MERCATUS CENTER
GEORGE MASON UNIVERSITY

REGULATORY STUDIES PROGRAM

Public Interest Comment on
Security Holder Director Nominations; Proposed Rule[1]

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the Securities and Exchange Commission's (SEC's) proposed rule, *Security Holder Director Nominations,*[2] does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the Commission's proposals on overall consumer welfare.

To help address the issues raised in this proposed rule, the Mercatus Center held a Symposium on Shareholder Access on December 10, 2003. Speakers at the Symposium included individuals representing shareholder activist organizations, academia, and the corporate boardroom. This comment represents the authors' views, but informed by the discussion and papers presented at the Symposium (see Appendix II for a list of speakers and a short summary of comments).

This comment is organized such that Section I provides a brief introduction to the proposed rule. Section II discusses the benefits attributed to the rule. Section III discusses the difficulties that are likely to be encountered if the proposed rule were implemented, and Section IV discusses some alternatives to the SEC's proposed rule that work to enhance shareholder control over their firms. Section V draws conclusions.

I. Introduction

The SEC's proposed rule represents one attempt to remedy a principal-agent problem. Clearly, some boards of directors (and firm managements) have made decisions with their own rather than the shareholders' best interests in mind. The key question therefore—and

[1] Prepared by Wendy L. Gramm, Distinguished Senior Fellow and Jay Cochran, Research Fellow, Regulatory Studies Program. This comment is one in a series of Public Interest Comments from Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University.

[2] See, "Security Holder Director Nominations; Proposed Rule," *Federal Register* 68 (205), pp. 60784-60826. Hereafter referred to as the "proposed rule."

one which the proposed rule seeks to remedy in part—is how one might better align the decisions of management (the agent) with the interests of the shareholders (the principals).

To improve this alignment, the SEC's proposed rule opens a window, albeit narrowly, into the nominating process for members of a publicly traded firm's board of directors. If adopted, the SEC suggests the proposed rule may give shareholders more access to the nominating and proxy process, and in so doing, the rule may enable firm owners to exert additional influence over the direction of their firm beyond currently available remedies. As the SEC states in its opening discussion of the rule:

> The proposed rules are intended to improve disclosure to security holders to enhance their ability to participate meaningfully in the proxy process for nomination and election of directors. …[T]he proposed rules are intended to create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials where there are indications that security holders need such access to further an effective proxy process. This mechanism would apply in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process. [Proposed Rule, *Federal Register 68* (205): p. 60784]

The proposed rule installs several hurdles that must be surmounted by a shareholder (or group of shareholders) in order to set the rule's nomination process in motion. These so-called "trigger" mechanisms include,[3]

1. More than 35% of the votes cast at an annual meeting were "withheld" for at least one of the company's nominees for the board of directors; *or*
2. A security holder or group holding more than 1% of the company's stock for more than one year (a) proposes, pursuant to Rule 14a-8, that the company become subject to these new shareholder access rules AND (b) this "direct access" shareholder proposal receives more than 50% of the votes cast at the company's annual meeting.
3. The SEC is also considering adding a third trigger, where a security holder proposal (under 14a-8 procedures) received more than 50% of the shareholder vote but was not implemented by the company.

Once a triggering event has occurred, shareholders face another set of qualifications, eligibility requirements, and procedural hurdles in order to use the nomination process. A non-exhaustive survey of these additional requirements includes:[4]

1. The company must disclose the existence of the triggering event in the company's quarterly or yearend report (e.g., 10-Q, 10-K).

[3] Cf., Proposed Rule, pp. 60789-60793, and *passim*.

[4] Cf., Proposed Rule, pp. 60794-60807, and *passim*.

2. Once the triggering event has occurred, the shareholder or shareholder group must meet certain requirements to submit a nomination. They must own, for at least 2 years, more than 5% of the company's securities that are eligible to vote.
3. The director nominee must be independent of the shareholder or shareholder group proposing his or her candidacy. These independence requirements include not being an immediate family member, employee, or consultant of the nominating shareholder or member of the nominating group.
4. The nominee must also be independent of the company, and there can be no agreements between the company and the nominating group about the nominee.
5. There is a limit of one shareholder-proposed nominee for small boards (with 8 or fewer members), 2 nominees for boards of between 8 and 20 directors, and up to 3 nominees if the board has 20 or more directors.
6. The nominating person or group must provide to the company information, representations (concerning eligibility, independence, etc.), and documents along with their nominee at least 80 days before the company mails its proxy materials for the annual meeting. They must also provide notice to the SEC.
7. The SEC intends for the company to provide similar opportunities for the shareholder nominees as the company proposed nominees. If information or statements about the company nominees are made in the proxy statement, similar statements should be available for the nominee of the security holder. If the company determines that they are not required to include the nominee, it must provide information to shareholders about its determination and basis for the decision.
8. The SEC also proposes amendments to Section 16 of the Exchange Act to prevent this proposed nomination process from triggering the change of control contest regulations.

II. Benefits Attributed to the Proposed Rule

The SEC suggests that the proposed rule may improve the alignment of shareholder and board interests even if they the procedures are rarely used. The assertion seems to rest on a potentiality: That is, the rules may be effective simply because shareholders may resort to them if necessary.

> The proposed amendments may serve to align the interests of the board and security holders, thereby giving investors greater confidence that the board is serving the interest of security holders, even if the provisions of the rule are rarely used. This alignment can occur in three ways. First, the presence of triggering events, as described below, may improve the responsiveness of boards to security holder preferences. Second, the disclosure requirements may enable investors to better understand and evaluate the performance of the board. Third, the ability of relatively large and long-term security holders to make a board nomination that is included in the company's proxy materials may improve corporate governance by enhancing security holders' ability to

> participate meaningfully in the proxy process. [*Federal Register 68* (205): p. 60813]

It is important to note, however, that SEC provided no quantitative or even qualitative data to support its assertions regarding the rule's purported benefits. The Commission is correct that the rule *may* improve the principal-agent alignment, but in the absence of data or analysis, it is equally true that the rule *may not* provide the purported benefits. It is to this latter potentiality that we now turn.

III. Difficulties with the Proposed Rule

A. Lengthy and Complex Rule

The proposed rule and preamble runs more than 40 pages, and while much of this length is consumed with questions and other solicitations for comment, the rule is remarkably short on substantive analysis, while being quite long on qualifications, exemptions, and unsupported assertions. It is true that the SEC did perform an analysis as required under the *Paperwork Reduction Act*, for example, and that it did perform a perfunctory cost-benefit analysis. In the latter instance, however, that the SEC offered little concrete evidence to support rule beyond anecdotes, general impressions, and unsupported claims.[5]

The length and complexity of the regulation seems to be due to the SEC's recognition that there is little evidence to support the benefits of the proposed rule, or to help analyze the potential effects of the rule. While it is commendable that the SEC is cautious in its approach, and we appreciate the attempt to make the rule consistent with other regulations (independence of directors, 14a-8 procedures, for example), we cannot escape the stubborn fact that there is little evidence that the regulation as it is proposed will have any benefit.

The two-step process envisioned by the rule would make the application of this rule both time-consuming and costly. It is not clear that any of the problems the SEC identified to support the rule would actually be remedied by this proposed regulation.

Indeed, the available evidence from academic research, using information from the 14a-8 process for placing shareholder proposals on proxies, suggests that such proposals do not lead to improved company performance in the short-run or the long-run.[6] The academic

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[5] The lack of concrete evidence was also apparent from a brief survey of several comment letters already received by the Commission. In a letter from the Harvard Law and Business Schools, for example, the signatories indicated that they believed, "that increasing the number of contested elections beyond the current low levels would be desirable, and that the Proposed Rules could move us in this direction."

[6] In a working paper, Karpoff (1998) surveys the peer-reviewed literature on shareholder initiatives and concludes, "…the empirical literature provides little evidence that shareholder proposals create value, although some negotiation efforts may have. Both proposals and private negotiations have prompted some firms to make small changes in their governance rules. But there is little evidence that either has increased target firms' earnings or had much effect on operations." Cf., Jonathan M. Karpoff (1998), "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings," Working Paper available at http://faculty.washington.edu/~karpoff/Research/SApaper.doc, accessed December 5, 2003. See also, Jonathan

literature does indicate, by contrast, that an active and healthy market for corporate control leads to increases in shareholder value.

While some may argue that the data on the 14a-8 corporate proxy process are irrelevant, we would argue that it is relevant for several reasons. First, it is a proxy process that actually comprises the first step of the current proposal. Second, while evidence indicates that shareholders as a group are able to discriminate among the various proposals, in fact, shareholders who use the existing process have not offered proposals that lead to improved business outcomes. Third, the shareholder proposal data are the best evidence available, and should not be ignored by the SEC.

One particular aspect of the proposed rule that is likely to prove troubling in its implementation is the requirement for nominee independence from both the nominating shareholder(s) and from the company. We understand this provision seeks to prevent special interest nominees while simultaneously preserving director independence, but in its implementation it seems just as likely to produce nominees who pursue their own agendas rather than those of the company they serve or of the shareholders who nominated them.

Another issue the SEC fails to address is the level of expertise and other qualities that might be needed for service on a particular board—expertise that is, in some cases, required by the SEC itself. Neither does the proposed rule make any provisions for the exclusion of a board member for reasons of conflict with the business of the company on whose board he or she will serve. Requiring a company to finance a campaign against a board nominee who works for a competitor would be a waste of resources, not only for the company, but also for its shareholders and the economy.

As indicated above, at numerous points in the text of the proposed rule the SEC solicits comments and asks various questions related to its implementation. On the one hand, such solicitousness and probing may be suggestive of a rule-making process that seeks to balance a number of competing interests. On the other hand, and taken in conjunction with the complexity of the proposed rule and the lack of objective evidence furnished in its behalf, a simpler answer may be that the Commission has set for itself a task that is not particularly well-suited to a prescriptive rules approach. In other words, an investing world characterized by diverse preferences and opportunities, by frequent (i.e., annual) elections, as well as by a low-cost forms of exit, may be especially ill suited to rules patterned on tenets of *political* democracy—where the diversity of interests still exists but the frequency of elections is less and the costs of exit are quite high.

B. SEC Expects the Rule Will Be Rarely Used

As indicated above, the SEC expects that the rule will be rarely used. Both time and up-front financial resources are required from shareholders who wish to apply the rule. At a minimum the provisions of the rule require at least two years to apply, and involve the

M. Karpoff (1996), "Corporate Governance and Shareholder Initiatives: Empirical Evidence," (with Paul Malatesta and Ralph Walkling), *Journal of Financial Economics 42* (3): pp. 365-395.

expenditure of resources (e.g., communications, building a coalition of shareholders, monitoring progress, etc.) during that time. Then, assuming one has successfully managed to place one's candidate on the ballot, there is no guarantee the nominee will win a majority of shareholder votes. Taking the time, cost, and uncertainty of the process together suggests that the SEC's inference is properly drawn: The rule will indeed be rarely used because its application will prove too costly for most shareholders to apply effectively.

The correctness of the SEC's inference is also supported by the fact that other, less costly options remain open to dissatisfied shareholders. The most straightforward of these options, of course, is simply to sell one's shares. While doing so may translate what had been to that point a paper loss into a real loss, it is important to recognize that such investment losses, like all sunk costs, are not relevant to present decisions about the future prospects of a given investment.

It is possible that a large investor may calculate that the probability of recouping or restoring her investment may be improved by electing an outside director under the proposed rule. Given, however, that the uncertainties and sunk costs apply to institutional investors just as much as they do individual investors, the sale of shares and implicit discipline that such sales entail is much more likely to align shareholder and director interests in an efficient manner than is a highly prescriptive, rarely applied rule. This notion is underscored by the fact that the SEC offered no evidence that this current system of market discipline is ineffective at aligning the interests of management with those of the shareholders.

C. Rule unlikely to lead to improvement even if successfully applied

Even if a shareholder or a group of shareholders nominates and elects an outside director under the provisions of the proposed rule, what is the likelihood that the outside director will cause significant change?

In our view, the likelihood is small. First, on a small board with 8 or fewer members, shareholders may nominate one director using the procedures of the proposed rule. (Larger boards must permit more nominees under the rule, but the proportional representation remains roughly the same.) With the outside director representing about 13 percent of the votes on the board, his or her opinion and/or vote may not be heeded. The success of the shareholders' director will depend on many factors, including the willingness of the incumbent board and management to work with and listen to the new director. It is not clear that a board whose interests are not fully aligned with the shareholders' will be responsive to the new director. Poorly performing boards and management seem more likely to view the shareholders' director as upsetting what had been an insular arrangement, and therefore, to be less responsive to his or her views.

It is important also to point out that the successful installation of an outside director under the provisions of the rule may actually retard the movement of assets to higher valued uses. This result would obtain if investors mistakenly believed that the new board member gives shareholders more effective internal control. Shareholders may be induced to hold their shares longer than they would have otherwise. Once shareholders realize their error, however, shareholder values will be dissipated through sales—an event that would have transpired sooner were it not for the rule.

While many of the questions raised in the preceding paragraphs could also be raised for directors elected in a proxy contest, there is a major difference between these two methods of electing dissident directors to the board of a company. In a proxy contest, or in a takeover attempt, those trying to win seats on the board do so using their own resources.

IV. Alternatives to the Proposed Rule

As we suggested at the outset, there is no doubt but that some boards operate at variance with their shareholders' best interests. Given that, the question then becomes what is the best way to realign those interests, or failing a realignment, to wrest control of company assets from such managers and directors. For the reasons outlined earlier, the proposed rule is very unlikely to be effective at achieving either goal, and so it is incumbent upon those of us who would criticize the rule to offer alternatives.

A. The Grundfest Solution

Joseph Grundfest, Professor of Law at Stanford University has suggested an analog to the advice and consent clause of the U.S. Constitution. In short, his proposal suggests that the board may nominate any candidate it wishes, subject to the consent of the shareholders. Nominees failing to gain shareholder approval would be federally encumbered from a securities law standpoint. While we will not undertake to analyze Professor Grundfest's solution in detail here, suffice it to say that his approach has merit inasmuch as it relies on the virtues of specialization, while preserving a useful separation of powers. In any event, it is certainly worthy of detailed consideration if the SEC is truly serious about increasing shareholder influence over the boardroom.

B. Private Provision of Board Information

It is almost axiomatic that when interests of two interrelated parties diverge, a profit opportunity emerges. That profit opportunity is typically cloaked in the form of information provisioning. Lenders for example would like to lend only to borrowers who pay them back, while some borrowers would like to make use of borrowed funds for other than stated purposes. To control this tendency toward moral hazard, lenders rely on information providers who furnish credit histories and credit scores, for example.

Boardrooms can also be subject to moral hazard. This observation suggests that a profit opportunity may exist in terms of providing information to existing and potential shareholders about the alignment of shareholder and board interests. Indeed, several such providers already exist, albeit with differing degrees of focus. From a general standpoint, credit rating agencies, for example, provide some analysis of and check on board operations through their periodic analysis of a firm's credit standing. More specifically, companies such as the Corporate Library specialize in compiling, analyzing, and distributing information about the structure and operations of corporate boards.[7] In addition, providers of Directors and Officers (D&O) insurance are likely to be keenly interested in the alignment of board and shareholder interest, since divergence of these interests may ultimately generate claims against D&O policies.

C. Market for Corporate Control

Perhaps the single most important device for aligning shareholder and board member interests rests in the market for corporate control. Boards who consistently operate at variance with shareholder interests (i.e., who do not maximize share values) will see the values of their firm's shares fall, other things equal. As the shares become cheaper, the firm becomes a more attractive target for takeover. Even barring takeover (because of, say, a poison pill provision), a persistent abuse of shareholders interests must eventually result in bankruptcy. In either instance, assets will be stripped from the self-dealing board's control and surrendered to others who may be better able to enhance share values. Indeed, the recent spate of corporate scandals has, if anything, provided vivid testimony as to how quickly and efficiently this market process works in practice.

V. Conclusions and Recommendations

The SEC's proposed rule attempts to better align the interests of corporate managers with shareholders by increasing shareholder access, under certain conditions, to the nominating process for members of a publicly traded firm's board of directors.

While some boards of directors have acted contrary to the interests of shareholders, the SEC has provided no quantitative or even qualitative data to support its assertions that this problem of misalignment is widespread enough to warrant a federal regulation or that the proposed rule will address the problem. The Commission is correct that the rule *may* improve the principal-agent alignment, but in the absence of data or analysis, it is equally true that the rule *may not* provide the purported benefits.

The SEC recognizes that economically rational shareholders are very unlikely to avail themselves of the proposed rule's provisions, preferring to sell their shares in mismanaged firms. If sufficient numbers of shareholders do the same, the price decline can result in a takeover or other outcomes that lead to changes in a firm's board of directors. Even if the proposed rule were successfully applied, the likelihood of an outside director having a significant influence on management decisions is small, and the successful installation of an outside director under the provisions of the rule may actually retard the movement of assets to higher valued uses.

The SEC should not undertake a regulation without sufficient evidence that benefits would exist. Evidence that the 14a-8 process does not appear to produce any benefits should cause the SEC to consider whether it is wise to move forward with a rule that builds on essentially the same procedures.

[7] Cf., http://www.thecorporatelibrary.com

This comment has highlighted specific problems with the rule, but the fundamental problem may be the presumption that the principles of political democracy can be effectively applied to corporate governance. There is no economic foundation for supposing that application of political democracy to the company boardroom will produce desirable results. An investing world characterized by diverse preferences and opportunities, by frequent (i.e., annual) elections, as well as by a low-cost forms of exit, may be especially ill suited to rules patterned on tenets of *political* democracy—where the diversity of interests still exists but the costs of exit are quite high.

The SEC would be wise to examine carefully the basis for the proposal, and to consider alternatives, such as the ones suggested above. Given the costs and uncertainties of successfully applying the proposed rule, coupled with the fact that less costly alternatives for shareholders already exist, proceeding with the proposed rule would not likely benefit shareholders, and indeed, may be contrary to their interests.

Appendix I
RSP Checklist

Security Holder Director Nominations; Proposed Rule

Element	**Agency Approach**	**RSP Comments and Grades**
1. Has the agency identified a significant market failure?	No. The SEC offered no evidence that existing solutions to poorly performing boards do not work. ***Grade: F***	Not only was no evidence of a market failure offered, by the SEC's own admission the rule is expected to be applied only rarely. In other words, it is a regulation whose expected utility is virtually zero.
2. Has the agency identified an appropriate federal role?	Yes, and the SEC was careful in the proposed rule not to trump existing state laws. ***Grade: B***	Federal securities law underpins the proposed rule, but it is interesting that this rule has been proposed in varying forms for several years as a solution to various problems. However, the SEC provided little evidence as to why state solutions are inferior to a federal regulation.
3. Has the agency examined alternative approaches?	No. ***Grade: F***	While the SEC did ask for comment and posed myriad questions about the proposed rule, it has failed completely to consider any approach other than regulation to solve the purported problem.

Element	Agency Approach	RSP Comments and Grades
4. Does the agency attempt to maximize net benefits?	Partly. The SEC does perform some limited cost benefit analysis. ***Grade: D***	The benefits ascribed to the rule, however, are so tenuous and lacking in specificity that a reliable net benefit estimate cannot be made. The best estimate, therefore, in the alternative is that the rule will produce no tangible benefits while imposing some costs on subject companies and shareholders.
5. Does the proposal have a strong scientific or technical basis?	No. ***Grade: F***	There is no economic foundation for supposing that application of political democracy to the company boardroom will produce desirable results. Indeed since the political and economic spheres operate with differing sets of constraints, it is entirely possible that the rule will prove counterproductive. The SEC's basis for the rule appears to be anecdotes and comments provided in an appendix of an earlier study.
6. Are distributional effects clearly understood?	No. ***Grade: F***	No analysis appeared concerning how the rule might affect the transfer of resources among shareholders or between boards and shareholders.
7. Are individual choices and property impacts understood?	Partly. The SEC takes pains not to allow the proposed rule to disrupt the rules regarding proxy fights. ***Grade: C***	The SEC seems to understand that economically rational shareholders are very unlikely to avail themselves of the proposed rule's provisions, and so they are careful not to disrupt other avenues for shareholders to exert control over their firms.

Appendix II

Executive Summary of Shareholder Access Symposium Panelists' Remarks
Symposium Held December 10, 2003
1539 Rayburn House Office Building
Washington, DC

PANEL 1

Nell Minow *(Editor, thecorporatelibrary.com)*

- Boards of Directors do not do good jobs [no data]. Since they are beholden to the CEO who hired them, they tend to march in lockstep w/his-her decisions.
- The reason for checks and balances (either politically or financially) is to establish the legitimacy and accountability of the system. [The checks and balances provide a means for the principal to monitor the agent.]
- What Directors really need is independence of character, but unfortunately (as Warren Buffet is alleged to have observed) collegiality usually trumps independence.

William Patterson *(Director, Office of Investment, AFL-CIO)*

- Milton Friedman agreed that shareholders should have or be able to exert control over the boards.
- The issue of control, however, goes beyond proxy access.
- Market-induced checks and balances (market for control) are "far worse" than the SEC proposal.
- No trigger mechanism should be required for shareholders to have access to the proxy.

Jonathan M. Karpoff *(Norman J. Metcalfe Professor of Finance, School of Business, University of Washington)*

- At a Harvard-sponsored symposium in October on Corporate Governance, virtually no one offered evidence pro or con about the rule.
- A summation of the empirical research suggests that 14a8 shareholder proposals do nothing to improve short-run or long-run stock values (or other metrics like ROE, ROA, etc.)
- M&A activity and proxy fights (i.e., market-based challenges to corporate control) do, however, lead to increases in shareholder value.
- Conclusion: It may be entirely possible that corporate governance may not be effectively run as an analog to political governance.

Joseph A. Grundfest *(William A. Franke Professor of Law and Business, Stanford University Law School)*

- Agreed with Karpoff's presentation of the data.
- Claims the real solution is to reinvigorate the market for corporate control (challenging poison pills, unresponsive boards, etc.)
- But that's not going to happen, so we're in the world of the second best.
- The proposed rule does not seem to be the ideal second-best solution. It is a very complicated rule premised in confrontation rather than conciliation.
- The SEC mechanism may fuel special interest candidates and grandstanding.
- An alternative is a process based on a model of advice and consent. The board uses its comparative advantage to propose a slate of qualified candidates, but the shareowners hold a (federally enforced) veto. Vetoed candidates would be federally encumbered and thus unlikely to serve.

PANEL 2

James Melican *(Executive Vice President for Investor Relations, International Paper)*

- The current rule is a rehash of an older rule that was originally designed to address non-responsive boards.
- It has since morphed into a vehicle for direct shareholder nomination using the proxy process.
- How much shareholder value is added by the proposal, and is the issue important to shareholders?
- In his experience, little value is added, and most shareholders simply don't care.
- Recommendation: Wait to see how the SRO (NYSE) and SEC governance and nominating committees work. They should work well in his view to provide a venue for shareholders to exert more effective control over boards of directors.

The Honorable Henrietta Holsman Fore *(Director, U.S. Mint, speaking not as a representative of the U.S. Mint, but as a former CEO and corporate board member)*

- What boards require are directors with (a) business experience and (b) independence of thought, judgment, and personal finances.
- Specifically:
    1. Good governance skills (transparency, accountability, view of shareholders as partners not adversaries)
    2. Succession planning for both the company and the board
    3. Skills in the allocation of capital
    4. Understanding of the basic lines of business

Stuart L. Gillan *(Assistant Professor of Finance and Director of Research at the Weinberg Center for Corporate Governance, Alfred Lerner College of Business, University of Delaware)*

- 14a8 data are relevant in that they show shareholders indeed have the ability to discriminate between proposals that advance their investment, and those that do not.
- TIAA-CREF used the 14a8 process effectively to bargain with boards.
- The opportunity to offer a "short slate proxy" can also be effective.
- Perhaps a better solution than the present rule would be one in which the shareholders could offer binding by-laws changes.
- Also cautioned about the increasing federalization of what had been previously state regulatory domain.