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SYMPOSIUM ON CORPORATE ELECTIONS

Lucian Bebchuk, editor

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Symposium on Corporate Elections

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Abstract

This paper contains the proceedings of the Symposium on Corporate Elections held at Harvard Law School in October 2003. The symposium brought together SEC officials, CEOs, directors, institutional investors, money managers, shareholder activists, lawyers, judges, academics, and others to discuss the subject from a wide range of perspectives.

The symposium included six sessions. The first session focused on the basic pros and cons of shareholder access. It featured a presentation and discussion of two papers: "Election Contests in the Company's Proxy: An Idea whose Time has not Come" by Martin Lipton and Steven Rosenblum, Wachtell, Lipton, Rosen & Katz; and "Shareholder Access to the Ballot" by Lucian Bebchuk, Harvard Law School.

The second session focused on the perspective of boards and management. The panel speakers were Richard Breeden (Chairman, Richard C. Breeden & Co.), John Castellani (President, The Business Roundtable), James Rogers (Chairman of the Board and Chief Executive Officer, Cinergy Corp.), and Ralph Whitworth (Chairman of the Board, Apria Healthcare Group, Inc.).

The third session focused on the perspective of institutional investors. The panel speakers were Orin Kramer (Partner, Kramer Spellman, L.P.A), Robert Pozen (Visiting Professor of Law from Practice, Harvard Law School and formerly Vice-Chair, Fidelity Investments), Michael Price (Managing Partner, MFP Investments) and Sarah Teslik (Executive Director, Council for Institutional Investors).

The fourth session of the symposium focused on the perspective of shareholder activists and advisers. Panelists were Jaime Heard (Chief Executive Officer, Institutional Shareholder Services), Robert Monks (Founder, Lens Governance Advisors), Damon Silvers (Associate General Counsel, AFL-CIO), and John Wilcox (Vice Chairman, Georgeson Shareholders).

The fifth session focused on legal problems in designing a shareholder access rule. The panel speakers were John Coffee (Professor of Law, Columbia Law School), Joseph Grundfest (Professor of Law and Business, Stanford Law School), Robert Todd Lang (Senior Partner, Weil, Gotshal & Manges), Charles Nathan (Partner, Latham & Watkins), and Leo Strine (Vice Chancellor, Delaware Chancery Court).

The final session featured concluding remarks. The speakers were Robert Clark (Harvard University Distinguished Service Professor and Professor of Law, Harvard Law School), Floyd Norris (Chief Financial Correspondent, The New York Times), and Harvey Goldschmid (Commissioner, U.S. Securities and Exchange Commission).

Each session started with opening presentations by the panelists, followed by a discussion among the panelists and between the panelists and other participants in the symposium.

Key words: corporate governance, directors, shareholders, shareholder voting, corporate elections, proxy fights, proxy contests, proxy rules, corporate elections, SEC.
JEL classification: D70, G30, G32, G34, G38, K22.

Table of Contents

Editor's Note:

This edited transcript seeks to make publicly available the proceedings of the Symposium on Shareholder Access to the Ballot that was held at Harvard Law School on October 3, 2003. Editing was done by the speakers and the editor, with the aim of retaining the spirit of the symposium while ensuring that the speaker's message is clearly and accurately conveyed to readers.

The conference was the first event of the recently established Harvard Law School Program on Corporate Governance. It was sponsored by the Program and by the Harvard Law School John M. Olin Center for Law, Economics, and Business. I wish to thank Professor Steve Shavell, the director of the Olin Center, and Dean Elena Kagan for their support.

I am also grateful to various colleagues for their help in organizing the symposium and moderating its sessions, including John Coates, Brian Hall, Howell Jackson, Reinier Kraakman, Jay Lorsch, and Guhan Subramanian; special thanks go to Mark Roe for his advice and encouragement throughout. Finally, for their help in administering the symposium as well as in preparing its proceedings, I am grateful to Erica George, Julie Johnson, Kiwi Kamara, and Rob Maynes.

List of Speakers

Panelists, Moderators, and Discussion Participants

Lucian Bebchuk, Harvard Law School
Alan Beller, U. S. Securities and Exchange Commission
Matthew Bishop, The Economist
Richard Breeden, Richard C. Breeden & Co.
John Castellani, The Business Roundtable
Robert Clark, Harvard Law School
John Coates, Harvard Law School
John Coffee, Columbia Law School
Jill Fisch, Fordham University School of Law
Harvey Goldschmid, U.S. Securities and Exchange Commission
Joseph Grundfest, Stanford Law School
Brian Hall, Harvard Business School
Paul Healy, Harvard Business School
Jamie Heard, Institutional Shareholder Services
Howell Jackson, Harvard Law School
Reinier Kraakman, Harvard Law School
Orin Kramer , Kramer Spellman
Robert Todd Lang, Weil, Gotshal & Manges
Martin Lipton, Wachtell, Lipton, Rosen & Katz
Jay Lorsch, Harvard Business School
Robert Monks, Lens Governance Advisors
Charles Nathan, Latham & Watkins LLP
Floyd Norris, The New York Times
Robert Pozen, Harvard Law School
Michael Price, MFP Investors
Mark Roe, Harvard Law School
James Rogers, Cinergy Inc.
Steven Rosenblum, Wachtell, Lipton, Rosen & Katz
Damon Silvers, AFL-CIO
Leo Strine, Delaware Court of Chancery
Guhan Subramanian, Harvard Law School
Sarah Teslik, Council for Institutional Investors
Ralph Whitworth, Apria Healthcare Group and Relational Investors
John Wilcox, Georgeson Shareholder

Session 1: The Basic Pros and Cons of Shareholder Access to the Ballot

Panelists: Martin Lipton and Steven Rosenblum, Wachtell, Lipton, Rosen & Katz
Lucian Bebchuk, Harvard Law School

Moderator: Mark Roe, Harvard Law School

Discussion Participants: Robert Monks, Lens Governance Advisors
Brian Hall, Harvard Business School
Jay Lorsch, Harvard Business School
Charles Nathan, Latham & Watkins LLP
Joseph Grundfest, Stanford Law School
Matthew Bishop, The Economist
Allen Beller, U. S. Securities and Exchange Commission
Michael Price, MFP Investors
Leo Strine, Delaware Court of Chancery

Mark Roe: I'm Mark Roe; I'm going to moderate our first panel. Just a few introductory comments; the people on the panel don't need any introduction. The mechanics: Marty and Steve will talk for about twenty minutes on their topics. Lucian will talk for about twenty minutes on his topic. There've been heavy negotiations on the moderator's authority, and I have much more authority than is typical. I have this bell to keep people quiet after twenty minutes, or if the questions go on too long. After twenty minutes, we'll have a few minutes of response on either side, and then questions to the people presenting the papers.

I think it's fair to say that Marty Lipton's been, of the last 25-35 years, the most articulate, thoughtful spokesman for the view of maintaining managerial autonomy in large firms, and Lucian has provided several of the deepest analyses of why firms would be better-run with more authority moved to shareholders' hands. There's a surreal quality about addressing these issues today, in that we know the SEC is going to propose a rule that we're going to be talking about today, but we don't know the details of the rule, so we can't focus on details. We can only focus on the big picture. And the surreal quality, I think, corresponds to the panel this morning.

In some ways, the big picture is clear. We kind of know what Marty has got to say, and we kind of know what Lucian is going to say, although the details may differ, and the analyses may get to a deeper level. So I've actually suggested this morning that we approach this in a different way, consistent with this being a law school education**.** Marty, I suggested, should take the position that managerial autonomy has gone much too far, and I suggested to Lucian that he take the perspective, and defend the perspective, that managers really need to be left alone so that they could run their companies and these kind of things are just distractions that don't do anybody any good. So we'll see if they take this up! Marty? Steve?

Steven Rosenblum: Okay, I'm going to start and then turn it over to Marty. I wanted to say thank you to Lucian for inviting us and letting us put some of our ideas down on paper and present them here. We've obviously made a number of arguments in our paper, and we don't have time to touch on all them. I just wanted to make a couple of points, and then Marty has a few more.

First, we take issue with the title of this morning's session: "The Basic Pros and Cons of Shareholder Nomination of Directors." This isn't about whether shareholders have the right to nominate, or put forward director nominations. They do, in most every jurisdiction, and we obviously don't have any problem with that. The real title ought to be "The Basic Pros and Cons of Encouraging More Election Contests," because that's really what this proposal is about. Alan Beller referred to this yesterday as "an incremental proposal," and it *is* incremental. How big the increment is, is open to debate. The basic point is that people can run election contests now. They do run election contests now. There were about forty of them last year. And really, the question is, "Do we want more of them, and if we want more of them, how many more of them do we want?" I was heartened to hear Allen say that we don't want fifteen thousand. I think Marty's and my view is that the optimum number is about where it is today, and really the debate is: is it a good idea to have more election contests?

I also wanted to try to explain a little bit as to why we devoted so much of our article to the academic model of shareholder as principal or owner and managers as agents. It's really a model that I think dominates the academic literature, and it's one that I know I've been contesting, not just going back to Marty's and my quinquennial article, but all the way back to law school, when I had this young Turk law professor straight out of law school named Reinier Kraakman, who had these new notions. He threw away the textbook and gave us a bunch of Xeroxed handouts from Berle & Means and Jensen & Meckling, and told us that the central issue of the modern corporation was the separation of ownership and management, giving rise to the agency problem, and how to get managers to conform to the wishes of the owners and put aside their self-interest. That model really does dominate the academic literature and, I think, also finds its way into the rhetoric of the debate of this issue, as well as a number of other issues.

If you accept the notion that the shareholder is the owner of the corporation in the same way that I own a car or a building, then the answer is pretty easy: the shareholder is the owner, so more shareholder voice is better, more shareholder control is better. The question answers itself. Which is why we felt the need to talk a little bit about how it's more complex than just to say that the shareholder is the owner. Obviously, shareholders provide a very important input into the corporation in terms of risk-taking capital, but there are all kinds of other constituencies that also provide significant inputs into the corporation, and all those need to be balanced. I think the question, and the debate in the context of this proposal is, "Where is the right balance?" Is the right balance to put more control into the hands of shareholders, or is the right balance to come up with other mechanisms for constraining and motivating. One of the problems I think we have with the notion of "the shareholder is owner, and therefore should control the corporation," is that it leads pretty quickly to what we've dubbed "the managerial discipline model." This model says that the main goal of corporate governance is to discipline managers so that they don't go astray, which, again, is a great oversimplification.

What you want is to find a way not just to discipline managers, but to motivate managers, to have them run the corporation more successfully and better, to the benefit of shareholders and all the other corporate constituencies. The trend in the current corporate governance environment, not just with this proposal, but with some of the other proposals, seems to be to focus on the constraints as opposed to the incentives and the motivations. We think this is to the detriment of the operation of the corporation in terms of excessive risk aversion, in terms of people being afraid to do things that they really should be doing in running the company.

The one other point that I wanted to talk about is what is the likely impact of the proposal. We're in a bit of a vacuum in terms of not knowing exactly what the proposal is, but one has to believe that the likely impact is that, at a minimum, there will be more election contests. Because if there aren't going to be more election contests out of this proposal, what's the point? And probably, given more election contests, there will be more successful elections of dissident directors. What we tried to do in the paper is to focus on, "Is it a good thing? Is it a good thing to have more election contests? Is it a good thing to have more dissident directors in boardrooms?" We obviously think there are significant costs to both of those, and Marty is going to talk a little bit about that. And we have yet to see a compelling argument for what the benefit is in terms of the operation of the corporation.

The public debate seems to focus on "shareholders are owners, more shareholder voice is better, therefore this is good." But if you're able to get past the model of shareholder-as-owner and say, "Well, that's a useful analytical tool for some purposes, but it really doesn't drive you to the end conclusion," then really the question is, "What is going to make the corporation run better and operate better and be more successful." And you have to ask, "What benefit are you getting out of (1) more election contests, and (2) more dissident directors?" I think there is debate among at least some of the institutional investors as to whether they really want this – the institutional investors who are really purely economically motivated.

My view is that, at least in the near-term, this will primarily be used by the more political institutions: the public pension funds and the unions, who really have other motives for using it. The institutions that really are focused on improving the economics of the corporation have better ways and better avenues to provide their input into the corporation than a public, adversarial proxy contest. And they've been using those avenues. I think there's no question that, over the last two decades that I've been in law practice, and a couple more decades that Marty has, the responsiveness of boards and managers to investor input has grown quite a bit, I think for the better. That should be allowed to continue without creating this politicized and adversarial process that will result from encouraging more election contests.

Another, I think unintended, impact that comes out of one aspect of the SEC proposal – namely, the trigger mechanism – is that if that's adopted, it will give much greater leverage to 14a-8 proposals. We're already seeing this concern among our clients. The notion of saying "If we pass this precatory resolution and you don't adopt it, then we're going to impose this access regime," is like putting a gun to the head of the board and saying, "If you don't do what we tell you to do in this precatory resolution, then you're going to have to face this consequence that you probably don't want to face." My view of it is that if you're going to pull the trigger, just pull the trigger and get it over with. Don't have the constant threat of the gun to the head, with a mechanism that says "If you don't do what I want, I'm going to shoot you." Anyway, with that, I'll turn it over to Marty.

Martin Lipton: As Mark said, all the arguments back and forth are well-known. This red folder contains a full compendium of the philosophical and the pragmatic arguments, including a very innovative variation on the theme that Joe Grundfest will talk about this afternoon. I'd like to pick up on the last point that Steve mentioned as to what are we really getting at here, and share some practical experience over the past three or four years with the interplay between 14a-8 resolutions relating to redeeming the poison pill, un-staggering the board, and similar types of what I'll call "corporate governance proposals." I have a real issue here, and it is one of bending the will of management to that of the shareholders, and just how that's going to be accomplished. As Steve said, no one disputes that the shareholders have the right to nominate directors and, ultimately, to control the makeup of the board of directors. Clearly, the shareholders can conduct a proxy fight to replace the board of directors – it's settled law every place. Indeed, in Delaware, much of the learning is that you can't unduly interfere with the shareholders' franchise; that the great no-no, insofar as taking action with respect to shareholder control, is "Don't mess with the ability to vote."

The growth in Rule 14a-8 precatory resolutions on governance subjects started, more or less, in 1986, '87, when TIAA-CREF first proposed precatory resolutions with respect to the poison pill. It's built over the period since then. Each year there are several hundred resolutions. They grow each year – I guess they're up to nine hundred currently. There have been on average in recent years about 50-60 poison pill resolutions, and almost all of them now gain a majority vote. Indeed, in many cases, a substantial majority vote. The same seems to be true of the un-staggering-the-board proposals and some of these others. The reaction to these precatory resolutions, frequently based on advice that we and other lawyers would give the company, was that these issues are basically business judgment issues for the board of directors, that the board was not bound to accept the advice of the shareholders expressed in the precatory resolution, and the board could exercise its business judgment as to whether it was going to redeem the poison pill or not redeem the poison pill.

As we come closer to today, particularly after the Enron/WorldCom scandals, the New York Stock Exchange corporate governance proposals, Sarbanes-Oxley, SEC regulations, and so on, there's a much different attitude in the boardroom. Directors today are very concerned about the reaction of shareholders, and much more reluctant to accept the advice of management, the advice of lawyers, even the advice of totally independent lawyers who have no connection with the corporation. Basically, they are saying, "Well, this is what the shareholders are saying, and I don't want to face a withhold-the-vote campaign." Directors today are very, very concerned about the impact on their reputations if one is singled out as the culprit on one of these precatory resolutions, or two or three are singled out, and there's a withhold-the-vote campaign and they get a significantly lower vote than the other directors.

The institutions obviously have become aware of this. Within the past two weeks, CalPERS announced that it was going to withhold the vote for audit committee members of corporations that continued to allow their auditors to give tax advice – not preparation of the tax return, but tax *advice*. This was an issue that the SEC considered under Sarbanes-Oxley, and in the rule adopted by the SEC, auditors are not barred from giving tax advice. But as far as CalPERS is concerned, the SEC didn't go far enough. Therefore, CalPERS is taking an independent position with respect to auditors providing tax advice to the company that they audit, and they're trying to force their opinion through withhold-the-vote campaigns.

I think these are quite significant developments. Today there is a much greater response to the desires of shareholders. When you consider that along with the new corporate governance regimes, the first question I have is, "Is this the time to throw a whole new regime into the picture?" In other words, is this the time to say, "The ability to propose Section 14a-8 resolutions, the ability to conduct withhold-the-vote campaigns and so on, is not enough. Something more is needed. And now we have to run a direct election contest, where shareholders will propose one, two, three directors to run in opposition to the incumbent slate of directors."

Think about that for a moment, and consider the board of a typical large public company – it has 11-12 directors, more than half of them are CEOs of other large public companies – when the company has been faced with a precatory resolution. Or not even a resolution – consider a company that has received a letter from shareholders, or an institution, or an advisory organization to shareholders, asking for something to be done or not to be done. And consider if the company does not do what has been requested, and the shareholders commence a withhold-the-vote campaign or, if the failure to do what has been requested is sufficient to trigger this access proposal, and two or three nominees are then placed in opposition to the incumbent directors. There are very, very few directors who are CEOs of major companies who want to run the risk of the embarrassment of losing one of these election campaigns, and the natural reaction is to turn to management, and try to get management to go along with whatever the request may be. In large measure, there's an enormous shift in influence, from the board of directors and the management considering collegially what is the appropriate strategy or action for the corporation, to this pressure on directors to go along with what shareholders want.

Joe Grundfest, in a little exchange he and I have had recently with respect to our respective proposals, stated it best. He said, "Well, to sum up your position, Marty, what you really object to is a proxy fight on the cheap." And I think that does sum up my position. I object to a proxy fight on the cheap. If shareholders feel strongly enough about either a governance position or a corporate strategy, whatever it may be, I think the appropriate thing is for them to conduct a real proxy fight, not a proxy fight on the cheap. And not try to combine the various 14a-8, withhold-the-vote, and now access provisions to, in effect, dominate the board of directors with respect to their particular issue, and force their view in opposition to the view of management and the board of directors. I think it's a significant problem. It's going to have a major impact on management's attitude toward certain kinds of risky ventures, transactions, and so on. There is a real concern that management will not engage with the board of directors, for fear that the strategy that's adopted will not be acceptable to investors and, therefore, result in a real difference of view between management and the board of directors.

I'll close by commending to you two articles in *Fortune* magazine within the last year. The first was an interview by the reporter with Daniel Vasella, who is the chairman of the board of Novartis, a major Swiss pharmaceutical company, and the other is an article by Bill George, the recently-retired CEO of Medtronics Corporation. Both are quite well known here at the Harvard Business School. Both have been participants in Jay Lorsch's symposium on corporate governance issues, and each of them discusses the tremendous pressure that they felt as CEOs to meet quarterly earnings goals, the pressure that they got from analysts, portfolio managers and so on, and how difficult it is for a CEO to resist those pressures. They discuss how many CEOs succumb to those pressures to create reserves or, in one way or another, to fiddle with the books, cook the books, some of them crossing the line in the scandalous situations, actually committing fraudulent acts. I'm not at all sure that passing to a potpourri of shareholders the ability to have that much influence on the board of directors and management of the corporation is going to be good for the business of the corporation and, accordingly, good for the economy of the country. On that note, I'll end.

Mark Roe: Thank you, Marty.

Lucian Bebchuk: What I do in my paper for the Business Lawyer symposium, and what I'll try to do here, is to give an overview of the case for shareholder access to the ballot. The starting point is – and it's worth reminding us of this starting point -- that elections do play a critical role in the accepted theory of the corporation.

Chancellor Allen, in his well known *Blasius* opinion, reminds us that "the shareholder franchise is the ideological underpinning upon which the legitimacy of the directorial power rests." In *Unocal*, the Delaware Supreme

Court stresses that "if the shareholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out." Marty Lipton and Paul Roe, in an article published last year in support of takeover defensive tactics, stress that, whereas shareholders should not have a choice with respect to takeovers, shareholder choice has a place elsewhere. The say: "There is one critical place in the statutory scheme for 'shareholder choice,'…,'shareholder choice' is exercised in elections for corporate directors."

Shareholder power to replace the board is supposed to serve as a safety valve, improving both the selection and the incentives of directors. But this safety valve is actually missing; it's largely a myth. Marty and Steve said earlier this morning that shareholders have the right to nominate directors. But this right is very theoretical. To see that this is the case, let's take a look at the data.

In the last several weeks – with the help of some students, especially Fred Pollock and Rob Maynes who are here in the audience – I looked at the incidence of challenges to the board of directors. There were 200 cases of contested solicitations in the seven-year period from '96 to 2002 – that's roughly 30 a year. And as Marty and Steve mentioned this morning, there were about 40 such cases last year. But only a minority of these cases were of the type to which the above quotes refer.

The contests about which the Delaware Supreme Court talks in *Unocal* are ones in which a rival team proposes to run the firm as an independent entity in a way that would serve shareholders better. Of the 200 cases of contested solicitations, some are not about directors, many are in connection with an attempt to acquire or sell the company, and some concern attempts to open-end or restructure a closed-end fund. We were able to find less than 80 cases during the seven-year period 1996-2002 in which a contest was fought over who will run the firm as a stand-alone entity. This is about 10 per year.

Moreover, among the companies that were the subject of such attempts, most were very small companies. In terms of market capitalization, about 25% percent were below $30 million, 50% below $37 million, and 80% below 200 million. So we were able to find only 11 such contests – it's less than two a year – for companies with a market cap above $200 million.

Steve Rosneblum suggested earlier that our session should be titled "Should we have more elections?" I am happy to have this characterization of our subject. Given the above data, our question is whether we should have more elections than the negligible number we currently have. To concretize the likelihood of an electoral challenge that directors are currently facing—the likelihood of their confronting such a challenge in any given year is roughly similar to the likelihood of their being killed in a traffic accident in that year.

Also in terms of empirical evidence, a substantial body of empirical evidence produced by various researchers now indicates that insulation of boards from takeover threats hurts shareholders. Researchers have found that such insulation reduces firm value. It leads to worse performance along several dimensions, and it makes executive compensation less sensitive to performance.

Marty Lipton talked earlier this morning about the pressure from investors to de-stagger boards. It is worth mentioning in this connection an empirical project about staggered boards that Alma Cohen and I have recently completed. We find that charter-based staggered boards are associated with a reduced market value. The reduction in market value associated with such staggered boards is economically significant, with a median of about of about 6%. These findings, of course, raise questions of causation that we are exploring in our study. But the only point I wish to make here is that the shareholders pushing for de-staggering boards might not be completely wrong.

Now, I agree with Steve Rosenblum that the question of "What's the optimal incidence of electoral challenges?" is a difficult one. It's certainly less than 15,000 a year – it's much less. But I think it's highly likely that the optimal incidence is higher than the negligible one we have at present. If so, it would be desirable to move the incidence up. Furthermore, we must keep in mind that the current proposal is a very mild, moderate step, unlikely to produce overshooting.

The proposal currently under consideration is moderate in several ways. It's only about short slates. Furthermore, there is not going to be any reimbursement of campaign costs (which is desirable for reasons I discuss in my paper). Without any reimbursement of outsiders' campaign costs, it's not going to be the "proxy contest on the cheap" that worries Marty. It's going to be a bit cheaper, but it's not going to be all that cheap. In addition, we're going to have ownership and holding requirements, and the SEC is now talking about adding triggering events; such triggers would make the arrangement too mild in my view, though still a step in the right direction.

In my paper, I tried to go over all the objections that appear in the letter comments to the SEC and to explain why none of them provides a good basis for opposing the proposal. With the paper providing a comprehensive response to the full range of objections raised, I'll just note here the weaknesses in some of the main objections.

One main objection is that shareholder access would produce a lot of disruption and waste. However, given that there will be costs and threshold requirements, we are probably going to have only a limited number of contests. More than a couple a year for over 200 million dollar companies, I hope, but not a very large number. In any event, since the SEC can adjust the threshold requirements as experience accumulates, it can ensure that the incidence of contested elections will not grow too much.

A second objection that opponents make is related to what Steve Rosenblum said earlier. He wondered: if the reform gets you to 30 or 40 electoral challenges a year, is this such a big deal? Well, if it's not a big deal, why are Marty and Steve and other supporters of board control so concerned about the change? The reason is, I think, that 30 or 40 electoral challenges a year can have a system-wide consequence. Thus, while actual costs will be incurred only, say, in 30 or 40 cases, these contests are going to have an impact on accountability across the board.

A different set of objections accepts that shareholder access could have a significant impact, but argues that their impact on the composition of boards would be a negative one. One concern that is raised is that we'll have special interest directors. But the shareholder access proposal does not really open the door to special interest directors. This could happen if we had cumulative voting, so that 10% of the shareholders could get a person on the board. But with the majority of the shareholders necessary to elect a shareholder-nominated candidate, special interest directors would not be elected. Indeed, when you look at the patterns of voting on precatory resolutions, you find that proposals catering to special interests do not come even close to passing. The only proposals that ever get sufficient support from institutional investors to get a majority are those that institutions conclude, whether correctly or incorrectly, would increase shareholder value.

Opponents of shareholder access also worry that the election of shareholder-nominated directors creates a risk that the board would be Balkanized and become dysfunctional. But this risk is one that voting shareholders would recognize and could take into account. They would presumably vote for someone only on those rare occasions in which they conclude that, given directors' dismal performance or their corporate governance failures, the risk of Balkanization is worth bearing. Note also that the number of cases in which shareholder-nominated candidates would be actually elected would not be large, whereas the benefits would result in companies across the board.

It is worth noting that, in their well-known article from ten years ago Marty Lipton and Steve Rosenblum found a shareholder access regime acceptable. To be sure, they proposed to have shareholder access in the context of a proposal to prohibit hostile takeovers, which the law has since largely done, and they proposed to have elections with shareholder access only once every five years. But the mechanism that they propose, and that they thought would work well, is similar to the one that we are discussing here. Under their proposal, shareholders with over 5% would be able to put someone on the ballot. Indeed, Marty and Steve were willing to provide challengers with a reimbursement of costs. They also dismissed the concern that we would have a wholesale replacement of directors on grounds that the main effect of such reform would be indirect: the very credibility of an electoral challenge would lead directors and managers to behave differently.

Marty Lipton talked earlier about the concern that, if we make directors more accountable to shareholders, this will subject management to incentives and pressures to act in a myopic, short-termist way. The claim that shareholder influence will lead to corporate myopia is one that has been often invoked by supporters of insulating management form takeovers. But there is no empirical evidence that this kind of effect is of significant magnitude. To the contrary, the empirical evidence indicates that insulation from takeover pressures is correlated with lower firm value and worse performance.

In any event, even if one is concerned about management's not being able to pursue a long-term strategy, one should at most oppose having real, serious elections each year. Holding this view might lead someone to seek measures that facilitate an electoral challenge only every two or three years. But such measures are necessary at some point. The answer to when a serious electoral challenge could be mounted should not be "never."

Opponents of shareholder access also raise the issue of other constituencies, the stakeholders. The claim is that we shouldn't increase accountability to shareholders, because that might come at the expense of stakeholders. It's good to insulate management, so the argument goes, in order to enable it to protect stakeholders. But we must keep in mind that directors' interests are hardly aligned with those of stakeholders. Thus, by providing broad insulation, we are reducing accountability to shareholders, but we are not creating accountability to stakeholders. Insulation simply creates accountability to no one. It protects and facilitates occasional poor performance that can hurt not only shareholders but likely also stakeholders.

I also would like to say a few words about the objection that "maybe it's a good idea, but now is not the time." Now is not the time, it is argued, because we already have some recent and pending reforms, which would increase the dominance of independent directors on boards in general and on nominating committees in particular. But director independence, by itself, is not a magic cure-all.

For each company, there are millions of people who would qualify as independent director. In the face of such a vast pool of independent candidates, the question is: "How do we ensure an optimal selection of those people and to provide those selected with the right incentives?" For these purposes, we need not only independence from insiders -- but also some dependence on shareholders. Even if we expect the nominating committees to do a pretty good job most of the time, it would be beneficial to have at least a limited safety valve. Indeed, having the safety valve would make it more likely that nominating committees would work well to begin with.

Let me conclude by answering Steve's question. Do we want to encourage more contests than the practically zero contests we now have for public companies of any significant size? The answer to this question should be "yes." The case for moving the incidence of electoral challenges up is very strong. How far up might be a question, but not one that needs to bother us when examining the moderate step that the SEC is now considering. Indeed, for reasons that I discuss in my paper, it would be desirable to adopt some additional measures for further invigorating the corporate elections process.

Mark Roe: Marty? Steve?

Martin Lipton: Ah, yes, we have comments, I'm sure.

The statistics that Lucian uses are essentially irrelevant to the debate. It isn't a question of how many election contests there are, whether companies that have staggered boards do, in fact, have a lower market value than those without. For every one of the statistical studies one can find a counter statistical study. The real issue here is: will this have a beneficial impact on the way companies operate? Because what we're really concerned about is: what is the overall impact on a society that, basically, is a corporate economy society?

Today it has become extremely difficult for companies to recruit new directors. I think that this proposal will exacerbate that problem. The combination of the reforms, together with the litigation and reputation exposure, has done two things. One, most major companies are now limiting the number of boards their CEO can serve on. Many, many companies today say to their CEO, "You can only serve on one outside board" for a combination of reasons, but the principal one is that the job of a director today takes so much time that an active CEO really doesn't have the time to serve on three, four or five boards. At best, that's something that a retired CEO can do.

Anything we do at this time that is a deterrent to companies being able to create boards that can be helpful with respect to the strategy and the business of the company is a mistake. I think that most boards – the overwhelming majority of boards of the major companies today – are acutely aware of the governance issues, and so on, and we don't need a further safety valve. The safety valve is having a board that has a majority of independent directors, and appropriate procedures so those directors focus on the issues that they should focus on. The history of the past 10 years, starting with General Motors, is that boards of major companies will take action to change management when it's clear that management should be changed.

Mark Roe: Lucian? Couple of minutes?

Lucian Bebchuk: A quick reaction to Marty Lipton's point that "the statistics are irrelevant." The question of "What way would it be better to run the economy?" cannot be resolved fully except with hard empirical evidence. There are policy arguments on both sides and empirical evidence is needed to shed light on the significance and magnitude of potential effects. Marty said that for each study, there is a study that goes the other way. But I don't know of any study that shows that board insulation in general, and staggered boards in particular, improve value. And if Marty can find or produce such a study, I promise to write a strong letter to the SEC objecting to the shareholder access proposal.

One point that Marty made—and this is a point that probably rings strongest of all the objections filed with the SEC—was that the considered reform could deter good directors from serving, so it could make matters worse rather than better. We should keep in mind that, in the business world, individuals holding various business positions may generally be replaced to provide a safety valve for selection and to provide incentive. And this makes me wonder: is there no way to run our corporate system without ensuring that the people at the very top face no risk whatsoever – even not a risk of 3% a year – of an electoral challenge.

Note also that, if the proposed measure is adopted, directors asked to serve on a board will not have to expect that they will necessarily and immediately have to participate in a contest. They would just face some likelihood that, down the road, if the company doesn't perform well, a short slate might be run against them. This sort of small risk is something that we could compensate people for. The value of improved accountability and incentives in our large publicly traded companies is sufficiently significant that we should not be deterred easily by having to increase compensation to directors.

Martin Lipton: I don't see anything in this proposal about it being triggered by the company not running well, Lucian. And as you well know, what's going to trigger this is not the way the company runs, but whether some gadfly's favorite corporate governance point has been acceded to by the Board of Directors, and whether enough pension funds and union funds will be frightened enough by ERISA or something else into supporting the position that the gadfly is urging. So if this was, in fact, an election based on whether the company was doing well or not, you'd have a valid point. Absent that, I think that you're accomplishing nothing favorable. Insofar as comparing companies, unless you're comparing peer companies with respect to things like staggered boards or poison pills or something else, your statistics are totally invalid.

Lucian Bebchuk: Actually, we *are* controlling for all the relevant company characteristics. We will send you the paper and we look forward to comments. As far as we can tell, we have controlled for all the relevant—

Martin Lipton: All of your studies, Lucian, your control points and mine are totally different. Staggered boards, poison pills, and so on…

Lucian Bebchuk: Okay, but—

Mark Roe: In lieu of reading the papers right now, why don't we… Lucian has a quote. And then after the quote, questions and comments from the rest of the group.

Lucian Bebchuk: Marty was asking me, "Why would it happen mainly with poorly-performing companies?" Well, if we look at the current proxy contests, most of them are for companies whose performance is worse than the industry. We can expect that shareholders will have a meaningful chance of electing a dissident short slate, and thus will bother to nominate one, primarily when performance is rather poor.

In their article on their quinquennial proposal, Marty and Steve explained why they thought that a five percent threshold will get it right as follows: "These thresholds are high enough to exclude 'gadfly' stockholders, but low enough not to impede the serious, substantial stockholder who wishes to propose nominees … in an election contest…”. I also believe that a threshold ownership requirement of this sort can serve as a good screening device. The screening mechanism that was good for Lipton and Rosenblum in their youth should be for good enough for us and for the SEC today.

Martin Lipton: It's my very old age; it was Steve's youth. But again, you're taking it totally out of context. It was in the context that the election would be based on the company's performance, with performance statistics. It had nothing to do with thresholds or anything else other than that was the starting point. The whole purpose of the proposal was to have a focus on the company performance in relationship to the performance of peer companies. So, again, you're taking it out of context to make your point. That's not what we were proposing. We were not proposing, willy-nilly, that at some threshold, institutions should be permitted to run an election contest at the cost of the company.

Mark Roe: Questions? Comments? Mechanics – say your name, if you like, a short biography after your name and a tape, then, will be transcribed.

Robert Monks: I'm Bob Monks, and I'm never sure what a gadfly is. The people I refer to as gadflies, I don't like, but I've been referred to as a gadfly very often by a lot of people, and, as I hear the discussion, I really want to put it in some kind of context, and the context is: do we presently have a problem? And to my way of thinking, going back to 1992, Congress indicated, as a matter of public policy, they wanted to discourage increased pay for CEOs, and they wanted to put a $1 million cap on deductibility.

According to Pearl Meyer, the compensation consultant in New York, the principal managers of American companies own, or had options on, 2% of the total of public company stock in 1992. In the year 2000, according to Pearl Meyer, they have 13%, so during the 90's, 11% of the total capital of publicly-traded companies moved, in effect, from shareholders to managers. A certain amount of this, deservedly, is called “stealth” compensation, because people really did not understand the implication of options. I submit that this is the classic case of the definition of a problem. It's, in effect, a 10% tax on shareholders in a year. How many more 10% decades can shareholders stand? How soon are we going to destroy a common stock as being something that intelligent people buy as a repository for their wealth?

We already see, increasingly, people going into private equity. Why do they go into private equity? Well, if you get 10% taken off every ten years of the value of your holding, it's not going to be very valuable, so I think there's a kind of crisis. So, as I listened to the discussion – which is a very informed and learned discussion, for which I am grateful – I'm a little confused, because to my way of thinking, we have to do something. The situation is not tolerable, the present level of CEO pay is not tolerable, and the only question is *what*?

Now, having been involved in the effort to effect change in a number of these things for many years, I am drawn back to the fact that the really legitimate place for shareholder focus is on the board of directors. I mean, shareholders really have no business trying to manage companies – they're not paid to do it, they're not qualified to do it – but one place where ownership expresses itself is through the composition of the board. As a practical matter, the board is – it's not a secret – a self-perpetuating institution. So long as it is a self-perpetuating institution, there really is no meaningful way for shareholders to be involved in the process. So the question, to me, is *how* they should be involved.

Now, anytime anybody stands up and makes a proposal for how they should be involved, they will be wrong, because they will make a mistake. That should not bother anybody. What is really important here is that the proposition of the entitlement and the propriety – indeed, the necessity – of shareholder involvement in the selection of directors be affirmed.

Mark Roe: I'll interpret that as a question to Marty.

Martin Lipton: I thought it was an affirmation for Lucian.

Mark Roe: There were other hands. Brian? Brian Hall?

Brian Hall: Yeah, I do have a question for Marty. Brian Hall, professor at the Harvard Business School. I don't understand your comment about the independence of directors, because one of the things that seems pretty clear is that even if we passed rules that ensure independence, that there's really no effective way, when the CEO is the Chairman of the Board in a self-perpetuating situation, that that influence isn't going to be very strong. I mean, that is the fundamental problem – that the board is not independent, and I just don't see how we could have any comfort, given our current situation, that that won't continue. There's just really nothing that can penetrate that board, if the CEO is exercising an influence. The screening is going to happen no matter what we do, and I don't understand what counter-proposal we have to solve that.

Martin Lipton: I'm going to refer your question to your colleague, Professor Lorsch, who's sitting there in front of you, who is much better at responding to it than I am.

Jay Lorsch: Brian, I just really don't agree with you that it's impossible for boards to be independent. We've made a lot of progress in that direction. There's no question in my mind that independence is not only a legal concept, but a psychological concept, and that directors always have the problem, the longer they've been on the board, of maintaining their independence from the management and the CEO, particularly if the company is doing well, but I think, you know, unless we're going to scrap the whole idea of boards of directors as we know them in America, we've got to stay with this idea of independence and believe we can make it work.

Brian Hall: So, Jay, you wrote a terrific book about 12 years ago, and the basic point – really a great one – was just that boards often look like pawns. Read the WorldCom report today, if that looks like a pawn board. I agree that things have gotten better, but it sure looks like there's a lot of pawn behavior going on out there; I'm not sure what it is that we have that's going to stop that.

Jay Lorsch: Well, you and I need to go across the river and have this debate.

Mark Roe: After that, Chuck Nathan.

Charles Nathan: It's Chuck Nathan, and the issue I'd like to raise for both Marty and Lucian is along the following lines: Marty, in the beginning of his remarks, gave what I believed to be a very fair characterization of the true dynamic of today's board in the face of precatory proposals, at least in the area of governance, and perhaps farther than the area of governance; that, very often, they lead to a negotiation with the proponent of the precatory in an effort to get the precatory proposal withdrawn and find an accommodation that is deemed suitable by the proponent, very often a large public pension fund or union pension fund, and I think Lucian skirted around the same issue.

The question I have is: are we really talking today about 15 or 20 or 30 of what Alan Beller calls "small-'c' contests" for directors – you know, for shareholders to place directors on board. Are we talking about a fundamental shift in the power relationship between the large public pension funds and union funds and boards of directors that will be exercised and take place behind the scenes in negotiations not only about who is on the board, but about all other sorts of corporate behavior. I mean, isn't that the real issue that we're addressing today, although we're not characterizing it that way?

Martin Lipton: Yes.

Lucian Bebchuk: No, but…

I wish to comment on the precatory resolutions and the "pressure behind the scenes" that Marty and Chuck talked about. There are about 200 resolutions for dismantling or de-staggering boards a year, and most of them receive majority support. It's still very common for the board, whatever happens behind the scenes, to ignore a precatory resolution in favor of de-staggering the board. Boards do so even though the staggered boards are often ones that were installed back in the 80's or even earlier, when their current anti-takeover significance was not fully anticipated.

I also wish to react to what Chuck said about unions and pension funds. The concern is that their influence might be dangerous because they have an agenda that does not fully overlap with increasing shareholder wealth. But the unions and the pension funds generally do not even come close to having a majority of the votes. Thus, the issues that can lead to a majority vote against management are only those that have substantial and broad support from institutional investors that focus on shareholder wealth.

Mark Roe: Joe, you were going to say?

Joseph Grundfest: Yeah. Joe Grundfest, Stanford Law School. Two observations and a question for Marty and a question for Lucian to keep it fair. First off, I think it's clear that if you like, or if you're entertained by the California gubernatorial campaign, you will love the commission's proposal. There are fundamental similarities there, and one should expect similar experiences.

Second, Marty made an observation that I think is accurate with regard to an authority that shareholders already have – and Bob and Sarah, they know about this authority – is to withhold authority for the re-election of a director. It's my impression that a large percentage of directors have fairly thin skins on these issues, are susceptible to a great deal of pressure and to moral persuasion and the like, and perhaps shareholders haven't been using authority that they have had for a very long period of time most effectively to try to get to many of the changes that many of the shareholders want to have. So if we see a bit of a governance crisis, is it possible that part – I'm not suggesting all – that part of the responsibility comes from the fact that the shareholder community itself hasn't been as effective as it could have been in joining issue with corporate boards?

The question I'd put to Lucian first is, that I agree with your reading of the data with regard to shareholder value – that the evidence is that if you insulate corporations from takeovers, that's very bad for shareholder value – but many of these proposals we're talking about have nothing to do with anything that's ever been demonstrated to enhance shareholder value, and they are susceptible to being vehicles for special interest agendas, and as Marty, I think correctly, points out, there's no reason to expect that the commission is going to think that way.

And the question that I'd put to Marty is – and here I'm quoting you, you just said that "If this is an election on whether a company is doing well, you would have a valid point" – but that's what I thought a takeover was about, and much of the agenda that you've been advocating over the years, Marty, raises the cost of an election about whether a company is doing well, and, from my perspective, I'd be willing to grant tenure to boards of directors, make them academic-type positions, make them monarchical, if you had an easier market for takeovers. If somebody said, "Look, this is not a proxy on the cheap; this is a proxy on the expensive. Here's ten billion dollars; here's an X percent premium over what the company is trading at today. That's as expensive as a proposal gets. Let's put it up for a vote – take it or leave it."

Mark Roe: So, Marty? Tenure? Takeovers?

You could just say "yes" again.

Martin Lipton: I guess I could say yes. I think it's the whole point of the quinquennial proposal – a referendum on whether the company was doing well, rather than a different way of getting at a change of control for companies that aren't doing well. I think that shareholders *should* change the management of companies that aren't doing well. I think that there's virtually no permanent takeover defense today, Joe. It is extremely rare that a company remains independent in the face of a takeover bid today, or very, very rare that a board stands in the face of a cash bid at a significant premium for 100% of the shares of the company. In most cases, the effort is to use the takeover defense to try and obtain a better deal for the shareholders. So I don't really see any need for this kind of proposal to deal with the takeover issues.

You and I have always disagreed with respect to takeover defenses; we're not going to agree today or in the foreseeable future. I don't see any real utility to unlimited hostile takeovers, and I don't think the results on a zero-sum basis have been favorable for the shareholders of companies at all. You need to take into account the shareholders of the acquiring company and balance that against the obvious profit or benefit that the shareholders of the target company get and, therefore, it's not beneficial for the economy as a whole. But I'm afraid that's a debate that's taking us off the main point of this.

As I said to you, I think your idea with respect to withholding the votes is an interesting idea. I don't think you'd need to go as far as you've gone with it in terms of handicapping the director who's had votes withheld. Just the withholding of the vote is a very potent weapon, and before the SEC takes this step, we ought to have a bit more experience with that. I think the CalPERS position with respect to the audit committee members is an interesting experiment, and we should see how that goes.

Mark Roe: Lucian?

Lucian Bebchuk: Joe Grundfest views pressure from shareholders to dismantle the takeover defense as good. But then has asked "What about all those other proposals out there?" Well, the evidence on precatory resolutions, which the Georgeson shareholder website provides, indicates that the only proposals that pass are those about de-staggering the board and dismantling poison pills. Proposals that are of a special interest or social activism nature regularly fail to pass. Mutual funds and money managers, whose support is necessary to getting a majority, do not vote for such proposals. The evidence suggests that institutional investors are somewhat deferential to management, and that they will support proposals opposed by management only on issues such as takeover defenses where they feel that management's position is clearly not serving shareholder wealth.

As to Marty's point that, in the end, takeover defenses do not really prevent takeover targets form being acquired: John Coates, Guhan Subramanian and I provide evidence on this issue in an article published last year. We find that a majority of the companies with an effective staggered board that receive a hostile takeover remain independent -- both in the short run and in the long run, defined as two and a half years down the road. Furthermore, remaining independent reduces significantly, both in the short run and in the long run, the returns to target shareholders. The evidence on this topic, at least, is clear: takeover defenses do work, and they do so to the detriment of the shareholders of targets that have them.

Mark Roe: I've seen several hands pop up in the last few minutes, and we now have about a few minutes to do it, so why don't we work on short, pointed questions and short answers. Matthew Bishop?

Matthew Bishop: Yes, I was rather shocked by Marty's denunciation of the quality of people on corporate boards and in shareholder institutions; they seem to be these figures that will roll over at the first criticism by a shareholder to a corporate board member, and you won't be willing to go to a board if you're going to be criticized and in some bruising election. Likewise, institutional shareholders, you seem to feel, are such weak people that a trade union could put a proposal on a proxy and they'll just roll over and vote for it for fear of being embarrassed.

I must say, my experience of dealing with people both in shareholding institutions and on company boards, as a journalist, is that they aren't these figures, but I'm willing to go with this that they're all terribly weak and feeble individuals, and I was wondering what Marty feels we can do, actually, to raise the quality of people on boards and whether journalists on boards might be the answer.

Martin Lipton: What we have to do is put journalists in both positions, as portfolio managers and as corporate directors.

Matthew Bishop: Strange that we've never been asked. I'm willing to sell out, though.

Martin Lipton: How noble!

Alan Beller: This has been extremely interesting and helpful to me. I think there is a sea of windmills in the middle of this table, and I think that this conversation and, I think, the subsequent ones might be more interesting if we got some of them out of the way. I might be able to help since I suppose I know more about what we are contemplating than others. First, to Joe's comment – I'm sure the average intelligence has gone down at 4 55th Street since you left the building, but I *promise* you we are smart enough to avoid the California election whatever it is.

Secondly – and more seriously – a lot of the discussion has focused on the inter-relationship of what the SEC might be thinking about and the current issues with respect to precatory shareholder proposals. It is true that the Division's report talks about adopted, unimplemented precatory proposals as a possible triggering event. For those of you who weren't at dinner last night, I did spend a little time talking about why that prong suffers from some issues of indirection and the like. I don't think the discussion today should be anywhere near dominated by that particular issue. I think there are more important ones out there to talk about.

And I suppose the last thought I would share with you is I don't quite understand the on-the-cheap point, and I don't quite understand the at-the-company's-expense point, with respect to this kind of a short-slate proposal.

At least, I don't necessarily understand it, and it seems to me a more profitable dialogue around those points would be, "What should companies be required to do if you have such a proposal?" Don't assume it looks like 14(a)(8); don't assume anything.

And secondly, I think— I don't understand how one can expect the majority vote without some activity by the proponents, and I don't think that's "on the cheap." Any proposal of the sort talked about in the report would not require the proposing shareholders to make that very expensive initial mailing to all the shareholders. That, I would ask you to discuss as the principal economic difference between what might result if the commission were to move forward, and the case today, and I guess I don't understand why taking a million dollars of the shareholders' money and throwing it in the wastebasket is either an expense to the corporation or causes the election to be "on the cheap."

Now, to my question, because I wouldn't have raised my hand without one. Marty, would you be interested if we had a triggering event? We've talked about it in the report as a possibility. Suppose we had a triggering event that *was* tied to corporate performance: Less than X percent earnings or EPS increase over the last three years; less than Y percent return on assets. Would it be appropriate to open the kind of proxy process we are talking about to be used at companies where these kinds of performance targets aren't satisfied?

Martin Lipton: Not on the basis of your proposal right now. There are things like the quinquennial proposal, where I think that is an appropriate approach. But I think this approach, the approach that, in effect, is opening every company to a proxy contest with respect to some members of the board of directors, is a mistake.

Alan Beller: Every company that doesn't perform.

Martin Lipton: Every company; every company, whether it performs or not. I think there are means for dealing with under-performing companies or companies that are not performing, but I don't think this is the way to accomplish it.

Mark Roe: Okay, a couple more questions, and then maybe a minute or two…? I see Michael Price right now, and Leo Strine.

Michael Price: I'm Michael Price. I used to run a mutual fund, now I'm an individual investor. A few comments on what I've heard, and then one big point that I think everyone is ignoring. The comments are first to Bob Monks, on the idea of "We're giving 10% of our equity away, and that's why so much money is flowing to private equity," makes no sense if you look at what private equity managers get paid.

Robert Monks: I know what they get paid.

Michael Price: It doesn't go anywhere. I think there's also a kind of blending of shark-repellant arguments with this corporate governance issue. To me, a staggered board is solely shark repellant. I don't like 'em. But it has nothing to do with outsiders proposing directors.

And the last point – and then my big point – is there seems to be a grab of power from Delaware, mostly, and other states, to Washington, in this effort, and, basically, since '92, and even back into '80, we had pretty good success with forcing change. I think that boards today are not circling the wagons the way they did in the 80's. I think boards and managers, CEOs – and their lawyers, because, you know, often, they'll sit in on meetings if we call someone to task – will really push hard. They have a whole different mentality, and this is not the time to introduce this kind of grab by Washington from Delaware.

But there is one big problem I have, and we all have, and that is you can't find good directors. Okay? If there are 10,000 more-or-less decent-sized companies in this country, so that means there are, call it 60,000 outside non-management directors? Maybe 500 or 5,000 are good. Maybe. And, out of those 10,000 boards, I'll bet you half of them are looking to add at least one, and 10 or 20% are looking to add two or three directors today. They're all doing searches. There's no way to find anywhere near that number of directors who will take phone calls on a Saturday morning when they have a golf game, right? Who have a net worth, because they're 60 years old and they have some net worth, that are going to subject themselves to, you know, lawsuits by shareholders, SEC actions, shareholder criticism, *The Wall Street*

Journal, *The Economist*, whoever want to write about them, okay? They're not there today!

So here you're all arguing about, "Oh, let's put guys up or not." There aren't good people to put up. That's our big problem. Finding directors (a) who have credentials is number one, and (b) who have backbones. You might have credentials but you don't have a backbone. And the third is they have to be paid a lot more than they've been paid, so we're ignoring the fact that they're not there to put on boards.

Mark Roe: Leo? So you scared away all the good directors?

Leo Strine: Leo Strine from the Delaware Court of Chancery. I was struck by how much this current discussion really, as Mike said, this is really a sort of sideshow to the real discussion, in that what we're doing is trivial things, so that the SEC doesn't have any real Congressional mandate to do any of this, and the stockholder advocates are frustrated about staggered boards… Why not just go to Delaware, ask us to get rid of staggered boards in exchange for management not having to deal with silly precatory proposals, and then we'll see how that works for a couple of years with Sarbanes-Oxley.

Now, that might be a mature discussion about costs and benefits, but this seems to be about people not wanting to put up long slates, they want to put up short slates, and they want to do it every year in a few situations, management doesn't like that— I mean, it doesn't really sound like a real debate about institutional change in any sophisticated way that takes into account, "Where are you going to get these people? Who's going to fill out these slates?" And if you only want to put up short slates because you can't put up a long slate, maybe you're not really a responsible entity to be determining the future of a public company.

Martin Lipton: I'd back that deal right now.

Mark Roe: People will have more chances at the microphone later in the day. Why don't Lucian and then Marty or Steve take a minute to sum up, or get one point that you've got to get out before we take a coffee break?

Lucian Bebchuk: Just a quick reaction to the discussion of antitakeover arrangements. Antitakeover arrangements and the absence of shareholder access to the ballot are quite connected. Michael Price views them as very different things, but they are connected in that both are part of what defines how insulated the board is from shareholders. And, as Joe Grundfest said before, strong insulation from takeovers that now exists makes the voting mechanism all the more important.

Also, Michael said that having shareholder access will require paying directors much more. But improving the incentives and selection of directors even a bit would be valuable to have – given that publicly traded companies have a value in the order of $10 trillion – even if this required paying people somewhat more, or even significantly more.

Mark Roe: Marty? Steve?

Steven Rosenblum: Just a couple of points. One is about statistics - and I generally agree with Marty that they are largely irrelevant - but I was interested that Lucian's statistics went from 200 election contests in seven years, to two a year, to one a year, to practically zero, and to being similar to the risk of dying in a traffic accident. The fact of the matter is that the incidence of election contests today does drive and affect director and management behavior. Just as the fact that not many people die in traffic accidents doesn't stop people from wearing seatbelts and worrying about car safety. And there are many other avenues already that are putting pressure on directors, and pressure on management, to be responsive.

I think that Michael is actually right in that there's been a huge transformation over the last fifteen years. There's been a whole panoply of new governance proposals that will have impacts – exactly what they are is too early to tell – but to be throwing this on top of all those is a mistake.

And your point that the SEC can gain experience and then modulate the threshold to create the optimal incidence of contested elections, I think, is just wrong. Once the threshold is set, you're never going to raise the threshold, at least in the near term politically. In the governance environment we have today, it's just not doable. So you're taking a shot in the dark that we think is going to have an adverse impact, if any impact. And I'd also agree with Michael and Leo that it's really missing the point, which is finding good managers and good directors to perform better. This proposal will not help that; it can only hurt.

Mark Roe: Well, thank you. This is a good discussion. We've got a whole day ahead of us, and I can see that minds are being changed and people are giving up opinions that they had when they came in the room! Coffee break, and then we reconvene in about fifteen minutes.

Session 2: The Board/Management Perspective

Panelists: Richard Breeden, Richard C. Breeden & Co.
John Castellani, The Business Roundtable
James Rogers, Cinergy Inc.
Ralph Whitworth, Apria Healthcare Group and Relational Investors

Moderator: Jay Lorsch, Harvard Law School

Discussion Participants: John Wilcox, Georgeson Shareholder
Robert Pozen, Harvard Law School
Damon Silvers, AFL-CIO
Robert Todd Lang, Weil, Gotshal & Manges

Jay Lorsch: Okay, good morning. Good morning again. We'd like to get started. I thought Mark did such a good job of being a moderator that I was going to follow his example, so say very little, and ring the bell when necessary. We have four distinguished gentlemen who are going to give us their views about this proposal, and although he's objected, we had a little discussion here and decided we'd go in alphabetical order. So we'll first hear from Dick Breeden, and then go alphabetically from there. We'll try to take about five minutes each, so we'll have some time for questions and answers and discussion afterward. Dick?

Richard Breeden: Thanks, Jay.

Jay Lorsch: You're not going to read that whole report, are you?

Richard Breeden: I'm not going to. I was just going to say I hope you all work hard on getting the balance right of accountability and responsiveness versus concerns of orderliness and tidiness that we've been debating this morning, because if you don't, then you may wake up someday, and find you have a corporate monitor, and you'll get a whole bunch of recommendations. You won't have just one recommendation to deal with, you'll have about seventy-five.

While I'm on that subject, because it has been a question of some debate out there as to whether restoring trust represents a set of recommendations that every company in America ought to adopt, and I just wanted to indicate that WorldCom – and I don't delve into its sordid past and history – but it was about as bad a set of facts of corporate governance as could occur, and so I think not surprisingly, the clean-up there involves everything up to, and including, the kitchen sink. And I think all the recommendations we put forward, we thought are a good idea for WorldCom, and would work at other companies.

That doesn't mean that every company ought to adopt all of them. We do think it's a menu of items that a particular company in a particular set of circumstances can look at the different suggestions that we've made and, some of them may make sense in a particular company, none of them may make sense in a particular company, or all of them might make sense, but governance is not a one-size-fits-all, and we weren't trying to write a piece of legislation, and we didn't have the challenge that Harvey and Allen have of working on regulations that would apply to all of corporate America. It was a tailored solution to try to clean up one very big, very sick company, and to really fix the problems of that company.

Apropos of this issue about the regulations, obviously the point in our report that bears most directly on it is a requirement that the company, commencing in 2005, have at least one new director every year, and it must utilize a process under which the nominating committee, upon developing a list of nominees, could be in an ad hoc group of shareholders representing at least 15% of the shareholdings of the company. Hopefully, they could agree on candidates that the company was considering would be proposed. If they're acceptable, fine. If the shareholders object, they would have a discussion. If they couldn't agree on a mutually acceptable candidate for that vacancy, then the shareholders group would have the right to put an alternative candidate on management's proxy.

In our system, there is no requirement of triggering events. The triggering event was the destruction of $200 billion in shareholder value. We think that's enough to trigger a bit of intervention, and so that's the system that will be in effect if there are any vacancies in 2004. You'll see it work in 2004. If not, you'll see it working in 2005.

Just to mention briefly a couple of other issues that are touched and some related points: I was struck a little bit by the discussion of whether or not you can find directors. Maybe going on the board of MCI is the most attractive offer that anybody could get these days, but I've been actively involved in the search process of looking for new directors, and I can tell you that we had more than three times as many candidates – *good* candidates, I mean very solid candidates, every one of whom met standards of excellence – for every seat on the board.

A number of those people – Eric Holder, one example, former judge, both state judge and federal judge, and former deputy attorney general of the United States, had never served on a public board. I think there are lots and lots of people in this country who are highly capable board candidates, including, I suppose, journalists. We certainly didn't find any difficulty, though we did go a bit outside the normal pond to fish in, looking for our candidates, but we certainly had no trouble finding them.

We also believe pretty solidly on the question of whether you should pay directors more. So many companies in the U.S. say they can't find any directors, but they do expect their directors to put their entire personal net worth at risk for a relatively tiny board fee: $30 thousand, $40 thousand, $10 thousand to sit on an audit committee is not uncommon in the U.S. At WorldCom, the annual board retainer was $35 thousand a year. The board met four times. The compensation committee met seventeen times a year, reflecting both their per-meeting fees and their priorities. We increased the board retainer substantially.

A lot of people don't want to do that because, I guess, there's a notion that if we paid directors more, heaven forbid they might think they're supposed to *do* something, and we actually do expect our directors in the future to attend quite a few meetings of both the Board itself and committees to be actively involved with the Company in assessing and evaluating its risks and working with management, and we think that's a very big job, a time-consuming job, and one that should merit reasonable compensation. So our proposal was with committee fees, all of our directors will be getting between $175 thousand to $225 thousand a year, and then 25% of that they would be required to re-invest in company stock, and in an attempt to actually align shareholder interests with those of managers and directors, we're actually going to make them pay for the stock instead of giving it to them. So we're paying a cash retainer, letting people pay their taxes on that, and then from that, reinvest in stock in the company.

My time is up, and I'll stop there. Thanks very much!

Jay Lorsch: You're a marvelous panelist, Dick. Thank you. Thanks to Floyd's newspaper this morning, I noticed that there are sort of two sides to this debate. If you saw the Times' business section, you'll notice that Sarah Teslik and her colleagues had a meeting, I guess yesterday somewhere. You weren't there, were you? I think you were reported as having been there. In any event, the point of view of those institutional investors represented there was that this proposal is not enough. And I think we're maybe going to hear now from John Castellani. I'm assuming that the Business Roundtable will offer the other point-of-view, which is that this proposal is too much. So, John?

John Castellani: Thanks, Jay. I feel, even though this is the second panel, a little bit like the person Shaw introduced one time during his illustrious life, with the introduction saying, "Everything that has been said about the topic has been said, but not unfortunately, not everybody has had a chance to say it."

So I'd like to take my brief time here to make several points, and first, let me say that nobody planned this. It has come about as a result of some unfortunate circumstances, but it is one of those teachable moments for reminding us about what the roles of shareholders and directors are in a corporation.

Secondly, to no surprise, as Jay said, we feel that there are a number of technical and legal problems with the SEC proposal, or at least what we think the SEC proposal will be.

Third, we think that the unintended consequences could be very serious.

And fourth, and perhaps the best thing that we feel we should do, is to step back and absorb the reforms that we've implemented over the last eighteen months, and understand the results of what we have done, because we have done so much.

Let me begin with the first point, the useful debate. It has been useful in challenging the public impression that corporations operate like a New England town meeting. I think we all know that that's not what corporations and shareholders are about, but I'm not sure that everybody who is involved in this process does understand that. We know that these are teams for stakeholders that range from our managers to our employees to our customers to our communities, and, yes, the most important, our shareholders. And on this team, calling the plays are the management and directors, holding these positions because of proven competence, experience and commitment. And there are a series of checks and balances in place, especially with Sarbanes-Oxley, the proposed listing standards, and some of the principles that our companies have adopted, and they will provide new and important accountability.

And further, a point I'd like to make is that, despite the popular impression to the contrary, there has been a tremendous turnover in both chief executive officers, and a decline in holding periods of stock of institutional investors, which demonstrate that the premise that managers and directors are permanently entrenched is not correct. Just to point out: when you come to our meetings, the average time in a job of a chief executive officer of the Business Roundtable in 1985 was eight-and-a-half years. It is currently four-and-a-half years, and 30% of our members have held their jobs for less than two years. So running a corporation like a New England town meeting, while it sounds great in the abstract, the reality is – and it should be – that it should be a team approach, and it should be a team that is always the best, and turns out to be the best.

The second point I'd like to make is that there are a number of technical problems with the SEC proposals. These are important problems, and we're not just nitpicking. For example, currently, all director nominees have to go through a very rigorous vetting process conducted by nominating committees composed solely of independent directors. And when we survey our members, we now have in excess of 80% of our members with two-thirds of them holding independent directors, and most are moving to having a completely independent nominating committee, well ahead of the requirements of the listing standards. Boards won't have the opportunity to do this same kind of due diligence on shareholder nominees that are inserted into a company proxy statement under a shareholder access rule.

And secondly, direct shareholder access may be inconsistent with state corporation laws. Third, under the proposal, proxy battles could proliferate, resulting in constant disruption of corporate operations, and that's certainly something we need to be concerned about. Candidates put up by special interests for directors could have financial ties to competitors, or otherwise not be independent, and that could violate other regulations. And last, the so-called "trigger events" that we've seen so far have been so broad that they could drag many well-managed companies into damaging proxy battles.

My third point of unintended consequences is also something about which we need to be very cautious. The famous sociologist Robert Merton wrote in the 1930's about the five sources of what he terms "unanticipated consequences." The first two are "ignorance" and "error," which certainly don't apply in this room or anywhere else. But the third was "the imperious immediacy of interest," and that happens, he wrote, when people want a result so badly that they choose to ignore any evidence of unintended consequences, and that's what we want to avoid; that we strive so hard to rid ourselves of rogue corporations and officers that we ignore the very real possibility of collateral damage to our corporations, and to those corporations' economic prospects.

One of the possibilities of a more direct control by shareholders could be the replacement of experienced, involved directors committed to the long-term success of the corporation by nominees put up by special interest blocks of shareholders, directors with axes to grind, or outside agendas. Second, as I mentioned, frequent proxy campaigns and excessive director turnover. Third, disrupted meetings and other director deliberations that consume the attention of the CEOs and the senior management who should be running the corporation and not be preoccupied by Board politics. And most importantly, while we've talked about, and Richard just talked about, the availability of well-qualified candidates, there is a difference between finding well-qualified candidates for boards of directors – and there are many out there – and well-qualified candidates who are willing to run in a contested election. And what we're talking about is, potentially, contested elections.

Everybody's talking about the California recall campaign, and I think it is relevant. But it goes beyond just California for a lesson, and that is in state after state, we've seen where voter referenda are straight-jacketing legislators and governors on issues ranging from property tax limits to protecting sows from inhuman confinement during their pregnancy. We should all learn lessons from state governments. Yesterday, as Damon knows, when I was testifying in front of the Senate Banking Committee on Sarbanes-Oxley a year later, senator Sarbanes said, "Well, we're a democratic process. We work very well." The concept of the Senate Banking Committee managing a large corporation was something that, thankfully, I didn't respond to immediately.

I think we do have to be concerned, because we are concerned, because we are talking about economic enterprises, and right now, that economy is suffering an overhang after the terrorist attacks and the ongoing war on terror, the bursting of the 1990's technology bubble, and the unfortunate loss of investor confidence due to the corporate scandals. We have to be careful in moving forward so that we don't create a fourth overhang, and that is a risk-averse environment for companies and their management.

My fourth and last point, that slowing down and taking stock may be best, requires some explanation. Remember, we've not yet fully understood the full impact of all of the Sarbanes-Oxley and the listing standard reforms that have been put in place just a year ago. We do know that corporate America has taken the reforms seriously, even though all of them are not legally required at this point, and in the survey that I referenced, let me just reiterate a couple of the high points: Eight of ten Business Roundtable members have boards that are at least three-quarters independent now. Virtually all of them have a closed meeting of independent directors without a CEO present. In fact, more than half of them expect to have at least five of those meetings per year in this year. Most all of our members have appointed an independent lead director or presiding outside director, or a chairman who is not a CEO.

And so the independence, and the independence that is so important to these reforms, is certainly taking on and taking hold. Some of the things we do know are these things are working. Some of the things we don't know yet are the long-term impacts of the reforms. And this'll take time, meaning we should all take a deep breath, watch this new era of corporate governance take shape, and learn from the need for further reforms, rather than jump into further reforms now.

Now, while much work remains, let's appreciate the new way corporations are being governed today. There is a great commitment, and an even greater and growing commitment, to independent directors and accountability of senior management. It is our desire to catch the misdeeds of rogue corporate officers and directors. They have hurt all of corporate America, and they have hurt both the value and the reputation of companies that had no reason to be affected because they were run well and governed well.

But let's not rush headlong into a new regulatory adventure that we don't know how it'll work, just because it seems like another good reform. Let's also appreciate how strongly our private sector is reformed in great part because of the confidence and dedication to serving all of the stakeholders. By and large, our directors have intimate, specific and deep knowledge of their companies, and their companies' entire commercial mission: its products, its capabilities, its competitive environment, its regulatory boundaries and its problems. And that's something that's worth protecting, and it's my hope that we do just that.

Wrapping up, we believe we need to digest the important reforms of the last eighteen months before we embark on a whole new set of reforms that could potentially jeopardize what we're trying to accomplish. Thanks.

Jay Lorsch: John, thank you very much. When Lucian asked me to help put together this panel, I figured we needed a real CEO, so we got Jim Rogers to come, and we're delighted you're here. People like Jim, as has already been attested to, are very, very busy, so I appreciate your time.

James Rogers: Jay, thank you very much. I'm delighted to be here. I was somewhat nervous, but as a CEO of an energy company, I've become increasingly comfortable with being in a room with many lawyers. I think that's a good thing. And even though we're headquartered in Cincinnati, I want the record to reflect that we had nothing to do with the August 14th blackout. So let me start.

Let me, if I may, frame my comments around three points, or three questions. One question is: will this proposal – and we're not entirely clear what the proposal is at this time – will this proposal actually encourage shareholder activism, and is there a need for that? Is that good public policy? And as I think about that, I would really direct you to consider I.S.S.'s numbers for last year for the proxy season. It was our first 1K proxy season, where we had over a thousand shareholder proposals, more than 800 governance resolutions, 152 majority votes – which is greater than ever, with the highest prior year at 106. So to put this in some context, I don't believe this is an aberration. This is a trend. And it's not clear that more proposals are needed to have greater shareholder activism when you see the level of activism we had last year. So, again, that would be the first consideration.

The second approach would be, in a broader context, from a public policy perspective: do we need this proposal to rebuild confidence in, and improve the credibility of, corporate America? Do we need it to restore the integrity of capital markets? Now, a bull market would really restore the integrity very well. Just kidding. Indeed, we need to rebuild confidence in corporate America, and maybe this idea (Proxy Access) is a good idea. Sarbanes-Oxley has already taken steps in that direction. We've yet to see the results completely of the enactment of that legislation.

And my third area is whether this proposal (and, by the way, this isn't a new proposal; in the late 40's, the early 70's and again in the early 90's, similar proposals were considered by the SEC)… will alter the behavior of members of boards and CEOs? And, frankly, I think you need to look at what the actual motivation is behind a shareholder proposal. If the motivation is simply poor performance, I believe that most boards in this country – and I serve on two other boards – are highly motivated to deliver.

We feel the scrutiny more now than ever. So if it's about poor performance, I don't believe this proposal will actually change those behaviors. It might accelerate the reaction to the poor performance, but I think it's an open question as to whether it really changes the focus that currently exists on performance. Now, if the motivation behind the proposal is special interest – it raises a different set of questions. Our company has received a number of shareholder proposals.

For example, as an energy company, we burn 30 million tons of coal per year. We have significant emissions from our plants of SO_2, NO_X, mercury and CO_2, and we've had a number of shareholder proposals from environmental groups. Also we have received proposals from unions who want us to use union contractors rather than non-union contractors. In summary there are many specific interests that are pursued through shareholder proposals. The fact of the matter is I've sat down with these groups and have reached mutually agreeable outcomes without our shareholders feeling the need to submit a proposal for a vote of shareholders. But I think that you have to look at the motivation behind the shareholder proposal, and, again, it really gets to the specific issues that are being driven. And so I believe that boards will respond – and our board has responded - when specific interest groups came forward with proposals. I don't think it will change the behavior of boards with respect to that, because I think we're already paying attention.

If you look at the SEC proposal it's not clear… My dad was a lawyer and he always said the devil was in the details; my mom always said God was in the details. And I heard a lot of religion here in the earlier panel with respect to this issue. I happen to be in the God's in the details camp. But here are the facts: if the proposal is as the SEC, I believe, has suggested, it's a two-step process. And if you think institutional investors are going to hang around when the primary driver of the proposal is poor performance, they won't be there. They'll be out of there. There'll be a new set of shareholders there at the time. So, from an institutional shareholder's perspective, it will not make much of a difference.

The second point I'd make is that, again, it gets back to the motivation behind the proposal. I believe, at the end of the day, most managements and boards will negotiate outcomes with these special interest groups. I would conclude by saying that the best defense for proposals motivated by poor performance is a great shareholder price and strong performance in the market, and the best defense to special interest is really good governance practices that are centered on a stakeholder philosophy, and that's certainly been our philosophy. Thank you.

Jay Lorsch: Thank you, Jim. Okay, now, finally, we're going to hear from Ralph Whitworth, who has been involved with a company which, I understand, Ralph, has a little bit of this proposal already in place and in action.

Ralph Whitworth: Yes. Okay, it's an interesting position for me to be sitting on a panel discussing the board and management perspective. I have served on a number of public company boards, and chaired a couple of them. I continue to chair the board of Apria Healthcare, which is the largest home healthcare company in the world. I've thought a lot about this issue going way back into the 1980's.

Back then, I wrote a petition for rulemaking to the SEC, and one of our panelists, Richard Breeden, was the commission's Chairman then. We had lots of discussions. We asked for basically three things: better compensation disclosure, a change in the "bona-fide nominee rule," because prior to that time if you wanted to run for a board you had to run a whole slate or no slate and you couldn't run a so-called "short slate," which we can now, and third, it asked for shareholder access to the proxy.

Well, the SEC, as we all know, did the good work on compensation disclosure, and they changed the bona-fide nominee rule. They didn't change proxy access. That issue has now resurfaced. Back then, we heard the same horror stories about the short slate process that we are now hearing about proxy access. Well, since then, the short slate rule has only been used about thirty times. I've used it about six or seven of those, and it's been very effective. It hasn't been disruptive.

None of all of the terrible things that were predicted have arisen from that, and I would argue that it's been extremely positive because it gives investors a process other than watching a company go bankrupt, making a tender offer, or seeking control of the entire board to effect change and spur optimal performance. So this isn't – I mean, we've heard a lot this morning – this isn't about just waiting until a company is so crippled or has such problems like WorldCom, where you get a monitor, or where you're bankrupt, or where your price has sunk so low that someone can buy you out. This is really about spurring optimal performance.

If you think about our elections system in corporate America, we have the incumbents, they pick a slate, they make out a ballot, they send it out to the investors, the investors vote, they sign their name and send it back to the incumbent, the incumbent counts it and they tell you how it turned out. But whether you vote for, against, or not at all, you get the same slate. No matter how many votes are withheld, that's the slate you get. So proxy access is about changing that. Why do we need that change, and why did we make that change at Apria?

Let's look at all of the corporate scandals that we've experienced. And by the way, we talk about how we don't want to disrupt these well-run companies and vaunted companies, well, these companies that suffered these scandals were *the* most vaunted, venerated companies in our country. This was WorldCom. This was Enron. It was on the cover of all the business magazines. This was Tyco, which was the "new model for the conglomerate." So these were not "rogue companies," these were not "rogue directors," these weren't "rogue managements."

And when you look at the boards of these companies, and you look at the people, you would say, my goodness, these were – maybe not to-the-person – but there were many very good people on those boards. It causes you to wonder: why is it that no one blew the whistle when Enron's management went to its board and said, "We've got a great idea, but there's a little difference here from some of our previous ones, we have to waive our ethics policy."

And they talked for three minutes about it. Why didn't someone blow the whistle? Well, my thesis for that is that you dance with who brought you. I don't say that cynically. I say that because we, as human beings, tend to defer to those people that have shown confidence in us, and people that we feel collegial with, and we want to be liked, by and large, and we want to be considered to be thoughtful and collegial. That is the prevailing environment on corporate boards. It really is. I mean, that's been all of my experience.

So is there anything we can do about that? Well, maybe not, but does that mean we shouldn't try? So here's what we did at Apria. I woke up one morning and said, "Gee, I've been an advocate of this proxy access concept, and here's a company of which I'm Chairman. I at least have the obligation to propose this to my board and get them to debate it." And so I did; I proposed a straight-access process without the triggering mechanisms.

The triggering mechanisms -- we can get into those, but essentially, what they're doing-- the premise of those is that this isn't a good idea, and so let's make it so that it would be very rare that it would ever be used. I mean, if the SEC is going to do it, then they just go ahead and do it. If they're not, then let's forget about it. There is already a process for us to nominate and try to elect short slates, and it's been used effectively in a number of cases.

So at Apria we said, "Okay, let's have an access process." It was debated; we have a former member of the SEC on our board, you know, some very thoughtful people. We talked a lot about it, and we concluded, after also consulting our lawyers, of course, that the best approach was a straight access policy that says that if a shareholder or a group of shareholders has 5% of the stock, if they want to nominate a director, they can nominate a director, and we'll put him on the proxy and give him the same dignity as all the other directors. We don't consider it a "proxy battle" if someone says, "Gee, you know, instead of Ralph, how about Joe?" and their credentials are there, the shareholders can have a look at it.

A lot of these arguments, if you think through them, they're basically saying, "Well, we need to be careful because shareholders are stupid. They're going to put these special interests on the board; they're going to disrupt things, or they're going to put an environmentalist or maybe a women's rights activist or a union activist on the board." But they're not going to do that if they think that that's going to impair the value of their investment. And remember, they're going to have to get a majority of the vote to place one of these people. And people said, "Well, don't you fear that?" And we said, "No, we think our investors are smart." This is going to spur us to look at our board every year and try to make sure that we don't have that vulnerability. So we won't have people who have conflicts, who don't own stock, who have too close connections to other members of the board.

There's obviously a lot more to be said and already has been said, as John said, about this, but that's a summary of my views on it after having thought a lot about this over a number of years.

Jay Lorsch: Thank you, Ralph. I was debating whether we should open it up for questions or whether the panelists wanted to say something about what they heard from each other, so I'm going to compromise and say whoever raises their hand, whether they're on the panel or out there, I will recognize, and we'll get a discussion started, I hope. So let me just see – is there anything anybody on the panel has to say about what they've heard from each other first?

Richard Breeden: I think there's an element of truth in both sides of the arguments here. I do tend to agree with Ralph on the triggering events. If this is something that it's worth doing, it's worth doing without making it a two- or three-year process before it takes effect. That's why we avoided any triggering event in our system for MCI. But I think there's truth on both sides.

Management has a legitimate interest in wanting to have a strong role in running a company, and if they do a bad job, ultimately, they should be replaced. The ultimate mechanism is for a board to replace management that isn't performing, either through board action or through a changing control transaction. And in the meantime, they need an awful lot of discretion and authority to run the business of the company, and I think anybody that's been involved in -- you only have to spend a couple of days running a $24 billion/year revenue company with 55,000 employees and you become very sensitive very quickly to how many decisions have to be made, and you can't always go get shareholder views or get board views. So there's a good deal of truth in the Roundtable position and talking about the importance of protecting management's responsibilities.

On the other hand, I just don't think you can sit here at this time in our country's history, having watched the string of these enormous companies where tens of billions of dollars of shareholder investments were blown away through rampant wrongdoing on the part of senior managers with boards that were sound asleep, and say there isn't a problem. There clearly *is* a problem.

The problem isn't that there's rampant fraud in American companies. I don't believe that to be true. I think that we have a very good record in the business community of most companies being well-run by honest people. But, clearly, we do have a problem, a problem in executive compensation. It is out of control. And there hasn't been enough of a private sector response to find a workable mechanism to try to control excessive behavior. And I think, rather than debating this – are the proposals of any kind going to unleash complete chaos in corporate America? – that the best thing and most healthy thing we can be doing would be for each company to be assessing how it can go beyond the minimum standards and create an excellence in their own internal governance practices, and find means that will work in that company of controlling excessive behavior. It's a risk we all face.

Jay Lorsch: Thank you, Dick. Are there other comments or questions? Yes—could you just state your name, please?

John Wilcox: Yes, John Wilcox. I'd like to ask Ralph a question. You made mention of the changes in the 1992 proxy rules that opened things up and made short slates possible, and, as we've discussed, shareholders also have the right to present nominees to the nominating committee. Why haven't these been used more by shareholders other than you and maybe Mike Price, who has also been very aggressive?

It seems to me that it can be argued that there are lots of avenues that large shareholders particularly could use to influence board behavior, and what the large shareholders have done is complain and whine about the failure of companies to do what shareholders want without really making an effort to use the tools available to them. So we are now considering some more tools, which some people have argued probably won't be used very much anyway. Where does this cycle end, and why are shareholders not using the techniques that are available to them?

Ralph Whitworth: Well, I think you're absolutely right. I think they won't be used that much, and so it's not that we don't have to worry about the harm from them. We won't achieve a lot of the good that could come from it. And that is quite an enigma to me. I gave a talk way back in 1993, and said that one of the things that we should fear from the short slate rule was that it may potentially be used by special interests, sort of a harassment technique and so on. That's a fear, and that's a legitimate concern today as we talk about this access issue, but that really hasn't happened.

And investors, I don't think, have been very responsible at all. I've talked to groups. I've talked to Sarah's group and others. I've said if we really want to look at who's to blame for what's happened in corporate America, we really have to look to the owners because they do have the tools, they have the tools already in place, without changing the rules any further, to have a very powerful effect on the composition of boards. And they're not used very often. It is expensive. There's a lot of legal hurdles; this access rule would make it a bit cheaper, would streamline the process.

But it's a very good question, and it's probably worth a whole other panel, but I think if anything, it goes to sort of the incentives and the structure, governance-wise, of how most of this money is held. I mean, if you look at these institutions that hold the money and what their incentives are, their own processes, it doesn't pay them to get that involved. It's much easier for them to just sell their shares and move on.

Jay Lorsch: I was just, as you were talking, thinking about Pozen over there, who wrote an article in the Harvard Business Review. I can't remember when it was, Bob, but you made the basic point that shareholders are more likely to sell, particularly people who have the capability to make buy-and-sell choices. I don't know if you want to comment on that or not, but…

Robert Pozen: I think the question of why institutional shareholders haven't used this nominating process more really goes back to the basic cost-benefit analysis that most institutional shareholders utilize. Some of the costs are out-of-pocket costs, but the more serious costs are management-time costs, because any time Fidelity was involved, I had to get involved, and there was also serious time cost for the portfolio managers. And then you have legal risks – though the SEC, in some of its proposals, has talked about legal safe harbors, which would be helpful.

On the benefits side, even if you own two or three percent of the stock you have a huge free-rider problem. Basically, you're competing against a lot of other institutions. Now, actually, Michael Price ran a different sort of fund where he had a few very large positions, and probably had a different philosophy. But if you were running the sort of money that we were, which was $800 or $900 billion, you're going to have these big positions, but you're not really interested in engaging in costly tactics that are going to make all your competitors get better returns. And you have no way to actually recoup any of the benefit that's generated for other interests. People have to deal with these questions like whether or not there could be some sharing arrangement on costs in order to encourage institutional activism.

On rare occasions, Fidelity would put up names to nominating committees, and sometimes they would be considered, and sometimes they would be elected, and sometimes they wouldn't, but it usually was only when we thought performance was really bad at the company. I think that the second point – and I think somebody else made this point – is that the time frame here is very important. So one of the things that bothers me the most about the SEC's triggering events, is that it looks like a two-year process, and two years is an eternity in this game. If you have to have a set of problems, and then you have to go through a procedure, and then you have to go through another procedure, that's just not a viable approach.

People like to think of institutional investors as the great hope of corporate governance, but until we come to grips with the fundamental cost-benefit analysis that institutional investors employ (and their timeframes) they will be disappointed. And that's why I was interested to hear Marty's comment to trade off precatory resolutions for staggered boards. If the board is really doing a bad job and the company is really in trouble, you want to do something now. Even if the staggered board makes it more difficult to do, I suggested cumulative voting as a way for one shareholder to make a quick impact by electing a director.

Jay Lorsch: Damon?

Damon Silvers: I'm Damon Silvers, I'm with the AFL-CIO. We in the labor movement, and our pension funds, in thinking about this issue, thought a lot about the special interest question that has been raised a whole bunch of times by this panel and the other panel. And after a fair amount of debate, we concluded that the threat that the mutual funds might extort benefits from the companies in terms of 401(k) management was a risk we were willing to take.

The point I'm trying to make here – a little bit at Bob's expense – is, although I agree, actually, with everything that Bob just said – it is the point that, in fact, when you look at participants in the corporate governance arena, almost everyone has multiple interests in the companies. Management does, as a recipient of salaries and other benefits. Obviously, to the extent that pension funds are vehicles for employees, those employees have other interests. Service providers have other interests. There are very few other people who truly don't represent some interest other than that of the company as a whole.

So I just had to say that first, but I have a question: I'm very interested in the panel's response to Dick Breeden's point that there needs to be a way of dealing with misconduct. Misconduct, not only that which rises to the level of flagrant illegality, but a range of other matters, and particularly a response to the idea that, with all the objections that have been aired today to the proposal for proxy access, the fundamental question of "What do you do if not this?", in light of what Bob just said about the costs of other kinds of action. There was some burden, I believe, on those who think that we should, first of all, do nothing, to suggest how it is that a responsible long-term investor would act in the current environment, in light of the corporate law regime that John Castellani referred to, in which, in fact, ultimate remedies, with real muscle behind them legally, are not available to shareholders.

Jay Lorsch: Does anybody want to respond to that question?

James Rogers: I'll start out by making the observation that if it's misconduct or if it's fraud, that's unacceptable. I think most companies have an ethic that anything that's unlawful or fraudulent is just totally unacceptable.

But the point I would make is that a lot of people are tending – and the media does a wonderful job of implying this and actually making the point – that somehow, if we have incredibly independent directors, whatever *that* means, and somehow, if we have world-class corporate governance, that all investors, forever, will be insulated from cycles in the market; from business risks; from just bad business decisions. I hear it here, a little bit, in the comments, like somehow, if we just get this mechanism or we just get this governance, somehow, it'll always be 10%-15% returns forever, and life will be good. I just don't think that's the way capital markets operate, and we will breed even more cynicism if we leave people with the impression that somehow, with this mechanism coupled with good governance, that the investor is insulated from market risk.

Jay Lorsch: Todd?

Robert Todd Lang: Could I sort of answer that question? That's not what I was going to ask.

Jay Lorsch: You can ask that question and then answer a question.

Robert Todd Lang: Okay. Look, I think there's already a place to go. You've got a governance listing standard that, presumably, will be adopted at some point, which requires an independent nominating committee except with respect to controlled companies. I think it's a powerful thing, not just another paper-over what you've been doing before. It doesn't apply so far to unlisted companies, which was going to be my question. So it seems to me that that's coupled with an SEC requirement that the nominating committee issue a report to be included in this proxy statement – we have one for the compensation committee and we have one for the audit committee – and talk about the process that they follow, not individualizing any person because you don't want to affect their reputation, but the fact of the matter is that there's going to be a spotlight on what they do.

It's up to the private sector, then, to take this mechanism and use it effectively. If it doesn't, then there's going to be something else coming up. But I think that's available, and that should be allowed to work before you go into access, because every form of access that's being discussed has got some warts on it. Nobody likes it entirely; you're looking for methods of sustaining it; what are good triggering events; are these real; does one size fit all; and all that sort of thing.

The other thing I was going to say, and my question to the panel was: the underlying premise of all this discussion so far is that we're dealing with larger companies. That there's fifteen or so thousand public companies in the United States, but maybe four or five thousand are listed – I don't have the exact number – and the rest of them are not. And I'm just wondering if you can use the same mechanism for those thousands of public companies with their thousands and thousands of shareholders as you will for IBM and General Motors and Intel and so forth. I wish somebody up there would talk on that. It's something I've discussed a lot with Alan Beller and others have, as to whether the SEC should have a rule on this subject that says, "One size fits all".

I think that we should design a system for the size of the company and take into account other specific company conditions applicable to all these smaller companies. You've got somewhat the same problems with Sarbanes-Oxley. You know, the costs for smaller companies dealing with all that looks onerous to some people. So I think somehow, the more we can adjust these rules and regulations for company size as well as, perhaps, some other things, the better off we're going to be in making this system work. And Dick wanted to comment on something else.

Richard Breeden: I would agree with that, except I'd put a little gloss on it, on that point. I think there are common principles that every company should have to deal with: conflicts; independence; qualifications. But small companies have to deal with things in a different way than huge companies, so you can't have one-size-fits-all, that you try to use the exact same techniques to try to accomplish goals like preventing fraud or inaccurate financial reporting. You have to be willing to use different techniques in different-size companies.

On the question of some of the responses, how we deal with some of these problems… There is this mentality that the Stock Exchange listing standards have solved all the problems and, if anything, it is manifestly unclear by recent shenanigans at the New York Stock Exchange and the behavior of its own board should be – and, certainly, we have found it to be the case in WorldCom – that those standards are by no means perfect at this point, and they need a little retooling. WorldCom, for example, had 80% of the board that officially met New York Stock Exchange independence standards, but we had 1.2 directors who were actually independent. Maybe one and a half.

And we had people who officially met the standards of independence who were people who, for the last 20 years, had done nothing in their lives but work for Bernie Ebbers in one form or another, and yet they satisfied the standards of independence. So I think we have to look at some of those practical issues of conflict, because it's conflicts and lack of independence that, more than any other thing, will create problems. And they create problems not just for shareholders – they create problems for good managers, too! And so when you have problems of conflicts on the board, that can lead to a lot of subtle problems down the road, so I think if there were one area that would be a nice starting point – and I agree that the access issue is important – but independence and conflicts are something that we need to spend attention on. Not just that we have an official standard, but having a standard that works.

Ralph Whitworth: The problem with the independence that Bob brought up – that let's let this independence rule work – is that we define director independence by whether they work at the company or not, or whether they have a financial conflict with the company or not, and that doesn't nearly go deep enough, as Richard just was alluding to, instead of, "How did you get your job?" And that conflict, in any of the systems that have been proposed, has really not been dealt with. And as far as, just quickly, to your question: We have Sarbanes-Oxley, we have 10(b)(5), we have lots of rules for fraud and abuse, and plenty of laws for that, and I don't think that's really what this is about--it's how do we deal with bad actors? Because we're going to have them, as Jim said. We're not going to have a perfect world. We're going to take risks, and some are going to work and some are not.

For me, here's what this is about-- Sarbanes-Oxley set some minimum standards, but it did nothing, nothing to spur optimal performance. That cannot be done by government, that can only be done by the owners, by the investors, and yes, if you want to give them some more tools, fine, I've been a proponent of that. But even if we don't do that, the investors still have to step up here and become much more engaged in these companies. I know there's a lot of impediments, as Bob talked about, but if that doesn't happen in this country, it's going to be very hard for government to cause it to happen.

We're going to continue to have very similar things happen over time. And we shouldn't kid ourselves, or let the public think that, well, we've fixed all of this because we passed Sarbanes-Oxley. Because all it hits are symptoms. Like, when I used to cut the tops off dandelions and my mom would say, "No, no, you've got to dig down and get the root out." Well, that's what Sarbanes-Oxley did – it just cut some tops off some dandelions. It did nothing to really get into the root of the real problem here.

John Castellani: I want to get to the same point and address that same point, and the point that Richard raised. And that is we can all agree on one thing: the best corporate governance comes from qualified, active, involved and independent directors dominating the process, and that independence is not the just in independence that's defined in the proposed listing standards, Richard. Our principles say it's independence both in fact and in appearance, and it has to be a much tougher standard that goes to the kind of things that Ralph talked about and Richard talked about, about where did you get your job? Where do you play golf? How long have you known each other?

But the key I think that we can all agree on with the combination of the listing standards and Sarbanes-Oxley – and the work that's being done in corporate America over the last twelve months, which has been a tremendous period of a lot of blocking and tackling. I don't know why I'm on sports metaphors, especially now Boston is 0 and 2, so I'll stop sports metaphors. But there's been a lot of very good work, but the best of the work is when you have truly independent directors who are capable and bring a broad diversity of capability, who are not only on the nominating committee (exclusively independent), on the audit committee (which we all agree on exclusively independent), but also, to get to Bob Monks' point earlier, on the compensation committee, that are truly independent and capable. And those are the things that we support. Those are the things that are taking place and, we believe, now need to take place more often, and more deeply.

Jay Lorsch: I have a note that we need to end, but since I'm the chairman, I get to say the last word, right? I wanted to come back to the dandelion analogy, which I had not heard before, because I think it's important in this discussion to remind all of us that we're focused on this particular proposal, and therefore on boards and the relationships between boards and shareholders, whether they're the owners or not – that's a debate we haven't had yet, perhaps, fully.

But I think the other thing I'd like to remind all of us of is we're talking about a complex system of corporate governance which involves – and it's not just the SEC and shareholders and boards, but also auditors, investment bankers, analysts… a whole range of people and institutions engaged. And I think our view in the workshops we've been running over the last year, as our Dean says: "It's not just a few rotten apples; it's a problem with the barrel." There are a lot of problems with the barrel.

And the problems with the barrel exist in a lot of institutions, which has led us to the position we find ourselves in, where there's so much emphasis on short-term results and we have all these accounting tricks that have been going on, some legal, some just questionable, and we also have this excess compensation which has been referred to several times. All that, I think, is the product of the system. So while I think we may be focusing on an important issue here, it's only one of many, many issues that I think we need to address.

And on that note, I'll stop. Thank you!

Session 3: The Perspective of Institutional Investors

Panelists: Orin Kramer , Kramer Spellman
Robert Pozen, Harvard Law School
Michael Price, MFP Investors
Sarah Teslik, Council for Institutional Investors

Moderator: Reinier Kraakman, Harvard Law School

Discussion Participants: Robert Clark, Harvard Law School
Joseph Grundfest, Stanford Law School
Brian Hall, Harvard Business School
Damon Silvers, AFL-CIO
Leo Strine , Delaware Court of Chancery

Reinier Kraakman: Why don't we start? I'm Reinier Kraakman and I'm delighted to be the moderator of this panel because, as Steve Rosenblum mentioned earlier today, I've always been on the side of principals in the principal-agent conflicts, and here we have the panel of principals, the owners, the shareholders or at least their agents, I guess.

So I want to start by posing a general question to my panel, which they are free to ignore, and that is the theme that's been running through the entire conference thus far: Why don't the principals, i.e., the owners, do more? Why don't they engage more?

More particularly, if the point (that Michael Price made earlier on, and I guess that Leo Strine made earlier on) is that there are not enough good directors out there, then maybe access to the corporate proxy just isn't enough. Maybe the most important self-help measure that the principals, the owners, would take, is to grow their own (collectively, not individually), fine folks out there with the incentives and the independence, or, should I say, *de*pendence on shareholders, that make for a good corporate director. Now, Bob Pozen has mentioned the collective action problems associated with that, or with any kind of institutional action, but why not think about having to surmount those problems?

Now, I'll just throw that out there, and now I'll let the panelists proceed unimpeded, beginning with Orin Kramer.

Orin Kramer: I think that was an introduction that could go on for an hour, but in any event. I think I'm here wearing two hats. I run a private investment pool; I have for a number of years, and we've been, from time to time, an activist shareholder, including, actually, in situations Mike probably doesn't know about, but with his whole firm. And in addition, I am the Chair of the Security Investment Counsel that oversees the state pension fund system. With the caveat that I am speaking for myself and not other Council members, I'd make several points.

Number one, corporate law in this area rests on a set of theoretical constructs: that the directors act as our agents, us being the owners of the company; that the directors actually oversee management; that they engage in arm's-length agreements with management on compensation; that the directors, independently of management, nominate people who will serve our interests; and that, at the end of the day, these are real elections which act as a check to assure that our interests are genuinely being served. Without debating the prevalence of the problem, there are clearly many instances where there is a disconnect between those theoretical constructs and what is happening, and that's what I think we're trying to address.

My view is that if there are a significant number of shareholders, not two labor unions, not two politicians, but if there is a significant body of shareholders who believe that this disconnect exists and that their interests are not being represented by the people who are their putative agents, that there ought to be a window for their acting, and that is totally independent of the legitimate point Mike Price made earlier, which is that there is a paucity of qualified directors, and we don't pay them enough. That's a separate issue from whether we ought to have legal recourse when they're not acting in our interest.

Secondly, on the SEC proposal, my view is that there ought to be certain inalienable rights for owners. Those rights should not devolve into some kind of two-year effort. Bob Pozen raises the fair point that for many shareholders who think of themselves as renters, a two-year program just won't work. As the SEC proposal has been described to me, it creates serious problems in terms of actually having some meaningful corrective power.

Third, there has been a lot of concern here expressed today about moving too fast. Part of the argument for not doing anything in this area is that we've already implemented significant reforms, and we should let things gestate for a while. I share the concern that we are moving too much toward a set of highly-regimented rules-based prescriptive remedies, that we've got this new Roberts' Rules of corporate governance. That is a problem, but that is distinct from the issue of whether we want to be able to throw people out if they're not representing our interests. In general, I would give boards more operational flexibility, but also give shareholders the ability to act when management is not acting in our interest.

The argument has been raised that if you open the door in this area, you're going to empower splinter groups carrying their social agendas. The concern is that there are a limited number of socially, politically motivated funds in the country, that they will be carrying the ball on their own issues, and we're going to be in this constant political campaign for corporate America, and that's obviously not productive for the economy. What strikes me when I hear that concern is that it reflects an inordinately critical view of corporate management and capitalism.

I don't believe that corporate management is so poorly-perceived that you would have a widespread problem with large numbers of companies facing a credible threat that the majority of the stockholders will want to overthrow management. And, too much credit is being given to the social conscience of institutional investors. I live in that world. While we often make mistakes, and we often lose money, I am not aware of any instance where any institutional manager I know ever acted for reasons other than risk-aversion and greed.

The real problem is not that institutional investors en masse will support some social agenda, which is not going to happen, but that it is difficult to induce most institutional shareholders to act against management even when the purely economic incentives are clear. There's a reason the sleeping giant is sleeping – because the sleep makes the conflicts disappear. That's a serious problem, so it's going to be hard enough to motivate institutional activism under any set of circumstances, but at least we need a regime that removes the friction cost when some institutions are actually willing to do the work.

Reinier Kraakman: Thank you. Bob Pozen?

Robert Pozen: Thank you. I've already given my usual spiel on cost/benefit analysis, as elaborated in my paper, but let me try to make three specific points. First, if we look at the cost/benefit analysis, I think one really good thing about what the SEC has been talking about in the staff report is the use of the Internet for proxy solicitations. This is a big step forward. Obviously, there are lots of other proxy costs – John Wilcox would tell us all these – but it's a good start to really try to get that cost down to a reasonable level.

I think the benefit side is much more difficult, and one I think people ought to look at by analogy -- when we allow institutional investors to be the lead plaintiffs in class actions — and try to learn from that experience about how few private managers ever want to do that because it involves a huge cost. The first time a group I know served as a lead plaintiff, they were deposed by a plaintiff's law firm about whether they were really a representative group so the question is, "What's the benefit?"

And there, in that context, I would think that we ought to at least try to come to grips with whether there should be a premium for institutional investors who play such a role. We have to figure out a way to reward these institutions who are really sticking their necks out, taking a huge amount of management time, et cetera. If we can't figure out how to give the lead plaintiff some sort of premium in a class action recovery, the chances of figuring out how to give a premium to an institutional investor who took the lead on director nominations are probably much less.

The second thing, which I think was alluded to by James Rogers when he was here, is the question of what type of benefit we're really looking for. There is a fundamental divide, which has been papered-over somewhat in the institutional community. On the one side are people like Orin, who focused on either greed or avoidance of risk—the critical question is, "Is the share price going to go up?" That's the issue. And for most institutional investors, it's really not a question of good corporate governance or bad corporate governance – they want to know, is this company going to have a better financial return over the medium term, meaning two or three or four years. On the other hand, when we see who are the activists among a subset of the institutions, there are a lot of people who seem to have more of an interest in corporate governance as a process, than getting financial returns for their shareholders.

You can argue that better process in the long term will lead to better financial returns for your shareholders, but I think all of us who have seen the studies know that they are not that closely allied. That has two implications. One is that for some institutional investors – and I think this is what's being said, perhaps by Marty and other people – their benefit includes a political benefit. Roberta Romano has argued this point, in contrast to financial returns, so I think that you see a real split here.

The second implication is that, for people who are really interested in financial return, time is of the essence. This is where we get back to the issue that waiting for these two-year and three-year scenarios to be completed is just much too long. But I think we ought to recognize that there's a big difference between people who want corporate governance to improve and have some sort of faith that corporate governance over the long-term produces better financial returns, versus those people who are looking mainly at the financial returns and what they're interested in, in the specific case, is how to get that better financial return.

My third point, which is related, is: We've heard a lot about "triggering events" and "precatory resolutions" but one thing people haven't made clear enough yet is how to implement this new director election process? According to the staff report, what you're going to have is a triggering event leading to a precatory shareholder proposal for a new director election process. Ironically, one triggering event is a shareholder vote on a precatory proposal which management ignored, and so you solve that problem by having another proposal to change the director nomination process, which is precatory in itself. This is because the SEC doesn't seem to have the authority to require a mandatory proposal for a new election process. Will management, which has already shown itself to be not particularly responsive to a precatory shareholder vote in the first instance, become very responsive in the second instance to a precatory shareholder vote?

This just points up that the whole problem for the SEC is a matter of authority – and I'm sure the legal mavens will tell us more after lunch. Similarly, the SEC has little authority to de-stagger the boards or to require cumulative voting… These are much more direct ways to change the election process than this notion of a two-step precatory proposal. The problem is, as we all know, those measures have to be initiated by the board under corporate law. So the SEC is constructing this not-too-effective proposal because it has limited authority to approach the election process directly. I'll stop there. Thanks.

Reinier Kraakman: Wonderful. Thanks, Bob. Michael Price?

Michael Price: Thanks. I thought when the last panel left off, Jay Lorsch had a very good point, which is there are so many balls up in the air now – new laws and new pressures and press and cleaning up some huge spills of the late 90's – that it makes sense to me to see where a lot of things work out. Boards are getting better all the time. I still think that it's very easy to find directors for MCI coming out of bankruptcy; when the balance sheet's clean, when it's a high-profile, big New York Stock Exchange company. It's tougher, when you get down to the next couple of hundred companies, to find really qualified directors.

But I want to spend two minutes going back through a little history of our money management business from when I started, which was in the '73, '74, '75 period, when nobody in America wanted to own common stocks. And I remember my partner/mentor Max Heine said, when I showed him a very cheap stock – but it was an A and a B, the A voted and the B didn't – he said, "Oh, we can't buy that because you don't get the vote." So I learned very early on that when I buy a share of stock, I get two things: I get ownership and I get the right to vote.

Well, what happened in America was back, you know, from the mid-70's, when the ownership of common stocks was unpopular, to the mid-80's when it became very popular, and it became very popular, and the flows into Fidelity and other mutual fund groups were so huge, those portfolio managers said, "I've got to put this money to work. I'll buy Coors non-voting Class B stock or Comcast, which happens to be well-run, non-voting – where, you know, the family has 5% of the economic interest but 95% of the vote – or Sumner Redstone or Rupert Murdoch or any of the successful managers, but they entrench themselves and protect themselves with the A/B structure.

So we had the pressure of this huge amount of money to invest, and we started to go away from our principles, which, when stocks were cheap, we didn't have that much money to invest, we could *find* things to do with the money. Then stocks got more expensive and we have to look in other places, and we have to take fewer protections. Just like in the bond market before Milken invented junk bonds, you know, you would buy first-mortgage railroad bonds backed by railroad cars, real estate, warehouses, double-track, all this stuff. Then they invented junk bonds because companies needed to raise money, and you gave up those indenture provisions, and so many of the bonds that were issued that created all these losses in the WorldComs and the Enrons of the world had no provisions for the bondholders. Why? The investors – our own group – we were at fault in buying securities that didn't protect us. Okay?

But I'll tell you – frankly, from when I started in the business, I didn't want to give up my vote. In the 80's, I felt I had it all along. I remember Marty Lipton, calling me from the floor of a stage in the Irving Trust/Bank of New York merger, asking for my vote. We had 440,000 shares and decided to vote for it, but, to make a long story short, I mean, we always had the right to vote, and we exercised it, and waiting until the last minute to exercise it, and that's the right thing to do. We have it. We have it today, we go to Delaware, we protect it, so I don't think anything needs to be done. I think you watch and you pay attention, and investors have lots of rights.

Now, that leads me to my colleague here. Some very large investors with all sorts of votes – powerful blocs of stock – don't use them enough, and I really don't understand why. I think the basic idea that, well, maybe they'll lose a corporate client. Yeah, that's part of it, but I think it's, you know, giving up part of your job. You're not doing part of your job if you don't take management and directors to task. You're in, you're out. Harvard—Harvard has, you know, Harvard management here… They've run proxy fights. Harvard funded a firm in Boston called Highfields. They run proxy fights. All that's been terrific. I mean, Highfields has forced *Reader's Digest* to do things—They eliminated the A & B shares. The management was so poor at *Reader's Digest* that they're losing money anyway.

So just because you use your rights doesn't mean you can't lose money, right? If you pay too much for the stock. But that's really good to see, and I'm pretty surprised that after we had some success that led to good performance and growth in assets because of the press we got in running corporate fights, that more people aren't more active. There are a few, but there aren't that many. So I think there's enough mechanism there today.

Reinier Kraakman: Sarah Teslik?

Sarah Teslik: Thank you. I always get nervous when a meeting starts with someone telling us to pay no attention to the data, as we heard at the beginning, when Lucian Bebchuk was offering data and Marty Lipton said, "Well, actually all the data are conflicting, and you just ignore the data." It's like, "Ignore the man behind the curtain." I think that, in fact, probably everyone in the room, whether or not we admit it, has some sense of what the data are – and it goes a lot farther back than Lucian's data – and has some sense of what the data tell us.

I recall, about 20 years ago, reading a book that looked at the early civilizations of China, India, other Eastern civilizations – and the question the book asked was, "Given that Eastern civilizations started much earlier than ours, and were much more sophisticated that Western civilizations in the Dark Ages, why did Western civilizations eventually triumph?" And the answer was – and it was backed up with really a phenomenal amount of data – that Western civilizations put fewer barriers between owners and property, and that by far, the best wealth-generating mechanism we know is to turn people's self-interest, which will motivate most of us most of the time, most fiercely, and channel it in such a way that creates wealth. And what we're talking about here today is whether or not we should increase or decrease exactly that barrier.

Whether or not you're familiar with these particular data comparing civilizations, most people in the room probably have a knee-jerk reaction – a gut view – that that is the case; that when owners tend to their property, they will do a better job than managers, on average, over time, not because they're any smarter, but because the motivations will, in general, make them learn what they need to learn. I call a lot of the people who will oppose access to the proxy, or other mechanisms that allow owners of companies to act like owners, "NIMBY capitalists," "not-in-my-back-yard capitalists," because they do believe in capitalism everywhere else in the economy, except at their own companies.

People who are opposing shareholder access, if they were a big owner in a venture capital company, would expect to put people on the boards; if they owned a restaurant and the cook didn't cook, they would expect to fire the cook rather than the cook telling them to sell, or telling them that they didn't know enough to know what was good cooking, and that, in fact, it is a principle that most of us, whenever we had our first economics classes, believed, and that although it *sounds* better to look at Soviet collective planning, where the people in central casting know best what we all need, that, in fact, that doesn't work as well, hasn't worked as well, and through the history of time, hasn't worked as well.

I agree with Orin Kramer that a lot of the governance provisions that we currently have in statutes, in regulations, in policies, and in governance plans for boards, could be ditched if we could merely increase the effectiveness of shareholders selecting directors, because, although it is the case that shareholders do have a vote, and many of them, like Michael Price mentioned, are voting, there aren't as many important things to vote on as there should be, because the number one thing to vote on is "Who represents you?" And I don't particularly care about the quality of directors as much as I care about who picks them. I don't know how to define a great American or an archangel, and I don't particularly want to try.

It's not so much that directors should be independent from management as they should be accountable to shareholders, and I think that is, actually, the foundation-stone of our entire private sector, and if we don't agree on that – but I suspect we do – and we have professional and other needs not to agree – we are really very far apart, indeed.

I know it's lunchtime. I looked at the agenda, and I knew you would need two minutes out of me max, and so I'll answer, in closing, the question that was asked to open this panel, and that is essentially, "Why aren't institutional investors more active given the current rules that we have?"

Two reasons: one is that the current restrictions on shareholder actions are much more substantial than most people understand, and although a Michael Price might be willing to undertake both the costs and the reputational risks of being sued by submitting a slate of directors, if you are a public pension plan, and you file a slate of directors and you are sued – and it's technically a suit for securities fraud – and the paper runs the headline, "Iowa State Pension Fund Sued for Securities Fraud," you don't keep your job. And you can't plan a year in advance when you budget, because institutional investors are not individuals, and they can't just say, "What the heck, let's spend $20 million." They have to budget. You can't budget for a proxy fight, because you cannot predict, with any kind of ballpark figure, what it will cost. The costs are huge. As I said at the beginning, what we've learned from history is that the more you reduce those costs, the better off we are.

But there is also an aspect of habit here, and of law. Since this is the Law School, we might as well end before lunch on a legal point, and that is: Trust law which governs pension funds and some other institutional investors derives from English common law of trusts, when trusts were developed where one person took care of one other person's assets for a short period of time. Like you managed your great aunt's money until she died. And, therefore, what trust law recommended was that you diversify all over the place, and in a truly conservative way, and be prudent in an inactive, terribly diversified way. That's the only legal precedent there is for trust law, and, therefore, the lawyers applying trust law to pension funds take that law and apply it. And, essentially, one of the four principles of ERISA is "diversify," which most pension funds therefore interpret to mean, "Buy tiny stakes of 1,300 companies." There is no reason under trust law or ERISA to buy tiny stakes in 1,300 companies.

The securities law is not to buy 5% - and that's a crime, because it seems to me that, really, the reason behind §13(d) is to say no shareholder can own enough to be a real owner – but the fact is, you could be fully diversified and own a hundred companies, 4.9% of them, and then these questions would become a lot easier. But there's a legal overhang here that makes that difficult, as well as an avoid-the-headlines phenomenon that, indeed, a number of pension funds after this era of frauds *further* diversified from 1,300 companies so that no matter what company tanked, when the reporters called and said, "How much did you own?" the answer was, "Almost nothing."

Reinier Kraakman: Thank you, Sarah. Let me give you each a chance to respond to anything said by anyone else on the panel before turning it over to questions.

Michael Price: Proxy fights today don't cost $20 million to run. You know how a proxy fight runs? You hit the holdings screen on your Bloomberg, you see who else owns the stock, and you call. And then if you've sensed that there's 5, 10, 20% of the stock that agrees with your point-of-view about the management, the board, the acquisition they are making (just like we've seen with Hewlett-Packard/Compaq in the last year), today— I mean, right away, you know if you've got 20 or 30% of the vote, then you guys go call the CEO and say, "Hey, we'd like to come and see you." That's today's version of the proxy fight. It's very effective, you don't spend any money, period. So there is not the barrier that you claim there is.

Sarah Teslik: Well, actually there is. If you're an institutional investor, it's not quite that simple.

First of all, the decision-making process cannot happen with your reading the paper and deciding to make the phone call. And if you have to put it on a board agenda – and there's really no other way if you are a public entity – you can't make that call that quickly. In addition, to form a group, the filings that you have to make require a budgetary allocation, and §13(d) filings are expensive to make. And you will get sued, which is a major problem if you are taken seriously. And a number of our members have been advised, that, since, of course, most of them externally manage, that all of their money managers who have any amount of stock in the company you're interested in will also have to file §13(d)'s.

So it's really a much more complicated proposition, and one that can't be done as quickly, and can't be budgeted for, and even if it's millions – which, actually, it still is, given the lawsuits and given the deposing of all the board members, which, when Lone Star Steakhouse had a dissident running for the board, the company called us, they called the major pension funds that were members and said, basically, "If you make even a noise suggesting that you like this, we will depose all of you," and you can't responsibly run a pension fund without preparing your board members. It's a substantial undertaking.

Reinier Kraakman: Anyone else of the panel? Bob?

Robert Pozen: I think what we see here is that like most categories, institutional investors have a lot of different flavors. I mean, Michael Price represents a type of fund that takes highly-concentrated positions and is very adept and very experienced at really putting a lot of pressure on management and gets returns that have a significant impact on the performance of his funds in those relatively few positions. And his investors are all prepared to take the heat in terms of this sort of thing happening because that's why they come to Michael Price. That's his rep, and he's very good at it.

But I think that isn't the same position for a lot of institutional investors, and I think, in fairness to Sarah, what you're hearing is people who have run very large pools of money (meaning several hundred billon) and have a very strong diversification requirement wind up with relatively small positions with companies – 1% or 2% at most – so they have a very different viewpoint. And, to the extent that they have to explain to a board of trustees, many of whom may not be investment experts, as to why, exactly, they are in these types of fights and what they're getting out of them, it's a much more difficult situation.

So I think there is not a real conflict, we just have two very different groups that are both called "institutional investors". What we have is very different groups that are responding to the realities of their situation, and I think it's really not fair to say that the big pension funds and mutual funds don't exercise their vote – they do! They diligently vote their proxies. They diligently vote on every shareholder proposal. Most of them have guidelines that say that they will vote for the repeal of poison pills, they will vote against most anti-takeover amendments and various other things. But we ought not to confuse voting with a form of activism that involves putting pressure on management to change its strategy. That's a very different thing, and for most very large institutional investors with diversified portfolios, and with boards who have a very different view than your board and your management team… That's a much more complicated challenge.

Reinier Kraakman: Orin?

Orin Kramer: The only thing I would say is, in general, it's hard to find these situations where (a) there's a problem with the company, (b) there's a fairly easy-to-understand answer about what ought to be done about the problem, but then (c) that I've got 20-plus percent of the shareholders, who are, in effect, willing to have their name used when I go and talk to the CEO, and (d) in situations where there has been the 20 or 30 percent it's certainly been my experience, and the experience of others from time to time, that a CEO understands that, ultimately, you don't have the leverage to force them to do anything, and they can make whatever arguments they want, but the discussion basically just dies.

There are a significant number of shareholders who will say, "I cannot be perceived as being active in some manner. Having said that, if there is something actually on the ballot, then I will be able to vote in my economic self-interest, but I can't speak outside the ballot, in my economic self-interest." That may be indefensible, but there's a lot of that that goes on.

Reinier Kraakman: I'm going to open up the questions now. Brian, I saw your hand up first.

Brian Hall: I have a question for Michael Price. So let's bring some data into the analysis. What – because, in a sense, what you're arguing, that maybe the Fidelities and other groups of the world aren't taking advantage of a situation that they could take advantage of – and so what I'm wondering is, just empirically, what percentage of the companies could you realistically go in and – say you decided that you wanted to do something - not of the companies that you're investing in, but if you look at the 8,000 publicly-traded companies, you look at the list, and you'd actually know who to call—

Michael Price: Mid-cap and smaller, assuming they are value kind of stocks. Stocks that trade at discounts from their asset values, where the management's making a big mistake.

If you're in the growth stock area, which we're not — You know, you're going to have a whole different set of owners that don't think the way we think, and, you know, they're betting on that management big-time, and they're subject to a lot more risk. And if you think back to the Enron and WorldCom situations, they were totally loved by Wall Street.

Brian Hall: So would you agree, though, then, that we had this serious problem with all of those other companies?

Robert Pozen: I think he's really saying that there's actually a fairly small group of companies we're talking about. He's probably trying to identify ten companies in a year out of all those small- and mid-cap stock. Sarah would probably say that most institutional investors invested in those companies, especially large pension funds, can't be having a 15% position like a hedge fund.

Orin Kramer: In terms of most people's economic interests - because I traffic in that same world – but in terms of, "Where do people have the money in life," 85% of the money is in the companies which are outside the world of activism opportunities.

Michael Price: Take General Electric. General Electric basically went from the absolute darling three years ago, right before Jack Welch left– and $65 a share – to $20 a share after Jack left. They have a great new CEO, they probably have the best corporate governance, but look how they were criticized. And nobody could influence them with votes, really. It's too big.

Reinier Kraakman: Bob?

Robert Clark: I'm Bob Clark, a professor here and former Dean. A question for Bob Pozen: several times this morning, you've mentioned the problem with the triggering event – the two-year process – and asked which Fidelity-type institutional investor is ever going to do anything with that kind of time frame? So let me get specific. Suppose something like the SEC proposal suggested by the staff was adopted <u>without</u> this triggering aspect, but with just a threshold. Would we see any change in behavior of the large mutual fund complexes?

Robert Pozen: At Fidelity, when I was there, we would get involved, as Michael would say, informally put pressure on management in at most 10 cases a year. And in those cases, we would be disposed to actually put pressure on management pretty quickly—

Orin Kramer: And it would go up to 20 a year.

Robert Pozen: Maybe. Maybe that level or lower. But the fact is that anything that involves waiting two years is just not attractive. If the stock is undervalued now, if you have a big position, you've got to decide if you are going to sell the stock or is there enough potential here, in a relatively modest amount of time (meaning nine months or twelve months), to get a better return. And, in many situations, the election of a new director may or may not be helpful in solving the company's problems.

Now, if you had a situation where you had somebody who was getting affiliated contracts, where you really felt the company was being exploited, then putting somebody on the board might make a difference, because somebody might stand up and say, "Look, you've got to re-price these contracts." So then you'd want to get that person on the board right away. But, how many situations are there in that category?

Leo Strine: I had a question for you all about, what is this system. I mean, if you analogize this to a system of accountability in the political process, what is the system you all want? Is it a representative democracy? Is it a popular democracy? I mean, I've heard a lot of misuse of terms, I've heard "New England town meetings" used to describe a move toward representational democracy, but what we have is a really mixed system, because remember, stockholders also have significant voting rights that involve, for example, approval of major transactions like mergers, sale of substantially all of the assets. There are actually some increased voting rights now about certain compensation types of things under the law, plus you have the ability to elect directors.

And I wonder whether there's a difference between the Bob Pozens and the Mike Prices of the world about what they want, which seems to be the ability to weigh in when, really, control of the board and company policy is really critical to maintaining value. I mean, Bob has said he's a renter; I mean, he wants to kick the vote right away. He wants to kick the bastards out or he wants to sell, which sounds like we're back to the takeover debate, whereas I may be hearing something about pension — And I just wonder, what is the thing you want? Do you want this mix of popular democracy and representative democracy? Do you want representative democracy? What would you ideally have?

Reinier Kraakman: Michael, can you start with that?

Michael Price: I think that, when we look at something… We study the board before we buy the stock, and we have an impression of whether the guy who's running it, the CEO, who's a director, is good or not. Sometimes, there's more value when they're not and you try and do something about it, but I think what we're really talking about is where you made the mistake of becoming an owner, and he wasn't as good as you thought, and you need to do something about it, because you just don't want to sell so cheaply, okay? Then you need a process.

And what I've said all day is I think the process is in place. I think that the '92 changes helped a lot, I think the frequency of management's threatening shareholder litigation is gone, and the very easy way to deal with that is call Floyd Norris at *The Wall Street Journal,* or *The New York Times,* and say, "Hey, I just got a phone call threatening me!" They love those stories.

Robert Pozen: I don't think I disagree much with Mike Price. I think basically, you try not to buy into those companies in the first place. But what you're really talking about is where you've bought into a company, and you have a pretty big position, then you feel like with some change in management or policies, you can realize a lot more value.

So I think when you say, "What is it that institutional investors want?" in those situations – which are a limited number of situations – you want to be able to press the safety valve fairly cheaply and fairly effectively. And what that means, in many cases, may just be having more certainty on the §13(d) rules, so you can put informal pressure on the management. I guess *occasionally* that could mean electing a director: for example, in the exceptional situation where you really want someone on the board who'll say no, you can't do this affiliated transaction. The most important thing is to figure out a way to keep the cost low and get some sort of return on the activism. So I get back to this question — Why would anybody be a lead plaintiff in a shareholder class action unless you, as an investor, can get some sort of premium for playing that role? Michael is often in a situation where his fund owns 15% of a stock and so it can have a huge impact on the return of his fund. That's not true of most large pension funds and mutual funds. They won't have that big a position, and even if they did, the dollar value of impact on their total returns is pretty low.

Leo Strine: Well, I mean, what we've seen is either over-weighted people who take big positions, or certain public pension funds.

Orin Kramer: I don't believe under any set of circumstances, you would have a lot of contested elections. A contested election is a failure to achieve what any activist shareholder tries to achieve, which is a negotiated outcome. If you say, "What is it that you want?" What you want is to have a legal framework which conditions those negotiations, which recalibrates the balance of power between the owners of the company and the people who are supposed to be their agents.

Joseph Grundfest: I think Orin's point is apropos. A question I'd like to ask to anybody on the panel who wants to answer it. We're talking very much in the abstract about the idea of shareholder access. Can we make the conversation more concrete in the following sense? Let's assume some version of the Commission's rules are adopted and enacted. Which boards would institutions actually target? I'd like to hear some names. Which directors would they want off? All right? I'd like to hear some names. Which directors would actually be proposed to replace those directors? I'd like to hear some names. And why? What would the rationale be for picking those companies, targeting those directors, and suggesting those replacements? Because, to me, it's really remarkable that we've spent all this time talking about these things in the abstract, and I know I would be illuminated if I could understand, well, all right, what do you want to do? Anybody?

Damon Silvers: I think that's a very good question. I'm willing to answer it, at least in part. And the reason I had my hand up is probably in relation to this. I'm here in part, at least, on behalf of funds that share Michael Price's willingness to mix it up with folks.

To a certain extent, unions and union pension funds are prepared to fight. However, we're very aware that there's a range of preparedness, and a lot of funds that invest our members' retirement money don't have that kind of ability for the very reasons that Sarah outlined. But nonetheless, the bulk of our money, as Orin Kramer said, is in large-cap stocks, where there isn't anybody with the willingness to fight and the concentration of ownership to take it on.

If this were to pass, it would solve that problem. If the Commission votes and we get something real, then those are the type of companies that our funds are going to be interested in trying to organize a candidate -- large-cap companies where our money is. And I'll name one, because I know of one company that we would be prepared to run a candidate tomorrow. Unfortunately, I can tell you who it is we want to take out; but I haven't figured out who we would want to put in, but I can describe the kind of person we would want to put in.

A company we'd be prepared to run a candidate on tomorrow is Lockheed Martin, and the reason is because Lockheed Martin continues to have a former Enron director, Frank Savage, who cannot explain what he did to help prevent or cure what happened at Enron. He's been there for two years. We've had withhold campaigns at that company that have gotten the highest level of withhold votes at any large-cap company in the history of the world, and he still sits there, and they keep re-nominating him. And we want someone else! Now who's the someone else? Well, we haven't come up with an individual – and if we had, I wouldn't want to out them here without asking them – but I can tell you the kind of person we're looking for, and I'll tell you it's not—

Robert Pozen: Can I press you on this? Because this is a good illustration, as I happen to know Frank, I happen to think he's a reasonable guy. I think he became a director in Enron very late, though he may not have been diligent enough about the complex transactions in Enron. But what makes you think that taking Frank Savage off the board – and let's assume not replacing him with anybody – is going to make any difference to Lockheed Martin's financial returns?

I can assure you, that's not what Michael's looking for. He would pick a company that's a significant value company that's under-performing, where he thinks that getting new blood on the board is going to really result in a new policy. Or the other example that I've tried to give, where there really is a conflict with affiliated transactions, where you really wanted somebody to stand up and say, "Hey, no. This isn't any good." But you get Frank Savage off the board, it would probably have little impact on the stock price.

Joseph Grundfest: Any new examples or are we doing all this rule-making to get rid of Frank Savage?

Damon Silvers: I mean, this is why Fidelity, I believe, declined to withhold, is this particular argument. And, frankly, that's why we didn't get a majority – because a couple of mutual funds think that that's the kind of guy that ought to be protecting our money. We disagree.

In terms of the outcome, though, think about what our funds—what we do. Our members' money is invested, indexed across the whole world of companies. We don't want people with that kind of record protecting our money. And we believe that holding them accountable to their records protects our investment and adds to value across the board. Feel free to disagree. I don't think very many people you took this argument to out there in the larger world, the people whose money it actually is, I don't think that there'd be very many investors who'd be very interested in the idea of continuing to protect such people.

And, frankly, with 30% of the company's stockholders at Lockheed Martin withholding, there's a pretty powerful argument there that they don't agree, either. Now, can I tell you exactly what event will happen at Lockheed Martin as a result of removing Frank Savage? I don't know, but I'm pretty certain that I would sleep better at night as a steward of other people's money invested in that company if I knew that he wasn't on that board and somebody with a demonstrated record of protecting people's money was. And that's the kind of person we would be looking for. The kind of person we would be looking for to replace Savage would be an experienced, savvy businessperson, not a labor movement person, not a social activist, but an experienced, savvy businessperson with a history of independent thinking and hard questioning. That's what we're about.

Michael Price: It's interesting that you pick Lockheed Martin, because Lockheed Martin, I think in the late 80's, fought off Harold Simmons and gave a board seat or two to Lanny Martin and Harold Simmons. They pushed him hard. We were involved with that – we owned 5% of it then. The company outperformed, I believe, through the 90's, and then we got to the war phase of the whole defense deal and they've done okay. The stocks are too high now, but what I think you need to do is focus on, "Why do you index?"

Damon Silvers: We index because indexing is cheaper and more effective in the long run than wasting money on active managers as a group, frankly.

There's a stack of books and data, which some people are contemptuous of here, over at the Harvard Business School, that proves that, to the satisfaction of anybody who doesn't have a financial interest in the opposite proposition.

Joseph Grundfest: I'm sympathetic on many levels, but what kind of expense should be incurred in order to induce fundamental change at the corporate level, and, from an economic perspective, what the agency would be doing would be lowering the barrier to entry in order to make a fundamental change in the structure of the corporation's board. Now, whether, in this context, outside of a takeover area, whether that's going to be a good idea or a bad idea is an interesting question. We know we don't have data that have already run that experiment. Why? Because we've never had that regime. Therefore, we can't do that event analysis. So that's real easy to resolve. But what we *can* do is we can ask the players – we have many of the key players in the room – if you had the authority that the agency is thinking about giving you, how would you use it?

Lucian Bebchuk: I would like to respond to Joe Grundfest's challenge. He was asking which companies would be targeted. In addition to Lockheed that Damon is going to target, I expect that the set of companies that will be targeted will include two types of companies: first, companies that have been chronic underperformers for a long period of time; second, companies that seem to have severe corporate governance problems -- a record of serious self-dealing, abuse of executive compensation, and so forth.

Joe's second question was: "Who in the world will be the directors we choose?" Just sitting here and looking around the room, and without asking those people to say "yes" or "no," I notice Bob Pozen, Bob Clark, Brian Hall, Joe Grundfest, Jack Coffee, and Richard Breeden. So here are six people – and, you know, the table here is not all that large – who conceivably could be candidates.

Finally, to Joe's third question: "What would they do when they get in there?" The main point to emphasize is that, when they get in there, because the shareholders nominated them, their loyalty will be to the shareholders. It has already been mentioned today a source of potential problems with current independent directors has to do with how they got in there. We're all socialized so that when we are invited by somebody, then, at least on the margin, this is going to influence how to deal with things. So, Joe, if you were invited to serve on the board, and you were asked to do so by institutional fund managers rather than incumbent directors, then I expect that you'd be more attentive to shareholder interests than the average director getting in there as a result of nomination by incumbents.

Reinier Kraakman: I've got time for one last question, very short. Brian?

Brian Hall: Yeah, I was just going to say, you know, getting back to your earlier point, Joe, it would be, I think, the main group that would be targeted would be the same groups that would be targeted in takeovers, but Delaware has made it sufficiently difficult to do that, that we are going to this, we're having this conference because we're looking for a second-best solution, which has a lot less teeth, but given that difficulty, I think it's something to seriously consider.

Reinier Kraakman: Okay, let's break for lunch. I'm sure more names will be named afterward.

Session 4: The Perspective of Shareholder Activists and Advisers

Panelists: Jamie Heard, Institutional Shareholder Services
Robert Monks, Lens Governance Advisors
Damon Silvers, AFL-CIO
John Wilcox, Georgeson Shareholders

Moderator: Howell Jackson, Harvard Law School

Discussion Participants: Charles Nathan, Latham and Watkins
John Coates, Harvard Law School
Lucian Bebchuk, Harvard Law School

Howell Jackson: Welcome back. I'm Howell Jackson from the Harvard Law School Faculty and I'm delighted to be hosting the first session of this afternoon's panel. The focus for this session is Shareholder Activists and Advisers, an opportunity to get their perspectives on the issues, which were raised this morning.

As Mr. Beller said yesterday evening at his talk, this is an area in which there is a fair amount of difference of opinion about what would happen and what should happen and so I look forward to hearing from our panelists today. We are going to hear a five-minute introductory statement from the four members of the panel and then a little colloquy among ourselves and then we will open it up. I'm told by Lucian I have to ring the bell one hour from now, and I will do that to keep us on schedule, but I'm happy that we will be starting off with Jamie Heard as our first speaker.

Jamie Heard: Thank you, Howell.

I thought I'd talk a little about what might happen, or what I think will happen, if the SEC does adopt a rule on board access. To answer the question which was asked in the first session this morning, "Is this a good idea or not?" my response is, yes, it's a good idea, but it does matter how the rule is constructed. Institutional Shareholder Services supported the concept of board access in our letter to the SEC of June 13. We outlined some thoughts at that time about how a proposal might be structured, so we look forward to the Commission's release on Wednesday.

Let me make a few comments about things that might be good and things that might not be good about a proposal. First of all, the trigger idea: for all the reasons that were given this morning, I think the trigger idea is a bad concept. It slows things down; it introduces uncertainty. If we are going to have access to the proxy for purposes of nominating directors, we should just have it. It should be an unqualified right for those who meet the other threshold requirements, the most important of which, in my opinion, is the ownership test. I'm not sure exactly what the right ownership level is (it's kind of a Goldilocks thing—you want it not too hot, not too cold, just right). One percent might be too low, 20% is probably too high.

We said in our letter to the SEC, that perhaps 3 or 5%, for a large company might be good, and perhaps the threshold ought to be higher for smaller companies. Clearly, the threshold needs to be set at a high enough level so that the process is not going to be used by gadflies. That's not the intent here. We want to make sure that anyone who is going to use this process is going to use it in a very serious way. This shouldn't necessarily be an easy thing to do. You ought to have to stretch a bit perhaps. Just to give you some idea of how much money we are talking about, I believe Exxon, in its letter to the Commission in June, said that 1% of Exxon would be about 1 billion dollars. So, if you had to get 5% of Exxon, that'd be 5 billion dollars, more or less, or is it a trillion, Joe? You are looking at me in a puzzled way. Was it a billion?

Well in any event, getting 5% or getting 10%, you're not going to have a lot of gadflies doing that, in my opinion. So setting the threshold at the right level is really important.

Regarding the question as to whether you are going to get qualified candidates running or not, or people that may not have the right qualifications, I believe that anyone who is going to go through the trouble to use this process is going to look hard to find qualified candidates, and I believe that they will find qualified candidates. After all, they are going to want to win. They are not going to want to put candidates up for election whose lack of qualifications will become a major issue. When we look at contests, when we analyze a contest at ISS, and are making recommendations on different slates, we're looking at the qualifications of the various individuals who are being put up for directors. Institutional investors are doing that as well.

I don't think this process will be used nearly as much as perhaps some of the speakers said earlier this morning. It may be used to get more leverage for negotiating purposes in some cases where shareholders may want to sit down and talk to the company and talk to the board. The very fact that you might be able to run a slate if the negotiations don't go well would give you some leverage. But I wouldn't expect to see hundreds of these every year. I'd expect to see perhaps more of them than you would see for full proxy contests, but the idea that corporate America is going to be overwhelmed by contests if this rule is adopted is a bit alarmist.

Most of the companies that are going to be targeted are companies that are going to be targeted because they aren't doing very well. I certainly hope that would be the case. Our experience with proxy contests suggests that, in most cases, that in fact is the case. Companies that have performed poorly for some period of time, companies that have flawed or failed strategies, companies that may be in need of restructuring. These are the types of companies that will stand out. That's not to say there won't be companies that might be targeted, or directors that might be targeted, such as Lockheed, which was discussed earlier today. But again, I would expect the focus to be primarily on companies that are not performing well.

I don't think there is much danger that this process will be hijacked by special interests because the economically focused investors whose support is needed if directors are to be elected are not interested in special interest agendas. They are really interested in what was talked about in the panel before lunch: how to use the process to improve performance, and improve returns.

I thought there were interesting comments before lunch on institutional investors and why more of them don't step up. Bob Pozen's thoughts on that rang a bell for me, but I would say there are probably more Michael Prices out there, or Michael Prices in training, perhaps, today, than there were a decade ago. Anything we can do to level the playing field here -- and that's what we are really talking about, leveling the playing field to some degree, will help. Anything we can do that will encourage those types of institutions to get involved will help. If we had ten Michael Prices out there using this process that would be enough to catalyze many other institutional investors.

While many institutional investors, particularly fund managers and mutual funds, remain reluctant to be activists or real leaders, increasingly they're willing to be followers in the way they vote. You can see that by the voting results on shareholder resolutions over the last several years. I would expect that where a good case can be made that the election of a minority slate is in shareholders' best interest, you will see many of the financial institutions supporting those efforts.

When you step back from this, this does not strike me as a really radical proposal; it strikes me as a very modest proposal, to give shareholders the opportunity under certain circumstances to nominate alternative directors. It's time to say, "Are we going to make corporate democracy a reality, or will it remain a myth?"

I hope as we move forward over the next three or four months, we are going to see a thoughtful proposal from the Commission, and we are going to see some constructive comments. I'm hoping we're going to see the adoption of a new rule that if done in an expeditious manner, could be in place for the 2004 annual meeting season.

Robert Monks: Corporations are creatures of law. They are not a natural flesh and blood person, notwithstanding the Supreme Court's views to the contrary. It is important to realize, that in the year 2003, a majority of the ownership of publicly traded companies is held by institutions, trust institutions, the scope of whose responsibility is definable by the federal government under existing law. By this I mean, if you add up the mutual funds, the pension funds, and the bank trusts, you get to over 50%.

What is needed is a policy, a national policy of ownership. Is it the national policy that involvement by owners in the affairs of corporations is in the public interest? Most of the discussion we have had deals with this as an academic question, but it doesn't have to be an academic question. The default setting doesn't have to be at zero, if it is in the public interest that ownership be intelligently involved in corporate governance, it is not much more difficult than the White House convening the chairman of the SEC, the assistant secretary of labor, and a suitable official from the Federal Reserve to say "Henceforth the default setting is that fiduciaries subject to our laws are required to inform themselves as to the facts of the companies in which they are invested and to take appropriate steps to preserve value for their beneficiaries."

If you did that, the pattern would change very materially and you don't have to pass any new laws to do that. You don't have to do anything other than to have a meeting of three federal officials. If that were to be the case, the very, very difficult business plan for a profitable involvement that now exists would change. It would change because there would be a negative incentive. If for example, you were an ERISA trustee, and you failed to take action, one of the remedies the Department of Labor has is to decertify you as someone eligible to take ERISA fiduciary accounts. That would get people's attention.

If you want to have owners, you can create a positive inclination in that direction. If you have that, you have an incentive to avoid liability. We have to face up to one extremely disappointing phenomenon, for me at least. Having been involved in this for about 25 years, when I look out and say, "Who are the owners today, who are the owners who are actually involved?" there aren't any new faces. They are the same people we had 25 years ago. Are there any other Michael Prices? Ralph Whitworth is another kind of Michael Price. But every once in a while you get a very gifted special purpose, investment manager, who does a very good job, but Jamie, you don't multiply Michael Prices by ten. You get one, and that's it. Then maybe twenty years from now you may get somebody who's a little like it.

But we have a Michael Price; we have an increasingly informed involvement by organized labor, which has been unhappily silent for the last twenty years. We have the public pension funds that fluctuate wildly, depending on whether the treasurer in Connecticut is in jail, or is an activist investor. We have the continuing involvement of the California public employee retirement system.

Many people think, and I'm sorry Sarah isn't here to comment, that public fund trustees got involved in activist investment so that the trustees could supplement their otherwise modest compensation by a free trip east to go to council meetings every year. Frankly, it's a very difficult thing because notwithstanding Damon's articulateness, the fact of being a labor shareholder clearly suggests he has an interest. Clearly, he has a viewpoint. Doesn't mean to say he's not an owner, but he expresses an identifiable perspective. When you have CalPERS being a lead shareholder – who is CalPERS? They are white-collar unions. They are intelligent people. They are decent people, but do they know anything about business? They don't know anything about business. They aren't the people you want to be your owners.

Okay, then you have a few people who are charitably described as gadflies, in which category I might fit. We're not the straw that stirs this soda. We can every once in a while get people's attention, but we don't stir this soda. So the hell of it is that in the existing system, without having the declaration of a federal policy of shareholder activism, the only owners who are actively involved are marginal. I don't like thinking of myself as being marginal, but "them's the facts."

Where are the great and the good? Where are the people who ought to be doing something here? Who's the largest shareholder? Well, the largest shareholder is the private pension system plans subject to ERISA. I've spent the last twenty years trying to get them involved. I even went to the extraordinary limits of getting myself made the responsible official of the department of labor to create the law that made them do it in the first place. I'm sorry to tell you, in the interest of humility and full confession, every once in a while you think you've accomplished something and you're almost always wrong. The fact is the law has never been enforced and as Jamie Heard has written several times, there has never been an occasion of involvement in activism by an ERISA plan. Never. Not one. The IBM pension plan has never been involved.

Very recently this has gotten quite embarrassing because there was a very large case involving the merger of Compaq and Hewlett Packard, which has given rise to a number of judicial proceedings. One in the Delaware court, where Chancellor Chandler saw the powder wounds, but couldn't say there had been an act of homicide committed, and so there was no bribery, in his view, no coercion. The SEC, God bless them, with a relatively modest statuary entitlement has come in and assessed a fine against Deutsche Asset Management. As it happens, the facts on the record are an absolute per se violation of ERISA and the Department of Labor does nothing. Absolutely nothing. Same thing it's done for twenty years. So we're not getting involvement because the law isn't enforced. One way to start to look at this is to say, we have a framework for a federal law of ownership. We have, at least in the SEC, an agency with enforcement capability and we could, therefore, change the paradigm under which we are operating.

Let me move a little bit further than this. Yesterday, I took advantage of the occasion to return to a town that I lived in for twenty years with great pleasure. For someone like me, it's always an honor to be accorded an interview with the president of Harvard, who is, usually, by local lore, referred to as the President, just to distinguish himself from the impostors on the Potomac. I went to see the president and I said, "This is the occasion of the 50th anniversary of my graduation from college and it is a custom, that one should make a gift to Harvard." He thought that wasn't a terribly original idea, and I said, "Well, you know, over the years I have made gifts. I used to live here on Follen Street, across the way in a lovely house, and when I left I gave it to Harvard…for a professor at the Law School, I said. They sold it. But that's another question."

I said, "This time, I've got something better." I pulled out a letter I had spent a year writing, fifty pages long, called "To Harvard with Love". What I said to him was this, "You have to nourish the market." You can't have all your smart guys over there picking up wonderful inefficiencies in the prices of stock and the prices of bonds unless somebody is going to help to have a real market. Someone's got to nourish the market. You can't just sit there and bet against this thing that everyone is giving inadequate information to, and pretend it's something you can rely on. I said to him, my thought is that Harvard is not a small shareholder. If he really wanted to have his endowment at the same relative level 100 years from now, as it is now, it would be incumbent on Harvard to use its legendary initiative and imagination to figure out some way in which they could be involved as a shareholder activist.

I have a feeling the president is a fine man; he will have read the letter in probably ten minutes, and will discover in another three, why it is worthless. Nonetheless, it made me feel good to make the present. I haven't had a comparable conversation with the CEOs of foundations, but I did spend quite a bit of time with the Ford Foundation, and I said to them, in effect, "Look, arguably, you have companies who are performing acts that are creating conditions that you are giving grants to try to cure. Doesn't it strike you as a bit odd that you would be investing in these same companies? While divesture has its limitations, I'm not sure what you accomplish by divesting. As a matter of fact, I don't think you accomplish anything except to enrich the brokers. Don't you think you ought to become actively involved?" Their answer was: "No, there are two departments around here; one department runs the money, the other spends it."

I said, well, it's funny, the world isn't like that, and the world is holistic. We have to live with ourselves and so do you. Well, so much for them. I haven't seen them in an activist form, lately, and so, if you think, if you put together the private pension funds, the universities, the great foundations, you would have a framework for shareholder involvement that was perceived as being legitimate. At the moment, what we are talking about is a fringe activity and it isn't fringe because we are fringe people; it's fringe because nobody else finds it convenient to join us. Everyone always says, "Well, the institutions don't want to be involved." Since when were people free, unilaterally, to divest themselves of a responsibility? So what if they don't want to be involved, they should be involved. If it were up to me to make a national policy, there would be a policy that would declare that as the default setting.

Thank you.

Howell Jackson: You are going to have many friends at Harvard if you persuade Larry to improve the stock market instead of us. Our next speaker is Damon, who has a connection to the proposal that the SEC may or may not adopt next week. Maybe he'll tell us a little about that.

Damon Silvers: Thank you, Howell.

It's hard to know where to begin when one has been called marginal and self-interested by my friend Bob Monks, but I'll do my best to ignore that.

First off, I work for the AFL-CIO, which is a federation of America's unions. We have 65 member unions with 13 million members. Union members have invested, on their behalf and for their benefit, approximately five trillion dollars. This money is in union sponsored pension funds, in public pension funds that have gotten some attention, today, and in the corporate funds that Bob Monks was just talking about. Our members are the beneficial owners of that money and that is the capacity in which I am here today.

Obviously we, and our organizations, have a lot of other interests in the companies in which our funds are invested, primarily, but not exclusively, as employees of those companies. We wear many hats, and we don't hide that fact. Now, I'm going to come around to what Howell Jackson asked me to talk about which is the role that the AFL-CIO did play in helping to bring about the access to the proxy initiative which sort of got us here today. But let me talk for a moment about what sort of investors our members and their funds are, and how that got us interested in this.

Our funds are primarily retirement funds; they have long-term objectives, thirty and forty year time horizons. Increasingly they are large funds that have no choice but to hold the entire market in one form or another – the paradigm of this rule is CalPERS – funds that are unable to take advantage of short-term market moves in any serious way, or big opportunities in particular companies, both by economics and the law governing how their funds work. So we hold the whole market, and we have long-term interests. By virtue of holding the whole market, in a sense we are investing in both the entire US economy and increasingly in the global economy.

A lot of the sort of things people say, and have said for a long time about how investors should react to self-interested, or incompetent behavior by management, just don't work for us. The notion that we are going to sell, which is problematic in any case, at least what I learned around here is that if people are going to behave badly, and your solution is selling, it's kind of too late. You've probably already lost. But in the case of most of our funds, selling is simply not an option. There is no place to go.

So, governance as a strategy is all about what our funds are, and what their options are for insuring long-term returns. I say governance; I do not mean by governance a code word for takeovers or for an active corporate control market, necessarily. We actually read and listened too, and took seriously, some of the things that people like Jay Lorsch, Marty Lipton and Chancellor Allen said ten years ago about governance as a different approach.

We are pretty persuaded by the data that shows that takeovers, at least in the large cap world, have tended to be, at best, a zero sum enterprise for investors of our type. Meaning that we hold both the acquirer and the acquiree, and we hold them forever, so we were pretty persuaded by the notion that what we need to do is be involved in governance in changing the sort of organic behavior of companies. I'm not sure now whether the authors of some of that sort of way of thinking now maybe wish we hadn't read them, but that is sort of where we came from.

We got involved increasingly in governance issues during the nineties, and with a real vengeance, after Enron and WorldCom. Despite our funds' efforts to diversify themselves, the cumulative impact of the scandals in corporate America, both at companies whose value completely disappeared, and the overall depressive effect that those events had on the marketplace, was very harmful to our funds and to individual union members, and individual working people, of course most tragically, those people who actually worked for those companies that collapsed.

So as the labor movement and worker funds became more involved in these matters, we became concerned by essentially the fact that at the end of the day, the company which is willing to stiff arm its investors on governance matters, can do so quite successfully. Particularly, the large cap companies, the bulk of our investments, for whom the threat of a takeover, in recent times really doesn't exist. Irresponsible people can stay on boards, CEOs whose pay is beyond the reasonable and poorly structured in relationship to what their objectives should be can continue to do these things, and there is really not much we can do about it.

We can have precatory proposals. We can talk to people like Floyd Norris. We can withhold our vote, as was mentioned earlier, but at the end of the day, if the people on the other side of these things are willful, and it often turns out they are, we are kind of out of luck. This was brought home to us by a couple of experiences we've had in the last few years of thinking about running genuine proxy contests at large cap companies and going out to price that proposition.

Going out and talking to competent counsel with the resources to engage in a proxy fight with a large cap company; and going out talking to our printer because when you talk about doing that, you're talking about for the first mailing, just the mailing, just the printing and the postage it's a million dollar proposition. Getting that mailing to the point where you can legally send it, meaning writing the documents and getting it through the SEC process is between 250,000 and 500,000 dollars, if it is not seriously contested. Any serious contest is not going to be just one mailing: it's going to require multiple mailings plus a phone bank. So you are talking about a proposition that is at least, to be done seriously, a two million dollar proposition. Even the largest pension fund, looking at that kind of bill, in relation to its investment in a large cap company cannot justify it. It just doesn't make sense.

Thus, we came to where we are today, which was, we became convinced, that in order for there to be effective corporate governance, and a real ability for our long-term indexed funds to be able to hold the managers of the companies we invest in accountable, we needed to solve the collective action problem through access to the proxy. We drafted and sent to the SEC, last spring, a rule-making petition asking for just that, focusing on our belief that the access to the proxy should go only to a substantial block of investors. I think in our letter, we said 3%; we suspected it was unlikely to be below five, an amount that involves multiple billions at most large cap companies.

We did that, proposing not a system by which our funds or our views of the world – and Bob is right, we have a view of what makes a good business, what makes sound management, of what makes a sound economy, reflective of who we represent. We make no bones about that. That's what we're about. Others disagree with us. That's life. We proposed, and the Commission appears to be considering, a rule-making proposal that would require not a consensus, but a genuine gathering of opinion among people of as diverse opinions perhaps as ourselves and Fidelity before such a person could be nominated, let alone elected.

Election requires an actual majority. I can tell you right now, if every single fund which we had any say, or any influence, over, voted for something that is nowhere near a majority. In fact, in many of these companies, speaking quite honestly, if the funds that we actually have some participation in as a labor movement were involved is hardly 5%. These numbers are such that they really require a significant consensus among a broad range of the investor community. That's what we set out to propose and we did, and apparently it has had some relevance to what is happening now. We're very much supportive of this, but we really believe, very strongly, that you can disagree with this idea, but it's really quite unfair to suggest that it is a special interest vehicle in that 5% of a large cap public company represents a large block that would really require the involvement of either the entire public fund community or the mutual funds, and a majority is a majority.

A majority of the stock in our public companies today is simply not a special interest by anybody's means, and no one can get onto a board under the proposal being brought forward, according to *The New York Times*, by the SEC without getting that majority. If you believe unity is the highest value on a board then you are going to oppose this proposal, and oppose it properly. I personally, and the labor movement collectively find that argument, after Enron and WorldCom, to be a very hard one to support. There are some things that are better than unity, in some circumstances, and accountability and some degree of oversight is certainly one of them.

Thank you.

John Wilcox: My company is a service provider to corporations in the area of proxy work. We help corporations understand who owns their stock, which isn't so easy to decipher because beneficial owners are often hidden behind street name accounts. We also advise clients how shareholders are likely to respond to initiatives requiring shareholder approval, and then we help them design campaigns to go out and bring in that vote. So we're right in the middle of this proposed rule change.

I have to confess to some degree of frustration. First, I'm a little frustrated because today we are not going be able to discuss some of the most important questions, which are very critical to understanding how this proposal is going to work. These include issues such as how the New York Stock Exchange's ten-day rule on discretionary broker voting will be applied under the SEC proposal. If there is shareholder access to the proxy, will brokers be able to vote in their discretion on those directors who are unopposed, or will the whole slate be suddenly no longer discretionary? There are lots of technical issues like that. How will shareholder-nominated board candidates be handled in back office processing? Will the Internet be able to be used by proponents for solicitation and voting? At this conference, we cannot analyze those very critical issues, which have a lot to do with how the rule will impact the voting results, because we haven't seen the details in the SEC proposal.

Secondly, I'm frustrated because I think the SEC has overshot the mark. As Steve Rosenblum said this morning, when he corrected the title of his panel, I think we should be dealing with the nomination process rather than with the placement of candidates directly onto the proxy. Let me say that I am very much in favor of the first half of the SEC proposal, which came out in August, proposing disclosure requirements to provide insights into how the nomination process works and mandating disclosure on how boards and shareholders can communicate. These are constructive suggestions. We now have in US corporate governance a system in which the elected representatives are unable to communicate with the people they represent. That is inappropriate and contrary to the basic principles of representative democracy.

What I had hoped, and what I suggested in my comment letter to the Commission in May, was that we would look at the nominating committee and open up its process. The idea I suggested was that a qualified shareholder, which would be a group or an individual shareholder owning 10%, could have a spot on the nominating committee, submit candidates, review discussions with search firms and vote on the final state – and all this would be disclosed. I suggested a high threshold of 10% because I believe it is very easy for shareholders to organize using the Internet at very low cost to talk to each other and to assemble support. The SEC can deal with the (13d) issues, group formation, and the other legal issues, which are relatively easy to resolve through safe harbors. It would then be easy for shareholders to organize themselves and to get the support to meet the high threshold. So a qualified shareholder would need 10% for this privilege. I suggested a time period for holding of three years, but I think that time periods may not be needed at all now. I've changed my mind on that.

To allow a qualified shareholder to participate in the deliberations of the nominating committee, to actually have a vote, to be able to suggest and recommend candidates, to have them discussed within the committee, to work with the executive search firm--it seems to me that this would be a valuable experience both for the corporation and for shareholders. Shareholders now feel shut out of the boardroom. They don't know what goes on there. The windows are closed. At the same time, the directors don't have ways of finding out what shareholders want. So why not have them work together in this area of director nomination where there is the least danger of getting into Regulation FD problems or encountering other types of inside information about the actual business and financial prospects of the corporation, and have shareholders work with the board to select those representatives who are going to represent them?

But that is not the path that the SEC has chosen.

At this point, what I would like to do is answer the questions that Alan Beller asked yesterday.

First, is shareholder access a good idea?

I think it is a very good idea if you are talking about access to the nominating committee. I think it is not a good idea if you are talking about placing candidates directly onto the ballot. Our system of governance now is already extremely adversarial, excessively confrontational. If you look at the UK, by contrast, or if you look at the way TIAA-CREF and some other shareholders use our system, you see a different model from the one the Securities and Exchange Commission is trying to promote. I don't think we have to continue to be as adversarial as we have been historically. If we find ways for shareholders and boards to work together, we're going to do more to promote the common economic objectives that both share. For example, if you have directors working with shareholders on the choice of board candidates, they are all going to be using the same selection criteria set by the nominating committee and should be able to produce better qualified candidates satisfactory to both sides.

The second question is: What is the purpose of voting rights?

A very important question, which I think needs careful examination, particularly in light of changing shareholder demographics and the growing power of institutions. I use something I call the corporate governance triangle to explain how corporate governance functions. It's basically an equilateral triangle. At the three axes you have shareholders, management and the board of directors. A series of arrows runs back and forth between the axes defining the mutual obligations and expectations of the three power bases in the corporate enterprise.

We should be looking for ways in which these three groups, who share in the enterprise even though they come from different viewpoints and have different objectives, can make that enterprise successful. Voting rights are clearly part of the responsibilities of shareholders. What we heard earlier today was a very insightful discussion of why it is sometimes frustrating for shareholders to exercise those voting rights in an informed and appropriate manner. I think there has not been a sufficient amount of examination of the mechanical obstacles and conflicts of interest that interfere with the voting responsibilities of shareholders. We are beginning to see the governance spotlight shift from the board of directors to Wall Street, to accounting firms, to mutual funds, and pretty soon it's going to come right back on to the shareholders themselves. We have to recognize that shareholders have both responsibilities and conflicts just as boards and managers do.

Joe Grundfest and I were having a discussion a bit earlier about the Enron situation and the responsibility of institutional shareholders who were investors in Enron's off-balance sheet partnerships as well as their equity. In these cases the left and the right hand did not communicate with each other. I think there are some very real legal and fiduciary issues there. Voting rights impose all kinds of responsibilities on shareholders that need to be examined.

Third question: Is a system of access not involving control or direct representation a good idea?

I think, absolutely, yes it is. Access to the nominating committee would provide a way for the shareholders to obtain greater understanding of what is going on within the corporation and better appreciation for their elected representatives. That is worth doing even without issues of control or direct representation. In fact, shareholders claim they don't want to sit on the boards because of conflicts of interest.

Fourth question: Are triggering events a good idea?

I think we are reaching a consensus here that they are not—and I agree with that. I do not think that a basic shareholder right such as access to either the nominating process, or to placing a candidate on the ballot should be based on a punitive trigger. We are not trying to punish management here. We are trying to create a situation where the organization or enterprise can work better. I don't see any benefits from creating a new shareholder right based on bad corporate behavior rather than on the merits of the right itself.

Final question: Will shareholder access improve the quality of directors?

Yes. If you do it the proper way you will have everybody—both directors and shareholders--understanding what is needed for this particular corporation: What are the director qualifications? What are the criteria for selecting candidates? What is required in a candidate's background? What pieces are missing from the board now in terms of expertise and skills? With the shareholders, managers and board all working with the same criteria, the resulting nominees are bound to be better.

I'll just conclude by saying that in some respects I'm arguing against my own interest in making these arguments against the SEC's adversarial approach, because if we have a rule that increases proxy fights, it's going to be absolutely great for my business.

Howell Jackson: Glad to hear that. Let me just put a couple of questions to the members of the panel then we'll open up. Jamie, I was wondering if you might just react to this idea of access to the nominating committee as an alternative to what the SEC's proposal might be?

Jamie Heard: I think sitting down and having a chat with the nominating committee is a fine idea, but I wouldn't view it as a substitute for giving shareholders the right to have their own nominees included in the proxy statement. It may well be, and this goes back to something that was said on a couple of the panels this morning, that the outside directors of public corporations now are looking at things in a different way than perhaps they did a couple of years ago.

If shareholders come to a company, to the nominating committee and sit down and say, "Look, we think there are some issues there with regard to the board, whatever those issues may be, we have some concerns. We even have some suggestions about individuals, or types of individuals you might put on the board," I think that is fine and we ought to encourage that. If we have the access rule, the right to have your nominee included in the proxy, I think it helps you get people's attention. Because if you don't have a successful conversation, then you have a ready alternative.

Howell Jackson: Damon, let me put one question to you: Is one way of reading your comments, to say, you know people with 5% of the shares and you recommended a threshold of 3%, so it sounds like you and your friends might be able to invoke this process, even though you might not be able to win it under the majority rules. How could the SEC be sure that you might not use the implication in a way to advance what are legitimately your members' interests but maybe not the interests of the broader capital markets?

Damon Silvers: It's a fair question. The point about 5%, or 3% for that matter, is that if you assume for a moment, and obviously it's not our view, but certainly it's the view of some people who have expressed opposition to this proposal. If you assume for a moment that there is something uniquely nefarious about working people and their institutions that invest in the capital markets having a voice in proportion to their investment, there is something wrong with that in your mind, all right.

Let's just assume that is true for a moment, although I've got some real problems with it as expressing a class bias, because, as I said earlier, almost everybody who's operating in our corporate economy has multiple stakes in the businesses that they are involved in. Contractual stakes and equity-like stakes, which are what workers, have, too. But assume for a moment that there is something uniquely nefarious about us.

The fact is that those institutions in which workers (employees), have a real voice, in any meaningful sense, do not have anywhere near 5% of the market. In order to get there, in order to get the 5% you've really got to bring in the corporate funds that Bob was talking about earlier, where there is no worker voice, they are controlled by management, or bring them in indirectly through their money managers. The reality is that if you look at the history of shareholder activism in the last few years as it has escalated, what you see is you can get that level of support—but remember this is not 5% for an anonymous vote somehow, this is 5% to actually come out and say "this is our candidate," "this is our guy."

You've got to get, you've got to pull together institutions that have completely professional managements and governance of their own, that have a diverse client base. I think you are looking at having to get a substantial proportion of the public fund community, plus some significant money managers, where those are mutual funds or regular money managers. The reality is that's not possible unless you've got a compelling case that this is something that is generally in the interest of shareholders. It just can't be done otherwise.

We, in formulating our proposal, felt that as both a political matter and a substantive matter, that that was the appropriate way for this thing to be structured. That it should not be structured so that a relatively small holder could use it, but rather at a level which required a larger involvement. But, I will say, though, there have been some like The Business Roundtable, which have suggested a much higher threshold, a 20% threshold. A 20% threshold effectively would require the involvement of institutions that have never been willing to be active in any way. That would require the involvement of multiple large mutual funds which have refused to get involved in anything in the area of corporate governance or shareholder activism that would require public scrutiny.

Charles Nathan: With regard to the difficulty of assembling a 5% block, I appreciate a company the size of Exxon or Mobil, that may well be true although I've never looked at their shareholder list so I really can't speak from knowledge, but I think at the next level down, instead of the 100 billion market cap company take a 5 billion, 10 billion market cap company, which is a pretty significant economic enterprise and it is very, very common to see 10 or 12 funds control 50% of the vote in 10 or 12 and 5% is very easily done with 1,2, or 3 holders, so I'm not sure the math is as daunting as you're suggesting. I'm not arguing that therefore the threshold should be 20%, I just don't frankly believe it's as daunting as you're portraying it in terms of assembling a requisite percentage to invoke access under the proposal we are all expecting to see on Wednesday.

That could be good or bad but I think it's a much easier task than you're suggesting.

John Wilcox: I would basically agree with that. First of all in the US we have the luxury of lots of publicly available information about ownership. You can go to the 13F filings and find out who all the major institutional owners are. As Michael said earlier today, if he has a company where there is a problem, he pulls up the 13F files and makes a bunch of phone calls to those guys. It is not that difficult to do.

It is more difficult if you have a special issue which you care about but that a lot of other people don't care about. You're going to have trouble getting 5%. You're going to have trouble getting even 1%.But if you've got an issue which does affect the shareholders generally, you're going to have no trouble at all assembling support for that. You can use the Internet. In fact that is a very good exercise. It's like a primary election.

I think the shareholders should take more responsibility for figuring out what matters to them as a group at large. They have been permitted to do that since the '92 proxy rule changes. They can talk to each other. They can go out and assemble support. That would help the shareholder proposal process become much more efficient. If shareholders would assess excess levels of support beforehand instead of acting alone, they could avoid the cost and publicity of sponsoring losing proposals.

Jamie Heard: On that point John, I think there is a lot more communication, since the SEC's proxy rules were changed a decade ago, amongst institutional investors on the whole variety of issues where they were reluctant to talk amongst themselves until the rules were changed to permit open communication on voting issues.

John Wilcox: I think that's true. The other frustration I would express here is this: because we work right in the middle of the process--with institutional shareholders, and also with corporations--I get very frustrated when I hear shareholders complain, "oh, companies ignore us," or "the directors ignore us." Anyone who works for corporations in any kind of advisory capacity knows very well that corporate boards are wringing their hands over these shareholder proposals. They are sensitive to the opinions of institutional shareholders and they are trying to adapt their actions and policies to what they think the shareholders want. The trouble is the shareholders don't see that happening and assume it isn't happening, but it is.

John Coates: John made an allusion to the United Kingdom where there was apparently a less adversarial relationship between the shareholder community and the board community. I just wanted to suggest that the reason that's the case is that if in the UK the top ten institutions, say owning 50% of the stock, think the board should do something, like sell the company, it happens. In the United States, it doesn't happen.

Lucian Bebchuk: The difference between the UK and the US that John Wilcox was talking about has a clear explanation in my view. As many people were saying today, all conversations between shareholders and the company are conducted against the background of the governing rules of the game. When shareholders have more power, such conversations might produce different outcomes. In terms of the power of shareholders vis-à-vis the board, there is a big difference between the US and the UK, which I describe in detail in a recent paper, *The Case for Empowering Shareholders*.

In the UK, shareholders generally can, in a short period of time, replace the board. In contrast, in the US, it will often take two annual elections for shareholders to replace the board. This difference explains why institutional investors yield greater influence in the UK. In the UK, when such investors come to talk with management, the latter knows that demands by shareholders have power to replace the board quickly if they so choose, power that US shareholders commonly do not have.

Jamie Heard: Would you agree that this is in some way an analog, although not as strong as what you have in the UK, to the ability to nominate one or more members?

Lucian Bebchuk: Well, access to the ballot would move us a bit in the direction of the UK in terms of increasing shareholder power a bit. Even with access to the ballot, however, US shareholders would have much less power than their UK counterparts. In any event, what we should all keep in mind going forward is that, even though working out disagreements between shareholders and management through dialogue might well be preferable most of the time, it still matters a great deal what the underlying allocation of power in the corporation is and, in particular, what options shareholders will have if the dialogue does not bear fruit.

Jamie Heard: Does that suggest, Lucian, that the next seminar you have should be one on say, Delaware law, and what changes might be made there?

Lucian Bebchuk: Moving us further toward the UK model would definitely be a desirable step and one worth considering.

Damon Silvers: This has been heard a number of times in this conversation, today, from people who were sympathetic to the argument that management needs to be insulated to a certain extent from pressures of various kinds, and by the way, I'm not unsympathetic to that concept. I think that in many ways the right question is not "Should management be left alone, or left accountable?" but rather the question is, "In what fashion and to whom?"

We left management accountable very nicely to short-term traders through stock options and look where it got us. The pension holders that I represent have a different view, and we see governance and voting as the right way to do it. But this notion that has been put forward today, a number of times, by the people who were against the access to the proxy that investors are at fault for not being active enough, really has to contend with the fact that if you look at the history of the last five years or so, while a lot of precatory proposals have been passed, and a few people, a very few people have been the subject of withhold campaigns, not a single member of the board of a large cap company has actually been removed from office by shareholder action, despite the fact that in theory this can be done.

It has not happened once. One might say, "Oh well, that's because shareholders are happy, that's because the system works, that's because the directors of boards do so well at generating value." That would have been precisely the argument that would have been raised had we held this meeting in 1999. I can't imagine how anyone could say that with a straight face today.

John Wilcox: Damon, some of them are going to jail. That's one way to get them off the board.

Damon Silvers: Unfortunately, a few underlings have gone to jail. The number of directors who have gone to jail is rather small. I can't think of any, actually.

Howell Jackson: I wanted to thank our panelists for a very enlightening conversation and we have kept on Lucian's schedule.

Session 5: Legal Problems in Designing a Shareholder Access Rule

Panelists: John Coffee, Columbia Law School
Joseph Grundfest, Stanford Law Schoool
Robert Todd Lang, Weil, Gotshal & Manges
Charles Nathan, Latham & Watkins
Leo Strine, Delaware Chancery Court

Moderator: John Coates, Harvard Law School

Discussion Participants: Damon Silvers, AFL-CIO
Brian Hall, Harvard Business School
Reinier Kraakman, Harvard Law School
Paul Healy, Harvard Business School

Leo Strine: I happen to believe it is difficult to justify the current election system in its pure form. The idea that the incumbents get to spend money and no one else does all the time is hard to justify and I'm not going to try to justify it. That said, I'm not sure, I think we are talking about tinkering around the margins with a very important subject, and I think we ought to think about what overall system of corporate governance we want to have and what level of government ought to do it.

We need to think about things like whether renters should really be accommodated. What I mean by that is do we do things every year? I think a realistic reform that might strike a better balance would be to do this periodically, say every three years, to have the threshold, as Damon talked about, at 5%. I don't see any congressional mandate for a lot of this, but certainly the idea that the SEC is going to come up with criteria for non-performing companies and use that to trigger ballot access strikes me as ludicrous and absurd, much less that we are going to use precatory proposals which are an invention of the SEC anyway, and don't even exist under substantive corporate law. That groups of people, who are elected, because they don't follow a precatory proposal, are going to be subjected to an election process again strikes me as strange.

What are we getting at? Is this representative democracy or is it popular democracy?

I think if you did this every three years with the 5% trigger, let Mike Price do his stuff in-between, let other bidders for control do their stuff in-between, you could have a rational system. The reality is that the AFL-CIOs of the world and the CalPERS of the world cannot concentrate on every public company every year. There is no need for it. The reality is it's expensive enough, even under this proposal that they will need to express increasing frustration over time and find that they are resisted by management until they rise to the level of doing this. If they really have a stake in the companies over time, if they are really indexed investors, they'll be there every three years and they can make a decision, and they can rotate their focus. This would make it less expensive.

I would suggest, however, that if they have the right every three years to put up candidates who will propose a specific platform, that they ought not have the right every year to throw pizza up against the wall of every public company on specific proposals, non-binding pizza. Except that's really an oxymoron, right? Because it doesn't work, I guess, because mozzarella does stick but I think if we are moving towards an increased form of representational form of democracy as a guarantee of accountability, we ought to take out the popular democracy that doesn't make any sense.

I happen to believe that what really matters is affecting corporate policy. What I heard from Bob Pozen and Mike Price, is that's when they want to intervene, and that the problem we have to solve is large cap companies that are difficult to be disciplined by the takeover market, and where you need to get over the collective action problem of the institutional investment community. I still think starting every three years, and allowing frustration to build might be a sensible way to get at that.

I need to say something about Delaware because I've heard a lot of big talk about Delaware bashing. I had not known that we did not have an M&A boom over the last fifteen years. That escaped me. It had escaped me that a lot of Delaware companies hadn't been subject to takeovers at high premiums. It had escaped me that the Delaware Chancery Court and the

Delaware Supreme Court hadn't played any role in encouraging independent directors to be in charge of that process, encouraging deals like Pfizer and HAAP to come out the way they did, encouraging termination fees to be reasonable. I just hadn't known that.

I also hadn't seen my friends from ISS or the Council of Institutional Investors. I haven't seen them in Delaware make any specific proposal about changing state law. I would like to know when they did that. Last time we saw you was in '87, section 203. So before you criticize what you have—the failure to react to proposals that haven't been made, I suggest that some may be made and I suggest that you find a different state, perhaps Virginia, or Massachusetts – this is a great state—to incorporate, and as an ideal take over.

John Coates: Thank you, Leo.

Joseph Grundfest: Thank you, Leo. One of the many reasons I love Leo is that he can make me seem moderate. I have learned a great deal today. One thing I learned is that the more I hear about the Commission's proposal, the less I know about the Commission's proposal. In particular, I'm not sure about the details of the release on which we are commenting are, but I have been reliably informed that I will be able to find both God and the devil in those details. Also, I am not sure how those details are going to be implemented.

One possibility is that all of this – and I know this is an exaggeration—is being done to "out" Frank Savage at Lockheed Martin. What I was hoping and expecting to hear were the names of very particular and specific large cap companies that have been in the press, and that represent the types of situations you'll read articles about. I was expecting to hear someone talk about Disney and to hear suggestions that Disney would be the kind of company where you might be able to add some value through shareholder access.

I was also expecting people to talk about Time Warner which, in the corporate world, is as close as you get to "three strikes and you're out" when it comes to governance, takeovers and the like. Here we have Time Warner, recently AOL Time Warner, formerly Time Warner, almost formerly Paramount, and formerly Time. If you look at the history of each one of those deals, and if you want to see an incumbent management that has gotten it wrong, at every step of the process, and, with all due respect, protected by the Delaware courts in their right to get it wrong at every step of the process, it's hard to do better than this example.

Another type of situation that I was expecting to hear about involves companies like Merrill Lynch -- companies that could arguably be taken over, at a premium. These are three characteristics of what I was expecting to hear and it was fascinating not to hear them.

But taking a step back from that, and assuming that there actually is a commitment at the Securities Exchange Commission to increase shareholder access, we have to have to ask ourselves, mechanically, is the proposal that the Commission has on the table the best way to go or is there a better way? I'd like to suggest without concluding that shareholder access makes sense, but let's assume for the sake of discussion that it does.

Even so, there may be another approach that is simpler, that creates fewer legal issues, that will be less subject to legal challenge and that might actually work. This alternative approach assumes that the agency is looking to adopt a rule that actually does work as opposed to adopt a rule that says shareholder access on it but doesn't necessarily deliver. It's a real simple approach that relies on a modification of the approach used in Article 2, section 2 of the United States Constitution – an advice and consent mechanism. In the Constitution, the President gets to nominate who the secretaries of the cabinet will be and the Senate, in effect, gets to say "no, you can't have that crony." You've got to get a majority of the Senate in order to approve a nomination. It is possible to implement a similar mechanism using existing proxy measures.

Shareholders, today, have the right to withhold authority for the election of any member of the board that is being nominated by the incumbent board of directors.

What is interesting is the way Delaware law works, and every state law of which I'm aware works, is that a director needs to be elected by a plurality. That means that if a million shares count as a quorum, and if 999,999 ballots strike your name out and say no, you, as the director, owning only one share, and you vote for yourself, congratulations, you win. You have the plurality.

Under federal law, there is no reason of which I'm aware that requires that the SEC or any of the SROs to afford equal dignity to any director who is elected over the objection of the majority of the shareholders. In other words, the SEC, using solely the mechanisms of federal law, or the SROs using internal listing standards, could apply disabilities to any director elected despite the opposition of the majority of the shareholders who are purportedly electing them. Let's admit that this is a curious and interesting form of election. You're elected over the will of the majority. Well, we don't have to treat you the same as directors who are elected with the will of the majority.

Now, how might we impose disabilities on you? There are a variety of different ways to do it and the agency can select from a list of alternatives.

One alternative is that the Commission or the SROs can simply say, "hey, you're not going to be independent" or "we're going to sterilize your votes." We are not going to respect you as an independent director for purposes of federal law. Under Delaware law, you're a director, you get to vote on any matter that's required under state law, and your vote is fully respected for purposes of state law. However, if you have to file a registration statement, you need the signature of directors, and the Commission need not recognize you as a director for purposes of the federal securities laws.

The SEC also has authority to define directors as individuals who are elected and for whom a majority of the votes cast are not withheld. There are a variety of levels of disabilities that the Commission or SROs could apply, and if you take it to the max, and if you really want to hit people over the head with the classic two-by-four, with a big spike coming out the other end, the SEC could take the position, that if you're elected not withstanding the fact that the majority of the shareholders withhold authority, we're going to take the position that it is a violation of policy for the company to indemnify or insure you for any liabilities arising solely under the federal securities laws. Not breaches of duty of care, not breaches of the duty of loyalty, not breaches of the duty of candor, all of which arise under state law.

Now, it's my surmise that not many directors are going to be excited about serving once having been elected subject to any of these disabilities. Simply being elected to the board and being sterilized for a variety of federal purposes won't make a director excited about serving, and it also will reduce the level of enthusiasm from among that director's colleagues about service by that director. So, how does that game play out? It then becomes a compromise and negotiation game between incumbent directors and shareholders. Notice that under this mechanism the outside shareholders who withhold authority never put forward a specific candidate to run for the board. Instead, the board will have to sit down and negotiate with the shareholders, and will have to come up with a candidate who is satisfactory to the board and to the shareholders.

That's also how the advice and consent mechanism works between the Senate and the Executive Branch in the Constitution. As a practical matter, there is an economic logic to that form of compromise. There is good reason to believe that shareholders have a comparative advantage in identifying situations where governance is sub-optimal. I don't think outside shareholders have a comparative advantage in solving the problem once it's been identified.

Here's a simple and recent case study: let's look at the New York Stock Exchange. You can probably use the NYSE as an example for any story that you want to tell these days, but shareholders have been very active in saying, "look, we've got a real problem here." The shareholders did not, however, find the former chair of Citigroup to come in and take over running the Exchange; that solution was identified through a form of compromise involving the incumbent board.

John Coates: Thank you, very much.

Leo Strine: I think Joe's proposal is very innovative and I think under current case law, he's right about the effect of withhold votes. I would think again that's a situation for dialogue with the states, because I think I could imagine a statutory proposal being made into state law to treat withheld authority. I think most of the withhold authority case law is based on the SEC's interpretation of federal law. I think states could consider that a no vote and create implications for that about whether those directors actually got a plurality, if you treated the no as part of the equation.

John Coffee: I'm going to set an ill-advised precedent that no one else will follow and actually focus on the subject matter of this panel. Big mistake. So let's set aside this great pillow fight in the battle between managers and shareholders, and focus on the simpler engineering issues of what would a serious proposal have to look like.

What are the design characteristics? My assumption here is that shareholders and managers, like everyone else, have to bargain in the shadow of the law. Thus, even though I think the real significance of the SEC's proposals are that they will enhance bargaining between shareholders and managers, the extent to which they succeed depends on the extent to which they describe a clear, coherent, credible election procedure that the shareholders can invoke.

What's necessary for such a procedure? That raises a number of issues, and I won't get near going into details on most of them. First, triggering events that are clear and effective. I'll come back to the slow fuse that I hear in the existing proposal, which I think is considerably too long. Second, we've got to avoid the California recall problem which arises when you announce an election and a multiplicity of candidates show up; and I think that could happen.

Third, we have what I call a Trojan horse problem which is that I think under the existing proposal as we think we are going to see it, there is a great capacity for management to decide who wins the primary by using its influence with friendly institutions to pick who would be the nominee that would run against management's own candidates. Fourth, there are safe harbor proposals. Allen mentioned this last night and he gave it the back of his hand. They are not interesting enough to deal with this group but they're critical; they're life and death under 16B. Then there is reimbursement of proxy expenses area. That's where state and federal law should be integrated.

Now, to the extent we have seen any puffs of white smoke appear over the SEC, and we've seen a few, they seem to be telling us that the triggering event that has been discussed to this point is some kind of managerial failure to implement a precatory shareholder proposal that received a majority vote. I think that's a terrible triggering event. We've also heard that there is going to be a fairly slow trigger, maybe and 12- or 18-month delay between the first vote and the ultimate vote on the short slate. That may be politically necessary. I have to admit their politics deserves some concession, but it's far from optimal and it means this won't be the remedy that it's designed to be.

What's wrong, first of all, with using the precatory shareholder vote? Anytime you use a substantive issue, take an issue for example such as whether we are going to expense stock options. This presents a very strange stocking horse by which to approach the real issue, opening up access to the proxy statement, by linking the two issues to automatically skew the vote. For example, if the vote is on whether or not we are going to expense stock options of this particular company, we're going to get some proponents who will vote for this, even though I think it's a bad idea to expense because they want to get access to the shareholder proposal, they have nominated a short slate. Then we'll get some other people who think it's a great idea who won't vote for it because they're afraid they're going to open up access to the shareholder proposal and there are going to be a slew of contests. I would therefore say, first of all, that there ought to be an opt-out provision saying anyone who makes the shareholder proposal should have the right to say this won't trigger that second step because I want an undistorted vote. I want a vote that is not affected by these ulterior considerations. I think I told you that the precatory proposal is bad.

What's the simpler triggering event? I think the simplest one is simply this: to have an opt-in vote of both deliberately structured as a shareholder vote or a by-law amendment which would be adopted pursuant to SEC rule 14a-8, so it would be a low cost vote with no initial investment, and the questions would be: should the company's by laws be amended to permit this specific short slate system? You can opt-in to the SEC proposal, which would be clear and simple, or you could opt-in to a different proposal if you wanted to divine your own.

Now in theory, shareholders in every American jurisdiction have the power to amend the bylaws. It's in every state statue. There is however considerable doubt about the ability of shareholders to use bylaw amendments to accomplish substantive gains such as rescinding a poison pill.

But I see a day and night distinction here between using bylaws to attempt to rescind the poison pill and using bylaws to change procedures. The classic role of bylaw is to set procedures, particularly for shareholder voting. Thus I think that ultimately, the wise and enlightened courts in Delaware probably would uphold far more amendments that were simply addressing shareholder-voting procedures. I can be corrected on that but we'll see.

Leo Strine: We never get asked about bylaw amendments.

John Coffee: The real problem with this kind of proposal is that management can respond to it proactively and preemptively. Management can do the following: management can say we're adopting an advance piece of proposal, 70% super majority for shareholder-initiated bylaws. Will that work? If that works it makes this triggering event unsatisfactory.

But frankly I think Delaware law actually gives a very strong basis, today, for saying an effort of the board of directors to invalidate shareholder voting by adopting such a blocking bylaw amendment will run afoul of the recent Delaware decisions. I'm referring to particularly the *Liquid Audio* decision adopted last year, which I think is a very important, constructive Delaware decision. These cases have been saying that anytime the board acts to block shareholder voting, the board has to meet a compelling corporate interest standard, which is a very high permitable standard.

My point here, really, this is a big point, that the optimal resolution of these issues requires some greater integration of federal and state law because if Delaware law were interpreted the way reasonable Delaware judges should interpret it, there would be a mechanism already available by which this all could be done by the bylaw amendment process, and it tends to frustrate that. It would have to be justified against the *Liquid Audio* standard. That doesn't mean that the SEC shouldn't do this. The SEC probably should adopt a very simple procedure, but I think the implementation of this may already be possible under Delaware law and we've got to approach this issue, I suggest, on two levels. There is a slow fuse problem, but I think I've run out of time so I won't get into the slow fuse problem. I'll turn it over.

John Coates: Thank you very much, Jack. Todd?

Robert Todd Lang: Well, I was at the same meetings you were Jack, but I sort of got a different body language from the SEC. I suspect, without knowing, we'll all find out Wednesday sometime, that the triggering event as we knew it, the precatory proposal is, if not dead, going to be substantially limited.

John Coffee: Good.

Robert Todd Lang: There seems to be a lack of enthusiasm for it because it really is not a standard. It doesn't tell you anything, and we won't repeat everything that people have said on this earlier. So therefore, you are likely to see, and Harvey won't tell us now, we'll find out whether there is going to be some other form of direct access, which will avoid the uncertainty.

The SEC I think has been consistently trying to find an objective standard to which they could relate limited access in recognition of the fact that unlimited access would be chaotic. You have to have some control over this. So, I'm not going to be the one to predict, but I suspect we are going to see one or more forms of direct access.

There are other proposals out there. Five models are in the ABA Task Force Report. One of them has some possibility if combined with the governance-listing standard requiring an independent nominating committee. That is this: if you wanted to give those standards, which I doubt the SEC will, time to function, you could have the nominating committee establish slots. This is our "model three" in that report. They will take only those limited number of qualified candidates who are put up by institutional or other investors who have the requisite amount of stock. The advantage of that is that they can apply the same standards to those people as they would to any other director. When you have access, if it's guaranteed, other than an SEC definition of independence and of no conflict, probably you are not going to know the person you get on the board, and that's one of the great failings.

So I'm just saying there is a great opportunity to use the nominating committee effectively. Note that this is a listing standard. And not an SEC rule. Therefore, the thousands of unlisted companies might not want to follow that standard. So, some attention would have to be given as to how to get those best practices through to those companies.

So, leaving that and trying to go back to the subject, as Jack said, of this panel, I'd like to speak very briefly, on collateral but related issues, but highly relevant ones. One of them is: what is the SEC's authority in all of this? Without getting into a major federalism discussion in three minutes or whatever I have remaining, under Section 14, the proxy rules, the SEC has very broad powers with respect to disclosure. The issue can come up: what happens if the SEC rules go significantly over the boundaries of disclosure, and mandate governance items? At some point – nobody, knows where the line in the sand is – that could violate state law. If you took the teaching of the Business Roundtable decision, there's a possibility that this could get knocked out on the theory that the SEC cannot do through the back door by application of its regulatory powers to governance matters which the Congress leaves to the states.

Sarbanes-Oxley preempted two important state law governance matters: Congress prohibited insider loans and mandated SEC rules respecting audit committee listing standards. It could have selected other items if that was its intent. If it didn't, why does the SEC have an implied power? That's the question. I'm not going to debate the contours of it; it's much too difficult. The other points I want to make are these: there's a number of what I call collateral, but terribly important, related matters to access issues. They affect not only the company, the candidate, and the proponent, but other shareholders, including those who might become part of a group, those who have filings and those who are reluctant to assume the legal burdens of being active.

But the main thing I want to talk about is this: right now, since former Chairman Breeden's administration, the institutional holders have a proxy solicitation exemption. It's by law, so long as they don't hand out a proxy card and seek proxy authority. When that was put in, and Richard and I were reminiscing about this before, there was a concern that many institutions were going to get together and have consciously parallel voting. They were going to go in the back of the room and make decisions that affect control of the company. Well, it didn't happen, but it could happen. I'm mentioning it because if you combine that with what John said before, about limitations under New York Stock Exchange rule 452 on discretionary voting, you could find a significant power and influence change.

Now, whether it's going to happen, and whether all institutions are going to get together, I do not know. I believe they're diverse, they're not monolithic as the expression goes, but it's something to pay attention to. Another is, we talk a lot about control but the SEC phrase "influencing control" is more relevant to access. At what point does activism constitute influencing control to make the activist a 13D filer, not a 13G filer? There are many related technical issues connected to that which really need to be clarified. Now, we and others have made the point to the SEC staff that the time has come to clarify some of those issues, so people know, on all sides of the fence, what they can expect, what the transparency obligations are, who has to file on what form with what consequence.

Another point I want to make is this: the mechanics of access to the extent that you have it are terribly important as to how people vote. Most shares are held in nominee name and I can tell you going through ADP and then to who owns what is no simple process. If you add to that internet voting, which I assume is going to emerge one of these days, maybe sooner rather than later, it seems to me that there's got to be a lot of technical attention to make it work fairly and effectively so that people don't get disenfranchised. The SEC staff is sensitive to this, but it is all something we should be watching.

Finally, I was going to say, but it's already been done, that all these rules should be examined under the laws of the particular state in which the company is organized. There are state laws on proxies and other things and without going into them all now, those are important checklist items.

Chuck?

Charles Nathan: I am in either the enviable or unenviable position of being last up. I want to draw together a lot of the concepts and ideas I saw emerging over the course of the day and see if there are some conclusions at least I'm prepared to draw about where we are headed, at this point.

I think it's very, very clear the SEC is going to adopt an access rule. I don't think there is any doubt about it. Whether the Business Roundtable or other commentators' protest, the handwriting is very clearly on the wall. The clear sense of the day's discussion is that there will be only a few incidences each year where the access power will actually be utilized. This is for two reasons. One is the design element. The SEC is consciously trying to design a rule that will not be available for 15,000 corporations every year. The other is because of the very real problems of gathering even 5% shareholder support for a nomination and the realities of how to put that candidate over the top.

So, I don't think we're really talking about a sea change in corporate governance at the level of board elections. It will be marginal. It will be very important but it's not a sea change. It isn't letting a thousand proxy contests bloom. This is not a Maoist kind of revolution. Rather the critical consequence will be a very dramatic shift in relative power between shareholders and boards of directors because, as a number of people have observed, the power to threaten credibly, a quasi-proxy contest creates a huge change in leverage.

Marty Lipton began the morning by observing directors don't like being put in the position of being subject to a proxy contest, much less being the victim of the election, being the one who is singled out and is not elected. As a consequence there is going to be huge pressure inside a corporation to head off threats of shareholder access nominations at both the management level and the board level. These pressures will give shareholders the opportunity to negotiate with management and the board a lot more directly about what is bothering shareholders. So in some ways, you could say that is a great outcome, that the point of a shareholder access rule is to facilitate direct communication and negotiation between unhappy shareholders of significance and the managers of their company, a place where we should want to go.

I next observe that the institutional investor community is not monolithic. As Todd said; it's very, very diverse. We heard from diverse parts of the community today, and I don't think it's hard to predict that unless Bob Monk's solution is adopted (and I don't think that is on the horizon), we will have a very specialized group of institutional investors trying to utilize new leverage. This group, sometimes called activist investors, is composed largely of public pension funds, unions and union pension funds, and a very, very small number of for-profit money managers. As Bob Pozen and Michael Price, among others have made clear, the vast majority of the institutional investor community, the managers of the private pension system and the mutual fund complexes, have no reason to get involved in corporate governance at this level.

I recognize, and this is the dialogue I had with Damon, there is a question whether the activist investor constituency has enough power to be a credible threat, assuming shareholder access requires a 5% ownership level. I think they will be able to muster enough support to reach a 5% threshold on all but the largest companies. And maybe even there, they will be able to scare people, because as Todd and others have pointed out, use of the 1992 proxy rule revisions to gather together a silent minority of that size isn't all that complicated.

So now we're left with a very curious outcome. Only one very specialized group of investors is likely to take advantage of the new leverage created by a shareholder access rule. That's a group of investors who, as Damon concedes, don't make company-specific investment decisions. This is a group of investors who either delegate investment decisions to professional money managers to run their pension funds or are strictly index investors.

So, what is their interest in governance and what are they all about? Where do they get their mandate from? We call them investors because they happen to own the vote. They don't make investment decisions, they just happen to own the vote, and as far as I know, none of them make any effort to ascertain the wishes of their beneficiaries. Unlike the stock exchange, the brokerage community and nominee and street name registered holders which have made a significant attempt to find out how the underlying beneficial holders want to vote street name stock through the ADP process, there is no comparable way of polling beneficiaries on the part of public and union pension funds. So the beneficiaries are never heard from.

The activist institutional investors just assume they know what their beneficiaries want, they have the curious privilege, or luxury, to talk, or to do what they do in the corporate governance arena without any meaningful economic consequence to the funds they are nominally in charge of. So it's a free-ride system. It may be very, very good for the people enjoying the free ride. It probably provides them with a great deal of emotional satisfaction. It certainly allows them to pontificate on corporate governance without having to accept economic responsibility for their actions or to be accountable in a meaningful way to the beneficiaries of the funds they nominally manage.

But I wonder if this is the right or best way to run a corporate governance system, particularly when the point of the corporation is to create economic wealth for its owners. What we really are creating is a kind of co-determination (to borrow the European concept). The activist investor community is populated almost exclusively by union and state employee representatives. Their growing voice in the corporate boardroom is not different in principle from the more formal voice labor has in the boardrooms of Continental Europe. Co-determination may be a wise or foolish corporate governance system, but it has not been the subject of meaningful public discussion or debate in the United States. Yet here we are today debating a shareholder access proposal without any open recognition of its true impact on Corporate America.

John Coates: Great. Thank you all, very much. Any questions?

I'll ask a question of Jack Coffee. It's really for Harvey Goldschmid but I expect he might not answer it. Leo just left, but one of the most important things I heard today is that "no one ever asks us about bylaws," meaning the Delaware courts are not asked about bylaws. And in order for Jack's proposal to work well, it seems to me you have to ask the question: why has the SEC Corporate Finance staff gotten in the habit of allowing the exclusion, granting no-action relief on bylaw proposals on which there is absolutely no controlling precedent under Delaware law?

John Coffee: Because the SEC makes the understandable mistake of listening to the bar. You can get opinions from every Delaware firm that something is impermissible. Those opinions are not based on a single decided case. There is an argument to be sure that there are limits on what the bylaw power does, because the bylaw power is in tension with the board of directors' power.

What ultimately one has to assume is that both of those provisions in the statute, the power given to the board and the power given to shareholders to amend the bylaws, both describe some power that belongs to each. Some compromise, some balances to be struck. And I think the SEC needs to recognize that the Delaware courts have never told them that there is any limitation on the bylaw power to this point.

Robert Todd Lang: Let me just say that the argument against it always is that it impinges on the powers of the board, which are prescribed by statute. So if you put it in, and it may depend on the nature of the bylaw amendment, which is the point here, and nobody goes to test it, the SEC staff may say we can't sit here all with hundreds of these requests and get into matters of individual state law, so unless it's okay, we are not going to allow it in. I think there is an open issue, but it will ultimately depend on what the item is you are talking about for the bylaw.

Damon Silvers: I'd like to make two somewhat different points: one is with respect to the bylaw issue. In terms of access to the proxy, the issue with the SEC is not Delaware, where there is at least one firm that is willing to give an opinion the other way which stalemates the SEC, it's more the Commission itself has held, at least in recent years, and mistakenly, in my opinion, in relation to prior Commission staff precedent, that access to the proxy proposals under Rule 14-a-8 are excludable, as related to an election of a director.

John Coffee: But you know what you will both say, and this even agrees with what Todd said: there are some bylaw proposals that should be excluded because they really are disguised substantive inferences with the board's power, and there are others that should be permissible. I think procedural voting is the safest of all of this.

Damon Silvers: Yes, and I agree. I agree with that. As a Delaware matter, I think that is the case. The easiest case to prevail on in Delaware on a shareholder initiated bylaw will be this kind of procedural matter.

Robert Todd Lang: Can I interrupt for one second? Isn't there a reason for that? Because 14a-8 has a specific exclusion for director elections.

Damon Silvers: Right, but only in the last few years has the Commission staff applied it in this way. In the '80s and early '90s the commission staff allowed those proposals, and it's my belief that, were all this to be litigated, the proponents would have a strong case.

The other point I wish to make is just to point out, and ask Charles Nathan to respond, you raised the question of the legitimacy of the authority of activist pension funds. I'd like to point out that CalPERS' board, for example, is in substantial part elected by CalPERS' beneficiaries in contested elections. Union pension funds, at least on the union side of the board, I can't speak for the employer's side of the board, half and half, the union side of the board is made up of elected union officials who have to stand election for office and who, in my experience, are very much held accountable for the performance of those funds. People check those statements and they insist that those funds perform well and when you make a mistake, you lose office.

By contrast, those funds that are most passive and most silent, the corporate funds and the mutual funds have absolutely no accountability to the participants. Zero. So that the evidence would suggest that to the extent that beneficiaries are consulted at all, they want activism.

Charles Nathan: As to mutual funds and other types of for-profit institutional investors, I don't claim for them any greater legitimacy in that sense, although most of them are subject to discipline by the Wall Street rule which is a very effective form of discipline.

I think the underlying reality is most shareholders just don't care. That doesn't make it wrong. That may be the right answer. The wrong answer may be that corporate governance is critical to economic wealth creation. The fact that shareholders don't care isn't necessarily a wrong view of the world. And as to the issue of how you know what your beneficiaries want, maybe the CalPERS and union elections are a good marker for that, and maybe they're not. They're certainly not as direct as the system Wall Street uses with the actual ballot going to the beneficial holder on every single proposal that is being voted on.

Brian Hall: In responding to Damon Silvers, maybe I don't understand the facts, here, but I, if you're CalPERS you have money that you control and nobody can take the money out. If you're Fidelity, and you are doing a bad job and your fund isn't performing well, somebody is going to take their money out. At least it strikes me, as actually there being more accountability at Fidelity than there is at CalPERS. I understand the board point, but the other point didn't ring true unless I don't have facts.

Damon Silvers: At Fidelity it's a mixed matter. At CalPERS the board is in large part elected. There are beneficiary representatives who are elected to the board of CalPERS and have to campaign as to what they do. At Fidelity it's correct…

Brian Hall: That's good because there's a captive set of funds there. You have to introduce some accountability.

Damon Silvers: Hold on. At Fidelity, right, you have a pool of money that comes to Fidelity in different ways. Some of that pool of money is in fact quite able to come and go from Fidelity based on Fidelity's performance because it's individuals investing through taxable mutual funds.

However the question that everything that Fidelity is doing may not be known to them in quite the way that CalPERS is. At least it's not known yet because the mutual fund disclosure rules on proxies haven't come into effect yet. Everything CalPERS does is on their website, in this area, at least. However, a large portion of the money that Fidelity has comes through 401(k) plans, and to a substantial extent, depending of the policies of the employer, if you are a participant in a Fidelity dominated 401(k) plan, you don't have a lot of choice, assuming that you want to make a particular investment strategy.

You want to index money; you get a Fidelity indexed fund. If you want large cap growth, you have their large cap growth fund. In order to exit, you have to choose essentially, a different set of investment strategies, or not to take advantage of the 401(k) tax break. So Fidelity, or a comparable fund is a mixed bag, in my opinion, on that subject. What is certainly true is that you have to make a sort of…at CalPERS, for example, you have two separate decisions, if you think that CalPERS is a terrible way to invest your money for retirement, and that's really important to you, I suppose you can quit your job, right? But you also get to vote on the people who run it. At Fidelity, it's just kind of an all or nothing thing. As an investor, you can't say, why I think Fidelity is decent enough, but I think these guys are a little bit off, and so I want to vote them out. I mean, in theory, you have that right, but you don't really. At CALPERS, it's a real right. They have real elections with real contests and people win or lose.

John Coates: A crazy Yale law professor who moved to Harvard, Reinier Kraakman, has a question. That's how he was introduced this morning by Steve.

Reinier Kraakman: That was a little different, a little more flattering.

John Coates: Fair enough. He's a former student; I'm a colleague.

Reinier Kraakman: I wanted to go and pick up on a point that Charles made from earlier. What conclusion do we draw from the number of activist investors who are indexed? What conclusion should we draw from that fact, for their incentives in this arena, in particular for enhanced shareholder access?

I want to suggest that you're indexed; you hold a portfolio of market or some representative subset of the market. Your natural interest is going to be in reforms with market-wide implications, that affect everything in your portfolio, and I would suggest that maybe the shareholder access proposal is one of those proposals with market-wide implications, so in fact, it's not so curious that you might want to get behind it. It's the kind of thing that can affect big works, the value of all companies in a portfolio, even if you get involved in one of these short slate contests, presumably you'll do it because you respect part of your returns not to be in the firm in which you elect a short slate, but in the incentive effects, that this move will have on other firms in your portfolio. You're going to be capturing those positive effects.

John Coffee: There might be a simpler explanation on the same line, Reinier, which if indexing may express the view that some institutions shareholder voice is not profitable to exercise. Then if that's true, do you stop there? One response is to subsidize shareholder voice and by economizing on the cost of a short slate, we are transferring of shareholder voice from the individual shareholder exercises to all shareholders and we second, in effect, we socialize the cost because we make a more political judgment if there is something valuable about subsidizing shareholder voice.

Charles Nathan: Well, I would just say that I did not mean to suggest there was anything wrong or inappropriate with the public funds or union funds championing the access proposal and I agree with Reinier's view of that. It's what happens next and the opportunities for unintended or intended consequences afterward, because if we're all right, the access proposal will be used very sparingly. It won't affect a great deal of behavior very directly. It's the indirect effect and the ability of people to utilize shareholding power to gain a special audience – a non-transparent audience with the corporation to influence corporate behavior in ways that may advance agendas that are peripheral to that of share ownership that is worrisome.

There are a lot of quasi-social policies floating around that could be pressed at the corporate level that shareholders may or may not like and boards may or may not like, but they may think it's a lot easier to give in than to face an election contest or a threatened election contest. What I see as the real problem is that there is no way to limit the ability of activist investors utilizing their newly found leverage to advance agendas that are peripheral or quite possibly inimical to the financial success of the corporation.

Paul Healy: One of the things I found somewhat interesting, we've been debating – there's been a variety of points of view as to the extent of which of these types of shareholder actions are going to take place under this proposal and if you follow your logic through you could actually try to understand if a director didn't get majority vote, they wouldn't be on the board. Do you have any sense from a historical perspective what the impact of that was? How many situations have arisen?

Joseph Grundfest: Historically, I doubt there have been five situations where a majority of shares have been withheld, but part of the reason for that may simply be that people who have the ability to withhold, say "why bother?" There is no consequence that follows from the action, accordingly, why do it?

On the other hand, if a consequence follows from the action, then all of a sudden you've added value to the right to withhold. Today, the right to withhold is entirely semiotic. It's a symbol. Symbols have consequences and you can embarrass some directors, but if you actually attach a regulatory consequence, then all of a sudden a right that's really been just lying fallow may turn out to be very valuable.

Robert Todd Lang: I'd like to make one other point. We should also look at how large institutions or others who index or invest on a broad basis make their voting decisions. That process is critical. If they are using proxy advisors who are making recommendations on particular subject matter, it's much easier to follow their recommendations. After all, the institution is paying for that advice. A lot of them just go along with it so, there's a good deal of voting power organization on issues through the use of proxy advisors, the fact that there is an intermediary changing of things.

Session 6: Concluding Remarks

Panelists: Robert Clark, Harvard Law School
Floyd Norris, The New York Times
Harvey Goldschmid, U.S. Securities and Exchange Commission

Moderator: Brian Hall, Harvard Business School

Discussion Participants: Guhan Subramanian, Harvard Law School
Jill Fisch, Fordham University School of Law
Robert Todd Lang, Weil, Gotshal & Manges
Charles Nathan, Latham & Watkins LLP
John Wilcox, Georgeson Shareholder

Brian Hall: In this last session we are going to give three people, very distinguished guests that are here to have the last word. So with that, I'll start with Bob Clark, who, now that he's done being Dean, is allowed to engage in really substantive matters.

Robert Clark: I'm not sure that any important argument hasn't already been voiced today, so I thought I would play the role of a judge of the debate and give you an interested observer's reaction.

My background is a bit different from that of the panelists. Most bring one particular perspective or another. My background and perspective are rather mixed-up. I practiced corporate law for a while. I was a corporate law professor for a decade and taught many students who went on to make a name from themselves, such as Eliot Spitzer (no, I'm not claiming credit or responsibility), and in that role my attitude was very much like Lucian's: let's empower the shareholders and put a clamp on these guys who are running companies. Then I became Dean and did that for about 14 years, so I acquired the managerial perspective. I heard a lot of faculty talk about the importance and benefits of faculty governance; the effect, however, was to make me very skeptical about democracy in all its forms.

The other relevant kind of experience involves outside activities. I have long served as a trustee of TIAA-CREF, the behemoth institutional investor; I have been chair and am still an active member of its corporate governance and social responsibility committee, which looks at all shareholder proposals to decide what to do, and decides when to initiate our own proposals, so I've got much of the perspective of the institutional investor. But I've also been a director of some public companies, and in this role I have acquired a deep appreciation of what really goes on in boards, and of the profound importance of collegiality, mutual respect, and related intangibles that as a professor I thought were total nonsense.

So I have a diversified (though you might say, totally confused) perspective, which shapes my assessments of the debate.

I'm assuming there will likely be an SEC proposal of a shareholder access rule that will give access to the proxy mechanism of the company and, subject to strict conditions, will reduce the costs of nominations for some of the directors. The basic question is whether the new rule would be a good thing. In all honesty, my strong starting point is one of agnosticism.

Will the rule, as it is likely to emerge, lead to additional contested elections and many different directors being put in place? And will such effects in fact lead to changes in financial performance in the corporate world as a whole? And will any such positive change outweigh the costs -- direct, indirect and unintended -- that are created by the process? The answer is: truthfully, I'm not sure. That's my first point.

Second point: Do I think empirical evidence is important in trying to assess these important questions? Yes, absolutely; we should continue to do financial-economic studies of the effects of these rule changes, assuming they are made. I'm not sure it's feasible to do the studies, but I absolutely believe in the importance of efforts to do scientific studies, instead of relying solely on interest-group arguments. But in the meantime, I suppose, the SEC has to make a decision that is based on the power of arguments relying on general theory and practical experience.

So I offer my third point, for what it's worth. As a hypothetical judge I find in favor of adopting the shareholder access proposal, essentially for reasons articulated by Professor Bebchuk, although I'm less certain about my conclusion than he appears to be.

Let us focus first on what is to be gained by this process. It may well be that the climate is the motivation, and the only reason it's possible for the shareholder proposal to happen is that we've had such salient corporate scandals in the last few years, which involved instances of major fraud and managerial disloyalty. It is very clear to me that the access rule won't address these kinds of problems particularly well, if at all. Consider a thought experiment. Suppose the access rule had been in place at the end of 1999, or early 1999. Would it have prevented WorldCom, Enron, and some of the other major scandals? I can't see how it would have.

On the other hand, the access rule will serve the function of providing an additional safety valve. There are many such mechanisms already in place to control managerial slack and disloyalty, but this would be another one. If things get really bad, shareholders can "send a statement" and elect a new director. More importantly, as numerous people have pointed out, the new rule would increase the bargaining leverage of major shareholders.

One of the things that has most impressed me from my experience with TIAA-CREF (which has been an active institutional investor) is how much can be done in a quiet way, by just going to the management of firms and saying, "We have an issue with the way you're doing things. We are thinking about a shareholder resolution, but we don't really want to do that. Can we talk?" Overwhelmingly, the responses are positive. Thus, the most effective way of getting independent directors on boards, in order to shift them towards a majority of independent directors (in the period before the recently proposed New York Stock Exchange listing requirements), was this soft-shoe method. It did not often happen by actually bringing a shareholder resolution and then having to vote on it. In sum, I think that the access rule would create a lot of leverage for institutional investors.

I must admit that, when I first read the Lipton and Rosenblum paper, I was very taken by all of the specific problems with the access rule that they indicate. I don't think their more philosophical argument -- their ranting about the academics' use of the principal-agent theory and the ownership model -- was particularly forceful as an argument *in this context*. I actually agree with some of their ranting, but I don't think their general viewpoint settles the particular issue of whether we should have an access rule as an extra safety valve for shareholders. But some of their particular arguments against making it easy for shareholder nominations -- the risk of special interest directors, the destruction and diversion of resources, and the harm to board collegiality and good functioning -- were quite powerful. Nevertheless, I also think that Lucian did a good job of taking us through each one of these bad effects and showing how they are not likely to be serious if the proposed rule is designed properly. In the end, I am willing to believe Lucian's counterarguments, at least until I see how the rule works in practice.

Moving to specifics: my preference, if I had to advise the SEC, would be to drop the triggering event aspect of the access rule. The main reason I would drop it is to encourage those institutional investors that are really oriented almost entirely to financial performance rather than special issues, to engage in some activism when it is really important, that is, when a company is in serious trouble.

Another more specific reaction concerns the ownership threshold – who can nominate shareholders. It should be set on the high side of the range that is being discussed. I'm not sure what the perfect number is, but it should be on the high side because the observation that someone made earlier today is valid: it will be hard to raise the percentage once it is set. Politically, it will be difficult to raise it, but less difficult to lower it, if subsequent experience suggests doing so. From this perspective, I would favor something like a 10% threshold, though that may be a tad too high, and perhaps it should vary with particular kinds of companies. Finally, much attention should be paid to the mechanics of how to implement the access rule. The many points that Mr. Lang raised were very good.

Having reacted to the particular proposal, let me offer a final, broader comment. I feel a certain regret that so much high brow attention, and so much expertise, is being focused on this kind of issue, which is not nearly as important as some other kinds of governance reforms that could be made. That is my major misgiving today, not the fact that maybe the access rule won't do anything, or that its cost may exceed the benefits. It would probably be better for the performance of the corporate world if we did something else, like getting rid of staggered boards, or facilitating takeovers in appropriate situations. Such topics are obviously subjects for another conference, Professor Bebchuk, and I hope we have one.

Floyd Norris: I want to thank Harvard and Professor Bebchuk for inviting me to this conference. I go to academic conferences, occasionally, and inevitably walk away wondering why I did. This is the exception. This has been very educational for me and I'm very grateful.

Journalists tend to think we have no conflicts of interest, which of course, makes us purer than others, but this is not true, as you all know. My particular conflict of interest in this area is that I love proxy fights. They give me something to write about and they give my employer lots of money. I thought Hewlett-Packard and Compaq was a model of corporate governance. I hope that it can be repeated many times.

Another problem we have in journalism is what we call the Central Park phenomenon. If you lived in Iowa and all you knew about New York's Central Park was what you read in the local paper, you might think that no woman had entered it and ever left without being assaulted. For the last two years, I have not written about a lot of companies that had decent corporate governance. That inevitably colors my perspective. Nonetheless, over time we have seen a lot of bad corporate action, and bad as I use it here is defined in the eye of the beholder. The proposal that we seem to think the SEC is going to do Wednesday--excuse me that my colleague Steve Labaton, says they will, so I have no doubts about it--seems to me to be a very modest proposal, for reasons you've heard from many people here today.

I think it reflects the frustration of a lot of shareholders. Now you can question, as some do, whether they are really shareholders, or whatever, but people who have the voting power. They have felt ignored by the imperial board. Over time, the lawyers told the board that these shareholder votes were only precatory. Did you all notice the way they pronounced the word precatory? It sounds really nasty, and that the boards could ignore them with impunity. And they did. That led to a lot of frustration. There are institutions that pride themselves on having open door policies and you get the impression that your consultation may or may not be welcome, but is certainly not paid any attention to.

One of the most encouraging things I heard today was from Mr. Lipton, who said the boards were not listening as much to the lawyers as they used to. I don't think we would be here today, perhaps we'd be talking about something more important instead, if the lawyers had been telling the boards that right or wrong, wise or not, if the majority of shareholders clearly have an opinion, the company ought to listen to it. So, as these proposals went on, the shareholder proposals started with things like South Africa, and then they gradually come to things like takeover defenses where shareholders tended to think their interests differed from those of management, and they, generally, were ignored.

On the margin, I think the rule that the SEC is going to adopt will increase the power of institutional holders who of course have their own conflicts of interest. We've heard some of them discussed today. I'm a little nervous about how that power is going to be used by these holders, how it will be use by what Mr. Pozen called "informal pressure" outside of the public eye. Watching bankruptcy fights, we've seen institutions use informal pressure to their benefit and to the non-benefit of classes of investors not at the table, but I hope the new power the institutional investors will get will be used reasonably well, and with some caution. I think the rule the SEC is putting in is going to assure that it will be used with some caution and with considerable delay. Whether that is good or not, I'm not sure.

Thank you.

Brian Hall: Thank you. So, I think we have two votes for, although yours is colored by conflicts of interest. So with the final word, we are pleased to have Harvey Goldschmid.

Harvey Goldschmid: Someone told me years ago that when you get two votes on a three judge court, you say thank you, sit down and don't say any more. I will say more, but first I better give my disclaimer. The staff keeps telling me I've got to do it, and here I really have to do it. Alan Beller must have given you the full text, but basically, no one has to take seriously anything I say at 450 Fifth Street in Washington, DC. Think of me as wearing my Columbia hat. I did keep my tenure, which makes Washington much safer.

Alan Beller suggested before he left, that a lot of the criticisms were tilting at windmills. Indeed, they are windmills that aren't there. A lot of the critiques are about things that aren't going to happen. On the technical level, Jack Coffee correctly raised all the right issues, and assume that we've been colleagues a long time, and I've thought about it too, and that we've taken care of all of them. In so far as we haven't, there obviously will be a comment period and we'll correct any flaws. That's not a problem.

Assume furthermore that the questions about SEC power, which we will have to answer as you see the design, are not serious questions. Section 14(a) gives the SEC very broad rule-making authority. The only thing that could stop us from setting up a scheme for proxy voting in this context would be if a state said shareholders may not nominate directors. If a state does that, we can have a very different system, but I want to see the state -- operating with a remarkable lack of wisdom -- that does so. There is no question we have the power. Once shareholders can nominate, the SEC can set up the process for shareholders nominating in different forms.

In this area, the history, someone referred to it today, ought to be kept in mind. The SEC first thought about this issue in 1942. The Commission thought about it again in the late 1970s and thought about it again to a degree when Richard was chairman, in the early 90s. We've never been able to go forward. Let me give you, wearing my academic hat, my sense of why we ought to move forward on the access proposal now.

I started off as a great believer in shareholders. Not so much because they put up capital, although that counts, but because if they understand the system, they have precisely the right instincts. After everyone else gets paid, they get the residual; they get what's left. Therefore, their basic interest is in productivity, efficiency, and profitability. That's healthy for them; it's also a national need. We want to encourage the fulfillment of these shareholder goals, and for me, that's what this is all about: it's encouraging efficiency, productivity, and profitability, and the kind of board that will lead you in the right direction.

There has been a good deal of talk about the reforms of Sarbanes-Oxley, and the SEC building upon and implementing Sarbanes-Oxley. I'm a great fan of independent directors and the so-called monitoring model. I began teaching in 1970; Penn Central went bankrupt that year. The average director of a public corporation in 1970 worked 30 or 40 hours a year. The whole movement in corporate governance since then has been to get much greater activity. Before these recent scandals, it had reached an average of 150 hours a year in the large corporation. With all that has been done over the last year, it probably will move to 200-250 hours. That's all healthy, and for many boards, that system will work. In many companies, oversight by active, independent directors will lead to efficiency, productivity, and profitability.

But the mind's eye, at least as I see things, sees the dead board and the dead company. Assume that the company could be much more efficient. Its disclosure is okay; it's acceptable, but it's very painful for shareholders. What can you do about that?

One answer is some kind of hostile takeover, but we know that whole debate, and hostile takeovers (at least of the 1980's style) have had mixed and debatable results. What about a proxy fight, is the basic issue that jumps to mind; this would be a way of getting a more serious and active board in companies that need it.

Well, the free-rider problem was raised, and more importantly, in many ways, the rules for proxy fights in the United States are prohibitively risky and expensive for insurgents. If Leo were here, and I'll talk to him somewhere along the way, Delaware's great contribution could be, first, to remove provisions permitting staggered boards, and second, to change the proxy expense rules for proxy fights. But under state law, right now, the incumbents can spend lavishly across the board, for all of the modern paraphernalia of the proxy fight. They can use company employees, newspaper ads, letters, millions of dollars of work and they get reimbursed automatically out of company assets. They have an ability to persuade that is so broad as to be basically unreasonable in terms of the freedom to make large expenditures.

For any insurgent in this game, you've got to put up your own money. The risk is enormous. There's not a penny to be gotten back unless you win and get a shareholder vote. In the real world, the bottom line has been almost no proxy fights in the United States. The exception there, and it's a relatively small exception, is the hostile takeover where you are trying to deactivate a pill and you have special economic interests. Those things aside, Lucian is clearly right: there just aren't realistic contests in the United States. That cannot be helpful. That cannot be healthy.

The Commission is carefully crafting, and I don't want to tell you too much, but think about a direct access proposal. Shareholders would simply be saying: we think we need access; the governance process in this public corporation is not working. If the majority of shareholders vote for that access, they will get it in Year Two. Some say why? And others say why wait so long? The basic answer is that this process would eliminate problems such as which shareholders, what percentage, or what about the danger of special interests.

The proposal, which is like a Rule 14a-8 proposal, is one that a majority of shareholders would have to vote for. If they voted for it, clearly, in this kind of constituency, it would mean there was something basically wrong with that corporation. There would be concerns about efficiency, productivity, and profitability; the things we have to care about as a nation. In Year Two, a shareholder group, perhaps, think of the lead plaintiff provision in the 1995 Reform Act, would get to nominate one or two or three directors. That would be a very healthy constraint.

Winning the contest in Year One would be an indication of basic problems at the corporation; winning would give the shareholders considerable leverage. Indeed, the very threat of an access proposal may give concerned shareholders leverage. If they have to win another majority vote in Year Two, obviously that would shake up the corporate dynamics and the board. But the insurgent nominees would not be wild directors, they would obviously be put there by the largest shareholder group, and would be getting majority votes. The result would be a company that's bound to be run better, or at least the odds are high enough, in this kind of context.

Well, I better stop there. I will take questions. But please understand that the current Commission is being cautious and thoughtful. We don't want to set up wild numbers of fights. The direct access proposal won't create the distraction that the business community is legitimately concerned about. What we are trying to make vulnerable, in corporate governance terms, are companies that are not working well and that ought to be vulnerable. Directors will not refuse to serve; special interests will be not be empowered. But no longer will ineffective or unconscionably compensated CEOs -- with compliant boards -- be relatively safe. No longer will managements be able to ignore a dissatisfied majority of shareholders. Anyway, the direct access proposal is at least one possibility that an academic thinks the SEC may be thinking about.

Brian Hall: Thank you. I think we have about ten minutes for questions left. Guhan, I saw your hand.

Guhan Subramanian: Yes. A year is a long time between the triggering event and the actual short slate. Are there circumstances that might reverse the trigger, in some sense?

Harvey Goldschmid: Don't forget what we're talking about. I mean, if you get Enron or WorldCom, civil lawsuits and criminal prosecutions are in order; corporate governance will be dramatically changed by bankruptcy proceedings; what we are trying to reach is a weak corporation. Someone mentioned GM, for instance, this morning, as a good example of the ability of boards to turn things around. I remember GM year after year, people said: why can't that company do anything? Why won't they change? Nothing happened there until the independent directors had a secret meeting. The process took years and years. If we can turn around some of our largest corporations that are in trouble, it will have an enormously important economic consequence. The new power for shareholders is very healthy. You have to be concerned about the boards that haven't been good enough and the managers who just aren't doing enough. Now these are not venal managers; these are managers just not doing the job.

Guhan Subramanian: It just seems to me that a board, once the trigger has been activated, would be very likely to do things like fire the CEO rather than operate for a year with what has been described as a gun to their head.

Harvey Goldschmid: That may not be so bad, in the right circumstances. That's why I say this changes the dynamic.

Jill Fisch: Harvey, you draw the analogy to the 14(a)(8) provision and talk about shareholder groups, and I wonder if you've thought about the possibility that shareholders may be subject to manipulation and accumulations of these groups for the second stage nomination process, and that institutions or other people may try to amass groups of shareholders that really aren't informed or interested, simply to swell the numbers.

Harvey Goldschmid: Well, one has to have some faith that those shareholders, particularly those with a significant number of shares, have some intelligence, care, and understand that the bottom line is their bottom line. There are two basic things to worry about. One, you've got to worry about a group that would be aligned with management, so the original triggering vote won't be very meaningful. It's possible the Commission has thought about that. The other side of the coin to worry about is technically, the 16(b) kind of problem, that the nominees not be too aligned with the nominating shareholder group. The head of CalPERS, if they're involved in a group, should not be the person nominated. Again, there are ways of both taking care of that, and yet keeping a wide net where shareholder groups will be able to find people they care about. Reinier mentioned today, and forgot to cite his piece which suggests, a process for institutions getting together to begin to think about directors; that idea is still valid and around.

Robert Todd Lang: Harvey, if this is adopted in some form Wednesday, how would this be integrated with the nominating committee process, particularly in terms of qualifications reviews?

Harvey Goldschmid: Todd, that's a fair question. Again, there are ways of making sure that the directors nominated by any group are appropriate in terms of state law, listing requirements, and that their backgrounds can be looked at.

Robert Todd Lang: Would they be vetted, in effect?

Harvey Goldschmid: Again, if I weren't at Columbia and at the SEC, I think I could figure out a way to do that.

Charles Nathan: I'm actually very curious about – and maybe there isn't time for this discussion—people's guess as to whether – in a hypothetical system that Harvey describes, whether the trigger is simply a vote of what you call a 14(a)(8) vote change of corporate governance, however it's done.

Whether votes for that are going to be treated the way a lot of precatory proposals are today, where there is a lot of voting by rote, a lot of their policies, a lot of for-profit money mangers just have policies we always vote for this thing where ISS as practical matter determines a lot of voting and where it's very predictable. Right now, you know what a poison pill vote is going to produce. The question is how can the majority…

Harvey Goldschmid: Let me give you a reaction to that which I've thought about, of course. If ever there is a case-by-case issue, this is it, in terms of ISS. I would hope they would make this, and I suspect they surely would, a matter about which you don't have across-the-board voting. It wouldn't make any sense. If you've got a direct-access resolution in a good company, I want to vote against it. If that board is alive, the company is alive, the nominating committee is functioning effectively, why would anyone in their right minds, who care about that efficiency and profitability, vote for such a resolution? On the other hand, it's the weak company it's aimed at, and one would hope that there'd be information out, and you'd vote case by case.

John Wilcox: I can't imagine it wouldn't be case by case.

Harvey Goldschmid: That sounds good to me.

John Wilcox: It sounds like a lot of work for ISS.

Robert Clark: I wonder… it sounds like Harvey's talking about the two-step process and my hearing of the conversations earlier in the day is that there is a lot of opposition to that. I just wonder -- could we take a vote here? Assuming there is going to be a rule, how many would favor the two-step trigger? Should we do it with the trigger? No trigger? Not at all?

Brian Hall: All those in favor of the trigger raise your hand.

All those not in favor of having a trigger?

[A majority of the hand raisers vote against a trigger.]

Well, this vote is purely advisory.

Harvey Goldschmid: I notice my votes.

Brian Hall: First, let me just thank the last three panelists who did a terrific job. Thank you.

Secondly, following Floyd's earlier remarks that as a reporter he's gone to many academic conferences and walked away scratching his head, well as an academic, I've done the same thing, but this clearly is not one of those. I can't imagine a better group of people to pull together. Thank you all for coming.