

## **CEO Elections out of Shareholders' Control**

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When I explain how directors are elected to the boards of US companies, the most common initial reaction I get is one of disbelief. Management nominates directors, and shareholders are allowed to vote “yes” or abstain, but they cannot vote “no” on the mail-in election ballot. If 99 per cent of the voters abstain, management’s proposal for directors still passes (although with obvious embarrassment). The message is clear: Directors, you are hired by management, not by shareholders.

Recently, however, the Securities and Exchange Commission proposed reforms to make it easier for shareholders to nominate directors (see box). The reforms have stirred strong opposition, pitching managers currently in control of large, publicly traded US corporations against investors who seek curbs on excessive managerial influence over the board. The ultimate outcome of this power struggle has implications for the corporate governance reform debate internationally, as the electoral advantages of incumbency are universal

Roadblocks to shareholder voting are common throughout the world. Less than a quarter of the OECD countries allow voting by mail. Most countries with the French civil law tradition, as well as Germany and Scandinavia, require shareholders (or their representatives) to show up in person to vote. By that time, it is too late to effectively oppose director nominees.

The SEC proposal for reform is a cautious, first-step attempt to give investors holding 5 per cent or more of the shares access to the company’s director election ballot. Subject to certain triggering events, the proposal is to let these shareholders enter competing director names for election on the ballot that the company sends to shareholders prior to the annual shareholder meeting. Thus, it allows shareholders to economise on the existing system for soliciting votes.

A contested election dramatically changes the dynamics of the director election process. Under a reformed system, the message to prospective directors is: you are hired by shareholders, and if you fail to represent shareholder interests you risk being ousted in a very public election contest.

Judging from the strength of opposition, the prospect of reform appears to serve as a lightning rod for much of the accumulated frustration across corporate America over recent legislation to limit corporate excesses. The proposals have also emboldened institutional investors to become more active, as exemplified by recent events at Disney. Michael Eisner resigned as chairman of Disney’s board after an unprecedented 45 per cent of shareholder votes were withheld for his re-election in March.

Good corporate governance requires active participation by shareholders. Historically, shareholders have been largely passive, due to ownership dispersion and direct legal constraints on institutional investor activism. From a governance perspective, the problem is that small shareholders have little or no incentive to oppose management. They rely instead on larger owners to monitor management performance.

Throughout much of Europe, these large shareholders often represent members of founding families or wealthy individuals. Such owners do have the requisite incentive to monitor. In the US, however, financial institutions have over the past 30 years accumulated an ownership of close to 50 per cent of the US stock market.

Until the repeal in 1999 of the Glass-Steagall Act, such institutions faced severe legal restrictions on their ability to exercise ownership rights. As a result, a majority of the shareholder votes in large US companies were passive, with these votes effectively supporting management by default. This structural deficiency in the governance system led to a power shift towards management.

Knowing shareholders were going to remain passive, managers throughout the 1980s boldly adopted strong anti-takeover mechanisms such as poison pills and staggered boards. By the early 1990s, virtually all of the companies in the S&P stock index had severe poison pill defences. Not surprisingly, incidents of hostile takeovers were reduced to a trickle. Management was now solidly entrenched.

There has been no shortage of governance reforms lately, yet election reform is different. Changes such as the Sarbanes-Oxley Act of 2002, the recent reform of mutual fund boards and new stock option expensing policies still leave shareholders with little control over CEOs and boards. Only election reform directly changes the balance of power in favour of shareholders.

### **No Alternative by Proxy**

Some have argued that election reform is unnecessary because shareholders can always mount a proxy contest for control. In such a contest, one seeks permission from shareholders to vote on their behalf. This requires sending out proxy material in competition with management and tracking the mailing of the proxies. However, proxy fights are prohibitively costly.

Consider Walter Hewlett's failed attempt two years ago to stop the proposed merger between Hewlett-Packard and Compaq. Mr Hewlett, then a director and a member of the founding family of Hewlett-Packard, lost the vote by a small margin. He spent more than \$30m from his own pocket to finance his campaign, while management used shareholders' money to fight him.

As a founding family member, Mr Hewlett was probably motivated beyond the consequence for his share ownership per se. A typical financial investor - small or large - will not expend such resources. The bottom line: as a governance mechanism, proxy contests do not work.

Opponents of election reform, such as the Business Roundtable, the organisation of the chief executives of the largest US corporations, argue that giving shareholders real voting power exposes the company to special interest groups and investor “gadflies”. Yet any shareholder proposal must attract a voting majority to pass. In large, publicly traded US corporations, the largest institutional shareholders own on average only 1 per cent of the shares. The idea that institutional shareholders may get thousands of small investors to go along with a proposal that is fundamentally against their own interests is too far-fetched to be taken seriously.

Corporate executives have become powerful not only because of biased election rules and access to the company purse. There is also a human factor. While most directors are intelligent, honourable and dedicated, they tend to be consensus-builders. Many have difficulty asking tough questions. Shareholders are a distant and impersonal constituency. So why rock the boat after being elected? The result is often a weak board that is no match for the superstar CEO.

Take Tyco’s board. In 2001 Dennis Kozlowski, the CEO, asked his board to amend his contract so that, should he leave the company for any reason short of a felony conviction, he would retain lucrative benefits. In the words of governance activist Nell Minnow, someone might have said, “Dennis, we’re sorry: are you planning to knock over a bank? Is there something you want to tell us?” Instead, the board signed the contract.

How do we empower board members to stand up to management? For directors, there is a carrot and a stick. The stick is the loss of reputation, higher director turnover and the increased liability that goes along with the types of scandals we have lately seen. Moreover, there is now a greater focus on the performance of board members.

The carrot includes a compensation package that makes directors think like shareholders. That means payment in company stock, locked up for a sizeable period after the director leaves the company. Companies should also consider requiring directors to invest a significant amount of their personal wealth in the company’s stock.

However, we know that these personal incentive mechanisms are not by themselves sufficient to restore the proper balance between the power of CEOs and directors. Directors must be made unambiguously aware that they are hired by - and work for - shareholders. The proposed election reform takes the US corporate governance system in this direction.

Will the election reform actually happen? Pressure against reform is mounting to the point that the SEC appears to have retreated from its initial boldness and is deadlocked at the time of writing. The SEC rejected proposals for shareholder-nominated directors on the ballot in 1942 and again in 1978. The rules were softened in the 1990s, but with little effect on the cost of mounting a proxy contest. The current reform proposal also is a modest change. Its main importance is in setting in motion a trend towards a governance

system where shareholders can rely on strong boards to protect their financial interests. One can hardly find a more powerful motivation for a governance reform.

BOX:

**Election reform**

The US Securities and Exchange Commission proposes to allow shareholder-nominated directors on the ballot

- if more than 35 per cent of the votes cast at the shareholder meeting withhold support from a board nominee, or if a proposal to allow shareholder nominees on the proxy is approved by more than 50 per cent of the votes cast.
- The corporation must then list a maximum of three independent shareholder nominees on the next ballot.
- Only shareholders or groups with at least 5 per cent of the outstanding shares may submit such nominations.