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SHAREHOLDER ACCESS

A "Common Sense" Approach to Shareholder Access: A Modest Proposal for an Access Bylaw

By John C. Wilcox

For more than five years issuers and investors have been debating whether shareholders should have the right to nominate board candidates for inclusion in the company's proxy. This so-called "access" right is rooted in a longstanding concern that, short of a proxy contest, procedures for nominating directors at US companies are not sufficiently accessible to shareholders. Since corporate legitimacy rests squarely on the integrity of the director selection process and a meaningful shareholder vote, the validity of an access right is difficult to challenge.

The Securities and Exchange Commission attempted to find a workable approach to access in 2003 with proposed Rule 14a-11, a fine-tuned but complicated concept that failed to attract support from either investors or corporations. Efforts to define and implement an access right later shifted to the shareholder proposal process, further polarizing the views of companies and investors. Following a controversial interpretation of Rule 14a-8(i)(8) by

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the SEC earlier this year, the fight over access has been suspended for at least the duration of the current proxy season. The issue will probably not be taken up again until after the Presidential election.

This intermission may turn out to be a blessing in disguise, provided that companies and investors are willing to use the time to cool down, reevaluate the pros and cons and seek constructive ways to develop a moderate and flexible form of access acceptable to both sides. Based on past experience with Rule 14a-11 and subsequent SEC initiatives, federal rule-making is probably not the most effective way to establish an access right. Following the path that led to acceptance of the majority vote standard in director elections, access might be more easily derived through a careful analysis of its implications under state corporate law.

Start with a Dispassionate Analysis of Shareholder Access

A dispassionate analysis of access should start with an understanding of the preferences and limited goals of long-term institutional investors. Their agenda does not include election of special-interest directors, back-door proxy contests or advocacy for causes unrelated to performance enhancement and long-term value creation. They envision access as a new engagement tool—a new step on the ladder of shareholder rights—that is more aggressive than precatory shareholder proposals or votes against directors, but less aggressive than a short-slate election, control contest or takeover bid.

Access, as conceived for use by long-term investors, would function as a potent but narrowly defined accountability mechanism applicable primarily to companies with serious strategic, governance or performance problems. The need for such a tool has become urgent in recent years, as shareholders have confronted deep-rooted governance and performance problems at US companies. Abusive compensation practices, ill-conceived mergers and acquisitions, improper accounting, neglect of succession planning, self-dealing, conflicts of interest and ethical lapses have occurred at many companies. The three remedies currently available—divesting stock, waging a proxy contest, or developing an engagement program—have in many cases failed to provide efficient or timely means for institutional investors to respond to these crises.

Selling or divesting shares of troubled companies is usually not an option for large, indexed long-term investors whose performance is measured against market benchmarks. From an economic viewpoint, divestment can be particularly inappropriate when a portfolio company's stock price is depressed by the very problems the investor seeks to remedy.

Proxy contests present numerous obstacles and potential conflicts for institutional investors. Because of the economic and fiduciary constraints involved in managing large portfolios, institutions may not be in a position to take on the organizational demands, costs, exposure, time commitment, legal complications, disclosure requirements, liability concerns and other risks and obligations associated with waging a proxy fight. For economic reasons investment managers are often rationally reluctant to further disrupt an already troubled company with a discounted stock value. The free-rider problem is often perceived as an obstacle. In addition, institutions may not support the goals of short-term activists willing to initiate proxy contests.

Active engagement with the boards and managers of targeted companies has always been the remedy of choice for long-term investors. Engagement has proven extremely effective as a means to promote shareholder rights, improve governance practices, increase director accountability and promote policy changes. But the slow pace of traditional engagement campaigns makes them less useful to "jump-start" companies that are languishing or ignoring their problems.

A Proposed Shareholder Access Bylaw

Conceptually, an access right would provide shareholders with a stepped-up form of engagement—a new accountability mechanism for dealing with seriously troubled companies. By bringing shareholder concerns directly into the boardroom, access would inject a note of heightened urgency and promote the kind of "director-centric" solution needed to deal effectively with serious governance or performance crises.

Access will work in practice, however, only if the right is properly structured so as to encourage change without opening the door to abuses or excessive disruption.