firm owned by someone who also controls twenty percent of the public company's stock and who tends to dominate its board of directors. In that instance, the election of one or two independent directors to that public company's board will likely result in the repricing, or even elimination, of those related party transactions.[15]

One final aspect of the benefit side of institutional activism is the question of "free riders,"[16] that is, who receives the benefits if an institutional investor makes the expenditure to nominate and elect a director for a poorly performing company, and that director substantially enhances the price of the company's stock? The answer is that all the shareholders of the company benefit, although only that one institutional investor has incurred the costs of activism. If the SEC wishes to encourage activism by institutional investors on director nominations, it should find a reasonable way for other beneficiaries of institutional activism to contribute proportionately to the costs incurred by the activist institution.

ABA Proposals

The American Bar Association Section of Business Law has examined the advantages and disadvantages of five possible alternatives that the SEC might pursue with regard to shareholder nominations of directors. The pros and cons of each alternative are discussed generally in a report by the ABA Task Force, published in this issue of *The Business Lawyer*. This Article will analyze each of the five

12. *See* Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106.

13. For examples of indices of corporate governance procedures, see the Dow Jones Sustainability Indexes, *available at* http://www.sustainability-index.com; the FTSE4 Good Index Series, *available at* http://www.ftse.com/ftse4good/index.jsp; or the Standard & Poor's Corporate Governance Score, *available at* http://www.standardandpoors.com.

14. The exceptions may be certain public pension funds, which sometimes may be more motivated by political than financial considerations. *See* Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 231–32 (2001).

15. Such transactions would have to be approved by a majority of the disinterested directors of the public company as "fair" to that company. *See* DEL. CODE ANN. tit. 8, § 144 (2001).

16. *See*, *e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 821 (1992).

alternatives[17] under the cost-benefit framework generally used by institutional investors in evaluating whether to engage in activism.

Increasing Shareholder Input into Nominating Committees

Under this first alternative, shareholders holding more than a specified percentage of the company's voting stock would be eligible to submit candidates for directors to the nominating committee of the company's board. The nominating shareholders would be required to provide background information on their candidates, who in turn would be required to confirm their willingness to serve as a company director. After conducting whatever diligence they deem appropriate, the members of the nominating committee would decide whether to include any shareholder-nominated candidates on the company slate. The nominating committee would give notice of their decision to such candidates in time for them to run their own short slate (discussed below) if they were not chosen for the company slate. In addition, the nominating committee would issue a report, included as part of the proxy statement, indicating the number of candidates proposed by eligible shareholders, as well as the process and the criteria used by the committee in deciding upon the company's slate. The committee report would not include the reasons for rejecting any shareholder-nominated candidates for the company's slate, however, and would not include the reasons for choosing one candidate over another.

Under this alternative, the costs of submitting candidates to the nominating committee would be minimal for any institutional investor meeting the eligibility requirements. There would be no litigation threats, and little risk that a company would cut off access to the institution's analysts. Moreover, even if a candidate put forward by the institution were chosen by the committee, he or she could not reasonably be considered a representative of the institutional investor. At most, the institution would have to spend a modest amount of time and effort in developing a list of suitable director candidates.

On the other hand, the probable benefits from submitting candidates to the nominating committee would also be minimal for the institutional investor. Even a nominating committee composed entirely of independent directors[18] is not likely to choose a candidate put forward by shareholders as part of the company's slate, unless the candidate is already known personally to a member of the committee as someone who would contribute constructively to the board process and who would "not rock the boat." And the committee report could avoid an explanation of its rejection of the candidate nominated by the institution. Furthermore, if the institution's candidate were in fact selected as part of the company's slate, the probable impact of this one director on the company's stock price or net income

17. *See* ABA Task Force Letter, *supra* note 5, at 4–5. These five alternatives have been reordered for purposes of analysis.

18. *See* Amendment No. 1 to the NYSE's Corporate Governance Rule Proposals, File No. SR-NYSE-2002-33, at 4(a) (Apr. 4, 2003).

would be modest, unless the company were involved (or soon to be involved) in a takeover bid or proxy fight. Yet it is precisely these situations in which the nominating committee would be reluctant to select an institutional shareholder's candidate for the company's slate.

Allocate Specific Board Seats for Shareholder Candidates Through Company Nominating Process

Under this second alternative, the New York Stock Exchange (NYSE), the NASDAQ and other exchanges would amend their rules to require that the nominees for a certain number of seats on boards of listed companies be allocated to candidates put forward by eligible shareholders,[19] subject to the nominating committee's acceptance of the candidate. Although the company's board would determine the number of allocated seats, at least one seat up for election in any year would have to be allocated to candidates nominated by shareholders. As with the first alternative, this alternative would require shareholders to meet certain eligibility criteria to nominate directors. Eligible shareholders would then be required to submit specified information about their candidates and the nominating committee would perform reasonable due diligence on such candidates. If the nominating committee rejected all the candidates put forward by eligible shareholders, then no director would be elected to fill the allocated seats, which would effectively be reserved for shareholder-nominated candidates in future elections.[20]

In contrast to the first alternative, this second alternative is very likely to result in the actual election of the board of candidates nominated by institutions. Indeed, a few institutional investors may be the only ones meeting the eligibility requirements for nominating candidates to fill the allocated seats. Would institutional investors be interested in having director slots allocated to their nominees on a regular basis? If the company's financial performance is strong, an institutional investor would probably perceive little benefit in vetting and recruiting director nominees for that company. Institutional investors would be willing to take advantage of allocated director slots only if the company were in financial trouble or subject to potential domination by a large shareholder.

At the same time, the potential costs of nominating candidates under the second alternative may be greater than the costs associated with the first alternative. The ABA Task Force believes that a director in an allocated seat should have the same duties as all other directors,[21] and should not be deemed to be a "representative" of the nominating institution.[22] The courts have from time to time held an institution liable for short-swing profits under Section 16(b) of the Securities Exchange Act of 1934, however, because the courts concluded that a company director,

19. These seats would presumably be allocated to shareholder-nominated candidates on an exclusive basis, or at least on a highly favored basis.

20. As the ABA letter notes, it is unclear whether the SEC has the legal authority to require the exchanges and NASDAQ to adopt such amendments to listing standards on allocated board seats. *See* ABA Task Force Letter, *supra* note 5.

21. *Id.* at 18.

22. *Id.*

nominated by an institution, was "deputized" by that institution.[23] Similarly, judges might examine carefully whether an institutional investor received from a company director (that it nominated to an allocated seat) any nonpublic material information about the company for purposes of SEC Rule 10b-5,[24] or any selective disclosures about the company for purposes of the SEC's Fair Disclosure (FD) regulation.[25] Therefore, if the SEC wants to encourage institutional investors to nominate candidates for allocated seats, it must provide these institutions with safe harbors, including appropriate conditions such as the maintenance of firewalls,[26] to avoid the potential legal risks under Section 16(b), Rule 10b-5 and Regulation FD.

Simplify Proxy Solicitations for Short Lists of Director Candidates

Under the third alternative of short lists, as compared to the first and second alternatives, shareholders would not submit their candidates through the company's nomination process. Instead, shareholders would run their own short list[27] of one or two candidates for the company's board and solicit proxies directly from other company shareholders. Although the proponents of such a short list must make public disclosures required by the SEC for anyone who solicits proxies for a company's directors,[28] the ABA Task Force suggests that proponents of short lists be allowed to publish such disclosures, along with cards granting the right to vote proxies on the Internet so that shareholders may "conduct election contests with less cost and effort than now permitted."[29] The ABA Task Force also urges the SEC to clarify what level of shareholder support of the short list would *not* require the filing of disclosures as "affiliates" or "participants" in Internet proxy solicitations in order to "facilitate shareholder involvement in election[s]."[30]

The likelihood of actually electing director candidates put forward by institutional investors would be significantly lower under this short list alternative than under the second alternative, which allots a specified number of board seats to shareholder-nominated candidates. Company management would probably oppose the election of one or two shareholder-nominated candidates, because they would necessarily compete against one or two members of the company slate selected by its own nominating committee. In addition, the institutional activist would be more exposed to legal risks (discussed above) if it nominated director candidates and directly solicited proxies for them, as compared to submitting

23. *See* Blau v. Lehman, 368 U.S. 403, 409–10 (1962).
24. *See* Commodity and Securities Exchanges, 17 C.F.R. § 240.10b5-1 (2003).
25. *See id.* §§ 243.100–.103.
26. By analogy, see the SEC safe harbor in the tender offer rules under section 14(e) involving the maintenance of firewalls. 17 C.F.R. § 240.14e-3 (2003).
27. This is a short list because it contains fewer than the number of candidates that would be needed to fill the total number of board seats subject to election at that meeting.
28. *See* Schedule 14A, 17 C.F.R. § 240.14a-101 (2003).
29. ABA Task Force Letter, *supra* note 5, at 14.
30. *Id.* at 15.

their candidates to the company's nominating committee. Because candidates on a short list directly promoted by an institutional investor might well be considered its "representatives" by the courts, the institution would have to establish special firewalls to avoid possible legal liabilities for insider trading or short-swing profits.

On the other hand, the ABA's suggestions on conducting proxy solicitations for short lists over the Internet constitute a potential breakthrough on the costs of institutional activism. At present, the expense involved with mailing proxy cards to millions of shareholders is daunting. The cost savings would be enormous if an institution could attach proxy voting cards for a short list of director candidates to proxy materials distributed over the Internet to company shareholders. Similarly, the support of other institutions for such a short list would be significantly enhanced if they could abide by the terms of a SEC "safe harbor," so they would not be considered "participants" or "affiliates" in an Internet proxy solicitation by the proponent of a short list.

It remains to be seen, however, whether an Internet-only solicitation of proxies would be sufficient to result in the actual election of director candidates nominated by shareholders. Shareholders must normally spend millions of dollars—e.g., on proxy solicitors, newspaper advertisements, and litigation—to win a proxy vote on directors elections. Yet even victorious director candidates may recoup their election expenses from the company only upon a majority vote of its board. If shareholders nominate a short list of only one or two director candidates, they will never gain control of the company's board so they are not likely to obtain board approval for the company's reimbursement of their election expenses.[31]

Permitting Shareholders to Solicit for their Short Lists Through the Company's Proxy Machinery

This fourth approach would reduce the costs to a shareholder of soliciting proxies for their director candidates by including a supporting statement for such candidates in the proxy materials sent out by the company. Again, this alternative would be available only to shareholders holding a minimum number of shares, who were prepared to submit the required information to the company. Furthermore, the SEC would establish a limit on the total number of shareholder candidates to be included in any company proxy statement,[32] a limit on the length and nature of any material supporting such candidates, as well as deadlines for submitting such material to the company.

In contrast to the first and second alternatives, this fourth alternative (like the third alternative on short lists) would provide no role for the company's own nominating committee in selecting director candidates put forward by shareholders.

31. After prevailing in derivative suits, some shareholders have persuaded courts to require a company to reimburse their attorneys' fees on the theory that the derivative suit conferred benefits on all company shareholders. But those precedents have not been applied to company reimbursement of election expenses to victorious proponents of director nominees. *See* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1108–10 (1990).

32. Priority would presumably be determined by the largest share holdings.

This means that candidates nominated by a large institutional investor would most surely be included on the ballot for a company's election of directors. On the other hand, such director candidates would almost certainly be opposed by company management because they would implicitly be competing for board seats against members of the company's slate of directors. As in the third alternative, this alternative would also involve substantial legal risks to the proponent institution, which would have to establish firewalls to avoid a judicial determination that a director nominated and supported by the institution "represented" that institution on the company board.

The alleged advantage of the fourth alternative (over the third alternative of short lists) is lowering the cost of soliciting proxies for shareholder-nominated candidates by including a supporting statement in the company's proxy material. However, this is the relatively inexpensive portion of the proxy solicitation process; as discussed above, this portion of the process could be accomplished at a very low cost by an Internet posting of a short list of shareholder-nominated candidates, with a proxy card attached to the Internet message. The bulk of the costs in electing a director not on management's slate involves hiring a proxy solicitor to contact shareholders, running advocacy advertisements in newspapers and conducting litigation if needed.

Moreover, the inclusion of shareholder-nominated candidates in the company's proxy statement has the distinct disadvantage of potential confusion. Less sophisticated shareholders might be confused by a company proxy statement that includes supporting statements on several director candidates actually opposed by management. Such a multi-functional proxy statement, as the ABA Task Force points out, "might cause confusion among shareholders in regard to which nominees are supported by the incumbent board and which are supported by shareholder proponents (and which shareholder proponents support which candidates, where there are multiple ones, as seems likely to occur)."[33]

Allow More Shareholder Proposals Concerning the Director Nomination Process

The fifth and last alternative is qualitatively different from any of the other four alternatives. The other alternatives each delineate a particular method of increasing shareholder involvement in the process of nominating company directors. This alternative does not attempt to delineate any such method. Instead, it proposes to expand the scope of shareholder proposals so that the shareholders of each company could define a customized method for their involvement in the director nomination process. Under this final alternative, revised SEC Rule 14a–8 would permit any shareholder proposal relating to the director nominating process (with a few exclusions) to be included in a company's proxy statement and voted upon by all shareholders. Revised SEC Rule 14a-8 would exclude only three types of shareholder proposals—those preventing the election of a particular

33. ABA Task Force Letter, *supra* note 5, at 21.

nominee as a director, those commenting on an individual who is a director nominee, and those that would operate to change the control of the company.

Given the heated debate on the question of the appropriate level and type of shareholder involvement in the director nomination process, it would be quite sensible to adopt an approach customized for a specific company. In arriving at such a customized approach, institutional investors should have a substantial say as the largest shareholders in most publicly-traded companies. Yet, the ABA Task Force states that shareholder proposals defining shareholder involvement in the director nomination process "might be precatory in nature or mandatory in nature, as permitted under the applicable corporation law."[34] Thus, if state corporate law is interpreted to preclude a mandatory bylaw on the director nomination process put forward as part of a shareholder proposal,[35] company boards would be free to ignore any such proposal—even if it were approved by an overwhelming majority of the company's shareholders.[36]

Conclusions and a Sixth Alternative

The SEC has announced that it intends to propose rules that would enhance shareholder involvement in the process of nominating directors of publicly-traded companies in the United States.[37] In proposing such rules, the SEC should take into consideration the cost-benefit analysis utilized by most institutional investors before embarking upon shareholder activism. Although institutional investors are the largest shareholders in most publicly-traded companies, they may be reluctant to become activist regarding the nomination process for company directors, because enhancements to this process are not directly related to the stock price or net income of a financially sound company in normal times. Rather, the SEC should recognize that most institutional investors would be interested in changing the process for nominating directors only if a company's financial performance is weak, or if the company is likely to become enmeshed in a control battle (precipitated by someone other than the institutional investor).

From the perspective of institutional investors, the first and second alternatives outlined by the ABA Task Force involve both modest costs and modest benefits. In these alternatives, the institution simply submits a few names to the company's nominating committee, which is free to reject any director candidates put forward by any shareholder. By contrast, the costs of winning a proxy contest for a short list of shareholder-nominated directors under alternative three could be quite high, even if proxy cards could be distributed by the Internet along with the required proxy disclosures. Although the fourth alternative would reduce the costs

34. *Id.*

35. Compare Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos., Inc., 975 P.2d 907, 913 (Okla. 1999), with Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292 (Del. 1998) for cases supporting and opposing, respectively, mandatory bylaws.

36. In 2002, ninety-eight precatory shareholder proposals were approved by majority votes, but only fourteen were adopted by management according to the Council of Institutional Investors.

37. *See* Stephen Labaton, *S.E.C. May Ease Voting for Outside Directors*, N.Y. Times, July 16, 2003, at C1.

to shareholders of soliciting proxies for their director nominees, the inclusion of supporting statements for such nominees in the company's own proxy statement may lead to investor confusion about who supports which nominees. Moreover, the expected benefits from proxy solicitations for shareholder-nominated candidates under the third or fourth alternatives are unclear, because the company is likely to push hard for its own slate of directors.

Because none of the four alternatives is compelling from the cost-benefit perspective of institutional investors, they might well favor the fifth alternative—a customized approach to the director nomination process for each company as delineated by a shareholder resolution. This approach seems to be favored by the recent SEC staff report to the Commission.[38] The SEC staff suggests, however, that shareholder resolutions on the director nomination process should be permitted only after the occurrence of specified "triggering events," such as a company's failure to implement an advisory proposal on any subject supported by a majority of its shareholders, or the withholding of a significant percentage of votes for the slate of management-nominated directors.[39] On the other hand, the SEC staff rejects as "triggering events" any indicator of poor financial performance by a company, like lagging a peer index for many years, because the SEC staff believes "that any triggering event should be more closely tied to evidence of ineffectiveness in the proxy process."[40]

By rejecting the performance of a company's stock price as a "triggering event," the SEC staff is ignoring the key factor that is likely to motivate institutional investors to advocate shareholder involvement in a company's nominations of directors. An increase in a company's stock price directly confers substantial benefits on the clients of these institutions. In contrast to the SEC staff, most institutional investors are not interested in the quality of the proxy process for its own sake. With a few exceptions, institutional investors will not become activist in order to obtain the abstract benefit of improved governance procedures for a company with strong financial performance.

The SEC staff does a better job at understanding the cost concerns of institutional activism in regard to nominating directors. The SEC staff recognizes that nominating shareholders will be concerned about potential liability for short-swing profits under Section 16(b) of the Securities Exchange Act, and about being deemed to have a "control purpose" under Section 13(d) of that Act.[41] The SEC staff also focuses on who would bear the cost of using the company's proxy machinery to distribute proxy materials for director candidates by individual shareholders,[42] as well as how the Internet might be utilized to reduce the proxy solicitation costs for such candidates.[43] Yet the SEC staff does not offer any solution

38. *See* SEC DIVISION OF CORPORATION FINANCE STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS (July 15, 2003).

39. *Id.* at 9.

40. *Id.*

41. *Id.* at 15.

42. *Id.*

43. *Id.* at 17.

to the "free rider" problem that is the most serious constraint on potential activism by institutional investors. Even where an activist institution spends large amounts of time and money to change the director nomination process in a financially troubled company, the institution will not gain control of that company. Rather, even in the best of situations, the revised nominating process will lead to the election of one or two new directors, who may help improve the company's business strategy. As a result, the share price for the company would increase, but over ninety percent of these price increases will typically accrue to shareholders other than the activist institution.

The cost effectiveness of this fifth customized approach ultimately depends on whether shareholder resolutions concerning the director nomination process will be considered binding on the company's board or merely advisory. This question in turn depends less on SEC rules and more on state corporate law, as determined by state legislators and state judges. For example, the SEC staff would allow a shareholder resolution on the director nomination process if a company fails to implement an advisory shareholder proposal on any subject supported by a majority of shareholders. But the staff then maintains that the shareholder resolution on the director nomination process will itself be advisory because of state law constraints. Would a company that failed to follow the majority will of its shareholders in one advisory proposal be likely to implement an advisory resolution on the director nomination process? Thus, in order to establish a viable approach based on "triggering events," institutional investors would have to encourage state authorities to recognize as binding any shareholder resolution on the nomination process for a company's directors if the resolution is approved by a supermajority (e.g., two-thirds) of the votes cast at any shareholders' meeting. The requirement of a supermajority vote is the best indicator that shareholders are genuinely dissatisfied with a company and want to change its process for nominating directors.

A final alternative, which would be simpler than the "triggering event" approach, would promote cumulative voting in company elections. In most company elections—for twelve directors, for instance—shareholders may cast only one vote per share for each of the twelve director slots. With cumulative voting, by contrast, shareholders may cast twelve votes per share by concentrating all their votes on only one director slot. Accordingly, cumulative voting would typically allow institutional investors with large holdings in a company's shares to nominate and elect one company director of their choice—by soliciting proxies for a non-management nominee. The availability of cumulative voting is determined by company charters, however, which generally do not have this feature.[44] Furthermore, only directors may propose charter amendments in most states, though shareholders must subsequently approve these proposals. Thus, institutional investors might want to advocate changes to state corporate laws which

44. Only 9.2% of the S&P Super 1500 have cumulative voting, according to the Investor Responsibility Research Center. IRRC Corporate Governance Service 2003, BACKGROUND REPORT F: CONFIDENTIAL AND CUMULATIVE VOTING (Jan. 2003).

would presumptively permit cumulative voting in company charters,[45] or which would allow shareholders in appropriate circumstances to initiate the process of amending company charters.[46]

In short, shareholder nomination of a company's directors should happen infrequently, e.g., only when a company has a serious problem such as a continued decline in financial results or a troubling pattern of affiliated transactions. But the mechanism permitting such shareholder nominations should be established in advance, so that the mechanism can be utilized relatively quickly in these infrequent instances. If an institutional investor must wait for both the occurrence of a "triggering event" and the adoption of a resolution at the next shareholders' meeting before it can nominate a director, this is too long a delay to address a serious problem. A company charter with cumulative voting permits institutional investors with large share holdings to exercise self-help by nominating and electing a director in a much shorter time period. To reduce the costs associated with this exercise, the SEC should follow the suggestions of the ABA Task Force on proxy solicitations for short lists by allowing Internet distribution of nominations and proxy materials, while creating safe harbors for "affiliates" and "participants" in the proxy solicitation process. The SEC should also clarify the application of Sections 13(d) and 16(b) of the Securities Exchange Act to these short list solicitations. Such an approach, based on the general availability of cumulative voting instead of specific "triggering events" defined by the SEC, would allow reluctant institutions on infrequent occasions to introduce a new voice into board deliberations of companies with serious problems.

45. Seven jurisdictions make cumulative voting mandatory, fourteen provide for cumulative voting unless the corporation opts out, and twenty-nine do not allow cumulative voting unless a corporation opts in. *Id.*

46. Alternatively, institutional investors might advocate changes to state corporate laws that would allow shareholders (as well as directors) to initiate the process of amending company charters in certain circumstances—a process already requiring approval from both a majority of directors and shareholders. *See* Lucian Bebchuk, The Case for Empowering Shareholders (Mar. 2003) (unpublished manuscript), *available at* http://ssrn.com/abstract=387940 (last viewed Oct. 7, 2003).