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Access to the Company Proxy for Shareholder Nominees to the Board

On April 14, the Securities and Exchange Commission announced plans to conduct a full review of its proxy rules and to develop possible changes "to improve corporate democracy," including possible changes "regarding the procedure for the election of corporate directors." This announcement came together with the SEC's confirmation that current proxy rules permit exclusion of a Rule 14a-8 shareholder proposal that would mandate shareholder access to a company's proxy statement for board nominations. The implication is that the SEC will consider adopting rules to allow such shareholder access.

Allowing shareholders to use the company's proxy statement for director nominations would be a mistake. This is not a question of whether shareholders should have the right to nominate candidates for the board. They should have that right and state laws give them that right. Nor is it a question of whether companies should be receptive to shareholder input in selecting board nominees. Most well run companies provide a mechanism for shareholders to make suggestions to the nominating committee, a committee that under the new stock exchange rules must be comprised entirely of independent directors. Rather, this is a question of whether the SEC should require, and whether it has the legal authority to require, a company to include in its proxy statement nominees for its board who are selected outside the company's nominating process and are running against the board's own nominees.

The SEC and Congress have considered and rejected proposals to require access to a company's proxy statement for shareholder board nominations on a number of occasions. The SEC considered such a proposal as far back as 1942, but abandoned it in the face of unfavorable public comment and strong Congressional criticism. By 1947, the SEC added the express provision of Rule 14a-8 that permits companies to omit shareholder proposals that relate to elections of directors. The SEC again considered the issue of shareholder access for director nominations in 1977 and again rejected it. In the early 1990's, a number of shareholder activists once more proposed giving shareholders access to company proxy statements for director nominations. The SEC adopted sweeping reforms to the proxy rules in 1992, including rules that made it easier for shareholders to run an election contest, but did not adopt these shareholder access proposals. Again last year, shareholder access proposals were introduced amidst the turmoil that gave rise to passage of the Sarbanes-Oxley Act. Despite significant support for corporate governance reform, and rapid approval of the Sarbanes-Oxley Act and new stock exchange rules, none of these shareholder access proposals was adopted.

There are a number of sound reasons why the latest round of shareholder access proposals should again be rejected. First, the election of directors is a fundamentally different exercise than a vote on a management or shareholder proposal. Board elections go to the very heart of corporate governance, of who will be responsible for running the company. In contrast, a vote on a single proposal involves only one isolated decision. The threshold for running an election contest is and should be significantly higher than for a shareholder proposal.

Second, an election contest is a tremendously disruptive event for a company. Because of the supreme importance of board elections in corporate governance, when a company faces a contested election, the company typically devotes a significant amount of resources and time to explaining why the board-nominated slate should be elected. This kind of disruption would be very unhealthy for our nation's companies if it became the rule rather than the exception. The number of Rule 14a-8 shareholder proposals submitted in recent years has been growing steadily. Already in 2003, almost 900 shareholder proposals have been presented at annual meetings. If shareholders had access to the company's proxy materials to make nominations for directors as well, the resulting disruption and diversion of resources would be significant and destructive. The possibility of hundreds of election contests each year, with all that entails, would simply be disastrous for companies and their shareholders.

Third, giving shareholders access to the corporate proxy machinery for director nominations would facilitate the nomination and election of special interest directors. While diversity and fresh viewpoints are good for a company and its board, the election of special interest directors is not. Electing directors who view themselves as representing the shareholder activists, unions, social activists or some other subset of the shareholder population would balkanize boards and render them dysfunctional. A company's board works best when it works as a unified whole, without camps or factions and without internal divisions.

Fourth, requiring someone who wants to conduct an election contest to file separate proxy materials assures a level of disclosure and accountability that is both important and healthy. This requirement also avoids the logistical difficulties and confusion that would result from having more nominees on a single proxy card than there are seats and from having nominees opposing the company's slate listed in the company's own proxy statement and card. The SEC has long recognized the importance of disclosure and accountability in the context of an election contest, and the proxy rules contain special provisions and require enhanced disclosure for such contests. The rules recognize that the election of directors goes to the core of the company's governance, and that shareholders need full and detailed disclosure about director candidates as well as the parties that are proposing and soliciting proxies for those candidates. These rules are not anti-democratic, nor do they preclude shareholders from nominating and soliciting proxies for director candidates of their choosing. Rather, they simply require added disclosure for election contests, clear identification of soliciting parties and pre-filing of proxy materials in contested elections. These rules work well, avoiding confusion and furthering the shareholder protection and disclosure objectives of the securities law. Allowing shareholder access to company proxy statements for director nominations would require a wholesale reworking of these rules, a difficult effort that would create problems rather than solving them.

Fifth, there already exist constructive avenues for shareholders to have meaningful input into the nominating and election process. When the SEC rejected shareholder access proposals in 1977, it suggested studying ways to improve the nominating process instead. When it decided not to adopt the shareholder access proposals advanced in the early 1990's, it did adopt sweeping proxy reforms to improve shareholder communications and allow shareholders to run a "short slate" election contest (*i.e.*, to nominate less than a full slate of directors for election). The most recent corporate governance reforms ensure that public company nominating committees will be comprised entirely of independent directors, and further tighten the definition of independence. The recent reforms also require nominating committees to adopt and publicly disclose their charters. All of these reforms have improved the nominating process and given shareholders the ability to provide more meaningful input into that process.

Particularly given the contentiousness and divisiveness of election contests, and the difficulty and confusion that would be involved in reworking the proxy rules to permit shareholder access to company proxies for director nominations, proponents of such access simply cannot show the need for this far-reaching change. Instead, the best way to continue to improve the quality and responsiveness of public company boards is to remain focused on the company's existing nominating process. In determining the nominees for election to the board, as in other actions taken by directors of a public company, the members of a public company's nominating committee and board are subject to fiduciary duties to act in good faith in what they believe to be the company's best interest. Shareholders are not subject to the same duties in proposing director nominees, nor is there a mechanism to ensure that shareholders nominate well qualified candidates. The best route for shareholders to influence the nominating process is to propose nominees to the company's nominating committee, which should take bona fide nominee proposals from shareholders seriously. The nominating committee can then consider these proposed nominees from the vantage point of the best interests of the company as a whole. Acting within the framework of its fiduciary duties and the new stock exchange rules, the nominating committee is in the best position to ensure that strong candidates with fresh views and diverse backgrounds may be added to the board.

Sixth, under the existing rules, running an election contest is already a viable alternative and a viable threat. Running an election contest is obviously not as easy under the existing rules as bringing a Rule 14a-8 shareholder proposal, nor should it be. But shareholders do run election contests on a regular basis under the existing rules. Last year, there were 40 election contests. As noted above, the SEC's 1992 proxy rule reforms have made contests easier by permitting shareholders to run a short slate proxy contest. In recent years, the majority of election contests have been short slate contests, and a majority of those contests have resulted in either the successful election of the shareholder nominee(s) or a negotiated settlement with the company. In addition, the mere threat of a proxy contest has often been enough to push companies to negotiate with shareholders and agree on one or more mutually acceptable board nominees. Successful contests have been run not only by institutional investors, but by individuals as well, undercutting any argument that there are insurmountable obstacles to an election contest. To the extent the threat of a proxy contest is necessary to keep a company's nominating committee and board "honest", that threat is very real today. Given the policy reasons why an election contest should be a last resort, rather than a first, one could argue that the SEC should make it harder to run such a contest, not easier.

Seventh, it is far from clear that the SEC has the authority under the federal securities laws to require companies to include shareholder nominees in the company's proxy statement. Under state law, the board of directors has the authority and responsibility to manage the business and affairs of the company. One of the most basic and fundamental tasks performed by a board is to direct the process of electing new directors. Requiring the board to expend corporate funds and grant use of the corporate proxy machinery for director candidates nominated outside the board's nominating process would infringe on this function.

In *Business Roundtable v. SEC*, the 1990 case invalidating the SEC's one-share, one-vote rule, the D.C. Circuit court held that the SEC's authority under the Securities Exchange Act does not extend to regulation of an issue that is "far beyond matters of disclosure" and is "concededly a part of corporate governance traditionally left to the states." While the proponents of opening the corporate proxy machinery to dissident nominees will portray the proposal as a "procedural" proxy rule, there is no question that such a rule would fundamentally and substantively change the nature of director elections, a matter at the core of corporate governance. Shareholder access proposals constitute a substantive requirement under which a company, in effect, must solicit proxies for nominees opposed to the company's own slate. This goes far beyond the central purpose of the proxy rules, namely to ensure a fully informed and orderly vote on matters coming before the shareholders. Like the one-share, one-vote rule invalidated in the *Business Roundtable* case, the shareholder access proposals would extend "far beyond matters of disclosure" and would create substantive requirements in the arena of "corporate governance traditionally left to the states."

Fundamentally, the question of how to treat shareholder nominees and election contests must be considered within the overall context of our entire corporate governance system, not just the context of the SEC's proxy rules. Requiring shareholders who wish to conduct a proxy contest to do so through their own proxy materials is part of an overall corporate governance balance, one that has been reexamined and reaffirmed on several occasions. In 1991, we wrote an article proposing a "new system of corporate governance" that included, as one element, access to the corporate proxy machinery for major shareholders in the election of directors.[*] This was part of a broader proposed new system in which directors would come up for election once every five years. We recognized in that article that granting access to the corporate proxy for shareholder nominations would constitute a fundamental change in American corporate governance, and that it should be considered only in the context of a reexamination of the entire corporate governance system. We also noted that our proposal would require legislative action at both the federal and state level.[**]

For the SEC to grant shareholder access to the corporate proxy machinery for director nominations as a result of its review of the proxy rules, outside the context of any federal and state legislative overhaul of the entire corporate governance system, would be both unwise and unwarranted. Instead, the SEC should again reach the same conclusion that it and Congress have reached in the past. Whatever decisions the SEC may reach regarding whether other proxy rule reforms are necessary or desirable at this time, it should again reject the proposals that would give shareholders the ability to run an election contest using the company's own proxy statement.

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[*] Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187 (1991).

[**] Recently, two well-known shareholder rights activists published a paper proposing that the law in both the U.K. and the U.S. be amended to require all major public companies to have two sets of directors: the customary set consisting of independent and management directors, and a special set of three directors nominated by institutional shareholders. Robert Monks and Allen Sykes, *Capitalism without Owners Will Fail: A Policymakers Guide to Reform*, Centre for the Study of Financial Innovation (2002). We oppose this proposal for the same reasons we oppose granting access to a company's proxy statement for director nominations.