



Enhancing the Return on Capital
Through Increased Accountability

Senator Richard Alarcón
State Capitol, Room 4035
Sacramento, CA 95814

July 26, 2006

Dear Senator Alarcón:

As an investor in several California corporations and the publisher of a popular internet site on corporate governance for more than ten years, I write in support of SB 1207, which you recently amended to simply permit, rather than require, publicly-traded California companies to use majority vote requirements in uncontested elections.

Recent comments¹ by Keith Bishop and others asserting SB 1207 would "gut" California's long-standing support of cumulative voting are simply untrue and should not deter anyone from voting in favor of your bill. Cumulative voting is only meaningful for contested elections and your majority voting option will only apply in uncontested elections.

The Corporations Committee of the State Bar appears intent on forcing an "either or" choice between majority voting and cumulative voting. In other words, they would permit California corporations to adopt majority voting in uncontested elections only if they were willing to eliminate cumulative voting in all elections, whether contested or uncontested. I agree with your approach, that choice is best left to each corporation and its shareholders. Corporations already have the ability under Section 301.5 to opt-out of cumulative voting if they wish to do so. There is no reason to force a choice in law.

Background

On August 1, 2002, Les Greenberg and I petitioned² the Securities and Exchange Commission for the right of shareholders to place their nominees on the corporate proxy. The Council of Institutional Investors said our petition "re-energized" the "debate over shareholder access to management proxy cards to nominate directors."

¹ <http://www.thecorporatecounsel.net/blog/archive/001171.html>

² <http://www.sec.gov/rules/petitions/petn4-461.htm>

The SEC introduced a very complicated rulemaking, [S7-19-03](#),³ to allow Shareholder limited access to the proxy. That rulemaking received more support than any other rulemaking in the SEC's history. Unfortunately, it was shelved because of opposition from the Business Roundtable and the Chamber of Commerce, both dominated by CEOs. Although I believe shareholder access to the proxy is ultimately necessary, SB 1207 is a good interim measure that will make directors much more dependent on the will of shareholders.

Impediments to Improving Corporate Governance

Solutions, which seek better disclosure and stiffer penalties, miss the big picture. Tweaking rules and regulations at the margins will only minimally improve the quality of corporate governance. Yours is a much more effective approach because it potentially transfers at least a minimal level of democratic power to shareholders, allowing them to hold directors accountable. The discussion on the need for "independent" directors often misses the point. Yes, we need directors who are independent of management. However, more than that, they need to be dependent on shareholders who own the company.

What Happened To Democracy?

While the corporation laws of every state, solemnly recite that the Shareholders elect the Directors, each year shareholders are asked to participate in an exercise which bears little resemblance to the word "election" as commonly used in any democratic country.

When intelligent, honest professionals repeatedly use a legal term in a manner contrary to its commonly accepted usage, we are entitled to ask why. When the corporation laws of 50 states indicate that shareholders "elect" directors; that shareholders "vote" for their choice of "nominees"; that proxies are solicited for the "election" of directors, we are given an impression contrary to actual practice.

Until directors can be held personally accountable, e.g., removed from office by irate shareholders, they will not be responsive to the desires of shareholders. However, it is almost impossible for shareholders to replace directors who they deem to be incompetent and/or corrupt.

Near Insurmountable Hurdles to Shareholders Who Wish to Elect Directors

In essence, most hurdles to engaging in an effective proxy solicitation effort occur because the name of shareholders' director-nominees will **not** appear on a corporation's ballot. Under applicable state corporate law, shareholders can easily nominate a candidate for a corporate directorship, but, under present SEC rules, *only the names of those persons nominated by the corporation need appear on the corporation's ballot*. The assets of *all* shareholders are expended by management to distribute those ballots. With plurality voting laws, as currently

³ <http://www.sec.gov/rules/proposed/34-48626.htm>

exists in California, 99% of shareholders can vote against a director but they are still elected.

Public Investor Reaction to Learning of Difficulties of Shareholder Selection/Election of Directors

Most public investors are shocked to learn how directors are selected/elected. The general investing public does not think about such issues. However, when awakened to the issue, investor confidence in corporate governance tends to decline.

Many written responses to our petition were received.

The following, from an investor in Germany, is a sample response. "When I have started to invest in the USA about 3 years ago I was sure that elections of directors are fair. ... So when I have discovered that elections of directors of USA public companies are not democratic I was very surprised and disappointed. ... This is EXACTLY how voting in communist countries worked. Everyone could vote, but there was just NO CHOICE of candidates. The point was not how to be elected, but how to get on the election list. With this system no changes were possible, so there was no motivation to improve the governance." (Emphasis in original.)

Conclusion

Entrenched managers and directors will only improve corporate governance when they can be held personally accountable, e.g. voted out of office and replaced by candidates acceptable to shareholders.

I urge the Legislature to pass SB 1207 in order to bring some semblance of democracy to election of corporate directors. Please call on me if I can provide any assistance in moving this measure through the California Legislature and on to the Governor for signature.

Sincerely,

James McRitchie

cc: Assemblymember Alan Nakanishi
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