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Via e-mail: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth 'street, N.W.
Washington, DC 20549-0609

Attn: Jonathan G. Katz, Secretary

RECEIVED
OCT 24 2003
OFFICE OF THE SECRETARY

Re: Security Holder Director Nominations
(Release No. 34-48626; IC-26206; File No. S7-19-03)

Ladies and Gentlemen:

This letter is submitted in response to the Commission's request for comments on its release captioned "Security Holder Director Nominations," issued October 14, 2003 (the "Release"). The Release seeks comment on a series of rules pursuant to which certain shareholders could, subject to specified conditions, nominate a limited number of candidates for board positions on the corporation's own proxy (the "Proposed Rules").

This letter offers two distinct observations.

The first observation is that proponents of shareholder access have not clearly articulated the situations in which they might seek to exercise the rights that would be created by the Proposed Rules. The Commission and commenters alike must therefore engage in more speculation than might otherwise be necessary as to the potential implications of the Proposed Rules. The quality of the rulemaking process and the ability of all commenters to provide concrete, useful observations regarding the Proposed Rules would be materially advanced if, in accordance with the observations in Part I of this letter, institutional investors and other constituencies likely to avail themselves of the rights created by the Proposed Rules, offered precise examples of situations in which they would seek to nominate directors.

The second observation assumes that the Commission will decide that some form of direct shareholder access to the corporate proxy is desirable. Without urging that shareholder access is or is not socially beneficial, the second observation suggests that there is an alternative and potentially preferable method of providing shareholder access that is based on the advice and consent procedure created by Article II Section **2** of the United States Constitution. As described in Part II of this letter, an advice and consent mechanism may be preferable to the Proposed Rules because it: (1) eliminates the need to define triggering events; **(2)** eliminates the need to define qualified shareholders; **(3)** is not susceptible of the possibility that presently effective or prospectively adopted provisions of state law will create a conflict with the Commission's rules; **(4)** eliminates the possibility that shareholders will use the Commission's rules to promote special interest candidates with no realistic possibility of election; (5) dramatically reduces the probability that shareholders will be able to elect to boards special interest directors who are unable to work with incumbent board members; and **(6)** relies on economic principles of comparative advantage which suggest that institutional investors have an advantage in identifying suboptimal governance relationships but that incumbents have a comparative advantage in remedying those deficiencies, provided that the incumbents accept those deficiencies as material.

I. How Will the Prouosed Rules Be Applied in Practice?

The literature is rife with speculation over how the Proposed Rules will be applied in practice. Some observers express an almost apocalyptic concern that proxies will become littered with special interest candidates who, if elected, will factionalize boards and cause them to become dysfunctional entities. Other observers adopt an almost Panglossian view that because a majority of shareholders can be relied upon not to engage in actions that would harm the enterprise, there is no meaningful cause for concern over the adoption of the Proposed Rules.

Significantly, the institutional investor community has been largely silent as to how it might seek to take advantage of the Proposed Rules if they are adopted. The Commission and commenters alike are therefore forced to engage in an unnecessary degree of speculation regarding the implications of the Proposed Rules. This gap in our understanding is not entirely necessary and could be resolved in part *if* the investor community provided detailed responses to the following questions:

First, is it possible to identify specific directors at specific companies that investors would like to have removed from their current board seats? Who are these directors? At which companies do they serve?

Second, why would investors want to remove these specific directors from their seats? Which objective criteria, if any, would be applied to reach these decisions?

Third, with whom would the investors want to replace the ousted directors? Why would investors prefer these alternative candidates? Identifying specific replacements would again be useful in order to make the nature of the controversy concrete.

Fourth, on what basis would investors believe that the newly constituted board would, as an entity, be superior to the prior board?

It bears emphasis, however, that even if investors provide cogent responses to each of these questions, there can be no assurance that the future will in fact even remotely resemble the path described in these responses. Indeed, investors would,have every incentive to provide only the most high-minded examples of situations in which they would seek to replace directors. Investors would have no incentive to describe situations in which they would be nominating special interest directors with agendas that diverge from traditional shareholder interests, or directors who would likely be viewed as disruptive to the operation of a corporation's board.

Responses to these questions should therefore not be viewed as unbiased predictors of the likely application of the Proposed Rule. Instead, these responses should be viewed as "best case" predictors, and should be interpreted with appropriate caution precisely because of the predictable bias inherent in the responses.

II. An Advice and Consent Mechanism for Providing Shareholder Access

If one assumes that the Commission is committed to providing some form of shareholder access to the corporate proxy, then it may be useful to observe that there exist alternative mechanisms for shareholder access that may be preferable to the mechanisms currently under consideration in the Proposed Rules.

In particular, there is cause to believe that institutional investors have a comparative advantage in identifying suboptimal governance structures, but that incumbent boards have a comparative advantage in rectifying those shortcomings, provided that the incumbents concur that the shortcomings are material. It follows that a desirable governance mechanism would simultaneously allow shareholders to specialize in the area of their comparative advantage (*i.e.*, the identification of governance problems) and boards to specialize in their area of comparative advantage (*i.e.*, the crafting of solutions to identified problems), while forcing boards to take shareholder criticism seriously.

The "advice and consent" procedures defined by Article II Section 2 of the United States Constitution provide a model of functional specialization within the structure of a representative democracy. This "advice and consent" mechanism can be adapted to the corporate context by providing that any director who is elected under state law, notwithstanding the fact that a majority of shareholders withhold authority for that director's election, would suffer a variety of material disabilities imposed under SEC or SRO regulations. For example, the director might not be deemed independent for purposes of listing standards, or might be prohibited from voting on any matter required by SEC or SRO rules. More aggressively, such directors could also be subject to rules that would call into question a corporation's ability to insure or indemnify them for violations of federal securities laws.

Directors are unlikely to be enthusiastic about serving subject to such disabilities. Boards are also unlikely to be enthusiastic about the continued service of such directors. By crafting a series of "cure" provisions that would attach to any such disabilities, the proposed advice and consent mechanism would effectively allow shareholders to use their existing authority to withhold approval as a means of denying consent to the election of directors. Such action would then force negotiations directed at identifying board members satisfactory both to shareholders and to the surviving incumbent directors.

An advice and **consent** mechanism has several clear advantages over the Commission's proposed shareholder access initiatives. An advice and consent mechanism greatly reduces the danger that shareholders will resort to the proxy mechanism as a device for promoting special interest agendas. It also greatly diminishes the dangers of factionalization that can arise from the election of Qissident directors to a board. The proposal also eliminates the need for the Commission to adopt complex and potentially arbitrary rules defining "trigger conditions" and "qualified shareholders," and there is far less risk that the mechanism would be subject to a successful legal challenge.

I attach for you further consideration a draft paper entitled Advice and Consent: An Alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors. That paper describes and analyzes the advice and consent mechanism at substantially greater length, but does not purport to address all issues raised by this alternative technique for expressing shareholder voice.

With best regards,

Sincerely,

Joseph A. Grundfest

Joseph A. Grundfest
The William A. Franke
Professor of Law and Business

Attachment

JAG:smf/SEC Comment Letter 10-22-03/jg03

“Advice and Consent”:
An Alternative Mechanism for Shareholder Participation
in the Nomination and Election of Corporate Directors

Joseph A. Grundfest*
Stanford Law School
Version of September **29,2003**

PRELIMINARY NOTE: This paper is in draft form. It has not been fully footnoted and several arguments will be developed in detail in future revisions. This paper is being shared in its present state to provide background for participants in the Conference on Corporate Elections to be held at Harvard Law School on October **2-3,2003.**

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Research support for .this project was provided by the Roberts Program in Law and Corporate Governance at Stanford Law School.

“Advice and Consent”:
An Alternative Mechanism for Shareholder Participation
in the Nomination and Election of Corporate Directors

Joseph A. Grundfest
Stanford Law School
Version of September **29,2003**

Abstract

There is cause to believe that institutional investors have a comparative advantage in identifying suboptimal governance structures, but that incumbent boards have a comparative advantage in rectifying those shortcomings, provided that the incumbents concur that the shortcomings are material. It follows that a desirable governance mechanism would simultaneously allow shareholders to specialize in the area of their comparative advantage (*i.e.*, the identification of governance problems) and boards to specialize in their area of comparative advantage (*i.e.*, the crafting of solutions to identified problems), while forcing boards to take shareholder criticism seriously. The direct shareholder access proposals under consideration by the SEC lack the significant benefits that can result from such functional specialization.

The “advice and consent” procedure defined by Article II Section **2** of the United States Constitution provides a model of functional specialization within the structure of a representative democracy. This article adapts that “advice and consent” mechanism to the corporate context. Under the proposed mechanism, any director who is elected despite the fact that a majority of shareholders withhold authority for that director’s election would suffer a variety of material disabilities imposed under SEC or SRO regulations. For example, the director might not be deemed independent for purposes of listing standards, and might be prohibited from voting on any matter required by SRO or SEC rules. Such directors could also be subject to rules that would call into question a corporation’s ability to insure or indemnify them for violations of federal securities laws. Directors are unlikely to be enthusiastic about serving subject to such disabilities. Boards are also unlikely to be enthusiastic about the continued service of such directors. The proposed advice and consent mechanism can thereby create significant incentives for boards and shareholders to reach a compromise regarding acceptable board structures and candidates.

An advice and consent mechanism has several clear advantages over the Commission’s proposed shareholder access initiatives. An advice and consent mechanism greatly reduces the danger that shareholders will resort to the proxy mechanism as a device for promoting special interest agendas. It also greatly diminishes the dangers of factionalization that can arise from the election of dissident directors to a board. The proposal also eliminates the need for the Commission to adopt complex and potentially arbitrary rules defining “trigger conditions” and “qualified shareholders,” and there is far less risk that the mechanism would be subject to a successful legal challenge.

"Advice and Consent":
An Alternative Mechanism for Shareholder Participation
in the Nomination and Election of Corporate Directors

Joseph A. Grundfest*
Stanford Law School
Version of September 29,2003

1. Introduction

The principle of comparative advantage is central to modem economic analysis and suggests that societies benefit greatly when they are organized to promote functional specialization. The same principles of comparative advantage, and functional specialization can be expressed in electoral systems. Indeed, one of the many reason to prefer representative democracy to direct democracy is that representative democracy allows for the evolution of a "governing class" that can specialize in decision-making that is necessary for the intelligent exercise of governmental authority.

A key tension in the design of any system of representational government arises from the need to craft a mechanism that balances the power entrusted to the governing class against the danger that this class will come to act in its own self interest, rather than promote the interest of the constituencies they are charged to represent. There is no generally accepted solution to this vexatious problem either in the political sphere or in the corporate realm where it is often described as a form of an "agency problem."

Richard Posner's most recent book, Law, Pragmatism and Democracy,[1] masterfully describes these tensions in the political realm. Posner sets forth an intriguing if incomplete argument for a Schumpeterian form of competition among collectives of representatives, experts, or elites, and the work is described as providing the "beginnings of an economic theory of democracy."[2]

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[1] Richard A. Posner, LAW; PRAGMATISM AND DEMOCRACY (Harvard Univ. **Press,** 2003).

[2] Alan Ryan, ***The Legal Theory of No Legal Theory,*** The New York Times Book Review, Sept. 14,2003, at 20.

Posner's description of the United States' constitutional structure and its historical evolution is intriguing and potentially relevant to the main topic of this article:

> "The founding fathers, Posner says, did not want to set up a democracy but a mixed government. That is in fact what they created – with monarchial elements in the presidency, aristocratic elements in the Senate and Supreme Court, and democratic elements in the lower house. The whole thing was intended to be a balance of interests in a way Cicero said a successful republic must be."[3]

It also follows that:

> "once you have agreed that government is a job for the full-time expert and that "rule by the people" is literally impossible, you need some way in which the ordinary man can stop the elite from walking off with the store. The London mobs used to smash the windows of the rich; universal suffrage serves the some purpose with less damage."[4]

The system of mixed government with its complex web of "checks and balances" described in the United States Constitution contains a provision that can be emulated to great benefit in the current debate over shareholder access to the ballot. Article II Section **2** of the Constitution defines a mechanism for "advice and consent" between the Executive Branch and the Senate that, as a practical matter, preserves for the Executive the initiative in selecting the members ***of*** his own administration, but forces compromise with the Senate in the event that a particular candidate cannot gamer support of a majority of that body. As applied to the operation of the Executive Branch, this mechanism has great merit as an expression of the principle of comparative advantage. The Executive is far better able than either House to determine the identity of appointees who will be able to carry out the Executive's agenda.[5] The fact that the Executive was duly elected does not, however, give him ***carte blanch*** to fill the government with every crony he likes. The need to attain the consent of a majority of the Senate provides a safeguard against that outcome, while still respecting the

[3] ***Id.***
[4] ***Id.***
[5] The same **argument regarding comparative advantage and functional specialization does not apply with equal force to the advice and consent procedure as applied to the judiciary. Instead, in my view, the power to nominate** Article **III judges subject to the advice and consent of the Senate is better modeled as one of the perquisites of office that the electorate knows** it **is granting to the Executive upon election for reasons that are unrelated to the principle of comparative advantage. It is a spoil** of **electoral battle.**

Executive's rational prerogative, rooted in the principle of comparative advantage. Thus, the Senate can never formally select a Secretary of State or a member of the SEC, but a majority of the Senate can, as a practical matter, force a wide range of compromises on Presidential nominations through the exercise of the veto embedded in the "advice and consent" mechanism.[6]

As described in greater detail below, the SEC and the SROs have clear authority to adopt rules and regulations that can operate as a corporate analogue to the "advice and consent" mechanism employed by the Framers. Under the proposed mechanism, the incumbent board would retain authority to nominate directors and the current proxy rules need not be changed at all. However, if a director is elected notwithstanding the opposition **of** a majority of shareholders then the director can be subject to a variety of disabilities under SEC and SRO rules. Those disabilities will give the director an incentive not to serve. They will also give the board an incentive not to want to have that director serve. To fill the slot, the incumbent board would have to find a candidate that would not be opposed by a majority of shareholders.

This mechanism effectively synthesizes an "advice and consent" rule for the election of corporate directors. It allows shareholders to focus on the area of their comparative advantage – the identification of suboptimal directors or board structures – and liberates them from the need to assume responsibilities that they might not discharge as well. It also forces directors to take shareholder views seriously, while preserving for the incumbent board the right to determine the most suitable directors, subject to shareholder approval.

Part 2 of this article describes the operation of the proposed rule. Part 3 describes evidence that shareholders may have a comparative advantage in the identification of suboptimal governance structures, but that incumbents may have comparative advantage in the resolution of identified deficiencies, once the incumbents concede that the deficiencies should be addressed. Part 4 describes the advantages of the proposed rule over the Commission's direct access proposal. Part 5 describes some

[6] The advice and consent provision therefore often forces various forms of "horse-trading" between the Executive and Senate. The Senate might agree to support the President's nominee for Position **A** if the President agrees to nominate a key Senator's favorite for Position B. The pressure of such a strong incentive to compromise is, as explained below, one of the great potential virtues of an advice and consent model as applied to the election of corporate directors.

of the disadvantages of the proposed rules, recognizing that there are no perfect solutions to the problems presented in any governance debate.

2. A Corporate Analogue to Article II's "Advice and Consent" Mechanism

In capsule form, the proposed corporate advice and consent mechanism provides that if a director is elected notwithstanding the fact that a majority of the votes cast are marked to withhold authority for that director's election, then a series of disabilities would attach to that director's service at the SRO and/or SEC levels. The disabilities can be structured so as to provide a strong incentive for any director not to want to serve against the will of the majority of the shareholder base, and for the board not to want any such director to serve. The disabilities could be structured to take effect with a lag. "Cure" mechanisms could also be structured in order to provide an effective opportunity for compromise negotiations among shareholders and incumbent directors. Thus, if the mechanism operates as envisioned, the incumbent board would retain the initiative in identifying potential new directors, just as the Executive retains that initiative under Article II, but the shareholder base can by majority vote block service by any nominee, just as the Senate has that right under Article 11.

This section expands on the potential operation of this mechanism by first describing the state law that permits directors to serve over the objection of a majority of shareholders. It then describes specific disabilities that can attach at the SRO and SEC levels, and explains how delayed effective dates for these disabilities together with "cure" mechanisms can help force compromise among incumbent directors and objecting shareholders. This section concludes with observations regarding situations that can arise if the parties fail to reach a compromise.

2.1 The Election of Directors Notwithstanding Majority Shareholder Opposition

"SEC regulations in effect since 1967 require that the "form of proxy which provides for the election of directors.. .provide... means for security holders to withhold authority to vote for each nominee" even when the nominee stands unopposed for election."' A decision to withhold authority to vote for a nominee on the corporation's own slate "has no legally binding effect.. . . Under Delaware law, if a quorum is present at the shareholder's meeting shareholders elect directors with only "a plurality of the votes of the shares present in person or represented by a proxy at the meeting and entitled to vote on the election of directors." A majority is not necessary. A proxy marked to withhold authority from an incumbent counts for purposes of determining a quorum but does not count against the nominee. Therefore, even if the overwhelming majority of shareholders withhold authority from management's unopposed slate, those unopposed nominees will still successfully gain a plurality of the votes cast as long as a small minority of shareholders supports management's nominees."[8]

The central point that bears emphasis for present purposes is that state law is not alone in its utter indifference to the opposition of a majority of shareholders as expressed by a decision to withhold authority for election of a director. SEC and SRO rules are also utterly indifferent to that fact. Under SEC and SRO rules, a director is a director and is fully respected as a director even if 99.9% of the shares are marked to withhold authority for that director's election, and the only votes cast in favor of that director's election are cast by the incumbent board itself. This need not be.

2.2 SRO and SEC Disabilities That Can Be Imposed Upon Service by Directors Elected Notwithstanding a Majority of Votes Being Withheld

The SROs and the SEC have full authority to take into account the fact that a director has been duly elected under state law notwithstanding the opposition of a majority of shareholders. Nothing in the law requires that such directors be treated at the SRO or SEC levels with a dignity equal to that afforded directors who have majority support from the corporation's shareholder base. Accordingly, SROs and the

'Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stanford L. Rev. 857,903 (1993), *citing* Rule 14a-4(b)(2), 17 C.F.R. §240.14a-4(b)(2) (1992).

[8] *Id.* at 904-905, *citing inter alia*, Del. Code Ann. tit 8, §§ 141(b), 216(3) (1991). Accord, United States Securities and Exchange Commission, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15,2003) at notes 19 and 25 and accompanying text.

SEC can impose a variety of disabilities on directors elected without the support of a majority of the shareholder base.

SRO listing standards could, for example, be amended so to exclude from the definition of "independent director" any director as to whom a majority of votes are withheld. Listing standard could also be amended to provide that no director elected over the opposition of the majority of the shareholder base shall have his or her vote counted for the purposes of any director vote that is required pursuant to a listing standard. Such directors would thus have their votes "sterilized" and would become non-entities for purposes of all SRO rules and regulations.

Federal securities laws also make several references to the role of "director."[9] Without seeking to be encyclopedic, "at least a majority of the board of directors or persons performing similar functions" must sign registration statements and periodic disclosure filings.[10] Certain disclosures must also be made in registration statements with regard to the Commission's view that indemnification of directors can raise public policy concerns under federal securities laws.[11]

The Commission could readily amend its rules so as to preclude from the calculation of "majority of the board of directors" for purposes of certain filing requirements all directors serving over the objection of a majority of shareholders. Those rules could be written so as to continue to hold those directors liable for any misrepresesentations or omissions in those filings. The directors at issue would thus also be "sterilized" from participation in filing decisions while remaining exposed to liability.

The Commission could, in addition, amend its policy with regard to the indemnification of directors elected over the objection of a majority of the shareholder base, and commit to litigate the validity under federal securities laws of any indemnification agreement with such a director. Further, although Commission rules currently state that there are no policy *concerns* related to ***insurance of*** directors with

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[9] Section 3(a)(7) of the Exchange Act defines the term "director" to mean "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." 15 U.S.C. 78c(a)(7). Rule 405 under the Securities Act provides an identical definition.
[10] ***See**, e.g.*, Form S-3, Signatures, Instruction **1**; Form 10-K, General Instruction D(2)(a); Regulation S-K, Item 702.
[11] Regulation S-K, Item 702.

regard to securities liabilities,[12] the Commission could change its view as to this matter in the case of directors serving over the objection of a majority of shareholders.

More aggressively, the commission could adopt the position that insurance and/or indemnification against federal securities law liabilities of a director elected notwithstanding a majority of votes withheld is against public policy and require that all registrants submit undertakings not to provide insurance or indemnification to directors serving under such circumstances. Further, as a matter of internal policy, the Commission could determine to apply greater scrutiny to all '33 and **'34** Act filings by registrants whose boards contain directors elected over the objection of a majority of the shareholder base.

The net result of such actions at the SRO and SEC levels would, as a practical matter, cast every director elected over the objection of the majority of the shareholder base as a second class citizen. These rules would also impose burdens on boards and registrants that continue to allow such directors to serve.

Actions of this sort by the SEC and SROs could also influence the behavior of state courts, notwithstanding the fact that, as a formal matter, SEC and SRO actions do not change state law. While these observations regarding reactions by state courts are admittedly speculative, it is instructive to observe that no state court has, to the best of my knowledge, ever confronted the question of whether decisions by a director elected with only minority shareholder support should be afforded deference or dignity equal to that provided to decisions by a director elected with majority shareholder support. **A** court's ability to provide less deference to decisions by such directors would, no doubt, depend on the circumstances **in** which the question was presented. The distinctions already drawn between interested and disinterested directors, as well as between independent and non-independent directors, are potentially illustrative of the distinctions that could evolve even absent action by state legislatures.[13]

[12] "Insurance against liabilities arising under the Act.. .will not be considered a bar to acceleration.. . ." Rule 461(c).

[13] Another mechanism for enhancing shareholder voice would **look** to state legislators to amend corporation codes to attach certain disabilities to, or even prevent, the election of directors over the objection of a majority of shareholders. The focus of this paper is, however, on federal strategies. I therefore put aside for the moment the observation that the sates could step forward to take significant action on their own. Such action at the state level would, for a wide variety of reasons, be preferable to

2.3 <u>Delayed Effective Dates and "Cure" Mechanisms</u>

In some instances, the immediate imposition of one or more of the disabilities just described could lead to delisting or other adverse consequences that would not necessarily be in the best interests of the corporation or its shareholders. In addition, it may be in the best interests of shareholders and of the enterprise alike to provide for a period of negotiation during which shareholders and the board can meet and confer as part of an effort to identify appropriate compromise candidates or other governance measures that would suffice to reduce tension between incumbent directors and the majority objecting shareholder base. These objectives can be furthered by adopting delayed effective dates for the imposition of directorial disabilities and by providing for "cure" mechanisms. As a practical matter, it would also be prudent to adopt a provision allowing the Commission and/or the SROs to stay the effective date of any or all disabilities upon a showing of good cause and for whatever period might be determined appropriate by the Commission or SRO.

An effective date provision could provide, for example, that disabilities do not attach to a director's service for a 90-day period following the election. A "cure" period provision could provide that if the board and shareholders can reach an appropriate accommodation then the submission of written consents by shareholders who previously withheld authority for the election of the director and who represent a minimum percentage of votes withheld, and causing the number of shares withheld to now fall short of a majority, would eliminate all disabilities attached to service by that director. For example, if the cure period was 90 days (*i.e.*, identical to the effective date delay) and if the minimum cure percentage was 20% of the votes withheld, and if 60% of shareholders withheld authority for the election of Director X, then written consent by 12% of the total shareholder base (12%= 20% of 60%) (provided that these shareholders previously withheld authority) submitted within 90 days of the election would be sufficient to eliminate the disabilities attached to that director because the

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intervention at the SEC and SRO levels, but it would require a political initiative much more complex than that required to effect change at the federal level.

remaining objecting shareholders would constitute less than a majority (60% **-12%= 48%).** The appropriate percentages for such a mechanism are, of course, not written in stone.

The anticipation is that directors and shareholder will huddle during this cure period to see if they can arrive at some set of satisfactory compromises. One possible set of compromises would have the board adopt a series of governance reforms or changed compensation polices as a precondition to the grant of a sufficient number of consents. Another set of comprises would involve the identification of substitute directors acceptable to incumbents and to a critical mass of shareholders alike.

Boards also have the capacity to nominate and elect new directors who may serve for material periods before standing for shareholder vote. The rules could be written so that any director selected by a board to fill a vacancy created by the resignation of a director who was opposed by a majority of shareholders would be subject to the same disabilities, unless the same number of shareholder consents could be obtained as would be required to "cure" that director. Such a rule could help avoid potentially objectionable evasive strategies that could be used by recalcitrant boards.

The net effect of these rules would therefore be to provide strong incentives for compromise between shareholders and incumbent directors over appropriate board composition and governance structures.

2.4 The Failure to Find Compromise

There is, of course, no guarantee that a board and objecting shareholders will be able to fashion a workable compromise. What then?

The failure to reach a compromise could well serve as an advertisement that a board has lost shareholder support and that a traditional proxy contest, whether or not coupled with a takeover bid, would have a very high chance of success. Alternatively, the failure to compromise could act as a trigger for direct shareholder access to the ballot, but the trigger would then only be pulled after a demonstrated inability to reach a consensus through negations in which each party is able to emphasize their respective comparative advantages,

3. The Shareholders' Comparative Advantage and the Incumbents' Comparative Advantage

There is good cause to believe that shareholders are better able to identify suboptimal governance structures than incumbent boards and management, but that incumbent boards and management will be better able to resolve those problems once the incumbents agree that the problem is real. The most effective real-world illustrations of this phenomenon are probably to be found in the area of CEO succession. There is broad agreement that deciding when a CEO should be replaced is, perhaps, the most important and difficult job that faces a board of directors. The data suggest that incumbent boards often wait too long to replace a CEO, although there is reason to believe that the problem may not be as serious today as it once was. Experience also indicates that incumbent boards who wait too long to oust a CEO can reach perfectly sound decisions when it comes to finding a replacement, and there is no reason to believe that outside shareholders would have been able to do as good a job.

An optimal allocation of responsibility under these circumstances would allow shareholders to exert greater force on boards to cause them to replace certain CEOs more quickly, while allowing boards to continue to retain the responsibility to select the new CEO. The same logic suggest that shareholder would have an advantage in deciding which board members should be replaced, but that incumbents could do a better job of identifying the effective replacements. Recent leadership battles at the NYSE and PCAOB, along with the recent CEO outplacments at Motorola, and older experience at Goodyear, General Motors, IBM, Allied Signal, and Tenneco, all support this underlying thesis.

3.1 The NYSE

Some observers suggest that a critical turning point in the debate over Dick Grasso's future came when large institutional investors expressed the view that Mr. Grasso would have to step down.[14] Significantly, those intuitions are not owners of the Exchange. Instead, they are customers who can direct significant order flow and who have a meaningful ability to sway public opinion.

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[14] *See, e.g.*, Vincent Boland, "Institutional Investors Pull the Trigger," Financial Times, Sept. 20, 2003 at 11.

The institutions and other outsiders, however, played no discernable role in the decision to identify John Reed as interim head of the NYSE, and press reports suggest that **Mr.** Reed was the first choice of the Board committee charged with the responsibility to find a replacement.[15] The decision to select Mr. Reed appears to be broadly supported by the SEC, institutional investors, and other outside observers, and it is valuable to observe that there is no discernable criticism suggesting that a specific alternative candidate would have been a better choice. Accordingly, there is little reason to believe that institutional investors, or other outsiders, would have been able to identify and attract a candidate superior to Mr. Reed as an interim Chairman.

This pattern of events is quite consistent with the hypothesis underlying the "advice and consent" proposal. Outsiders with appropriate incentive structures, such as institutional investors, can be effective in forcefully identifying problems, but incumbents can be more effective in resolving those problems – if they are committed to finding a resolution.

3.2 The Battle Over Chair of the PCAOB

The battle over leadership of the PCAOB follows a similar pattern. Some institutional investors and others supported John Biggs for the position. For a variety of reasons, Mr. Biggs was not acceptable to some key decision-makers. Judge William Webster was suggested as an alternative, but his supporters soon discovered that he was subject to disabilities that prevented him from credibly serving as head of the PCAOB. Institutional shareholders were again particularly vocal in voicing opposition. Ultimately, the Commission selected William McDonogh to head the PCAOB. That decision has been broadly hailed as an excellent choice.

This sequence of events again underscores the potential merit of a process that emphasizes advice and consent. Institutions and other critics may have been quite correct that Mr. Webster wasn't the right man for the job. It does not, however, follow that their preferred candidate, Mr. Biggs, was the only logical alternative, notwithstanding the fact that he may have been eminently qualified for the post. Again, the principle of comparative advantage suggests that institutional voice might work best

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[15] Susanne Craig, Anthe Jeanne Dugan, Kate Kelly, and Laurie P. Cohen, **"As** End Neared, Grasso Held on in Hopes Pay Furor Would Ebb," Wall St. J. , Sept. 26, 2003, at **A1, Col. 4.**

when it focuses on the identification of problems and leaves to others the task of prudently identifying a solution.

3.3 Other CEO Replacements

Most recently, Chris Galvin's September 19, 2003, resignation as CEO of Motorola correlated with a 9% increase in the price of the company's common stock. That market response corresponds to an approximate $2.6 billion increase in shareholder value. No successor has yet been named. However, the market's response suggests confidence in the board's ability to select a competent new CEO because if the market expected that the new CEO would perform only as well as the recently ousted CEO, then there would have been no reason for Motorola's share price to increase upon Galvin's ouster. Shareholders have been suggesting for quite a while that management changes at Motorola were called for, and the pattern of events to this point suggests another example of a board that has been too slow to respond but that can probably be relied upon to identify an effective replacement once it becomes committed to change.

Ten years ago I suggested that significant shareholder value could be created if boards, listening to the responsible concerns of large shareholders who have no agenda other than the preservation of the value of their investments, moved more rapidly to replace underperforming CEOs.[16] That study indicated that CEO replacement decisions at Goodyear, Allied Signal, Tenneco, and General Motors, increased shareholder value by 11.6%, 12.5%, 14.7% and 6.1%, respectively. At early 1990's equity values, which are much lower than current values, those CEO replacements added $2.7 billion in market capitalization. Subsequent instances of CEO replacements at IBM and at many other major corporations reinforce this basic trend, and are consistent with the comparative advantage hypothesis upon which this advice and consent proposal is based.

4. Advantages of the Proposed "Advice and Consent" Model

An "advice and consent" model of shareholder participation has several identifiable advantages over the Commission's shareholder access proposal. In particular:

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[16] **Joseph A. Grundfest, *Just Vote No: Strategies for Dealing with Barbarians Inside the Gates*, 45 Stanford L. Rev. 857 (1993).**

(a) An advice and consent mechanism dramatically reduces the probability that the electoral process will be "hijacked" by a group of shareholder who seek to promote a special-interest agenda through the candidacy of a specific director. Shareholders will be able to challenge the inadequacies of sitting boards and will be able to force significant compromises, but it will be difficult to use the "advice and consent" mechanism to advocate a special-interest agenda.

(b) The advice and consent mechanism dramatically reduces the probability that successful participation by shareholders in the governance process will lead to the creation of divisive boards that have difficultly in functioning well as a team. The objective of the "advice and consent" mechanism is to force a workable compromise between an incumbent board and a disaffected shareholder majority. **As** suggested above, if no such compromise is reached, the incumbent board becomes an easy target for a traditional proxy contest.

(c) "Advice and consent" eliminates the need for the Commission to define the category of investors who would be "qualified" to propose nominees for the corporate ballot. Any such definition would be essentially arbitrary and highly judgmental, and will be open to reasonable criticism from shareholder advocates as having been set "too high" and/or criticism from defenders of the status quo as having been set "too low." The agency will not be able to present any data that can objectively support any conclusion it might reach with regard to setting thresholds for "qualification."

(d) "Advice and consent" eliminates the need for the Commission to define a "triggering event" that would serve as a necessary pre-condition to shareholder access. Again, critics from all sides will be able to attack any definition proposed by the Commission as arbitrary and as being either too liberal or conservative. Again, the agency will be able to present no data upon which it would be able objectively to support any decisions it might reach.

(e) The probability that opponents of shareholder voice will be successfully able to challenge an "advice and consent" rule in the courts is materially lower than the risk of a successful challenge to a shareholder access rule. The "advice and consent" model changes absolutely nothing about the traditional process for electing directors as governed by state law. Instead, it changes the implication of a shareholder's decision to withhold authority under federal law and for purposes of listing standards. State law, however, has no legal authority to set standards for federal securities laws or public listing requirements. The prospect for successful challenge is therefore reduced.

(f) "Advice and consent" reduces coordination costs among disaffected shareholders. Under the Commission's shareholder access model, shareholders would first have to agree that specific directors should be replaced and then further have to identify and agree upon appropriate replacement candidates who would be willing to enter into a potential bare-knuckles political campaign in which the candidate's background will be scrutinized by private investigators and any foibles or weaknesses trumpeted in full page ads in the Wall Street Journal or New York Times. Because it will be easier for shareholders to identify a problem than to agree on a solution, successfully navigating this second step of the process greatly increases the coordination costs of shareholder action. For that reason, responsible shareholders may weli prefer a model in which they can, *de facto*, force the restructuring of underperforming boards without having to assume the potentially difficult challenge of identifying and promoting a named alternative. Put another way, it will likely be far easier for a majority of shareholders to agree that a particular director or set of directors should be forced out than to develop equivalent agreement over the most appropriate replacements.

5. Disadvantages of the Proposed Advice and Consent Model.

There are no perfect solutions to the problems that the Commission seeks to address through its shareholder access proposal. The "advice and consent" mechanism described in this paper has its own obvious flaws and limitations. Readers with a fresh pair of eyes and experience broader than my own will no doubt be able to contribute to the following list of shortcomings:

(a) "Special interest" agendas can have very broad and legitimate social support notwithstanding the fact that they are motivated primarily by concerns that have little to do with the profitability or governance of the enterprise. For example, the anti-apartheid movement relied on the Sullivan principles and shareholder initiatives to build support in the business community. The ability directly to nominate individual dissident candidates to a board who would aggressively promote an anti-apartheid agenda could certainly be viewed as a valuable tool by shareholder constituencies seeking to change social norms. The "advice and consent" mechanism proposed herein would be a weaker tool in pursuit of such objectives because it would not provide shareholders with the ability to rally around a strong, affirmative voice for an express point of view. To the extent that society benefits from the ability to present stark, confrontational choices in the sphere of corporate governance, the more accommodating, compromising approach inherent in an "advice and consent" mechanism might not be preferred.

(b) Notwithstanding the observation that outside shareholders generally do not have a comparative advantage in resolving the problems they have identified, there may well be situations where their preferred candidate is strictly superior to any compromise acceptable to the incumbent board. An "advice and consent" model will be less likely to allow shareholders to prevail in those situations.

(c) There is no guarantee under the proposed "advice and consent" mechanism that shareholders and management will reach a consensus notwithstanding the disabling consequences that follow from the decision of a majority of shareholders to withhold authority for a director's election. Further, even though such a board would likely be a sitting duck for a traditional proxy fight, there is no guarantee that such a proxy fight would result, or that insurgents would be successful in their efforts to unseat a board.

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