Undercutting CEO Power

A series of rules changes is **eroding the authority** of chief execs.

WHEN DAVID BATCHELDER of Relational Investors pulls up his chair to the boardroom table as Home Depot's newest director, it will no doubt be a decorous and polite occasion. Yet not so many years ago it would have been simply unthinkable—a 1% shareholder, loudly opposed to management's strategy, being welcomed onto the board of one of America's largest companies. It's the latest, most dramatic example of one of the great power shifts in U.S. business: Owners are taking back control of big, publicly traded corporations, and they're just getting started.

As proxy season 2007 gets underway, it's worth thinking about what has really happened and what's next, because this is a case of many small changes—some virtually unnoticed by most businesspeople—adding up to a major long-term downsizing of CEO power.

For example, until 1993 institutional shareholders could not legally pick up the phone and talk to more than ten others about a company in which they all held shares unless they first filed voluminous SEC forms, thus alerting management. The rule was changed, the phone lines buzzed, and a few weeks later Westinghouse CEO Paul Lego was out, followed within days by IBM's John Akers, American Express's James Robinson, and others. Another new rule forced more detailed disclosure of CEO pay; sparking public outrage and a law restricting the corporate tax deductibility of CEO salaries. Bam, bam—two hits to CEO power.

HOME DEPOT IS THE LATEST EXAMPLE OF OWNERS TAKING BACK CONTROL.

Then the Enron/WorldCom/etc, scandals prompted the NYSE and Nasdaq to impose new listing requirements that sap CEO power further. Boards must consist mostly of independent directors ("independent" is strictly defined) and must meet regularly in so-called executive sessions—that is, without management. The NYSE is explicit as to the reason: "To empower non-management directors to serve as a more effective check on management." Another hit.

Now add a 2003 SEC rule requiring mutual funds to report how they vote their shares in all companies whose stock they own. Most institutions had previously just voted the way management recommended. It was easy, and institutions that also sold corporate services like 401(k) plan management had no wish to antagonize potential customers by voting against them. But with those votes on sensitive matters like executive stock options and poison pills open to public scrutiny, institutions are voting their massive holdings against management a lot more often. Bam.

The next CEO-humbling trend is clear. The No. 1 shareholder proposal at this year's annual meetings would require directors to be elected by majority vote. Most companies still run Soviet-style board elections: There's one candidate for every seat, and you can vote for him or withhold your vote, but you can't vote for a rival candidate, and you can't even vote no. As long as a candidate receives just one vote—which he could cast for himself, assuming he owns at least one share—he's elected. CEOs can effectively control boards just by naming the nominees. A majority-vote policy requires that a candidate get an actual majority of votes cast.

Again, a little-noticed rule change provides muscle: Delaware amended its laws last summer so that if shareholders approve a majority-vote rule, the resolution is binding; previously it hadn't been. Since nearly all big companies are incorporated in Delaware, the effect is powerful. Shareholders have introduced majority-vote resolutions at more than 100 companies this proxy season, the most ever, says Institutional Shareholder Services. Many of the biggest companies—General Electric, Walt Disney, Lehman Brothers, Bank of America, and others—have recently agreed to adopt majority-vote rules on their own rather than endure the shareholder resolution process. Bam yet again.

The power shift from CEOs to shareholders is far from over. Ready for something really radical? "The ultimate answer is reimbursement" to competing candidates for board seats, says Charles Elson, director of the University of Delaware's corporate-governance center, who has sat on several boards. A procedure to allow opposing candidates and to subsidize their costs of running would make genuine, contested elections routine. Such a change is unthinkable, of course, but so were all the others. Slowly, incrementally, U.S. corporations' owners are gaining control of what they own. As an aging America becomes ever more dependent on the performance of equities to pay for retirement and medical care, it can't happen soon enough. Q

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