The fight for better boards

Financial reformers try to redefine what it is to be a shareholder.

NEW regulations are emerging from Congress in response to the meltdown in the financial industry. Yet their impact, likely to be felt by every public company in America, may weaken rather than strengthen corporate governance.

It was the glaring weaknesses exposed in the boards of Wall Street giants such as Citigroup and Lehman Brothers that prompted some in Congress to propose making it easier for shareholders to nominate candidates for election as directors—something that had hitherto been costly and time-consuming. CalPERS, a big Californian pension fund, is said to have been recruiting a bench of candidates in expectation of a sharp increase in contested elections. Then something went wrong in the process by which two different reform bills passed by the House of Representatives and the Senate are likely to be reconciled.

Reformers have for years tried to make it easier for shareholders to nominate directors by securing readier access to the proxy forms that firms circulate before voting on board candidates at annual meetings. But company bosses have jealously guarded the proxy, which usually contains only the names that management wants on the board. Consequently, the names of alternative candidates have to be circulated separately by those wishing to propose them. The Securities and Exchange Commission (SEC), the main markets watchdog, has often attempted to improve access to the proxy—and is thinking of trying again—only to be deterred by fierce business lobbying.

Such lobbying seems to have been behind a controversial amendment proposed on June 16th by Chris Dodd, who has steered financial reform through the Senate. The original bills passed in both houses made clear that the SEC could order better access to the proxy, leaving the exact details to be worked out later. But Mr Dodd wants shareholders wishing to nominate candidates to pass two tough tests. First, they must own at least 5% of the firm's shares; second, they must have held those shares for a minimum of two years.

This could lead to even fewer contested board elections than the 30 or so a year that has been the norm for the past decade (around one-third of which have been successful). The vast majority of contests are initiated by hedge funds or wealthy individuals such as Carl Icahn. Neither of these are known for their long-term share ownership, according to "Missing in Activism", a study by Lee Harris in the Columbia Business Law Review. Even pension funds and mutual funds, which take a relatively long-term approach to investing, now trade their entire share portfolios every ten months or so (down from three years in the early 1980s), so might fall foul of Mr Dodd's proposed rule. Besides, pension funds and mutual funds hardly ever initiate contested board elections, says Mr Harris.

Mr Dodd's proposal has alarmed institutional investors in America and abroad. A memo by the Council of Institutional Investors, which represents many of America's big pension and mutual funds, claimed that it would "essentially gut proxy access". Similarly, the International Corporate Governance Network, which includes many of the biggest foreign institutional investors, complained that "the ownership threshold is too high, in particular for larger companies, and the holding period is too long."

Mr Dodd's ownership threshold would be less worrying if it were clear that it did not have to be a single shareholder having 5%, but could be several acting together. The SEC is considering a 1% threshold for big firms and a 3% bar for smaller ones.

There are plenty of respectable supporters of a minimum holding period, including Warren Buffett. Even the SEC is considering a one-year holding period. Yet there is no evidence that holding a share for longer makes an investor more engaged in corporate governance. As for fears that the interests of short-term investors may conflict with those of longer-term shareholders, the great thing about elections is that if the majority do not like the slate of candidates offered by the insurgents, they don't have to vote for them.

As The Economist went to press, it was unclear if Mr Dodd's amendment would succeed. Ominously, his proposed changes to shareholder rights are said to have the support of the White House. Even if it does not get through, bosses have signalled their determination to keep fighting attempts to make boards properly accountable to shareholders. That spells yet more trouble for reform.

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