**STATE BOARD OF ADMINISTRATION
OF FLORIDA**

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January 19, 2010

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

Re: File No. S7-10-09: Facilitating Shareowner Director Nominations

Dear Secretary Murphy:

I am writing on behalf of the Florida State Board of Administration (SBA) to express our support for the proposed rules for facilitating shareowner director nominations and provide comment on the matters discussed therein. The SBA believes the proposed rules represent a key development in the progress of shareowner rights. The SBA manages the Florida Retirement System (FRS) on behalf of 1.1 million beneficiaries and retirees. In combination with our other mandates, SBA assets under management total approximately $140 billion.

The SBA encourages the Commission to implement proxy access, with some comments on the Commission's rule release noted in our letter of August 17, 2009. For the reasons in our prior letter and those listed below, we believe universally-applied, facilitated nominations will result in stronger boards, higher performing companies, and better investor protection.

We support the universal application of the Commission's facilitated nomination rules. We agree that shareowners should have potential for a larger role in the nomination of directors, subject to ownership and holding requirements. We view facilitated nominations as similar to shareowner proposals. Both simply require the inclusion of a shareowner-suggested item in the company proxy for presentation of a vote. Shareowner proposals cover a variety of governance mechanisms; facilitated nominations would allow presentation of a candidate for the board from a shareowner or group having substantial equity ownership of at least one percent (or more at mid-sized and smaller companies) and maintaining their investment for at least one year.

We favor universal application of facilitated nominations in the same way we favor universal application of shareowner proposal eligibility. Were we now considering the adoption of Rule 14a-8 for making shareowner proposals, certainly we would hear the same arguments against the process, including that the Commission has overstepped its bounds and that private ordering would be a better system. Even with substantially lower ownership requirements, the shareowner proposals enabled under Rule 14a-8 result in proposals at only a small minority of companies each year. And a system of private ordering would lead to a number of problems. It would be intensely time-consuming and expensive, as individuals at each company would be required to expend considerable effort in crafting and promoting their own system, and within the 500-word limit allowed for proposal descriptions. It would leave diversified investors with a complex myriad of rules to decipher at each portfolio company. Additionally, some companies have significant hurdles that affect or eliminate shareowners' ability to even make such a proposal in the form of a binding bylaw, raising the probability that a precatory vote would be ignored by the company board. Facilitated nominations as proposed by the Commission are a much preferable and efficient system, and the fact that it mirrors the proposal system currently in place, but with more stringent ownership requirements, leads us to believe the implementation and use of the rule will be highly effective.

Without universal application of this rule, investors at most companies will go years or decades without meaningful ability to nominate directors. Supermajority voting requirements at a substantial portion of companies and the inability for shareowners to propose bylaw amendments at some companies pose as considerable obstacles to private ordering. The Commission should move forward with a universal application of facilitated nominations and simply allow the shareowners to vote on the fitness of the candidates that arise as a result.

The Commission has asked for comments on data and analyses submitted in response to its release. Comments on each submission are provided in numbered sections below.

I. *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation, in Support of Comments by Business Roundtable*, NERA Economic Consulting, August 17, 2009

This work was submitted for inclusion in the public comment file on August 17, 2009, by the Business Roundtable. We respond in turn to each point made in the analysis.

II.A. "The market provides multiple means of management discipline." – The analysis highlights research concerning CEO and management discipline, not that of the board. The facilitated nominations deal with owners' ability to select their representatives, who will ideally monitor management so that market discipline is avoided.

II.B. "Managers associated with wrongdoing are ousted." – This analysis highlights the fact that 93 percent of managers associated with enforcement actions from the Commission and the Department of Justice lose their jobs, with 62 percent being fired. These are the most egregious of cases cited from a paper studying managers involved with financial misrepresentation. We do not believe this is a rationale for why shareowners should not have greater ability to participate in choosing candidates for board elections.

II.C. The low frequency of contested elections "suggests they are rarely needed." – In fact, the low frequency is explained by the large cost that must be undertaken now by shareowners wishing to nominate a candidate for election. They will bear all of the cost, yet share proportionately with all other shareowners in the gains according to their level of holdings. This is a well-known collective action phenomenon, and it suggests that contests are an inefficient mechanism for instituting board change when necessary.[1] The costs arising from the collective action problem are inversely proportional to holdings of the owner initiating the contest; therefore, we frequently see contests proposed by owners with quite large holdings of stock and infrequently see contests initiated by owners of smaller amounts (e.g. under five percent). There are many more cases where board change is warranted, but no significant shareowner is willing to undertake the substantial cost to act.

II.D. "Contesting elections is not expensive." – The research cites an average cost reported by Automatic Data Processing of $368,000. This figure strikes us as both significantly prohibitive to many investors, including potential institutional investor nominations from parties or groups such as ourselves, and also appears quite low. The authors go on to argue that costs would only fall $18,000, or five percent, due to printing and postage, that investors can further mitigate costs of proxy contests by collaborating, and that costs could also be reduced by reliance on electronic proxy distribution. We agree that costs can be contained in this manner; however, we feel that owners should have the right to place a nominee on the corporate proxy in the same manner that shareowner proposals can be made. To the extent that many of these proposals, and expectedly that many of the director nominees, will be of sufficient quality to win endorsement by the majority, it behooves all owners to share the marginal costs, which should be minimal, of printing these items in the annual company proxy.

[1] Bebchuk, Lucian A., "The Myth of the Shareholder Franchise," November 2006 Discussion Paper, John M. Olin Center for Law, Economics and Business, Harvard.

III.A. "The proposal would inefficiently allocate the benefits and costs of proxy contests." – In the prior section, the authors argued that the proposal would save merely $18,000 in printing costs to the wager of a proxy contest. We expect the marginal costs to the company would be even less, as their costs already include printing and postage. Here they suggest that the proposal will cause "significant costs on fellow shareowners." They predict that company subsidization of costs will lead to excessive nominations. However, the difference is that now those costs are being subsidized solely by another shareowner in a contest. To the extent that all owners benefit from a necessary board change, all should be involved in paying that cost. It is the system in place now that is inefficiently allocating the costs of remedying a significant problem within the board on behalf of all owners.

III.B.1. "Companies with dissident board members substantially underperform compared to their peers." – Recent research published by the Investor Responsibility Research Center Institute (IRRC) suggests otherwise. The authors suggest studies which are each at least 15 years of age to bolster this claim. The IRRC research is timely and the results directly contradict their conclusion.[2]

III.B.2. "Board skill composition will be adversely affected." – The authors claim that academic studies recognize that shareowners have little incentive to carefully weigh proxy contest choices and, as a result, inferior candidates may win. They cite no studies to support this claim. This strikes us as overly paternalistic and in the absence of research, we rely on our own experiences in proxy contest voting and outcomes, which suggest shareowners are actually very careful and hesitant to elect dissident candidates—the Florida SBA's voting patterns actually reflects considerably lower support for dissident nominees than for company nominated director candidates.[3] The authors also suppose that activist shareowners may select candidates with different objectives and agendas than other owners. The simple outcome of this event is that owners will not elect special interest candidates. Only qualified directors and well-designed, appropriate proposals are well received by the shareowner electorate. Both arguments imply that owners are not sophisticated enough to rationally cast votes. If true, the entire voting framework for corporate elections would fail. We see no evidence of such problems.

III.B.3. "Shareowners will nominate candidates to advance agendas at odds with shareowner value." – The authors state the Commission unrealistically intends for shareowners to nominate candidates who will only work collegially and contribute positively to management and shareowner value. We believe the Commission has clearly stated its intent is to allow owners the potential to participate in the nomination of the directors that will serve their interests, and not simply ratify those selected by the board or management in every case. There is no guarantee that any board member, regardless of nomination source, will be collegial or effective. However, the authors point to hedge funds and unions as advancing short-term interests or special agendas as a matter of illustrating their point. The simple outcome is that those nominees will not be elected.

III.B.4. "The proposal's first-come, first-served rule will fail to select the best-qualified shareowner nominee." – We agree that the first-come, first-served rule is not optimal and suggested other frameworks in our August 17, 2009, letter, as did many investors in favor of the proposal overall. Other mechanisms can be applied to make the process more efficient while still limiting the number of eligible submissions to a reasonably small number.

III.B.5. "Higher share ownership thresholds for nomination would mitigate incentive problems and negative effects on board quality." – The authors aggregate the top five and top 10 institutions to illustrate how higher thresholds would be attainable yet limit nominations. The evidence provided by the Commission's Division of Risk, Strategy, and Financial Innovation shows that the proposal's thresholds are already of sufficient measure to ensure the proposal would not be overused or abused. It is well known that the top five and top 10 institutional investors tend to be investment banks reporting aggregated positions, and that these investors are extremely limited in shareowner activities beyond casting votes. The potential use of nomination provisions is greatly overestimated by

[2] Cernich, Chris, Fenn, Scott, Anderson, Michael, and Westcott, Shirley, "Effectiveness of Hybrid Boards," May 25, 2009, Investor Responsibility Research Center Institute, available at http://www.irrcinstitute.org/projects.php?project=36

[3] During fiscal year 2009 the SBA voted in favor of approximately 71 percent of all uncontested director nominees, whereas votes in favor of management-opposed dissident candidates stood at only 32 percent.

applying ownership thresholds to these investors. The statistics compiled and reported by the Council of Institutional Investors are also more likely than those reported here to accurately predict the use of the provisions.

III.C. The proposal does not distinguish between expressing disapproval of an incumbent and "electing an outside insurgent director." – The authors state that the Commission's proposal goes well beyond simply enhancing investor dissatisfaction with incumbent directors. We agree. The goal is to provide more meaningful elections. Investors already have mechanisms to adequately express disapproval.

III.D. "Companies will incur additional efficiency costs to evaluate shareowner-nominated candidates." – While the authors previously stated that the cost of a proxy contest was below $400,000 on average to the dissident shareowners, they now cite statistics from a Business Roundtable survey that the company will spend approximately $1,160,000 "for the services of outside professionals, as well as approximately 300 hours of company personnel and director time" due to inclusion of a shareowner nominee. There is no mention of how much of this cost is voluntary, and indeed, we expect that the facilitated nomination process would eliminate much of the likely legal wrangling that might have otherwise ensued. If the cost of printing and postage to the dissident nominee was a mere $18,000, we are inclined to believe that much of the above cost cited in the survey of companies was voluntary spending and that "outside professionals" such as lawyer fees would be minimized.

IV. "The proposal will render U.S. equity markets less competitive with foreign markets." – It is unlikely that additional candidate choices could make an election outcome worse. Only narrowing an election field is likely to have that effect. Voters will select the best candidates. The proposal appropriately narrows the ability of shareowners to nominate candidates so as not to overwhelm or disrupt the election.

IV.A. "U.S. equity market competitiveness has already been impaired by high regulatory costs." – We do not share their expectation of increased costs to companies, and we see potential for significant benefit that could increase our market competitiveness.

IV.B. "Private placement and private equity financing have grown at the expense of the public equity market." – We see no evidence that this proposal will add to the regulatory burden of public ownership, as the authors' state. As a public firm, a company agrees to allow shareowners to elect directors. This is made less meaningful when they have no corresponding ability to nominate. This proposal simply facilitates nominations.

V. "The proposal will undermine competitiveness and capital formation at the company level." – Rather than serve as a deterrent to participating in the public markets, the requirement to move control from the founders is a hallmark condition of the process. We hope the response from companies to this proposal will be more thoughtful board selection and more appropriate responsiveness to shareowner concerns.

VI. "The benefits predicted by the SEC will be at best small, and possibly prove to be costly rather than beneficial." – We believe that the direct benefits of this proposal will be to substantially improve elections, and the indirect benefits will be for companies to improve their responsiveness to owners and more careful selection in board nominees. The threat of shareowner nominees alone may be enough to increase board quality.

II. *Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation* by Andrea Beltratti and René M. Stulz, July 2009

This work was submitted for inclusion in the public comment file on September 11, 2009, by John J. Castellani, President of The Business Roundtable. The work finds poorer performance among "shareowner friendly" boards, as measured using indices derived from a commercially available governance rating, tailored in academic works to proxy for company-level governance. To our knowledge, none of the directors at the banks used in this research were nominated by shareowners or elected by contest. Therefore, this analysis has very little to contribute toward the discussion of proxy access or director choice. Since these directors were elected under the traditional system, it bears no additional insight on board risks that would arise as a result of proxy access. If shareowners more frequently had choices among director candidates, the effects would potentially be positive, but unfortunately, this academic work is unable to address any questions or hypotheses relevant to the issue of proxy access. However, this work may be helpful to the Commission in its other work evaluating regulatory reform and oversight for the banking industry, as is called for in the Commission's other duties.

The submission of this material appears to have been made to support the view held by the Business Roundtable that proxy access may exacerbate "short-termism", a potential consequence noted in their letter on the proxy access proposal of August 17, 2009, since this particular research paper contains analysis of bank performance during the recent credit crisis in relation to variables for governance and bank characteristics. However, in their analysis for company-level governance factors, the authors note that a particular governance attribute "can be valuable for one firm but also can destroy wealth in another firm, so that on theoretical grounds there is no necessary relation between governance indices and firm value. The literature has also questioned whether governance indices measure the right governance attributes. A further difficulty is that, as noted by Adams and Mehran (2003) for the U.S., regulation typically affects governance more for financial institutions than it does for other firms. In this paper, our ambition in using the governance attributes of the CGQ rankings is limited."

The question of whether good governance has demonstrable value is more fully examined in many other works of research.[4] This particular analysis is limited to one industry, during one short time period of unprecedented stress in which the authors measured governance using academically-generated indices derived from just one of several commercially available governance indices, the CGQ ratings. We believe a full analysis of the academic evidence supports the connection between good governance practices and performance in a strong and robust manner. We fail to see illumination on the issue of proxy access resulting from the inclusion of this work in the public file.

III. *The Limits of Private Ordering: Restrictions on Shareowners' Ability to Initiate Governance Change and Distortions of the Shareowner Voting Process*, The Corporate Library

The Shareowner Education Network and the Council of Institutional Investors submitted this work on November 18, 2009. It aptly demonstrates that making shareowner bylaw amendments to opt in or out of proxy access is difficult or impossible at many companies. A number of companies do not allow shareowner bylaws to be proposed, and many have supermajority voting thresholds that require as much as 80 percent support from the shares outstanding. Since not all shares are voted for each meeting, this can result in an amendment requiring 85 percent to 90 percent, or more, of the votes cast for passage. The simplest and most agreeable governance items may not garner support levels so high, and even some management proposals have more difficulty passing with supermajority voting standards. Another obstacle is the existence of dual-class shares at certain companies, which afford superior voting power on a per share basis to a minority of shares. The minority with superior voting power would be able to effectively block a bylaw allowing for director nominees, even if such nominees could be elected by the class with inferior voting power due to different director choices within class elections. Nearly half the firms in the Russell 3000 have at least one of these obstacles. Also, the paper notes that only Delaware ensures the ability under state law to have a legitimate, shareowner-crafted access bylaw, leaving greater than 40% of companies in states where the effect of such a bylaw is uncertain. The work by Corporate Library makes a compelling case, highlighting a myriad of structural problems that would significantly impede any efforts to affect shareowner nominations by private ordering alone.

IV. Supplemental analysis of share ownership and holding period patterns from Form 13F data by the Commission's Division of Risk, Strategy, and Financial Innovation, November 24, 2009

The data compiled support the ownership thresholds and holding periods as called for in the Commission's proposed release and use different methods than those of the Business Roundtable, which we expect to reflect a truer estimate of the potential for facilitated nomination use. This data supports the assertion that proxy access will be used sparingly and not lead to free-for-all races to submit directors at each eligible company.

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[4] For one of many comprehensive studies, please see Cremers, Martijn, and Ferrell, Allen, "Thirty Years of Corporate Governance: Firms Valuations & Stock Returns," Yale International Center for Finance Working Paper No. 09-09, September 2009.

V. *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, Joseph A. Grundfest, Stanford Law School and the Rock Center for Corporate Governance, October 20, 2009

The main contention espoused within this work is that the Commission contradicts itself by proposing a floor set of conditions to base facilitated nominations at all companies and allowing companies or owners to go beyond these requirements if chosen, but not to lessen them. The author asserts that these contradictions between self-determination and the anti-democratic and paternalistic aspects of the universal structure are so severe as to render the law vulnerable to being struck down as "arbitrary and capricious" via the Administrative Procedure Act.

The author suggests that the shareowner proposal system under Rule 14a-8 would be a better resource for allowing shareowners and/or companies to craft their own unique, tailored approach to these nominations. Ironically, the proposal system under Rule 14a-8 itself however could be subject to the exact criticisms that the author levies against this proposal for facilitated nominations. It is a universally applied method for allowing shareowners access to the corporate proxy. Within the eligibility rules, they can submit proposals for a vote among all owners. The Commission dictated minimum ownership and holding requirements, as they have done for the facilitated nominations proposal, and they dictated the parameters and scope of the proposals. Companies are free to go beyond what is called for in Rule 14a-8, but not below it. To our knowledge, Rule 14a-8 has never been challenged as arbitrary or capricious, despite allowing a system without opt-out and prescribing the details of its use. Therefore we reject the author's claim that the proposal contains a fatal contradiction, any more so than his call to use Rule 14a-8 to establish a tailored approach might.

The author believes an opt-in or opt-out system would remedy the failures he sees in the current proposal structure. He believes it would be more appropriate to allow owners to vote to allow such nominations. The owners would be voting on whether to allow nominations in the future with some prescription for eligibility and the range of nominees. We do not share the author's optimism in the ease of such a process. As stated in other comments, such as the Corporate Library report, there are significant impediments to passing shareowner bylaws. Bebchuk and Hirst have performed a thoughtful analysis on the relative merits and ease of private ordering, which we would like to introduce into the public record.[5] Further, we are comfortable with the provisions of the proposal, which like Rule 14a-8, set a mechanism for a shareowner to be heard and lets the majority speak their will. An individual who meets the criteria should be able to make a proposal or a nomination, and the democratic impact is that the majority will speak to its success or failure.

The author is concerned about what he terms "megaphone externalities," which result from a nominating owner who meets the threshold to nominate but just wants the press and attention that go with the nomination to further their ideological cause, or perhaps to exert pressure on management into making other concessions. We see special interest groups using the shareowner proposal process in the manner described, and their proposals fail miserably, typically without any fanfare, just as their potential nominees would. We view any media attention or company leverage that a special interest group would be able to garner as greatly overestimated by the author.

VI. Comments on opt-out and opt-in systems; private ordering

Due to frequent discussion among market participants of an opt-in or opt-out system since our initial comments, we would like to briefly address the ramifications of each. Both opt-in or opt-out systems would likely result in an absence of meaningful nomination standards at a substantial number of companies, but particularly at those where investors are at greatest need of such a system. We do not support an opt-in system due to the extremely high costs of private ordering among investors and the high likelihood that companies in greatest need may not see adoption of any standards. An opt-out system could be more amenable if the option provided certain important protections for as long as the company uses the exemption; however, it is our great preference to have universal facilitated nominations due to the complexities and obstacles present at many companies. In our

[5] Bebchuk, Lucian A., and Hirst, Scott, "Private Ordering and the Proxy Access Debate," November 2009 Discussion Paper, John M. Olin Center for Law, Economics and Business, Harvard.

opinion, the following governance characteristics, in place for the duration of the opt-out period, would be crucial to our own level of support.

- The provision would have to be shareowner approved by the same voting thresholds and standards as would be applied to any shareowner-proposed bylaw change or proposal for the duration of the opt-out period. For example, a company that applies a standard of "votes outstanding" versus "votes cast" to shareowner proposals or bylaw amendments would be required to use the same standard to approve a facilitated nomination opt-out. The same provision would apply to the necessary voting threshold for approval. Alternatively, the Commission might disallow supermajority voting thresholds and require the use of votes cast as the basis for voted matters.
- The provision should coincide with the absence of any advanced-notice provisions (and related bylaw restrictions) governing the timing and notice of shareowner communications.
- The provision should coincide with annual election of all board members, with no classified director terms.
- The provision should coincide with only shareowner-approved poison pills (a.k.a., shareowner rights plans).
- The provision should include a sunset feature allowing the opt-out to last no more than three years, but which could be reversed at any time by shareowner approval.

We note that some of the staunchest proponents now of what is being termed "shareowner choice" (the ability to either opt-in or opt-out) were described by Lucian Bebchuk and Scott Hirst as previously being anti-shareowner choice, when they opposed allowing shareowners to include proposals to opt-out of the current no-access rule on the corporate ballot. These opponents of shareowner choice then included the Business Roundtable, the Chamber of Commerce and prominent corporate law firms, one which now even proposes its own model access bylaw, which would allow each five percent shareowner (with no group aggregation) to nominate one director, with substantial liquidity restrictions and loss of nominating rights in the subsequent year. We suggest that real shareowner choice will come in the form of being able to choose among candidates nominated by shareowners in a universally applied and clear manner as prescribed in the Commission's release.

In summary, we appreciate the Commission's efforts in crafting these proposed rules. The Commission clearly has the authority and responsibility to govern what items must be placed on the corporate proxy for a shareowner vote. We believe these reforms would make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors, and more vigilant in their oversight of companies. We do not believe these rules will result in undue complexity or disruption to the current election process. We hope the Commission will implement these recommendations and enhance the ability of shareowners to elect the most qualified representatives. Thank you for your consideration of this significant issue impacting our pension investments. If you have any questions, please contact Mike McCauley, Senior Officer—Investment Programs and Governance, at (850) 413-1252 or governance@sbafla.com.

Sincerely,

Ashbel C. Williams
Executive Director & CIO

cc: Governor Charlie Crist, as Chairman of the SBA
CFO Alex Sink, as Treasurer of the SBA
Attorney General Bill McCollum, as Secretary of the SBA
Chair Mary L. Schapiro
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes

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PRIVATE ORDERING AND THE
PROXY ACCESS DEBATE

Lucian A. Bebchuk and Scott Hirst

Discussion Paper No. 653

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Harvard Law School
Cambridge, MA 02138

This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance

PRIVATE ORDERING AND THE PROXY ACCESS DEBATE

Lucian A. Bebchuk and Scott Hirst**

Abstract: This article examines two "meta" issues raised by opponents of the SEC's proposal to provide shareholders with rights to place director candidates on the company's proxy materials. First, opponents argue that, even assuming proxy access is desirable in many circumstances, the existing no-access default should be retained and the adoption of proxy access arrangements should be left to opting-out of this default on a company-by-company basis. This article, however, identifies strong reasons against retaining no-access as the default. There is substantial empirical evidence indicating that director insulation from removal is associated with lower firm value and worse performance. Furthermore, when opting-out from a default arrangement serves shareholder interests, a switch is more likely to occur when it is favored by the board than when disfavored by the board. We analyze the impediments to shareholders' obtaining opt-outs that they favor but the board does not, and we present evidence indicating that such impediments are substantial. The asymmetry in the reversibility of defaults highlighted in this article should play an important role in default selection.

Second, opponents of the SEC's proposed reforms argue that, if the SEC adopts a proxy access regime, shareholders should be free to opt-out of this regime. We point out the tensions between advocating such opting out and the past positions of many of the opponents, as well as tensions between opting-out and the general approach of the proxy rules. Nonetheless, we support allowing shareholders to opt-out of a federal proxy access regime, provided that the opt-out process includes necessary safeguards. Opting-out should require majority approval by shareholders in a vote where the benefits to shareholders of proxy access are adequately disclosed, and shareholders should be able to reverse past opt-out decisions by a majority vote at any time.

The implications of our analysis extend beyond proxy access to the choice of default rules for corporate elections, and to the ways in which shareholders should be able to opt-out of election defaults. In particular, the current plurality voting default should be replaced with a majority voting default, and existing impediments to the ability of shareholders to opt-out of arrangements that make it difficult to replace directors should be re-examined.

The paper is scheduled to appear in the February 2010 issue of *The Business Lawyer* together with an article by Joseph Grundfest in defense of retaining the current no-access default. Grundfest's article, "The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law," is available at http://ssrn.com/abstract=1491670.

Keywords: Proxy access, Securities and Exchange Commission, shareholder voting, corporate elections, corporate governance, directors, default rules, private ordering, boards.

JEL Classifications: G3, G38, K2, K22.

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* William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance, Harvard Law School.

* Co-Executive Director of the Program on Corporate Governance, Harvard Law School.

For helpful comments and discussions, we are grateful to Albert Choi, Bob Clark, John Coates, Jesse Fried, Reinier Kraakman, Mark Roe, Holger Spamann, Leo Strine, Beth Young and participants in the Proxy Access Roundtable hosted by the Harvard Law School Program on Corporate Governance. For financial support, we are grateful to the Harvard Law School John M. Olin Center for Law, Economics, and Business and the Harvard Law School Program on Corporate Governance.

Abstract

This article examines two "meta" issues raised by opponents of the SEC's proposal to provide shareholders with rights to place director candidates on the company's proxy materials. First, opponents argue that, even assuming proxy access is desirable in many circumstances, the existing no-access default should be retained and the adoption of proxy access arrangements should be left to opting-out of this default on a company-by-company basis. This article, however, identifies strong reasons against retaining no-access as the default. There is substantial empirical evidence indicating that director insulation from removal is associated with lower firm value and worse performance. Furthermore, when opting-out from a default arrangement serves shareholder interests, a switch is more likely to occur when it is favored by the board than when disfavored by the board. We analyze the impediments to shareholders' obtaining opt-outs that they favor but the board does not, and we present evidence indicating that such impediments are substantial. The asymmetry in the reversibility of defaults highlighted in this article should play an important role in default selection.

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Keywords: Proxy access, Securities and Exchange Commission, shareholder voting, corporate elections, corporate governance, directors, default rules, private ordering, boards.
JEL Classifications: G3, G38, K2, K22.

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I. INTRODUCTION

The ability of shareholders to place director nominees on the company's proxy materials is an issue that the Securities and Exchange Commission (the "SEC") has been considering for over 60 years.[1] In its 2009 proposed rule, "Facilitating Shareholder Director Nominations," the SEC has once again revisited this topic. Specifically, the reform proposes a new rule that would become Rule 14a-11 (henceforth, "Rule 14a-11") of the General Rules and Regulations promulgated under the Securities Exchange Act of 1934. The proposed Rule 14a-11 would, under certain circumstances, require companies to include shareholder nominees for director elections in the companies' proxy materials.[2]

The SEC has received a welter of comments regarding the proposed reform.[3] Although the adoption of a federal proxy access regime has received significant support from shareholder groups and those who work with them,[4] the proposed reform faces strong opposition from the corporate side; comments in opposition have been submitted by many of the country's largest corporations, the Business Roundtable,[5] the U.S. Chamber of Commerce,[6] and other business organizations, as well as many prominent corporate law firms and bar groups.[7] Many of the

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[1] *See* Securities and Exchange Commission Release No. 34-3347 (December 18, 1942).

[2] Facilitating Shareholder Director Nominations, Exchange Act Release No. 60,089, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified in various parts of 17 C.F.R.); hereinafter, the "Proposed Rule."

[3] 534 comment letters (or memoranda noting meetings with SEC commissioners or staff members) were received through the end of September 2009. All letter comments are *available at* http://www.sec.gov/comments/s7-10-09/s71009.shtml.

[4] See, e.g., the Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Elizabeth Murphy, Secretary, Securities and Exchange Commission (August 4, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-78.pdf.

[5] *See* the Letter from Alexander M. Cutler, Chairman and Chief Executive Officer of Eaton Corporation and Chair, Corporate Leadership Initiative, Business Roundtable, to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-267.pdf (hereinafter, the "Business Roundtable Letter").

[6] *See* the Letter from David T. Hirschman, Senior Vice President, U.S. Chamber of Commerce, to Elizabeth Murphy, Secretary, SEC (August 14, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-181.pdf (hereinafter, the "Chamber of Commerce Letter").

[7] *See* the Letter from Jeffrey W. Rubin, Chair, Committee on Federal Regulation of Securities, American Bar Association Business Law Section, New York, New York, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (August 31, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-456.pdf (hereinafter, the "ABA Letter").

commentators opposed to the SEC's proposal hold the view that proxy access would generally be value-reducing for publicly traded firms. Whether this is the case was the subject of an exchange between Martin Lipton and one of us published by the *Business Lawyer* in 2003, when the SEC previously considered proxy access reform.[8] This time, however, many commentators also stress a set of additional "meta-arguments" against the adoption of a federal proxy regime: they argue that the proposed reform should be opposed even if a proxy access is desirable in many or most publicly traded companies. We focus in this paper on these meta-arguments. We will refer to those commentators who make one or both of these meta-arguments collectively as the "Proposal Opponents." While the views expressed by the Proposal Opponents differ in various respects, this article will focus on their common use of the meta-arguments to oppose the SEC's proposal.

Part II of this article focuses on the argument made forcefully by the Proposal Opponents that, even if proxy access is desirable, it should be adopted in a more limited fashion than proposed by the SEC – by private ordering against the background of a no-access default rule. The Proposal Opponents are willing to support the SEC's proposal to amend Rule 14a-8 to allow shareholders to place proposals with respect to director nomination procedures on the corporate ballot;[9] once such an amendment is adopted, they argue, the adoption of proxy access can be left to private ordering in the marketplace. Such private ordering, they argue, can be expected to produce a proxy access arrangement in any company in which such access is desirable. Such an argument for retaining the existing no-access default is made not only by many comments in the SEC file but also by Joseph Grundfest in a recent discussion paper.[10]

We argue that this objection by the Proposal Opponents should be rejected. The Proposal Opponents are not justified in conflating a preference for private ordering with a preference for the current no-access default. A preference for private ordering may provide a basis for allowing opting-out of whatever default is selected, but does not favor any specific default. In particular,

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[8] *See* Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUSINESS LAWYER 43, 48-64 (2003); Martin Lipton and Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUSINESS LAWYER 67 (2003). See also Lucian Bebchuk, *The Business Roundtable's Untenable Case Against Shareholder Access* 55 CASE WESTERN RESERVE L. REV. 557-568 (2005).

[9] *See* the Proposed Rules, *supra* note 2, at 29,031.

[10] See Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, Rock Center for Corporate Governance at Stanford University Working Paper No. 64, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1491670, forthcoming in The Business Lawyer.

assuming that shareholders will be allowed to opt-out of the chosen default, we discuss two clear reasons why a no-access default is inferior to, and dominated by, an access default. First, the existing empirical evidence and considerations of director accountability suggest that an access default is more likely to be an efficient arrangement for most public companies. Moreover, efficient opt-outs are much easier to execute when the board of directors favors opting-out than when it does not. Our analysis of the impediments facing opt-outs to an access regime from a no-access default indicates that, in many companies where they would be efficient and favored by shareholders, such opt-outs are likely not to occur – or to occur only after a long and costly delay.

Having concluded that the SEC should set access as a default, we focus in Part III on the question of whether opting-out of the default to a no-access regime should be permitted, as the Proposal Opponents forcefully advocate. There is a tension between the Proposal Opponents' position in favor of allowing opting-out of Rule 14a-11 and (i) the opposition most of the Proposal Opponents expressed in 2007 to facilitating opting-out by shareholders from the current no-access default, and (ii) their support – or tacit acceptance – of shareholders' inability to opt-out of various arrangements that currently make it more difficult for shareholders to replace directors. The Proposal Opponents over-state the strength of the case for allowing shareholders to opt out of the adopted federal access regime. Nonetheless, such opting-out should be permitted provided the opting-out process contains adequate safeguards to ensure that proxy access is denied only in those cases where shareholders are and remain in favor of having opted-out. In particular, any opting-out of the SEC's access regime should require shareholder majority approval in a vote in which the benefits to shareholders of an access regime are adequately disclosed, and shareholders should be able to reverse past opt-out decisions by a majority vote at any time. Permitting opting-out of the SEC's access regime should also lead to a general reconsideration of shareholders' current inability to opt-out of arrangements that make it difficult to replace directors.

This analysis has implications beyond the proxy access debate. By analyzing the differences in the ease of passing efficient changes when such changes are supported or opposed by boards, the discussion highlights a consideration that should play an important role in the setting of corporate governance arrangements in general and those governing corporate elections in particular. For example, the analysis suggests that majority voting should become the default arrangement rather than merely a standard from which firms are free to opt-out. Similarly, the analysis of how opting-out from Rule 14a-11 should be conducted has implications for opting-out of other rules governing corporate elections.

II. SHOULD NO-ACCESS REMAIN THE DEFAULT RULE?

This part focuses on the Proposal Opponents' argument that, even if proxy access is desirable for the shareholders of many companies, the current no-access default and the adoption of proxy access arrangements should be left to the marketplace – that is, to private adoption by individual companies. A no-access default with the freedom to opt-in to an access regime is far from the best response to the proxy access issue. In particular, it is inferior to, and dominated by, a federal access regime with freedom for shareholders to opt-out of proxy access. For the purposes of this part's analysis, we will assume that whatever default rule is chosen – an access regime or a no-access regime – will allow shareholders to opt-out of the rule. And we will focus on examining whether the case made by Proposal Opponents that the default rule should be no-access is well grounded. For ease of exposition, we first put forward the case against retaining the no-access default assuming that shareholders' preferences are binary – for either the no-access regime or for the access regime offered by Rule 14a-11; at the end of this part we introduce the possibility that shareholders prefer some other access regime and show that the case against a no-access default remains strong when this initial simplifying assumption is relaxed.

Section A of this part explains why a preference for private ordering should not by itself lead – as the Proposal Opponents seem to believe – to favoring the current no-access default. Sections B and C discuss the two main reasons why an access default should be favored: Proxy access is more likely to be efficient for most public companies, and efficient opt-outs are easier to achieve when the board favors them than when the board does not, making it more difficult for shareholders favoring proxy access to opt-out of a no-access default than it would be for shareholders favoring no-access to opt-out of a federal access regime.

A. The Conflation of Opposition to Proxy Access with Preference for Private Ordering

A central argument put forward repeatedly by the Proposal Opponents is that, even assuming that access is beneficial for many public companies, the optimal approach is to retain no-access as the default arrangement and let the provision of shareholder access evolve through the adoption of access arrangement on a company-by-company basis. To facilitate such adoption, the Proposal Opponents now endorse a position many of them opposed in 2007: allowing shareholders to place on the corporate ballot proposals with respect to director nominations.[11] The Proposal Opponents stress the virtues of "private ordering," which can tailor arrangements to companies' particular circumstances, and seem to believe that a preference for private ordering and "one-size-does-not-fit-all" recommends against SEC intervention to provide a proxy access regime.[12]

However, it is a mistake to conflate a preference for private ordering and "one-size-does-not-fit-all" with a preference for a no-access default, as the Proposal Opponents do. There is no reason to assume, as the Proposal Opponents do, that private ordering should begin from a no-access default. A preference for private ordering merely implies a preference for allowing opting-out from whichever default is set, and does not imply that the ideal default is no-access. No matter what the default rule, it is possible to have private ordering: If the default rule provides for proxy access, there can be private ordering by allowing corporations to opt-out of the regime;[13] if the default rule is no-access, there can be private ordering by allowing

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[11] *See*, e.g., Letter from Cravath, Swaine & Moore LLP; Davis Polk & Wardwell LLP; Latham & Watkins, LLP; Simpson Thacher & Bartlett LLP; Skadden, Arps, Slate, Meagher & Flom LLP; Sullivan & Cromwell LLP; and Wachtell, Lipton, Rosen & Katz, to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-212.pdf (hereinafter, the "Seven-Firm Letter") , at 45; the ABA Letter, *supra* note 7, at 4.

[12] *See*, e.g., the Seven-Firm Letter, *id*., at 6-7, recommending that shareholders be permitted "to submit proxy access proposals that are designed to fit a company's particular circumstances" and that companies would "benefit from the flexibility to adopt the type and form of proxy access standard that best reflects the will of the stockholders, rather than a uniform, one-size-fits-all standard," or the Business Roundtable Letter, *supra* note 5, at 45, suggesting that "permitting shareholders to propose amendments to a company's bylaws to facilitate proxy access would allow shareholders to take advantage of the opportunity that state law affords to tailor a system of proxy access to the needs of the individual company."

[13] Note that allowing opting-out of the regime – what Joseph Grundfest refers to as "symmetric opt-out" – is different from the current proposed Rule 14a-11, which would only allow shareholders to make the rule

shareholders to opt-in to proxy access. Therefore, although Proposal Opponents base many of their arguments on a preference for private ordering, such a preference cannot provide a basis for opposition to the provision of an access regime. A preference for private ordering is fully consistent with a proxy access regime as long as opting-out is permitted by the regime. The Proposal Opponents' position is thus grounded *not* in their preference for private ordering but in their preference for a no-access default over an access default.[14]

Grundfest recognizes the need to make an argument in favor of a no-access default, and he claims that, in choosing among alternative defaults, no-access is the only acceptable choice.[15] He argues that the SEC should not adopt an access default without first conducting a scientific survey of shareholders in public companies to confirm that shareholders prefer to have proxy access.[16] This argument implicitly relies on a presumption in favor of a no-access default. We see no reason for such a presumption. Furthermore, and most importantly, the analysis below shows that there is a strong basis for favoring an access default over the current no-access default.

B. The Benefits of Proxy Access

In choosing between two or more arrangements for a default rule, a natural starting point is to ask which arrangement is more likely to be efficient. If it is as easy to opt-out of a no-access default as to opt-out of an access default (although we shall see this is not the case), the consideration of which arrangement is more likely to be efficient in most cases should be decisive. Both the logic of corporate accountability and the available empirical evidence indicate that an access default is more likely to be efficient than a no-access default.

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less restrictive for shareholder proposals, and not more restrictive (what Grundfest refers to as an "asymmetric opt-out"). *See* Grundfest, *supra* note 10, at 4.

[14] The fact that Proposal Opponents have a strong preference not just for private ordering over federal intervention but also for having no-access as the default is also evident from fact that nowhere in their submissions, nor at any time prior to this debate – including during the discussion of the recent amendment of the Delaware General Corporation Law to add Section 112, allowing opting-in to proxy access – did any of the Proposal Opponents seek to have access as the default arrangement under state law.

[15] *See* Grundfest, *supra* note 10, at 16.

[16] *See* Grundfest, *supra* note 10, at 23.

Given the central role of directors in corporate governance, their selection and incentives are important: Corporate law provides shareholders with the power to replace boards in order to ensure that directors are adequately selected and perform well.[17] This power should create accountability and incentivize directors to serve shareholders' interests.[18] However, existing arrangements make it difficult for shareholders to replace directors, and give incumbents substantial advantages over outsiders who might seek to replace them in the event of unsatisfactory performance. For example, incumbents' campaign expenses are borne completely by the company, but outsiders have to pay their own campaign costs. Thus, challengers who might be able to improve the management of the company may be discouraged from running because they will bear all of the costs but capture only a fraction of the benefits from any improvement in governance.[19] Electoral challenges are in fact quite infrequent.[20]

Although proxy access would not eliminate the disadvantages facing challengers, it would reduce them somewhat. Challengers would still bear costs that incumbents can charge to the company, but in some circumstances challengers would avoid the costs of distributing proxy cards to shareholders and paying for their return, and would also avoid intangible disadvantages that may result from being on a separate card.[21] By making it easier for shareholders to replace directors, proxy access can contribute to making directors more accountable to shareholders and more attentive to their interests. The primary benefits of proxy access will result not so much from its use, but from its availability and its general effect on directors' incentives and behavior.

There is a substantial body of empirical evidence that is consistent with the view that making boards more accountable by invigorating corporate elections increases shareholder

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[17] *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985) ("If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out," quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)).
[18] *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (Chancellor Allen observes that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.")
[19] Robert Charles Clark, CORPORATE LAW 390-96 (1986); *See* also Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1088-96 (1990).
[20] For empirical evidence on the incidence of electoral challenges, *see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VIRG. L. REV. 675 (2007).
[21] *See* comments of Roy Katzovicz in Lucian Bebchuk and Scott Hirst (editors), *The Harvard Law School Proxy Access Roundtable*, forthcoming Harvard Law School Olin Discussion Paper.

value.[22] Empirical studies consistently find that proxy fights are associated with an increase in shareholder wealth.[23] These studies focus on the *ex post* effects of proxy contests (their effects on shareholder wealth once a proxy contest has taken place), and do not consider the *ex ante* benefits of proxy contests (the effects of the prospect of a proxy contest on boards in general). Even though these studies therefore focus only on a subset of the benefits of electoral challenges, their findings are clearly consistent with the effect of such challenges being positive.[24]

Furthermore, there is considerable empirical evidence that reducing incumbent directors' insulation from removal has, overall, a beneficial *ex ante* effect on the management of public companies. Empirical studies have found that increased insulation from management removal by change of control produces worse management decisions and performance along a significant number of dimensions.[25] Among other things, there is evidence that:

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[22] For a review of this evidence, *see* Bebchuk, *The Myth of the Shareholder Franchise*, *supra* note 20, at 711-714.

[23] *See* Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 FIN. MGMT. 22 (1992); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432–33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998).

[24] In their comment letter, the RiskMetrics Group indicates that they have tracked the returns of a portfolio of companies where activists gained board seats in 2005, and found that this portfolio outperformed the S&P 500 index over the subsequent four-year period; *See* Letter from Martha Carter, Head of Global Research and Global Policy Board, RiskMetrics Group, to Elizabeth Murphy, Secretary, SEC (August 13, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-166.pdf (hereinafter, the "RiskMetrics Group Letter"), at 3 (concluding that it "appears that election of a shareholder-nominated director may create value over a multi-year period").

[25] To the best of our knowledge, the only benefit of provisions entrenching management was identified by Bates, Becher & Lemmon – Thomas Bates, David Becher and Michael Lemmon *Board classification and managerial entrenchment: Evidence from the market for corporate control*, 87 J. FIN. ECON. 656–677 (2008) (finding that staggered boards are associated with higher takeover premia). However, this study also shows that staggered boards are associated with a lower likelihood of an acquisition. Moreover, the study dos not question, but rather confirms, that overall staggered boards are associated with lower firm value.

• The passage of anti-takeover statutes is accompanied by increases in "managerial slack";[26]

• Companies whose managers enjoy more protection from takeovers are associated with poorer operating performance – including lower profit margins, return on equity, and sales growth – and are more likely to engage in empire-building;[27]

• Acquisitions made by companies with stronger anti-takeover protection are more likely to be value-decreasing;[28]

• Anti-takeover protection is associated with higher compensation levels;[29]

• Anti-takeover protection is associated with lower sensitivity of compensation to performance, and with lower sensitivity of CEO turnover to firm performance;[30]

• The removal of anti-takeover protection is associated with increases in stock market value;[31] and

• Greater insulation from removal via a takeover is correlated with lower firm value (as measured by the standard Tobin's Q measure).[32]

To the best of our knowledge, the only empirical study identifying a beneficial aspect of entrenching management is that by Bates, Becher and Lemmon.[33] This study finds that staggered

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[26] *See* Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999) (reporting that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth").

[27] *See* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 136-37 (2003).

[28] Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851 (2007).

[29] *See* Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation* (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1998), http://papers.nber.org/papers/W6830.pdf.

[30] *See* Olubunmi Faleye, *Classified boards, firm value, and managerial entrenchment*, 83 J. FIN. ECON. 501, 503 (2007).

[31] *See* Re-Jin Guo, Timothy A. Kruse, and Tom Nohel, *Undoing the Powerful Anti-Takeover Force of Staggered Boards*, 14 J. CORP. FIN. 3 (2008) 274-288.

[32] *See* Gompers et al., *supra* note 27; Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 430 (2005); Lucian Bebchuk, Alma Cohen, and Alan Ferrell, *What Matters in Corporate Governance*, 22 REV. FIN. STUDS. 783, 785 (2009).

boards are associated with higher takeover premia. However, this study also shows that staggered boards are associated with a lower likelihood of an acquisition and, more importantly, it confirms that, overall, staggered boards are associated with lower firm value. On the whole, the body of empirical evidence provides strong reasons for believing that reducing the extent to which directors are insulated from removal would be value-enhancing.

C. Default Choice and Reversibility

Having so far focused on whether no-access or access is more likely to be efficient for most public companies, we now discuss another consideration that weighs heavily against choosing a no-access default: it would be far more difficult for shareholders to opt-out of a no-access default when doing so would be efficient, than it would for them to opt-out of an access regime when doing so would be efficient.

It is important to take into account the possibility that opting-out of different default rules is not equally easy. In an imaginary Coasian world with no transaction costs, permitting opting-out would always result in an efficient arrangement, no matter what the initial default. In the real world, however, there are impediments that may prevent efficient opting-out, and it is necessary to consider the possibility that these impediments may vary depending on the default that is initially chosen. In particular, as was stressed in an article co-authored by one of the authors together with Assaf Hamdani, the choice of default in corporate and securities law should depend on which selection would be more easily "reversible" by shareholders wishing to see it changed.[34] Under the reversible defaults theory developed in that article, it is important to take into account the fact that an efficient opting-out is easier to accomplish and more likely to occur when a board of directors favors such opting-out than when the board disfavors it.[35] Below we provide additional support for this view, explaining in detail the causes of this asymmetry as well as demonstrating its significance.

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[33] Thomas Bates, David Becher and Michael Lemmon *Board classification and managerial entrenchment: Evidence from the market for corporate control*, 87 J. FIN. ECON. 656–677 (2008)
[34] *See* Lucian A. Bebchuk and Assaf Hamdani, *Optimal Defaults For Corporate Law Evolution*, 96 NW. L. REV. 489-520 (2002).
[35] *Id*.

When an efficient opt-out is favored by the board, it will likely be adopted. The board will have an incentive to bring the opt-out proposal to a vote, will have access to internal and external professionals with the necessary skills to draft and explain the proposal expertly, and will have the power to place the proposal and detailed reasons for it in the company's proxy materials. In contrast, the adoption of an opt-out that is efficient and favored by shareholders but disfavored by the board will be much more uncertain due to the various impediments we describe in detail below.

The asymmetry between opt-outs favored and disfavored by the board strengthens the case for selecting proxy access as the default rule. Indeed, the asymmetry provides a basis for selecting access as the default even if no-access is more likely to be the efficient default. Suppose, hypothetically, that proxy access is optimal for 45% of companies and no-access is optimal for 55% of companies; suppose further that shareholders are able to opt-out in all cases in which opting-out is favored by the board, but only in one-third of those cases in which opting-out is disfavored by the board. In these circumstances, setting an access default would result in the more efficient arrangement prevailing in all companies: All of the 55% of companies for which the access default is inefficient and disfavored by shareholders will opt-out. In contrast, setting a no-access default would result in 30% of companies ending up with an inefficient arrangement: Of those 45% of companies for which no-access is inefficient, only one-third will opt-out.

Grundfest recognizes the need to take these asymmetries into account, arguing that they are reduced in this situation. However, even if this is the case, as long as there is an asymmetry that makes it easier to opt-out of proxy access than to opt-in, a default rule of proxy access will be preferable. Grundfest concedes that where there are asymmetries in favor of management, the default rule that is less preferred by management should be chosen. However, he claims that, because the adoption of proxy access could be done by a bylaw amendment without director initiation, a different recommendation is appropriate.[36] However, the passage that Grundfest cites for this proposition also states that, where collective action problems impede initiation of bylaw amendments by shareholders (as this section demonstrates), opting-out by a bylaw

[36] Grundfest, *supra* note 10, at 23, citing Bebchuk & Hamdani, *id.*, at 505.

amendment will not eliminate the asymmetry, and as a result, some presumption in favor of arrangements more restrictive of managers is called for.[37]

D. Impediments to Shareholder Bylaw Amendments and the Precatory Proposals Route

Why do the Proposal Opponents expect the marketplace to effectively produce access arrangements whenever they are efficient? In assessing this question, it is worth noting that companies have had many years to adopt access bylaws and have not chosen to do so. State corporate law, including in Delaware, contains no restrictions on allowing shareholder access.[38] However, only three companies have put in place a proxy access arrangement, and each of these three instances is peculiar because of either the nature of the company or the circumstances surrounding its adoption of proxy access. One access bylaw was adopted by RiskMetrics Group, Inc., which advocates proxy access reform for the companies in which its clients invest;[39] another was adopted by a company which had as its chairman and significant blockholder a well-known shareholder activist who has strongly advocated proxy access;[40] the third access bylaw was adopted by a firm attempting to recover from an option-backdating scandal that led to criminal charges against three former executives.[41] It is clear that the implementation of proxy access in those three cases resulted from unique circumstances.

Why should we expect the future to be different from the past? The Proposal Opponents seem to believe that the future will be different if the SEC amends Rule 14a-8 (an amendment they now support) to allow shareholders to place on the corporate ballot proposals concerning

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[37] *See* Bebchuk & Hamdani, *supra* note 34, at 505.
[38] Although the introduction of Section 112 of the DGCL makes it explicitly clear that bylaws may permit proxy access, the permissibility of such bylaws was generally recognized prior to the enactment of Section 112.
[39] *See* the RiskMetrics Group Letter, *supra* note 24.
[40] Apria Healthcare Inc. had Ralph Whitworth, head of investment advisor Relational Investors LLC, as its chairman and significant stakeholder during the period in which it adopted a proxy access bylaw. Mr. Whitworth is a strong advocate of proxy reform, and advocated the change to the board. *See* Letter from Ralph V. Whitworth, Principal, Relational Investors LLC to Elizabeth Murphy, Secretary, SEC (August 13, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-185.pdf, at 1. Apria Healthcare Inc. has subsequently been acquired.
[41] Comverse Technology, Inc., which adopted a proxy access bylaw in 2007. *See* Ted Allen, Comverse Adopts Access Bylaw, Risk and Governance Blog (Apr. 27, 2007), http://blog.riskmetrics.com/2007/04/comverse_adopts_access_bylawsu.html.

director nomination procedures in general, and proxy access in particular. Shareholders' ability to bring such proposals, it is argued, can generally be expected to produce access bylaws in companies in which such bylaws are efficient and favored by shareholders.

It is worth noting that the process the Proposal Opponents have in mind appears to be one in which boards adopt access bylaws following shareholder proposals recommending such bylaws, rather than one in which shareholders adopt such bylaws directly. Although shareholders submit hundreds of proposals to publicly traded firms each year, the overwhelming majority of these proposals are precatory in nature; only a small fraction of shareholder proposals are proposals for binding bylaw amendments. In particular, during the last five proxy seasons, on average only 12 proposals for corporate governance bylaw amendments were voted on each year – about 3% of the proposals voted on during the season.[42]

The use of bylaw proposals is impeded by the fact that, in many firms, the amendment of bylaws requires a supermajority: As of September 2009, 42% of public companies[43] and 34% of the Fortune 500 required a supermajority approval for any shareholder-initiated bylaws.[44]

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[42] In the last two proxy seasons for which Georgeson Shareholder reports figures, the number of proposals to amend the bylaws was 12 in the 2007 proxy season (out of 375 corporate governance proposals) and 17 (out of 339 corporate governance proposals) in the 2008 proxy season. *See* Georgeson Shareholder, *2007 Annual Corporate Governance Review: Annual Meetings, Shareholder Initiatives, Proxy Contests*, and *2008 Annual Corporate Governance Review: Annual Meetings, Shareholder Initiatives, Proxy Contests*, each *available at* http://www.georgesonshareholder.com/usa/resources_research.php.

[43] Based on our search in Sharkrepellent.net on September 6, 2009. Out of the 3,889 companies in the Sharkrepellent.net universe (comprised of Russell 3000 companies and those companies that have had initial public offerings or implemented poison pills since 2001), a total of 1,624 companies had a supermajority vote requirement for amending the bylaws of the corporation.

For subsequent confirmation of this point, see Beth Young, *The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process*, White Paper Prepared for the Council of Institutional Investors, November 2009, available at http://www.cii.org/UserFiles/file/The%20Limits%20of%20Private%20Ordering%20UPDATED%2011-17-09.pdf, at 7 (showing that 36.1% of Russell 1000 companies, 39.1% of Russell 3000 companies, and 35.4% of S&P 500 companies employ a supermajority vote standard). That paper also suggests that another impediment to private ordering will exist for companies with multiple class capital structures with disparate voting rights (7.1% of S&P 500 companies, 8.8% of Russell 1000 companies, and 7.5% of Russell 3000 companies), such that an access bylaw favored by shareholders holding a majority of the shares of the company by value may not receive a majority of total votes.

[44] Based on a search in Sharkrepellent.net on September 6, 2009. Out of the Fortune 500 companies, 168 companies had a supermajority vote requirement for amending the bylaws of the corporation.

Indeed, even among companies that do not have a supermajority requirement, the standard requirement of approval by a majority of the outstanding shares makes passage conditional on obtaining a supermajority of the votes cast.

Furthermore, the initiation of access bylaws by shareholders would be discouraged by the fact that Rule 14a-8 imposes a 500-word limit on the text of the proposed bylaw and the supporting statement. It might well be difficult to fit the text of an access bylaw that explicitly addresses most of the relevant elements (not to mention the supporting statement) within such a limit;[45] to illustrate, the model access bylaw recently put forward by the American Bar Association Task Force on Shareholder Proposals contains 2,436 words,[46] and the text of Rule 14a-11 itself contains 1,929 words.[47]

The Proposal Opponents have not expressed concerns about these considerable impediments to shareholder-initiated access bylaws. To make their support of opting-out against the background of a no-access default tenable, they have to rely on the ability of shareholders to pass precatory shareholder resolutions recommending that the board adopt an access bylaw. Once Rule 14a-8 is amended to allow such precatory proposals, it might be argued, the boards of many companies can be expected to adopt access bylaws after the passage of such proposals or

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[45] A shareholder wishing to have an access bylaw might believe, for example, that such a bylaw should ideally deal with, among other things, ownership and shareholding requirements of proponents, disclosure of information, and resolution procedures.

[46] *See* the Illustrative Access Bylaw with Commentary by the American Bar Association Task Force on Shareholder Proposals, (hereinafter, the "ABA Model Bylaw") attached to Letter from Robert Todd Lang, Co-Chair, and Charles M. Nathan, Co-Chair, ABA Task Force on Shareholder Proposals to Elizabeth Murphy, Secretary, SEC (June 15, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-29.pdf. To take another example, the model bylaw circulated by Wachtell, Lipton, Rosen & Katz contains 1,401 words; *See* Model Proxy Access Board Resolution and By-Law prepared by Wachtell, Lipton, Rosen & Katz (hereinafter, the "Wachtell, Lipton, Rosen & Katz Model Bylaw"), available on the Wachtell, Lipton, Rosen & Katz website at http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16648.09.pdf, and discussed in Ted Mirvis, *SEC's proxy access proposal undermines state-federal balance*, Harvard Law School Forum on Corporate Governance and Financial Regulation (May 24, 2009), http://blogs.law.harvard.edu/corpgov/2009/05/24/secs-proxy-access-proposal-undermines-state-federal-balance/. Word counts were calculated in Microsoft Word after cutting-and-pasting the text of the bylaws (including section numbering, but excluding footnotes and explanatory text).

[47] *See* the Proposed Rules, *supra* note 2. The number of words was calculated in Microsoft Word after cutting-and-pasting the text of Rule 14a-11 from the original PDF files version. The word count includes section numbering and section headings but excludes titles, footnotes, explanatory text and instructions.

in anticipation of – and with a desire to preempt – the future passage of such proposals.[48] However, as the next subsections demonstrate, this process also cannot generally be relied on to produce proxy access arrangements whenever shareholders prefer to have them.

E. Lessons from Majority Voting and Staggered Boards

It is instructive to begin by looking at the evidence on the diffusion of majority voting arrangements, which were often adopted by boards in response to or in anticipation of shareholder resolutions in favor of majority voting. In arguing that private ordering from a no-access default could be relied on to produce proxy access arrangements whenever they would be efficient, the Proposal Opponents argue that the widespread adoption of majority voting from the plurality voting default via private ordering demonstrates that private ordering can produce desirable election reforms.[49] The Business Roundtable Letter, for example, refers to the "swift adoption" of the majority voting standard, and states that some form of majority voting had been adopted by 75% of their members by 2008.[50]

In fact, however, the empirical evidence on the diffusion of majority voting highlights the limits of relying on private ordering by firms, rather than on a change in default arrangements, to produce necessary reforms. Consider a hypothetical situation in which majority voting is the default arrangement from which firms can opt-out only with shareholder approval. Given the strong support for majority voting among investors,[51] it is likely that the overwhelming majority of companies would not be able (and indeed would not try) to get shareholders to approve opting-out of majority voting into plurality voting, and that most public firms would have majority voting in place. This is a very different outcome than that produced by firms' opting-out of the current default of plurality voting.

In fact, several years after the widespread recognition of the desirability of a majority voting standard, a large fraction of public firms, including a large majority of smaller public

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[48] *See*, e.g., the Seven-Firm Letter, *supra* note 11, at 1; the ABA Letter, *supra* note 7, at 4; the Business Roundtable Letter, *supra* note 5, at 3.
[49] *See*, e.g., the ABA Letter, *supra* note 7, at 1, 2, 7, 12; the Seven-Firm Letter, *supra* note 11, at 6.
[50] *See* the Business Roundtable Letter, *supra* note 5, at 5-6.
[51] Of the 220 proposals to change plurality voting to majority voting that have been voted on since 2007 (as reported by Sharkrepellent.net), the number of shareholders in favor of the resolution was 59% of the shares outstanding, and 70% of the votes cast in favor or against.

firms, have not yet opted into majority voting. As of September 2009, data from RiskMetrics Group shows that only 60% of companies in the S&P 500 had majority voting (with an additional 15% having plurality voting with a director resignation policy), and that only a small minority of the large number of public companies outside the S&P 500 have majority voting.[52] Of the 5,930 firms outside the S&P 500 that are followed by RiskMetrics Group, only 12% have majority voting (an additional 5% had plurality voting with a director resignation policy). Altogether, of the 6,630 public firms in the RiskMetrics database, more than 80% have plurality voting without even a resignation policy for directors receiving a majority of withhold votes.[53]

The above evidence indicates that, as long as the default arrangement remains the same, many public firms can be expected to avoid opting-out into arrangements that make director removal easier – even when there is strong support for such arrangements among shareholders. We discuss below in detail the reasons why private ordering cannot be relied on to produce such governance improvements. The lessons from the incomplete diffusion of majority voting are worth keeping in mind while considering that analysis.

Indeed, if the adoption of proxy access arrangement is left up to firms opting-in to such arrangements, shareholders' ability to implement the access arrangements they favor is likely to face even greater obstacles than those faced by majority voting. Most importantly, boards have generally displayed much more resistance to proxy access than to majority voting. In the beginning of this decade, both proxy access and majority voting were considered important measures for addressing growing concerns about corporate governance in general and corporate elections in particular.[54] Both at the time and since, companies have been open to considering and adopting majority voting, but have been strongly opposed to proxy access.[55] What might be

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[52] E-mails from Carol Bowie, RiskMetrics Group, Inc., to Lucian Bebchuk (October 9, 2009) (on file with authors).

[53] *Id*.

[54] *See* Security Holder Director Nominations, Exchange Act Release No. 38,626, Investment Company Act No. 26,206, 68 Fed. Reg. 60,784, 60,794 (proposed Oct. 14, 2003).

[55] *See*, e.g., Letter from Steve Odland, Chairman, President & CEO, AutoZone, Inc.; Chairman – Corporate Governance Task Force, Business Roundtable, to Jonathan G. Katz, Secretary, SEC, dated March 31, 2004, *available at* http://www.sec.gov/rules/proposed/s71903/brt033104.pdf ("The proposed rules would have widespread and harmful unintended consequences, enabling a small number of shareholders and advisory services to impose significant costs on all shareholders, often for reasons wholly unrelated to sound corporate governance or the welfare of the corporation").

the reasons for the difference in corporate attitudes? Perhaps incumbent directors and executives find majority voting less threatening because it does not create risks that outsiders not screened and selected by the incumbent team will join the board; or perhaps reasonable and persuasive objections to majority voting are difficult to identify. Whatever the reason, incumbent directors' resistance to proxy access arrangements should be taken into account in any assessment of the expected incidence of the adoption of such arrangements from a no-access default.

Furthermore, in contrast to majority voting arrangements, the design of proxy arrangements seems to be more complicated and their consequences seem to depend on many more design details.[56] As a result, as discussed in detail below,[57] firms have many ways to design proxy access arrangements that in practice make their use by shareholders very difficult. This consideration is especially important given the expected reluctance of boards to adopt proxy access arrangements that could make a practical difference.

The evidence of staggered boards is also instructive in assessing how difficult it is for shareholder preferences expressed in precatory shareholder proposals to produce widespread changes that would make it easier to replace directors. For the last two decades, companies have generally not been able to get shareholders to approve the adoption of staggered boards. Moreover, shareholders have displayed strong preferences for the removal of staggered boards where companies already have them in place. Proposals in favor of de-staggering have obtained, on average, more than 70% of the votes cast for such proposals in each of the years 2003 to 2009, with the average percentage of support in 2007 and 2008 reaching levels of 86% and 80% respectively.[58] This opposition by shareholders has led to de-staggering by a significant number of companies, though most of the companies with staggered boards have stuck to an arrangement that does not have majority support among shareholders. Among the (approximately) 4,000 public firms whose antitakeover arrangements are tracked by Sharkrepellent.net, about half still have staggered boards in place.[59] This evidence suggests that strong impediments exist to

[56] *See* notes 46-47, *supra*.
[57] *See* Section C.4(c) and notes 71-75, *infra*.
[58] Based on Sharkrepellent.net search on October 19, 2009.
[59] Based on SharkRepellent.net search on September 27, 2009, showing 1,911 corporations in the SharkRepellent.net universe with a staggered board and 1,977 without a staggered board.

shareholder efforts to make corporate governance changes that would facilitate replacing directors. We now turn to a discussion of these impediments in some detail.

F. Impediments to the Effectiveness of the Precatory Proposals Route

The Proposal Opponents claim that a no-access default regime with freedom to opt-in to proxy access will produce access arrangements whenever they are favored by shareholders. The evidence discussed above casts doubt on this claim. This subsection discusses three reasons for expecting that a no-access default that allows shareholders to include proposals concerning proxy access on the corporate ballot will not result in the adoption of such arrangements in all firms whose shareholders would benefit from them.

First, due to the limited incentives shareholders have to make proposals, most companies will not receive, and will not expect to receive, shareholder proposals to adopt a proxy access arrangement, even when such proposals would pass were they initiated. Second, even if proxy access proposals are passed (or are expected to pass), boards may elect not to follow shareholders' explicit preference in favor of proxy access. Third, even in those cases where boards adopt a proxy access bylaw – either in response to or in anticipation of the passage of a shareholder proposal – the board may adopt a version of an access arrangement that is substantially more diluted and restrictive than shareholders favor.

1. The Limited Reach of Precatory Proposals

The Proposal Opponents implicitly assume that companies whose shareholders would pass a proxy access proposal, were one to be initiated, would receive or expect to receive such a proposal. But the fact that a proposal would be passed if initiated hardly implies that a proposal will be initiated. Most shareholders have little incentive to initiate such proposals, and the evidence clearly indicates that shareholder proposals that routinely receive large shareholder support are initiated in only a small subset of relevant companies. Although it takes only one shareholder to initiate a proposal, most firms do not receive even a single shareholder proposal.

In particular, according to an analysis of RiskMetrics Group data, less than 25% of the firms in the S&P 1500 were targeted for corporate governance proposals in each of the years

2006 and 2007.[60] The RiskMetrics shareholder data focuses on S&P 1500 companies on the grounds that shareholder corporate governance proposals are infrequent in other companies. According to this data, about 50% of the S&P 500 firms received such proposals (243 in 2006 and 265 in 2007). Among those S&P 1500 firms not in the S&P 500, only about 10% to 12% received corporate governance proposals (101 in 2006 and 121 in 2007).[61] Note also that, even though proposals to de-stagger boards and to adopt majority voting routinely pass when initiated in companies with a staggered board and plurality voting (respectively), such proposals are initiated only in a small subset of such firms each year. Thus, there is a good basis for expecting that, in a no-access default regime, many companies – including most companies outside the S&P 500 – will not expect to be the target of a proxy access proposal, even if such a proposal would pass were it to be initiated, and thus the boards of those companies will face little pressure to adopt an access arrangement.[62]

2. Precatory Proposals May Be Ignored

As discussed in section D of this Part, the process that the Proposal Opponents envisage is that shareholders will proposal precatory resolutions to implement proxy access. However, when a precatory resolution in favor of proxy access passes, the board may elect not to follow it. As a legal matter, the passage of a precatory resolution does not bind the board – the board is

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[60] E-mails from Fabrizio Ferri, New York University Leonard N. Stern School of Business, to Lucian Bebchuk (October 14, 2009) (on file with authors).

[61] *Id*.

[62] Grundfest, *supra* note 10, at 26, asserts that "collective action costs [for shareholder proposals] are low" and refers to what he regards as a large number of shareholder proposals. However, placed in the context of the number of publicly traded companies and the number of different corporate governance proposals facing shareholders, the number of corporate governance proposals initiated each year is hardly large. Indeed, the great majority of publicly traded companies do not receive even a single proposal in any given year. The 1,141 proposals Grundfest describes represents an average of 0.12 proposals per publicly traded company, or one proposal for every eight publicly traded companies (using the 8,949 publicly traded U.S. companies in the Compustat database as of December 31, 2008). Moreover, the number of proposals Grundfest refers to includes corporate social responsibility proposals; the number of corporate governance proposals is considerably lower (S&P 1500 companies received 652 corporate governance proposals in 2008). And in any given year, even the most popular corporate governance issues attract very few proposals – in 2008 there were 80 proposals regarding majority voting and 60 regarding 'say-on-pay,' the two most popular issues for shareholder proposals that year. *See* the 2008 Georgeson Annual Corporate Governance Review, *supra* note 42.

legally free to elect to retain the existing state of affairs. As a practical matter, the chance that a board will fail to follow a successful precatory resolution is likely to be greater if the resolution is the first proposal on the subject passed by the company's shareholders, if the issue is especially important to incumbents,[63] and if the resolution passes without a large majority.

This analysis is consistent with the evidence of boards' failure to follow numerous precatory resolutions passed in favor of de-staggering boards. A study by one of the authors shows that, of the precatory resolutions passed by shareholders during the period 1997-2003, boards had elected not to follow about 69% of such resolutions by the fall of 2004.[64] Recent evidence suggests that the incidence of boards failing to implement de-staggering proposals is now lower – possibly as a result of the consistently large support for such resolutions recently– although a significant number of firms still continue to have staggered boards despite the passage of one or more shareholder resolutions in favor of de-staggering.[65] Thus, even in the event that shareholders pass resolutions in favor of proxy access in some companies, some boards can be expected to ignore such resolutions, and the incidence of such refusals is likely to be higher during the initial years in which proxy access resolutions are passed and when such resolutions pass with less than overwhelming majorities.

3. Precatory Proposals May Be Only Partly Followed

There is another reason why the process suggested by the Proposal Opponents cannot be expected to result in the proxy arrangements favored by shareholders of particular companies being universally adopted by those companies. Even if the board elects to adopt an access bylaw in response to (or in anticipation of) the passage of a precatory shareholder resolution favoring

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[63] *See* Lucian A. Bebchuk, "The Case for Increasing Shareholder Power," 118 HARV. L. REV. 833, 852-856 (2005).
[64] *Id*, at 854.
[65] Sharkrepellent.net Comprehensive Summary of Majority Voting Proposals, 2008. For instance, between 2001 and 2008, there were 52 corporations in which shareholders successfully passed at least one precatory resolution recommending the repeal of their particular corporation's staggered board but, as of September 2009, the respective boards of directors had not taken steps to declassify the boards. In 18 of these instances, shareholders have passed such resolutions on more than one occasion. For instance, the shareholders of The Stanley Works have passed resolutions calling for the removal of a staggered board in each of the seven annual meetings from 2003 to 2009, yet there has been no repeal of the staggered board.

proxy access, the board may choose to adopt a bylaw considerably more restrictive than the arrangement favored by shareholders. By adopting an access bylaw, the board can claim to accommodate its shareholders' preference. However, the devil is in the details, and the bylaw adopted by the board may fall significantly short of that favored by shareholders.[66]

In response to (or in anticipation of) shareholder resolutions in favor of a majority voting standard, for example, some boards have nonetheless retained the default plurality standard but have sought to placate shareholders by adopting a "director resignation policy."[67] Such policies require directors receiving a majority of "withhold" votes to tender their resignations, but fall short of a majority voting standard, as they are binding neither on directors (to tender their resignations), nor on the board (to accept tendered resignations). During the 2009 proxy season, directors of Pulte Homes, Inc. and Dollar Tree, Inc. failed to receive a majority of votes cast, yet even though both companies had director resignation policies that were triggered by the votes, their boards decided not to accept the resignations of the directors.[68] As noted above, RiskMetrics Group data indicates that 15% of companies in the S&P 500 (and 5% of all companies followed by RiskMetrics Group) have director resignation policies but not majority voting rules.[69]

This problem is especially significant for proxy access bylaws. As discussed above, the design of a proxy access arrangement can critically affect its effectiveness in providing shareholders with meaningful access to the company's proxy materials. It is possible to draft proxy access arrangements with thresholds and requirements that largely negate their potential value for shareholders.

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[66] This impediment is largely avoided if shareholders adopt a binding access bylaw. However, as discussed earlier, the passage of binding bylaws by shareholders faces considerable impediments, and this is not the process that the Proposal Opponents envisage.

[67] For example, in May 2008, shareholders of Invacare Corporation passed a precatory resolution recommending adoption of a majority voting policy. Instead, the board of directors adopted a director resignation policy. *See* Sharkrepellent.net Comprehensive Summary of Majority Voting Proposals, 2008.

[68] *See* Ted Allen, A Closer Look at High Withhold Votes, Risk & Governance Blog (October 2, 2009), *available at* http://blog.riskmetrics.com/2009/10/001372print.html.

[69] Emails from Carol Bowie, RiskMetrics Group, Inc. to Lucian Bebchuk, *supra* note 52.

To illustrate, consider a company whose board passes a bylaw based on the model access bylaw put forward by Wachtell, Lipton, Rosen & Katz.[70] An examination of the fine details of the model bylaw indicates that it provides access in name only. First, it requires a nominator to have more than 5% of the voting shares of the corporation (a "5% shareholder") and does not allow shareholder groups to aggregate their holdings for this purpose.[71] As a result, if the company lacks 5% shareholders, or if the 5% shareholders are affiliated with management, there will effectively be no shareholder access to the ballot. Second, although the model bylaw theoretically allows shareholders to place on the ballot nominees numbering up to one-third of the number of board seats,[72] each 5% shareholder may nominate only one director.[73] Therefore, to have three shareholder nominees included on the ballot of a company with nine directors, the company must have at least three 5% shareholders, each of which must elect to exercise its proxy access rights. Finally, the model bylaw also deters the use of proxy access rights by 5% shareholders by making such use quite costly: Shareholder exercising their right to nominate a director are precluded from nominating directors or soliciting proxies in the following year[74] and are subject to substantial limitations on their ability to sell shares, imposing a significant loss of liquidity.[75] The adoption of a bylaw with such tight restrictions should hardly be viewed as providing shareholders with meaningful proxy access.

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[70] *See* Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46. This model bylaw imposes significantly more restrictive conditions on proxy access than the ABA Model Bylaw, *supra* note 46, which is in turn significantly more restrictive than Rule 14a-11. Although the access restrictions in bylaws adopted by boards pursuant to the process that the Proposal Opponents envisage will vary, that process will allow boards to adopt bylaws that are more restrictive than what shareholders would prefer.

[71] *See* the definition of "Required Interest" in Subsection (b)(v) of the Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46.

[72] *See* the definition of "Permitted Number" in Subsection (b)(i) of the Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46, which is defined, with provisos, as "one-third of the number of seats on the Board of Directors to be filled in the Election (rounded down to the nearest whole number but not less than one)."

[73] *See* Subsection (c) of the Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46, which states that "each Eligible Stockholder, together with its Affiliates, may nominate one, and not more than one, individual under this Section for inclusion in the Corporation's proxy statement and on its proxy card."

[74] *See* Subsection (c) of the Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46.

[75] *See* Subsection (d)(i) of the Wachtell, Lipton, Rosen & Katz Model Bylaw, *supra* note 46, requiring an affidavit delivered by the nominating shareholder to represent that the nominating shareholder "will not sell or otherwise dispose of its Beneficial Ownership and Economic Interest of voting securities of the Corporation so as to reduce the Beneficial Ownership and Economic Interest held by such [nominating

G. Different Access Regimes

We have so far assumed for the purposes of this part that shareholders' preferences are binary, for either the access arrangement specified by a federal access regime or no-access. The Proposal Opponents stress that "one size does not fit all" and that companies vary considerably in their characteristics and circumstances. We now consider the possibility that optimal access regimes, and those preferred by shareholders, may differ among companies. We conclude that, also under this assumption, an access default would be preferable to retaining a no-access default.

We continue to assume that shareholders will be free to opt-out of whichever default rule is chosen. In Part III we discuss in detail the manner in which shareholders should be permitted to opt-out of a federal access regime. Under the SEC's proposal, firms would be able to adopt bylaws that provide more expansive access rights than provided by the federal access regime. As will be explained in more detail in Part III, we also support allowing shareholders to adopt resolutions opting-out of the federal access regime. Thus, a firm would be able to substitute an access regime with more restrictive access rights than provided in the federal access regime by (i) passing a shareholder resolution to opt-out of the federal access regime, and (ii) as the company would no longer be governed by the federal access regime, adopting a bylaw providing the desired set of access rights.

Consider a set of companies whose shareholders prefer access regimes (which might vary from company to company) that provide access rights that are more restrictive than those provides by the federal access regime. Each of these access regimes may be viewed as being located on a spectrum between no-access and the federal access regime. In the view of the Proposal Opponents, a no-access default should be the baseline from which shareholders of any given company in the set opt-out to the access arrangement that they prefer. However, setting the federal access regime as a default would be more likely to result in a given company becoming subject to the access arrangement preferred by its shareholders.

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shareholder], together with its Affiliates, below the [5%] Required Interest on or prior to the date of the Election] (and representing that they have no present intention of reducing, within one year following the Election, their aggregate Beneficial Ownership and Economic Interest below the greater of (x) the [5%] Required Interest and (y) seventy-five percent (75%) of their aggregate Beneficial and Economic Interest as of the Advance Notice Date)".

The reason for this is the asymmetry discussed above between opting-out in a direction favored by incumbent directors and opting-out in a direction disfavored by incumbent directors. Because of this asymmetry, if a no-access default is retained, many firms whose shareholders prefer an access arrangement would likely remain without such an arrangement. In contrast, if a federal access regime is set as a default, and the shareholders of a company prefer an access regime that provides more restrictive access rights, a change to the shareholders' preferred regime would be more likely. Such a change would be likely to take place since it would be favored not only by the shareholders but also by the directors, and the board could therefore be expected to ensure that shareholders have the chance to vote on a resolution to opt-out of the federal access regime and adopt a bylaw providing the desired access arrangement (or the board could pass such a bylaw themselves). We conclude that the case for a no-access default is not strengthened by recognizing that "one size does not fit all" and that the optimal access regime that shareholders prefer varies among companies. Instead, the impediments to opting-out in a direction disfavored by directors make a no-access default an inferior starting point for moves to optimal access arrangements.

More generally, assuming a federal access regime is provided as a default, and that shareholders are permitted to opt-out to both more and less restrictive access rules, the above analysis indicates that changes to access rules preferred by shareholders of particular companies are less likely to occur where shareholders prefer more expansive access rights than provided by the federal regime, than where shareholders prefer less expansive access rights than provided by the federal regime. This conclusion provides an important insight concerning the setting of the various dimensions of the federal access regime, such as eligibility thresholds and procedural requirements for nominating directors. The SEC should not design the default access regime in accordance with what it believes to be optimal for the "average" publicly traded company. Because it would be more difficult for shareholders seeking changes to expand access rights than to restrict them, the optimal default rule will be one that provides more expansive access rights than are likely to be optimal for the "average" company.

Thus, although a discussion of the design of the various detailed dimensions of the federal access regime is beyond the scope of this paper, our analysis of private ordering and the proxy access debate suggests an important consideration for such an analysis. The design of the federal access regime should err on the side of providing meaningful access rights. This would result in more companies becoming subject to the exact access arrangements preferred by their shareholders.

H. An Access Regime Should be the Default

The above analysis and empirical evidence clearly demonstrates the limitations of the process on which Proposal Opponents wish to rely as a substitute for a federal access regime. Retaining a no-access default and leaving the adoption of proxy access arrangements to company-by-company adoption cannot be expected to result in the general adoption of proxy access arrangements by all of the public companies whose shareholders would favor such an arrangement. Among the thousands of public companies, many – possibly most – will avoid adopting a proxy access arrangement, at least for several years, and a number of those companies adopting proxy access arrangements will implement details that are significantly more restrictive than those favored by their shareholders.

It should be stressed that the outcome for public companies as a whole is likely to be even worse than the percentage of companies failing to adopt proxy access arrangements favored by their shareholders would suggest. That is, the companies that will avoid adopting proxy access arrangements are likely to be among those whose directors are already less accountable to shareholders and less attentive to shareholder interests — in other words, the companies for which effective proxy access is especially important.

I. Beyond Proxy Access

Although we have so far focused on proxy access, the analysis in Part II has implications that go beyond proxy access – in particular, for the choice of default arrangements with respect to other election arrangements. As detailed above, the empirical evidence suggests that subjecting directors to enhanced risk of removal in the event of under-performance can be expected to increase shareholder value. Given the centrality of election arrangements to the corporate structure, public officials would do well to reconsider whether existing arrangements that insulate directors from removal are warranted.

We have also analyzed the impediments to shareholders forcing companies to opt-in to arrangements favored by shareholders but disfavored by boards, and have discussed evidence showing how these impediments substantially limit the speed and efficacy of adopting such arrangements. Our analysis lends support to the "reversible defaults" analysis put forward earlier by one of the authors together with Assaf Hamdani.[76] In selecting default arrangements, public officials should take into account the fact that a switch from an inefficient default to a more efficient arrangement that would be favored by shareholders is more likely to occur when such a switch is favored by the board than when it is disfavored. This consideration should be given significant weight when defaults are initially selected, and also whenever they are re-examined.

In addition to changing the default rule that currently denies shareholder director nominees access to the corporate ballot, other defaults should be re-examined with the above considerations in mind. For example, we believe there is a strong basis for replacing the current default of plurality voting with a majority voting default. Although there is now widespread recognition that majority voting should be the standard for director election, we have shown that its diffusion has been much more limited than is commonly supposed: As noted above, a substantial number of S&P 500 companies, and a large majority of the thousands of public companies outside the S&P 500, remain subject to plurality voting. This is due to the difficulties of getting public companies, and especially smaller companies that are not usually the target of shareholder proposals, to adopt arrangements favored by shareholders but not by boards of directors.

Accordingly, it is not sufficient to allow companies to opt-in to majority voting. As long as plurality voting remains the default, many if not most public companies will be governed that way, even if their shareholders prefer majority voting and would not support plurality voting if asked to vote on the matter. Switching to a majority voting default, which will contribute to improving corporate elections, is therefore warranted.

III. SHOULD SHAREHOLDERS BE ALLOWED TO OPT-OUT OF THE FEDERAL ACCESS REGIME?

Part II of this article concluded that there is a strong case for replacing the current no-access default with a proxy access default. Because state law has failed to provide proxy access arrangements, federal law should provide a proxy access default rule. We now consider whether and to what extent opting-out of a federal access regime should be permitted.

[76] *See* Bebchuk and Hamdani, *supra* note 31.

The Proposal Opponents argue forcefully in favor of allowing opting-out; this is the position taken by the Business Roundtable Comment Letter,[77] the Seven Firms Letter,[78] and by the letters of numerous law firms[79] and corporations.[80] Indeed, Grundfest goes so far as to claim that an SEC rule that did not allow opting-out would be irrational, to such a degree that it would fail the rationality test of the Administrative Procedure Act.[81]

Section A begins by pointing out the inconsistencies between the Proposal Opponents' strong support for the ability to opt-out of a proxy access regime and (i) their prior positions against the ability to opt-out of the current no-access regime when the SEC considered allowing such opting-out in 2007, and (ii) their acceptance of mandatory arrangements making it difficult for shareholders to replace directors, from which shareholders are not permitted to opt-out. We also note that the Proposal Opponents over-state the strength of the case for allowing opting-out, and that preventing opting-out in a way that would dilute the protections accorded to shareholders by the proxy access regime is consistent with the general structure of the proxy rules. In Section B we turn to our own position on the subject. Although prohibiting opting-out

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[77] *See* Business Roundtable Letter, *supra* note 5, at 47 ("We believe that shareholders should be permitted to propose amendments to a company's bylaws that would increase or decrease the requirements of the [Proposed Rules]").

[78] *See* the Seven Firm Letter, *supra* note 11, at 1-2 ("Any prescriptive proxy access regime should permit private ordering under state law so as to permit stockholders to modify the SEC's proxy access regime as they see fit, including by opting-out of the SEC's proxy access regime in its entirety").

[79] *See*, e.g., the Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-263.pdf (hereinafter, the "Wachtell, Lipton, Rosen & Katz Letter", at 10 ("If the SEC enacts a federal shareholder access rule, we urge that it adopt a default rule that each company may supplement, replace or repeal as befits its individual circumstances") and 11 ("no access rule [the SEC] adopts should prevent shareholders and the companies in which they have invested from opting-out of, or otherwise modifying, one or more aspects of that rule"), and Letter from Sullivan & Cromwell LLP to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-430.pdf, at 4 ("If Rule 14a-11 is adopted, it should be … a default rule that permits companies to opt-out with shareholder approval").

[80] *See*, e.g., Letter from Mary T. Afflerbach, Air Products and Chemicals, Inc., and others, to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-472.pdf, at 4 ("Companies, boards and shareholders should be allowed to determine the proxy access regime at their companies").

[81] *See* Grundfest, *supra* note 10, at 29, where he suggests that it is irrational to accept that shareholders have the capacity to nominate and elect directors, and simultaneously to view them as not capable of making good choices about whether to opt-out of an access regime; he contends that this contradiction, and a second contradiction that he describes, "are likely fatal to the Proposed Rules under the Administrative Procedure Act."

that would weaken shareholder rights would not be unreasonable, we support allowing opting-out of the proxy access regime in both directions – provided, however, that such opting out is done by a process that contains certain important elements and conditions. We also argue that allowing opting-out of proxy access should be accompanied by a reconsideration of existing rules that prevent shareholders from opting-out of arrangements that make replacing directors more difficult.

A. Some Questions about the Proposal Opponents' Position on Opting Out

The Proposal Opponents present a forceful defense of shareholders' right to opt-out of proxy access rules.[82] The Seven-Firm Letter, for example, stresses that depriving shareholders of their right to opt-out of the access regime would be "wrong as a matter of policy."[83] This recognition of the value of shareholder choice expressed by corporations and corporate law firms is welcome and encouraging. However, it is interesting to observe that many of the Proposal Opponents seem more inclined to allow opting-out of arrangements making it easier to replace directors than opting-out of arrangements making it difficult to replace directors. Their underlying position seems to be guided not by the view that permitting opting-out is desirable, but rather by the view that director removal should be difficult.

Two inconsistencies in particular are worth discussing. First, the Proposal Opponents' current position in favor of allowing opting-out conflicts with the position many of them Proposal Opponents expressed in 2007 when the SEC considered allowing shareholders

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[82] *See*, e.g., the Wachtell, Lipton, Rosen & Katz Letter, *supra* note 79, at 10 ("If the SEC enacts a federal shareholder access rule, we urge that it adopt a default rule that each company may supplement, replace or repeal as befits its individual circumstances"), or the Business Roundtable Letter, *supra* note 5, at 47 ("We believe that there is no legitimate reason to allow shareholder proposals that would impose more lenient but not more restrictive access requirements on nominating shareholders. Rather, the Commission should let companies and their shareholders decide whether or not, and to what degree, they wish to permit shareholders to include their director nominees in company proxy materials").

[83] *See* Seven-Firm Letter, *supra* note 11, at 11 ("If the SEC adopts proposed Rule 14a-11, stockholders should have the option to opt-out of proposed Rule 14a-11 either by a stockholder vote or ratification of board action. ... [P]roposed Rule 14a-11 would deprive stockholders of their ability to exercise their rights under enabling state laws to implement the specific form of proxy access that they believe best fits their particular company and fellow stockholders, or alternatively to choose to forego entirely the costs and burdens of proxy access. We think this result is wrong as a matter of policy and raises significant administrative law issues.").

satisfying certain eligibility standards to include on the corporate ballot proposals to opt-out of the current no-access default.[84] Although the Proposal Opponents now argue strongly that shareholders should be allowed to opt-out of *any* access regime, in 2007 many of them Proposal Opponents– including the Business Roundtable, the U.S. Chamber of Commerce, and a number of prominent corporate law firms – strongly opposed allowing shareholders to include proposals to opt-out of the current no-access rule on the corporate ballot.[85] For example, the U.S. Chamber of Commerce, in a comment letter regarding the 2007 Shareholder Proposal Rule, indicated that they "strongly oppose the [2007 Shareholder Proposal Rule] as unnecessary, overreaching and potentially disruptive and harmful to companies and shareholders."[86] At the time, the strong opposition to allowing shareholders to opt-out of the current no-access default prevailed, and the SEC adopted the current rule allowing companies to exclude opt-out proposals.[87]

Comparing the positions of many Proposal Opponents in 2007 with their positions today, it seems that the fundamental principle underlying their current position is not that of permitting shareholders to opt-out and choose the arrangements they find most fitting. Rather, the position of these Proposal Opponents regarding opting-out seems to depend on the nature of the default arrangement in place: They strongly support opting-out when proxy access is the default, but strongly oppose opting-out when no-access is the default. Although these Proposal Opponents have reversed their 2007 position and now support allowing shareholders to opt-out of the

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[84] Shareholder Proposals, Exchange Act Release No. 34-56160, 72 Fed. Reg. 43,466 (proposed July 27, 2007) (to be codified in various parts of 17 C.F.R.); hereinafter, the "2007 Shareholder Proposal Rule."

[85] *See*, e.g., Letter from David T. Hirschman, Senior Vice President, Chamber of Commerce for the United States of America, to Nancy M. Morris, Secretary, SEC (October 2, 2007), *available at* http://www.sec.gov/comments/s7-16-07/s71607-482.pdf (hereinafter, the "2007 Chamber of Commerce Letter"); Letter from Keith F. Higgins, Committee Chair Committee on Federal Regulation of Securities of the American Bar Association, Section of Business Law, to Nancy M. Morris, Secretary, SEC (October 2, 2007), *available at* http://www.sec.gov/comments/s7-17-07/s71707-126.pdf; Letter from Anne M. Mulcahy, Chairman & CEO, Xerox Corporation, and Chairman, Business Roundtable Corporate Governance Task Force to Nancy M. Morris, Secretary, SEC (October 2, 2007), *available at* http://www.sec.gov/comments/s7-17-07/s71707-77.pdf; Letter from Sullivan & Cromwell to Nancy M. Morris, Secretary, SEC (October 2, 2007), *available at* http://www.sec.gov/comments/s7-16-07/s71607-458.pdf; and Letter from Wachtell Lipton to Nancy M. Morris, Secretary, SEC (September 19, 2007), *available at* http://www.sec.gov/comments/s7-16-07/s71607-190.pdf.

[86] *See* the 2007 Chamber of Commerce Letter, *supra* note 85.

[87] *See* Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70,450 (adopted December 6, 2007), initially proposed in Shareholder Proposals Relating to the Election of Directors, Release No. 34-56161, 72 Fed. Reg. 43,488 (proposed July 27, 2007).

current no-access default, this new position seems in reality to be part of an effort to avoid the adoption of a stronger proxy access regime by the SEC.

The second tension worth noting is between the Proposal Opponents' opposition to a proxy access regime that does not allow shareholders to opt-out, and their acceptance of various arrangements that make it difficult for shareholders to replace directors, from which arrangements shareholders cannot opt-out. Such arrangements have long existed under both federal law and state corporate law. For example, several of the federal proxy rules introduced in the 1950s with respect to consent solicitations have long made mounting proxy challenges more difficult and more costly.[88] Similarly, state law includes mandatory rules that prevent shareholders from initiating charter amendments.[89] To the best of our knowledge, none of the Proposal Opponents now championing opting-out by shareholders from proxy access have expressed dissatisfaction about shareholders' inability to opt-out of current arrangements that make it difficult to replace directors, or has proposed changes to facilitate such opting-out. This is again consistent with the Proposal Opponents' fundamental commitment to arrangements that make electoral challenges more difficult rather than to arrangements that facilitate private ordering and opting-out.

Finally, before proceeding, we should note that the Proposal Opponents substantially over-state the strength of the case for allowing opting-out. The Proposal Opponents suggest that there can be no justification for not permitting opt-outs that would dilute the rights provided by a federal access regime.[90] In fact, both state corporate law and federal securities law establish protections for shareholders, both in general and with respect to corporate elections, that

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[88] *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 at 613 ("In the 1950s, the SEC federalized proxy contests to make them harder for insurgents to win, moving even before states acted definitively") and 645 ("The 1950s proxy rules, widely viewed as responses to managerial pressure, impeded insurgents"), citing the discussion of these rules in John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. FIN. ECON. 241, 263-67 (1991). For another discussion of the proxy rules from this perspective, see Lucian A. Bebchuk and Assaf Hamdani, *Federal Corporate Law: Lessons From History*, 106 COL. L. REV. 1793-1839 (2006), at 1805-1807.

[89] *See* Del. Code Ann. tit. 8, § 242(b)(1) (2009).

[90] *See, e.g.*, Grundfest, supra note 9, at 4-5 (viewing as irrational any proxy access regime that does not allow shareholders to opt out in order to weaken the rights provided to them by the regime).

shareholders cannot vote to dilute.[91] There is also a substantial body of academic work that identifies and discusses at length various reasons for adopting minimum standards of investor protection as mandatory rules from which opting out is not permitted.[92]

Moreover, it should be noted that the long-standing approach of the shareholder proposals rule has been to provide shareholders with minimum rights of access to the company's proxy card for their proposals, and to allow companies to provide shareholders with additional rights, but not to derogate from the set minimum.[93] More generally, the proxy rules – and the securities laws in general – have long provided mandatory arrangements establishing a minimum level of protection for public investors, allowing companies to add additional protections, but not to reduce investors' protections below the established minimum. Thus, an "asymmetric opting-out" arrangement that allows opting-out of the federal proxy access regime only to expand shareholder rights but not to weaken such rights would be consistent with the long-standing structure of the federal securities laws.

B. Opting-out of the Federal Access Regime

Although it would not be unreasonable to support asymmetric opting-out, we support "symmetric opting-out" – that is, opting-out of the proxy access regime either to strengthen or weaken the access rights of shareholders. One of the factors motivating us to take this position is the inevitable uncertainty about the optimal eligibility thresholds for proxy access in any given company. We believe that the difficulties shareholders face in opting-out of default rules in the "direction" disfavored by the board – that is, toward less restrictive requirements for access –

[91] For example, state corporate law does not enable shareholders to opt out of their rights to vote on directors annually, and federal securities law does not enable shareholders to vote to approve their being furnished by proxy challengers with less information than is required by the proxy rules.

[92] For an early set of articles on the subject, see *Symposium on Contractual Freedom in Corporate Law*, 89 COL. L. REV. 1395-1774 (1989). This symposium includes articles from authors representing different perspectives and methodologies – for example, Victor Brudney, Frank Easterbrook and Daniel Fischel, Robert Clark, and Jeffrey Gordon – who all support some limits on opting out. One of us has over time written extensively on the various reasons for placing some limits on opting out; see, e.g., *Why Firms Adopt Antitakeover Arrangements* 152 UNIV. OF PENN. L. REV. 713-753 (2003); *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments* 102 HARV. L. REV. 1820-1860 (1989); *The Debate on Contractual Freedom in Corporate Law* 89 COL. L. REV. 1395-1415 (1989).

[93] *Securities and Exchange Commission v. Transamerica Corporation, et al.*, 163 F2d 511 (3d Cir. 1947).

make it desirable to set reasonably low eligibility thresholds for the access default. However, if eligibility thresholds are set at a reasonably low level, it is desirable in turn to allow shareholders to tighten those requirements if they consider more restrictive requirements to be preferable.

However, opting-out of the federal access regime should be permitted only if the opting-out process is designed in such a way that companies are released from the federal access regime if and only if their shareholders prefer a different arrangement. Below we discuss several principles that should govern the opt-out process.

1. Opting-out Only by Majority Shareholder Approval

We believe that boards of directors should not be able to opt-out of governance arrangements that make it more difficult to replace incumbent directors.[94] Thus, companies should not be able to opt-out of a federal access regime by means of board-adopted bylaws. In our view, the federal access regime should allow opting-out only by a shareholder resolution passed by shareholders representing a majority of the outstanding shares.[95] Boards should be free to initiate a vote on such a resolution, as should shareholders. With boards free to initiate votes on opt-out resolutions, such votes are likely to occur whenever passage of such opt-out resolutions is likely – that is, whenever a majority of the shareholders prefer to opt-out of the access regime. Such opt-out resolutions, in their most basic form, would merely remove from the company's shareholders the access rights provided by the federal access regime. However, as will be discussed below, such resolutions could be accompanied by proposals to adopt bylaws that would provide alternative access rights distinct from those conferred by the federal access regime.

[94] For an analysis supporting this principle, *See* Bebchuk, *The Myth of the Shareholder Franchise, supra* note 20, at 709-711.

[95] A similar approach is used by Section 216 of the DGCL, which prevents directors from repealing bylaws on majority voting that have been adopted by a vote of shareholders. See – Del. Code Ann. tit. 8, § 216 (2009). Unfortunately, the DGCL does not extend this principle to other shareholder-adopted bylaws.

2. Shareholder Ability to Reverse Earlier Opt-out Decisions

The process for opting-out by shareholders from a federal access regime should leave the door open for shareholders to later reverse their choice and opt-back-in to proxy access. Shareholders' preferences may shift over time, with new information and as the shareholder body changes. The SEC's rules should therefore ensure that shareholders wishing to opt-back-in to the federal access regime do not face excessive impediments: Opting-back-in should occur by the same process as opting-out, and should be similarly easy.[96] In particular, any firm that is no longer subject to the federal access regime as the result of an opt-out resolution would again become subject to the access regime once shareholders representing a majority of the outstanding shares approve a resolution to that effect.[97] Public companies will therefore not be subject to the federal access regime only if (i) an opt-out resolution has been passed by shareholders representing a majority of the outstanding shares, and (ii) no subsequent resolution to opt-back-in to the federal access regime has been passed by shareholders representing a majority of outstanding shares.

3. Permissibility of Bylaws That Add to Access Rights Provided by Federal Law

Firms should be free to adopt bylaws that allow shareholders additional rights to access the company's proxy card beyond the baseline rights provided by the federal securities laws – that is, either the access rights provided by the federal access regime, or a basis of no access rights if shareholders have adopted a resolution opting-out of the federal access regime. If most shareholders prefer an access regime that is more restrictive than the federal access regime, we would expect the board to initiate a resolution opting-out of the federal access regime, coupled

[96] An alternative way to ensure that the non-applicability of the federal proxy access regime to a corporation continues to be supported by its shareholders is to have any decision to opt-out of the access regime "sunset" after a fixed number of years. For example, the SEC could specify that a corporation is not subject to the federal proxy access regime if shareholders holding a majority of the outstanding shares approved a resolution (which was not subsequently reversed) to opt-out of the access regime during the preceding five years.

[97] One advantage of having the opt-out done by shareholder resolution rather than by adoption of a bylaw is that companies may have charter provisions requiring a supermajority of shareholders to approve bylaw amendments; this would effectively make it much harder for shareholders who had opted-out to later opt-back-in to a proxy access regime.

with a bylaw amendment to adopt the more restrictive access regime desired by shareholders. In this way, shareholders would be able to opt-out into alternative and more restrictive access regimes instead of being able to opt-out only into a no-access regime. If shareholders prefer a regime that provides more expansive access than the federal access regime, they should be able to adopt such an expansive access regime by augmenting the federal access regime with a bylaw providing additional access rights.

4. Access to Arguments and Information against Opting-out

The SEC's rules should ensure that shareholders voting on a proposal to opt-out of the federal proxy access regime have access to information explaining both sides of the issue. Without such a requirement, the company's proxy statement, distributed to all shareholders eligible to vote on the opt-out resolution, would contain only the views expressed by the company's board in favor of opting-out – if a shareholder wished to present the case *against* opting-out the shareholder would have to engage in a costly proxy solicitation. To ensure that shareholders voting on an opt-out proposal *are* informed about both sides of the issue, the SEC could consider requiring companies to include in their proxy materials a standard statement, drafted by the SEC, that explains the benefit to shareholders of proxy access provided by the federal regime.

C. Beyond Proxy Access

As we have discussed, the debate on proxy access has led public companies and corporate law firms to recognize and stress the value of allowing shareholders to opt-out of governance arrangements. This recognition should lead as well to a general reconsideration of existing restrictions on shareholders' ability to opt-out of governance arrangements that make it difficult for shareholders to replace directors. The adoption of SEC rules permitting shareholders to opt-out of the federal access regime should be accompanied by such reconsideration. The SEC, Congress, and state legislatures should closely review these restrictions on shareholders opting-out of the prevailing arrangements governing corporate elections.

Public officials could start by considering how to facilitate the ability of shareholders to, among other things, (i) opt-in to annual elections in companies that currently have a staggered board, (ii) adopt bylaws governing elections without being required to include ”fiduciary outs” that eliminate much of the bylaws’ potential significance, (iii) limit the use of poison pills that make it difficult to remove directors, and (iv) opt-out of arrangements that make it difficult for institutional investors to coordinate their actions. We hope that the recent realization by many public corporations and corporate law firms of the value of private ordering and allowing shareholders to opt-out of corporate governance arrangements will lead them to support such changes.

IV. CONCLUSION

This article has sought to contribute to the debate on the SEC’s proxy access reform and governance reforms more generally. In particular, the article has focused on “meta” objections that accept the desirability of reforms but argue that such reforms should be left to adoption through board action in response to shareholder proposals, against the background of the status quo default rule. There are strong reasons for replacing the current no-access default. In particular, there are reasons for believing that a proxy access regime is more likely to be efficient, and, moreover, that the greater difficulty of opting-out where disfavored by the board (compared to where the board is in favor of opting-out) provides a strong reason for adopting a federal access regime as a default. We further identify certain principles that should guide the ability of shareholders to opt-out of the federal access regime. Our analysis has significant implications, beyond the proxy access debate, for the choice of corporate default arrangements in general and for the processes of opting-out from such arrangements. We hope that our analysis will be useful to the SEC as it decides how to move forward with proxy access reform, as well as to future examinations of governance reforms in the critical areas of corporate elections and shareholder rights.