5-15-2006

We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance

Rose A. Zukin

Follow this and additional works at: http://digitalcommons.pepperdine.edu/plr

Part of the Corporation and Enterprise Law Commons

Recommended Citation
Rose A. Zukin We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance, 33 Pepp. L. Rev. 4 (2006)
Available at: http://digitalcommons.pepperdine.edu/plr/vol33/iss4/6

This Comment is brought to you for free and open access by the School of Law at Pepperdine Digital Commons. It has been accepted for inclusion in Pepperdine Law Review by an authorized administrator of Pepperdine Digital Commons. For more information, please contact Kevin.Miller3@pepperdine.edu.
We Talk, You Listen: Should Shareholders’ Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance

I. INTRODUCTION

II. CORPORATE GOVERNANCE
   A. Why Corporate Governance Matters
   B. Reforms Related to Corporate Governance
      1. Sarbanes-Oxley Act of 2002
      2. Stock Exchanges
      3. SEC Release No. 33-8340
   C. Participants
   D. Current Corporate Governance Issues

III. PROXY SOLICITATION
   A. What is a Proxy?
   B. Rules Relating to Proxy Solicitation
   C. Current Nomination Procedure
   D. How a Shareholder can Participate in the Current Nomination Procedure

IV. PATH TO REFORM
   A. Prior SEC Attempts To Involve Shareholders in the Nomination Process
      1. 1942
      2. 1977
      3. 1980
      4. 1992
B. Catalysts for the Proposed Rule
   1. Corporate Crises
   2. Affirmative Institutional Investor and Corporate Action
      a. AFSCME
      b. Apria Healthcare, Inc.
      c. Call for Public Comment
         i. Comments Encouraging the Proposal of Such a Rule
         ii. Comments Discouraging the Proposal of Such a Rule
         iii. AFL-CIO Petition to the SEC
d. The Division's Recommendation

V. SHAREHOLDER DIRECTOR NOMINATION PROPOSED RULE
   A. Objectives of the SEC
   B. Proposed Changes to the Proxy Rule
   C. Safeguards
      1. Limits on the Number of Shareholder-Nominated Candidates
      2. Triggering Events
         a. Withhold Votes
         b. Proposal Submitted Pursuant To Rule 14a-8
         c. Proposed Third Triggering Event: Failure of the Company To Implement a Shareholder Proposal That Received a Majority Vote
      3. Candidates Must Meet Independence Standards
      4. Nominating-Shareholders' Eligibility Requirements
         a. Holding Requirements
         b. No Intention of Controlling Company
   D. Obligations of a Company
   E. Authority Under Federal Law
   F. State Law

VI. PROXY ENVIRONMENT POST-PROPOSAL
   A. How Often Have the Proposed Rule Requirements Been Met?
      1. One Percent Ownership Threshold for Submission of Proposal
      2. Five Percent Ownership Threshold for Director Nomination
      3. Thirty-Five Percent Withhold Vote
   B. Decreased Number of Proxy Fights in 2004
VII. POINTS OF CONTROVERSY

A. SEC Has No Legal Authority To Promulgate Rules Governing Shareholder Access to the Issuer's Proxy Materials
B. Scandal Is Not the Norm
C. Potential Costs of the Rule Outweigh Its Benefits
D. Risk of an Influx of Special Interest Directors
E. Triggers Will be Used Frequently
F. Creation of an Adversarial Relationship Between Directors and Shareholders
G. Risk of Balkanized and Dysfunctional Boards
H. Risk of Deterring the Most Skilled Men and Women from Serving on Public Company Boards
I. Investors Are Not Well Suited To Nominate
J. Companies Are Sufficiently Responsive to Shareholders
K. Recently Enacted Corporate Governance Rules Must Be Given Time To Be Effective

VIII. WHY HAS THIS PROPOSAL NOT BEEN PASSED?

A. Public Reaction to Delayed Passage
B. Political Pressure
   1. Secretary of Treasury John Snow
   2. U.S. Chamber Of Commerce
C. Division Among SEC Commissioners
D. Response to Criticism: Alternative Proposals

IX. CONCLUSION

I. INTRODUCTION

In 2001, approximately $7 trillion in market value vanished almost overnight.1 When the fraud perpetuated by such established companies as Enron, Tyco and WorldCom became public knowledge, the stock market plunged, and shareholders wondered how such deceptions could occur without their knowledge. In response to this "corporate crime wave," President Bush placed the blame for these offenses on dishonest corporate

---

management. "We've got thousands of citizens who own shares of publicly held companies, many in pension plans, mutual funds, a lot of them direct ownership," President Bush stated during an address on corporate responsibility. "And this country must hold CEOs—CEOs of publicly held companies, to the highest of high standards."

President Bush's words captured the feelings of the public. Corporate scandals in reputable companies shook investors' faith in corporate management—the very individuals who are employed to look after shareholders' interests. Major corporations, which investors previously thought could do no wrong, engaged in a pattern of behavior that led to egregious losses of money. Executives operated without board intervention, "bankrupting their companies and leaving shareholders with nearly worthless stock." While very few companies were victimized by such wrongdoing, all public issuers were left with a negative image. These crises emphasized the importance of good board performance, and corporate governance of public issuers of securities became the focus of attention.

Activist shareholders demanded a greater role in corporate governance, specifically, allowing investors a greater say in the election of directors. Under current U.S. Securities and Exchange Commission ("SEC") rules, shareholders are given an opportunity to vote only on those candidates nominated by the company. Shareholders can nominate candidates to replace incumbent directors, but they cannot include their nominee's name on the company's official proxy, which lists only the company's
candidates. In order to wage an election contest with the corporation’s nominees, a shareholder’s proposed slate must “be mailed separately to all investors.” This method can require substantial expenditure by the investor, who must prepare and distribute proxy materials that comply with the SEC’s proxy rules. Shareholders are left with little opportunity to actively participate in the nomination process.

After taking into consideration views expressed by commentators, the SEC Division of Corporation Finance (“Division”) recommended changes to the proxy rules related to the nomination and election of directors. The Division stated that the “fundamental problem with American corporate governance” is that directors and managers of corporations are insufficiently responsive to shareholders. Two years after the string of corporate governance failures, the SEC proposed the Security Holder Director Nomination Rule, anticipated to make directors more receptive to the needs and demands of shareholders.

The proposed Security Holder Director Nomination Rule (“proposed rule”) “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.” Under certain circumstances, the proposed rule would

13. Id.
17. Deborah Solomon, SEC May Boost Holders’ Power to Nominate, Elect Directors, WALL ST. J., Oct. 9, 2003, at C12. “Board unresponsiveness is sometimes tied to governance weaknesses,” said then SEC Chairman William Donaldson. Id. “This will give shareholders a more important voice.” Id.
19. Id.
require companies to include shareholder nominees for director elections in their proxy materials.20 These circumstances include “the occurrence of one or both of the nomination procedure triggering events.”21 The first triggering event would occur if at least one of a company’s nominees for director “received ‘withhold’ votes from more than 35% of the votes cast at an annual” shareholders’ meeting.22 The second triggering event would occur if a shareholder submitted a proposal pursuant to Rule 14a-8 of the Securities Exchange Act of 1934 providing that the company become subject to the proposed rule, which later received more than 50% of votes cast on the proposal at a shareholders’ meeting.23 When one or both of these triggering events occur, a shareholder may submit a nominee for inclusion in the company’s proxy materials if the shareholder (or shareholder group) beneficially owns more than 5% of the company’s outstanding securities “continuously for at least two years as of the date of nomination” and continues to own the securities through the date of the annual shareholders’ meeting.24

The passage of the proposed rule would “be one of the SEC’s most significant rulemakings in years.”25 If shareholders win the right to include their nominees on the company’s proxy, the nature of election contests could change dramatically. This proposal provides a different alternative to what shareholders had previously viewed as a “symbolic election of directors, who typically run unopposed and are assured of victory” in some states by a “plurality” of a single vote.26

20. Id.
21. Id. at 60,789.
22. Id. (internal citation omitted).
23. Id. at 60,789-90.
25. Id. at 25.
26. INSTITUTIONAL SHAREHOLDER SERVICES, 2004 POSTSEASON REPORT 5 (2004). Shareholders may nominate board candidates by either a majority or a plurality vote. See generally Patty M. DeGaetano, The Shareholder Direct Access Teeter-Totter: Will Increased Shareholder Voice in the Direct Nomination Process Protect Investors?, 41 CAL. W. L. REV. 361, 390-91 (2005) (discussing the difference in effect of a withheld vote in each type of vote). A candidate is elected under a majority vote if he or she receives support from a majority of shareholders eligible to vote. See, e.g., ALA. CODE § 10-2B-7.28(a) (2004); COLO. REV. STAT. § 7-107-206(1) (2003); MD. CODE ANN., FIN. INST. § 7-109(c) (LexisNexis 2003). Under plurality voting, on the other hand, the nominee who receives the most votes is elected. Security Holder Director Nominations, 68 Fed. Reg. at 60,786 n.52. If there are no more candidates than available board positions, each candidate will be elected to the board, regardless of whether they received a majority of votes or only one vote. Id.; see, e.g., CAL. CORP. CODE § 708 (West 1990); DEL. CODE ANN. tit. 8, § 216 (2004); N.Y. BUS. CORP. LAW § 614(a) (McKinney 2003); MODEL BUS. CORP. ACT § 7.28(a) (1984). Companies largely use plurality voting for director elections. Security Holder Director Nominations, 68 Fed. Reg. at 60,789.
Investors have greatly anticipated this proposed rule, and lobbying efforts to shape it began soon after the SEC requested public comment in April 2003. While most of the comments received by the SEC have been in favor of proxy rule reform and of the proposed rule, opponents claim that there are sound legal and policy grounds for opposing the proposal.

The SEC favors giving shareholders more power, but it is still trying to determine exactly how to do that. It is deciding which triggering events shareholder access to the proxy statement would require and whether there should be "eligibility requirements to nominate a candidate." The SEC is also considering other alternatives, such as allowing shareholders and boards to reach a decision about the nomination together.

Although currently there is a great deal of discussion about the proposed rule, increased shareholder participation in the election of corporate directors has been a "topic of interest and debate" for the past sixty years, arising with vigor during periods when individual corporations and their management have been under attack. Previous proposals dealing with this subject matter have not been implemented, but the recent number and scale of corporate scandals and widespread public distrust of corporate boards have encouraged shareholders to be vocal in their criticisms of board mismanagement and the election processes.

27. TheCorporateCounsel.net, Shareholder Access to the Ballot (May 21, 2003), http://www.thecorporatecounsel.net/Audio/05_21_03_transcript.htm (Webcast Program); Garris et al., supra note 24, at 25.

28. Bebchuk, supra note 8, at 43; see also infra Part VII. For example, some opponents claim that the SEC has no legal authority to promulgate rules governing shareholder access to an issuer's proxy materials, since such access relates to corporate governance, a topic that is traditionally left to the states. Deborah Solomon & Michael Schroeder, Back Off! Businesses Go Toe to Toe With SEC—Lawyers and Lobbyists Criticize Agency Proposals About Options, Proxies, Hedge and Mutual Funds, WALL ST. J., Oct. 27, 2004, at C1; Telephone Interview with James J. Moloney, Partner, Gibson Dunn & Crutcher LLP, in Malibu, Cal. (Nov. 17, 2004) [hereinafter Interview]. Other opponents contend that investors are not well suited to nominate candidates as their strengths lie in financial analysis, while those that traditionally nominate candidates are trained in business operation. Lipton & Rosenblum, supra note 16, at 77.

29. Solomon, supra note 12.

30. Id.


33. Olson & Moloney, supra note 9, § 10.13. As a result of the corporate scandals, the stock market plunged, resulting in great loss to institutional investors. Interview, supra note 28. Institutional investors did not want to sell their stock while share price was low, since such an action
formerly been a means of showing dissatisfaction with a company,\textsuperscript{34} it may be inferred through the recent corporate crises that this method does not effectively monitor nor improve corporate governance.\textsuperscript{35}

This comment will argue for the passage of the proposed rule, which will provide investors with a means of confronting the inefficient proxy solicitation system currently in place. It will first discuss corporate governance in the current environment of publicly held companies and why it is important.\textsuperscript{36} Three groups of people are involved in corporate governance, and their interaction is a concern that the proposed rule addresses.\textsuperscript{37} The SEC and other institutions have recently passed several laws that attempt to solve flaws in the corporate governance process.\textsuperscript{38} Next, would disadvantage portfolio return. \textit{Id.} Institutional investors chose to become more vocal instead of selling. \textit{Id.}

\textsuperscript{34} See infra note 106 and accompanying text.

\textsuperscript{35} In order to illustrate displeasure with a company's management, shareholders can sell the company's stock and force share prices down. \textsc{Business Roundtable}, \textsc{Detailed Comments of Business Roundtable on the "Proposed Election Contest Rules" of the U.S. Securities and Exchange Commission} 25 n. 127 (Dec. 22, 2003), http://www.sec.gov/rules/proposed/s71903/brt122203.pdf (citing as support Rachel Weber, \textit{Why Local Economic Development Incentives Don't Create Jobs: The Role of Corporate Governance}, 32 \textsc{Urb. Law.} 97, 113 (Winter 2000) (stating that "[i]n addition to exercising 'voice' to influence management, shareholders have another powerful and more commonly used control tool at their disposal: exit. If shareholders are not pleased with management's performance, they will 'vote with their feet,' sell their stock, and force share values down.")} [hereinafter DETAILED COMMENTS OF BRT]. The corporate governance crises of recent years occurred despite this shareholder weapon. \textit{See Congress Watch, supra note 1, at 3} (citing William H. Donaldson, \textit{Corporate Governance: What Has Happened and Where We Need to Go,} \textsc{Bus. Econ.}, July 1, 2003).

\textsuperscript{36} See infra Part II.

\textsuperscript{37} Shareholders, management, and the board of directors participate in maintaining corporate governance at a corporation. Stewart M. Landefeld & Danielle Benderly, \textit{New SEC Rules Require Expanded Nominating Committee Disclosure,} \textsc{Insights: The Corp. & Sec. L. Advisor}, Jan. 2004, at 2, 4. Shareholders own an interest in a corporation through their purchase of its stock. John F. Olson & Michael T. Adams, \textit{Composing a Balanced and Effective Board to Meet New Governance Mandates,} 59 \textsc{Bus. Law.} 421, 424-25 (2004). A corporation's management is assigned with tasks dealing with a company's operations. \textit{Id.} at 425. The board supervises management's decisions and ensures that management's actions are consistent with a company's corporate strategy. \textit{Id.;} Burns, \textit{supra} note 6. The proposed rule addresses the interaction between shareholders and directors. With the proposed rule, the SEC attempts to address shareholder complaints that corporations do not respond to their concerns and requests. Solomon, \textit{supra} note 12. Altering corporate elections would tackle this problem by "improv[ing] the selection of directors and the incentives they face." Bebchuk, \textit{supra} note 8, at 44. Directors would consequently have incentives to be responsive to shareholders if they wanted to remain in their position. \textit{See id.}

the current proxy solicitation process will be presented, detailing the methods in which shareholders can nominate candidates and the disadvantages of each method.\(^3\)

This comment will further describe the path to reform that led to the proposal of the rule.\(^4\) While this is not the first time the SEC has proposed a rule whose objective is to increase shareholder participation in the director nomination process,\(^4\) several company and investor initiatives indicate that this proposal has extensive support and that the public views its passage as inevitable.\(^4\) Next, the proposed rule will be detailed.\(^4\) The SEC has listed specific objectives it hopes the proposed rule will address relating to corporate governance and objections to the current director nomination

---

[39. See infra Part III. Shareholders may nominate directors by proposing candidates to a corporation’s nominating committee, by nominating a candidate at an annual shareholders’ meeting, or by soliciting proxies for candidates to be distributed to voting shareholders. Lipton & Rosenblum, supra note 16, at 69; BRIEFING PAPER, supra note 14. These options leave shareholders frustrated, because such actions are often costly and futile. BRIEFING PAPER, supra note 14; Interview, supra note 28.]

[40. See infra Part IV.]

[41. The SEC addressed whether to allow shareholders’ nominees for directors on the corporate ballot in 1942, 1977, 1980, and 1992. STAFF REPORT, supra note 31. The SEC’s focus often is a result of a time period during which the corporation and management have been heavily criticized, such as the corporate scandals of the 1970s and the takeover battles of the 1980s. Brownstein & Kirman, supra note 32, at 1-3. The corporate scandals of 2001 brought the SEC’s attention to corporate governance reform once again. Lipton & Rosenblum, supra note 16, at 68.]

[42. Organizations, corporations, and shareholders support the proposed rule. Organizations such as the pension plan AFSCME and the AFL-CIO have expressed their endorsement: AFSCME submitted a similar proposal to six S&P 500 companies in the spring of 2002, while the AFL-CIO submitted a rule-making petition in May 2003 seeking a rule to allow shareholder-nominated candidates for director on a corporate ballot. OLSON & MOLONEY, supra note 9, § 10.13; Silvers & Garland, supra note 15 (manuscript at 5). Two companies, Apria Healthcare Group, Inc. and Ashland Inc., have voluntarily adopted shareholder director nomination plans. See Solomon & Lublin, supra note 5; Phyllis Plitch, Ashland Joins Short List Seeking Shareholder Board Picks, MORNINGSTAR.COM, Jan. 27, 2005, http://news.morningstar.com/news/DJ/M01/D27/200501271858DOWJONESDIONLINE001415.html (last visited Feb. 21, 2005). Individual investors support the proposed rule, stating that the current director nomination process does not provide shareholders with the rights to which they are entitled as owners of the corporation. STAFF REPORT, supra note 31.]

[43. See infra Part V.]
process. Under the proposed rule, a company’s proxy statement will now list a shareholder’s nominees for director. To prevent abuse, however, several safeguards have been implemented in order to ensure that the proposed rule will be used for its stated objective and not for purposes that could be detrimental to the affected companies. The SEC finds its authority to execute the proposed rule in federal law, but specifically states that the proposed rule is not meant to conflict with state law, and state law will govern if such an incompatibility occurs. A few states, however, have introduced bills similar to the proposed rule.

This comment will next describe the proxy environment in the post-proposal era. The proposed rule is retroactive to the past proxy two seasons. If any of the triggering events occurred in 2004 and the proposed rule is passed in the near future, eligible shareholders may place qualified directors on the company’s proxy for the next annual shareholders’ meeting. This comment will further discuss the specific arguments in favor of and against the passage of the proposed rule. Proponents and opponents have battled over how the proposed rule will affect corporate


45. Id. at 60,786.

46. These safeguards were added by the SEC to prevent shareholders from abusing the rule for reasons unrelated to the well-being of the corporation. Garris et al., supra note 24, at 25. Shareholders could only nominate a specific number of directors that could sit on the board at any one time—a number determined by the size of the board. Id. The company would only be subject to the proposed rule if one of the two triggering events— withhold votes or a proposal submitted pursuant to Rule 14a-8—occurred. Id. Shareholders could only nominate candidates that are “independent” from the board and the nominating shareholder. Id. Only shareholders who have no intention of controlling the company could nominate a candidate for director. Id.

47. Id. at 60,784 (noting that “[t]he proposed rules would not provide security holders with the right to nominate directors where it is prohibited by state law”).


49. See infra Part VI.

50. The triggering events could be activated during shareholder meetings held after January 1, 2004, even though the rule had not been adopted by that date. Security Holder Director Nominations, 68 Fed. Reg. at 60,789.

51. Id.

52. See infra Part VII.
governance, and whether or not the SEC may legally implement the rule.\footnote{Proponents of the proposed rule, who argue that shareholder participation in the current director nomination process is too costly to be used as a valuable tool for ensuring proper corporate governance, state that the proposed rule would be useful in ensuring that directors will be held accountable for their actions. \textit{Staff Report}, \textit{supra} note 31. Opponents of the proposed rule, on the other hand, contend that "[g]iving some shareholders access to company proxies would be costly and disruptive and would weaken the functioning of strong independent boards to the detriment of all shareholders, by breeding misdirection and dissension." \textit{U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule}, 36 SEC. REG. & L. REP. (BNA) 1029, 1029 (June 7, 2004) (according to the U.S. Chamber of Commerce, a vocal critic of the proposed rule). Further, opponents assert that the SEC does not have the authority to control a corporate proxy ballot. \textit{Id.}} It is impossible to foresee the consequences of the proposed rule’s passage, as it is unprecedented.\footnote{The great majority of opponents of the proposed rule included corporations, corporate executives, and corporate directors. \textit{Sec, Summary of Comments: In Response to the Commission’s Proposed Rules Relating to Security Holder Director Nominations} (Mar. 5, 2004), http://www.sec.gov/rules/extra/s71903summary.htm [hereinafter \textit{Summary of Comments}]. These groups would naturally oppose the proposed rule because the passage of the rule would give shareholders more power by allowing them to nominate directors—a privilege which had previously been given only to existing directors and nominating committees—in certain circumstances. \textit{See Security Holder Director Nominations}, 68 Fed. Reg. at 60,789. Additionally, it would be expected for corporate directors to prevent shareholders from exercising the proposed rule by withholding votes from the director and the director’s colleagues. \textit{See id.}} Allowing director nomination processes to exist as they are, however, would be more disadvantageous to shareholders and corporate governance than any unintended drawbacks of the proposed rule.\footnote{The proposed rule is the first of its type to be implemented. Joseph A. Grundfest, \textit{Advice and Consent: An Alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors, in Shareholder Access to the Corporate Ballot} (Lucian Bebchuk ed., forthcoming June 2006) (manuscript at 6, available at http://www.law.stanford.edu/faculty/grundfest/advice.pdf).}

This comment will subsequently explain why the proposed rule has not yet been passed.\footnote{Former SEC Chairman William Donaldson believes the proposed rule is a "clever way" to address corporate governance troubles. Judith Burns, \textit{Holder Groups Worry SEC Loses Steam on Proxies}, \textit{Wall St. J.}, Mar. 3, 2004, at B2H. If directors refuse to address shareholders’ concerns, then shareholders “ought to at least have an opportunity to have a voice on the board.” \textit{Id.} If the proposed rule would be used for dubious purposes by investors, the SEC will be quick to amend it. \textit{Interview, supra note 28.}} Strong lobbying efforts on behalf of high-ranking government officials, as well as governmental bodies, have prevented its acceptance by the SEC.\footnote{The U.S. Chamber of Commerce and Treasury Secretary John Snow have been vocal critics of the proposed rule. \textit{Stephen Labaton, S.E.C. Feels Pressure to Weaken Some Rules}, \textit{N.Y. Times}, May 10, 2004, at C5; \textit{U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule}, \textit{supra} note 53, at 1029.} In addition, several SEC commissioners object to the rule in its current form, arguing that its safeguards are either too...
restrictive or not restrictive enough. In the face of these objections, former SEC Chairman William Donaldson, in office at the time of the rule’s proposal, considered altering the proposed rule, while present SEC Chairman Christopher Cox favors increasing shareholder participation in the director nomination process through the modern medium of the Internet. Finally, the conclusion will discuss the short-term and long-term effects of the rule, should it be passed. The comment also suggests that the proposal should be passed because of the current corporate governance environment, the strength of support proponents have shown, and the positive effects that the proposed rule’s adoption will have on shareholders, directors, and publicly held corporations.

II. CORPORATE GOVERNANCE

Corporate governance refers to supervision of a company’s management. Typically, such administration includes ensuring the directors properly run management and the shareholders are treated

59. Republican commissioners Cynthia Glassman and Paul Atkins oppose even alternate, more lenient versions of the proposed rule. See Deborah Solomon, SEC May Dilute Plan to Increase Holders’ Power—Under Pressure From Businesses and Resistance From Democrats, Donaldson Considers Alternative, WALL ST. J., June 8, 2004, at C1. Commissioner Atkins believes that only companies with proven troubles should be subject to the proposed rule. Solomon & Lublin, supra note 5.

60. Democratic commissioners Roel Campos and Harvey Goldschmid favor the proposed rule in its original form, or a tougher version. Solomon, supra note 59.

61. Chairman Donaldson considered a number of proposals in order to appease both opponents to the rule and the Republican commissioners. Id. One such alternative called for nomination committees to replace a director whom shareholders have targeted for removal. Deborah Solomon, SEC Nears Compromise on Shareholder Plan, WALL ST. J., Aug. 11, 2004, at C1 [hereinafter Solomon, Compromise]. Another alternative would have prevented companies from having to put a shareholder-nominated director candidate on the corporate ballot if directors and shareholders agreed upon a director to place in an available space on the board. Id. The SEC staff is also considering adjusting the triggering events. Deborah Solomon, Moving the Market: SEC May Temper Plan To Boost Shareholders’ Powers, WALL ST. J., Apr. 19, 2004, at C3. While not expressly commenting on the proposed rule, Chairman Cox believes that the Internet may be used by shareholders as an effective means to wage proxy fights because it provides widespread communication of information at an “insignificant[ ]” cost. SEC’s New Leader Shares His Views On Range of Issues, WALL ST. J., Sept. 19, 2005, at A13.

62. See infra Part IX.

63. The latest corporate governance crises of Enron and WorldCom emphasized the consequences that result in the face of bad board performance and poor corporate governance practices. See Bebchuk, supra note 8, at 44. Proponents for change, such as pension plans, are taking affirmative action to allow shareholder nominations on the corporate ballot. See OLSON & MOLONEY, supra note 9, § 10.13. Corporations have adopted shareholder director nomination plans as well. See, e.g., Solomon & Lublin, supra note 5; Plitch, supra note 42. Reforming corporate elections would improve the selection of directors, prevent such scandals from occurring in the future, and enhance shareholders’ confidence in the corporations in which they invest. See OLSON & MOLONEY, supra note 9, § 10.13.

64. Burns, supra note 6.
Companies who practice good corporate governance have such qualities as formal evaluation of directors and responsiveness to shareholder requests for information. Boards of directors of companies with good corporate governance are primarily paid in company stock or a similar type of compensation. These boards are also comprised of a majority of directors who are "independent of the company and its managers," and own a substantial amount of the company's stock.

A. Why Corporate Governance Matters

Patrick McGurn of the proxy-advisory firm Institutional Shareholder Services stated that "poor governance is a substantial risk factor" for investors. Good corporate governance, including formal evaluation of the board of directors, assures shareholders that directors are held accountable for the implementation of strategies which result from the corporate objective, and that the company conforms to federal and state law as well as the company's own bylaws. Good corporate governance is of great concern to shareholders even though it does not guarantee superior profits on investments. Despite this return uncertainty, studies show that institutional investors often pay an average premium of fourteen percent for shares of a company that is managed according to high corporate governance standards.

B. Reforms Related to Corporate Governance

The reforms described below are depicted as "the most far-reaching set of new corporate regulation since the Securities Act of 1933 and the Securities Exchange Act of 1934." These developments, aimed at

---

65. Id.
66. Id.
67. Id. (citing the opinion of consultants McKinsey & Co.).
68. Id. (citing the opinion of consultants McKinsey & Co.).
69. Id.
71. Burns, supra note 6.
72. Id. Institutional investors are found to pay as much as a thirty percent premium for shares in well-governed companies in emerging markets. International Chamber of Commerce, supra note 70.
73. Lipton & Rosenblum, supra note 16, at 68. The Securities Act of 1933, often referred to as the "truth in securities" regulation, was passed by Congress in light of two objectives: (1) "require that investors receive financial and other significant information concerning securities being offered
improving corporate governance practices, lead to greater responsiveness on the part of corporations addressing issues of director responsibility and oversight. 74 Companies are currently working to comply with their requirements. 75

1. Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was passed in response to the Enron, WorldCom, and other corporate crises and accounting scandals. 76 Congress's stated objective in passing this act was to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws." 77 By regulating certain activities and implementing regulatory bodies, 78 Congress intended to strengthen both corporate governance and investor confidence by "improving the quality of corporate disclosure and financial reporting, strengthen[ing] the independence of accounting firms, and increas[ing] the role and responsibility of corporate officers and directors in financial statements and corporate disclosures." 79

for public sale;" and (2) "prohibit deceit, misrepresentations, and other fraud in the sale of securities." SEC, How the SEC Protects Investors, Maintains Market Integrity, http://www.sec.gov/about/laws.shtml (last modified Feb. 11, 2005). These objectives are achieved by requiring the registration of securities, which provides for disclosure of essential financial information. Id. Congress crested the SEC with the passage of the Securities Exchange Act of 1934. Id. With this Act, Congress provided the SEC with power over the entire securities industry, as well as the ability to discipline both persons and entities that commit prohibited conduct in the market. Id.

74. Lipton & Rosenblum, supra note 16, at 69. These reforms include strengthening the standards of independence for directors, requiring the audit, nominating, and compensation committees to be composed of all independent directors, and imposing stricter standards for members of the audit committee. Id. at 88.

75. Id. at 68.

76. Bost, supra note 38, at 4; see also OLSON & MOLONEY, supra note 9, § 10.1. The Sarbanes-Oxley Act of 2002 ordered the execution of several reforms aimed at "enhanc[ing] corporate responsibility, enhanc[ing] financial disclosures and combat[ing] corporate and accounting fraud." SEC, supra note 73.


78. Examples of such measures include forbidding a corporation's audit firm from providing consulting services to its client; creating the Public Company Accounting Oversight Board to oversee the activities of the auditor; requiring corporate counsel to report a "'material violation' of securities law, a breach of fiduciary duty, or similar violation;" forbidding personal loans to executives; forbidding insiders from trading during pension fund blackouts; protecting corporate whistle-blowers; and requiring CEOs and CFOs to certify a corporation's periodic reports filed pursuant to the Securities Exchange Act of 1934. Bost, supra note 38, at 5-20.

79. Id. at 4.
2. Stock Exchanges

An SEC examination of the operation and regulation of the New York Stock Exchange ("NYSE") and three other exchanges in 2003 revealed pervasive abuses on the trading floor, leading to investor deception. As a result, the SEC pushed the exchanges to enhance their corporate governance practices. The NYSE and NASDAQ soon adopted new rules promoting administration of management. These rules operate to restrict the definition of director independence and strengthen board committee structures.

3. SEC Release No. 33-8340

The SEC has become responsive to shareholders’ wishes for an effective means of communication with boards of directors. It believes that by providing investors with greater knowledge about how to communicate with directors, the "transparency of board operations" will be improved and shareholders will have an enhanced understanding about the companies in which they invest. To address these goals, the SEC issued a series of rules in 2003 that require publicly held companies to include in their proxy statements significant additional information about their nominating committees and their processes for nominating directors. The enhanced

---

80. Solomon, supra note 38.
81. Burns, supra note 6.
82. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 10. These new regulations are detailed in the NYSE Listed Company Manual Section 303A.04 and NASD Rule 43.50(c). Landefeld & Benderly, supra note 37, at 2 & n.2.
83. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 10. With these improvements, the "old ceiling became the new floor." Id. at 9.
84. Id. Audit, nominating, and compensation committees were affected by these rules. As a result of these changes, the NYSE requires an independent audit committee and separate nominating and compensation committees, also composed of solely independent directors. Id. Under NASDAQ rules, at least a majority of the compensation and nominating committees must be independent. Id. Both markets require that directors periodically hold meetings without management present. Id.
85. Meeker et al., supra note 38, at 13.
86. Id.
87. See Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors; Republication, Exchange Act Release Nos. 33-8340, 34-48,825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 69,204 (Dec. 11, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 270, 274). The additional disclosures that now must be included in the proxy statement are: (1) "‘minimum qualification’ of nominees;” (2) “[description of] the material terms of the company’s policy for accepting shareholder recommendations, including a specific statement as to whether the nominating committee will consider shareholder
disclosure is anticipated to provide shareholders with detailed supplementary information, which can be used to assess the boards and nominating committees. The new rules also require the proxy statement to disclose how the company’s shareholders can communicate with directors. These rules improve corporate governance by encouraging director operations to be more visible.

C. Participants

Corporate governance in a particular corporation depends on three groups: “shareholders, management, and the board of directors.”

Shareholders provide capital to the corporation through their purchase of the company’s stock, retaining ownership interest. Management handles “decisions regarding corporate operations, including strategic planning, risk management, and financial reporting.” The board of directors supervises the management’s performance on behalf of the shareholders. The board also oversees corporate strategy and the production of the company’s financial reports, which are provided to shareholders by the corporation.

During the first half of the twentieth century, share ownership was fragmented among small individual investors. The ownership of publicly held companies in the U.S. has gradually become more condensed. This development became more rapid in the late 1990s with the extraordinary development of the mutual fund industry and indexed equity money.

88. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors; Republication, 68 Fed. Reg. at 69,205.

89. Landefeld & Benderly, supra note 37, at 2. Specifically, the proxy statement must now include answers to several questions: (1) “Does the company have a process for shareholders to communicate with the board of directors?”; (2) “If not, why does the board of directors think that it is appropriate not to have a process?”; (3) “If so, how do shareholders send communications to the board of directors and, if applicable, to specific individual directors?”; (4) “Does the company filter shareholder communications intended for the board of directors, and, if so, what is the company’s process for determining which communications will be relayed to board members?”; (5) “Does the company have a policy about directors attending the annual shareholder meeting? How many of the company’s directors attended the prior year’s annual shareholder meeting?” Id. at 5.

90. Id. at 2.

91. Olson & Adams, supra note 37, at 424.

92. Id. at 424-25.

93. Id. at 425.

94. Id.

95. Bums, supra note 6. Publicly held companies in the United States normally have twelve board members. Id.

96. Silvers & Garland, supra note 15 (manuscript at 1).

97. Id.

952
management. By the end of the twentieth century, mutual funds, pension funds, and money managers working for pension funds owned a substantial portion of publicly held companies. The groups, often called institutional investors, can be very effective at demanding corporate governance changes because of the breadth of their holdings. Due to the potential strength of their influence, institutional investors believe they have a responsibility to press companies for both better corporate governance and strong stock performance.

One such institutional investor is the California Public Employees’ Retirement System (“CalPERS”). First operational in 1932, CalPERS today manages funds for more than 1.4 million public employees, retirees, and their families. Investments and income from 2003 to 2004 totaled more than $24 billion. A thirteen-member board of administration, including elected, appointed, and statutory-designated officials, oversees the fund. Before CalPERS reached a level of distinction among its peers in the 1980s, institutional investors often “dumped their shares” if discontented with a company. CalPERS, however, conducted itself in an entirely different

98. Id.
99. Id. In 1998, institutional investors held more than 60% of the voting shares of important corporations. Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?, 60 BUS. LAW. 1, 9-10 (2004). In 2002, institutional investors held 49.8% of U.S. equities. Id. at 10. This decline may have been a consequence of the corporate governance scandals of 2001. See id.
100. In addition to these groups, institutional investors also include labor unions, insurance companies, and bank trust departments. Id. at 9.
101. Burns, supra note 6. It may be inferred that corporations succumb to the will of institutional investors because of the fear that they will sell stock if unhappy, plunging share price. However, James E. Heard, Vice Chairman of ISS, a proxy advisory service, stated that institutional investors are “serious long-term investors.” INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 7.
102. Burns, supra note 6 (citing TIAA-CREF).
105. Id. at 2.
106. This practice is often called “voting with your feet.” See DETAILED COMMENTS OF BRT, supra note 35 (citing Rachel Weber, Why Local Economic Development Incentives Don’t Create Jobs: The Role of Corporate Governance, 32 URB. LAW. 97, 113 (Winter 2000) (stating that “[i]n addition to exercising ‘voice’ to influence management, shareholders have another powerful and more commonly used control tool at their disposal: exit. If shareholders are not pleased with management’s performance, they will ‘vote with their feet,’ sell their stock, and force share values down”).
manner: "[i]f you don't govern the company well, it told corporate board members, we'll publicize your shortcomings and, possibly, withhold votes for your re-election." CalPERS is a proponent of the SEC proposed rule and believes that shareholders should have effective access to the director nomination process.

Another institutional investor is the Teachers Insurance and Annuity Association—College Retirement Equities Fund ("TIAA-CREF"). At present, TIAA-CREF manages the assets of 3.2 million participants, and its debt and equity investments totaled $36.5 billion in 2003. In its corporate governance agenda, TIAA-CREF focuses on the quality of the board. It believes that shareholders should withhold votes from directors whose actions indicate that their election to the board would be against shareholders' best interests.

D. Current Corporate Governance Issues

A frequent complaint regarding boards of directors is that they too strictly control the director nomination processes. Nominating committees suggest candidates for inclusion on a company's proxy ballot. The board takes the nominating committee's recommendations into consideration and selects nominees. Then, shareholders vote for candidates. Some shareholders do not agree with this process: they would like companies to disclose how they decide candidate qualifications and deal with shareholder-nominated candidates. In addition, some shareholders would like companies to disclose shareholder candidates in a company's proxy materials. Unresponsiveness to these requests has left shareholders "properly infuriated" and has encouraged investors to play a more active role

108. Id. CalPERS responded recently to corporate governance-related controversies at several large oil companies, pushing major oil companies to independently audit their energy-reserve estimates, thereby coercing the oil industry to "improve the transparency of its reserves accounting." Chip Cummins, Outside Auditing of Oil Reserves Pushed by Calpers, WALL ST. J., Nov. 9, 2004, at A6.


112. Id.

113. Burns, supra note 6.

114. Id.

115. Id.

116. Id.

117. Id.

118. See supra note 27 and accompanying text.
in corporate governance.\textsuperscript{119} As a result, boards of directors are focusing on corporate governance reforms.\textsuperscript{120}

Another shareholders' corporate governance concern relates to their power to replace directors. Replacement of directors is an important safeguard in the "structure of... corporate law."\textsuperscript{121} Theoretically, if directors do not act in shareholders' interests, or if they appear unqualified to serve on the board, shareholders have the power to replace them.\textsuperscript{122} However, shareholders' power to replace directors is "largely a myth."\textsuperscript{123} Even in corporations that continually under-perform, attempts to replace directors are uncommon.\textsuperscript{124} Company-nominated directors usually run unopposed and their election is guaranteed,\textsuperscript{125} whether or not their interests are equal to shareholder's interests to maximize shareholder value.\textsuperscript{126}

\textbf{III. Proxy Solicitation}

\textit{A. What is a Proxy?}

A proxy is a document in which a shareholder authorizes another person to vote on the shareholders' behalf at a shareholders' meeting.\textsuperscript{127}

\begin{itemize}
\item \textsuperscript{119} Burns, \textit{supra} note 6 (quoting Goldman, Sachs & Co. managing director Abby Joseph Cohen at a corporate governance conference).
\item \textsuperscript{120} \textit{Id.} (referring to the opinion of Goldman, Sachs & Co. managing director Abby Joseph Cohen as stated at a corporate governance conference).
\item \textsuperscript{121} Bebchuk, \textit{supra} note 8, at 44.
\item \textsuperscript{122} \textit{Id.}
\item \textsuperscript{123} \textit{Id.} at 45.
\item \textsuperscript{124} \textit{Id.}
\item \textsuperscript{125} "The key for a director's re-election is remaining on the firm's slate." \textit{Id.} Because of the expenses and difficulties that accompany shareholders' efforts to nominate a director by launching a proxy contest, it is rare when a candidate runs against another who was not nominated by the current board or the nominating committee. \textit{See id.} If the number of candidates equals the number of available spaces on the board, then all of the candidates on the firm's slate will be elected. \textit{See id.} "[T]he formidable advantages that incumbents enjoy permit boards sympathetic to current management to retain control almost without limit." John H. Matheson & Brent A. Olson, \textit{Corporate Law and the Long-term Shareholder Model of Corporate Governance}, 76 Minn. L. Rev. 1313, 1361 (1992) (citing George W. Dent, Jr., \textit{Toward Unifying Ownership and Control in the Public Corporation}, 1989 Wis. L. Rev. 881, 903-05 (1989)).
\item \textsuperscript{126} Bebchuk, \textit{supra} note 8, at 45.
\item \textsuperscript{127} Carnell & Hanks, \textit{supra} note 7, at 24.
\end{itemize}
B. Rules Relating to Proxy Solicitation

The SEC obtained extensive control over proxy solicitation of publicly held companies with Section 14 of the Securities Exchange Act of 1934 ("Section 14"), which makes it unlawful for such a corporation to solicit proxy votes in contravention of SEC rules and regulations. Congress created this Section with the intention of addressing the problem of a board of directors' ability to control the proxy process.

Rule 14a-8, which implements Section 14, was designed to give small individual investors an opportunity to have their voice heard on certain governance issues through shareholder proposals included on a company's proxy ballot. Rule 14a-8(i)(8), however, permits the corporation to omit shareholder proposals that relate to election of directors.

C. Current Nomination Procedure

Under existing SEC rules, shareholders are given an opportunity to vote only on those candidates nominated by the company. In voting on the director slate, the shareholder may choose to approve all directors, withhold their vote from all directors, or approve all directors except specific directors chosen by the shareholder. Shareholders can nominate candidates to replace incumbent directors, but they cannot include their nominee's name on the company's official proxy, which lists only the company's candidates.


129. Silvers & Garland, supra note 15 (manuscript at 1-2). In 1934, the Committee on Banking and Currency recommended that the SEC govern proxy solicitation and issuance in order to prevent a corporation from abusing the proxy process by misstating or omitting important information from proxy materials. S. REP. No. 73-792, at 12 (1934) (reporting the comments of Mr. Fletcher on behalf of the Committee on Banking and Currency). Prior to this rule's passage, corporations often would not disclose to shareholders the real reasons why the shareholders' vote was wanted. Id. In one instance, the president of a company sent proxy materials to shareholders, which sought their approval of a number of corporate transactions. Id. The corporation, however, did not reveal in its materials a number of factors which could influence the voters' decision, such as the president's personal interest in the proposed transactions and undisclosed company stock options. Id. Congress created Section 14 so that a stockholder will have sufficient knowledge of a corporation's financial condition and policies in order to make an informed vote. Id.

130. Silvers & Garland, supra note 15 (manuscript at 1).


134. Solomon, supra note 12.
D. How a Shareholder can Participate in the Current Nomination Procedure

Under the existing corporate governance system, shareholders can nominate directors through a number of alternative methods. Shareholders may propose potential director candidates to a company's nominating committee. A nominating committee has a duty to consider qualified candidates and to select nominees that it believes will best serve the interests of the company and its investors. A shareholder may nominate a director at the annual shareholders' meeting, as long as the nomination complies with state law and company bylaw requirements. Shareholders may attempt to prevent the nomination of a director by withholding authority from specific candidates. In order to replace one or more incumbent directors, shareholders have the right to nominate their own director candidates by soliciting proxies for them (also called a "proxy fight" or "election contest").

Despite these options, shareholders are increasingly frustrated. Investors view these means of participation as "toothless" and insufficient, especially if they wish to use these tools in order to strike out and hold unproductive directors accountable for their actions.

Security holders have indicated that recommending candidates to a company's nominating committee, although possible, generally is futile.

136. Id.
137. BRIEFING PAPER, supra note 14.
139. See id. This typically occurs if the company and its incumbent directors are performing poorly. Interview, supra note 28.
140. Silvers & Garland, supra note 15 (manuscript at 3).
141. Id. Shareholder participation in the director nomination process may be viewed as "toothless" because often these efforts are very costly or futile. Printing and mailing proxy statements to run an election contest may result in expenditures of more than one million dollars. Interview, supra note 28. The majority of shareholders do not have the funds to conduct a proxy contest. See Bebchuk, supra note 8, at 45. Shareholders have the ability to participate in the nomination process without spending money by recommending candidates to a corporation's nominating committee or by nominating directors at the shareholders' annual meeting. BRIEFING PAPER, supra note 14. Such actions are ineffectual, however, because obtaining access to a nominating committee is difficult, and a candidate presented at an annual meeting is unlikely to receive sufficient support for nomination. Id.; Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,786 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). Shareholders have no effective means of nominating a candidate for the board of directors. Silvers & Garland, supra note 15 (manuscript at 3).
142. BRIEFING PAPER, supra note 14.
Shareholders have a difficult time gaining access to board members and nominating committees.\textsuperscript{143} Even if access is granted, nomination committees seldom nominate candidates recommended by investors.\textsuperscript{144} Although shareholders may nominate directors at the shareholders’ annual meeting, this action is largely ineffective. Most shareholders vote through a mailed proxy ballot instead of voting in person at the actual meeting.\textsuperscript{145} A candidate presented at an annual meeting is unlikely to receive sufficient support for nomination.\textsuperscript{146}

While withholding votes from director candidates has become a more common practice, it has no effect in states such as Delaware, which use plurality rather than majority voting for board elections.\textsuperscript{147} Plurality voting is a process in which the nominee winning the greatest number of votes is elected.\textsuperscript{148} If the number of nominees equals the number of available board positions, each nominee will be elected, regardless of whether they received only a single vote or whether votes were withheld from that nominee.\textsuperscript{149}

Most often, an election contest by means of a proxy fight is a “last resort” for investors.\textsuperscript{150} Not only is an election contest extremely disruptive to the entire company,\textsuperscript{151} but the expenses and difficulties of running an election contest make them uncommon.\textsuperscript{152} This process involves printing
and mailing proxy statements to all record holders of stock, which requires substantial expenditures that run in the millions of dollars. Furthermore, the shareholders’ proxy materials must comply with the SEC’s proxy rules. The company’s lawyers regularly attack such proxy materials as deficient.

Shareholders’ means of nominating candidates are limited and often fruitless. Several large institutional investors have communicated that the director nomination process is fundamentally a “rubber stamp” for the board-elected nominees.

IV. PATH TO REFORM

A. Prior SEC Attempts To Involve Shareholders in the Nomination Process

This proposed rule is not the first that the SEC has made in an attempt to place shareholder-nominated board candidates on the corporate proxy ballot. Such proposals are often introduced after periods during which the corporation and management have been heavily criticized, such as subsequent to the corporate scandals of the 1970s and the “hostile takeover battles” of the 1980s. Therefore, the proposed rule was a natural consequence of the publicity of the “unprecedented” corporate scandals of 2001, which caused widespread mistrust of boards and management among the public.

1. 1942

The SEC first addressed the issue of allowing shareholders’ nominees for director on a company’s proxy ballot in 1942. At that time, the SEC

153. Interview, supra note 28.
154. BRIEFING PAPER, supra note 14.
155. Interview, supra note 28.
156. OLSON & MOLONEY, supra note 9, § 10.13.
157. Brownstein & Kirman, supra note 32, at 1, 3.
158. Id.
requested that its staff review the proxy rules and recommend changes.\textsuperscript{160} The staff proposed that "stockholders be permitted to use the management's proxy statement to canvass [sic] stockholders generally for the election of their own nominees for directorships, as well as for the nominees of the management."\textsuperscript{161} Corporations countered that shareholders would make unwise decisions by nominating and electing careless directors.\textsuperscript{162} Consequently, the staff proposal was not adopted.\textsuperscript{163}

2. 1977

In the 1970s, hundreds of U.S. companies were accused of unlawful payments to international politicians and corporations.\textsuperscript{164} In response, the SEC conducted a broad review of corporate governance, including an appraisal of shareholder communications and shareholder participation in the director election process.\textsuperscript{165} The SEC called for public comment in addressing whether "shareholders [should] have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors."\textsuperscript{166} Unexpectedly, the proposal gained support from the Business Roundtable, a group of CEOs that is a vocal opponent of the SEC's latest proposal.\textsuperscript{167} In a 1977 statement, the Business Roundtable stated that "shareholders 'are the proper persons to resolve the question' of how directors should be nominated."\textsuperscript{168} But the SEC

\textsuperscript{160} \textit{Id.} (testimony of Chairman Ganson Purcell).
\textsuperscript{162} Solomon & Lublin, \textit{supra} note 5.
\textsuperscript{163} \textit{Id.} The rejection of the proposed rule serves as an example of how SEC decisions may be motivated more by political concerns than concerns for shareholders' well-being. Milton V. Freeman was the SEC attorney who wrote the plan. \textit{Id.} Some members of Congress labeled him a communist, and the SEC did not adopt the proposal. \textit{Id.} This political motivation is indicative of the present time. Passage of the current proposed rule has been substantially delayed by opposition from the two Republican commissioners, while the two Democratic commissioners support it. Solomon, \textit{supra} note 59.
\textsuperscript{164} Solomon & Lublin, \textit{supra} note 5.
\textsuperscript{165} STAFF REPORT, \textit{supra} note 31.
\textsuperscript{167} Solomon & Lublin, \textit{supra} note 5.
\textsuperscript{168} \textit{Id.} Nominating committees serve to propose candidates for director elections. Sundquist, \textit{supra} note 144, at 1477. Because nominating committees are ideally composed of independent directors, they objectively recommend candidates based on the candidate's qualifications and the needs of the shareholders and corporation. Bernard Black et al., \textit{Corporate Governance in Korea at
did not adopt the proposal, claiming it would be of no use since companies were voluntarily creating nominating committees.\textsuperscript{169}

3. 1980

The SEC yet again considered adopting a shareholder director nomination rule in 1980, and instructed its staff to make a recommendation. Because of the rising popularity of nominating committees, the staff advised the Senate that the SEC should not propose a proxy access rule at the time,\textsuperscript{170} but rather supervise the development of nominating committees.\textsuperscript{171} If many companies did not adopt nominating committees, or if nominating committees did not improve shareholders' participation in the election processes, then an SEC rule might be required.\textsuperscript{172}

4. 1992

The SEC considered proposing a shareholder director nomination rule in 1992, but was hesitant because of the issue's potentially disruptive effect.\textsuperscript{173} The idea was forcefully condemned: "[p]roposals to require the company to include shareholder nominees in the company’s proxy statement would represent a substantial change in the Commission’s proxy rules."\textsuperscript{174} Rather than a shareholder access rule, the SEC adopted broad proxy revisions that would make it easier for shareholders to conduct proxy fights.\textsuperscript{175}

\begin{footnotesize}
\textsuperscript{169} Solomon & Lublin, supra note 5.
\textsuperscript{170} STAFF REPORT, supra note 31.
\textsuperscript{171} Id. 
\textsuperscript{172} SEC, Div. of Corp. Fin., Staff Report on Corporate Accountability A60-65, A69 (Sept. 4, 1980).
\textsuperscript{173} Solomon & Lublin, supra note 5.
\textsuperscript{175} Solomon & Lublin, supra note 5.
\end{footnotesize}
B. Catalysts for the Proposed Rule

1. Corporate Crises

As noted in Part I, the string of scandals in 2001 involving corporate governance failures encouraged a new focus on reform.\textsuperscript{176} The SEC’s interest in the shareholder nomination process reawakened.\textsuperscript{177}

2. Affirmative Institutional Investor and Corporate Action

\textit{a. AFSCME}

Labor-affiliated institutional investors became more vocal about promoting the adoption of a shareholder access rule in the spring of 2002.\textsuperscript{178} The pension plan for the American Federation of State, County, and Municipal Employees ("AFSCME") devised a proposal in December 2002 that would give shareholders greater access to corporate proxies.\textsuperscript{179} This proposal, submitted to six S&P 500 corporations, would have required these "companies to include on their proxy ballot the name of a board candidate who was nominated by shareholders holding at least [three] percent of a company’s stock."\textsuperscript{180} While the SEC issued these companies no-action letters that allowed the companies to keep the AFSCME proposal off their proxy materials,\textsuperscript{181} the incident caused such concern among agency officials that the SEC instructed the Division to provide a staff report on the state of shareholder access,\textsuperscript{182} with an "eye toward possible reforms."\textsuperscript{183}

\begin{itemize}
\item \textsuperscript{176} Lipton & Rosenblum, \textit{supra} note 16, at 68.
\item \textsuperscript{177} Landefeld & Benderly, \textit{supra} note 37, at 2.
\item \textsuperscript{178} Silvers & Garland, \textit{supra} note 15 (manuscript at 5). As a result of the corporate scandals of 2001, the stock market plunged, resulting in great loss to institutional investors. Interview, \textit{supra} note 28. Institutional investors did not want to sell their stock while share price was low, since such an action would disadvantage portfolio return. \textit{Id.} Institutional investors became more vocal immediately after these crises, instead of selling. \textit{Id.}
\item \textsuperscript{179} OLSON & MOLONEY, \textit{supra} note 9, § 10.13.
\item \textsuperscript{180} \textit{Id.} The S&P corporations targeted include Citigroup, Sears Roebuck & Co., Exxon Mobil Corp., AOL Time-Warner, Eastman Kodak Co., and the Bank of New York. \textit{Id.} AFSCME also lobbied 150 public employee pension funds to adopt voting policies in favor of such "shareholder access" initiatives. Brownstein & Kirman, \textit{supra} note 32, at 1.
\item \textsuperscript{181} The Division allowed these companies to keep the shareholder proposals off of their proxy materials because the proposals "relate[d] to an election for membership on the company's board of directors" in violation of Rule 14a-8(i)(8). STAFF REPORT, \textit{supra} note 31.
\item \textsuperscript{182} OLSON & MOLONEY, \textit{supra} note 9, § 10.13.
\item \textsuperscript{183} Silvers & Garland, \textit{supra} note 15 (manuscript at 5).
\end{itemize}
b. Apria Healthcare, Inc.

Despite the apparent inactivity by the SEC, one company decided to act on its own by voluntarily adopting a shareholder director nomination plan. In 2003, board chairman Ralph Whitworth convinced the split board of Apria Healthcare Group, Inc. ("Apria"), a company that provides home healthcare products and services, to let shareholders nominate candidates. Under this new plan, stockholders owning at least five percent of Apria stock continuously for two years can nominate two new directors every year for placement on the company’s official proxy ballot. This move marked the first time that a publicly-held U.S. company has acted to develop shareholders’ participation in the board selection process. The corporate world saw Apria as a leader in good corporate governance. Its achievement “is the wave of the future,” said Richard Ferlauto, AFSCME’s director of pension investment policy, who further expressed that “[t]he fundamental problem in corporate governance today is that shareholders don’t have real power to elect the board of directors.”

The Apria move intensified the SEC’s attention on the issue of shareholder director nominations. A shareholder’s appeal to overturn recent no-action letters prompted the SEC to ask the Division in April 2003 to devise possible modifications to the proxy rules regarding the shareholders’ participation in the election of directors.

184. Interview, supra note 28.
185. Id. Mr. Whitworth won support from his fellow board members by pointing out that a “more open election process” would strengthen the board’s independence and improve effectiveness. Joann S. Lublin, Apria Will Let Holders Nominate Board Candidates, WALL ST. J., June 11, 2003, at B2.
187. Solomon & Lublin, supra note 5.
188. Id. The plan was made effective in 2004, but no shareholders came forward with their nominees in time for the 2004 annual shareholders’ meeting. Id.
189. Lublin, supra note 185.
190. Id.
191. Landefeld & Benderly, supra note 37, at 2 (citing E-mail from James McRitchie, Editor, CorpGov.Net, to William Donaldson, Chairman, United States Securities and Exchange Commission, http://www.sec.gov/rules/petitions/4-461/jmcritchiei.txt (Mar. 29, 2003, 01:10:00 PST)).
c. Call for Public Comment

After receiving the Division's review of the proxy rules and regulations relating to the nomination of directors, the SEC solicited public views on the Division's findings in May 2003.193

i. Comments Encouraging the Proposal of Such a Rule

A great number of commentators urged the SEC to adopt shareholder access rules, stating that such modifications to the nomination processes would provide shareholders an effective means of exercising "their rights and responsibilities as owners of their companies."194 Individual investors stated that the current director nomination process does not provide shareholders with the rights to which they are entitled as owners of the company.195 Reform of the proxy rules would make directors more responsive to shareholder concerns because investors would at last be given a meaningful position in the oversight of the nomination process.196 Commentators also noted that corporate directors lack accountability under the current nomination process.197 Furthermore, nominating committees have not made the nomination process "sufficiently transparent."198

ii. Comments Discouraging the Proposal of Such a Rule

Commentators opposing modifications to the proxy rules included corporations and corporate executives, and a majority of the legal community and associations.199 It was argued that such a proposal would be

194. STAFF REPORT, supra note 31.
195. Id.
196. Id.
197. Id.; see also E-mail from James McRitchie, Editor, CorpGov.Net, to William Donaldson, Chairman, United States Securities and Exchange Commission, http://www.sec.gov/rules/petitions/4-461/jmcritchiel.txt (Mar. 29, 2003, 01:10:00 PST) (stating that "[e]ntrenched managers and directors will only improve corporate governance when they can be held personally accountable—through the possibility of being voted out of office and replaced by candidates nominated by shareholders").
199. STAFF REPORT, supra note 31.
“terribly disruptive to the corporate governance process.” Instead of adopting a new rule, the SEC should allow the Sarbanes-Oxley Act of 2002 and stock exchange listing standards “a chance to operate before making such a fundamental change to the director nomination process.” In addition, commentators questioned the SEC’s statutory authority to propose such a rule, arguing that neither Section 14(a) nor any other statute authorizes the SEC to regulate matters dealing with corporate governance. The Supreme Court and lower courts have held that corporate governance is a topic that is traditionally reserved for states. Commentators stated further that shareholder access to a company’s election processes would have a harmful effect on a corporation.

iii. AFL-CIO Petition to the SEC

The American Federation of Labor and Congress of Industrial Organizations (“AFL-CIO”) petitioned the SEC on May 15, 2003 to propose a rule that would allow shareholder-nominated directors to appear on a company’s proxy ballot. The AFL-CIO’s petition clarified that only long-

200. Id. (quoting commentator Alston & Bird LLP). Opponents to the rule argue that the proposed rule will impose a substantial disruption upon shareholder meetings, as it completely changes the way director candidates are nominated and elected. Silvers & Garland, supra note 15 (manuscript at 7-8). Further, it is maintained that the proposed rule will disrupt the “collegiality” of the board of directors by introducing shareholder-nominated directors to the board. Olson & Moloney, supra note 9, § 10.13.

201. STAFF REPORT, supra note 31 (quoting commentator Alston & Bird LLP).


203. Id. Rules regarding a corporation’s shareholder rights are conventionally decided by the state in which the company is incorporated. Sundquist, supra note 144, at 1496. “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.” Id. (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (emphasis omitted)). Corporate governance has customarily been left for the states because state law is the creator of the fiduciary duties the board of directors owes the corporation’s shareholders. Interview, supra note 28.

204. SEC, SUMMARY OF COMMENTS IN RESPONSE TO THE COMMISSION’S SOLICITATION OF PUBLIC VIEWS REGARDING POSSIBLE CHANGES TO THE PROXY RULES app. A at 23 (July 15, 2003), http://www.sec.gov/news/studies/proxycomsum.pdf. The U.S. Chamber of Commerce, a staunch opponent to the proposed rule, claims that it “will stifle business innovation, decrease productivity and inhibit economic growth.” U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule, supra note 53 (quoting U.S. Chamber of Commerce Senior Vice President David Hirschmann).

205. Silvers & Garland, supra note 15 (manuscript at 5).
term shareholders should be permitted to include a candidate on such a proxy.206

d. The Division’s Recommendation

The Division provided the SEC with its report after taking commentators’ views into account, and suggested changes to the proxy rules related to the nomination and election of directors.207 The agency’s recommendation was a triumph for investor-rights advocates, who had mercilessly campaigned for companies to include shareholder-nominated candidates along with their own slates of nominees on corporate proxies.208

The SEC proposed the Shareholder Director Nomination rule for public comment in October 2003.209

V. SHAREHOLDER DIRECTOR NOMINATION PROPOSED RULE

A. Objectives of the SEC

The SEC’s expressed objective in proposing a shareholder access rule is to “improve disclosure to security holders to enhance their ability to participate meaningfully in the proxy process for the nomination and election of directors” without unduly burdening companies.210

B. Proposed Changes to the Proxy Rule

The proposed rule would operate to require companies,211 under certain circumstances, to include shareholder-nominated directors for election on
their corporate proxy ballot.\textsuperscript{212} Such circumstances will be triggered only if there is sufficient evidence to suggest that the company has been unresponsive to shareholder concerns regarding corporate governance or the proxy process in general.\textsuperscript{213} If a trigger occurs, then companies are obligated to include a limited number of investor-elected nominations from shareholders who meet certain eligibility requirements, without forcing the nominating shareholders to print and distribute their own proxy materials.\textsuperscript{214}

A significant difference proposed by the SEC, as compared to the current nomination process, is that the number of director candidates presented to shareholders for election must be different than the number of available places on the board.\textsuperscript{215} As a result, each director will be individually considered for election.\textsuperscript{216}

C. Safeguards

The SEC has included several safeguards within the proposed rule that prevent abuse by shareholders.\textsuperscript{217} Shareholders would be allowed to nominate only a specific number of directors that could sit on the board at any one time.\textsuperscript{218} Furthermore, the occurrence of one or both of the two triggering events would subject a company to shareholder nominations for only a two-year period.\textsuperscript{219} In addition, shareholders may only nominate candidates who are deemed “independent” from the company according to guidelines established by the SEC.\textsuperscript{220} Shareholders may not nominate any person with whom they would have a conflict of interest.\textsuperscript{221} Most notably, shareholders may nominate directors only if those shareholders have no intention of controlling the company.\textsuperscript{222} Together, these safeguards rigorously limit the ability of shareholders to use the triggering of the proposed rule for their own self-interest.\textsuperscript{223}

\begin{itemize}
  \item[212.] Id. at 60,784.
  \item[213.] Id.
  \item[214.] Id.
  \item[215.] DALY, supra note 133.
  \item[216.] Id.
  \item[217.] Garris et al., supra note 24, at 25.
  \item[218.] Id. This number, currently ranging between one and three, would depend upon the size of the board. Id. at 27.
  \item[219.] Id. at 25.
  \item[220.] Id.
  \item[221.] Id.
  \item[222.] Id.
  \item[223.] Id.
\end{itemize}
1. Limits on the Number of Shareholder-Nominated Candidates

A company may be required to include one nominee in its proxy materials if its board consists of eight or fewer members, two nominees if its board consists of nine to nineteen members, and three nominees for boards consisting of more than twenty directors. If a company receives a number of shareholder-nominated candidates in excess of these numerical boundaries, the company is required to include in its proxy materials only the number of directors in the approved limits, as nominated by the shareholder or shareholder group with the largest holdings. If the company has a classified board, the limitations on the number of shareholder nominees would take into account any current directors who were elected through this procedure but who are not up for re-election at the current annual meeting.

If the SEC adopts the proposed rule, shareholder-nominated candidates could be elected only by a majority vote. If the number of candidates exceeds the number of available positions on the board of directors, however, plurality voting would apply.

2. Triggering Events

The nominating procedure would become effective for a company only after the occurrence of one or both of the triggering events. These two

---

224. Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Release No. 26,206, 68 Fed. Reg. 60,784, 60,797 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). Most likely, the Division imposed these limits in order to address the concerns expressed by commentators in opposition to the proposed rule. See id. at 60,787. Relevant concerns include the argument that shareholders are not qualified to nominate director candidates and that shareholders may nominate candidates who support agendas that are not in the best interests of the corporation. See Lipton & Rosenblum, supra note 16, at 80.


227. Garris et al., supra note 24, at 27.

228. Burns, supra note 56.

229. SUMMARY OF COMMENTS, supra note 54.

230. Security Holder Director Nominations, 68 Fed. Reg. at 60,789-90. It is clear that the SEC took a “measured” approach when proposing the shareholder director nomination rule. Solomon, supra note 12. During the SEC’s solicitation of public views regarding changes to the proxy process, the Division received comments that discussed both the considerable benefits of such a procedure and the significant concerns commentators had regarding its passage, as well as its potential consequences. Security Holder Director Nominations, 68 Fed. Reg. at 60,787. This proposed rule is intended to deal with the wide-ranging procedural and substantive issues regarding its operation. Id. By allowing shareholders the right to nominate candidates to a corporation’s board of directors in certain circumstances, the SEC addresses shareholders who complain the corporation does not listen to their concerns. Solomon, supra note 12. By imposing a triggering requirement
triggering events are a withhold vote from more than thirty-five percent of the votes cast at an annual shareholders' meeting, and a shareholder proposal submitted pursuant to Rule 14a-8 which receives a majority vote in favor of its passage. The procedure would then be activated for any annual meetings or special meetings held during the subsequent two years. The triggers became applicable to activating the shareholder-nomination process beginning on January 1, 2004, even though the SEC did not adopt the proposed rule by that date.

a. Withhold Votes

One trigger for the proposed rule would be "withhold" votes, for at least one of the company-nominated candidates, from more than thirty-five percent of the votes cast at a shareholders' annual meeting at which directors were elected.

b. Proposal Submitted Pursuant to Rule 14a-8

Another trigger for the proposed rule would call for a shareholder "proposal submitted pursuant to Exchange Act Rule 14a-8 providing that the company become subject to the security holder nomination procedure."
The proposal would have to have been submitted for a shareholder vote at an annual shareholders’ meeting by an investor (or group of investors) that held more than one percent of the company’s securities. The trigger would occur if the “direct access” proposal received more than fifty percent of the votes cast on the proposal at that meeting.

\[\text{c. Proposed Third Triggering Event: Failure of the Company To Implement a Shareholder Proposal That Received a Majority Vote}\]

The SEC is considering a third trigger for the nomination procedure. This triggering event would require that a shareholder proposal submitted pursuant to 14a-8, other than a direct access security proposal described in the second trigger, was submitted for a shareholder vote at an annual shareholders’ meeting by an investor or group of investors that held more than one percent of the company’s securities for at least one year. The trigger would occur if the proposal received more than fifty percent of votes cast, but the board of directors of the company did not implement the proposal “by the 120th day prior to the date that the company mailed its proxy materials for the annual meeting.”

3. Candidates Must Meet Independence Standards

A shareholder-nominated candidate for director must meet independence standards, as set forth in a national securities exchange or national securities association listing standards. Furthermore, neither the nominating shareholders nor the nominee may have any direct agreement or indirect understanding with the company concerning the nomination of the candidate. The nominating shareholders must also represent to the

SEC Chief is Open to Revising Rules, Yet Stiff Fines Stay, WALL ST. J., Feb. 10, 2005, at A3; see STAFF REPORT, supra note 31.

236. Security Holder Director Nominations, 68 Fed. Reg. at 60,789. The SEC approximates that most companies have at least one shareholder that is eligible to submit a shareholder proposal under Rule 14a-8. Id. at 60,790.

237. Id. at 60,792.

238. Id. at 60,791.

239. Id.

240. Garris et al., supra note 24, at 27; INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 10. The audit, nominating, and compensation committees of a corporation were affected by these rules. As a result of these changes, the NYSE requires independent audit committees and separate nominating and compensation committees, also composed of solely independent directors. Id. Under NASDAQ rules, at least a majority of the compensation and nominating committees must be independent. Id. Both markets require that directors periodically hold meetings without management present. Id.

241. Garris et al., supra note 24, at 27.
company that their nominee “does not have certain familial, employment, compensatory or ‘control’ relationships with the nominating shareholders, whether through affiliates or otherwise.”

4. Nominating-Shareholders’ Eligibility Requirements

A shareholder, or group of shareholders, would have to fulfill several requirements in order to be eligible to place a candidate on the company’s proxy.

a. Holding Requirements

The nominating shareholder(s) would have to own more than five percent of the company’s outstanding voting stock, either individually or collectively, and have owned this five percent of outstanding stock continuously for at least two years prior to the date of nomination. The nominating shareholder or group of shareholders must intend to continue to own the outstanding stock through the date of the annual or special meeting at which the nomination is to be made.

b. No Intention of Controlling Company

The nominating shareholder or group of shareholders must also provide proof that they have no intention of controlling the company. This proof must be provided in two ways. The shareholder or each shareholder within the nominating group (1) must be qualified to “report beneficial ownership” on Schedule 13G, rather than Schedule 13D; and (2) have filed a

242. Id. A prohibited relationship between the nominee and the nominating shareholder would include an association in which the nominee would hold the interest of the nominating shareholder or shareholder group over the interests of the company. Security Holder Director Nominations, 68 Fed. Reg. at 60,795-96. Such nominees are referred to as “special interest” or “single issue.” Id. at 60,795.

243. See Security Holder Director Nominations, 68 Fed. Reg. at 60,798. In including these requirements in the proposed rule, the SEC is ensuring that those shareholders nominating candidates for the board of directors have interests that are in accordance with those of the corporation. See id. Shareholders who have demonstrated commitment to the company by owning more than five percent of the corporation’s stock for at least two years are not short-term investors out for a quick profit. See id. Shareholders who are not out to acquire the corporation are interested in its long-term growth, since such growth will lead to a profit in their investment. See id.

244. See id. at 60,794-95.

245. Garris et al., supra note 24, at 27.


247. Garris et al., supra note 24, at 27.
Schedule 13G or an amendment to Schedule 13G reporting that beneficial ownership as a passive or institutional investor, or group of investors, on or before the date that the nomination(s) for director is submitted to the company.248

D. Obligations of a Company

A company would be able to reject shareholder nominations if state law prohibits the proposed rules.249 A rejection could also be valid if a company’s governing documents prevent shareholders from nominating directors, or if the nominating shareholders and/or nominees have not complied with the requirements set forth in the proposed rules.250 If the company decides there are no grounds for excluding a nominee, however, the company would be required to include the nominee in the company’s proxy materials, along with any statements of support for the candidate, if the company elects to do so.251 On the company’s proxy card, it may label any shareholder nominees as such and suggest that shareholders vote against or withhold votes from those nominees, in favor of the corporate nominees.252
E. Authority Under Federal Law

Section 14, described in Part III, “was intended to ‘control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of security holders.’” Section 14(a) authorizes the SEC to impose proxy solicitation rules that are “necessary or appropriate in the public interest or for the protection of investors.”

The SEC believes that the proposed rule advances the objectives of Section 14. Investors are prevented from participating meaningfully in the proxy process because of the lack of methods available to them to contribute to nomination proceedings. Although the director candidates nominated by the current board or nominating committee are often not the most qualified to represent the shareholders’ interests, shareholders are forced to vote for these candidates. The proposed rule’s passage will aid shareholders in freely exercising their voting rights through the proxy process, since companies would be required to disclose shareholder nominees in company proxy materials in certain circumstances.

F. State Law

State laws and federal laws regulate different aspects of corporate processes. Federal proxy rules, as enacted by the SEC, regulate disclosure. State laws govern procedural rules and corporate governance

254. Id. (quoting 15 U.S.C. § 78n(a) (2000)).
256. The director slate is proposed entirely by the board of directors or the nominating committee, and shareholders are permitted to approve all directors, withhold their support from all directors, or approve only some directors. DALY, supra note 133. The current methods a shareholder can use to nominate their own director candidate are often costly and ineffective. See BRIEFING PAPER, supra note 14.
257. See Murphy, supra note 143, at 95. Boards nominate directors “in an informal and unregulated manner.” Id.
258. Matheson & Olson, supra note 125, at 1361 n.231. Investors “tend to vote for management because assertive shareholders encounter management hostility. Managers can deny rebellious shareholders valuable information.” Id. (quoting Dent, supra note 125, at 904).
260. Interview, supra note 28.
261. Id.
standards. While states recognize that "the 'right of shareholders to participate in the voting process includes the right to nominate an opposing slate,'" no state law operates similarly to the proposed rule.

Due to the lobbying efforts of shareholders to become more involved in the director nomination processes, the California legislature introduced a bill that "go[es] further" than the proposed rule. This bill would require any companies doing business in the state to permit nominations by investors who have held at least two percent of the company's outstanding stock for two years to appear on the corporate proxy. Vermont introduced a bill that would allow a voting shareholder to have its director nominees placed on the corporate proxy statement as long as the shareholder provides appropriate notice to the corporation, if the corporation so requires.

VI. PROXY ENVIRONMENT POST-PROPOSAL

Despite the fact that the SEC has not yet adopted the proposed rule, the introduction of the topic has considerably influenced the corporate environment, particularly the 2004 proxy season.

262. Id. Examples of procedural rules would be laws governing shareholders' meetings (time and place), or whether a director is elected by a plurality or a majority of votes. Id.


264. Solomon & Lublin, supra note 5. The California legislature's position as a supporter of the proposed rule is surprising, as states are expected to act in the interests of corporations in order to encourage companies to incorporate in their state. See Interview, supra note 28. However, California has become an advocate of the SEC's proposed rule because of the negative effect that corporate scandals of such companies as Enron and WorldCom have had on investor confidence. Assemb. J. Res. 79, 2004 Gen. Assemb., Reg. Sess. (Cal. 2004). California believes that urgent improvements to corporate governance practices are needed in order to "achiev[e] greater accountability" for boards of directors. Id. The proposed rule, in California's opinion, will accomplish such an objective. Id. Despite this hope, Governor Schwarzenegger vetoed the bill on September 22, 2004. Official California Legislative Information, AB 2752 Assembly Bill – History, http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab-2751-2800/ab_2752_bill_20040922_history.html (last visited Feb. 21, 2006).


266. H.B. 716, 68th Gen. Assemb., Biennial Sess. (Vt. 2005). If a corporation does require notice of intent to nominate director candidates, this notice cannot exceed the name of the nominating shareholder and the number of shares owned by this shareholder. Id.

267. OLSON & MOLONEY, supra note 9, § 10.12.
A. How Often Have the Proposed Rule Requirements Been Met?

1. One Percent Ownership Threshold for Submission of Proposal

Approximations by the SEC indicate that most companies have at least one shareholder that is eligible to submit a shareholder proposal under Rule 14a-8, one of the proposed rule’s triggers.\textsuperscript{268} Of companies that are listed on a national exchange or quoted on the NASDAQ stock market, the SEC estimates that eighty-four percent have at least one shareholder that has maintained ownership of at least one percent of the outstanding shares for one year.\textsuperscript{269}

2. Five Percent Ownership Threshold for Director Nomination

The SEC indicated “that roughly [forty-two percent] of [companies] have at least one shareholder that can meet this threshold, while roughly [fifty percent] of [companies] have two or more shareholders” who have aggregated ownership of this amount for the appropriate holding period of two years.\textsuperscript{270}

3. Thirty-Five Percent Withhold Vote

Campaigns to withhold votes, often called “vote-no” campaigns, were particularly popular in the 2004 proxy season.\textsuperscript{271} Automatic Data Processing, Inc. (“ADP”), a products and services company that handles recordkeeping, conducted a study of 2836 companies between June 2003 and January 2004 concerning “the number of directors within Russell 3000 companies that had a [thirty-five percent] or greater withhold vote.”\textsuperscript{272} Among Russell 1000 companies, ADP identified forty-six meetings at which at least one director received withhold votes of 35% or more.\textsuperscript{273} Of these forty-six meetings, a total of seventy-six directors received withhold votes of


\textsuperscript{269} Id. at 60,790.

\textsuperscript{270} Silvers & Garland, supra note 15 (manuscript at 14-15).

\textsuperscript{271} OLSON & MOLONEY, supra note 9, § 10.12.


\textsuperscript{273} DALY, supra note 133.

\textsuperscript{274} Id.
35% or more. Among Russell 2000 companies, ADP identified sixty-nine meetings at which at least one director received withhold votes of 35% or more. Of these sixty-nine meetings, a total of 137 directors received withhold votes of 35% or more.

The causes for withhold votes were numerous, "ranging from board independence to the company's failure to implement past majority votes." In several instances, companies implemented governance reforms subsequent to vote-no campaigns.

Several examples illustrate the strength of these campaigns. Shareholders of Federated Department Stores ("Federated") responded to repeatedly ignored majority votes by withholding from director Joseph Neubauer 61% of votes cast at an annual meeting. Votes were withheld also from three other Federated directors that were up for reelection.

The vote-no campaign against Michael Eisner, Chairman and CEO of Walt Disney Company ("Disney"), is described as the "most dramatic" of the proxy season, with 45% of votes being withheld over the issue of board independence. Disney swiftly responded to the withhold vote by replacing Eisner with George Mitchell.

275. Id.
276. Id.
277. Id. Despite appearances, these numbers constitute relatively few of the thousands of director elections that proxy season. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 5.
278. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 6.
279. OLSON & MOLONEY, supra note 9, § 10.12.
280. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 6. The company ignored declassification proposals that had received majority votes for five years, maintaining "that a classified Board provides for continuity and stability and enhances the Board's ability to implement its long-term strategy and to focus on long-term performance." Id. at 9 (internal quotation omitted).
281. Phyllis Plitch, Tracking the Numbers / What's Hot... and Not: Despite Disney, Proxy Wars Were Few, WALL ST. J., Dec. 13, 2004, at C3. A "vote-no" campaign was not organized by either shareholders or a proxy advisory service in this case. Brownstein & Kirman, supra note 234, at 51. Commentators theorized that the high withhold vote which resulted in the Federated annual meeting was a consequence of "the absence of an organized 'Vote No' campaign," which in turn led to the absence of a counter-campaign by management. Id.
282. Brownstein & Kirman, supra note 234, at 51. These withhold votes were also the result of Federated's failure to respond to majority votes. Id.
283. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 24.
284. The forty-five percent withhold vote is a revision of the previously calculated forty-two percent withhold vote. Id. at 5.
286. OLSON & MOLONEY, supra note 9, § 10.12.
The vote-no campaign against Coca-Cola audit committee member Warren Buffett was well publicized, but resulted in a withhold vote of between 10 and 20% over the issue of audit committee independence.\textsuperscript{287}

At Safeway, shareholders accused the board of participating in transactions with third parties with whom it was affiliated, leading to conflicts of interest that benefited directors.\textsuperscript{288} Arguing that the charges were "politically motivated," Safeway demonstrated the company's unyielding position with an extended labor dispute.\textsuperscript{289} The very public vote-no campaign produced a withhold vote of 17% against Chairman and CEO Steve Burd.\textsuperscript{290} As a result, the company announced "major corporate governance enhancements" to strengthen board independence and execute all investor proposals receiving a majority vote.\textsuperscript{291}

The AFL-CIO, Communications Workers of America, and the International Brotherhood of Electrical Workers announced a vote-no campaign against Comcast CEO Brian Roberts and director S. Decker Anstrom at the company's annual meeting.\textsuperscript{292} The labor groups criticized Roberts for sitting on both the nominating committee and the board of directors, and accused Anstrom of conflicts of interest.\textsuperscript{293} The board of directors of Comcast inserted a motion on the company's proxy requesting that shareholders vote to amend the articles of incorporation to ensure that Roberts may resign from the nominating committee, the nomination process is reformed so that it requires the approval of all board members, and the committee consequently becomes wholly independent.\textsuperscript{294} Shareholders voted to re-elect both Roberts and Anstrom, with both receiving the support of more than 90% of votes cast.\textsuperscript{295}

A few companies commenced reforms without facing vote-no campaigns.\textsuperscript{296} Boise Cascade and General Electric Company both elected to establish independent lead directors.\textsuperscript{297} Praxair Inc. requested shareholders approve a replacement for the anti-takeover measure that the board had

\textsuperscript{287} INSTITUTIONAL SHAREHOLDER SERVICES, \textit{supra} note 26, at 6.
\textsuperscript{288} \textit{Id.} at 26.
\textsuperscript{289} \textit{Id.}
\textsuperscript{290} \textit{Id.}
\textsuperscript{291} OLSON \& MOLONEY, \textit{supra} note 9, \$ 10.12.
\textsuperscript{292} INSTITUTIONAL SHAREHOLDER SERVICES, \textit{supra} note 26, at 25.
\textsuperscript{293} \textit{Id.}
\textsuperscript{294} \textit{Id.}
\textsuperscript{295} \textit{Id.}
\textsuperscript{296} \textit{Id.} at 5.
\textsuperscript{297} OLSON \& MOLONEY, \textit{supra} note 9, \$ 10.12.
terminated, which resulted in the proposal winning the support of 77.5% of the votes cast. 298

B. Decreased Number of Proxy Fights in 2004

A decrease in the number of shareholder proposals, 299 together with an increase in voluntary action on behalf of the company, was a noticeable pattern during the 2004 proxy season. 300 Shareholders withdrew their proposals to declassify particular corporations' boards when at least fifty companies voluntarily proposed to do the same. 301 Merck & Co. took such an action after shareholder proposals to declassify its board, on the corporate proxy for five years, finally received a majority vote from shareholders. 302 Shareholder proposals regarding board declassification at Lucent Technologies received the corporation's attention after the proposals garnered majority support for the past three years. 303

Shareholder proposals that requested investors be afforded the opportunity to nominate directors received mixed support from corporations. 304

In February 2004, a shareholder proposal at Qwest Communications sought to provide proxy access for particular shareholder-nominated candidates for director. 305 Qwest sought counsel from the SEC, and the SEC ruled "that Qwest could not omit the proposal under Rule 14a-8(i)(8)." 306 Later, the SEC reconsidered its position and issued Qwest a no-action letter, stating that it would not recommend enforcement action if the company

298. Id. (internal citation omitted).
299. The 2004 proxy season was characterized by an increase in communication between shareholders and corporations. INSTITUTIONAL SHAREHOLDER SERVICES, supra note 26, at 3. "Satisfied that their concerns were being [addressed,] shareholders withdrew a number of proposals." Id.
300. OLSON & MOLONEY, supra note 9, § 10.12.
301. Id. (internal citations omitted).
302. Id. (internal citations omitted).
303. Id. (internal citations omitted).
304. The refusal of some companies, such as Qwest and Disney, to implement shareholder access proposals is consistent with opponents' arguments that the SEC has no legal authority to implement such a proposal. See Solomon, supra note 17. These actions are indicative of the strong opposition to passage that the proposed rule faces among corporations. SUMMARY OF COMMENTS, supra note 54. Despite this opposition, some companies are acting in favor of the proposed rule, such as Marsh & McLellan. Solomon & Lublin, supra note 5. These corporations' decisions are significant because they are examples of the recent trend among corporations to adopt versions of the proposed rule, even in the absence of the rule's passage and a legal requirement to do so. See OLSON & MOLONEY, supra note 9, § 10.12; see also Plitch, supra note 42 (providing examples of corporations that have adopted shareholder access proposals as part of a shareholder litigation settlement: Ashland Inc., MCI Inc., and Hanover Compressor Co.).
305. OLSON & MOLONEY, supra note 9, § 10.12.
306. Id.
omitted the proposal from its proxy materials. Its reassessment was based on an examination of the company's view, which it ultimately supported, "that it may exclude the proposal where the proposal's definition of 'qualified shareholder' differs from the [shareholder] eligibility standard" of the proposed rule.

Four pension funds, among them AFSCME, with a combined holding of 1.3 percent in Marsh & McLellan, presented a proposal to its board requesting that they be permitted to nominate its directors. In March 2004, the company agreed to nominate a former federal prosecutor recruited by the pension fund group. Subsequently, the institutional investors agreed to drop their proposal. Richard Ferlauto, a pension fund official, said that the pending SEC rule "is what brought the company to the table."

The Division reversed a decision it made in December 2004, allowing Walt Disney Company ("Disney") to omit from its proxy a resolution adopted at an annual meeting that allowed shareholders to nominate board of director candidates. Originally, the Division told Disney to include the proposal on the ballot. This decision was considered a success for shareholder activists, since the SEC normally sides with management in such cases. After Disney appealed the Division's decision to the SEC's five commissioners, the Division reversed its pronouncement and stated it

307. Id.
308. Id. (internal citation omitted).
309. Solomon & Lublin, supra note 5.
310. Id.
311. Id.
312. Id.
315. This proposal was greatly influenced by shareholders' frustration with Disney's Chairman and CEO Michael Eisner. Verrier & Peterson, supra note 314. At a shareholders' annual meeting in March 2004, Eisner received a forty-five percent withhold vote from shareholders. Id. He was stripped of his title as Chairman, and soon resigned. Id. Although shareholders were pleased by the affirmative action Disney took with regard to Eisner, they were aggravated by the fact that the board rejected three people shareholders had recommended for director candidates. Id.
316. Id. "The staff has said for a long time that these types of proposals... don't have to be included," said an SEC staff member. Id. In this instance, however, the SEC was influenced by the proposed rule. Id.
would not seek enforcement should Disney exclude the proposal from its proxy materials.\textsuperscript{317} While the Division declined to be more specific about why its staff reversed its decision,\textsuperscript{318} the staff may have been concerned that the proposal did not resemble the proposed rule closely enough.\textsuperscript{319} Four pension funds have asked the SEC to reconsider its position.\textsuperscript{320}

VII. POINTS OF CONTROVERSY

A significant majority of commentators supported the proposed rules.\textsuperscript{321} The exceptions were corporations, corporate executives, corporate directors, law firms, attorneys, and most business associations.\textsuperscript{322} Some investors were critical of the rule if they believed it did not go far enough in addressing current corporate governance complaints.\textsuperscript{323}

\begin{itemize}
\item \textsuperscript{317} Orwall & Solomon, \textit{supra} note 313.
\item \textsuperscript{318} \textit{Id.}
\item \textsuperscript{319} \textit{Id.}
\item \textsuperscript{320} Walt Disney Co.: Public Pension Funds Ask SEC To Revisit Disney Proxy Opinion, WALL ST. J., Dec. 30, 2004, at B2. Richard Ferlauto, AFSCME’s director of pension investment policy, said that AFSCME was disappointed but will continue to pursue change. Orwall & Solomon, \textit{supra} note 313. “If any company was deserving of proxy access coming out of the 2004 proxy season,” Mr. Ferlauto said, “it was Disney, and they’re off the hook.” \textit{Id.}
\item \textsuperscript{321} The SEC received comments from more than 16,000 people and organizations, which is the largest response to a proposed rule it has ever received. \textit{CONGRESS WATCH, supra} note 1, at 10. Most of the commentators favored the proposed rule. \textit{Id.} (citing Carrie Johnson, \textit{SEC Chairman Under Pressure on Proxy Plan}, WASH. POST, June 8, 2004; Joseph McCafferty, \textit{Proposed SEC Rules on ‘Proxy Access’ Generated the Most Comment Letters Ever Received by the Commission}, June 22, 2004, http://www.CFO.com). The majority of commentators most likely approved of the proposed rule because of the effect that the recent accounting scandals have had on investor confidence. Solomon & Lublin, \textit{supra} note 5; see also Assemb. J. Res. 79, 2004 Gen. Assemb., Reg. Sess. (Cal. 2004). Investors believe that the only way to improve corporate accountability is to reform the proxy process. \textit{See OLSON & MOLONEY, supra} note 9, § 10.13.
\item \textsuperscript{322} \textit{SUMMARY OF COMMENTS, supra} note 54. Opponents, such as corporations, corporate executives, and corporate directors, are most likely threatened by the proposed rule because it would allow shareholders to circumvent their power in limited circumstances. \textit{See Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act No. 26,206, 68 Fed. Reg. 60,784, 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). In addition, shareholders would be able to hold corporate directors accountable for the failures of the corporation by withholding votes for their re-election. \textit{See, e.g., Marr, supra} note 285 (describing 2004’s withhold vote against Disney CEO Michael Eisner). These reasons are strong factors in the disagreement between proponents and opponents of the proposed rule: while shareholders would receive power in limited circumstances by being allowed to place their director nominees on a corporate ballot, corporate directors would lose power by no longer controlling the nomination process. \textit{See Security Holder Director Nominations, 68 Fed. Reg. at 60,784.}
\item \textsuperscript{323} Solomon, \textit{supra} note 17. Some commentators believe that the proposed rule is too limiting, and that a withhold vote trigger of twenty percent is more appropriate than one of thirty-five percent: a twenty percent trigger, it is argued, “is still a very high withhold level in terms of historic results of ‘vote no’ campaigns, but it is a level of withholds that has been achieved in a handful of cases.” Silvers & Garland, \textit{supra} note 15 (manuscript at 17).
\end{itemize}
A. SEC Has No Legal Authority To Promulgate Rules Governing Shareholder Access To the Issuer’s Proxy Materials

Opponents argue that the SEC has no legal authority to promulgate the proposed rule, since it is a matter of corporate governance and is a topic traditionally reserved for the states. Corporate governance has customarily been left to the states because state law is the creator of the fiduciary duties the board of directors owes the corporation’s shareholders. Consequently, the board of directors has the unique role of designating director candidates because its discretion is limited by its fiduciary duties to the company and its shareholders, while shareholders may nominate director candidates for self-serving reasons.

According to these opinions, the SEC does not cite any statutory provisions that authorize it to regulate corporate governance. Commissioner Paul Atkins has presented this argument as well, asking “[w]hat authority does the SEC have to regulate the nomination and selection of corporate directors in this way?” Stephen Bokat, the U.S. Chamber of Commerce’s general counsel, argued the proposed rule is “an overreaction” on the part of the SEC. He continued, “Our concern is that they’re going far beyond what they have authority to do and what the statute in these rule makings provides.” Opponents fear the passage of the proposed rule would make federal intrusion into and control over the operation of state-chartered companies acceptable.

In response to this argument, it is necessary to emphasize that “Section 14(a) authorizes the [SEC] to prescribe proxy solicitation rules that are ‘necessary or appropriate in the public interest or for the protection of..."
investors." Management and boards are often loyal to each other and not to shareholders, as evidenced by the implementation of resolutions that protect their interests over shareholders’ wishes. Board narrow-mindedness remains common. Therefore, the best method of avoiding another scandal like Enron and ensuring proper corporate governance is to implement an “open market for corporate control.”

Former Chairman Donaldson commented that the proposed rule, by “[m]aking it easier for dissatisfied shareholders to nominate [director] candidates,” will help stop corporate fraud and provoke executives to act in shareholders’ interests. As such, the goals of Section 14(a) are realized. Although the proposed rule intrudes upon an area that has customarily been reserved for states, the SEC expressly states that the shareholder access rule will not apply to those states in which it is prohibited.

B. Scandal Is Not the Norm

Opponents argue further that corporate fraud and dishonesty is not characteristic of the vast majority of corporate managers, despite the hugely publicized scandals in recent history. By and large, managers and boards are dedicated to their shareholders and are incredibly motivated to work towards the success of their corporations.

Despite this claim, revelations of corporate fraud continue. University of Texas securities law professor Henry Hu stated that “[e]xecutives who are trying to roll back some of these reforms are going to end up looking somewhat premature.” Even with the additional restrictions provided by the proposed rule, the degree of reform “would not be disproportionate to the magnitude” of the alleged abuses.

334. Id.
335. Id.
336. Solomon & Lublin, supra note 5.
339. Id.
341. Id.
342. Bebchuk, supra note 8, at 60.
C. Potential Costs of the Rule Outweigh Its Benefits

Opponents claim that the direct costs of the rule, which include increased proxy disclosure, services of outside professionals, and expenditures of an election contest, are far greater than the potential benefits. Shareholders, too, would be forced to expend costly resources in order to prepare and file the appropriate certifications for submitting a candidate for nomination.

In making this argument, opponents underestimate the potential benefits of the proposed rule. Its adoption would 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. The presence of triggering events may improve the responsiveness of boards to security holders' requests. The benefits of the passage of the proposed rule “should not be measured by the number of shareholder-nominated directors that would be elected,” but by “the effect that shareholders' greater power would have on the incentives of directors and nominating committees.”

D. Risk of an Influx of Special Interest Directors

 Opponents maintain that special interest groups are likely to be most active in seeking to nominate director candidates if the proposed rule is adopted. For instance, labor unions may threaten to trigger the shareholder nominating procedure as a component in their collective bargaining strategy or to gain power over boards in order to press forward.
certain objectives.\textsuperscript{350} Political pressures may prejudice public pension funds.\textsuperscript{351} Furthermore, taking into account that "the primary point of these proposals is to make running an election contest far easier than it is today, it is inevitable that if the proposals are adopted, the rate at which dissident and special interest directors are nominated and elected will be far greater than it is today."\textsuperscript{352} If such a "special interest" candidate is elected, then that shareholder nominee will advocate a particular policy objective over the well being of the corporation.\textsuperscript{353}

Despite these fears, proponents of the proposed rule argue that most institutional investors cannot be expected to initiate their own slate of directors because money managers are "reluctant activists."\textsuperscript{354} Institutional investors concentrate on security trading and portfolio management; they are unlikely to spend valuable management time focusing on one corporation's dubious corporate governance practices, especially since doing so might expose the institutional investors to the risk of company retaliation or litigation.\textsuperscript{355} In addition, private money managers tend to vote against company management only in cases of a takeover when it appears that management is acting in its own self-interest; past voting patterns suggest that private money managers vote with management when social issues are on the ballot.\textsuperscript{356} This precedent signifies that, "although shareholder access would not lead to the election of shareholder-nominated directors who run on a social agenda or represent special interests, it would occasionally lead to the election of such directors when incumbents' performance is especially poor and the election of these directors" promises increased shareholder value.\textsuperscript{357}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{350} Id. at 78. If institutional investors represent special interest groups, these investors will have the ability to activate the triggering events because of their large holdings, and will eagerly do so. See Evely Y. Davis, Do the Right Thing, Mr. Donaldson, WALL ST. J., July 27, 2004, at B2. However, even if the proposed rule is adopted and it is triggered, shareholder-nominated candidates must be elected by a majority of shareholders, which will ensure that a great deal of investors support the nominee and believe that the nominee’s qualifications will serve as a valuable asset to the corporation. See Burns, supra note 56.
\item \textsuperscript{351} Lipton & Rosenblum, supra note 16, at 78.
\item \textsuperscript{352} Id. at 83.
\item \textsuperscript{353} DETAILED COMMENTS OF BRT, supra note 35, at 40. "There are lots of special interests that will try to use the rule as leverage to further their own agenda," says Stephen Odland, chief executive of AutoZone, Inc. "That will divert attention from serving the interests of all shareholders." Solomon & Lublin, supra note 5.
\item \textsuperscript{354} Bebchuk, supra note 8, at 50 (quoting Robert C. Pozen, Institutional Investors: Reluctant Activists, HARV. BUS. REV., Jan.-Feb. 1994, at 140, 140).
\item \textsuperscript{355} Id.
\item \textsuperscript{356} Id.
\item \textsuperscript{357} Id.
\end{itemize}
\end{footnotesize}
E. Triggers Will be Used Frequently

Challengers of the proposed rule assert that if the proposed rule is adopted, the triggers will be activated far more often than the SEC anticipates and the triggering party may have incentives irrelevant to the proxy process or the corporate candidate. As such, the triggers will be a defective indicator of a corporation's responsiveness to shareholders, and in conflict with the SEC's objectives in the proposed rule's passage.

In reality, the shareholder nomination procedure, if adopted, would be used very rarely. Institutional investors, such as union and state pension funds, own such a minor portion of the vast majority of corporations that their holdings are unlikely to influence a shareholder vote, much less guarantee the enactment of a shareholder access proposal. Consequently, no evidence suggests that proxy wars will become frequent after the passage of the proposed rule; rather, election contests will take place in the few companies where shareholder dissatisfaction was widespread enough to result in a considerable withhold vote, or majority support on a shareholder proposal for access.

358. DETAILED COMMENTS OF BRT, supra note 35, at 40. The SEC anticipates that the triggers will be activated only in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process. Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

359. DETAILED COMMENTS OF BRT, supra note 35, at 35. In support, opponents have claimed that proponents of the proposed rule have "practically acknowledged" that they would activate the triggers if they saw an opportunity to advance their own special interests, even if they are unrelated to the interests of the corporation as a whole. Id. at 31. Such special interests may include political pressures or, for labor unions, union-related objectives. Lipton & Rosenblum, supra note 16, at 78. For example, Sean Harrigan, former president of CalPERS, was criticized for using his high rank at CalPERS to support the cause of a union, of which he was a senior executive, while it was in the midst of a labor strike against Safeway, Inc. Jim Carlton & Jonathan Weil, Moving the Market: Ouster isn't Expected to Alter Calpers Policy, WALL ST. J., Dec. 2, 2004, at C3. In addition, a seat on the CalPERS board is viewed as an excellent starting point for a person "seeking to run for state political office." Editorial, Canned at Calpers, WALL ST. J., Dec. 2, 2004, at A12.


361. THECORPORATECOUNSEL.NET, supra note 27 (quoting Beth Young, Senior Research Analyst, TheCorporateLibrary.com and Corporate Governance Consultant).


363. Bebchuk, supra note 8, at 52.
F. Creation of an Adversarial Relationship Between Directors and Shareholders

Opponents claim that the proposed rule threatens to lead to confrontation, rather than cooperation, between shareholders and incumbent boards.\(^{364}\) Its passage would have the effect of uniting a corporation’s directors and managers in a “defensive alliance” against shareholders, the perceived threat.\(^{365}\) An adversarial relationship between the groups will not lead to more effective corporate governance.\(^{366}\)

This argument may be well founded, but it is time to provide the corporate investor with a means to fairly and democratically affect ballots.\(^{367}\) California State Treasurer Philip Angelides remarked that “[n]o boards of directors or management should have a fear of directors being elected to the board that get a majority of shareholder votes.”\(^{368}\)

G. Risk of Balkanized and Dysfunctional Boards

Challengers claim that this new nomination opportunity and the selection of shareholder-nominated directors could divide the board of directors into two factions: (1) those nominated by the corporate nominating committee in order to represent all shareholders; and (2) those placed by—and more loyal to—particular shareholder interest groups, such as pension funds or labor unions.\(^{369}\) This “balkanization” will prevent the board from operating productively and collegially as a group.\(^{370}\) In order for the board to perform its duties effectively, the corporation’s directors must mutually respect and trust one another.

[I]t is simply human nature for an executive to respond differently in a relationship of mutual respect than in an adversarial relationship. In the latter situation, the information will be formulated and packaged more defensively and more formally in an

\(^{364}\) Grundfest, supra note 55 (manuscript at 3).
\(^{366}\) Grundfest, supra note 55 (manuscript at 3).
\(^{368}\) Carpenter & McTague, supra note 14, at 948.
\(^{369}\) Olson & Adams, supra note 37, at 440.
\(^{370}\) Id. at 423. As a result of this balkanization, U.S. Chamber of Commerce Senior Vice President David Hirschmann said that the proposal “is not good governance and will have unintended consequences that will stifle business innovation, decrease productivity and inhibit economic growth.” U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule, supra note 53.
effort to fend off the perceived possibility that it will be used to attack management rather than to assist them. Second, executives are far more likely to listen to advice from directors they respect and trust than from directors they view as adversaries . . . . Third, it is far more likely that the directors themselves will be able to work with each other to assist corporate decision-making if they respect and trust one another. In this environment, directors will feel comfortable discussing and debating the merits of business decisions, opportunities, and corporate policy and direction. In an environment where the directors are divided into warring factions, this kind of open discussion and debate simply does not take place. 371

These arguments are based on the perception “that collegiality among directors should be preserved regardless of the consequences to the corporation and its shareholders.” 372 A friendly and effective working relationship between directors is important, but a board’s most important function is to be a successful supervisor of management. 373 The public would be much better off today if the boards of Enron and WorldCom had been “less collegial and more willing to challenge their CEOs with uncomfortable questions . . . . Directors must be willing to challenge management to ensure that management’s business strategy is in the long-term interests of the corporation and its shareholders, and that management is effectively executing that strategy and managing risk.” 374

H. Risk of Deterring the Most Skilled Men and Women from Serving on Public Company Boards

According to opponents, an increase in the incidence of election contests—a natural consequence of the passage of the proposed rule—will intensify the struggles that have already arisen 375 in attracting and retaining

---

372. Silvers & Garland, supra note 15 (manuscript at 7).
373. Id.
374. Id. An example of such a challenge would be directors denying demands for excessive compensation by CEOs, who are also board members. Id.
375. The problems related to being a director in a publicly held corporation are numerous. Lipton & Rosenblum, supra note 16, at 86. The prestige of being a director has been tarnished by corporate scandals. Id. The corporate governance reforms that have been implemented recently require the board of directors to comply with a number of procedures that require both money and time. Id. In addition, recent court decisions have placed an additional burden on directors: perceived increased liability for wrongs committed against shareholders. See id.
talented directors in publicly held corporations.\textsuperscript{376} These potential directors, who are generally not in need of the position because of their previous successes,\textsuperscript{377} will not want to participate in an election contest.\textsuperscript{378}

Although this argument may have merit, it is too rash to say that shareholder access to the proxy ballot will diminish the appeal of holding the title of director, a position that is both prestigious and well-paid.\textsuperscript{379} Even with shareholder access to the nomination procedures, directors would face a relatively small likelihood of removal.\textsuperscript{380} If evidence suggested that shareholder participation discouraged qualified individuals from seeking these positions, shareholders can counteract this consequence by offering directors greater compensation.\textsuperscript{381}

In addition, newly elected directors having a greater commitment to shareholders than to other directors would "psychologically make an enormous difference," said Harvard Law School Professor Reinier Kraakman.\textsuperscript{382} "You would have a much better motivated and more able cadre of directors."\textsuperscript{383} Improving the selection and incentives for directors would positively affect corporate value.\textsuperscript{384}

\textit{I. Investors Are Not Well Suited to Nominate}

Opponents to the proposed rule claim that investors are not well suited to nominate director candidates for three reasons: (1) this function is not the expertise of institutional investors; (2) institutional investors have their own corporate governance problems; and (3) institutional investors do not adequately reflect the needs of the shareholders.

By investing in a company, shareholders have also invested in the skills of the existing directors, who are entrusted with making decisions that reflect the best interests of the corporation and its shareholders.\textsuperscript{385} Institutional investors are skilled in money management and financial

\textsuperscript{376} Id.
\textsuperscript{377} Id.
\textsuperscript{378} DETAILED COMMENTS OF BRT, supra note 35, at 43.
\textsuperscript{379} Bebchuk, supra note 8, at 54. Recent evidence would suggest that the threat of the proposed rule is not having the effect of repelling candidates. Martin Dunn, deputy director of the Division of Corporation Finance, stated that out of the 150 proxy statements he's analyzed, less than five percent of directors were not seeking election. Atkins, supra note 367.
\textsuperscript{380} Bebchuk, supra note 8, at 54.
\textsuperscript{381} Id.
\textsuperscript{383} Id.
\textsuperscript{384} Bebchuk, supra note 8, at 53.
\textsuperscript{385} DETAILED COMMENTS OF BRT, supra note 35, at 25.
analysis; directors, on the other hand, are trained to analyze how best to manage the business operations of the corporation.\textsuperscript{386}

Institutional investors have been criticized for advocating causes that are not directly related to the objective of striving for optimum investment returns.\textsuperscript{387} CalPERS, for example, has been criticized for interfering with issues that have ambiguous relationships with increasing shareholder returns,\textsuperscript{388} such as political\textsuperscript{389} and labor-union matters.\textsuperscript{390} TIAA-CREF is involved in a corporate governance scandal, prompted by two trustees’ improper business deal\textsuperscript{391} with outside auditor Ernst & Young LLP (“Ernst & Young”).\textsuperscript{392} Although “[c]orporate-governance activists long have pushed for companies to disclose any significant bad news as early and widely as possible,\textsuperscript{393} these trustees did not disclose their relationship with the auditor on their officer-and-trustee questionnaires for 2003 or 2004, which contained questions about whether either had an affiliation with Ernst & Young.\textsuperscript{394}

Shareholder activist Evelyn Davis\textsuperscript{395} claims that the adoption of the proposed rule would “disenfranchise” smaller shareholders.\textsuperscript{396} She argues

\begin{itemize}
  \item \textsuperscript{386} Lipton & Rosenblum, supra note 16, at 77.
  \item \textsuperscript{387} Weil & Lublin, supra note 107.
  \item \textsuperscript{388} CalPERS board member and California state treasurer Philip Angelides made a public statement on behalf of CalPERS requesting that the directors of CACI International, Inc. (“CACI”), the site of the Abu Ghraib prison scandal investigation, “to ‘get out of denial and hold company executives accountable for any misconduct that has hurt both shareholders and the country.'” Id. CACI rejected Mr. Angelides’s politically-motivated statement, stating that its shareholders are not hurt because its stock price has risen by fifty percent in the past few months. Id.
  \item \textsuperscript{389} Former CalPERS president John Harrigan has been accused of using his position in order to support the cause of a strike by a union in which he is a senior executive. Carlton & Weil, supra note 359.
  \item \textsuperscript{390} Id.
  \item \textsuperscript{392} Weil & Lublin, supra note 391.
  \item \textsuperscript{393} Id.
  \item \textsuperscript{394} Id.
  \item \textsuperscript{395} Ms. Davis claims to be the “First Lady of Corporate Governance.” Plitch, supra note 265, para. 6. Ms. Davis appears to be the only opponent to the proposed rule who is not affiliated with a corporation. See SUMMARY OF COMMENTS, supra note 54.
  \item \textsuperscript{396} Plitch, supra note 265. “One cannot disenfranchise [ninety-five percent] of the shareholders to benefit [five percent] of large institutional shareholders who wish to have their special interests represented on Boards.” Id.
\end{itemize}
that most institutional investors are short-term traders interested in selling stock quickly in order to obtain a profit. Furthermore, an institutional investor is not necessarily more representative of the interests of smaller shareholders than the board of directors, who owe state-imposed fiduciary duties to all investors.

In boardrooms today, directors feel a "divine right to continue on the Board without anybody challenging that assumption." For years, directors handpicked their fellow board members and their successors, often in exchange for receiving invitations to serve on other companies' boards. These directors often choose people who would not oppose their practices. "Re-evaluating the way new directors are chosen is 'a rather key component of corporate-governance reform.'" Although institutional investors may have their own difficulties, the accusations they face are no different from the accusations against boards of directors. Institutional investors’ fortunes are much more closely tied to the fortunes of other shareholders, as both depend on the performance of the corporation in which they invest. Directors, on the other hand, are often compensated regardless of corporation performance.

J. Companies Are Sufficiently Responsive to Shareholders

Opponents of the proposed rule argue that companies themselves are already correcting the corporate governance flaws that provide the opportunity for corporate fraud. Companies have engaged in conduct that has led to significant improvements in boardrooms. A study conducted in July 2003 shows the results of such improvements:

397. Id. Under the current proposal, nominating shareholders are required to have held their stock for one year. This may encourage institutional investors to buy stock for the purpose of placing a candidate on the proxy statement, instead of investing in the long-term growth of the company. Davis, supra note 350.


399. THECORPORATECOUNSEL.NET, supra note 27 (quoting Richard Koppes, Of Counsel, Jones Day).


401. Id.

402. Id. (quoting Richard Koppes, Of Counsel at Jones Day).

403. See Lipton & Rosenblum, supra note 16, at 81-82. Because institutional investors have come to hold large blocks of shares, directors and managers are more "sensitive" and "responsive" to these investors' views. Id. This responsiveness is due to the fact that if these institutional investors were frustrated enough with a corporation to drop its shares, the sale would lead to a dramatic decline in the corporation's stock price. Interview, supra note 28.

directors of eight in ten companies were no less than 75% independent; (2) the outside directors of 97% of companies meet once a year at a minimum; (3) while only 44% of companies evaluated their directors in 2002, over 70% of companies did so in 2003; (4) 55% of companies had an independent chairman or outside director; (5) 90% of companies promoted, necessitated, or operated director education programs; and (6) the nominating committees of 67% of companies operated a process which facilitated communication with shareholders.405

These steps reflect great improvements made to correct the flaws of poor corporate governance, but shareholders, as owners of corporations, must be provided a means of ensuring that directors will continue to perform their duties correctly.406 The proposed rule will operate as such a means of checks and balances, and will enable investors to better understand and evaluate the performance of the board. Former SEC Chairman Arthur Levitt Jr. stated, “To foster greater accountability, the SEC also should pass its current proposal to open up proxy access to shareholders and make directors accountable for their actions. The SEC proposal . . . would prevent a free-for-all of board nominations and management chaos.”407 The current corporate governance environment needs “a little bit of a tweak to the system to raise the level of accountability of directors, of individuals, to shareholders.”408 Increased shareholder participation in the nomination process is the most effective way to achieve this goal.409

K. Recently Enacted Corporate Governance Rules Must Be Given Time To Be Effective

Those who oppose the proposed rule contend that the Sarbanes-Oxley Act of 2002 and the NYSE and NASDAQ corporate governance listing standards have not been allowed sufficient time to be effectively evaluated; they should be given the opportunity to be implemented before the SEC enacts new rules.410 It is possible that the proposed rule attempts to correct corporate governance concerns that have already been addressed by other

405. Id.
406. Interview, supra note 28.
408. THECORPORATECOUNSEL.NET, supra note 27 (quoting Ted White, Director of Corporate Governance, CalPERS).
409. Id.
410. Garris et al., supra note 24, at 26. The two Republican SEC Commissioners, Mr. Paul Atkins and Ms. Cynthia Glassman, support this view. Solomon, supra note 17.
means.\textsuperscript{411} In addition, the increased concentration of institutional investor ownership in public companies has resulted in enhanced shareholder communications with boards.\textsuperscript{412}

Although the recently adopted corporate governance rules provide a means of policing fraud, those measures are "not enough," states former Chairman Donaldson.\textsuperscript{413} These reforms cannot ensure that directors will act independently, be responsive to shareholder concerns and contribute to develop the long-term value of the corporation.\textsuperscript{414} "Given the current incumbent-controlled election process, shareholders have no . . . effective means of holding directors accountable for failing" to perform their responsibilities for which they were hired.\textsuperscript{415} By allowing shareholders the opportunity to nominate directors in limited circumstances, the proposed rule will encourage directors to act more in accordance with the standards set forth by regulating bodies, and will lessen investors' reliance on regulatory supervision to provide relief for wrongs committed.\textsuperscript{416}

In addition, a majority of commentators acknowledged the importance of the Sarbanes-Oxley Act of 2002 and the stock exchanges' amendments to listing standards, but preferred the proposed rule as a means of addressing such problems as conflicts of interest and director accountability.\textsuperscript{417}

VIII. WHY HAS THIS PROPOSAL NOT BEEN PASSED?

A. Public Reaction to Delayed Passage

Shareholder groups are beginning to worry about the long delay in the passage of the proposed act.\textsuperscript{418} Ann Yerger, the Council of Institutional

\textsuperscript{411} See Lipton & Rosenblum, supra note 16, at 69. Board members claim that they are responding to the new laws and pressure, putting more effort and time into their job than they previously had. Burns, supra note 6. "Boards are being much more diligent than they ever have before," says Patrick McGurn, senior vice president and special counsel at Institutional Shareholder Services, a proxy-advisory firm. Id.

\textsuperscript{412} Lipton & Rosenblum, supra note 16, at 91.

\textsuperscript{413} Solomon & Lublin, supra note 5. Like SEC Chairman Donaldson, Cato Institute Chairman William Niskanen worries that shareholders and corporations will think that adhering to the regulations set forth in the Sarbanes-Oxley Act will be "enough." Sean Aylmer, Governed by Fear, AUSTL. FIN. REV., Nov. 3, 2003, at 68. In Chairman Niskanen's opinion, "'Sarbanes-Oxley is clearly necessary but it's partly harmful and clearly insufficient' . . . [C]ompanies, investors and bankers will think they are doing enough to meet community corporate governance standards by following the new rules. But they need to do more." Id. (quoting William Niskanen).

\textsuperscript{414} Silvers & Garland, supra note 15 (manuscript at 6-7); see also Aylmer, supra note 413, at 68 (noting that "[w]hat the stock exchange and government has done is accept prescriptions of the corporate reform movement without evidence, and that gives people a false sense of security that something has happened . . . [Sarbanes-Oxley] will have zero effect.").

\textsuperscript{415} Silvers & Garland, supra note 15 (manuscript at 7).

\textsuperscript{416} Id.

\textsuperscript{417} SUMMARY OF COMMENTS, supra note 54.

\textsuperscript{418} Burns, supra note 56.
Investors's Deputy Director, fears that the proposed rule is “going to stall and fall into oblivion,” as such measures have done so many times in the past.\(^{419}\) Statements from SEC staff indicate that Chairman Donaldson was subject to “immense political and industry pressure.”\(^{421}\)

B. Political Pressure

1. Secretary of Treasury John Snow

The SEC has heard objections to the proposed rule from Treasury Secretary John W. Snow.\(^{422}\) Mr. Snow was chairman of the Business Roundtable, an “association of 157 CEOs from the U.S.'s largest corporations”\(^{423}\) and a staunch opponent of shareholder nomination access, from 1994 to 1996.\(^{424}\)

2. U.S. Chamber Of Commerce

The U.S. Chamber of Commerce has urged the SEC to drop the proposed rule.\(^{425}\) "The SEC should reject bad regulations that would allow unions and narrow-interest groups to put special interests ahead of

\(^{419}\) Id. Currently, the proponents of the rule actively seek its passage because they are enraged by the recent corporate crises and the lack of means to hold directors accountable for their actions. Solomon & Lublin, supra note 5. The longer it takes for the proposed rule to be approved by the SEC commissioners, the longer it will be before shareholders are able use the rule to nominate candidates. See Solomon, supra note 17. The SEC may eventually decide that existing rules sufficiently address corporate governance problems. See, e.g., Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274) (describing the events of 1977, during which the SEC decided not to adopt a similar proposed rule because companies were voluntarily creating nominating committees).

\(^{420}\) Burns, supra note 56. The initiatives of 1942, 1977, 1980, and 1992, if proposed, were never adopted by the SEC. STAFF REPORT, supra note 31.

\(^{421}\) Labaton, supra note 58. Mr. Snow may be able to exert extensive political pressure upon the SEC commission if his objections are taken to be those of President Bush's administration. CONGRESS WATCH, supra note 1, at 3.

\(^{422}\) Labaton, supra note 58. The exact objections that Mr. Snow has to the proposed rule were not disclosed. See id. However, it can be inferred that Mr. Snow rejects the proposed rule for reasons similar to other opponents: the SEC has no authority to implement such a rule, and the operation of the proposed rule, if passed, would create chaos in the boardroom. See Solomon & Schroeder, supra note 28.

\(^{423}\) See Solomon & Schroeder, supra note 28.

\(^{424}\) CONGRESS WATCH, supra note 1, at 3-4, 13.

\(^{425}\) U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule, supra note 53.
shareholder interests in the board room," stated Chamber Senior Vice President David Hirschmann.\textsuperscript{426} He continued, "[i]f the [SEC] proceeds with this proposal, we will challenge it in court."\textsuperscript{427}

C. Division Among SEC Commissioners

Although the five SEC commissioners all voted both to propose the rule and to request public comment, the two Republican commissioners expressed "serious concern[]" about the rule's passage.\textsuperscript{428} In the face of this criticism, former Chairman Donaldson, who had previously adamantly backed the original proposal, considered a "watered-down" alternative.\textsuperscript{429} This compromise did not garner support, with the two Democratic commissioners\textsuperscript{430} favoring the original, tougher version of the proposed rule,\textsuperscript{431} and Chairman Donaldson's fellow Republican commissioners opposing even the lenient version.\textsuperscript{432}

Chairman Donaldson's hesitance to move forward with the shareholder access rule infuriated former Commissioner Goldschmid, who declared in an October 2004 speech, "The [SEC's] inaction to this point has made it a safer world for a small minority of lazy, inefficient, grossly overpaid and wrongheaded CEOs. So far, in my view, the worst instincts of the CEO community have triumphed."\textsuperscript{433}

D. Response to Criticism: Alternative Proposals

Former Chairman Donaldson attempted to create "a compromise that would appease the business community" as well as acquire majority support

\textsuperscript{426} Id. (internal quotations omitted). The Chamber believes that special interest directors will weaken corporate boards. Id.

\textsuperscript{427} Id. (internal quotations omitted).

\textsuperscript{428} Solomon, supra note 17. Republican commissioners Paul Atkins and Cynthia Glassman expressed concerns about the SEC's authority to implement the proposed rule and the triggering requirements needed for its activation. Id. Commissioner Glassman stated that a withhold vote trigger of more than fifty percent, as opposed to thirty-five percent, may be more appropriate. Id. Commissioner Atkins would prefer the rule to apply "only to companies with proven problems." Solomon & Lublin, supra note 5.

\textsuperscript{429} Deborah Solomon, Tough Tack of SEC Chief Could Relent, WALL ST. J., Jan. 12, 2005, at Cl.

\textsuperscript{430} The two Democratic commissioners at the time of the rule's proposal were Roel Campos and Harvey Goldschmid. Solomon, supra note 17.

\textsuperscript{431} Democratic Commissioner Harvey Goldschmid stated, "[i]t's critically important that we move ahead with an access approach that has integrity and will be effective." Solomon, supra note 59.

\textsuperscript{432} Id. More lenient versions that the SEC is considering include plans that require a board and shareholders to reach an agreement on a director candidate, or the current proposal with adjusted triggering events. Solomon, Compromise, supra note 61; Solomon, supra note 17.

\textsuperscript{433} CONGRESS WATCH, supra note 1, at 4.
from his fellow commissioners.\textsuperscript{434} He considered an alternative plan that would give nomination committees the option of replacing a director that investors sought to remove through the voting process.\textsuperscript{435} Another option would permit companies to omit the name of the shareholders’ candidate from the proxy ballot if the board and shareholders were able to agree upon a replacement director.\textsuperscript{436} The SEC staff is also discussing the adjustment of the triggering events; for example, increasing the withhold vote trigger from thirty-five percent to fifty percent.\textsuperscript{437}

Present Chairman Cox views the Internet as the ideal means of increasing shareholder participation, whether through exchanging information or waging a proxy fight.\textsuperscript{438} Although companies may not currently use the Internet freely to post shareholder materials,\textsuperscript{439} this may change in the near future as a result of a rule proposed by the SEC on December 8, 2005.\textsuperscript{440} This proposed rule would amend the proxy process by allowing companies and shareholders to post proxy materials online, as long as shareholders receive notice of the availability of materials from the

\begin{flushleft}
\textsuperscript{434} Solomon, supra note 59. Chairman Donaldson was a strong proponent of the rule when it was initially proposed, but backed away in the face of the proposed rule's opposition from business groups. Solomon, supra note 235. In early February 2005, he supported SEC staff in allowing three companies to reject shareholder nomination proposals from proxy materials. Id.

\textsuperscript{435} Solomon, supra note 59. In such an instance, investors would not nominate candidates: the process would remain in the hands of the nominating committee. See id. This compromise would respond to opponents' concerns that investors are not qualified to choose director candidates. See Lipton & Rosenblum, supra note 16, at 67. The SEC's stated objective in proposing the rule would be met because shareholders are still given an opportunity to contribute to the nomination process by targeting a director for removal. See Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

\textsuperscript{436} Solomon, Compromise, supra note 61. This alternative rule is favored by the Business Roundtable, which refers to it as "proposal for cure." Labaton, supra note 58. This compromise would leave the nomination process in the hands of both the board and shareholders. See Solomon, Compromise, supra note 61. It would appease opponents because the board, which is trained to choose qualified director candidates, would contribute to the nomination process. See Lipton & Rosenblum, supra note 16, at 67. The SEC's stated objective in proposing the rule would also be met because shareholders are still given an opportunity to participate in the nomination process by conferring with the board about a replacement director. See Security Holder Director Nominations, 68 Fed. Reg. at 60,784.

\textsuperscript{437} Solomon, Compromise, supra note 61. This compromise will answer opponents' concern that the triggers will be tripped too frequently, as fifty percent is a high threshold. See DETAILED COMMENTS OF BRT, supra note 35, at 27.

\textsuperscript{438} SEC's New Leader Shares His Views On Range of Issues, supra note 61.

\textsuperscript{439} Plitch, supra note 152.

posting party and are able to access these materials at will. While the passage of this proposed rule would make waging a proxy fight a much less burdensome process for shareholders because of the low cost of transmitting information over the Internet, a number of concerns must be addressed before the public is assured that all shareholders have the ability to participate meaningfully in the proxy process so that directors are held accountable for their actions. Notably, it is unclear whether Internet use among shareholders, especially elderly shareholders, is sufficiently widespread so as to allow shareholders to access proxy materials easily. A further concern is whether shareholders may find receiving materials in electronic format more burdensome than receiving the same documents in hard copy.

IX. CONCLUSION

In reality, it is impossible to foresee the consequences of the proposed rule if it were adopted, and "whether [it] will generate benefits in excess of [its] costs." The proposed rule is the first of its kind to be implemented. If the proposed rule is adopted, it can be expected that there will be increased labor and expenses for courts and publicly held corporations. If unexpected, negative consequences arise from its passage, the SEC will use its rule-making authority to manage the problem. If the proposed rule is not adopted, however, institutional investors will continue to be strong and influential figures in corporate governance reform. States are not likely to pass laws similar to the SEC's proposed

441. Id.
442. Plitch, supra note 152.
444. Id. Shareholders would have the burden of downloading and printing out proxy materials that are transmitted electronically. Id. The proposed rule would require a company to provide a paper copy of the proxy materials to a shareholder upon request; however, any other party submitting materials online would not be required to provide requesting shareholders with a paper copy. Id. at 74,599. This may limit the amount of information available to shareholders who do not access or are unable to access the Internet.
445. Grundfest, supra note 55 (manuscript at 6).
446. Id.
447. Interview, supra note 28. Often, the increased litigation will be the result of corporations challenging shareholder-nominated directors by stating that the director does not meet the independence standards required by the rule. Id.
448. Id. Section 14(a) of the Securities Exchange Act of 1934 authorizes the SEC to impose "proxy solicitation rules that are 'necessary or appropriate in the public interest or for the protection of investors.'" BRIEFING PAPER, supra note 14 (quoting 15 U.S.C. 78n(a) (2000)). If the passage of the proposed rule results in a consequence that negatively affects the investors so that they are not adequately protected, the SEC will use its rule-making power granted by Section 14(a) to amend the rule. Interview, supra note 28.
449. Interview, supra note 28.
rule, because state legislatures generally pass laws in favor of corporations.\textsuperscript{450}

At present, the SEC appears split on the rule.\textsuperscript{451} Regardless, the passage of the proposed rule would represent one of the most significant reforms made to the proxy solicitation process.\textsuperscript{452} “The recent corporate governance crisis highlighted the importance of good board performance, and reforming corporate elections would improve the selection of directors and the incentives they face,”\textsuperscript{453} preventing such scandals from occurring in the future.\textsuperscript{454} Since “half of the American population is an owner of securities in one form or another, directly or indirectly,” involving shareholders in the director nomination process, as recommended by the proposed rule, would allow “democracy in corporations.”\textsuperscript{455} This increased democracy would succeed in aligning the interests of the board of directors with the interests of shareholders, and in restoring proper corporate governance to publicly held corporations.

Rose A. Zukin\textsuperscript{456}

\textsuperscript{450} \textit{Id.} States want to encourage companies to form in their jurisdictions. \textit{Id.} States pass laws that are pro-corporation because they want to encourage corporations to incorporate in their jurisdiction, which leads to substantial employment opportunities and economic growth. \textit{Id.} The proposed rule is not pro-corporation, as evidenced by the majority of opponents who are affiliated with corporations. See \textit{SUMMARY OF COMMENTS, supra} note 54.

\textsuperscript{451} OLSON \& MOLONEY, \textit{supra} note 9, § 10.13.

\textsuperscript{452} Id.

\textsuperscript{453} Bebchuk, \textit{supra} note 8, at 44.

\textsuperscript{454} Id.

\textsuperscript{455} Atkins, \textit{supra} note 367 (quoting former Disney director Stanley P. Gold).

\textsuperscript{456} J.D. Candidate, Pepperdine University School of Law, 2006; B.A. in Economics, Brandeis University, 2003. I thank my family for their love, guidance, and inspiration; without their encouragement, this article would not have been possible. Special thanks to Professor Janet Kerr, Michelle Lipton, and James J. Moloney, all mentors, whose enthusiasm for the subject of securities law fuels my own.