Six degrees of reparation

Government is giving shareholders greater influence over corporate boards

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WASHINGTON (MarketWatch) -- The biggest financial crisis since the Great Depression, coupled with Bernard Madoff's $50 billion Ponzi scheme and ire over Wall Street bonuses, has lit a fire under Congress and the nation's investor watchdog, the Securities and Exchange Commission.

With public pressure boiling over, investors are on the verge of getting a greater share of the rules governing company directors -- or at least a bigger say in the changes that are made.

SEC chairwoman Mary Schapiro, already considered an investor advocate based on her stint at the agency from 1988 to 1994, is undertaking an array of actions to empower investors in their interaction with managements and boards. That includes new powers which could make it easier for investors to oust chief executives and other management-backed directors.

For example, investors could have an easier and cheaper way to nominate director candidates to boards -- a policy sure to transform shareholder-board relations.

And beginning next year, investor campaigns seeking to oust CEOs from boards will be more effective due to new SEC rules prohibiting so-called "ballot-stuffing," the long-held practice of broker-dealers casting undirected retail investor votes for management director candidates.

Action plans

These are major steps. The SEC has discussed giving investors a more central role in corporate director elections for decades, to no avail. But the credit crunch has given weight to arguments that corporate boards must be more accountable to shareholders, driving this round of reform efforts.

"What we're facing is a huge increase in the amount of rights that shareholders have," said Stephen Davis, Yale School of Management Professor, at an SEC investor advisory committee meeting last week.

As a result, the playing field, so heavily weighted in favor of top corporate executives, is now shifting in the direction of shareholders, including retail investors, public and corporate pension plans, hedge funds and other institutional stockholders.

Davis, who heads an SEC "investor as owner" subcommittee, said he expects the new powers to result in greater behind-the-scenes negotiations between investors and corporate boards, as directors seek to avoid embarrassment by privately negotiating with shareholders over pay packages and other policies.

Many reforms have already taken place. Others are still under consideration on Capitol Hill and at the SEC. Harvard Law School Professor Lucian Bebchuk, a longtime advocate of strengthening shareholder rights, anticipates that much of the investor-friendly legislation on Capitol Hill will be approved. He contends that the proposed changes are part of a broad movement that is transforming shareholder-corporation relations in a post-financial crisis period.

"It's a long overdue correction," Bebchuk said.

Here are six initiatives underway in Washington aimed at empowering shareholders in dealings with corporations and their boards:

1. Say on pay. The vast majority of investors, particularly retail shareholders, have a tough time influencing how corporations operate.

That is changing. Both Congress and the SEC are taking steps to give investors a non-binding but powerful vote on the compensation of executives.

The SEC has drafted a rule expected to be approved before year-end that would subject financial institutions receiving bank bailout funds to a shareholder vote on the pay of their executives. Moreover, a key congressional committee has approved a provision -- which is expected to become law later this year as part of broad bank reform legislation -- that would apply this measure to all U.S. corporations.

Corporations in the U.K. are subject to this salary rule, Yale's Davis points out, and he expects that in the U.S. it could drive management and board compensation committees into behind-the-scenes negotiations with investors over corporate pay.

2. Nominating directors. Giving shareholders an easier way to nominate a minority slate of directors has been on and off the agenda at the SEC since the 1940s, but has never come to fruition. Most recently in 2004, under the helm of then SEC chairman William Donaldson, efforts to give investors more power in board elections failed to gain traction.

Despite the long odds, the winds are shifting, said David Sirignano, partner at Morgan Lewis & Bockius in Washington, and former chief of the SEC's M&A office.

At least one initiative under consideration at the agency won't experience the failure of previous proposals, he claimed. The SEC in June proposed a measure to allow a long-term investor or a group of long-term shareholders to nominate one or two director candidates to a corporate board using the company's proxy documents. Shareholders have long held the right to nominate director candidates using their own proxy documents, at a significant cost.

But gaining access to a company's proxies -- papers filed to investors so they can vote on director elections and corporate audits -- will streamline the process, particularly at smaller public corporations. Once approved, investors could use the mechanism to launch corporate raider Carl Icahn-style contests to install their own director candidates at smaller corporations.

Sirignano said that Schapiro is taking time to make sure this rule is litigation proof. The commission isn't expected to approve the rule until next year, in part because the agency is waiting to see if Congress will pass legislation to make it less likely the rule would be overturned. Rep. Barney Frank, D-Mass., chairman of the powerful House Financial Services Committee, has expressed interest in considering the access legislation next year, raising prospects for its passage.

Richard Ferlauto, policy director for the American Federation of State, County and Municipal Employees pension fund, said the statute would be a "prophylactic" against litigation: "It would be helpful to see additional explicit language through legislation to clarify the authority I believe the SEC has."

3. Ballot stuffing and "just vote no." In many cases, investors want to influence a corporation's decision-making, or even oust management from a company's board, without nominating their own director candidates.

To do this, some investors have launched "just vote no" campaigns, also known as protest votes, seeking to garner enough support from other investors to embarrass CEOs and other management directors into resigning from boards.

The SEC in July approved a measure prohibiting brokers from casting director-election votes on behalf of investors who don't vote themselves. This will make a big difference in many cases. Typically, retail investors don't vote in corporate director elections. Brokers that hold these shares for investors until now have automatically voted the uninstructed stake known as "broker-non-votes" for the management-backed director slate.

Eliminating these so-called ballot-stuffing undirected votes can have a major impact on "just vote no" campaigns to oust CEOs from boards, because their removal can show the true extent of a shareholder group's vote of no-confidence in a particular management-backed director.

For example, in a letter to Bank of America Corp.'s board in April, a group of labor unions argued that about 25% of votes cast at the bank's shareholders meeting were "broker-non-votes," based on previous year trends. Harvard's Bebchuk contends that the broker-vote reform was long-overdue and will produce a more accurate picture of shareholder preferences.

Morgan Lewis's Sirignano warns that corporations are likely to see what appears to be larger turnouts for protest votes -- particularly at companies with a large retail voter base -- because undirected votes are now being scrapped. "We'll see how doing away with broker-voting affects things," Sirignano said.

4. Majority voting. At many U.S. corporations, executives can be re-elected to board positions at uncontested elections with just one share voting for them. But that advantage may be evaporating. Legislation on Capitol Hill introduced by Rep. Gary Peters, D-Mich., the House and Sen. Chuck Schumer, D-N.Y., in the Senate, would prohibit this practice. And this law, which is expected to be approved next year, would expand the impact of protest votes for incumbent directors.

The legislation would require directors at all U.S. corporations to win more than 50% of the votes of participating investors to be re-elected to the board. Those losing elections would need to submit their resignation to the board, which could accept or reject it.

Some corporations have already set up such a system, but making it law would empower "just vote no" campaigns and hold directors more accountable.

5. Post-Madoff reforms. After the SEC missed exposing the biggest fraud in its history -- Bernard Madoff's $50 billion Ponzi scheme -- expect considerable changes to how the commission handles investigations.

As a result, the SEC should become more accountable to shareholders and examiners ought to catch investor fraud earlier. The agency's Inspector General delivered a scathing indictment of the SEC's practices, followed by 58 recommendations on how it could reform itself. One proposal would require that tips and complaints coming from investors and other individuals be reviewed by at least two staffers experienced in the subject matter.

The inspector general's report also said the SEC should create investigative teams where one individual has "specific" knowledge of the topic, such as Ponzi schemes. (The report found that the majority of a critical 2005 Madoff investigation was performed by a staff attorney who recently graduated from law school and had never been a lead investigator before.)

Expect the agency to implement these reforms, including a measure that would have inspection teams document all interviews and log all examinations into a tracking system, said Columbia Law School Professor John Coffee.

"The idea of having two people review tips is a useful idea and I expect there will probably be a simple form to fill out to ensure that happens," Coffee said.

6. Surprise exams. Also in response to Madoff, the SEC introduced a proposal that would require more investment managers of hedge funds, mutual funds and other investors to obtain a surprise examination or spot check by independent public accountants.

Currently, if an investment manager's account statements are put out by the manager's custodian broker-dealer, which holds the fund's assets, then no outside audit is required.

However, Madoff didn't employ an outside custodian, leading to questions about his handling of client funds. The SEC measure, which is likely to be approved this year, is expected to require a surprise independent audit for all investment advisors at an irregular time on a periodic basis, even if they control their own custodian as Madoff did.

"The fact that such a huge firm employed no outside custodian should have triggered a red flag," Coffee said.

This will mean higher costs for institutional investors, but the provision is there to catch future Madoffs more quickly and ultimately help ordinary shareholders.