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Another View: Don't Gut Proxy Access

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DealBook

Lucian A. Bebchuk, a Harvard law professor, argues that Congress should reject attempts to impose severe limits on the ability of shareholders to place director candidates on the corporate ballot.

The Senate's representatives on the conference committee finalizing financial regulatory overhaul have proposed weakening the proxy-access provisions included in both the House and Senate bills. The senators' amendment would prevent shareholders owning less than 5 percent of a company's shares from ever placing director candidates on a corporate ballot.

Hard-wiring such an ownership threshold in the financial regulatory bill would be a significant setback for shareholders and corporate governance reform.

While shareholder power to elect new directors is supposed to serve as a foundation for our system of corporate governance, American shareholders seeking to replace incumbent directors face considerable legal impediments. Lowering these impediments would make directors more focused on shareholder interests. The case for doing so is supported by empirical evidence indicating that arrangements increasing directors' insulation from removal are associated with lower company value and worse performance.

Any reform of corporate elections should include ending incumbents' monopoly over the corporate ballot — the proxy card sent by the company at its expense to all shareholders. Only board-nominated candidates get to appear on this ballot; challengers must bear the costs of sending (and getting back) their own proxy card to shareholders. Providing shareholders with proxy access — the right to place candidates on the ballot — would contribute to leveling the playing field.

Managements have long opposed proxy-access reform and have thus far succeeded in blocking it. In the wake of the financial crisis, however, the Securities and Exchange Commission proposed a proxy-access rule and seemed determined to adopt it this year. Because business groups threatened to challenge in court the S.E.C.'s authority to adopt such a rule, the Senate and the House bills sought to support the agency's reform by affirming this authority. Under the senators' amendment, however, the financial regulation legislation would not merely affirm the S.E.C.'s authority but rather severely limit it.

The proposed amendment cannot be viewed as an attempt to reconcile the Senate and House bills. These bills were largely identical in affirming the S.E.C.'s authority and leaving the design of a proxy-access rule to S.E.C. rule-making. Rather than reconciling different arrangements found in the Senate and House bills, the amendment would replace an identical arrangement appearing in both bills with a different arrangement appearing in none.

If adopted, this new arrangement would largely eliminate the benefits that proxy-access reform could provide. A 5 percent ownership threshold would make the proxy provisions largely useless for the main set of investors whose involvement the proxy-access reform is intended to facilitate.

To be sure, a proxy-access rule with a 5 percent threshold would likely still be used in some cases where activist shareholders or hedge funds hold large stakes. When players holding such blocks of stock wish to replace incumbent directors, however, they commonly have the incentive to bear the costs of running a separate proxy solicitation. While proxy access might save such players some costs, it cannot be expected, nor is it intended, to have a substantial effect on their willingness to get involved.

The primary purpose of a proxy-access reform is to facilitate increased involvement by long-term institutional investors that have "skin in the game" but not a big block of shares. Consider, for example, the asset manager **TIAA-CREF**, a long-term investor holding on the order of half a percent of the shares of many large public companies. Because such an investor would be able to capture only a very small fraction of the benefits of improved governance, it cannot be expected to undertake a costly proxy solicitation even when it believes that replacing directors would significantly enhance firm value. But if this investor could place a director on the ballot, it might do so when it views governance as especially poor. And the ability of such institutional investors to do so might make boards more attentive to shareholder interests in the first place.

Under the S.E.C.'s proposed rule, the ownership threshold would be 1 percent for large companies. While such a threshold would serve as a meaningful screen, limiting the use of proxy access to special cases, involvement by such institutional investors would remain viable. Moreover, without the proposed legislative limit on its authority, the S.E.C. would be able to lower its initial threshold if it proved too burdensome.

With a hard-wired legislative threshold of 5 percent ownership, however, the proxy-access provisions would be largely practically irrelevant for such long-term institutional investors. Even if all the 10 largest public pension funds hypothetically banded together – a concerted action that would involve overcoming significant coordination costs and collective action barriers – they would commonly fail to reach the 5 percent threshold. For example, data put together by **Calpers**, the giant California state pension fund, indicates that the 10 largest pension funds hold less than 2.5 percent at **Bank of America**, **Microsoft**, **I.B.M.** and **Exxon Mobil**; even if all these funds joined forces, they would still have less than half of the amount needed to reach the 5 percent threshold.

Indeed, if the senators' proposed amendment were adopted, the legislation's proxy-access provisions would not only fail to produce significant benefit but would likely make shareholders worse off. The S.E.C. has long maintained (with good reason) that it has the authority to adopt a rule on proxy access, and it would likely adopt such a rule even without legislative language clarifying this authority. The legislation as amended would thus hurt shareholders by precluding any possibility that the S.E.C. would adopt proxy-access rules with a meaningful impact.

Even assuming that proxy access would be best introduced with a 5 percent threshold, enshrining such a threshold in legislation would be undesirable. Thus, if news reports that the Obama administration favors such a threshold are accurate, the White House should at most encourage the S.E.C. to adopt this threshold as part of its rule but discourage hard-wiring such a threshold into legislation. Congress has long left the design of proxy rules to the S.E.C. Given the S.E.C.'s expertise and superior ability to adjust rules over time as circumstances warrant, Congress would do well to continue following this approach.

The proxy rules have been intended by Congress, a famous court opinion stated, "to give true vitality to the concept of corporate democracy." If the conference committee adopts the senators' proposed amendment, the legislation's provisions on proxy access would undermine the S.E.C.'s ability to advance this important goal.

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