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Proxy Access Reform: The SEC Makes It Potentially Easier for Shareholders to Nominate Directors

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Summary

In response to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protections Act (P.L. 111-203) overhauled the nation's financial sector regulation. The 112th Congress is actively involved in overseeing the act's implementation, including provisions involving corporate governance such as expanding the role played by shareholders in the selection of public company corporate boards. While some regarded this as a change that would help make boards more sensitive to market developments and thus shareholder interests, others see it as a change that would place too much potentially abusable power in the hands of large shareholders.

Members of public company boards are supposed to play key fiduciary and management watchdog roles for the shareholders. At annual public company shareholder meetings, incumbent boards submit slates of board nominees for shareholder consideration as part of the official corporate proxy materials and statement sent to shareholders in advance of the meeting. Whereas states like Delaware (the state of incorporation for a large proportion of sizeable public firms) have largely governed substantive corporate matters for firms that they incorporate, the Securities and Exchange Commission (SEC) oversees matters related to the content of proxy materials.

Historically, the SEC has interpreted applicable federal securities laws as allowing companies to exclude from their proxy materials shareholder proposals involving the nomination of persons to their boards. Shareholders interested in pushing an alternative slate of nominees for fellow shareholder consideration must bear the printing and distribution costs themselves, which many believe poses a significant obstacle. Proxy access would reduce these cost barriers by allowing shareholder nominations to be included in the corporate proxy materials.

A provision in the Dodd-Frank Act (P.L. 111-203) enacted on July 21, 2010, explicitly authorizes the SEC to adopt proxy access rules. In August 2010, with the Republican commissioners dissenting, the SEC did so. The central and most controversial change, the adoption of Rule 14a-11 under Regulation 14, which the agency adopted in 1935 pursuant to Section 14(a) of the Securities Exchange Act of 1934, would permit individual investors or investor groups with at least 3% of the total voting power of a company's securities to put forward no more than one nominee, or several that will constitute up to one-fourth of a company's board, whichever is greater, via the company's proxy material at the annual meeting. Shareholders would also be required to have held their shares for at least three years and will not be eligible to use the proxy access rule if their securities are held for the purpose of changing corporate control. Some longtime advocates of proxy access, including various labor unions such as the AFL-CIO and pension fund groups such as the Council of Institutional Investors, claim that the rules should help improve management as well as enhance investor returns. Some opponents of proxy access as formulated, including various business interests such as the Business Roundtable and the United States Chamber of Commerce, criticized the access rulemaking. A major criticism was that the SEC's rules would empower large investors, such as unions, at the expense of the small investors, giving them unfair leverage over corporate activities.

On September 29, 2010, the Chamber and the Roundtable jointly filed a petition with the United States Court of Appeals for the District of Columbia Circuit alleging that Rule 14a-11 violated several federal statutes. On October 4, 2010, pending a judicial decision, the SEC agreed to stay implementation of the rule. On July 22, 2011, calling the rule arbitrary and capricious, the appeals court voted to vacate Rule 14a-11, a ruling that the SEC decided not to appeal. This report will be updated as events dictate.

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Introduction and Recent Developments

After the recent financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, which overhauled financial sector regulation. The 112th Congress is actively involved in overseeing the act's implementation, including provisions involving corporate governance, the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in the firm's relationship with its stakeholders.

Among the studies that identified corporate governance failings as a key factor in the development of the crisis are the Financial Crisis Inquiry Commission's report and a study conducted by the Organization for Economic Co-operation and Development (OECD) whose members include the United States, the United Kingdom, Japan, and Germany.[1]

Directors on the boards of public corporations are fiduciaries with responsibility for overseeing the best interests of the corporation and its shareholders. Among other things, they oversee management, including the hiring and firing of senior executives, approving executive compensation, providing overall strategic direction, and approving annual business plans. Typically, state-based business laws such as those in Delaware (where most of the nation's large public companies and about half of all U.S. public corporations are incorporated) establish the overall legal structures that incorporated firms are subject to. In the area of corporate governance, state laws typically mandate that management of a corporation's business shall be under the board's direction; and that shareholders generally have the right to vote for the election or removal of directors, amend the charter and bylaws, and vote on extraordinary transactions such as mergers or liquidation, when they are proposed by the board of directors.

Substantive corporate governance matters have traditionally been delegated to the states. State corporation laws have established that that shareholders have the right to vote their shares to elect directors and to approve or reject major corporate transactions at shareholder meetings. Under state corporation law, shareholders also have the right to appoint a proxy, a written authorization of voting power by a shareholder to vote shares on their behalf at shareholder meetings. Since most shareholders do not personally attend shareholder meetings, voting at the meetings occurs largely through the use of proxies that are solicited prior to the meetings.[2]

While the SEC has noted that its power to conduct proxy-related rulemaking under Section 14 of the Securities Exchange Act of 1934 (P.L. 73-291, the Exchange Act) has occasionally been

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[1] The Financial Crisis Inquiry Report concluded "We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis." The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, January 2011, p. xviii, available at http://www.gpoaccess.gov/fcic/fcic.pdf. The OECD Steering Group on Corporate Governance found "that corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of the financial crisis and that such weaknesses extended to companies more generally." OECD, "Corporate Governance and the Financial Crisis," *OECD Steering Group on Corporate Governance*, February 24, 2010, p.3, available at http://www.oecd.org/dataoecd/53/62/44679170.pdf.

[2] Securities and Exchange Commission 17 CFR Parts 240, 270, 274, et al. Concept Release on the U.S. Proxy System; Proposed Rule, *Federal Register*, p. 42984, http://www.sec.gov/rules/concept/2010/34-62495fr.pdf.

challenged,[3] SEC officials have consistently asserted the agency's broad authority to govern and make rules related to proxies and proxy solicitations.

When it adopted Section 14(a) of the Exchange Act, Congress determined that the exercise of shareholder voting rights via the corporate proxy is a matter of federal concern, and the statute's grant of authority is not limited to regulating disclosure.

Proxy materials and proxy statements are used to inform shareholders and to solicit votes for corporate decisions (such as the election of directors) and other corporate actions (including official management and shareholder corporate proposals for shareholder consideration). Slates of board-selected director nominees are typically voted on at annual shareholder meetings and an incumbent board and its nominating committee will use a company's proxy material to put forward a slate of directors to be voted on at the meeting. The majority of shareholders who do not attend the annual meeting can use the proxy ballots to vote in absentia.

The SEC derives its authority to regulate the solicitation of proxies from the Investment Company Act of 1940 (P.L. 76-768) and most significantly from the Exchange Act. A law review article published in 1965 detailed the evolution of the agency's powers over proxy solicitation under the Exchange Act during the first three pivotal decades:

> Section 14(a) of the 1934 Act … gave broad powers to the Commission to adopt rules governing the solicitation of proxies as may be necessary or appropriate…. This grant of power to the Commission, however, was limited to securities registration on a national securities exchange. When the Commission adopted its first proxy regulations under Section 14(a) in 1935, it marked the beginning of a totally new body of substantive and procedural law with respect to the solicitation of proxies…. At different times between 1935 and 1964, the Commission pursuant to Section 14(a), adopted a series of rules under the general heading of Regulation 14…."[4]

One of the ways by which shareholders can express their views on the management and affairs of a company is through shareholder proposals, which are governed pursuant to Rule 14a–8, which the SEC adopted under Regulation 14. Rule 14a–8 gives shareholders an opportunity to place a proposal in a company's proxy materials for a vote at annual or special shareholder meetings. Under the rule, a company is generally required to include the proposal unless a shareholder has failed to comply with the rule's procedural requirements or in the event that the proposal falls within several of the rule's substantive reasons for such an exclusion.[5]

One such substantive basis for excluding a shareholder proposal is Rule 14a–8(i)(8) under Regulation 14, which involves shareholder proposals regarding director elections. Under the rule, also known as the "election exclusion," the SEC permitted the exclusion of shareholder proposals aimed at establishing procedures that could result in contested elections for positions on a company's board of directors.[6]

[3] U.S. Securities and Exchange Commission, "Facilitating Shareholder Director Nomination," *Federal Register*, September 16, 2010, p. 56674, available at http://www.sec.gov/rules/final/2010/33-9136fr.pdf. Hereinafter, cited as "Facilitating Shareholder Director Nomination."

[4] W. McNeil Kennedy, "Proxy Regulation," *The Business Lawyer*, January, 1965, pp. 274-275.

[5] "Facilitating Shareholder Director Nomination," p. 56670.

[6] Ibid.

Shareholders interested in fellow shareholders consideration of an alternative slate of board nominees outside of inclusion in proxy materials must bear the distribution and printing costs of getting their slate to the dispersed corporate shareholders. Although there is some disagreement, many say that the cost of mounting such a proxy fight or proxy contest can pose a significant obstacle to shareholders who wish to do so. By some accounts, waging a proxy fight can require several hundred thousands of dollars.[7] Historically, among the several thousand public firms in the United States, there tend to be fewer than 100 such proxy fights in any given year.[8]

In a May 2009 split vote, in which the two Republican commissioners dissented,[9] the SEC voted to propose two rules involving proxy access. This represented the third time in seven years that the agency had wrestled with the issue of giving shareholders the ability to use corporate proxy materials to nominate candidates to corporate boards.[10]

One proposal would have established a new Rule 14a-11 under Regulation 14. Depending on a company's market capitalization and subject to various qualifications, the rule would have allowed shareholders with 1%, 3%, or 5% of a company's stock to nominate up to 25% of the board seats up for annual elections. The second proposal would have amended Rule 14a-8(i)(8) to permit shareholder proposals that involve the nomination process for directors.

The proposed Rule 14a-11 was especially controversial, reigniting a longstanding debate that has been dominated by pension funds and members of the business community. Pension fund groups generally praised the rule's goal of easing access to director nominations, saying that it would help to make boards more accountable to shareholder interests. Members of the business community voiced concerns that it would lead to more divisive boards and better enable groups such as pension funds to push parochial agendas with little connection to the fundamental issue of shareholder returns.

On August 25, 2010, with the two Republican commissioners again dissenting,[11] the SEC voted to adopt modified versions of the 2009 proposals. Under its major rulemaking reform, proxy access would be provided to large investors meeting minimum continuous stock ownership requirements and ownership thresholds. Companies would generally be required to include the nominees of

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[7] Joanne Lublin, "Reimbursements Aim For a Fairer Proxy Fight," *Wall Street Journal*, October 27, 2009, p. A-22.

[8] RiskMetrics, a proxy advisory firm, reportedly found that the number of proxy fights increased slightly in 2009, as it did in 2008 (39 through September 2009, 35 from January to September 2008, and 30 in all of 2007). In 2009, dissident shareholders who ran such board nominees reportedly saw at least some of their nominees elected in 22 of those 39 companies. In addition, as often happens, a number of companies who faced potential proxy contests entered into settlements and often added one mutually agreed upon person to their boards. David A. Katz "Reviewing the 2009 Proxy Season And Looking Ahead to 2010," *The Harvard Law School Corporate Governance Blog,* November 29, 2009, available at http://blogs.law.harvard.edu/corpgov/2009/11/29/reviewing-the-2009-proxy-season-and-looking-ahead-to-2010/.

[9] See "Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations by Commissioner Kathleen L. Casey," *U.S. Securities and Exchange Commission*, May 20, 2009, available at http://www.sec.gov/news/speech/2009/spch052009klc.htm.

[10] U.S. Securities and Exchange Commission, "Facilitating Shareholder Director Nominations, SEC Release Nos. 33-9046; 34-60089; June 10, 2009, pp. 21-22, available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

[11] "Speech by SEC Commissioner: Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations by Commissioner Troy A. Paredes," U.S. Securities and Exchange Commission, August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510tap.htm. "Speech by SEC Commissioner: Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations by Commissioner Kathleen L. Casey, U.S. Securities and Exchange Commission, August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510klc.htm.

such large shareholders in their proxy materials as have continuously owned at least 3% of a company during the previous three years. Each shareholder would be able to include no more than one nominee or a number of nominees representing up to 25% of the company's board of directors, whichever is greater.

In September 2011, shortly after the SEC rulemaking, two major business trade groups, the Business Roundtable (Roundtable) and the United States Chamber of Commerce (Chamber) filed a petition for review of the new but yet to be implemented SEC rulemaking under which proxy access would be provided to large investors meeting minimum continuous stock ownership requirements and ownership thresholds with the United States Court of Appeals for the District of Columbia Circuit on the grounds, among other things, that the rule was arbitrary and capricious. Pending the court's ruling, the SEC subsequently decided to discontinue implementation of the rule. On July 22, 2011, in *Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission*, No. 10-1305 slip op. (D.C. Cir. Jul. 22, 2011), the court vacated the SEC's proxy access rule.[12] On September 6, 2011, SEC officials announced that they would not seek an appeal of the court's decision. However, they indicated that a lesser part of the rulemaking, which would permit shareholders to submit shareholder proposals that seek to establish shareholder access regimes in companies, and had not been challenged in court, would go into effect at a later date.[13]

An earlier CRS report examined the SEC's aforementioned 2009 proxy access rule proposals and the policy debate surrounding it.[14] This report examines: key aspects and the potential impact of the proxy access rules that the SEC adopted in August 2010; a provision in the Dodd-Frank Act that affirms the SEC's authority to make proxy access rules; congressional opposition to that provision; and the aforementioned court case that resulted in the SEC tabling the implementation of a key part of its proxy access rules.

The SEC's August 2010 Proxy Access Rules

The proxy access rules adopted by the SEC involved two basic initiatives under Regulation 14, which the SEC adopted in 1935 pursuant to Section 14(a) of the Exchange Act:[15] (1) the creation of a new rule, Rule 14a-11, which would permit individual investors or investor groups with a certain threshold percentage of the total voting power of a company's securities to put forward board nominees on a company's proxy materials; and (2) a new amendment to Rule 14a-8(i)(8) which would loosen historical limits on the ability of shareholders to make proposals related to contested director elections. The initiatives are described below.

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[12] Available at http://online.wsj.com/public/resources/documents/ProxyAccessDecision07222011.pdf.

[13] "Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation," September 6, 2011, available at http://www.sec.gov/news/press/2011/2011-179.htm.

[14] CRS Report R41247, *Proxy Access Reform Being Considered by the SEC: An Overview*, by (name redacted).

[15] Kennedy, "Proxy Regulation," pp. 274-275.

Rule 14a-11

Key provisions of the amendment were as follows:

- If a shareholder meets certain conditions and is not otherwise prohibited by a state, or foreign law, or a company's governing documents from nominating a candidate for election as a director, companies would be required to include shareholder nominees for director in the company's proxy materials.[16]
- To nominate directors under the rule, a shareholder would be required to own and have continuously held for at least three years,[17] at least 3%[18] of the total voting power of the company's voting securities during its annual meetings to elect directors. Individual shareholders would be allowed to combine their holdings to meet the 3% threshold. Shares that are sold short or borrowed would not be counted toward meeting the threshold.

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[16] The SEC has indicated that it was not aware of any states that prohibited this. "Facilitating Shareholder Nomination," p. 56754.

[17] The SEC has explained its decision to require shareholders to hold company stock for a minimum three-year period:

> This decision is based on our belief that holding securities for at least a three-year period better demonstrates a shareholder's long term commitment and interest in the company. We also based our decision to have a holding period longer than one year [as suggested in the agency's 2009 proxy access proposal] on the strong support of a variety of commenters. For instance, we received comments that advised that we should adopt a more reasonable holding period of at least two years, and a minimum holding period of at least two years is appropriate because a shorter holding period would allow shareholders with a short-term focus to nominate directors who, if elected, would be responsible for dealing with a company's long-term issues.… Given the support expressed for a significant holding period, we believe a three year holding period, rather than one or two years, strikes the appropriate balance in providing shareholders with a significant, long-term interest with the ability to have their nominees included in a company's proxy materials while limiting the possibility of shareholders attempting to use Rule 14a-11 inappropriately.…

"Facilitating Shareholder Director Nomination," p. 56697.

[18] The SEC explained its decision to adopt a three percent shareholding threshold:

> We understand the result of our ownership threshold determination may be that shareholders will need to convince other shareholders to support their attempt to use Rule 14a-11. We believe this outcome reduces the potential for excessive costs to be incurred by companies and their shareholders. The data available to us also suggest that reaching the 3% ownership threshold we are adopting is possible for a significant number of shareholders either individually or by a number of shareholders aggregating their holdings in order to satisfy the ownership requirement. The data … also suggest that forming nominating shareholder groups with holdings aggregating 3% is achievable at many companies by a relatively small number of shareholders. Even factoring in the requirement of continuous ownership for three years, 31% of public companies have three or more holders with at least 1% share ownership each; and 29% have two or more holders with at least 2% share ownership each. Moreover, neither of these categories include companies with one holder of 2% and another holder of at least 1%, and none of these percentages includes companies having a relatively small number (e.g. four to ten) of holders whose aggregate holdings exceed 3% but whose individual holdings do not bring the company within any of the categories identified in the data.

Some, including the Council of Institutional Investors, have questioned the adequacy of the 3% threshold. The Council informed the SEC of a study that it oversaw that looked at the SEC filings of various public companies. For the individual companies, the research found that their 10 largest public pension funds had aggregated holdings that generally did not appear to exceed 5%, and would probably not meet a 3% threshold. However, citing the study's small sample size and its failure to include other types of shareholders, the SEC questioned the study's usefulness. "Facilitating Shareholder Director Nomination," p. 56693.

- An eligible shareholder would be able to include only one director nominee, or several nominees who represent no more than 25% of the members of a company's board, whichever is greater. (For example, if a board has three members, one shareholder nominee could be included in the proxy materials. If a board has eight members, up to two shareholder nominees could be included in the proxy materials.)
- When there is more than one eligible shareholder or shareholder group, a company would be required to include in its proxy materials the nominee or nominees of the nominating shareholder or group with the highest percentage of the company's voting securities.
- A nominating shareholder would be required to file with the SEC and provide the company with a new publicly available disclosure document (Schedule 14N). Among other things, it would require the disclosure of the amount and percentage of the voting power of the securities owned by the nominating shareholder, the length of ownership, and a statement that the nominating shareholder intends to continue to hold the securities through the date of the meeting.
- Nominating shareholders would be required to submit their candidates or proposals no later than 120 days before the anniversary date on which the company mailed its proxy statement the year before.
- Small companies with a public float[19] of less than $75 million in equity would be exempt from the rule for the initial three years after its effective date for larger companies.[20]

The Amendment to Rule 14a-8(i)(8)

The SEC's proxy access rulemaking also included an amendment to Rule 14a-8(i)(8). The Exchange Act permits companies to exclude shareholder proposals regarding elections. The amended rule stipulates that with certain limits, companies would be required to include in their proxy materials shareholder proposals aimed at establishing procedures in the company's governing documents for the inclusion of one or more shareholder director nominees.[21] Under the rule, shareholders could seek approval for more permissive corporate bylaws such as even lower ownership thresholds and require a company to reimburse shareholders for proxy expenses. However, a company could not opt out of the Rule 14a-11 proxy access standards.

[19] The portion of a company's outstanding shares that is in the hands of public investors, as opposed to company officers, directors, or stockholders that hold controlling interests.

[20] The SEC said that it recognized that smaller reporting companies may have had limited experience with prevailing kinds of shareholder use of the proxy process and many may not have developed sufficient infrastructures for managing issues involving proxy access. As a consequence, the SEC argued that delaying the adoption of the rule for small companies would enable them to learn from the experience of the larger firms, thus allowing them to "better prepare" for implementation. "Facilitating Shareholder Director Nomination," August 25, 2010.

[21] A company would still, however, be allowed to exclude a proposal under Rule 14a-8(i)(8) if it (1) disqualified a nominee who is standing for election; (2) removed a director from office before his or her term expired; (3) questioned the competence, business judgment, or character of one or more nominees or directors; (4) nominated a specific individual for election to the board of directors, other than pursuant to Rule 14a-11, an applicable state law provision, or a company's governing documents; or (5) otherwise could affect the outcome of an upcoming election of directors.

In cases in which a state law, foreign law, or a company's governing bylaws prohibit inclusion of shareholder director nominees in company proxy materials, or establish share ownership rules that are more restrictive than would Rule 14a-11, Rule 14a-11's terms would supersede them.[22] Conversely, where a state law, foreign law, or a company's governing bylaws prohibit inclusion of shareholder director nominees in company proxy materials, or establish share ownership rules more permissive than would Rule 14a-11, then the ability to pursue proxy access through Rule 14a-11 would not be available to shareholders with ownership levels, 2% for example, below Rule 14a-11's stated threshold.[23]

The SEC explained its basic rationale for adopting the new rule, Rule 14a-11, as follows:

> We believe that the new rule will benefit shareholders and protect investors by improving corporate suffrage, the disclosure provided in connection with corporate proxy solicitations, and communication between shareholders in the proxy process.[24]

Explaining its reasoning for adopting the amendment to Rule 14a-8(i)(8), the SEC said that it perceived the amendment to be an integral part of providing expanded shareholder suffrage benefits through the new Rule 14a-11:

> [W]e do not believe that adopting changes to Rule 14a8(i)(8) alone, without adopting Rule 14a-11, will achieve our goal of facilitating shareholders' ability to exercise their traditional state law rights to nominate directors. We believe that revising Rule 14a-8 will provide an additional avenue for shareholders to indirectly exercise those rights; therefore, the final rules include a revision to Rule 14a-8(i)(8). As adopted, companies will no longer be able to rely on Rule 14a-8(i)(8) to exclude a proposal seeking to establish a procedure in a company's governing documents for the inclusion of one or more shareholder nominees for director in the company's proxy materials.[25]

SEC chairwoman Mary Schapiro summarized the overall challenges associated with the rulemaking as well as its perceived benefits:

> These rules are the result of long and careful consideration of the often widely divergent views expressed by commenters, as well as constructive debate within the Commission and among its staff. These rules are stronger and will be more effective because of our concerted effort to balance competing interests. As the public reviews the changes that we have made from our proposal, it will see dozens of instances of "give and take."
>
> These rules reflect compromise and weighing competing interests. As with all compromises, they do not reflect all the views of any one person or group. They are, I firmly believe, rational, balanced and necessary to enhance investor confidence in the integrity of our system of corporate governance.

[22] For example, if a state law, foreign law, or a corporate bylaw were to require that shareholder nominees be included in company proxy materials only when they are submitted by shareholders with at least 10% of the company, a shareholder who does not meet the 10% threshold but does meet the requirements of Rule 14a-11, would be able to submit their nominee or nominees for inclusion in the company's proxy materials. "Facilitating Shareholder Director Nomination," p. 56678.

[23] Ibid., p. 56678.

[24] Ibid.

[25] "Facilitating Shareholder Director Nomination," p. 56731.

> Because the process created by these rules will represent a marked change to the status quo, I am committed to closely monitoring how these new rules are implemented. We will monitor not only in the context of future application to smaller companies, as I mentioned, but also so that we can make prompt changes for all companies, if practice demonstrates the need to do so….[26]

Except in the case of small companies under Rule 14a-11, the SEC's proxy access amendments were both to become effective on November 15, 2010, 60 days after they were published in the *Federal Register* on September 16, 2010.

SEC's View of the Rulemaking's Major Benefits

The SEC argued that the proxy access rulemaking facilitates its stated goal of furthering shareholders' ability to nominate and elect their own director candidates principally by enabling the shareholder to avoid certain costs connected with traditional proxy contests. The savings are predicated on the assumption that a shareholder would replace an intended proxy fight, the traditional director nomination done without a company's proxy materials, with a nomination that is published in the proxy materials as provided in Rule 14a-11. The SEC acknowledges that it cannot be assumed such substitutions would always take place. However, the agency noted that when an eligible shareholder opts to put forward director nominees through Rule 14a-11 instead of engaging in a proxy contest, the key cost savings were predicted as follows:[27]

- *Direct Cost Savings from Reduced Printing and Postage Costs*. A nominating shareholder or group may benefit from the direct cost savings that would come from a reduction in their printing and postage costs. The SEC determined that a shareholder who uses Rule 14a-11 to submit director nominations for inclusion in a company's proxy materials will save at least $18,000 in printing and postage costs on average.[28]
- *Direct Cost Savings from Reduced Expenditures for the Advertising and Promotion of Shareholder Nominees.* With proxy access, shareholders could also see a reduction in their advertising and promotion expenditures for their nominees.[29]

[26] "Opening Statement at the SEC Open Meeting by Chairman Mary L. Schapiro," U.S. Securities and Exchange Commission Washington, DC, August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510mls.htm.

[27] "Facilitating Shareholder Director Nomination," p. 56756.

[28] Ibid, p. 56756. The SEC reported that the Business Roundtable indicated that the benefits from cost savings by eliminating direct printing and mailing cost savings were less than the costs and disruption that would come with the proxy access rules. The Roundtable reported that the SEC's estimated average savings of $18,000 represented less than 5% of the cost of a traditional proxy contest and excluded costs that would be incurred by a shareholder who was actively seeking to elect a nominee, including costs associated with legal counsel, proxy solicitors, public relations advisers, and advertising. "Letter Submitted on Behalf of the Business Roundtable to the SEC," January 19, 2010, available at http://www.sec.gov/comments/s7-10-09/s71009-626.pdf. The SEC's response was that the intent of the proxy access rules is not to relieve shareholders of all of the expenditures they might incur in such a campaign. The intent is to improve their ability to nominate their own board candidates by reducing barriers in the proxy solicitation process that have impeded the number of shareholder-based nominees, specifically the direct cost of printing and mailing proxy materials.

[29] Ibid, p. 56756.

- *Cost Savings Due to the Mitigation of the Collective Action/Free Rider Problem.* A collective action problem exists when the time and the resources expended by a shareholder in promoting a nominee in a traditional proxy contest are not shared by the other shareholders who might benefit from the effort. Those other shareholders are thus *free riding* on the resource expenditures of their activist colleagues. The SEC argued that although a successful traditional proxy contest might produce greater total benefits for all a company's shareholders, the unequal cost sharing may discourage single shareholders from incurring the costs of a traditional proxy contest on their own. As a consequence, there was an economic cost from the forgone opportunities when a qualified director candidate is not nominated because no shareholder or shareholder groups are willing to incur the costs of a nomination. The SEC also contended that the direct cost savings through replacing traditional proxy fights with nominations through proxy access should help to mitigate these traditional collective action and free-rider concerns.[30]

Proxy Access in the Dodd-Frank Act

For many years, SEC officials said that the agency had the legal authority to adopt proxy access rules, authority that others have, however, questioned.[31] Title IX, Section 971 of the Dodd-Frank Act (P.L. 111-203) affirms the SEC's authority to adopt proxy access rules by expressly authorizing the agency to do so. It also authorizes the agency to establish the terms and conditions of such shareholder access and requires it to consider the compliance burdens of small companies in assessing whether companies can be exempted from proxy access rulemaking. The Dodd-Frank Act's conference report stressed that by confirming that the SEC had the authority to write proxy access rules, it could "help shift management's focus from short-term profits to long-term growth and stability."[32]

Key Congressional Opposition to Proxy Access and the Proxy Access Provision in the Dodd-Frank Act

In the 111th Congress, H.R. 3817 contained some provisions that were eventually included in the Dodd-Frank Act. One such provision affirmed the SEC's right to adopt proxy access. During the House Financial Service Committee's markup of H.R. 3817, the vote on the proxy access amendment split along partisan lines with the majority party unanimously in support and the minority party unanimously opposed.

During that markup, some opponents specifically criticized the proxy access reform provision. Among them were Representative Spencer Bachus, then the committee's ranking member and its

30 Ibid, p. 56756.

31 For example, see "U.S. Chamber of Commerce Opposes SEC Shareholder Access Rules," December 19, 2003, *U.S. Chamber of Commerce Press Release*," December 19, 203, available at http://www.uschamber.com/issues/letters/2003/us-chamber-commerce-opposes-sec-shareholder-access-rules.

32 "Dodd-Frank Wall Street Reform: Conference Report Summary," Senate Committee on Banking, Housing, and Urban Affairs, available at http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

chairman in the 112th Congress, and Representative Scott Garrett, chairman of the subcommittee on Capital Markets and Government-Sponsored Enterprises in the 112th Congress.

Explaining their opposition to the proxy access provision during the November 2009 markup, Representatives Bachus and Garrett joined with other Republicans on the committee to argue that proxy access reform would take the SEC away from its central mission of investor protection and that the states were already providing proper and enlightened leadership in this area:

> … [proxy access] takes the SEC away from its core mission of protecting investors. States are already enhancing shareholder rights. For example, Delaware has enacted legislation clarifying the authority of companies and their shareholders to adopt proxy access and proxy reimbursement bylaws and North Dakota has created a state proxy access right. These state actions allow shareholders to choose whether proxy access is appropriate and, if it is, to delineate specific details such as ownership thresholds and holding periods. The amendment would undermine 150 years of corporate governance that has served our capital markets well…[33]

Supportive Reactions to the Rulemaking

This section provides some representative supportive views of the SEC's proxy access reform initiative. Several derive from labor unions and pension fund groups that have advocated for proxy access for many years. For example, AFL-CIO President Richard Trumka reportedly characterized the rulemaking as a "historic step in empowering long-term investors, [a change that the labor federation has sought for] close to 70 years."[34] The Council of Institutional Investors (CII), a nonprofit association of public, union, and corporate pension funds with combined assets over $3 trillion), fellow CII member TIAA-CREF, and 14 other CII members expressed joint support for the proxy access rules in general and for Rule 14a-11 in particular. They argued that while few shareholders are expected to invoke their right to proxy access under the reform, the mere existence of that right should benefit manager and shareholder communications, ultimately benefitting managerial performance and investor returns:

> Absent a realistic prospect of removal, directors can fail to act in the long-term interests of the corporation, with disastrous results… Responding to those failures, the [the SEC proxy access] Rule [14-a11] allows certain shareholders to include director nominees in the company's proxy materials. The SEC carefully circumscribed that right, limiting it to shareholders with a large, long-term stake in the corporation, while deterring shareholders with parochial agendas. Experience abroad with similar rules strongly supports the SEC's conclusion that, while proxy access will rarely be invoked, it provides broad benefits: The possibility of shareholder candidates enhances communication between management and significant investors, improves management performance, and thereby limits the need to invoke proxy access. And when proxy access is invoked, it increases financial returns…[35]

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[33] U.S. Congress, House Committee on Financial Services, *Investor Protection Act of 2009*, report to accompany H.R. 3817, 111th Cong., 2nd sess., H.Rept. 111-687, part 1 (Washington: GPO, 2010). Reps. Bachus and Garrett were joined by Reps. Kenny Marchant, Randy Neugebauer, Adam H. Putnam, Erik Paulsen, and Christopher John Lee.

[34] Patrice Hill, "SEC Backs Labor on Corporate Board Votes," *Washington Times*, August 26, 2010, p. A-1.

[35] Brief of Council of Institutional Investors, TIAA-CREF, and 14 other Funds as Amici Curae in Support of Respondent Re: United States Court of Appeals for the District of Columbia Circuit Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission, Respondent. Petition for Review of Final Rule of the United States Securities and Exchange Commission, January 27, 2011, p. 22, available at (continued...)

The California State Teachers' Retirement System (CalSTRS, a pension plan for California teachers) was one of several pension groups that praised the rulemaking. CalSTRS chief executive officer, Jack Ehnes, reportedly observed

> This ruling is most welcome at CalSTRS, which as a fiduciary pledged to preserve our members' financial security, must maximize the value of its investments for the long haul. One of the lessons of this current economic downturn is to be mindful that governance is a significant risk factor and that greater accountability, which this ruling affords, will go a long way toward mitigating that risk.[36]

Some observers raised concerns that providing proxy access would further empower hedge funds who tend to have rather short-term corporate investment horizons, which some say could undermine a company's longer-term viability.[37] Others, however, have disputed this, saying that the SEC rulings are likely to primarily advantage "long-term, passive, institutional shareholders, such as pension funds" with interest in nominating a few alternative board candidates, not hedge funds or more activist shareholders. This argument was largely premised on the perception that hedge funds and activist investors will generally not be able to meet the rulemaking's 3% stock-ownership threshold and its passive investment test. Hedge funds often acquire shares for the purpose of controlling a company, which means they would fail the passive investor test.[38]

In addition, an attorney at Mayer Brown, a corporate law firm, suggested that concerns that proxy access will result in a significant number of board members who have been nominated by larger shareholders are probably exaggerated:

> Just because shareholders can publish their nominations in the proxy materials in no way guarantees that their nominees will be elected. The greater impact may be that the rules encourage companies to pay more attention to shareholder issues. The board of directors may proactively go out and increase dialogue with larger shareholders to get a sense of what issues concern them.[39]

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http://www.cii.org/UserFiles/file/CII%20TIAA-CREF%20et%20al%20%20amicus%20brief%2001-27-11.pdf.

[36] Michael Giardina, "Shareholder Proxy Vote Passes Despite Opposition," *Investment Management Weekly*, August 30, 2010.

[37] Others, however, say that hedge funds and private equity funds have tended to play a beneficial role in aggressively monitoring the companies they have stakes in because their investment strategies are designed to squeeze various managerial excesses and other inefficiencies out of underperforming companies in contrast to pension funds and mutual funds. Robert C. Illig, "What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight," *American University Law Review*, vol. 57, no. 225, 2007, available at http://ssrn.com/abstract=1079532. In addition, some researchers argue that while hedge fund short-termism is a potentially serious problem that appears to pervade hedge fund activism, a compelling case for legal intervention in this area has yet to be made. But more importantly, they stress that market forces and adaptive devices adopted by individual companies are ultimately better able to deal with the potentially negative effects of hedge fund short-termism, while also serving to maintain the positive aspects of hedge-fund activism. Marcel Kahan and Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*," ECGI - Law Working Paper No. 76/2006, available at http://ssrn.com/abstract=919881.

[38] "SEC Adopts Proxy Access Rules to Facilitate Shareholder Nominations of Directors," *Goodwin Proctor*, September 1, 2010. available at http://www.goodwinprocter.com/Publications/Newsletters/Client-Alert/2010/SEC-Adopts-Proxy-Access-Rules-to-Facilitate-Shareholder-Nominations-of-Directors.aspx.

[39] Lauren Williamson, "Proxy Fight: Amid Litigation, the SEC Puts a Stay on its New Proxy Access Rules," *InsideCounsel*, December 2010.

Lucian Bebchuk of Harvard University Law School is a corporate governance researcher and an advocate of proxy access. Scott Hirst is head of the law school's corporate governance program. The two jointly praised the SEC's proxy access rulemaking, predicting that while it was likely to be used sparingly, the reform should help boost shareholder returns:

> The case for the proposed rule is supported by the significant body of empirical work … indicating that reducing incumbent directors' insulation from removal is associated with improved value for shareholders. Although the case for proxy access is strong, corporate managements have long strongly resisted such access. The importance of the step taken today should therefore not be understated. We applaud both the SEC for adopting a proxy access rule and Congress for recently affirming the SEC's authority to do so. The details of the proxy access rule adopted today mean that its immediate consequences are likely to be modest. Under the rule, a shareholder (or shareholder group) would need to hold more than 3% of the company's shares for more than three years to be eligible to use the rule to place director candidates on the corporate ballot. These eligibility requirements, together with the rule's procedural requirements, will place substantial limits on its use.[40]

Other Supportive Arguments for Proxy Access

Other key arguments marshaled in support of general proxy access reform included

- Between 1990 and 2003, three academic researchers examined a corporate management entrenchment index based on several provisions in corporate charters, such as staggered boards,[41] limits to shareholder bylaw amendments, and supermajority board vote requirements for mergers and for charter amendments. The authors determined that increases in the level of entrenchment were statistically correlated with economically significant reductions in firm valuation, which they said suggested that entrenching provisions cause lower firm valuation.[42] Some view proxy access as an antidote to managerial entrenchment.

- Survey data from 760 independent board directors at large and medium-sized U.S. firms featured in a study that examined key influences on the prospect that the directors receive additional board appointments. It concluded that a director increased his or her prospects of being reappointed by providing advice and information to CEOs and engaging in ingratiatory behavior toward his or her colleagues on the board. The likelihood of reappointment was also bolstered by conducting only minimal levels of monitoring of company management. Summarizing the study's implications, one of its authors observed that "a common argument against shareholder democracy is that shareholders lack sufficient information or expertise to choose who runs their company. It seems ironic, then, that board members who gain the most influence are not those most involved in company governance but those most adept at currying favor with fellow directors."[43]

[40] Lucian Bebchuk and Scott Hirst, "Proxy Access Is In," August 25, 2010, available at http://blogs.law.harvard.edu/corpgov/2010/08/25/proxy-access-is-in/.

[41] Staggered boards are boards in which only a fraction of its directors are elected each year; the structure is often used to deter hostile takeover attempts.

[42] Lucian A Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?*, Harvard Law School John M. Olin Center Discussion Paper No. 49, 2004, available at http://ssrn.com/abstract=593423.

[43] Ithai Stern and James D. Westphal, "Flattery Will Get You Everywhere (Especially, If You are a Male Caucasian): (continued...)

- Proxy access could give shareholders a beneficial counterweight to the many boards whose managerial bias is heightened when the CEO also serves as the board chair, the dominant scheme among U.S. public companies.[44]

- Maintaining the status quo in which Delaware and other states would individually decide on proxy access regimes for their incorporated firms could result in a variety of standards that would differ from company to company and from state to state, arguably posing a burdensome, costly, and unnecessarily complex scenario for investors.

- Several other developed nations, including the United Kingdom, the Netherlands, and Australia have adopted proxy access. According to some reports, while the reform has been used sparingly, it has helped to foster more independent boards who are more attentive to "market sentiment."[45]

Unfavorable Reactions to the Rulemaking

The SEC's proxy access rulemaking also triggered an array of critical responses, many coming from entities associated with the business community. This section describes a number of such reactions.

Initial criticism of the rulemaking came from the SEC's two dissenting Republican commissioners, Kathleen Casey and Troy Paredes, on the day of the rulemaking.

Commissioner Casey said that she "adamantly" disagreed with all of the elements of the SEC release that explained the rules that it was adopting (which later became printed in the Federal Register) and asserted that the agency would be grappling with the implications of the rulemaking for "years to come." Ms. Casey emphasized that the rules appeared to be so flawed that they were unlikely to survive judicial scrutiny, and that if they did survive such scrutiny, they would burden the SEC staff with the responsibility of brokering disputes and responding to a spectrum of issues

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How Ingratiation, Boardroom Behavior, and Demographic Minority Status Affect the Likelihood of Gaining Additional Board Appointments at US Companies," *Academy of Management Journal*, April/May 2007.

[44] A recent study examined a large sample of U.S. public companies who had changed from a CEO duality structure in which a firm's CEO is also its board chairman to a non-CEO duality structure in which the CEO and the chairman cannot be the same person. After testing the hypothesis that the shift might have resulted in changes in the firms' financial performances, the study concluded that was no evidence of a relationship between firm performance and the existence of CEO duality. However, the study cautioned that it could not rule out that its conclusion might have been affected by some unobserved statistical anomalies. Chia-Wei Chen, J. Barry Lin, and Bingsheng Yi, "CEO Duality and Firm Performance, an Endogenous Issue," *Corporate Ownership & Control*, fall 2008, available at http://www.virtusinterpress.org/additional_files/journ_coc/Paper07.pdf.

[45] For example, see Dr. Daniel Summerfield, Co-Head of Responsible Investment, Universities Superannuation Scheme; Ann Byrne, Chief Executive Officer, Australian Council of Super Investors -Australia; Abigail Herron, Corporate Governance Manager, The Co-operative Asset Management -UK; Elizabeth E. McGeveran, Senior Vice President, Governance & Sustainable Investment F&C Management Ltd. -Boston; Wayne Kozun, Senior Vice President, Public Equities Ontario Teachers' Pension Plan -Canada; Marcel Jeucken, Head of Responsible Investment, POGM Investments - Netherlands; and Frank Curtiss, Head of Corporate Governance, Railpen Investments - UK "Letter to the SEC on Facilitating Shareholder Director Nominations," September 15, 2010, available at http://www.sec.gov/comments/s7-13-09/s71309-97.pdf.

that every proxy season arose from the federal provision of proxy access.[46] Another concern was that the rules give proxy access rights to larger institutional investors who do not represent the interest of all shareholders and that the rulemaking ultimately appeared to have been driven by "political pressures."[47]

Commissioner Paredes indicated he would have supported the amended Rule 14a-8, but that he was strongly opposed to the SEC's adoption of Rule 14a-11 because "it imposes a minimum right of proxy access, even when shareholders may prefer a more limited right of access or no proxy access at all."[48] He also asserted that Rule 14a-11 would displace both existing state corporate governance law and that its fundamental shortcoming is that even when shareholders prefer a more restricted form of proxy access, or simply no proxy access at all, it would enact "a minimum right of proxy access." A related concern, he indicated, was that tension existed between the Rule 14a-11 and the Rule 14a-8 rulemaking: as a practical matter, he also argued that Rule 14a-11 would place limits on the extent to which shareholders can use Rule 14a-8 to shape shareholders' preferred proxy access regime. The commissioner was also critical of what he termed a "one-size-fits-all" approach to corporate governance that "forces a universal governance scheme on all firms without permitting an enterprise to adapt its approach to governance and corporate accountability to its distinct circumstances." Commissioner Paredes also indicated that the available economic research did not support the adoption of the new Rule 14a-11, noting that the findings were consistent with the view that different governance structures were optimal for different companies.[49]

Seth Hamot, a manager of Roark Rearden & Hamot Capital Management, an employee-owned hedge fund company, predicted that if the SEC's proxy access rulemaking goes forward, it is likely to be used frequently: "I think this is going to be used a lot and I think it's going to be used a lot soon. It's going to be slowed down a little bit by litigation to clarify some of the rules, specifically the ones regarding communication with other shareholders."[50]

Both Hamot and Steven Shapiro, an official of Taylor Capital Growth, raised concerns that the proxy access reform could disproportionately affect small companies. They argued that smaller companies would have larger numbers of investors who could meet the 3% threshold and three-year holding period and with respect to the size of resources they might have to expend to fend off the proxy access facilitated shareholder nominees.

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[46] "Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations by Commissioner Kathleen L. Casey, Securities and Exchange Commission," August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510klc.htm.

[47] Ibid.

[48] "Speech by SEC Commissioner," Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations by Commissioner Troy A. Paredes, U.S. Securities and Exchange Commission, August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510tap.htm.

[49] Ibid.

[50] Seth Hamot in: "Proxy Access: Implications for Public Companies and Investors," *Directorship*, September 29, 2010, available at http://www.directorship.com/secs-new-proxy-access-practical-implications-for-public-companies-and-investors/. By contrast, in the event that the SEC's proxy access rules survive the Chamber and the Roundtable's court challenge Ann Yerger, executive director of the Council of Institutional Investors, which filed an amicus brief supporting the SEC in the Chamber and Roundtable's court case, reportedly said that she expects proxy access to be a "very, very limited tool," which will be used in rare circumstances and "when everything else has failed." She noted that many institutional investors are likely to have difficulty meeting the three year, 3% standard because they tend to turn over their corporate shares at a rather high rate. Lauren Williamson, "SEC Puts A Stay On New Proxy Access Rules," *Reuters*, December 1, 2010.

Mr. Hamot observed:

> The three percent hurdle is a high one for a large Fortune 500 or 100 company. Additionally, you just have questions of liquidity. In larger companies you have a lot of liquidity and people trading in and out of them and there's always a new statistic every year how short a time frame the aggregate investor owns a share of stock. That's less the case in small companies, where people tend to invest or tend to hold those stocks longer. It's also because people tend to like stories and stick around.[51]

Mr. Shapiro argued that

> [Small companies] are more likely to be the subject of these rules than larger companies… I think one of the unintended consequences might be the reaction of smaller companies, particularly the dedication of resources in response to these items both in terms of outlay of funds as well as management and board time to respond to them, particularly since, at least at the outset, so many of these rules will be untested.[52]

He also contended that the success of dissident shareholder nominated directors could rupture the critical collegiality of the boards:

> [Nominees] who may not have surfaced before as directors are going to have to disclose a lot of information about themselves that they hadn't had to disclose before. They're likely to be challenged, perhaps unfairly, in a very public forum. The ultimate victory is for them to serve as a minority board member in a board that would be antagonistic to them. In addition, and if you think this through, what's to say that the best directors on that board won't basically say, 'Look, if this is going to happen, I'm out of here,' leaving the company with fewer qualified directors.[53]

Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, reportedly raised investor fairness concerns. He has asserted that the SEC's 3% ownership threshold was formidable and would limit the ability of small individual investors and other shareholders to take advantage of proxy access to nominate board candidates: "The idea that only large shareholders have ability to nominate director candidates is against the SEC's investor protection role for all investors. Have you abrogated the smaller investors' rights?"[54]

Because of SEC-mandated filing requirements, Professor Elson also asked whether the presumed cost savings for investors who nominate directors under the SEC proxy access rules will be

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[51] Ibid.

[52] Steven Shapiro, in: Ibid.

[53] Ibid.

[54] Reported in: Ronald D. Orol, "SEC Approves Rule Giving Shareholders New Power; Rule Empowers Investors to Nominate Corporate Directors Starting in 2011," *MarketWatch*, August 25, 2010, available at http://www.marketwatch.com/story/sec-set-to-ok-rule-giving-shareholders-new-powers-2010-08-25. Reportedly echoing Professor Elson's view, Amy Borrus, deputy director of the Council of Institutional Investors, an association of institutional investors, observed that the 3% rule is a significant hurdle. At some large companies, she noted, even the holdings of the 10 largest U.S. pension funds do not add up to 3%. Reported in: David Nicklaus, "Finally, We Can Choose Corporate Directors. SEC Rule Lets Shareholders Name Board Candidates," *St. Louis Post-Dispatch*, August 27, 2010.

realized, noting that "the legal costs for meeting the process may ultimately be as much as the printing costs you're trying to avoid."[55]

The state of Delaware, where about half of the nation's public companies and most of its large public companies are incorporated, filed an amicus brief in support of the Chamber and the Roundtable's lawsuit. In the brief, the state observed that its corporate laws give corporations and their shareholders the latitude to privately order their corporate governance structure, giving them the right to choose from an array of proxy access models.[56] It also argued that the SEC's Rule 14a-11 was in direct contradiction to the rights that it provides:

> [I]n 2009, [Delaware] enacted "an amendment to the Delaware General Corporation Law to clarify that bylaws of a corporation could establish a right of proxy access [which] … gives stockholders the ability to decide whether and when stockholders would be granted such a right of access. This amendment, together with the amendments to SEC Rule 14a-8 adopted at the same time as Rule 14a-11, would allow stockholders increased flexibility in shaping the process by which directors are elected. This company-by-company flexibility is consistent with long-standing Delaware corporate law principles. SEC Rule 14a-11, which takes away that choice, is completely contradictory to Delaware's newly adopted statute governing proxy access.[57]

In an amicus brief supporting the Chamber and the Chamber's lawsuit against the SEC's rulemaking, the Investment Company Institute (ICI, a mutual fund trade association) and its affiliate, the Independent Directors Council (a trade group for independent fund directors) were critical of what they called the inapplicability of the agency's "one size fits all" proxy reform to mutual funds:

> In adopting Rule 14a-11, the SEC adopted a "one-size-fits-all" approach that decidedly does not fit the unique structure of fund governance and rests upon reasoning that is arbitrary and capricious. Focusing on how the rule would apply to operating companies, the SEC's regulatory statement provides no logical explanation for why the SEC deemed the material differences between funds and operating companies to be wholly irrelevant to Rule 14a-11.[58]

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[55] "SEC Passes Rule That May Help Investors Change Boards," *Bloomberg*, August 25, 2010.

[56] "Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission, Brief of the State of Delaware as Amicus Curiae in Support of Petitioners," December 29, 2010, available at http://law.du.edu/documents/corporate-governance/sec-and-governance/business-roundtable/Brief-of-the-State-of-Delaware-Business-Roundtable-v-SEC-No-10-1305-DC-Cir-Dec-2010.PDF.

[57] Ibid.

[58] "In the United States Court of Appeals for the District of Columbia Circuit, Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission, Brief of Amici Curiae Investment Company Institute and Independent Directors Council in Support of Petitioners and Vacatur as Applied to Registered Investment Companies," December 9, 2011, available at http://www.ici.org/pdf/24777.pdf. The SEC response to this kind of criticism was

> [I]nvestment company boards, like the boards of other companies, have significant responsibilities in protecting shareholder interests, such as the approval of advisory contracts and fees. We also do not believe that the regulatory protections offered by the Investment Company Act (including requirements to obtain shareholder approval to engage in certain transactions and activities) serve to decrease the importance of the rights that are granted to shareholders under state law. In fact, the separate regulatory regime to which investment companies are subject emphasizes the importance of investment company directors in dealing with the conflicts of interest created by the external management structure of most investment companies.

"Facilitating Shareholder Director Nominations," SEC, pp. 339-340.

(continued...)

After the SEC's rulemaking, Marcel Kahan of New York University and Edward Rock of the University of Pennsylvania released a study which found that the shareholder benefit part of the cost/benefit calculus from proxy access tends to be overstated and that it is likely that a limited number of shareholder nominees would result from the rules. Most of those, they argued, were likely to be defeated and the few who prevail are will probably have a marginal impact on the board:

> Overall, we believe that proxy access will have some undesirable effects - it will result in some increase in company expenses and may rarely increase the leverage of shareholders whose interest conflict with those of shareholders at large - and some desirable ones - it may occasionally lead to the election of nominees at recalcitrant boards, where such nominees may have a modest impact on governance and a marginal impact on company value. None of these effects is likely to be very material, and the net effect is likely to be close to zero.[59]

Other Criticisms of Proxy Access

General criticisms of proxy access, many of which predated the SEC's rulemaking are described below.

A major concern of critics of proxy access, including the Chamber and the Roundtable,[60] was that the reform will enable select numbers of large shareholders with particular agendas to use the threat of proxy access as a bargaining tool to pressure companies into pursuing parochial interests that may have little to do with the goal of maximizing shareholder returns.

Joseph Grundfest, a former SEC Commissioner and now director of Stanford University's Rock Center for Corporate Governance, detailed this concern:

> Labor unions and public pension funds rationally value proxy access for reasons that have nothing to do with the prospect of actually electing directors to corporate boards. Proxy access generates significant "megaphone externalities" in the form of the ability to draw attention to union and pension fund causes, even if the nominees have no chance of prevailing at the ballot box. These megaphone externalities are valuable to shareholder proponents even if they promote objectives that the majority of shareholders view as inimical to the best interests of the corporation. Proxy access advocates are therefore rationally and heavily invested in assuring that the Commission's proxy access rules make it as easy as possible to qualify for the ballot even if there is no prospect that their nominated candidate can prevail… Unions, pension funds and other proxy access advocates also appreciate that, if the matter were put to a majority shareholder vote, then there is a significant probability that the shareholder majority would establish qualifications for proxy access more stringent than

(...continued)

[59] Kahan, Marcel and Rock, Edward B, "The Insignificance of Proxy Access," University of Pennsylvania Institute for Law & Economics Research Paper No. 10-26, October 21, 2010, available at SSRN: http://ssrn.com/abstract=1695682.

[60] See "U.S. Chamber Joins Business Roundtable in Lawsuit Challenging Securities and Exchange Commission," *U.S. Chamber of Commerce Press Release*, September 29, 2010, available at http://www.uschamber.com/press/releases/2010/september/us-chamber-joins-business-roundtable-lawsuit-challenging-securities-an. "Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations by Commissioner Kathleen L. Casey, Securities and Exchange Commission," August 25, 2010, available at http://www.sec.gov/news/speech/2010/spch082510klc.htm.

> those proposed by the Commission. Those standards would dramatically constrain megaphone externalities. Maximizing the private value of megaphone externalities to special interest constituencies therefore requires the imposition of an anti-democratic Mandatory Minimum Access Regime that is purposefully designed to negate the will of the shareholder majority….[61]

Other key general arguments marshaled against proxy access include the following:

- During the past several years, senior managers at various financial firms reflected the dominant goals of their shareholders, managing in a manner that maximized the market price of company stock. As such, they managed to a market that focused on increasing observable earnings, but failed to factor in attendant and largely unobserved increases in risk. Doubts exist over whether expanding shareholder power through reforms like proxy access would have resulted in the adoption of more effective risk management regimes that could have helped to avert the financial crisis at the firms.[62]

- Under state law, the board of directors is given the authority to manage the affairs and business of a corporation. Boards also have fiduciary duties with respect to carrying out their responsibilities. Mandating shareholder access to the corporation's proxy statement to nominate directors would affect the use of corporate assets and control of the corporation's proxy mechanism, which are key areas of director responsibility. This would interfere with the board's authority over the management of the corporation under state law.

- Because of asymmetric information, outside shareholders may be less well positioned than management to choose the most appropriate board candidates.

- One study that examined companies that had been removed from the S&P 500 during the 2008 financial crisis found that rates of CEO turnover greatly exceeded normal CEO turnover rates among the "at risk" financial firms in the group. The study saw this as evidence that well-functioning corporate governance systems were generally present.[63]

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[61] Joseph Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, Stanford Law and Economics Olin Working Paper, October 20, 2009, p. 4. The full text can be accessed from the site of the article's abstract, available at http://ssrn.com/abstract=1491670. As stated more succinctly by a corporate governance practitioner, Charles Nathan, co-chair of the corporate governance practice at the Latham & Watkins law firm, such pension groups will be able to confront a corporate board and say "we're going to nominate you, but we don't have to unless you talk to us. There's nothing to stop a group from asking a company to publicly pledge to build the next factory in the U.S. or adopt a green agenda as the price of it going away." Lauren Williamson, "SEC Puts a Stay on the New Proxy Access Rules, *Inside Counsel*, December 2010, available at http://www.insidecounsel.com/Issues/2010/December-2010/Pages/SEC-Puts-A-Stay-On-New-Proxy-Access-Rules.aspx?page=2.

[62] For example, see William Bratton and Michael Wachter, *The Case Against Shareholder Empowerment*, University of Pennsylvania Institute for Law & Econ Research Paper No. 09-35, April 4, 2010, available at http://ssrn.com/abstract=1480290.

[63] Brian R Cheffins, "Did Corporate Governance Fail During the 2008 Stock Market Meltdown? The Case of the S&P 500," *The Business Lawyer*, November 2009, p. 1.

Event Studies Examine the Possible Impact of Proxy Access Reform on Shareholders

A fundamental goal of corporate shareholders is financial gain from their securities holdings. An event study is a statistical method for assessing the impact of events, such as corporate mergers, on the valuation of corporate shares. The studies do so by adjusting for the abnormal returns that can be attributable to an event by controlling the part of that return that derives from the share price fluctuation of the market as a whole. Several event studies have been conducted on the potential impact of proxy access reform on corporate share values.

Examining financial firms, which were assumed to be more vulnerable to proxy contests under a new proxy access regime, one event study looked at 14 events between September 2006 and December 2009 that were associated with the possibility of proxy access. It found that the existence of proposals to facilitate director nominations by shareholders, signifying an increase in the prospects that firm's eligible shareholders would be able to nominate directors, tended to result in a decline in a firm's valuation and thus shareholder wealth. It concluded that "increasing shareholder rights, specifically by facilitating director nominations by shareholders, may actually be detrimental to shareholder wealth…."[64]

Another event study examined stock price behavior at various firms surrounding 13 different events between March 2007 and June 2009 that were perceived to be associated with the prospect of adopting proxy access. The study found that the securities market tends to devalue shares of firms with large investors with holdings of 1% or more during such proxy access "bellwether" events. It concluded that its findings were consistent with claims that large investors will tend to use proxy access to benefit themselves at the expense of other company shareholders.[65]

Thus, both of the studies found evidence that proxy access reform may diminish corporate and shareholder value. However, as many event studies do, the two have been criticized. Questions are asked about the significance of some of the examined events as proxy access bellwethers, the limited duration of the share behavior studied, the dependency on the assumption that the securities markets act rationally, and the possibility that the results may have been improperly influenced by market noise,[66] a possibility that the authors acknowledged.[67]

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[64] Ali C. Akyol, Wei Fen Lim, and Patrick Verwijmeren, "Shareholders in the Boardroom: Wealth Effects of the SEC's Rule to Facilitate Director Nominations," *The Twenty-Third Australasian Finance and Banking Conference 2010 Paper*, June 7, 2010, available at http://ssrn.com/abstract=1526081.

[65] David Larcker, Gaizka Ormazabal, and Daniel Taylor, *The Market Reaction to Corporate Governance Regulation*, Rock Center for Corporate Governance at Stanford University, Working Paper Series No. 82, October 2010, available at SSRN: http://ssrn.com/abstract=1650333.

[66] Market noise consists of the price and volume fluctuations in securities markets, which can confuse an investor's interpretation of market direction. It is generally associated with market phenomena that do not reflect overall market sentiment.

[67] For example, both studies examined an SEC announcement of a roundtable on proxy access, arguably of questionable value as a bellwether proxy access event. In addition, the studies, as their authors acknowledge, may have been tainted by the presence of market noise and other irrelevant developments, which may have biased their results. Another concern is that event studies are premised on the assumption that the securities markets are efficient at quickly and robustly assessing the implications of examined events, an assumption that has been the subject of a longstanding academic debate. A corollary criticism is that during the initial events examined by the studies, securities market investors may have adjusted share prices for the perceived value of the benefits or costs associated with that proxy (continued...)

A more recent event study examined the market response to an SEC announcement on October 4, 2010, that it was delaying the adoption of its proxy access rules because of the suit filed by the Chamber and the Roundtable. The study involved a one-day event study of shares of Standard & Poor's 1,500 companies surrounding the announcement to delay implementation. It found that based on their level of institutional investor shareholdings, the shares of the firms most likely to be affected by the proxy access rules saw a drop in value, an indication that the markets appeared to take a positive view of the rulemaking.[68]

The study appears to be the first empirical study to equate proxy access with positive shareholder value.[69] Also, compared with the other two event studies, the research has the advantage of examining an event with greater significance to the actual adoption of proxy access reform. However, it does have some potential shortcomings. For example, because the research was only a one-day study, it did not address the behavior of the shares over longer periods. In addition, as with the earlier event studies, the study is predicated on the assumption that the securities markets are efficient at quickly and robustly assessing the implications of the designated events, a source of academic controversy. For both of these reasons, the study may have had a market noise problem. The research found that the positive effect on share value for companies incorporated in Delaware was less than for firms incorporated elsewhere, a fact that it attributed to Delaware's proxy access enabling laws. However, citing the law's limited use to date, at least one observer has questioned whether there might be other factors at play, including that of market noise.[70]

The Chamber of Commerce and the Business Roundtable Suit and the Court's Ruling

On September 29, 2010, two major business groups, the United States Chamber of Commerce (Chamber), which represents firms of various sizes, and the Business Roundtable (Roundtable), a group of some 200 chief executives at large U.S. companies, filed suit[71] against the SEC with the

(...continued)

access-related development and the probability of the effort's success. However, the subsequently examined events may have merely resulted in investors updating their initial assessments of the valuation impact and the probability of success. As a consequence, it may be hard to infer whether the price reactions are truly independent of the earlier events or simply updates of investors' prior expectations. For example, see Steven Davidoff, "The Heated Debate Over Proxy Access," *New York Times Dealbook*, November 2, 2010, and "Facilitating Shareholder Director Nomination," SEC.

[68] Bo Becker, Daniel Bergstresser, and Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge*, Harvard Law and Economics Discussion Paper No. 685, December 22, 2010, available at SSRN: http://ssrn.com/abstract=1695666.

[69] For example, see Steven Davidoff, "The Heated Debate Over Proxy Access," *New York Times Dealbook*, November 2, 2010.

[70] Ibid.

[71] Business Roundtable v. Securities and Exchange Commission, No. 10-1305 (DC Cir. Filed September 29, 2010). Hereinafter referred to as Business Roundtable v. Securities and Exchange Commission. It is available at http://www.uschamber.com/sites/default/files/files/1009uscc_sec.pdf. Among those who have filed amicus briefs in support of the Chamber and the Roundtable's suit are the Investment Company Institute, a mutual fund trade association and the Independent Directors Council, a group of independent mutual fund directors, and the state of Delaware. Among those who filed amicus briefs in support of the SEC were the Council of Institutional Investors, a nonprofit association of public, union and corporate pension funds, and a group of 36 law professors. Available at http://blogs.law.harvard.edu/corpgov/files/2011/01/Roundtable-v-SEC-Law-Professors-Brief.pdf.

United States Court of Appeals for the District of Columbia Circuit, questioning the legality of its Rule 14a-11 rulemaking. Both groups have a long history of complementary opposition to proxy access.[72]

The lawsuit charged among other things that the agency's "rules [were] unlawful under the Investment Company Act, Securities Exchange Act, and Administrative Procedure Act … [and that the] Proxy Access Rules are arbitrary and capricious and otherwise not in accordance with law; do not promote efficiency, competition, and capital formation; [and] exceed the Commission's authority; and violate issuers' rights under the First and Fifth Amendments of the Constitution.…"[73]

In addition, on September 29, 2010, the two business groups requested that the SEC stay whatever final rulemaking involving proxy access Rule 14a-11 pending a court resolution of their proxy access suit. The Chamber and the Roundtable did not, however, request a stay to the rulemaking associated with the amendment to Rule 14a-8.[74]

On October 4, 2010, the SEC announced that it, the Chamber, and the Roundtable had agreed to seek an expedited judicial review of the case and that it had also decided to stay Rule 14a-11 as well as the integrally related amendment to Rule 14a-8. It noted that "among other things, a stay avoids potentially unnecessary costs, regulatory uncertainty, and disruption that could occur if the rules were to become effective during the pendency of a challenge to their validity."[75] Instances such as this in which the SEC grants a stay to the implementation of its rules when it faces a legal challenge to the implementation are reportedly rare.[76]

On July 22, 2011, saying that the SEC acted "arbitrarily and capriciously" and also failed to sufficiently analyze the economic impact of the proxy access rulemaking, the three members of the appeals court unanimously voted to vacate Rule 14a-11. The opinion written by Judge Douglas Ginsburg observed:

> We agree with the petitioners and hold the Commission acted arbitrarily and capriciously … for having failed once again... [to] adequately to assess the economic effects of a new rule. Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters. For these and other reasons, its decision to apply the rule to investment companies was also arbitrary….[77]

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[72] Arthur Levitt Jr. "Corporate Culture and the Problem of Executive Compensation," *Journal of Corporation Law*, Summer 2005, pp. 749-751.

[73] *Business Roundtable v. Securities and Exchange Commission*, p. 1.

[74] "Motion for Stay of Proxy Access Rules by the Business Roundtable and Chamber of Commerce of the United States of America, September 29, 2010," available at http://www.uschamber.com/sites/default/files/press_release/1009motionforstayproxy.pdf.

[75] "In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America. Order Granting Stay, Securities and Exchange Commission," October 4, 2010, available at http://www.sec.gov/rules/other/2010/33-9149.pdf.

[76] "SEC Awaits Court Ruling on Proxy Rule," *Wall Street Journal*, October 5, 2010.

[77] *Business Roundtable v. Securities and Exchange Commission*, p. 1.

The Aftermath of the Court's Decision to Vacate Rule 14a-11

After the court of appeals vacated Rule 14a-11, the key part of the SEC August 2010 proxy access rulemaking, reactions to the ruling were mixed. Several business interests, including the Chamber and the Roundtable, joined several Republican leaders in praising the ruling. However, some investor advocacy groups criticized it and asked the SEC to appeal the ruling, actions that the agency opted not to pursue.

The Chamber and the Roundtable Praise the Ruling

Among those who reacted favorably to the court's decision were the suit's plaintiffs, the United States Chamber of Commerce and the Business Roundtable. In a joint statement, the two latter groups wrote:

> This is a big win for America's job creators and investors. We applaud the court's decision to prevent special interest politics from being injected into the boardroom. Companies and directors need to continue to focus on the important work of creating jobs and reviving our economy. Today's decision also sends a strong message that regulators need to meet their statutory requirement to clearly prove that the benefits of regulation outweigh the costs.[78]

Republican Leaders Praise the Ruling and Question the SEC's Pursuit of Proxy Access

In a July 28, 2011 letter reportedly sent to the SEC, three Republican leaders, Representative Scott Garrett (chairman of the House Financial Services Capital Markets Subcommittee), Representative Randy Neugebauer (chairman of the Financial Services Oversight Subcommittee), and Representative Jeb Hensarling (vice chairman of the Financial Services Committee), indicated their support for the court ruling. The letter was also reported to have asked why the agency would expend resources "defending a rule that was so clearly problematic from its inception, and that appears to many observers to have been motivated more by political considerations than by sound corporate governance principles." Also, the correspondence reportedly opined that the agency's pursuit of the proxy access "raises fundamental questions" about its exercise of its rulemaking authority and the adequacy of its rulemaking authority under the Dodd-Frank Act. [79]

As part of the correspondence, the members also reportedly informed SEC officials that given the unanimous nature of the court decision, the agency needed to be more cautious before concluding "that a rule would promote the efficiency of the economy on the whole." The letter was also said to include a request that the agency provide the members information on agency resources devoted to the proxy access rulemaking, including (1) the total number of staff hours and related dollars spent in drafting the rule, meeting with interested parties, and reviewing public comments;

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[78] "U.S. Chamber and Business Roundtable Applaud Court's Decision to Vacate Proxy Access Rule," July 22, 2011, available at http://www.uschamber.com/press/releases/2011/july/us-chamber-and-business-roundtable-applaud-court%E2%80%99s-decision-vacate-proxy-ac.

[79] The letter does not appear to be publicly available. See "GOP Members Ask SEC to Account For Resources Spent on Proxy Access Rule," *BNA's Securities Regulation & Law Report*, August 1, 2011, and "House Republicans Cite SEC 'Mismanagement' in Proxy Access Rule," *Bloomberg*, July 28, 2011, available at http://www.bloomberg.com/news/2011-07-28/house-republicans-cite-sec-mismanagement-in-proxy-access-rule.html.

(2) the number of staff hours and money spent litigating the rule; and (3) funds spent by outside counsel in work related to the rulemaking.[80]

The Council of Institutional Investors Urges the SEC to Appeal the Court's Decision

In August 2011, the Council of Institutional Investors wrote to the SEC, urging it to consider an appeal of the court's ruling. In the letter, the council argued that a determination on the costs and benefits of a particular policy were best left to agencies like the SEC, not the courts:

> The panel's decision reflects a failure to abide by the standards applicable to judicial review of agency determinations and, in particular, agency cost-benefit analysis. It is well-settled that 'a court is not to substitute its judgment for that of the agency. That is especially true when the agency is called upon to weigh the costs and benefits of alternative polices.'[C]ost-benefit analyses epitomize the types of decisions that are most appropriately entrusted to the expertise of an agency. An agency need only "consider relevant factors" and "articulate a reasoned basis for its conclusion. Unfortunately, the panel ignored these well-established principles.[81]

The SEC Decides Not to Appeal the Court's Ruling

On September 6, 2011, the SEC announced that it would not be pursuing an appeal of the court's ruling to vacate Rule 14a-11. Agency officials, however, did note that the agency would be implementing Rule 14a-8 at a later date. That rule, which was not the subject of litigation, would allow eligible shareholders to require companies to include shareholder proposals on proxy access procedures in company proxy materials, giving companies and shareholders an opportunity to establish proxy access standards one company at a time.[82]

On the SEC's decision not to appeal the court's ruling on Rule 14a-11, SEC Chairman Schapiro observed:

> I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets. It is a process that helps make boards more accountable for the risks undertaken by the companies they manage. I remain committed to finding a way to make it easier for

[80] Ibid. In response, a letter dated August 5, 2011, that SEC Chairman Mary Schapiro reportedly sent to Chairman Garrett estimated that roughly 21,000 staff hours had been spent on the rulemaking and 2,700 staff hours on the ensuing litigation. Chairman Schapiro also reported that the agency spent $2.2 million in labor costs over the two years that it took to craft the proxy access rules and subsequently spent about $315,000 to defend them in court. Defending the expenditures, the chairman also reportedly observed that the expenditures represented less than a tenth of a percent of the SEC budget during the period and that "writing rules to effectuate free and fair markets is a time-consuming, resource-intensive effort for the SEC." The letter to Chairman Garrett does not appear to be publicly available. This description of the letter comes from "SEC Spent Over $2.2M to Write, Defend Proxy Access Rule, Schapiro Tells Lawmaker," *BNA's Securities Regulation & Law Report*, August 15, 2011.

[81] "Letter to SEC Chairman Schapiro from the Council of Institutional Investors, Re: Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission (D.C. Cir.) (No. 10-1305), " August 19, 2011, available at http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/08-19-11%20Letter%20to%20SEC%20on%20Proxy%20Access%20%28Final%29.pdf.

[82] "Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation," September 6, 2011, available at http://www.sec.gov/news/press/2011/2011-179.htm.

> shareholders to nominate candidates to corporate boards. At the same time, I want to be sure that we carefully consider and learn from the Court's objections as we determine the best path forward. I have asked the staff to continue reviewing the decision as well as the comments that we previously received from interested parties.[83]

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[83] Ibid.