

Democracy Looks For an Opening -- In the Boardroom  
**SEC Plan to Boost the Role Of Investors in Elections  
Draws Ire of Companies**

**A 1932 Book Foretold Abuses**

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The latest antidote to what ails U.S. corporations is to run them more like New England town meetings.

It's not just at [Walt Disney](#) Co., where the board stripped Chief Executive Officer Michael Eisner of his chairman's title after he failed to win support for his board re-election from 43% of votes cast by shareholders. [Marsh & McLennan](#) Cos. just agreed to nominate a director recruited by institutional investors after months of negotiations. New rules at scandal-tarred MCI, formerly known as WorldCom Inc., will require the board to solicit director nominations from holders representing at least 15% of its shares.

Now the government is pushing for even more shareholder democracy. The Securities and Exchange Commission is weighing a rule that would allow, in limited situations, shareholders representing at least 5% of voting shares to put their own board nominees alongside management's choices on a company's official ballot. Making it easier for dissatisfied shareholders to nominate candidates will help prevent fraud and prod executives to act more in shareholders' interests, says SEC Chairman William Donaldson. The agency is expected to make a decision in May.

A bill pending in the California legislature would go further, requiring any companies doing business in the state to permit nominations by investors who have held at least 2% of the shares for two years.

Corporate executives and business lobbies are pushing back. They say such steps would foster dissent among directors, allow shareholders with agendas to hijack boards and put a costly burden on companies already buried in new corporate-governance rules. Others say the SEC plan would give too much power to large, institutional investors.

"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., a chain of auto-parts stores. "That will divert attention from serving the interests of all shareholders."

**Back and Forth**

The move toward greater shareholder democracy comes in the wake of corporate scandals that have rocked investors' faith in management and the boards who are supposed to be looking after shareholders' interests. But this isn't the first time the SEC has considered giving shareholders a greater say in deciding who will manage their companies. Throughout corporate history, the pendulum has gone back and forth on the question of how involved shareholders should be -- especially when it comes to the composition of company boards.

"There's an unresolved philosophical debate," says Joel Seligman, dean of Washington University law school in St. Louis. One view is that corporations are like political entities "in which

case you want to focus on consent of the governed." The other is that corporations are "more hierarchical," with decisions made by managers and directors.

In the early 19th century, companies usually had just a handful of shareholders. They ran the company, controlled the board and chose directors from among themselves. At the time, U.S. companies granted shareholders one vote per person, according to Colleen Dunlavy, a professor at the University of Wisconsin-Madison. As competition for capital increased, rules were changed to give more say to bigger investors. By 1850, most companies awarded one vote per share. Directors tended to represent the largest investors.

In the early 20th century, power was diffused as stock ownership spread. Individual shareholders' clout was diluted. Sometimes they were asked to vote for directors without knowing the identity of the nominees, says Mr. Seligman, who has written a history of Wall Street.

As companies grew, "no shareholders or groups of shareholders had enough shares to dominate the board," says Charles Elson, a corporate-governance scholar at the University of Delaware, who sits on three boards. "There was a vacuum, and management filled that vacuum by nominating their own folks."

### Wave of Reform

The stock-market crash of 1929 unleashed a wave of reform. In 1932, professors Adolf Berle and Gardiner Means published "The Modern Corporation and Private Property," highlighting the divergence between the interests of owners and managers. They called for more regulation to check abuses.

In 1934, Congress created the SEC and required companies to disclose information about their operations. But it kicked the question of shareholders' rights to the SEC, where it has been the subject of debate ever since.

## SHAREHOLDERS' RIGHTS

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200 years of history:

- **1800s:** Companies are small, owned and managed by shareholders who have one vote per person.
- **1850s:** To attract capital, firms switch to one vote per share.
- **1900s:** Shareholder power diluted as more people buy shares, companies select board members.
- **1934:** Congress creates the Securities and Exchange Commission and requires companies to disclose information.
- **1942:** SEC weighs allowing shareholder-nominated directors on ballot, but doesn't.
- **1978:** SEC again rejects giving holders proxy access, decides to monitor nominating committees.
- **2004:** SEC proposes rule to allow shareholder nominees on the ballot in some cases.

In 1942, the SEC considered requiring companies to include investor-selected nominees on their ballots. Corporations responded that shareholders would make foolish decisions and elect irresponsible directors. Milton V. Freeman, an SEC attorney who wrote the plan, was labeled a Communist by some members of Congress. The SEC never implemented the proposal.

Soon the SEC sought to bar proposals of a "political, social or economic" nature. In 1951, the SEC rejected a request by Greyhound Corp. shareholders to submit a proposal asking management to end its segregated seating policy in the South.

Three years later, the agency formally clipped shareholder rights by prohibiting investors from making proposals related to a company's "ordinary business." To this day, companies use that rule to exclude all sorts of proposals, **such as boosting the cost-of-living adjustment for retirees**. But the SEC has gradually opened the door to nonbinding resolutions about social policy, such as proposals that a company not do business in countries with poor human-rights records.

Public anger about corporate governance last peaked in the 1970s, when hundreds of U.S. corporations were accused of illegal payments to political and commercial figures overseas. Meanwhile, a wave of big companies, including Penn Central, the nation's largest railroad, went bankrupt -- wiping out the value of their public shares.

The idea of allowing investors to nominate directors gained support, even from an unlikely ally: The Business Roundtable, a group of big-company CEOs that is a staunch foe of the SEC's latest proxy proposal. In a 1977 memo, the group said shareholders "are the proper persons to resolve the question" of how directors should be nominated.

But the SEC decided against allowing shareholders to include their nominees on the corporate proxy, saying it wasn't necessary since companies were voluntarily creating "nominating committees" -- which select board candidates with shareholder input. In 1979, 29% of companies had nominating committees. Last year, 71% of about 3,400 public companies had such committees, according to the Investor Responsibility Research Center in Washington.

The SEC again flirted with allowing investors to include director candidates on the proxy in 1992, but the plan was heavily criticized and the agency opted to instead make it easier to conduct a proxy fight.

During the 1990s, the SEC made it easier for shareholders to put their proposals to a vote. In a landmark 1998 case, shareholders in Cracker Barrel Old Country Store, a division of CBRL Group Inc., were allowed to propose a ban on discrimination against gay employees; it eventually won by an overwhelming majority. The SEC now says many issues "transcend" ordinary business and may be put to shareholder vote. **While the resolutions are usually nonbinding, some companies do choose to adopt proposals that receive a majority vote.**

Today, the focus is back on the rules for choosing directors. The Sarbanes-Oxley Act, passed in 2002, and stock-market rules enacted last year, require more independent directors on boards as well as better systems for policing fraud. But that's not enough, says the SEC's Mr. Donaldson.

The SEC's proposed rule would give investors more power to challenge directors. In most cases, nominees are selected by management, and shareholders can vote them up or down. **But shareholders can replace directors only by proposing an alternative slate.** Since companies aren't required to include shareholder nominees in their annual proxy material, it can be costly and time-consuming to get information about dissident candidates in front of all shareholders.

## Burden on Shareholders

This puts a burden on shareholders, Mr. Donaldson has said, "forcing them to wage a wasteful proxy fight." Challengers must solicit proxies, or absentee ballots, from shareholders, often spending millions of dollars.

The new rules would make it easier for shareholders to nominate directors but would apply only under two circumstances: if more than 35% of the votes cast withhold support from a board nominee; or if a proposal to allow shareholder nominees on the proxy is approved by more than 50% of the votes cast.

If those conditions are met, then corporations would have to list independent shareholder nominees on the next ballot. One major point of contention: Only holders or groups with at least 5% of shares that carry the right to nominate directors, in most cases voting shares, could submit nominations.

The proposal is under attack from some corporations who say it goes too far. The U.S. Chamber of Commerce says it may challenge the SEC's authority on the matter in court. At the same time, other critics say it doesn't go far enough.

There's also dissension among the SEC's five commissioners. Paul Atkins, one of three Republican commissioners, says the rule should apply only to companies with proven problems. "I'd really like to have something targeted to directors who are not responsive," he says.

But Mr. Donaldson, a Republican, enjoys support for the rule from the SEC's two Democrats. The plan is aimed at "companies that aren't working well," says Commissioner Harvey Goldschmid. "This is the way for shareholders to help turn those companies around."

In a new argument that reflects the growing amount of stock held by mutual funds, insurers and pension funds, some say the proposed rule would hand too much control to institutional investors. That's one reason the Business Roundtable, which advocated giving shareholders the right to nominate directors in 1977, is now challenging the SEC's plan.

Already, proxy-advisory firms, such as Institutional Shareholder Services, influence some large shareholders by recommending how these clients should vote on shareholder resolutions and director candidates.

The SEC's plan will make proxy-advisory firms "extremely potent," says Jeffrey Sonnenfeld, an associate dean of Yale University's School of Management and an ISS critic. "It will put them in a kingmaker role for board nominees."

ISS Senior Vice President Patrick McGurn says the new rules wouldn't mean the firm would be out to remove directors indiscriminately: "We're going to look at what we need at the company and take the costs and benefits into consideration."

An unlikely opponent of the SEC's plan is Evelyn Y. Davis, the gadfly advocate who's been agitating for decades to make companies more responsive to shareholders. "This is discrimination against small stockholders," says Mrs. Davis. A better way to make companies responsive and prevent entrenched boards, she says, would be to limit outside directors to six-year terms.

Large investors counter that they'll use the new weapon only at troubled companies where boards are unresponsive.

Some institutional investors aren't waiting for the SEC to give them more clout. Four public-employee pension funds with 1.3% of Marsh & McLellan shares recently submitted a proposal to allow them to nominate directors at the company, whose Putnam Investments unit was embroiled in the recent mutual fund scandal. Last week, Marsh agreed to nominate a former federal prosecutor drafted by the investor group. In turn, the institutional investors agreed to drop their proposal. The pending SEC rule "is what brought the company to the table," says Richard Ferlauto, an official of the American Federation of State, County and Municipal Employees, whose pension fund was among the four involved.

At least one U.S. company is acting on its own. Last year, Ralph Whitworth persuaded fellow directors at Apria Healthcare Group Inc., a home-health concern based in Lake Forest, Calif., to let shareholders nominate board candidates without a full-blown proxy fight.

Stockholders owning at least 5% of Apria's common shares for two years can propose two new directors every year -- and get their picks listed alongside the official slate. The change went into effect this year, but no shareholders came forward with their own candidates in time for this year's annual meeting next month.

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