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COMMENTARY

Corporations Shouldn't Be Democracies

By LYNN A. STOUT
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Securities and Exchange Commission Chairman Christopher Cox faces a critical decision. Oct. 2 is the deadline for comment on two different proposed SEC rules for governing director elections in U.S. corporations.

One "proxy access" rule, backed by the SEC's Democratic commissioners, would transform U.S. corporate law by requiring companies to pay the expenses of dissident shareholders seeking to replace the company's board or directors. The other, a "no access" rule backed by the agency's Republicans, preserves longstanding regulations that discourage shareholder activism by requiring that dissidents use their own funds to mount a proxy fight. The chairman holds the swing vote that will determine which rule is passed.

Mr. Cox should vote "no access." The proposed proxy access rule is driven by the emotional claim, unsupported by evidence, that American corporations benefit from "shareholder democracy."

Successful corporations are not, and never have been, democratic institutions. Since the public corporation first evolved over a century ago, U.S law has discouraged shareholders from taking an active role in corporate governance, and this "hands off" approach has proven a recipe for tremendous success.

According to the Economist, 13 of the world's 30 largest corporations are American. Japan (which is also famously unfriendly to shareholders) is runner-up with six of the largest firms, while Germany and France tie for third place with three each. No other nation on earth comes close in terms of nurturing great corporations.

Companies seem to succeed best when they are controlled by boards of directors, not by shareholders. Why? One obvious advantage of board control is more informed and efficient decision making. An even more important factor, however, is that board control "locks in" and protects corporate assets and investment capital.

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Corporations typically pursue projects that require huge sunk-cost investments. In the 19th and 20th centuries, they built railroads, canals and factories. Today they design complex software and electronics, produce new drugs and medical treatments, and create valuable trademarks and brand names. Board control over corporate assets protects those assets and gives them time to work, allowing shareholders collectively to recoup the value of their initial investment (and then some) over the long haul.

Conversely, long-term investment becomes impossible if shareholders have the power to drain cash out of the firm at any time -- say, by threatening to remove directors who refuse to cut expenses or sell assets in order to pay shareholders a special dividend or fund a massive share repurchase program.

Whether out of ignorance, greed, or short-sightedness, these are exactly the sorts of threats that today's activist shareholders, usually at hedge funds, typically make. Consider Carl Icahn's demand this past spring that Motorola undertake a massive stock buyback program, at a time when the company desperately needed to invest in research and development to produce a successor product to its RAZR cellphone. By giving activists even greater leverage over boards, the SEC's proposed proxy access rule will undermine American corporations' ability to do exactly what investors, and the larger society, want them to do: pursue big, long-term, innovative business projects.

For evidence of this we need only compare the U.S. experience with that of our Anglo-Saxon corporate cousins across the Atlantic. American corporate law severely limits shareholders' rights. So does Japanese, German and French corporate law. In contrast, the United Kingdom seems a paradise for shareholders. In the U.K., shareholders can call a meeting to remove the board of directors at any time. They can pass resolutions telling boards to take certain actions, they are entitled to vote on dividends and CEO pay, and they can force a board to accept a hostile takeover bid the board would prefer to reject. (In the U.S., boards can "just say no.")

Yet the U.K. is headquarters to just one and a half of the world's 30 largest companies, BP and the "Royal" half of Royal Dutch Shell. Even the tiny Netherlands has nurtured more great corporations (2.5 to the U.K.'s 1.5).

If shareholder democracy were good for corporations and investors, the U.K. would be a corporate powerhouse. Instead, it's an also-ran in the global race for corporate competitiveness. The SEC shouldn't mess with U.S. corporate success. Shareholder democracy is a shallow idea based on a fundamental misunderstanding of what makes good companies tick. Chairman Cox, and the SEC, should reject it.

Ms. Stout is a law professor at UCLA and the principal investigator for the UCLA-Sloan Foundation Research Program on Business Organizations.

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