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January 18, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: File No. S7-10-09 Release No. 34-60089
Facilitating Shareholder Director Nominations

Dear Ms. Murphy:

The Securities and Exchange Commission on December 14, 2009, re-opened the comment period in the above captioned proceeding. The Commission specifically requested comment on four empirical studies earlier submitted to the record.

Attached please find a brief article addressing the four empirical studies cited in the Commission's notice, and drawing the Commission's attention to two recent empirical studies that examine the stock price response to the disclosure of information related to the Commission's proxy access proposal.

With best regards,

Sincerely,

Professor Joseph A. Grundfest
Co-Director, Rock Center on Corporate Governance
William A. Franke Professor of Law and Business
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Measurement Issues in the Proxy Access Debate

Rock Center for Corporate Governance

Working Paper No. 71

Joseph A. Grundfest

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Abstract: Recent empirical data indicate that the Commission's proxy access proposals reduce shareholder wealth and are inimical to the best interests of the shareholder community at large. Cross-sectional variation in stock price response data further suggest that the Commission should reject a 'one-size-fits-all' approach, and that an opt-in rule is less likely to destroy shareholder wealth than an opt-out rule. None of the studies cited by the Commission in its request for further comment support a competing conclusion. The studies cited by the Commission instead suggest a rational basis for the market's concern that the proxy access process can be captured by a small number of institutions with idiosyncratic objectives that conflict with the best interests of the larger shareholder community.

Keywords: Proxy access, Securities and Exchange Commission, corporate governance, directors, boards, shareholder rights, shareholder voting, event study, stock price

JEL categories: D72, D73, D78, G3, G38, K22, K23

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* The William A. Franke Professor of Law and Business and Co-Director of the Rock Center on Corporate Governance at Stanford University; Commissioner, United States Securities and Exchange Commission (1985-1990). Bryce Daniel Kaufman and John Cardenas Williams, members of the Stanford Law School Class of 2011, provided valuable research assistance.

Measurement Issues in the Proxy Access Debate

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January 18, 2010

The Securities and Exchange Commission ("Commission"), on December 14, 2009, re-opened the record in its Proxy Access Proceedings.[2] The Commission expressly requested comment on four submissions: (1) the supplemental analysis of share ownership and holding period patterns disclosed in Form 13F data prepared by the Commission's Division of Risk, Strategy, and Financial Innovation ("*Share Ownership*");[3] (2) *The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortion of the Shareholder Voting Process*, a study prepared by the Corporate Library and submitted by the Shareowner Education Network and the Council of Institutional Investors ("*Limits of Private Ordering*");[4] (3) *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation*, a study prepared by NERA Economic Consulting and submitted by the Business Roundtable ("*Efficiency, Competitiveness, and Capital Formation*");[5] and (4) *Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation*, a study by Andrea Beltratti and Rene M. Stulz, submitted by the Business Roundtable ("*Bank Performance*").[6]

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[2] Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9046, 34-60089, IC-28765; File No. S7-10-09, 74 Fed. Reg. 29,024 (proposed June 18, 2009).

[3] Memorandum from Jennifer Marietta-Westberg & Joshua White, Division of Risk, Strategy, and Financial Innovation, Securities and Exchange Commission, Share Ownership and Holding Period Patterns in 13F data (Nov. 24, 2009), http://www.sec.gov/comments/s7-10-09/s71009-576.pdf.

[4] BETH YOUNG, THE CORPORATE LIBRARY FOR THE COUNCIL OF INSTITUTIONAL INVESTORS, THE LIMITS OF PRIVATE ORDERING: RESTRICTIONS ON SHAREHOLDERS' ABILITY TO INITIATE GOVERNANCE CHANGE AND DISTORTIONS OF THE SHAREHOLDER VOTING PROCESS (2009), http://www.cii.org/UserFiles/file/The%20Limits%20of%20Private%20Ordering%20UPDATED%2011-17-09.pdf.

[5] ELAINE BUCKBERG & JONATHAN MACEY, NERA ECONOMIC CONSULTING, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION: IN SUPPORT OF COMMENTS BY BUSINESS ROUNDTABLE (2009), http://sec.gov/comments/s7-10-09/s71009-267.pdf.

[6] Andrea Beltratti & René M. Stulz, *Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation* (Fisher College of Business, Working Paper No. 2009-03-012, 2009), *available at* http://ssrn.com/abstract=1433502.

1. Stock Price Response to Proxy Access Proposals

As an initial matter, it is instructive to observe that none of the studies cited in the Commission's request for comment address a question central to the proceeding: Does the proposed proxy access rule promote shareholder welfare?[7]

The academic literature frequently cites to stock price effects correlated with the adoption or maintenance of corporate governance provisions as evidence of whether those provisions promote shareholder interests.[8] Provisions correlated with increases in shareholder value are viewed as consistent with shareholder interests. Provisions correlated with declines in shareholder value are viewed as inconsistent with shareholder interests. Indeed, proponents of proxy access rely extensively on studies that measure the stock price effects of governance rules other than the Commission's proposed proxy access rules, and also assert that shareholder wealth maximization should be the sole guiding principle animating regulatory action in the governance debate.[9] The Commission itself also relies on event studies in its own proceedings.[10]

Two recent studies examine stock price response to information regarding proxy access proposals and reach a consistent conclusion: proxy access, as currently proposed by the Commission, reduces shareholder wealth and, even if preferred by vocal institutional investors, is inimical to the best interests of the shareholder community as a whole.

The Regulation of Corporate Governance[11] examines the stock price response to thirteen legislative and regulatory events related to the Commission's proxy access proposal.[12] The study finds that, on average, "the market reacts negatively to proxy access regulation," and documents cross-sectional variation in stock price response.[13] Publicly traded firms with a larger number of

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[7] For additional analysis of the Commission's proposed proxy access rules from a perspective that emphasizes the preferences of the shareholder community as a whole, and articulates the potential danger of a proxy access rule that is not structured as an opt-in rule, or that establishes relatively easy access thresholds, see Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. (forthcoming Feb. 2010) (attached as Exhibit A).

[8] *See, e.g.*, Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. (forthcoming Feb. 2010) (manuscript at 8-9 & nn.27-38).

[9] *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842-843 (2005) ("Some supporters of greater shareholder power might regard increases in 'shareholder voice' and 'corporate democracy' as intrinsically desirable. I should therefore stress at the outset that I do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis. From this perspective, increased shareholder power would be desirable only if it would operate to improve corporate performance and value.").

[10] *See, e.g.*, Elaine Buckberg & Frederick C. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, 63 BUS. LAW. 347 (2008); Mark L. Mitchell & Jeffry M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545 (1994).

[11] David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, *The Regulation of Corporate Governance*, Rock Center for Corporate Governance and Graduate School of Business, Stanford University, Jan. 16, 2010 (submitted as a separate comment by Professor Larcker).

[12] *Id.* at 3, 14-16.

[13] *Id.* at 4.

institutional investors holding one percent positions display larger than average negative price effects. The negative stock price response is attenuated but still present at firms with a greater number of institutional investors holding positions less than one percent. This cross sectional variation is consistent "with critics' claims that giving shareholders who hold 1% or more the ability to nominate their own slate of directors and/or list proxy proposals increases the power of large blockholders who may not act in the interest of other shareholders (e.g., certain activists, bidders with toeholds, or corporate raiders)."[14] It is also consistent with the observation that "[a]s the costs to forming a coalition increase, the less likely small institutional shareholders will attain the 1% ownership threshold necessary to attain proxy access, and the less the negative reaction to proxy access regulation."[15] The authors conclude that "[b]ecause the costs and benefits of proxy access vary significantly across firms, our results suggests that shareholders may best be served by proxy access regulation which allows shareholders themselves (rather than the government) to determine the rules that govern proxy access on a company-by-company basis."[16]

Shareholders in the Boardroom[17] also documents a statistically significant negative stock price effect associated with key event dates indicating an increased probability of proxy access. It too finds statistically significant cross-sectional variations indicating that the negative shareholder wealth effects of proxy access increase as the probability of activism at a corporation increases. The authors conclude that "empowering shareholders in this regard [(i.e., through proxy access)] is not perceived to be increasing firm value."[18] They further observe that "the Commission might want to deliberate further on the details of the proposed rule, or may want to look for different ways to improve the effectiveness of the board of directors. Our cross-sectional results show that the 'one-size-fits-all' nature of the proposed rule might also be reconsidered."[19]

The best currently available empirical data thus indicate that, given a choice between the current regime and the Commission's proposed proxy access rules, shareholders seeking to

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[14] *Id.*
[15] *Id.* An alternative explanation for the less negative price response at firms with a larger number of institutional investors holding positions smaller than one percent is that the incentives of these smaller institutional holders are more likely aligned with the incentives of the larger shareholder base. This hypothesis is, however, problematic for at least two reasons. First, many institutional investors that hold positions in excess of one percent at some companies also hold positions smaller than one percent at other companies. The population of holders with positions smaller than one percent is therefore not distinct from the population of holders with positions in excess of one percent. Second, even if the populations are distinct, there is no basis in the literature upon which to conclude that the incentives of holders differ systematically in a manner that would support the observed regression coefficients. The more parsimonious and natural interpretation of the cross-sectional variation is that the easier it is for shareholders to nominate candidates under the Commission's proposed rules, the more negative the stock price effect.
[16] *Id.* at 33.
[17] Ali C. Akyol, Wei Fen Lim and Patrick Verwijmeren, *Shareholders in the Boardroom: Wealth Effects of the SEC's Rule to Facilitate Director Nominations*, Department of Finance, University of Melbourne, Dec. 14, 2009, *available at* http://ssrn.com/abstract=1526081 (incorporated herein by reference).
[18] *Id.* at 4.
[19] *Id.*

maximize returns would prefer the *status quo* because the proposed rules appear to destroy shareholder wealth. Moreover, if there is to be a proxy access rule, the cross-sectional variation in the data suggest that an opt-in regime, in which shareholders define for themselves the rules governing proxy access on a corporation-by-corporation basis, is likely preferable to an opt-out regime, in which the Commission has to guess at an optimal default rule, and where the data indicate that the Commission's current best guess destroys a statistically significant amount of shareholder wealth.[20]

2. Share Ownership

In *Share Ownership*, the Commission's Division of Risk, Strategy, and Financial Innovation analyzes Form 13F data and describes "how the percentage of issuers with individual institutional investment managers eligible to use the proposed rule declines as a function of increasing the holding size threshold and the holding period."[21] The analysis also reports comparable data for "four large pension funds" that are unidentified,[22] and describes "the total number of "eligible issuer-investor pairs" under various scenarios."[23]

The analysis presented in *Share Ownership* describes, from a variety of perspectives, the probability with which a single shareholder can, without the need to form a coalition including any other shareholder, independently satisfy a range of different proxy access thresholds. Entities with holdings sufficiently large to create coalitions that satisfy proxy access requirements are described in the voting theory literature as being "pivotal" to the proxy access decision.[24] When a single entity has a voting position large enough to be pivotal with respect to a decision, and need not form a coalition, that entity is also defined as "dictatorial" with regard to that decision because it can, like a dictator, determine the outcome without seeking the cooperation or consent of any other coalition or constituency.[25] *Share Ownership* thus describes the incidence of dictatorial proxy access positions across a range of ownership threshold and holding period rules.

These data are, however, susceptible of multiple interpretations. In particular, a shareholder with a position large enough to be dictatorial can more easily use the proxy access

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[20] Some analysts suggest that the Commission should adopt an opt-out regime with a default value that provides for easy proxy access on the rationale that shareholders who prefer an alternative regime can always opt out of the new rule. *See, e.g.*, Bebchuk & Hirst, *supra* note 8. The logic supporting this position is, however, particularly suspect if the evidence is that the default rule will, on average, destroy shareholder value, as is the case here. To adopt that sort of reasoning would also endorse the adoption of an infinite number of bad governance rules that harm shareholder interests on the rationale that shareholders can, through the mechanism of self-help, fix whatever mess the Commission creates.
[21] Marietta-Westberg & White, *supra* note 3, at 2 & tbls.1A & 1B.
[22] *Id.* at 2 & tbl.2.
[23] *Id.* at 2 & tbls.3, 4A & 4B.
[24] *See, e.g.*, ALAN D. TAYLOR, MATHEMATICS AND POLITICS: STRATEGY, VOTING POWER, AND PROOF 69, 103 (1995).
[25] *Id.*

process to pursue an agenda that generates private benefits.[26] If a shareholder's agenda is sufficiently idiosyncratic, then the only way that the shareholder can pursue its objective through the proxy access process is to hold a position large enough to be dictatorial because no other shareholders would rationally want to join a coalition. Further, to the extent that shareholders are required to build coalitions in order to satisfy proxy access requirements, the act of coalition building could indicate a broader potential base of support for the cause promoted by the proponent. Thus, the fact that a large number of institutions are dictatorial with respect to a given set of proxy access thresholds may indicate that the thresholds are set too low because they make it too easy for shareholders to initiate proxy access campaigns in pursuit of idiosyncratic objectives inconsistent with more broadly held shareholder values.

Indeed, the empirical analysis presented in *The Regulation of Corporate Governance* and *Shareholders in the Boardroom* suggests that higher access thresholds are likely to destroy less shareholder wealth than lower thresholds. The Staff's *Share Ownership* study does not, however, describe the optimal access threshold that would eliminate the negative wealth effect associated with proxy access. Nor does it suggest that an opt-out regime is preferable to an opt-in rule. Instead, *Share Ownership* merely describes the political calculus likely to arise among shareholder advocates seeking to obtain proxy access in order to promote agendas that the stock price data presented in *The Regulation of Corporate Governance* and *Shareholders in the Boardroom* suggest are adverse to larger shareholder interests.

3. Private Ordering

In *Private Ordering*, the Corporate Library "analyzes the prevalence of two governance mechanisms – limitations on shareholders' ability to amend the bylaws, and capital structures involving multiple classes of stock with disparate voting rights – in three different market indices: the S&P 500, the Russell 1000 and the Russell 3000."[27] The study concludes that at "between 38 and 43% of companies, depending on the index, shareholders are either unable to amend the bylaws or face significant challenges in the form of supermajority vote requirements."[28] Also, at "between seven and nine percent of companies, the capital structure varies from one share/one vote, giving disproportionate influence to holders of supervoting shares."[29]

The study's sponsors, the Shareholder Education Network and the Council of Institutional Investors, interpret these data as indicating that "permitting company-by-company decisions on access would effectively lock out shareholders at about 40 per cent of top U.S.

[26] For a discussion of "megaphone externalities" and "electoral leverage" as examples of how shareholders can use proxy access to generate private benefits that reduce overall shareholder wealth, see Grundfest, *supra* note 7, Part IV.
[27] YOUNG, *supra* note 4, at 2.
[28] *Id.* at 9.
[29] *Id.*

companies."[30] The sponsors thus conclude that "the only solution is a uniform proxy access rule. Private ordering would result in essentially no choice for shareholders at nearly half of all U.S. companies."[31] The sponsors' interpretation of the Corporate Library's data is, however, fundamentally flawed for three distinct reasons.

First, as indicated by the only empirical studies to have addressed the question, the proposed access rules would reduce shareholder wealth. This negative wealth effect is likely ameliorated, but not eliminated, through mechanisms that promote shareholder self-determination. Adopting a strict proxy access rule with no allowance for variation to reflect circumstances particular to individual corporations would thus seem to be a prescription for making a bad situation even worse.

Second, the finding that shareholders at between thirty-eight and forty-three percent of companies "are either unable to amend the bylaws or face significant challenges in the form of supermajority vote requirements" is relevant only if an opt-in or opt-out regime relies on existing state law or current governance provisions to define the operation of an opt-in or opt-out regime. However, if the Commission takes the position that it has statutory authority to adopt proxy access rules that pre-empt current state law and that supersede extant charter and bylaw provisions (as the Commission suggests to be the case), then it follows that the Commission also has authority to adopt an opt-in or opt-out proxy access rule that pre-empts all impediments to simple majority control of the opt-in or opt-out rule. Indeed, if the Commission determines to adopt a uniform, nationwide, opt-in approach to shareholder access, with regular referenda on the question, as I have elsewhere supported,[32] then all of the impediments documented in the Corporate Library's study are irrelevant.

Third, the observation that between seven and nine percent of all companies have at least one class of stock with disproportionate voting power is orthogonal to the proxy access rule debate. Nothing in the Commission's rule proposal seeks to alter that fact. Indeed, even if the Commission has authority to adopt a proxy access rule, it is hardly clear that the Commission has the authority to take any action that would impair the property rights associated with existing shares that have disproportionate voting power. It would take an entirely different rulemaking to address the questions raised by shares with disproportionate voting power.

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[30] Letter from Julie Greshman, Corporate Secretary, Shareholder Action Network & Ann Yerger, Executive Director, Council of Institutional Investors to Mary Shapiro, Chairman, Securities and Exchange Commission (Nov. 18, 2009), http://www.sec.gov/comments/s7-10-09/s71009-568.pdf.
[31] *Id.*
[32] Joseph A. Grundfest, *Internal Contradictions in the SEC's Proposed Proxy Access Rules* 16 (Rock Center for Corporate Governance at Stanford University, Working Paper No. 60, 2009), *available at* http://ssrn.com/abstract=1438308.

4. Efficiency, Competitiveness, and Capital Formation

Efficiency, Competitiveness, and Capital Formation provides an overview of a large body of research emphasizing means by which shareholders can and do discipline directors of publicly traded corporations without reference to proxy access. It asserts that "shareholders already possess means to address problems with management and board of directors."[33] It further asserts that these "tools for addressing dissatisfaction with management and boards have proved powerful, and empirical evidence demonstrates that they are effective in disciplining managers."[34] Its analysis also refers to the Commission's legal obligation pursuant to Section 3(f) of the Securities and Exchange Act of 1934 to "consider the effect of certain proposed rule on efficiency, competition, and capital formation,"[35] as well as Section 23(a) of the Act that "prohibits any rulemaking that would unnecessarily or inappropriately burden competition."[36] The Commission's proposing release suggests, contrary to recent empirical evidence, that proxy access can promote shareholder welfare, but does not proceed to consider the marginal benefit (if any) of proxy access over other existing forms of market discipline. The current state of the record thus seems susceptible to a successful judicial challenge.

Original research presented in *Efficiency, Competitiveness, and Capital Formation* also indicates that companies "with market capitalizations of $700 million or more have a median of 10.5 shareholders eligible to nominate directors."[37] As explained above, each of these shareholders is dictatorial with respect to the proxy access decision because each can force access without the need to build a coalition calling for the assent of any other shareholder. Thus, if the market is concerned that shareholders will utilize the proxy access rules to promote idiosyncratic agendas that do not further the best interests of the shareholder community as a whole, then this concern is rationally magnified by the realization that, as a median observation, any one of ten or so shareholders has the unilateral authority to impose these costs on all other shareholders. Put another way, all ten or so shareholders with holdings in excess of one percent would have to agree not to pursue an idiosyncratic agenda in order to avoid the imposition of wealth reducing externalities on all shareholders. This observation may be useful in explaining the empirical findings that the Commission's proxy access proposal is correlated with statistically significant declines in shareholder wealth.

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[33] BUCKBERG & MACEY, *supra* note 5, at 2.
[34] *Id.*
[35] *Id.* at 1.
[36] *Id.* In addition, the Administrative Procedure Act imposes an independent obligation on the Commission to consider reasonable alternatives to the proposed proxy access rules. *See* Grundfest, *supra* note 7, manuscript at 15 n.71 and citations therein.
[37] BUCKBERG & MACEY, *supra* note 5, at 13.

5. Bank Performance

Bank Performance examines "whether bank performance is related to bank-level governance, country-level governance, country-level regulation, and bank balance sheet and profitability characteristics before the crisis."[38] It finds that "[u]sing conventional indicators of good governance, banks with more shareholder-friendly boards performed worse in the crisis."[39] Superior performance was instead correlated with stricter capital requirements, higher Tier 1 capital, independent banking supervision, and more restrictions on bank activities.[40] The analysis also finds that "banks with more shareholder-friendly boards, which are banks that conventional wisdom would have considered to be better governed, fared worse during the crisis."[41]

Bank Performance does not directly measure the stock price effects of the Commission's proxy access proposals. Moreover, *Bank Performance* also does not examine whether the cross-sectional variation in stock returns of banks during the crisis is different from the cross-sectional variation in stock returns during non-crisis periods. As such it is unclear whether the cross-sectional relations documented in the study preceded the crisis, were a result of the crisis, or were attenuated or exacerbated by the crisis. For these reasons, the study's relevance to the Commission's current inquiry may be viewed as limited. Its conclusions are, however, entirely consistent with the findings of the more recent literature that negative stock price effects are associated with the Commission's proxy access proposals, particularly if support for proxy access is viewed as a "conventional indicator of good governance."

6. Conclusion

Recent empirical data indicate that the Commission's proxy access proposal is likely to destroy shareholder wealth and is therefore inimical to the best interests of the shareholder community at large. Cross-sectional variation in stock price response data suggest that the Commission should reject a 'one-size-fits-all' approach, and that an opt-in rule is less likely to destroy shareholder wealth than an opt-out rule. None of the studies cited by the Commission in its request for further comment support a competing conclusion. Instead, by documenting the broad and pervasive incidence of shareholdings large enough to be dictatorial with regard to the access decision, studies cited by the Commission help provide a rational basis for the market's concern that the proxy access process can be captured by a small number of institutions with idiosyncratic objectives that conflict with the best interests of the larger shareholder community.

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[38] Beltratti & Stulz, *supra* note 6, at abstract.
[39] *Id.*
[40] *Id.*
[41] *Id.* at 21.

Exhibit A

The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law

*By Joseph A. Grundfest**

The U.S. Securities and Exchange Commission has proposed proxy rules that would mandate shareholder access under conditions that could be modified by a shareholder majority to make proxy access easier, but not more difficult. From a legal perspective, this Mandatory Minimum Access Regime is so riddled with internal contradictions that it is unlikely to withstand review under the arbitrary and capricious standard of the Administrative Procedures Act. In contrast, a fully enabling opt-in proxy access rule is consistent with the administrative record developed to date and can be implemented with little delay.

From a political perspective, and consistent with the agency capture literature, the Proposed Rules are easily explained as an effort to generate benefits for constituencies allied with currently dominant political forces, even against the will of the shareholder majority. Viewed from this perspective, the Proposed Rules have nothing to do with shareholder wealth maximization or optimal corporate governance, but instead reflect a traditional contest for economic rent common to political brawls in Washington, D.C.

From an economic perspective, if the Commission decides to implement an opt-out approach to proxy access, it will then confront the difficult problem of defining the optimal proxy access default rule. The administrative record, however, currently contains no information that would allow the Commission objectively to assess the preferences of the shareholder majority regarding proxy access at any publicly traded corporation. To address this gap in the record, the Commission could conduct a stratified random sample of the shareholder base, and rely on the survey's results to set appropriate default proxy access rules. The Commission's powers of introspection are insufficient to divine the value-maximizing will of the different shareholder majorities at each corporation subject to the agency's authority.

I. Introduction

The strong agnostic position in theology is that "I don't know whether god exists. And neither do you."[1] The strong agnostic position in the proxy access

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1. For a more formal definition of strong agnosticism, see William L. Rowe, *Agnosticism: Degrees of Agnosticism*, *in* 1 Routledge Encyclopedia of Philosophy 121 (Edward Craig ed., 1998). For an alternative view of agnosticism, see Edmund T. Shanahan, *Agnosticism*, *in* The Original Catholic Encyclopedia (1913), http://oce.catholic.com/index.php?title=Agnosticism.

debate is that "I don't know whether proxy access is a good or bad idea at every corporation in America, and if it is a good idea at some, many, or every corporation, I don't know how to structure the access rules for every corporation. And neither do you."

I am a strong proxy access agnostic. And you should be too.

Because I (and you) do not know how to structure a proxy access regime that is suitably tailored to address the individual circumstances of the almost 12,000 publicly traded corporations in the United States,[2] it makes sense to support a fully enabling approach to proxy access that allows every publicly traded corporation, easily and cheaply, to determine by majority vote the rules governing shareholder access to the corporate proxy.

The U.S. Securities and Exchange Commission ("SEC" or "Commission") can easily achieve this objective. It can structure its proxy rules to allow shareholders, acting on their own initiative, to propose, and by majority vote to adopt, proxy access standards that are suited to the individual circumstances of each corporation. This simple opt-in approach is consistent with the academic literature[3] and with existing state law.[4] This opt-in approach is also the only approach consistent with the administrative record established to date in the Commission's 2009 Proposed Proxy Access Rules.[5] Put another way, given the statements already made by the Commission and the administrative record developed to date, there is a high probability that any proxy access rule not structured as an opt-in proposal will violate the arbitrary and capricious standard of the Administrative Procedure Act.[6]

The SEC, however, is anything but agnostic in the proxy access debate. The Commission's 2009 proposed Proxy Access Rules would dramatically transform

2. In 2006, 11,898 companies filed annual reports with the U.S. Securities and Exchange Commission under the Securities Exchange Act of 1934 ("Exchange Act"). *See* Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 33-8876, 73 Fed. Reg. 934, 935 (Jan. 4, 2008) (to be codified in scattered sections of 17 C.F.R.).

3. *See infra* notes 107–09 and accompanying text.

4. *See infra* Part III.B.

5. *See* Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60089, 74 Fed. Reg. 29024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274) [hereinafter "Proposed Rules" or "Mandated Minimum Access Regime"]. *See also* Letter from Jeffrey W. Rubin, Chair, Comm'n on Fed. Regulation of Sec. of the Bus. Law Section of the Am. Bar Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 31, 2009), *available at* http://www.abanet.org/buslaw/committees/CL410000pub/comments/20090831000000.pdf [hereinafter ABA Comment Letter] (urging the Commission not to adopt the Rule 14a-11 proposal). As a technical matter, this opt-in alternative is easily achieved by amending "Rule 14a-8(i)(8) specifically to permit stockholder proposals for proxy access (and for proxy contest expense reimbursement), regardless of whether such proposals are more or less restrictive than" the Proposed Rules. Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 7 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-212.pdf [hereinafter Seven Firm Letter]. *Accord* Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009) (transcript available at www.sec.gov/news/speech/2009/spch052009tap.htm) [hereinafter Paredes Statement]. *See also infra* text accompanying note 21.

6. *See* Administrative Procedure Act § 706(2)(A), 5 U.S.C. § 706(2)(A) (2006) (A reviewing court must determine that agency decisions are not "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.").

the process by which directors of publicly traded corporations are nominated and elected. The Commission's Proposed Rules would establish a Mandatory Minimum Access Regime under which corporations would be compelled, even against the will of the shareholder majority, to provide proxy access in accordance with SEC-established standards.[7] Shareholders could, by majority vote, set less stringent access standards, but not even an overwhelming majority could adopt more stringent proxy access rules.[8] These Proposed Rules presume, with no support in the record whatsoever, that the Commission knows better than the majority of shareholders at every publicly traded corporation precisely how to structure proxy access for every corporation. The Commission's Mandatory Minimum Access Regime thereby effectively disenfranchises the shareholder majority from serving any meaningful role in setting proxy access rules. It is thus not a mere rhetorical flourish to observe that the Commission's proposal is fundamentally anti-democratic.

To be sure, the Commission has every right to articulate a strong view regarding a matter of public policy within its jurisdiction. Indeed, that is its job. But even so, the Commission is not free to adopt any rule it wants for any reason it thinks sufficient.

The Administrative Procedure Act ("APA")[9] prohibits the Commission from adopting rules that are arbitrary and capricious.[10] Internally contradictory rules are, by definition, arbitrary and capricious, and therein lies the rub. Because the text of the Proposing Release is at war with the text of the Proposed Rules in a clash that generates two profound contradictions, each of which is alone sufficient to cause the Proposed Rules to be viewed as arbitrary and capricious, there is little prospect that the Proposed Rules can withstand APA challenge.[11] Indeed, the Commission's recent decision to defer the consideration of its Proposed Rules is motivated in part by the Commission's recognition that it needed to "shore up rulemaking requirements under the Administrative Procedure Act in light of potential litigation. Although the Commission cannot do anything regarding its authority to issue the rule, it can at least ensure that a record has been developed to satisfy the APA . . . ."[12] The more fundamental question, however, is whether any modification to the record can save the Commission's Proposed Rules as currently written.

The first contradiction relates to core principles of shareholder self-determination. A fundamental premise of every proxy access proposal is that the majority of shareholders are sufficiently intelligent and responsible that they can be relied

7. *See infra* Part II.

8. *See id.*

9. Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

10. 5 U.S.C. § 706(2)(A) (2006).

11. *See infra* Part V.

12. Yin Wilczek, *SEC Delays Vote on Proxy Access Proposal; Staff Reviewing Comments, Schapiro Says*, 41 Sec. Reg. & L. Rep. (BNA) 1811 (Oct. 3, 2009).

upon to nominate and elect directors other than the nominees proposed by an incumbent board. If this premise is correct, then these same shareholders are also sufficiently intelligent and responsible to define the protocols governing when, how, and to whom access is granted. But the Proposed Mandatory Minimum Access Regime prohibits the identical shareholder majority from establishing a proxy access regime, or from amending the Proposed Rules to establish more stringent access standards.[13] The Commission fails to explain how or why shareholders are so selectively intelligent or responsible. It cites no support for the proposition that shareholders can be relied upon to nominate and vote on directors, but not to set the rules by which directors are nominated and elected. Absent a rational basis upon which to conclude that shareholders are selectively intelligent or responsible in a manner that supports discriminatory, asymmetric reliance on the majority's mandate, the Mandatory Minimum Access Regime cannot withstand APA scrutiny.[14]

A second contradiction relates to the Commission's repeated assertion that the Proposed Rules merely modify the proxy process to replicate better the physical shareholder meeting as governed by state law.[15] Nothing in state law sets a minimum standard for proxy access, defines the contours of any proxy access proposal that must be considered by shareholders, or prohibits a majority of shareholders from amending a proxy access standard to make it more stringent while forbidding the same majority to make it more relaxed. The Proposed Rules thus utterly fail to replicate the shareholder meeting process. Instead, they impose restrictions that exist nowhere in corporate law. Again, absent a rational explanation that resolves this contradiction, the Proposed Rules cannot withstand APA scrutiny.[16]

How can these contradictions be cured? In theory, the Commission could disavow its commitment to shareholder self-determination and to the replication of the state law meeting process. But if the Commission does not believe in shareholder self-determination, then what does it believe in? And, if the Commission does not believe in shareholder self-determination, then how can it be a strong advocate of proxy access? Also, if the Commission is not replicating the shareholder meeting process as governed by state law, then is it in the business of writing a federal corporation code? If not, from where then do the principles guiding proxy access emanate?

These contradictions can be resolved if the Commission restructures its rules so that they create opt-in shareholder referenda pursuant to which shareholders could propose, and a majority could adopt, proxy access standards for each individual corporation. Given the administrative record established to date, no other strategy (including the suggestion that the Commission simply amend its rules to allow for unconstrained opt-outs by a majority of shareholders) resolves

13. *See infra* Part II.
14. *See infra* Part III.A.
15. *See infra* Part III.B.
16. *See id.*

the contradictions inherent in the Commission's Proposing Release, or generates a rulemaking record able to withstand APA review.[17]

How then did the Commission come to propose a proxy access rule that is so essentially anti-democratic and internally inconsistent? One answer lies in the politics of the proxy access debate. 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.[18] 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 will prevail.

The political battle at the Commission is therefore not exclusively about the process that leads to optimal corporate governance. It is also about the process that optimizes the political benefits that easy proxy access generates for identifiable political constituencies. None of this should come as a surprise, or be particularly controversial. Special interest politics is the norm in Washington, D.C., and the proxy access debate is no different. The proxy access debate is a politically animated clash of well-identified special interest groups, and should be understood as such.

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 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 in a manner that has no analogue in state law. Proponents of shareholder access thus seek to win a victory at the Commission table that they could never attain at the corporate ballot box. This politically animated articulation of the Commission's motives explains, with precision, how and why the Commission has drafted an internally inconsistent rule that, in the name of shareholder democracy, disenfranchises the shareholder majority.[19]

The academic literature provides useful guidance as to the proper structuring of proxy access rules. Whether one adopts a dynamic default rule approach to proxy access, applies principles of "libertarian paternalism," or refers to a large academic

17. *See infra* Parts III.C & III.D.
18. *See infra* Part IV.A.
19. *See infra* Part IV.

literature relating to the role of shareholder voice in corporate governance, the heavy weight of precedent supports a fully enabling opt-in approach to proxy access.[20] An opt-out approach has less support in the literature and raises difficult challenges that generally do not arise with equivalent force in other governance debates over the choice between an opt-in or opt-out regime. In particular, the opt-out approach would require that the Commission define a default rule. The administrative record in the proxy access proceeding already establishes that this is a very difficult, highly technical task, and that the Commission's proposal is subject to a plethora of complex flaws and objections rooted in mechanical issues that have nothing to do with the battle over the underlying philosophy of proxy access.[21] Further, because the Commission has no particular insight as to the preferences of the shareholder majority that might be viewed as value-maximizing at each company subject to the proxy access rules, the Commission would have to guess at the appropriate default rule. The Commission's conjecture as to the optimal default rule introduces a level of subjectivity and randomness that is entirely avoided through the opt-in approach.

Also, there is no support in the published academic literature, of which I am aware, for a Mandatory Minimum Access Regime with an asymmetric opt-out in the form proposed by the Commission. The intellectual basis for the Letter of Eighty Professors ("Eighty Professors Letter")[22] supporting the Commission's proposed Mandatory Minimum Access Regime is thus mysterious and elusive.

Indeed, the default rule literature, even to the extent that it can be read to support an opt-out approach to proxy access, provides no support for the process used by the Commission to set its proposed proxy access default standards. The literature supports setting a default rule that reasonably replicates the rule that would be adopted by a shareholder majority, and then allowing symmetric opt-outs from that standard.[23] The Commission, however, nowhere suggests that its proposed rule reflects the will of the shareholder majority, and, if anything, the record it has established indicates that the Commission does not care about the will of the shareholder majority. The Commission could cure this flaw in its rulemaking by conducting a stratified random sample of shareholder preferences and then setting its default rule, subject to a symmetric opt-out, to replicate the survey-determined will of the shareholder majority.

But this approach may be too democratic for the Commission. If influential constituencies calculate that the majority of shareholders surveyed would propose standards that impair the value of megaphone externalities, then these constituencies would also oppose the simple step of surveying shareholders to determine

20. *See infra* Part V.

21. *See, e.g.*, ABA Comment Letter, *supra* note 5; Seven Firm Letter, *supra* note 5.

22. Comment Letter of a Bi-Partisan Group of Eighty Professors of Law, Business, Economics, or Finance in Favor of Facilitating Shareholder Director Nominations to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-282.pdf [hereinafter Eighty Professors Letter].

23. *See infra* notes 107–09 and accompanying text.

their preferences in order to establish default rules governing proxy access. By this logic, proxy access must be imposed by the Commission in a form that would never obtain majority support from the shareholder community.

Finally, it is valuable to recognize that the proxy access debate is not occurring in isolation. Majority voting standards and "just vote no" campaigns are gaining steam in the corporate arena.[24] The fully enabling opt-in approach advocated by this analysis can also be rationally extended to address proposals that corporations reimburse shareholders for expenses incurred in proxy contests, as well as several other proposed forms of improved governance. The Commission's agenda might therefore be materially enhanced if it focused on a richer agenda of governance reforms, again structured in a manner consistent with a fully enabling approach to the rulemaking process, rather than on a narrow mandatory proxy access regime that is, as a logical matter, internally inconsistent, in conflict with state law, and at odds with the academic literature.

These observations are not lost on individual members of the Commission. In particular, Commissioner Troy A. Paredes observed that the Commission's proposed Mandated Minimum Access Rules "not only work to displace private ordering and state law, but risk negating the import of a shareholder vote" because "[e]ven if a majority of a company's shareholders determine that [the Mandatory Minimum Access Regime] is not in the firm's best interests, the proposal would nonetheless force the company's shareholders into the [Commission's] access regime, as shareholders cannot opt-out . . . by prohibiting access or by adopting eligibility requirements more restrictive" than those proposed by the Commission.[25]

Commissioner Paredes, consistent with this Article's analysis, suggests that instead of imposing Mandatory Minimum Access Rules, the Commission adopt an enabling approach that would

> permit shareholders to include in the company's proxy materials a bylaw proposal that would allow shareholders proxy access for nominating directors so long as the company's jurisdiction of incorporation has adopted a provision explicitly authorizing a proxy access bylaw. Such an amendment . . . would . . . rest on firmer legal ground than today's proposal.[26]

The Commission's recent decision to defer its proposed consideration of the Mandatory Minimum Access Regime because of concerns regarding implementation difficulties and other factors[27] creates two substantial opportunities for the

24. *See infra* Part VI.
25. Paredes Statement, *supra* note 5.
26. *Id*. An alternative articulation of Commissioner Paredes's proposal could permit proxy access proposals provided that the jurisdiction of incorporation did not preclude proxy access bylaws.
27. *See* Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Address to 48th Annual Corporate Counsel Institute: SEC Rulemaking—'Advancing the Law' to Protect Investors (Oct. 2, 2009) (transcript available at www.sec.gov/news/speech/2009/spch100209ebw.htm) (citing to comment letters that "raise a number of complex issues, including issues related to the workability of various aspects of our proposal," and stating that the Commission is unlikely to be able to act in time to influence the upcoming proxy season. Instead, the expectation is of "an adopting release sometime in early 2010" that would implicate the 2011 proxy season).

agency. First, a fully enabling opt-in approach to proxy access avoids the technical complexities that arise when specifying any opt-out regime, and can therefore be promptly adopted by the Commission in a manner that allows adoption of proxy bylaws in the 2010 proxy cycle. Thus, if the Commission wants prompt proxy access reform through rules that can withstand APA review, it can have that reform now.[28] Second, because a fully enabling approach can also encompass proposals relating to the reimbursement of proxy expenses and other proxy-related matters, the Commission would expand its proposal to include a broad range of reforms supported by shareholder advocates.

Part II of this Article briefly describes the Commission's proposed proxy access rules. Part III explains the internal contradictions created by the Commission's own proposals and the basis on which a reviewing court can easily vacate the proposed rules as arbitrary and capricious. Part III also observes that these contradictions can only be resolved by a fully enabling proxy access rule that empowers shareholders to decide whether, when, and how proxy access should be permitted. Part IV considers the political pressures operating on the Commission and suggests that the Commission has a powerful incentive to support the proxy access rules as proposed, warts and all, even if those rules are likely to be vacated. Part V considers the academic literature, and observes that the literature strongly supports a fully enabling approach to proxy access and provides no material support for the Mandatory Minimum Access Regime now proposed by the Commission. Part V also explains that if the Commission elects to adopt an opt-out regime, then default values should be determined as the result of a properly structured survey of shareholder preferences subject to symmetric majoritarian opt-outs. Part VI considers some of the larger changes now occurring in the corporate governance arena and observes that a fully enabling opt-in structure of the sort advocated in this analysis has profitable application in other aspects of the governance debate, including the debate over reimbursement of insurgents' proxy expenses. Part VII addresses questions raised by Lucian Bebchuk and Scott Hirst's companion article in this issue, *Private Ordering and the Proxy Access Debate*. Part VIII concludes.

II. The Proposed Mandatory Minimum Access Regime

The Commission proposes to add one new rule and amend an existing rule. Proposed Rule 14a-11 would provide for proxy access in the event a nominating shareholder, or group of shareholders, of a large accelerated filer have, for

28. *See* Letter from James L. Holzman, Chair, Council of the Corp. Law Section, Del. State Bar Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Oct. 9, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-547.pdf ("[I]t appears that a significant majority [of comments] believe that [Commission rules] should be amended to provide stockholders of publicly traded corporations with a right to implement proxy access bylaws, to the extent such bylaws are consistent with state law. At the same time, a consensus to clarify state law has also emerged, as illustrated by Delaware's adoption of a proxy access statute, and the publication of proposed access provisions for the Model Businesses Corporation Act.").

at least one year, held 1 percent or more of the company's voting securities.[29] Access would not be available to stockholders seeking a change in control, or to stockholders seeking more than a limited number of seats on a board.[30] Nominating stockholders would be required to make certain disclosures, subject to the antifraud provisions of Rule 14a-9.[31] These disclosures include representations that the nominees satisfy the objective criteria for director independence set forth in listing standards, that there is no agreement with the company regarding the nomination of the nominees, and that the nominating stockholders intend to continue holding the requisite number of shares through the date of the stockholder meeting.[32] Disclosure would also be required of relationships between the nominating stockholders, the nominee, and the company, if any.[33]

Modifications to Rule 14a-8(i)(8) would recast the election exclusion so as to require that companies include in their proxy materials stockholder proposals that would amend, or propose to amend, the company's governing documents regarding shareholder nominations.[34] The proposals could not, however, weaken or eliminate the proxy access criteria prescribed by proposed Rule 14a-11.[35]

Taken together, the Proposed Rules create a mandatory form of proxy access to be imposed on all publicly traded corporations subject to the rule, even if the majority of each corporation's shareholders object strenuously to the operation of the Proposed Rules. The Proposed Rules would permit modifications making access easier for stockholder-nominated directors, but forbid modification making access more difficult. Again, the will of the shareholder majority is irrelevant to the Commission. The Proposed Rules are thus accurately described as creating a Mandatory Minimum Access Regime.

III. The Proposed Rules' Internal Contradictions: Implications and a Cure

Administrative agencies are wise not to contradict themselves when rulemaking: contradictions invite courts to overturn agency action as arbitrary and capricious.[36] Also, like Charles Barkley's claim that he was misquoted in his au-

29. Facilitating Shareholder Director Nominations, *supra* note 5, at 29035. The threshold for accelerated filers is 3 percent and for non-accelerated filers it is 5 percent. *Id.*

30. *Id.* at 29037, 29043. "[A] company would be required to include no more than one shareholder nominee or the number of nominees that represents 25 percent of the company's board of directors, whichever is greater." *Id.* at 29043. In addition, if shareholder nominees were to possess one directorship or 25 percent, as above, their continued presence on the board would preclude the company from any duty to provide access for other shareholder nominees in subsequent elections. *See id.* Conflicts arising as to which shareholders may include nominees will be decided based on who first provides the company with notice of their intent. *Id.* at 29044.

31. *Id.* at 29041 n.165.

32. *Id.* at 29035, 29040–41.

33. *Id.* at 29041.

34. *Id.* at 29056.

35. *Id.*

36. See *infra* Part V for a brief discussion of the Administrative Procedure Act's requirement that Commission rulemaking not raise internal contradictions lest it be deemed arbitrary and capricious.

tobiography, contradictions spawn skepticism as to the credibility of the entire enterprise.[37]

The Commission has not, however, taken this observation to heart. The Commission's Proposing Release and Proposed Rules generate two significant contradictions. Each contradiction is sufficient to support a decision by a reviewing court to vacate and remand the Proposed Rules as arbitrary and capricious.

A. The First Contradiction: Self-Determination and Proxy Access

A fundamental premise of every proxy access proposal is that the majority of shareholders are sufficiently intelligent and responsible that they can be relied upon to nominate and elect directors other than the nominees proposed by an incumbent board. If this premise is correct, then the same shareholders are sufficiently intelligent and responsible that they can be relied upon to determine whether proxy access should apply at any particular corporation. They are also sufficiently intelligent and responsible to define the protocols governing when, how, and to whom access is granted.

As the Proposing Release explains, "[W]e believe that investors are best protected when they can exercise the rights they have as shareholders, without unnecessary obstacles imposed by the federal proxy rules."[38] These rights include the right to set standards governing proxy access and are not limited to the right to approve nominees pursuant to a Mandatory Minimum Access Regime adopted without any regard for the will of the majority. It is more than a touch ironic that the Mandatory Minimum Access Regime actually eliminates the shareholders' right to propose and adopt proxy access standards, thereby creating the very "unnecessary obstacles imposed by the federal proxy rules" that the Proposing Release purports to eliminate, and negating that "greater voice" that the Commission proclaims to provide.[39]

Indeed, there is no intellectually credible argument that shareholders are selectively intelligent and responsible: that they are competent to elect directors but incompetent to determine the rules governing the election of directors. There is also no support for the proposition that shareholders can be trusted to relax the mandatory minimum standards established by the Commission, but not to strengthen them. The Commission cites to no theoretical or empirical support for such a proposition, and thus leaves open the question as to whether there is any rational support for its proposed Mandatory Minimum Access Regime.

To be sure, the Proposing Release questions whether the Proposed Rules should be mandatory, whether they should be structured as opt-in or opt-out provisions,

37. *See* Charles Barkley & Roy S. Johnson, Outrageous! The Fine Life and Flagrant Good Times of Basketball's Irresistible Force (1992); Don Benevento, *Barkley: 'Outrageous' Misquotes 76ers Star*, USA Today, Dec. 13, 1991, at 4C.

38. Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29027.

39. *See id.* at 29031.

and whether shareholders should, pursuant to proposed Rule 14a-8(i)(8), be permitted to offer proposals to make proxy access requirements more rigorous.[40] Each of these questions, however, places the burden of proof with the wrong party. Asking for alternatives to an internally contradictory proposal does not cure the proposal's internal contradictions.

B. The Second Contradiction: Replicating the Shareholder Meeting

The Commission asserts that:

> The proxy rules seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders. Refining the proxy process so that it replicates, as nearly as possible, the annual meeting is particularly important given that the proxy process has become the primary way for shareholders to learn about the matters to be decided by the shareholders and to make their views known to company management.[41]

The Proposing Release also states that "[p]arts of the federal proxy process may unintentionally frustrate voting rights arising under state law, and thereby fail to provide fair corporate suffrage."[42]

The proposed Mandatory Minimum Access Regime, however, utterly fails to replicate the annual meeting process. As an initial matter, it is for the shareholders themselves to propose and adopt bylaw provisions governing proxy access. These standards are today not imposed by third parties or by state law on the corporation.[43] The proposed Mandatory Minimum Access Regime would, however, impose a standardized, mandatory form of proxy access that replicates nothing about the current annual meeting or about any aspect of corporate law governing the operation of those meetings. Thus, rather than promote fidelity to the principles of shareholder democracy as they exist at physical shareholders' meetings, the Commission is inventing a procedure entirely alien to the shareholder voting process.

The Commission seems to argue at cross purposes with itself when trying to justify this one-size-fits-all approach to corporate law.[44] For example, as evidence

40. *Id*. at 29033, 29058.

41. *Id*. at 29025; *see also id*. at 29025 n.32. The Proposing Release continues to observe that "[t]he action we take today is focused on removing burdens that the federal proxy process currently places on the ability of shareholders to exercise their basic rights to nominate and elect directors." *Id*. at 29027.

42. *Id*. at 29027.

43. The single exception appears to be North Dakota's corporate code, which now permits "five percent shareholders to provide a company of notice of intent to nominate directors and require the company to include each such shareholder nominee in its proxy statement and form of proxy." *Id*. at 29029 n.70 (citing N.D. Cent. Code § 10-35-08 (2009)). But even so, the Proposed Rules conflict with North Dakota law. If North Dakota shareholders wanted to amend the proposed federal standard to comport with the state's standard, Proposed Rule 14a-8(i)(8) would preclude any such action.

44. The Delaware State Bar Association, charged with recommending business law amendments to the Delaware General Assembly, critiqued the Commission's homogenous mandate in a Comment

of proxy "impediments to the exercise of shareholders' rights,"[45] the Proposing Release cites Delaware Vice Chancellor Leo Strine's comment that federal proxy laws seem "a little bit perverse" because Rule 14a-(8)'s exclusions can keep shareholder proposals valid under state law off the proxy while mandating inclusion of certain precatory proposals not even considered under state law.[46] Yet, the Proposing Release does not mention that Strine's logic is founded on the incongruity between state and federal law that the Proposed Rules will magnify and compound. Such "perversity" exists because federal law enables unenforceable proposals while disabling enforceable proposals. Ironically, Strine's emphasis "on company-specific decision[s] by stockholders to opt-in" via proxy access bylaws instead of "an invariable federal mandate"[47] is also at odds with the Commission's Proposed Rules, yet Strine is quoted in the Proposing Release as providing support for the Commission's approach. Quite divorced from Strine's arguments, the Proposed Rules impose new standards of propriety wholly independent of underlying state law, fulfilling the Vice Chancellor's warning that "federal action will be taken to mandate that all public companies adopt certain election practices favored by institutional investors."[48]

Further, the Mandatory Minimum Access Regime supplies a standard contract term that, even if it existed under state law, would be subject to amendment that could either strengthen the requirements for shareholder access or relax them. In stark contrast, the Commission proposes a set of proxy access standards that preclude all amendments that would relax its requirements.

The conflict between the reality of corporate law and the Commission's assertion that it is merely seeking to replicate the reality of the "actual in-person meeting of the shareholders"[49] through the proxy process is most apparent in Delaware. New Section 112 of the Delaware General Corporation Law, effective as of August 1, 2009, expressly authorizes corporations to provide bylaw provisions that would permit proxy access and to impose any lawful condition on the access provision.[50] Expressly permissible access requirements include minimum ownership provisions, minimum holding periods, information disclosure requirements,

Letter submitted to the SEC. "[We] concluded that [the proxy access mandates] would be inconsistent with the overall philosophy of the Delaware General Corporation Law: to enable stockholders and boards to establish their own corporation's internal rules in light of the wide variety of circumstances in which Delaware corporations function, rather than to limit their ability to do so." Letter from James L. Holzman, Chair, Council of the Corp. Law Section, Del. State Bar Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 5 (July 24, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-65.pdf [hereinafter DSBA Letter].

45. Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29026.

46. *Id*. at 29026 n.33 (quoting Leo E. Strine, Jr., Vice Chancellor, Del. Court of Chancery, Roundtable Discussion on Proposals for Shareholders 112 (May 25, 2007) (transcript available at http://www.sec.gov/news/openmeetings/2007/openmtg_trans052507.pdf)).

47. Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1087 (2008).

48. *Id*. at 1097.

49. Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29025.

50. *See* 2009 Del. Laws ch. 14, § 1 (Apr. 10, 2009) (H.B. 19) (West) (to be codified at Del. Code Ann. tit. 8, § 112).

restrictions on the number of nominees, and a requirement that nominating shareholders indemnify the company for losses resulting from false or misleading statements by shareholders in connection with the nomination of directors.[51]

Section 112 establishes no minimum standard for proxy access in terms of the percentage of shares held or the required holding period, and permits the imposition of any lawful condition on access.[52] The Mandated Minimum Proxy Access Regime, however, prohibits the imposition of an infinite number of lawful conditions. The Proposed Rules thus fail to replicate the situation that would exist at physical shareholders' meetings in Delaware, and are therefore fundamentally inconsistent with the Commission's own stated objective in proposing the proxy access rules. The contradiction could not be more clear.[53]

C. Internal Contradictions and the Administrative Procedure Act

Commission rules are subject to review under the "arbitrary and capricious" standard of the Administrative Procedure Act.[54] As interpreted by the U.S. Supreme Court in *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Auto Insurance Co.*,[55] the arbitrary and capricious standard compels judicial scrutiny of administrative agency rules beyond minimal rational basis review. When crafting administrative rules, agencies must consider relevant factors and "articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[56] Agency rules that offer explanations running "counter to the evidence before the agency" are considered arbitrary and capricious.[57] Agencies must also consider known alternatives before promulgating rules.[58] Thus, "[a]t its core, arbitrary and capricious review, or 'hard look' review as it is sometimes called, enables courts to ensure that administrative agencies

51. *See id.*
52. *See id.*
53. The Model Business Corporations Act ("MBCA") has been adopted in whole or substantial part by thirty states. Model Bus. Corp. Act, at v (4th ed. 2008). It grants shareholders concurrent authority with the board to amend the company's bylaws so as to adopt shareholder access provisions. *Id.* § 2.06(b). The Committee on Corporate Laws of the American Bar Association's Section of Business Law recently approved proposed amendments to the MBCA that would largely track section 112 of the Delaware General Corporation Law. *See* Comm. on Corp. Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act—Proposed Shareholder Proxy Access Amendments to Chapters 2 and 10*, 64 Bus. Law. 1157 (2009); *see also* Eriola Jahollari, *Corporate Law Committee Proposes MBCA Amendments*, 24 Corp. Couns. Wkly. (BNA) 203 (July 8, 2009). When these amendments are adopted, the conflict between the Commission's Mandatory Minimum Access Regime and the MBCA will be just as stark as the conflict with Delaware law.
54. Administrative Procedure Act § 706(2)(A), 5 U.S.C. § 706(2)(A) (2006). *See also supra* note 6.
55. 463 U.S. 29 (1983).
56. *Id.* at 43 (quoting Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962)).
57. *Id.*
58. *See* Brookings Mun. Tel. Co. v. FCC, 822 F.2d 1153, 1169 (D.C. Cir. 1987) (agencies have "a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives"); *see also infra* note 71.

justify their decisions with adequate reasons. . . . [A]gencies should explain their decisions in technocratic, statutory, or scientifically driven terms, not political terms."[59]

An agency is arbitrary and capricious when its logic is internally inconsistent. "[I]nternally contradictory agency reasoning renders resulting action 'arbitrary and capricious'; [inasmuch as] such actions are not 'founded on a reasoned evaluation of the relevant factors.' "[60]

In *Goldstein v. SEC*,[61] the court vacated and remanded the Commission's Hedge Fund Rule because, in part, the agency could not explain the contradictory implications of its proposed reading of the Investment Advisers Act of 1940.[62] "The Commission cannot explain why 'client' should mean one thing when determining to whom fiduciary duties are owed, and something else entirely when determining whether an investment adviser must register under the Act."[63] Because the Commission had not "adequately explained" these inconsistencies, the court concluded that the Hedge Fund Rule "is an arbitrary rule."[64]

Most recently, in *American Equity Investment Life Insurance Co. v. SEC*,[65] the Commission argued that it was not required to conduct a section 2(b) analysis of its fixed indexed annuity rule.[66] This position, however, contradicted the fact that the Commission had "conducted a § 2(b) analysis when it issued the rule with no assertion that it was not required to do so."[67] The court therefore rejected the Commission's position and ruled that a section 2(b) analysis was indeed necessary.[68] It then proceeded to vacate the rule on grounds that the Commission's section 2(b) analysis was arbitrary and capricious because, among other things, it failed "to analyze the efficiency of the existing state law regime" which provided an alternative to the Commission's proposed rule.[69]

59. Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L.J. 2, 5 (2009). *Accord* Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2380–81 (2001) (*State Farm* demands that the agency "justify its decision in neutral, expertise-laden terms to the fullest extent possible").

60. Defenders of Wildlife v. EPA, 420 F.3d 946, 959 (9th Cir. 2005) (quoting Ariz. Cattle Growers' Ass'n v. U.S. Fish & Wildlife, 273 F.3d 1229, 1236 (9th Cir. 2001) (internal quotation marks omitted)), *rev'd & remanded sub nom*. Nat'l Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 644 (2007). *See also* Gen. Chem. Corp. v. United States, 817 F.2d 844, 857 (D.C. Cir. 1987) (finding agency action "arbitrary and capricious" because it was "internally inconsistent and inadequately explained").

61. 451 F.3d 873 (D.C. Cir. 2006).

62. *Id*. at 882.

63. *Id*. (citations omitted).

64. *Id*. at 884.

65. 572 F.3d 923 (D.C. Cir. 2009).

66. *Id*. at 934–36. Section 2(b) of the Securities Act of 1933 states that for every rulemaking in which the SEC "is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 77b(b) (2006).

67. *Am. Equity Inv. Life Ins.*, 572 F.3d at 934.

68. *Id*.

69. *Id*. at 936. Section 3(f) of the Exchange Act imposes an identical obligation on the Commission to justify its proposed Mandatory Minimum Access Regime. *See* 15 U.S.C. § 78c(f[0]) (2006). Thus,

Several of the Commission's more recent prominent rulemakings, adopted as a result of vigorous political pressure, have not fared well under judicial scrutiny.[70] When rules are vacated and remanded, the Commission must restart the rulemaking process and address the concerns raised by the court, if the Commission is to act at all. That process can take several years. It is thus a Pyrrhic victory, at best, for champions of shareholders rights if the agency adopts proxy access rules that are simply waiting to be vacated and remanded by the courts. If the Commission is intent on crafting proxy access rules that are likely to be implemented on a prompt basis, without being overturned by the courts, then it will have to confront the more vocal and extreme advocates of proxy access. It will have to reject their agenda and instead adopt a more measured and nuanced set of rules that can pass muster before a dispassionate court that will not be subject to the political pressures that today buffet the agency.

D. Curing the Contradictions

These internal contradictions are cured if the Proposed Rules are amended to allow shareholder resolutions that define the terms and conditions under which a majority of shareholders can set the rules for proxy access.[71] This "fully enabling" strategy is entirely consistent with principles of shareholder self-determination: the same shareholders that are sufficiently intelligent and responsible to nominate and vote on director candidates are also sufficiently intelligent and responsible to define the process by which they nominate and elect those directors.[72] This fully enabling strategy is also entirely consistent with the Commission's stated desire to replicate the meeting process as it currently exists.[73] Further, this fully enabling

in addition to the agency's obligation not to contradict itself, the agency has an obligation to explain why its proposed Mandatory Minimum Access Rules "in addition to the protection of investors . . . will promote efficiency, competition, and capital formation" better than existing state law standards. *Id*.

70. *See, e.g.*, Fin. Planning Ass'n v. SEC, 482 F.3d 481, 483 (D.C. Cir. 2007) (vacating the Commission's rule interpreting an exemption from the Investment Advisers Act); Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006) (vacating the Commission's Hedge Fund Rule); Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005) (vacating the Commission's Mutual Fund Rule).

71. The Commission is, as a legal matter, required to consider this alternative and explain why it is inferior to its Proposed Rules. "[W]here a party raises facially reasonable alternatives . . . the agency must either consider those alternatives or give some reason . . . for declining to do so." *Chamber of Commerce*, 412 F.3d at 145 (quoting Laclede Gas Co. v. FERC, 873 F.2d 1494, 1498 (D.C. Cir. 1989) (emphases omitted)) (overturning the Commission's Mutual Fund Rule, in part because the agency had failed adequately to consider alternative regulatory resolutions as required by the APA). Alternatives that resolve the Commission's internal contradictions cure a fatal flaw in the agency's rulemaking and therefore cannot be "unworthy of consideration." *Id*. at 144. They are therefore also not "frivolous or out of bounds." *Id*. at 145.

72. Even strong advocates of proxy access recognize that shareholders are fully able to resolve the most critical matters relating to corporate governance including, without limitation, the power to "initiate and adopt rules-of-the-game decisions to amend the corporate charter or to reincorporate in another jurisdiction." Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 837 (2005) [hereinafter Bebchuk, *Increasing Shareholder Power*]. The very same logic supports the conclusion that shareholders can "initiate and adopt" proxy access rules.

73. The Commission recognizes that in "CA, Inc. v. AFSCME, 953 A.2d 227 (Del. 2008), the Delaware Supreme Court held that shareholders can propose and adopt a bylaw regulating the process by

opt-in approach generates three distinct benefits that are widely appreciated in the academic literature:

> First, even if the same arrangement were good for all public companies, public officials might err in identifying it. . . . Second, even if the arrangement selected by public officials were initially the right one, things might change over time, and private ordering can then provide adjustment to new circumstances. Third, one size might not fit all: companies differ in their circumstances, attributes, and needs.[74]

It should thus come as little surprise that leading scholars are already on record stating that "to facilitate shareholder adoption of election arrangements, shareholders should be permitted to place on the corporate ballot any proposed bylaw concerning elections that would be valid under state law if adopted."[75] This approach also avoids the problem that arises because "public officials have neither the information nor the resources to tailor different arrangement to the particular features of different companies."[76] For that reason, "it would not be optimal to have all companies abide by a general arrangement chosen by public officials. Rather, it would be desirable to allow private parties, armed with the best information about their particular needs and the best incentives to choose and tailor the most fitting arrangement, to make the relevant choices."[77] The fully enabling opt-in approach achieves precisely this objective.

It is significant to observe that an opt-out approach under which the Commission's mandatory access rule allows a majority of shareholders to amend the rule in any manner they wish, as could be implemented through a revised Rule 14a-8(i)(8), fails to cure either contradiction. Most obviously, the proxy access rules would then not replicate the physical shareholder meeting.[78] More fundamentally, an opt-out approach is inconsistent with shareholder self-determination because the Commission would be presuming, without any supporting evidence, that a majority of shareholders at every corporation would prefer an opt-out approach over an opt-in approach.[79] Even worse, the Commission would, without any sup-

which directors are elected." Facilitating Shareholder Director Nominations, *supra* note 5, at 29029 n.70. The Mandatory Minimum Access Regime, however, prevents shareholders from exercising that right because it imposes a proxy access regime without regard to the will of the majority.

74. Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 Harv. L. Rev. 1784, 1787 (2006) [hereinafter Bebchuk, *Letting Shareholders*].

75. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 707 (2007) [hereinafter Bebchuk, *Shareholder Franchise*].

76. Bebchuk, *Increasing Shareholder Power*, *supra* note 72, at 867.

77. *Id*. at 869.

78. There is no proxy access provision with an opt-out in Delaware or in any other leading commercial state. The proxy access provisions recently adopted in North Dakota also fail to replicate the Commission's Proposed Rule, even if it is structured as an opt-out provision. *See* Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29029 n.70.

79. The opt-out approach would therefore fail to satisfy the basic conditions for the application of the principles of libertarian paternalism, even if the Commission sought to rely on that literature to support its Proposed Rules. *See generally* Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness (2008); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159 (2003); Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism*, Am. Econ. Rev., May 2003, at 175.

porting evidence, be assuming that a majority of shareholders at every corporation would prefer the precise form of default rule proposed by the Commission. Put another way, the Commission would, without any foundation, be assuming its conclusion that a majority of shareholders at every corporation would prefer its Mandatory Minimum Access Regime subject to an opt-out, over the alternative of being able to decide for themselves, ab initio, the rules governing proxy access.

E. Pending Legislation

Pending legislation would mandate that the Commission adopt regulations requiring that every publicly traded firm offer proxy access, subject to the constraint that the Commission may not require access for any shareholder or group of shareholders who have held less than "one percent of the voting securities of the issuer, [directly or indirectly,] . . . for at least the 2-year period preceding the date of the next scheduled annual meeting of the issuer."[80] This legislation, if adopted, would eliminate uncertainty regarding the Commission's statutory authority to adopt proxy access rules,[81] but it would not resolve the contradictions inherent in the Commission's Mandated Minimum Access Regime. The Proposed Rules would remain therefore highly vulnerable to challenge as arbitrary and capricious under the APA, even if they were adopted pursuant to the statutory authority that would be created pursuant to the pending legislation. Indeed, nothing in pending legislative language would preclude the Commission from adopting a fully enabling opt-in approach to proxy access.

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80. *See, e.g.*, Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 4 (proposing to amend Section 14A of the Exchange Act by adding a new section 14A(d)). The proposed section states as follows:

> (d) Confirmation of Commission Authority on Shareholder Access to Proxies for Board Nominations—
>
> > (1) COMMISSION RULES—The Commission shall establish rules relating to the use by shareholders of proxy solicitation materials supplied by the issuer for the purpose of nominating individuals to membership on the board of directors of an issuer.
> >
> > (2) SHAREHOLDER REQUIREMENTS—The rules of the Commission under this paragraph relating to the use by shareholders of proxy solicitation materials supplied by the issuer for the purpose of nominating individuals to membership on the board of directors of an issuer may not provide for such use, unless the shareholder, or a group of shareholders acting by agreement, has beneficially owned, directly or indirectly, an aggregate of not less than one percent of the voting securities of the issuer for at least the 2-year period preceding the date of the next scheduled annual meeting of the issuer.

Id. See also Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. § 2 (proposing to add a new Section 16A to the Exchange Act of 1934 with text that largely parallels the language of S. 1074).

81. The decision in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), raises questions regarding the Commission's authority to adopt proxy access rules. For more on this issue, see Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Address at the Society of Corporate Secretaries and Governance Professionals: The American Corporation and its Shareholders: Dooryard Visits Disallowed (June 27, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch062709ebw.htm).

IV. Proxy Access Politics: Megaphone Externalities, Electoral Leverage, and the Commission's Incentive to Avoid Majority Shareholder Votes

The proxy access debate is not an abstract academic controversy over the optimal structure of corporate governance regimes. It is a knockdown, drag-out political brawl. Political pressures exert significant influence over the Commission's decision-making process, and a complete analysis of the proxy access debate demands an objective assessment of the political forces currently operating on the Commission. Only a naïf would believe otherwise.

The battle lines are relatively simple. Labor unions and public pension funds are among the strongest proponents of proxy access.[82] They are primarily allied with the Democratic Party.[83] Certain corporations and corporate lobbying groups are among the most resolute opponents of proxy access.[84] They are primarily allied with the Republican Party.[85]

When Republicans controlled the Commission, corporate interest groups lobbied hard to stall any and all efforts to facilitate proxy access in any form.[86] Proxy access opponents prevailed and the Commission did nothing to facilitate proxy access while Republicans were in charge.[87] It is no small irony that many of these

82. *See* Letter from Richard L. Trumka, Sec'y, Am. Fed'n of Labor & Cong. of Indus. Org., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Aug. 10, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-105.pdf [hereinafter Trumka Letter] (While "[c]orporate interests have long expressed concerns that contested director elections would upset the collaborative dynamic of boardrooms[,] . . . [p]ension funds and other institutional investors have pressed the SEC for proxy access for several years."); *see also* Letter from Terence M. O'Sullivan, Gen. President, Laborers Int'l Union of N. Am., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 14, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-238.pdf [hereinafter O'Sullivan Letter]; Letter from Joseph A. Dear, Chief Inv. Officer, CalPERS, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 14, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-259.pdf [hereinafter Dear Letter].

83. *See* Melissa Klein Aguilar, *Chaos Reigns on Proxy Access Proposals*, Compliance Wk., Oct. 10, 2007, http://www.complianceweek.com/article/3706/chaos-reigns-on-proxy-access-proposals.

84. *See* Jefferey McCracken & Kara Scannell, *Fight Brews as Proxy Access Nears*, Wall St. J., Aug. 26, 2009, at C1 (noting that the "largest U.S. businesses, law firms and business groups have stepped up their challenge to the 'proxy access' rule").

85. *See* Aguilar, *supra* note 83 (noting that "[s]hareholder activists [were] especially concerned about the departure of the two Democratic commissioners . . . who supported proxy access" while leading business groups supported "Republican commissioners['] . . . position that companies can exclude shareholders' director nominations from the proxy").

86. *See id. See also* Letter from David T. Hirschmann, Vice President, U.S. Chamber of Commerce, to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n 10 (Oct. 2, 2007), *available at* http://www.sec.gov/comments/s7-16-07/s71607-482.pdf (warning that "proposals to permit shareholder access and to advance shareholder nominees will be advanced by the types of activist shareholders that traditionally have used the shareholder proposal mechanism for the promotion of parochial interests or political or social issues having little to do with the company's business"); Trumka Letter, *supra* note 82, at 2 (stating that previous attempts to implement proxy access reform "were thwarted by vigorous lobbying from business groups. [Among] [t]he most vocal of those opposing proxy access were the Business Roundtable, an association of the chief executives of the nation's largest corporations . . . .").

87. *See* Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29055 ("Currently, Rule 14a-8(i)(8) allows a company to exclude from its proxy statement a shareholder proposal that relates to a nomination or an election for membership on the company's board of directors or a

proxy access opponents could well regret their lobbying efforts today. Had the Commission years ago established an intellectually credible opt-in regime, consistent with state law, the political pressure in support of a Mandatory Minimum Access Regime, however structured, would almost certainly be greatly diminished.[88]

Today, however, the Democratic Party controls the Commission.[89] Labor unions and public pension funds are powerful interest groups within the Democratic Party and are pressing hard for the most expansive form of proxy access possible, much along the lines of the Commission's Mandatory Minimum Access Regime.[90] There is heavy political pressure on the agency to adopt the rules as proposed because even small modifications could, as explained below, dramatically reduce the value of the rules to labor unions and pension funds.

Three interrelated political forces are at work in the current political debate, and it is important to appreciate the interaction effects among these three forces. First, proxy access generates "megaphone externalities" that are exceptionally valuable to labor unions and public pension funds. These megaphone externalities describe the additional publicity that accrues, at very little cost, to shareholder groups that run their own board nominees advocating a particular cause. To generate megaphone externalities, a candidate need not even come close to winning. The candidate need only gain publicity for the act of running. Second, proxy access generates "electoral leverage" by giving candidates and their supporters the ability to extract concessions from some corporations as consideration for not nominating candidates, for withdrawing candidates, or for modulating their campaign positions, even if the candidate has no credible chance of prevailing. Third, unions and public pension funds understand that if the matter were put to a shareholder vote, there is a high probability that shareholders would not support access at thresholds that maximize megaphone externalities or electoral leverage. Special interest groups will therefore rationally seek to influence the

procedure for such nomination or election. . . . [T]he Commission amended this provision in 2007 to expressly permit the exclusion of a proposal that would result in an immediate election contest or would set up a process for shareholders to conduct an election contest in the future by requiring the company to include shareholders' director nominees in the company's proxy materials for subsequent meetings. The Commission adopted this proposal in December 2007 to provide certainty to companies and shareholders in light of the AFSCME decision.").

88. *See, e.g.*, ABA Comment Letter, *supra* note 5; Seven Firm Letter, *supra* note 5; DSBA letter, *supra* note 44.

89. *See* Stephen Labaton, *S.E.C. to Propose Change in Election of Boards*, N.Y. Times, May 19, 2009, at B3 (noting that "the two Republican commissioners . . . would most likely dissent" from proxy access proposals, but that Democratic-nominated Commissioners likely provided "three votes to overcome the opposition").

90. *See* O'Sullivan Letter, *supra* note 82, at 1 ("We strongly believe that shareholders must be given the right and ability to nominate and run candidates for board seats and we believe that the time has finally come for true and meaningful proxy access."); *see also* Dear Letter, *supra* note 82; McCracken & Scannell, *supra* note 84 (noting that "groups like institutional-investing giant Capital Research & Management Co., the California State Teachers' Retirement System, the Ohio and Colorado pension funds and some large unions" are pushing for the SEC to maintain proposed proxy access reforms that have received heavy criticism from business interests such as allowing shareholders to replace 25 percent of a company's board).

Commission to adopt mandatory rules that would not be supported by a shareholder majority.

To be sure, political constituencies are entirely within their rights to attempt to structure any Commission regulation so as to maximize private benefits at the expense of shareholder wealth maximization, the greater public good, or any other objective. But leading scholars have a different view of the matter. They "do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective . . . . From this perspective, increased shareholder power would be desirable only if it would operate to improve corporate performance and value."[91] The battle over megaphone externalities and electoral leverage, however, establishes a clear mechanism of action whereby proxy access can work to impair shareholder value, and thus underscores the value of a fully enabling approach that allows shareholders themselves to determine whether, when, and how proxy access might or might not be value enhancing.

A. Megaphone Externalities

Political candidates rationally spend time and money running in elections they expect to lose. They do it to make a point. They run for the publicity of running and for the chance to draw attention to their cause. They value public attention for its own sake, and the ability to garner that attention generates meaningful benefits for the candidate, even if the candidate is thoroughly thumped at the polls. Just ask Ralph Nader.[92] Or Ron Paul.[93]

Labor unions and state pension funds are no different. They are in a position to benefit from substantial megaphone externalities simply by running candidates who promote platforms popular with the unions' and pension funds' parochial, non-shareholder constituencies, even if those candidates do not have a remote chance of prevailing in a shareholder vote.

In today's environment, the simple act of running proxy access candidates is sure to gain significant press coverage. How many articles will the *New York Times* or the *Wall Street Journal* run about the first candidates to get proxy access, regardless of whether they prevail?[94] How much coverage will the press give to

91. Bebchuk, *Increasing Shareholder Power*, *supra* note 72, at 842–43. *See also* Bebchuk, *Shareholder Franchise*, *supra* note 75, at 678 ("[I]ncreased shareholder power to replace directors would be desirable if and only if such a change would improve corporate performance and value. . . . I do not view 'shareholder voice' and 'corporate democracy' as ends in themselves—or as a necessary corollary of the nature of shareholders' ownership rights."); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Law. 43, 44 (2003) [hereinafter Bebchuk, *The Case for Shareholder Access*] ("[I]ncreased shareholder power or participation would be desirable if and only if such a change would improve corporate performance and value.").

92. *See, e.g.*, Michael Janofsky, *Will Nader Run? It Depends in Part, He Says, on 2 Others*, N.Y. Times, July 11, 2003, at A10.

93. *See, e.g.*, Ryan Grim, *Ron Paul: The World's Most Popular U.S. Congressman*, Huffington Post, June 22, 2009, http://www.huffingtonpost.com/2009/06/22/ron-paul-the-worlds-most_n_217971.html.

94. *See, e.g.*, Gretchen Morgenson, *Elect a Dissident, and You May Win a Prize*, N.Y. Times, May 23, 2009, at BU1.

candidates with controversial or novel proposals for corporate governance even if their candidates are hopeless as an electoral matter? Consider a board candidate who wants to limit the export of jobs to foreign factories, or to close down foreign factories in order to bring manufacturing jobs back to America. Consider a candidate who wants to cap all executive salaries at a multiple of the average hourly wage of the rank and file. Consider a candidate who wants the company voluntarily to comply with emissions standards that reduce global warming but that place the corporation at a competitive disadvantage in the marketplace. Just think of the talking head opportunities on CNBC, CNN, Fox, or MSNBC. Any of these candidates will garner valuable, low-cost publicity for their cause, and the value of that publicity has essentially nothing to do with the probability of winning the election.

Viewed from the perspective of a labor leader or pension fund decision maker (who may also serve as an elected political official), proxy access is manna from heaven. A union leader seeking re-election by the rank and file can point to union-nominated proxy candidates who supported the union cause and gained publicity for that cause. The fact that the candidacies failed is irrelevant because the union leader scores points with the rank and file simply by making noise in support of the cause. Politicians serving on pension fund boards have similar incentives. Why not support a board nominee with no chance of election if simply supporting the nomination garners political support from constituencies important in political primaries or general elections and who are sympathetic to the failed nominees' agenda?

Megaphone externalities also explain why proxy access advocates fight so hard to keep the access threshold at 1 percent rather than at 3 or 5 percent. If a candidate can only garner 5 percent shareholder support to get on the corporate proxy, the odds of winning a board seat are, I suggest, quite low. If the candidate can only garner 1 percent, the odds of winning are even lower. Why then all the *Sturm und Drang* over the difference between a candidate who can only satisfy an essentially hopeless 1 percent threshold and a candidate who can satisfy a slightly less hopeless 5 percent threshold? The battle is so pitched because unions and pension funds rationally care about the cost of getting onto the ballot (i.e., the price of buying the megaphone) and not just the probability of prevailing. With a 1 percent threshold, advocates will be able to grab the megaphone pretty much whenever they like.[95] With a 3 or 5 percent threshold, unions and pension funds will need more cooperation from third parties who may not share their agendas. The megaphone then becomes much more expensive and the private benefits of proxy access to unions and pension funds decline.

From an academic perspective, it is valuable to note that megaphone externalities are private benefits that accrue to unions and pension funds, just as surely as membership on a board generates private benefits to individual directors in terms of prestige, or that service as a CEO generates non-cash emoluments. A rich

95. *See* Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29035.

academic literature explores the potential adverse effects of private benefits,[96] and megaphone externalities should be subject to equivalent analysis.

From a political perspective, megaphone externalities are either good news or bad news depending on the message you expect to be projected through the megaphone. If the message is consistent with your preferred political agenda, then it makes sense to support proxy access at low access thresholds, and not care whether any director is ever elected through this means. The will of the shareholder majority is irrelevant from this political perspective.

B. Electoral Leverage

Electoral leverage describes the ability to extract concessions from corporations because of proxy access. Electoral leverage arises through two distinct mechanisms of action. One is directed at the corporation. The other is directed at individual incumbent directors.

The public relations costs of dealing with megaphone externalities can make it entirely rational for management to offer concessions to proxy access candidates with no realistic chance of winning a board seat. The degree of electoral leverage is a function of management's sensitivity to the issue being advocated. If the issue relates to ongoing legislative battles or regulatory initiatives, particularly if the shareholder advocates are allied with forces that can be pivotal in the political or regulatory process, then managements may be more willing to make concessions. Similarly, if the corporation is unpopular, ensnared in litigation or regulatory proceedings, or requires shareholder approval for any significant pending initiative, electoral leverage is again enhanced.

If the megaphone externalities are directed at an individual incumbent director, then the calculus is more complex. The value of the concessions that the corporation will offer will depend on the directors' personal sensitivity to the attacks and the corporation's commitment to make that director comfortable—not the competing candidates' probability of victory, or the actual potential cost to the corporation itself. Targeting "eggshell directors" who are valued by incumbent boards or managements then becomes a rational strategy, again without regard to the probability of electoral success.

Safeway Corporation's 2003–2004 proxy fight with institutional investor CalPERS serves as an example of megaphone externalities and attempted electoral leverage. CalPERS, the pension fund for the state of California, was a major shareholder of Safeway.[97] The president of CalPERS' board, Sean Harrigan, was also the executive director of the United Food and Commercial Workers ("UFCW") union.[98] In 2003, the UFCW organized a strike against Safeway because the company had cut worker's healthcare benefits.[99] After the CalPERS board discussed

96. *See, e.g.*, Bebchuk, *Increasing Shareholder Power*, *supra* note 72, at 868.

97. *See* Jonathan Weil & Joann S. Lublin, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, Wall St. J., Dec. 1, 2004, at A1.

98. *See id.*

99. *See id.*

the UFCW and Safeway's ongoing contract negotiations, Harrigan, acting in his capacity as CalPERS' president and with the support of the CalPERS board, wrote Safeway's CEO Steven Burd, stressing that the company finish union negotiations "fairly and expeditiously" because "fair treatment of employees is a critical element in creating long-term value for shareholders."[100] Two months later, Harrigan led a union rally where he called Safeway "a bad investment" and demanded Burd's resignation.[101] A month later, CalPERS announced it would withhold support for the re-elections of Burd and two other Safeway directors.[102] Although Safeway "tried to mollify dissidents by announcing plans to replace three of its other directors," CalPERS was not satisfied, and joined with pension funds in Illinois, Connecticut, New York, and Massachusetts to wage a proxy fight.[103] In the end only 17 percent of Safeway's shares, CalPERS included, voted against the targeted directors.[104] The affair illustrates the value of megaphone externalities even in situations where the candidate does not come close to prevailing, and the ability to generate leverage as a corollary of megaphone externalities.[105]

C. Shareholder Politics and Commission Politics

A fully enabling opt-in regime is not very appealing to labor unions and public pension funds because they calculate, properly I believe, that shareholder majorities at many corporations will either not support proxy access at all, or would subject proxy access to trigger conditions higher than those that unions and public pension funds could easily satisfy on their own. The benefits of megaphone externalities and of electoral leverage could then be greatly attenuated compared to the benefits that would result from the Proposed Rules as currently constructed.

And therein lies a critical political observation. Labor unions and public pension funds would prefer to win the three-two vote at the Commission level, and impose a Mandatory Minimum Access Regime, than to rely on an authentically majoritarian approach under which they could lose the majority vote at the shareholder level. The well-worn politics of agency capture[106] are thus again at work at the SEC, and explain with precision how and why the SEC has crafted internally inconsistent Proposed Rules that marginalize authentic shareholder self-determination so as to maximize the megaphone externalities and electoral leverage that accrue to the benefit of favored constituencies.

100. *Id.*

101. *Id.*

102. *See id.*

103. James F. Peltz, *Investors Lose Bid to Oust Safeway Chief*, L.A. Times, May 21, 2004, at C1.

104. *See* Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS' Activism*, J. Investing, Winter 2007, at 66, 78.

105. The *Los Angeles Times* reported that "some of the dissidents had hoped Burd would be denied 25% or more of stockholders' votes," a goal far below a prevailing threshold. Peltz, *supra* note 103, at C1. The CalPERS board ultimately voted to remove Harrigan as a board member in December 2004 following scrutiny of Harridan's political activities. *See* Barber, *supra* note 104, at 78.

106. *See generally* Richard B. Stewart, *The Reformation of American Administrative Law*, 88 Harv. L. Rev. 1669, 1684–88 (1975) (describing the process by which interest groups use political influence to "capture" the agencies assigned to regulate them).

V. The Academic Perspective

A rich academic literature addresses the proxy access debate and the closely related debate over the optimal design of corporate default rules.[107] Significantly, there is a strong and broad academic consensus that immediately rejects the Commission's proposed Mandatory Minimum Access Regime. As described by leading scholars, "There is no dispute . . . that a substantial part (if not all) of corporate governance should be regulated in an enabling manner, allowing companies to choose the arrangement that will govern them."[108] This consensus arises in part because the literature proceeds "using the premise that market players and investors in any given company are more likely than public officials to identify the superior arrangement for their company."[109] Because the Commission's Mandated Minimum Access Regime expressly precludes reliance on an enabling approach, whether structured as an opt-in or as a symmetric opt-out protocol, the Proposed Rules stand well outside the norms prescribed by the academic canon. With regard to structuring the optimal enabling approach for a proxy access regime, there are at least two obvious approaches: a focus on a hypothetical bargain or a focus on a reversible default rule.

The hypothetical bargain is

> [a] natural and widely accepted approach . . . to try to assess which . . . arrangement[] would be more likely to serve shareholder value. Under this approach, when public officials are uncertain which of two possible arrangements would be value maximizing, they should determine which arrangement would more likely, in their judgment, be the one that, *if applied*, would maximize shareholder value. This question is equivalent to asking which arrangement fully informed and rational shareholders would have most likely chosen had they considered the question. This so-called "hypothetical bargains" approach seeks to identify what arrangement *would have been* most likely adopted by shareholders had they considered the matter when the company first went public.[110]

So how is the Commission, in the context of the proxy access debate, to determine whether the majority of shareholders would prefer the proposed Mandatory

107. *See generally* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815 (1991); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549 (1989); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Va. L. Rev. 757 (1995); Adrian Vermeule, *Interpretive Choice*, 75 N.Y.U. L. Rev. 74 (2000).

108. Lucian Arye Bebchuk & Assif Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw. U. L. Rev. 489, 496 (2002).

109. *Id.* at 497. The literature also observes that "[i]ssues for which public officials are likely to know better than market participants what the desirable arrangement is should be regulated by a mandatory rule and thus should be outside the scope of the theory of corporate law defaults," *id.*, but nothing in the literature or in the Proposing Release supports the conclusion that public officials know how to construct proxy access rules better than shareholders. Indeed, the literature is replete with examples of situations where shareholder choice is advocated as the preferred mechanism of action for decisions more profound than or quite similar to proxy access. *See, e.g.*, Bebchuk, *Letting Shareholders*, *supra* note 74.

110. Bebchuk & Hamdani, *supra* note 108, at 491 (emphasis added) (footnotes omitted).

Minimum Access Regime, a rule that facilitates opt-in proxy access regimes, or a rule that sets a default but then provides for a symmetric opt-out?

The short, irreverent response is that the Commission does not care about the answer to this question. The Proposing Release cites to no data and expresses no concern for the will of the shareholder majority. Instead, the Proposing Release cites data measuring the probability that one or two shareholders will be able to satisfy a 1 percent shareholder access trigger.[111] These data are relevant only if one cares about how cheap and easy it will be to generate megaphone externalities and electoral leverage for candidates with low probabilities of prevailing in an electoral contest. These data are entirely irrelevant to any assessment of the will of the shareholder majority. These data might therefore also constitute the administrative equivalent of a Freudian slip. By considering only the ease with which insurgents can mount campaigns, has the Commission displayed its animating agenda, which is to make access as easy as possible, without any regard to the will of the shareholder majority?

The more substantive response is that the Commission could simply ask shareholders. It could conduct a stratified random sample survey of America's shareholders inquiring about their preferences for a proxy access regime. Academics have long emphasized that "public officials have neither the information nor the resources to tailor different arrangements to the particular features of different companies,"[112] but this situation is not immutable.

The Commission might learn that shareholders prefer the proposed Mandatory Minimum Access Regime, though I would wager against that outcome. Alternatively, the Commission could learn that shareholders prefer an opt-in regime that allows them to propose and vote upon a range of proxy access regimes. Or, the Commission could learn that shareholders are comfortable with an opt-out regime, but with default values that differ from those suggested by the Commission. The Commission therefore need not regulate in the dark, or through a process of introspection that is subject to influence through the traditional dynamics of agency capture, if its objective is truly to replicate the will of the shareholder majority. If the Commission cares about the will of the shareholder majority, it could ask the shareholders. It is that simple.

Another theme in the academic literature suggests that default rules should be designed according to a "reversible defaults" principle.[113] This literature exists in two distinct strands. With respect to charter provisions and other governance rules that require board approval as a precondition to a shareholder vote, the literature emphasizes that in any such situation managements have "an effective veto power," and that "an optimal approach to designing default rules must take this asymmetry into account."[114] When the asymmetry is present, and "when public

111. Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29035–36.
112. Bebchuk, *Increasing Shareholder Power*, *supra* note 72, at 867.
113. Bebchuk & Hamdani, *supra* note 108, at 489.
114. *Id.* at 492.

officials face significant uncertainty about which choice would be value maximizing, a better strategy often would be to make the choice in a way designed to facilitate change in the event that the chosen default arrangement turns out to be disfavored by shareholders."[115] As a practical matter, this reversible defaults principle urges that in the presence of the electoral asymmetry and uncertainty, regulators should select the arrangement that is more restrictive of (or less preferred by) management because if that arrangement "then turns out to be inefficient, relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement."[116]

The reversible defaults principle leads to a different recommendation when the question presented involves a bylaw amendment that does not require director initiation, and therefore does not give management an "effective veto power," as is the case with proxy access proposals. There, the analysis focuses instead on whether collective action problems "can be expected to impede the initiation of bylaw amendments by shareholders."[117] These collective action problems are unlikely to arise "when the issue governed by the default arrangement is sufficiently important to shareholders."[118] Examples of issues that are sufficiently important include "takeover arrangements" where "the recent emergence of shareholder proposals to amend bylaws of public corporations in order to impose limits on the board's power to use the pill" indicates that collective action problems are not severe.[119]

There is little doubt that the proxy access debate is very important to shareholders, and that collective action costs are low. More than 500 comments have been submitted in the current rulemaking,[120] and more than 34,000 comments were submitted in prior rulemakings on the matter.[121] The subject has received extensive coverage in major press outlets,[122] and shareholders have repeatedly emphasized the importance of the issue.[123] The Commission has been vocal about the significance of the question.[124] Drafting proxy access proposals also imposes

115. *Id.*

116. *Id.* at 492–93.

117. *Id.* at 505.

118. *Id.*

119. *Id.*

120. *See* Jesse Westbrook, *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*, Bloomberg.com, Oct. 2, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a2ZCxme0W84Y.

121. Annette L. Nazareth, Comm'r, U.S. Sec. & Exch. Comm'n, Address at Open Meeting: Opening Statement—Shareholder Proposals Relating to the Election of Directors (Nov. 28, 2007) (transcript available at http://www.sec.gov/news/speech/2007/spch112807aln.htm).

122. *See, e.g.*, McCracken & Scannell, *supra* note 84; Labaton, *supra* note 89.

123. *See, e.g.*, Dear Letter, *supra* note 82.

124. *See, e.g.*, Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Opening Address to the Council of Institutional Investors (Apr. 6, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch040609mls.htm) ("I strongly believe that all of the items on [the SEC's] immediate agenda are direct responses to some of the many failures that have led us to this difficult point in time" including "proxy access [to make] boards more accountable for the risks undertaken by the companies they manage.").

little cost on proponents inasmuch as standard form proposals have already been drafted and are in the public domain,[125] and the Commission's own Proposed Rules can also serve as a template for a shareholder proposal to amend a corporation's bylaws. The ability to place proposals on corporate proxies is very well understood by shareholders: in 2008, shareholders presented more than 1,141 proposals at company meetings,[126] and qualification is so easy that even law professors are able to use the process.[127]

Under these circumstances, "on issues that are of sufficient importance to shareholders, the reversible defaults approach can be consistent with public officials choosing whichever arrangement they deem most likely to be value enhancing, provided that opting out via bylaw amendments be allowed."[128] Value enhancing rules are those that seek to "improve corporate performance and value," and not those adopted because they promote the private interests of political constituencies that might be influential with the Commission.[129] The symmetric structure of the opt-out is important because "[b]y allowing opting out via a bylaw amendment, public officials would ensure that, if the chosen default turned out to be value decreasing, shareholders would be able to reverse it easily and not be stuck with a value decreasing arrangement."[130] Thus, no formulation of the reversible defaults principle, even if read most aggressively as favoring proposed Rule 14a-11, would support an asymmetric opt-out, as currently proposed by the Commission's amendment to Rule 14a-8. And again, because of the uncertainty over the default rule that would be value enhancing, the easiest resolution that is immune to the influence of agency capture and special interest politics is simply to ask the shareholder base through a properly structured stratified random sample of the shareholder base. Introspection by the SEC will not be able to discern the arrangement that most improves "corporate performance and value."[131]

Viewed against this background, the Comment Letter of a Bi-Partisan Group of Eighty Professors of Law, Business, Economics, or Finance in Favor of Facilitating

125. *See generally* Comm. on Corporate Laws, *supra* note 53; ABA Comment Letter, *supra* note 5.

126. Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 6–7 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-263.pdf.

127. Lucian A. Bebchuk, 14a-(8) Proposal for Electronic Arts Proxy, http://www.law.harvard.edu/faculty/bebchuk/pdfs/Electronic-Arts-Precatory-Proposal.pdf (last visited Dec. 5, 2009).

128. Bebchuk & Hamdani, *supra* note 108, at 505–06.

129. *Id*. Leading academics take the position that "increased shareholder power or participation would be desirable if and only if such a change would improve corporate performance and value." Bebchuk, *The Case for Shareholder Access*, *supra* note 91, at 44. Simply amplifying "shareholder voice" is an insufficient objective by this metric unless it also improves "corporate performance." *See id*. at 44 n.4.

130. Bebchuk & Hamdani, *supra* note 108, at 506.

131. The libertarian paternalism literature suggests reliance on "the approach that the majority would choose if explicit choices were required and revealed," or an approach that "would force people to make their choices explicit," or the approach that "minimizes the number of opt-outs" that would occur from the designated default rule. *See, e.g.*, Thaler & Sunstein, *Libertarian Paternalism*, *supra* note 79, at 178–79. The stratified sample approach is entirely consistent with the prescriptions provided by libertarian paternalism.

Shareholder Director Nominations[132] is a bit mysterious. The Eighty Professors Letter states that "[a]ll of the Submitting Professors urge the SEC to adopt a final rule based on the SEC's current proposals, and to do so without adopting modifications that could dilute the value of the rule to public investors."[133] Does this locution support the Proposed Rules without any amendment, thereby creating an asymmetric opt-out notwithstanding the lack of support for this approach in the academic literature? Or does this locution support a modification of the Proposed Rule to allow a symmetric opt-out on the rationale that such an amendment would not dilute the value of the rule to public investors but would instead enhance the value of the rule? Or, does this locution support the adoption of higher shareholder thresholds, again on the rationale that these higher thresholds would not dilute the value of the rule to shareholders, depending perhaps on the level at which the thresholds are set? Or, does this locution support eighty different modifications consistent with eighty different interpretations of amendments that dilute the value of the rule to public investors?

The Eighty Professors Letter also observes that

> [p]roviding shareholders with minimum rights of access to the company's proxy card, and allowing companies to provide shareholders with additional rights but not to take away the set minimum, is consistent with the long-standing and established role of the proxy rules (and the securities laws in general) and the division of labor between them and state corporate law. The proxy rules . . . have long provided mandatory arrangements . . . with companies being free to add additional protections but not to reduce investors' protections below the established minimum.[134]

But even if correct as a descriptive matter, this statement utterly fails as a prescriptive matter. It does not explain why a mandatory default rule with an asymmetric opt-out is the social optimum for any aspect of the proxy rules, much less for the pending proxy access rule. Indeed, the academic literature repeatedly states a case against the asymmetric opt-out approach embedded in the Commission's Mandatory Minimum Access Regime.[135]

The Eighty Professors Letter further observes that

> [i]n evaluating eligibility and procedural requirements, the SEC should also keep in mind that many institutional investors lack incentives to invest actively in seeking governance benefits that would be shared by their fellow shareholders. Accordingly, the final design of the rule should avoid imposing any unnecessary hurdles or costs on shareholders organizing or joining a nominating group.[136]

132. Eighty Professors Letter, *supra* note 22.

133. *Id.* at 1.

134. *Id.* at 2.

135. *See, e.g.*, Bebchuk, *Shareholder Franchise*, *supra* note 75, at 677 ("Whatever default arrangements public officials choose, they should at a minimum facilitate shareholder adoption of bylaws opting out of these arrangements."); Bebchuk, *The Case for Shareholder Access*, *supra* note 91, at 59 (arguing that if "one size does not fit all" then "the adopted SEC rule should leave firms free to opt out of the rule with shareholder approval").

136. Eighty Professors Letter, *supra* note 22, at 2.

To the extent this statement intends to suggest that significant collective action costs might support an opt-out default rule for proxy access, the fact that "many institutional investors lack incentives" to engage in governance activism does not negate the obviously correct proposition that a very large group of institutional investors have very strong incentives to engage in powerful forms of governance activism, and have indeed invested heavily in these activities in promoting proxy access. Nor does this statement negate the observation that proxy access rules can generate valuable megaphone externalities and electoral leverage that constitute private benefits to special interest shareholder constituencies. Nor does it contest the conclusion that collective action costs in the case of proxy access are sufficiently low as to negate application of a restrictive approach pursuant to the reversible defaults rule. The mystery of the meaning of the Eighty Professors Letter is thus again magnified.

VI. Other Mechanisms for Enhancing Shareholder Voice: "Just Vote No," Majority Voting, and Proxy Reimbursement

To be sure, the Commission may be disappointed that it cannot adopt proxy access regulations as intrusive as it would like while still passing muster under the APA. The Commission may therefore want to consider alternative means of strengthening shareholder voice that can withstand judicial review. A fully enabling approach can be useful to promote many of these additional governance initiatives.

Recent research finds "consistent evidence across a broad set of measures suggesting that on average [just vote no] campaigns are effective in spurring boards to act. The typical campaign target has significant post-campaign operating performance improvements."[137] Further, in "campaigns motivated by firm performance and strategy reasons, . . . boards take a variety of value-enhancing actions: 31% of these targets experience disciplinary CEO turnover and 50% of the remaining targets that do not dismiss the CEO make other strategic changes."[138] These benefits arise even if no director is ousted from the board as a consequence of a majority no vote. The empirical evidence thus demonstrates, as has long been suggested, that "just vote no" campaigns can be highly efficient, low-cost mechanisms for the positive expression of shareholder voice, notwithstanding their precatory nature.[139] Boards are thus not impervious to the expression of shareholder disaffection even if shareholders lack the power to oust any director or to place their own nominees on the corporate ballot.

137. Diane Del Guercio, Laura Seery & Tracie Woidtke, *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?*, 90 J. Fin. Econ. 84, 85 (2008).

138. *Id.* at 86.

139. *See* Joseph A. Grundfest, *"Just Vote No": A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 Stan. L. Rev. 857, 865–66 (1993).

Recent data suggest that "just vote no" campaigns are gaining steam among shareholders.[140] The percentage of directors standing unopposed who had at least 20 percent of votes cast marked to withhold authority for their re-election increased from 5.5 percent in 2008 to 9.8 percent in 2009.[141] The percentage of directors with 40 percent of votes marked to withhold authority increased from 1 percent in 2008 to 2.1 percent in 2009.[142] A total of eighty-four directors at forty-eight companies failed to garner majority support through August of 2009, triple the incidence observed in 2008.[143] The fact that only a small number of directors receive a majority of votes withheld, or that directors continue to serve even with a strong expression of disapproval, does not suggest that "just vote no" campaigns have failed. As described above, even failed campaigns can significantly increase shareholder value because these campaigns appear to instigate other forms of value-enhancing governance reform.

For example, Dollar Tree's lead director received 50.5 percent withheld votes in June of 2008.[144] The board observed that shareholder disapproval was based on disaffection with its classified board structure.[145] The board decided to recommend declassifying its board at its 2010 annual election, and rejected the director's offer to resign, which was made in accordance with its majority vote policy.[146] A similar pattern emerged at Pulte Homes where, after three directors received a majority of withheld votes, the board determined to phase out its classified board.[147]

The Commission may therefore want to consider measures that facilitate the operation and effectiveness of "just vote no" campaigns. It could relax the rules governing communication among shareholders seeking to organize precatory "just vote no" campaigns. It could also impose additional disclosure and communication requirements on registrants with directors who have a majority of votes withheld, regardless of whether the corporation has a majority vote policy.

Majority voting has spread rapidly and widely in corporate America, but remains concentrated among larger publicly traded corporations.[148] If the Commission seeks to promote the adoption of certain forms of majority voting, it could impose additional disclosure and communication requirements on registrants who fail to satisfy specified majority voting standards.[149] The Commission could

140. *See* Gretchen Morgenson, *Too Many 'No' Votes to Be Ignored*, N.Y. TIMES, Sept. 20, 2009, at BU1.
141. *Id.*
142. *Id.*
143. *ee id. See also* Jabulani Leffall, *Withheld: The Directors' Cut*, SHARKREPELLENT.NET, Oct. 1, 2009, https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20090930.html&Withheld_the_directors_cut&rnd=733988.
144. Kristin Gribben, *Trouble Looms for Director Elections*, AGENDA, Oct. 5, 2009, http://www.agendaweek.com/articles/20091005/trouble_looms_director_elections (subscription only).
145. *Id.*
146. *Id.*
147. *Id.*
148. *See* Facilitating Shareholder Director Nominations, *supra* note 5, 74 Fed. Reg. at 29029.
149. For a discussion of the relative benefits of majority voting regimes over proxy access regimes, see Joseph A. Grundfest, *The Wizard of Oz, the United States Constitution, and Corporate Governance* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 9, 2007), *available at* http://ssrn.com/abstract=1028424.

attempt to support these additional disclosure and communication requirements, in registration statements and in periodic filings, on the rationale that the lack of a majority vote provision creates governance risks that warrant heightened shareholder scrutiny. However, if Congress mandates majority voting,[150] then there would be no need for such action by the Commission.

Scholars have also called for situational reimbursement of insurgent expenses incurred in mounting a proxy campaign, but with differing views as to the optimal structure of these reimbursement rules.[151] Again, the Commission has no special insight as to the optimal structure of these rules at any corporation, and a fully enabling approach would allow shareholders to determine the optimal arrangement for their corporation. An expanded rulemaking could easily encompass an opt-in proxy reimbursement proposal alongside a proxy access proposal.

VII. Choosing Proxy Rules

The companion article in this issue by Lucian Bebchuk and Scott Hirst, *Private Ordering and the Proxy Access Debate* ("*Private Ordering*"),[152] addresses a select set of "meta" issues raised by the Commission's rulemaking. *Private Ordering* prefers a mandatory proxy access regime with symmetric opt-out over the Commission's Mandatory Minimum Access Regime or any opt-in regime.[153] The logic of *Private Ordering*, however, raises at least as many questions as it answers.

First, *Private Ordering* concurs with large portions of this Article's analysis rejecting the Commission's asymmetric opt-out structure.[154] *Private Ordering* also repudiates the Eighty Professors' support of asymmetric opt-outs, and underscores the extent to which that comment letter deviates from mainstream scholarship.[155] *Private Ordering* fails, however, to explain how one of its co-authors can also serve as primary signatory of the Eighty Professors Letter. *Private Ordering* thereby compounds the contradictions in the administrative record that might be cited in support of the Commission's proposal.

Private Ordering also fails to address core contradictions between the Commission's Proposing Release and its Proposed Rules. The Commission asserts that the Proposed Rules facilitate shareholders' ability to exercise existing state law rights through the federal proxy process,[156] but provides no example of any state

150. *See*, *e.g.*, Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 5; Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. § 2.

151. *See*, *e.g.*, Bebchuk, *Shareholder Franchise*, *supra* note 75, at 697–700; Bebchuk, *The Case for Shareholder Access*, *supra* note 91, at 64–65; Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Toward Proxy Contests*, 78 Cal. L. Rev. 1071, 1096–1100 (1990). Section 113 of the Delaware General Corporation Law was recently added expressly to permit bylaw provisions providing for corporate reimbursement of shareholder proxy solicitation expenses, and is not contingent on shareholder access to the corporate proxy. 2009 Del. Laws ch. 14, § 2 (Apr. 10, 2009) (H.B. 19) (West) (to be codified at Del. Code Ann. tit. 8, § 113).

152. 65 Bus. Law. ___ (2009).

153. *Id.* at ___.

154. *Id.* at ___.

155. *Id.*at ___.

156. *See supra* Part III.B.

law that replicates its proposed Mandatory Minimum Access Regime. In contrast, *Private Ordering* makes no pretense that its proposal comports with existing state law and tacitly concedes an essential point that the Commission tries to sweep under the rug: any mandatory proxy access rule, whether subject to a symmetric or asymmetric opt-out, constitutes a dramatic deviation from current state law practice and substitutes federal proxy law for state law governing internal governance processes.

Regarding the mechanics of proxy access, *Private Ordering* explicitly concedes its own "uncertainty about the eligibility thresholds that would be optimal for proxy access in any given company."[157] This same uncertainty motivates this Article's suggestion that the Commission not proceed with a mandatory access default rule (regardless of whether the opt-out is symmetric or asymmetric) without first conducting a scientifically designed stratified random sample survey of the shareholder population to ascertain shareholder preferences regarding the optimal structure of proxy access default rules. This survey would not be subject to the collective action or management-bias problems that animate *Private Ordering's* preference for a mandatory access regime. The survey would also be immune to the agency capture issues that can adversely influence the Commission's reliance on introspective processes. Indeed, the dominant theme in the academic literature suggests that default rules should replicate the decision that would maximize shareholder welfare, not the decision most inimical to incumbent managerial and directorial interests, on the premise that shareholders can then opt out of those constraints.[158] Therefore, even if one accepts the logic proposed by *Private Ordering*, which is a minority position in the literature, social welfare would be enhanced by setting the initial default value at the level preferred by shareholders rather than at a hypothetical extreme value, because the preferred default value would minimize transactions costs.[159] Moreover, if the Commission adopts an

157. Bebchuk & Hirst, *supra* note 152, at ___.

158. *See supra* notes 107–09.

159. *Private Ordering* relies on the obviously incorrect assumption that there are no transactions costs associated with its opt-out mechanism. It is therefore vulnerable to all of the traditional transactions cost critiques leveled against the friction-free analysis of the Coase Theorem. Indeed, Coase himself observed that the proper response to a situation in which transaction costs are high is that courts should make the initial assignment of rights so as to maximize total social wealth. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960). Therefore, as long as the costs of conducting the proposed survey are less than the transactions costs generated by the need to rely on thousands of corporations to structure opt-out votes regarding the proposed extreme low-threshold proxy access mechanism, the survey mechanism should lead to a socially superior outcome. To be sure, precisely the same logic can be used to argue that the survey mechanism is also superior to the opt-in approach advocated in this Article. One difference, however, relates to the state of the administrative record, rather than to the pure logic of any proposal. Given the administrative record established to date, if the Commission is to be consistent with the mandates of state law and true to the principles underlying shareholder access, it is constrained to follow an opt-in rule. If the Commission is willing to renounce these and other assertions regarding the rationale for and operation of its proposed proxy access rules, then the Commission could construct an argument for a survey-driven mechanism for setting default rules. No logic, however, supports the Commission's proposed Mandatory Minimum Proxy Access Rules, and *Private Ordering* demonstrates as much regardless of the state of the record.

opt-in regime then shareholders would be able to select the optimal proxy access thresholds for themselves, and avoid the uncertainty inherent in any governmental effort to impose a default value.

Put another way, because the Commission does not know the optimal default rule for purposes of designing a proxy access regime (and *Private Ordering* suggests that no one knows the optimal structure of the default rule), it is entirely rational that the agency take the simple step of surveying the relevant population to ascertain its preferences. An administrative record generated by constituencies with the strongest vested interests on either side of the question is not a rational substitute for a dispassionate survey.

Private Ordering also relies extensively on a large body of academic literature suggesting that greater directorial sensitivity to shareholder preferences improves corporate performance.[160] This literature is, however, not squarely on point with regard to the question presented by the proxy access debate. Low-threshold proxy access, as is proposed by the Commission, raises the possibility of megaphone effects and electoral leverage that are nowhere discussed in *Private Ordering*.[161] These negative externalities could reduce aggregate shareholder value while promoting the agendas of special interest constituencies that run candidates who have no credible chance of gaining shareholder support or of increasing shareholder value. The literature cited in *Private Ordering* deals instead with governance measures (such as the elimination of classified boards and of poison pills) that would uniformly increase shareholder value without raising the potential negative share price externalities that accompany low-threshold proxy access regimes. The empirical literature thus fails to support the proposition for which it is cited in *Private Ordering*, and rational shareholders could simultaneously support elimination of classified boards and poison pills while opposing low-threshold proxy access mandates of the sort that the Commission seeks to impose.

These observations regarding *Private Ordering* and its underlying rationale are not exhaustive. They are intended only to suggest that the logic and empirical support underlying the conclusion presented in *Private Ordering* are highly contestable and that a fully enabling opt-in approach constitutes a rational, preferable alternative, particularly given the current state of the administrative record.

VIII. Conclusion

While "foolish consistency" may be the "hobgoblin of little minds,"[162] the inconsistencies between the Proposing Release and the Proposed Rules are far from foolish. They are fundamental to the Commission's enterprise. They are also likely fatal to the Proposed Rules under the Administrative Procedure Act. The inconsistencies can, however, be cured by revising the Proposed Rules so that they

160. Bebchuk & Hirst, *supra* note 152, at ___.

161. *See supra* Part IV.

162. Ralph Waldo Emerson, *Self Reliance*, *in* The Complete Essays of Ralph Waldo Emerson 152, 152 (Brooks Atkinson ed., 1940).

constitute fully enabling provisions that allow a majority of shareholders to adopt a wide range of proxy access rules through an opt-in mechanism.[163]

The inconsistencies that characterize the Commission's approach are, however, readily explained as the consequence of a political process common in Washington, D.C. Consistent with the agency capture literature, the Proposed Rules generate megaphone externalities and electoral leverage for the benefit of constituencies allied with the currently dominant political force. They do so even at the expense of the will of the shareholder majority. From this perspective, the Proposed Rules have nothing to do with shareholder wealth maximization or optimal governance, and everything to do with a traditional contest for economic rents common to political brawls in Washington, D.C.

From an economic and public policy perspective, if the Commission determines to implement an opt-out approach to proxy access, despite the observation that this approach is suboptimal, it then confronts the difficult problem of defining the optimal proxy access default rule that should be subject to a symmetric opt-out by shareholder majority (not the asymmetric opt-out imposed by the Mandatory Minimum Access Regime, for which there is no support in the academic literature). The administrative record currently contains no information that would allow the Commission objectively to assess the preferences of the shareholder majority regarding proxy access at any publicly traded corporation. To address this gap in the record, the Commission should, if it determines to follow an opt-out strategy, conduct a properly designed stratified random sample of the shareholder base. It should then rely on the results of that survey to set appropriate default proxy access rules. The Commission's powers of introspection are insufficient to divine the value-maximizing will of the different shareholder majorities at each corporation subject to the agency's authority.

163. This Article's analysis does not address the full range of problems generated by the Commission's Proposed Rules. For example, it does not consider the myriad operational difficulties raised by the Commission's proposals; the adequacy of the rationale supporting the Commission's view that proxy access is the optimal means of enhancing shareholder voice; the evidence (or lack thereof) supporting the view that the current economic crisis is caused, to any material degree, by a lack of proxy access; or the Commission's ability successfully to conduct a section 3(f) analysis of its Proposed Rules. *See supra* note 69 and accompanying text. A summary of the argument that proxy access is not the optimal means of addressing the problem of shareholder voice can be found in Grundfest, *supra* note 149. Counterfactual analysis is likely to suggest that, even if proxy access rules were in place prior to the recent economic crisis, the crisis would neither have been averted nor ameliorated to any material degree. For a description of this form of analysis see, for example, Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 Wis. L. Rev. 199.