What Theory and the Empirical Evidence Tell Us about Proxy Access

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Abstract

Traditionally, the default rules of corporate and securities law have provided a public company's board of directors with exclusive authority to decide whether shareholder proposals on proxy access are to be included in that company's proxy solicitation materials. However, the Securities and Exchange Commission (SEC) has recently amended its rules to allow such proposals to be included whether or not a board approves. This study recommends that the SEC return to its traditional approach to proxy access and furthermore urges the SEC not to put universal proxy access back on its agenda absent consistent empirical evidence that shows proxy access to be value enhancing. These recommendations are efficiency based. The study argues that the board is the locus of authority and possesses expertise and access to information that is not available to shareholders and is thus presumed to be in a better position to determine whether proxy access is wealth enhancing for shareholders.

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What Theory and the Empirical Evidence Tell Us about Proxy Access

Bernard S. Sharfman

Traditionally, the default rules of corporate and securities law have provided a publicly traded company's board of directors with exclusive authority to decide whether shareholder proposals on proxy access—the ability of certain privileged shareholders to have their own slate of director nominees included in the company's proxy solicitation materials for purposes of voting at the annual meeting—are to be included in the company's proxy solicitation materials. However, the US Securities and Exchange Commission (SEC) has recently amended its rules to allow such proposals to be included whether or not the board approves. That change has resulted in a new issue that now needs to be addressed: What are the consequences of potentially providing a small group of privileged shareholders, in addition to the board,[1] the power to decide which nominees for election to the board of directors are to be included in a public company's proxy solicitation materials (the proxy statement and proxy voting card)?[2]

During the 2015 proxy season, the Office of the Comptroller of New York City (comptroller), the custodian and investment adviser to the New York City Pension Funds, submitted 75 of the 108 proxy access proposals that were received by publicly traded companies.[3] From the comptroller's perspective, the effort was successful. Of the 75 precatory proposals the

[1] According to Stephen Bainbridge, "There is no more basic question in corporate governance than 'who decides.'" *See* Stephen M. Bainbridge, *Executive Compensation, Who Decides?*, 83 TEXAS L. REV. 1615, 1650 (2005) (in the context of the board versus shareholders).

[2] For purposes of this study, a *public company* can be defined as a for-profit corporation that is publicly traded on a national exchange or over the counter but does not have a controlling shareholder.

[3] R. J. Lehmann, *Proxy Access: Shareholder Democracy or Creeping Mercantilism* (R Street Policy Institute, Study No. 38, 2015), *available at* http://www.rstreet.org/policy-study/proxy-access-shareholder-democracy-or-creeping-mercantilism/.

comptroller submitted,[4] 66 went to a shareholder vote, with 55 percent average support.[5] Of those 66, 41 received majority support.[6] Moreover, at six companies where withdrawal of the proxy access proposal was negotiated, management agreed to adopt proxy access or put forward a management-sponsored proposal next year.[7] Overall, 100 companies faced nonbinding proxy access proposals in 2015, with 60 gaining the majority support of shareholders.[8] Moreover, 115 companies in 2015 adopted a binding proxy access bylaw.[9] As a result, 117 of the S&P 500 companies (21 percent of the index) now have a binding proxy access bylaw in place.[10] It has been estimated that another 200 companies will face proxy access proposals in 2016,[11] including 36 by the comptroller and 40 by California State Teachers' Retirement System.[12]

As nonbinding proxy access proposals gain traction with shareholders and a number of boards begin to adopt binding proxy access bylaws in response to shareholder pressure, it may be only a matter of time before the SEC puts universal proxy access back on its agenda.[13] Universal

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[4] Precatory proxy access proposals are preferable because of the significant challenges involved in drafting a binding bylaw and at the same time trying to make sure it does not exceed Rule 14a-8's 500-word limit. Latham & Watkins LLP, *Proxy Access and Advance Notice Bylaws in the Wake of Invalidation of the SEC's Proxy Access Rule: An Approach to Private Ordering*, CORP. GOVERNANCE COMMENT., Nov. 2011, *available at* https://www.lw.com/upload/pubContent/_pdf/pub4437_1.pdf. Also, it has been suggested that a precatory proposal will garner more votes than a mandatory proposal because shareholders will take a precatory proposal less seriously. *See* Lawrence Hamermesh, *Precatory Proxy Access Proposals*, INST. DEL. CORP. BUS. L. (Nov. 15, 2011), http://blogs.law.widener.edu/delcorp/2011/11/15/precatory-proxy-access-proposals/#sthash.zXGjV6Qg.dpbs.

[5] ACTIVIST INVESTING: AN ANNUAL REVIEW OF TRENDS IN SHAREHOLDER ACTIVISM 41 (Josh Black ed. 2016), *available at* http://www.srz.com/The_Activist_Investing_Annual_Review_2016/.

[6] *Id.* at 40.

[7] Barry B. Burr, *Board Support Rising but Concerns Remain, Study Says*, PENSIONS AND INVESTMENTS (July 27, 2015), http://www.pionline.com/article/20150727/PRINT/307279997/board-support-rising-but-concerns-remain-study-says.

[8] Joe Cahill, *Four Companies Doing the Right Thing for Shareholders*, CRAIN'S CHICAGO BUSINESS (Nov. 25, 2015), http://www.chicagobusiness.com/article/20151125/ISSUE10/151129911/four-companies-doing-the-right-thing-for-shareholders.

[9] Che Odom, *NYC Pension Funds, CalPERS Prep for Proxy Access Blitz*, BLOOMBERG BNA, Jan. 28, 2016, *available at* http://www.bna.com/nyc-pension-funds-n57982066676/.

[10] ACTIVIST INVESTING, *supra* note 5, at 40.

[11] Cahill, *supra* note 8.

[12] ACTIVIST INVESTING, *supra* note 5, at 40.

[13] Cydney Posner, *Is the SEC Considering Reproposing Mandatory Proxy Access Rules?*, PUBCO@COOLEY (Aug. 3, 2015, 3:57 PM), http://cooleypubco.com/2015/08/03/is-the-sec-considering-reproposing-mandatory-proxy-access-rules/.

proxy access, a recurring topic of SEC focus for more than 70 years, would automatically allow certain privileged shareholders to place their nominees for the board into the proxy solicitation materials of almost all public companies without the need for a charter amendment or bylaw.

The possibility that the SEC will renew its interest in universally mandated (universal) proxy access was signaled by a recent empirical study of proxy access by staff economists in the SEC's Division of Economic and Risk Analysis. The study stated the issue as follows: "The fundamental question is whether private market forces, through the shareholder proposal process, would be able to realize (and perhaps surpass) the enhancements in shareholder value that could result from universally-mandated proxy access."[14]

This statement is surprising, because it relies on the premise that both shareholder-initiated proxy access and universal proxy access are superior to the historical approach of board-initiated proxy access in terms of shareholder wealth enhancement and firm performance. However, that premise has not been empirically verified and, as argued in this study, is incorrect. Another signal is a recent study done by the CFA Institute.[15] The objective of the study was to address the issues raised by the D.C. Court of Appeals in *Business Roundtable v. SEC* when it vacated the SEC's universal proxy access rule in 2011 and to thereby encourage the SEC to revisit universal proxy access.[16] Finally, the Council of Institutional Investors, a nonprofit association representing the interests of public pension

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[14] Tara Bhandari et al., *Public versus Private Provision of Governance: The Case of Proxy Access*, STAFF WORKING PAPER (US Sec. & Exch. Comm'n), July 24, 2015, *available at* http://www.sec.gov/dera/staff-papers/working-papers/public-vs-private-provision-of-governance.pdf.

[15] CHIARA TRABUCCHI ET AL., PROXY ACCESS IN THE UNITED STATES: REVISITING THE PROPOSED SEC RULE (2014), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n9.1. For a critique of this study, *see* Bernard. S. Sharfman, *Critiquing the CFA Institute's Report on Proxy Access* (R Street Institute, R Street Shorts No. 2, March 2016), *available at* http://www.rstreet.org/wp-content/uploads/2016/03/RSTREETSHORT21.pdf (finding that the report's shortcomings should disqualify it "from being used as support for mandatory proxy access; for shareholder proposals on proxy access; for board discussions about whether a proxy-access bylaw should be implemented; and, perhaps most importantly, for board discussions about whether a proxy-access bylaw needs to be rescinded").

[16] TRABUCCHI ET AL., *supra* note 15, at 1.

funds and labor union–related entities, continues to promote the idea of universal proxy access though its 2015 policy statement "that proxy access is a *fundamental* right of *long-term* shareowners" (emphasis added).[17]

This study makes three primary arguments. First, the SEC's current regime of proxy access, by no longer allowing companies to exclude shareholder proposals on proxy access from their proxy solicitation materials,[18] should not be understood as an enhancement to the "private ordering" of a company's governance arrangements. Rather, this regime acts as a federal barrier to the more efficient approach of board-initiated proxy access. Therefore, this study recommends that the SEC return to its traditional approach to proxy access, allowing a board to omit shareholder proposals on proxy access from a company's proxy materials at its discretion. Second, the superiority of board decision-making in the context of proxy access creates a presumption that universal proxy access is an inefficient and unnecessary means of nominating and electing directors. Third, that presumption can be rebutted with empirical evidence that consistently shows, at a high level of statistical significance, that universal proxy access is wealth enhancing for shareholders. That premise is required as the null hypothesis to be tested and can be stated as follows: the "preservation of managerial discretion" in the nomination of directors is wealth enhancing for shareholders. However, the empirical evidence does not currently exist to reject the null hypothesis. As a result, it would be reasonable for the SEC to keep universal proxy access off its agenda.

The issue of proxy access must also be understood in the larger context of shareholder empowerment (the shifting of decision-making authority from the board of directors and

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[17] COUNCIL OF INSTITUTIONAL INVESTORS, PROXY ACCESS: BEST PRACTICES 2 (Aug. 2015), *available at* http://www.cii.org/files/publications/misc/08_05_15_Best%20Practices%20-%20Proxy%20Access.pdf.
[18] 17 C.F.R. § 240.14a-8(i)(8) (2011).

executive management to shareholders).[19] Proxy access is clearly the corporate governance arrangement that is the current focus of those who advocate for shareholder empowerment. The problem with shareholder empowerment is that it tries to shift the balance between authority and accountability too far in the direction of accountability without proper theoretical or empirical justification. Rather, the balance should be heavily weighted toward authority for a public company (as subsequently discussed) to make the most efficient decisions.[20] Moreover, shareholder empowerment takes a one-size-fits-all approach without taking into consideration that all firms are different and that the optimal corporate governance arrangements at one company will not necessarily be the same at another.[21] Finally, there is no end in sight for shareholder empowerment.[22] The trend is toward "*creeping shareholder activism*, a constant movement toward shareholder empowerment without regard for what is lost in the process in terms of efficient decision making" (emphasis added).[23] A line must be drawn somewhere, and proxy access is as good a place as any to start pushing back against the negative aspects of the shareholder empowerment movement.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest US companies are incorporated,[24] and its corporate law often serves as the authority that other US states look to when developing their own statutory and case

[19] Bernard S. Sharfman, *What's Wrong with Shareholder Empowerment?*, 37 J. CORP. L. 903, 903 (2012).
[20] *Id.*
[21] *Id.* at 907.
[22] *Id.* at 908.
[23] *Id.*
[24] *See* LEWIS S. BLACK JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), *available at* corp.delaware.gov /whycorporations_web.pdf (stating that Delaware is the "favored state of incorporation for U.S. businesses"). According to the State of Delaware website, Delaware is the legal home to "[m]ore than 50% of all publicly-traded companies in the United States including 64% of the Fortune 500." *About Agency*, STATE OF DELAWARE, http://corp .delaware.gov/aboutagency.shtml (last visited Oct. 15, 2014).

law.[25] Therefore, the primary examples are from Delaware, but the study is meant to be global in nature.

This study first describes the SEC's current regime of proxy access. Second, the study discusses how the SEC's current regime of proxy access harms private ordering. That discussion leads to a recommendation that the SEC's current regime of proxy access be rescinded. Third, the study discusses universal proxy access. That section takes the perspective of an impartial SEC commissioner who is trying to decide whether to implement universal proxy access. This decision is difficult for a commissioner and the commission as a whole to make because the issue of universal proxy access resides in the world of corporate governance, not in securities regulation and its focus on disclosure. Moreover, the world of corporate governance arrangements rests on the foundation of state corporate law—again not an area of expertise for the commission—and on the private ordering approach to such arrangements. If such an approach can be understood to be generally wealth enhancing for shareholders, then a commissioner must tread very carefully when considering implementing universal proxy access. Such careful consideration requires that a vote for universal proxy access be supported by empirical evidence that consistently shows (from study to study) its value over time and that is not simply supportive of proxy access at any one point in time. This section argues that such empirical evidence does not currently exist. The final section concludes by summarizing this study's findings and recommendations.

The SEC's Current Regime of Proxy Access

From 1947 to 2011, the SEC's proxy rules on shareholder proposals allowed a public company to exclude any proposal from a company's proxy solicitation materials that related "to an

[25] See Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007).

election for membership on the company's board of directors or analogous governing body."[26] At a minimum, that exclusion meant that shareholders could not place their nominees in a public company's proxy solicitation materials without first getting the approval of the board. Notably, that requirement meant that universal proxy access was not allowed. Moreover, for most of that lengthy time period, with one significant exception,[27] the SEC also interpreted the relevant rule to mean that a board could exclude a shareholder proposal to establish a procedure by which certain shareholders could include their shareholder nominees in a company's proxy solicitation materials. Therefore, the implementation of proxy access has mainly existed under a corporate governance arrangement that can be referred to as *board-initiated proxy access*. Although it is subsequently argued in this study that the board, as well as shareholders, did not historically have the authority under Delaware corporate law to initiate proxy access through a bylaw, at the very least the board could initiate proxy access through the charter amendment process.

In practice, boards have resisted using their authority to initiate proxy access. Instead, the nomination of directors has been under the control of the board and its nominating committee. In 2006, it was reported that 99 percent of companies in the S&P 500 Index used a nominating

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[26] AFSCME v. AIG, 462 F.3d 121(2006) *citing* 17 C.F.R. § 240.14a-8(i)(8). The SEC's source of authority for this long-standing exclusion comes from Section 14(a) of the Securities Exchange Act of 1934.

[27] During the 1980s the SEC denied several requests for no-action letters where a company was trying to exclude a proxy access proposal dealing with "procedural rules applying prospectively to future elections to the board." Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L. J. 131, 140 (2008) *citing* Unicare Services, Inc., SEC No-Action Letter, 1980 SEC No-Act LEXIS 3289 (May 13, 1980); Mobil Corp., SEC No-Action Letter, 1981 LEXIS 3208 (Mar. 3, 1981); Union Oil Co. of Cal., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3001 (Jan. 29, 1981); Chittenden Corp., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 1955 (Mar. 10, 1987).

However, by the beginning of 1990, the SEC staff had changed its approach, allowing such exclusions. *Id. citing* Bank of Boston, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 206 (Jan. 26, 1990); Unocal Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 183 (Feb. 6, 1990); Amoco Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 242 (Feb. 14, 1990); Thermo Electron Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 549 (Mar. 22, 1990). This hard-line approach was successfully challenged on grounds that the SEC never provided sufficient reasons for changing its position. *See* AFSCME v. AIG, 462 F.3d 121 (2006). In response, the SEC quickly provided a release codifying the reasoning for the change by modifying the language of Section 14a-8(i)(8) to make it clear that the exclusion also applies to a shareholder proposal seeking a proxy access process. *See* Securities Act Release No. 56914.

committee.[28] Use of the committee meant that only candidates who had been screened and approved by the committee, with or without full board approval, would appear in the company's proxy solicitation materials for purposes of electing directors at the annual meeting.[29] Because shareholders could not place their slate of nominees in the company's proxy materials, the only alternative was to go through the cost-prohibitive process of entering into a proxy contest by creating their own proxy materials to nominate their slate. Therefore, board nominees—listed in the proxy materials and helped by the advantages of plurality voting—were always assured of winning an election except in those elections in which a proxy contest had been initiated.

However, in 2011, a dramatic change occurred in the way in which the SEC approached proxy access. By using authority granted to it by Section 971 of the recently enacted Dodd-Frank Act,[30] the SEC was able to modify Rule 14a-8(i)(8), the election exclusion rule, so that public companies could no longer exclude precatory or binding shareholder proposals on proxy access from their proxy solicitation materials.[31] The result is that there is now what can be referred to as *shareholder-initiated proxy access* in addition to board-initiated proxy access.

How the SEC's Current Regime of Proxy Access Harms Private Ordering

On its face, shareholder-initiated proxy access appears to be value enhancing, because it provides a low-cost alternative to a proxy contest for certain shareholders seeking to get their slate of nominees voted on at an annual meeting. Yet proxy access can be value enhancing for the corporation and shareholders only if proxy access actually enhances the private ordering of corporate governance

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[28] *See* Murphy, *supra* note 27, at 147.
[29] Del. Gen. Corp. L. § 141(c)(2).
[30] Section 971 of the Dodd-Frank Act provides the SEC with undisputed authority to promulgate proxy access rules as long as such rules can be justified on the grounds that they are "in the interests of shareholders and for the protection of investors." Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, § 971, 124 Stat. 1376, 1915, 2010, http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_971.html.
[31] 17 C.F.R. § 240.14a-8(i)(8) (2011).

and does not detract from it. As argued in this section, the SEC's current regime detracts from private ordering by its forced inclusion of shareholder proposals on proxy access in a company's proxy solicitation materials without providing the board the option to deny such inclusion. This argument is meant to correct the misunderstanding that the SEC's current regime of proxy access enhances the private ordering of corporate governance arrangements.[32] In essence, the SEC's current regime of proxy access creates a mandatory rule that overrides the approach to the private ordering of corporate governance arrangements that has traditionally existed under corporate law, board-initiated private ordering. The result is a less efficient decision-making process.

What Is Private Ordering under Corporate Law?

According to Michael Jensen and William Meckling, "Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc."[33] Most famously, Jensen and Meckling describe an organization such as a public company as a legal fiction that serves "as a nexus for a set of contracting relationships among individuals."[34] As explained by Jonathan Macey, "because firms consist of a complex web of contractual relationships, firm behavior depends critically on what those contracts provide. In turn, the contract provisions themselves depend on the outcome of the *bargaining process* that takes place between the contracting parties" (emphasis added).[35]

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[32] Troy A. Paredes, Comm'r, US Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news /speech/2009/spch052009tap.htm; Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 376 (2010) (concurring with Paredes).

[33] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

[34] *Id.*

[35] Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1272 (1999).

Because corporate law primarily provides default, not mandatory, rules, this contractarian theory of the firm can also be applied to a firm's governance arrangements. Private ordering under corporate law is implemented through a process of creating, modifying, and repealing bylaws and charter amendments.[36] Private ordering is considered efficient because it allows for the implementation of market-driven corporate governance arrangements.[37] That is, it "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[38] In effect, "observed governance choices are the result of value-maximizing contracts between shareholders and management."[39]

But private ordering is not a purely theoretical construct under corporate law. It is a structured approach that purposefully selects the board to take the lead in determining the optimal corporate governance arrangements. According to Michael Klausner, "The contractarian theory of the firm . . . implies a theory of the role of corporate law: corporate law should merely provide a set of default rules that managers may adopt on behalf of their firms, while leaving managers free to customize their companies' charters with legally enforceable rights and obligations."[40] That

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[36] Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance,* 37 DEL. J. CORP. L. 731, 743 at note 80 (2013).

[37] According to Jonathan Macey,

> [B]ecause informal norms generate outcomes that are generally welfare-enhancing, while law *at best* generates outcomes that are mixed (and tend strongly towards the welfare-reducing), informal norms should come with a strong presumption of legitimacy. Formal legal rules are likely to be inefficient at best and amorally redistributive at worst. Thus, under a wide range of circumstances, such as when society is interested in maximizing utilitarian considerations, and when society is interested in resolving standard legal disputes within groups, lawmakers are unlikely to improve upon the customary rules the group develops through voluntary, private interaction.

Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1140 (1997).

[38] Paredes, *supra* note 32.

[39] David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

[40] Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 780 (2006).

board-initiated private ordering approach permeates the thinking of the Delaware courts. For example, consider Leo Strine's discussion of the board's ability to unilaterally adopt a bylaw in *Boilermakers Local 154 Ret. Fd. v. Chevron*:

> As our Supreme Court has made clear, the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL [Delaware General Corporate Law]. This contract is, by design, flexible and subject to change in the manner that the DGCL spells out and that investors know about when they purchase stock in a Delaware corporation. The DGCL allows the corporation, through the certificate of incorporation, to grant the directors the power to adopt and amend the bylaws unilaterally.[41]

As a demonstration of how corporate law has supported board-initiated private ordering over an extensive period of time, Chancellor (now Chief Justice) Strine cited as his authority two Delaware Supreme Court opinions issued 80 years apart.[42]

The Board's Control of Private Ordering

Board-initiated private ordering of governance arrangements is an application of the most important default rule under corporate law,[43] the rule that provides the board with ultimate decision-making authority. For example, under Delaware corporate law, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[44] On its face, that statutory rule provides the board with unlimited managerial authority. Public companies never substantively modify the default

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[41] 73 A.3d 934, 939 (Del. Ch. 2013).

[42] Airgas, Inc. v. Air Products & Chemicals, Inc., 8 A.3d 1182, 1188 (Del. 2010) and Lawson v. Household Finance Corp., 152 A. 723, 726 (Del. 1930).

[43] Although default rules can be modified, "the default rule is tailored toward what the legislature believes most, but not all, of an organization's stakeholders would have agreed to if contracting were efficient." James D. Cox, *Corporate Law and the Limits of Private Ordering* (Duke Law School, Public Law & Legal Theory No. 2015-47, 2015), at 7, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2671850.

[44] DEL. GEN. CORP. L. § 141(a) (2011).

rule,[45] and its lack of modification via charter amendment needs to be acknowledged as the first and most fundamental step in such a company's private ordering process. The default rule is so universally accepted that it most likely could have been written as a mandatory rule without restricting the contracting parties' abilities to enter into private ordering.[46] That is, if a bargaining process truly goes on between contracting parties in a public company, then there seems to be overwhelming support for allowing the board to retain ultimate decision-making authority. Conversely, if the contracting parties wanted to implement shareholder empowerment to enhance decision-making efficiency, one would expect that at least some public companies would have charter provisions that substantively weaken board authority.

Superior decision-making efficiency is the rationale that explains why the outcome of the bargaining process always allows section 141(a) of Delaware General Corporate Law (DGCL) to be incorporated without modification into a public company's charter and that by extension allows the board to control the private ordering of corporate governance arrangements, including proxy access. Corporate law concentrates ultimate decision-making authority in the board because lawmakers recognize that a centralized, hierarchical authority is necessary for the successful management of a public company that can become extremely large in size. According to Robert Clark, hierarchies in large organizations lead to the "facilitation of cooperation in the carrying out of large-scale tasks."[47] According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a

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[45] *Id. See also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").
[46] Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551 (1990).
[47] ROBERT CHARLES CLARK, CORPORATE LAW 801 (1986).

centralized authority for a large organization to make informed decisions and minimize error in decision-making.[48]

Armen Alchian and Harold Demsetz argue that a centralized authority is necessary to eliminate the problems associated with having a large number of shareholders:

> If every stock owner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group, whose main function is to negotiate with and manage (renegotiate with) the other inputs of the team.[49]

In a public company, the board has a clear decision-making advantage over shareholders. As observed by Michael Dooley, for companies with a large number of shareholders, it is much more efficient for the board—the corporate actor that possesses overwhelming advantages in terms of information, including nonpublic information—to make corporate decisions than for shareholders or any other party that contracts with the corporation to do so.[50] In sum, what is desired by the contracting parties in terms of decision-making can be summarized in the following statement by Stephen Bainbridge: "Preservation of managerial discretion should always be the null hypothesis."[51]

Indeed, the presumption that the board provides the corporation with superior decision-making is endorsed by the courts through the explanation of why courts apply the business judgment rule ("a presumption that in making a business decision, the directors of a corporation

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[48] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974).
[49] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972).
[50] Michael P. Dooley, *Two Models of Corporate Governance,* 47 BUS. LAW. 461, 467 (1992).
[51] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VANDERBILT L. REV. 83, 109 (2004).

acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"):[52]

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).[53]

The implementation of corporate governance arrangements is heavily influenced by that deference to board decision-making. Therefore, it should not be surprising that the board has sole discretion to initiate changes to the corporate charter, even though shareholder approval would be required.[54] Moreover, as already discussed, the board may unilaterally create its own bylaws if the charter provides it with such authority.[55]

The Role of Shareholders in Corporate Governance Arrangements

Even though the board is provided the lion's share of authority to initiate changes in a public company's corporate governance arrangements, shareholders do have a role to play beyond approving charter amendments. Shareholders may propose and approve binding bylaws.[56] However, those bylaws, as well as bylaws in general, will not survive a legal challenge if they interfere with the board's substantive decision-making authority under DGCL Section 141(a).[57] According to the Delaware Supreme Court in *CA, Inc.*, "It is well established Delaware law that a proper function of bylaws is not to *mandate* how the board should decide specific substantive

[52] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985), citing Aronson v. Lewis, 473 A.2d 805, 812 (1984).
[53] Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).
[54] Del. Gen. Corp. L. § 242(b)(1).
[55] *Id*. at § 109.
[56] *Id.*
[57] CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 234–37 (Del. 2008).

business decisions, but rather, to define the process and procedures by which those decisions are made (emphasis added)."[58] Therefore, the threshold question for the legality of shareholder-initiated bylaws is "whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself."[59] For example, in *Gorman v. Salamone*, the Delaware Chancery Court invalidated a binding shareholder-initiated bylaw approved by written consent of the shareholders that would have granted shareholders the substantive decision-making authority of removing corporate officers without cause.[60] According to the court in *Gorman v. Salamone*:

> Valid bylaws focus on process, and "[w]hether or not a bylaw is process-related must necessarily be determined in light of its context and purpose." The Court may look to the intent and effect of a bylaw to determine whether it is a proper subject for stockholder action; "even facially procedural bylaws can unduly intrude upon board authority."[61]

In sum, unlike charter amendments, shareholder bylaws, when under court review, will be closely scrutinized to see whether they encroach on the substantive decision-making of the board.

Proxy Access under Corporate Law

As the Delaware Chancery Court said in *Gorman v. Salamone*, "even facially procedural bylaws can unduly intrude upon board authority."[62] That likelihood is the problem with shareholder proposals on proxy access, whether they are crafted as binding or precatory bylaws. The proposals in and of themselves request that the board be relieved of some of its authority to participate in the director nomination process without a charter amendment to authorize such a change as required under DGCL Section 141(a). Indeed, proxy access, the ultimate objective of

[58] *Id.* at 234–35.
[59] *Id.* at 235.
[60] C.A. No. 10183-VCN (Del. Ch. July 31, 2015).
[61] *Id.* quoting CA, Inc., 953 A.2d at 236–37.
[62] *Id.*

such shareholder proposals, allows for the placing of director nominees into the company's proxy solicitation materials without review and approval by the board nominating committee, the part of the corporation that is in the best position to determine which nominees are the most qualified candidates to serve as directors:

> The Board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information. Shareholders who want to take advantage of proxy access do not have this information available to them.[63]

Allowing proxy access undercuts the informational advantage held by "the nominating committee by failing to assign it any role in screening or approving shareholder nominations."[64] Most important, boards would be forced to abdicate their fiduciary duties because they would not be given the opportunity to deny placing shareholder nominees into the proxy solicitation materials after a review of their qualifications, the requirements of the company, how the candidates would interact with other board members, and so on. According to the Delaware Supreme Court in *CA, Inc.*, a bylaw cannot "violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[65] In *CA, Inc.*, the court invalidated a bylaw that mandated "reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude."[66] Proxy access creates an analogous situation as the proper

[63] Bernard S. Sharfman, *Why Proxy Access Is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1873469.
[64] Murphy, *supra* note 27, at 144.
[65] 953 A.2d 227, 238.
[66] *Id.* at 239–240.

application of the board's fiduciary duties could preclude the inclusion of shareholder nominees into a company's proxy solicitation materials.

But that is not the end of the story. Those shareholders who disagree with the invalidation of a bylaw "have two alternatives. They may seek to amend the Certificate of Incorporation to include the substance of the Bylaw; or they may seek recourse from the Delaware General Assembly."[67] In essence, the latter is what happened. A year after the decision in *CA, Inc.*, DGCL Section 112 was made part of Delaware's statutory corporate law.[68] Section 112 allows proxy access to be implemented through a shareholder bylaw proposal or board-created bylaw, no longer requiring a charter amendment as argued earlier. The legislature passed this legislation—despite the precedence that makes providing shareholders with such authority an outlier under Delaware corporate law—clearly in response to the prospect of SEC-mandated proxy access and not in an attempt to overrule the judicial approach taken in *CA, Inc.* According to a comment letter from the Corporate Law Section of the Delaware Bar Association to the SEC, there was no need for universal proxy access via Rule 14a-11 given the recent passage of DGCL Section 112.[69] Most importantly, whether intended or not, Section 112 extinguished any concerns that if the SEC eliminated the ability of boards to exclude shareholder bylaw proposals on proxy access, as it ultimately did, doing so would be deemed a violation of Delaware law and therefore could still be excludable under SEC's Rule 14a-8(i)(2).[70]

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[67] *Id.* at 240.
[68] Del. Gen. Corp. L. § 112 (2009).
[69] Letter from Del. State Bar Ass'n to Elizabeth M. Murphy, Sec'y, SEC, on facilitating shareholder director nominations (July 24, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-65.pdf. *See also* Mark J. Roe, *The Corporate Shareholder's Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV. 1, 18–20 (2012).
[70] 17 C.F.R. § 240.14a-8(i)(2) (1997) (This rule allows a public company to exclude a shareholder proposal from its proxy materials if it would "violate any state, federal, or foreign law to which it is subject.").

The Problem of Shareholder Opportunism and Proxy Access

The intrusion of the SEC's current regime of proxy access into the private ordering of corporate governance arrangements also implicates shareholder opportunism. While the board nominating committee and the board as a whole must adhere to their fiduciary duties of care and loyalty, such duties are not required of shareholders who submit proposals on proxy access or participate in the nomination of directors under a binding proxy access bylaw. Therefore, proxy access may allow certain shareholders, such as public pension funds and labor union–related entities, the ability to act opportunistically if they deem it to their advantage. As discussed below, several recent reports indicate that certain shareholders may be using shareholder proposals, including proposals on proxy access, as a means to act opportunistically.

In a paper sponsored by the Manhattan Institute, Tracie Woidtke examines the relationship between public pension funds engaged in shareholder activism and firm value during 2001–2013.[71] She finds that "ownership by public pension funds engaged in social-issue shareholder-proposal activism is negatively related to firm value" and that "there is no significant relationship between public pension fund ownership and firm value for funds engaging in shareholder-proposal activism focused on corporate governance rules."[72] If the proposals were intended to enhance shareholder wealth, one would expect some positive relationship.

Tara Bhandari, Peter Iliev, and Jonathan Kalodimos find that firms targeted by the comptroller for the submission of proxy access proposals did not exhibit statistically significant

[71] Tracie Woidtke, *Public Pension Fund Activism and Firm Value: An Empirical Analysis* (Manhattan Institute, Legal Policy Report 20, September 2015), *available at* http://www.manhattan-institute.org/pdf/lpr_20.pdf.
[72] *Id.* at 3.

stock market underperformance relative to the control group."[73] If those proposals were related to enhancing shareholder wealth, one would expect the proposals to target underperforming companies, but they did not.

In another recent paper, John Matsusaka, Oguzhan Ozbas, and Irene Yi examine the use of shareholder proposals by labor union–related entities.[74] Essentially, they find that shareholder proposals were being used as "bargaining chips in contract negotiations."[75] According to the authors, "Union proposal activity increases by one-quarter in years where the union is negotiating a new contract with the company, and by two-thirds when the negotiation is contentious as evidenced by a work stoppage."[76] The authors conclude that "The evidence suggests that sometimes having more rights can be costly for shareholders."[77]

In sum, those studies suggest that enhanced shareholder power through the ability to initiate shareholder proposals, which now includes proxy access, can lead to a reduction in shareholder value.

Empirical Evidence

So far, the study by Bhandari, Iliev, and Kalodimos, a SEC staff working paper, provides the only empirical study on the value of proxy access proposals.[78] The researchers focused their

[73] Bhandari et al., *supra* note 14. *See also* Jonathan B. Cohn et al., *On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access*, forthcoming, J. FIN, available at http://ssrn.com/abstract=1742506 (suggesting that unions and public pension funds participating in proxy access could lead to decreases in shareholder value).
[74] John G. Matsusaka et al., *Opportunistic Proposals by Union Shareholders* (Marshall School of Business, University of Southern California, Research Paper No. CLASS15-25), May 2016, *available at* http://ssrn.com /abstract=2666064 http://dx.doi.org/10.2139/ssrn.2666064. *See also* Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUDIES 187, 189 (2012) (finding that "[w]hen a firm's unionized employees are no longer represented by the AFL-CIO, the AFL-CIO's pension funds become significantly less opposed to the firm's directors in subsequent board elections").
[75] Matsusaka et al., *supra* note 74, at 14.
[76] *Id.* at 26–27.
[77] *Id.* at abstract.
[78] Bhandari et al., *supra* note 14.

study on the day the New York City comptroller unexpectedly announced the proxy access initiative to the public, November 6, 2014.[79] Bhandari and her colleagues find that the announcement led to a positive, statistically significant 0.53 percent abnormal return for the 70 firms that they used in their sample.[80] They also find that the firms targeted by the comptroller's initiative did not correlate with those that were perceived to have benefited the most from universal proxy access at the time the SEC stayed its proxy access rules.[81] As already discussed, such a finding is one indication that the comptroller was not using proxy access in the most value-enhancing manner.[82] Supporting this conclusion is the finding that the comptroller's choice of target firms was "not significantly associated with poor recent stock performance of the firm or the growth opportunities of the firm."[83]

Even though the study suggests otherwise,[84] the sample clearly suffers from selection bias, resulting in a lack of randomness, and is therefore not representative of the universe of public companies. Of the 75 companies targeted by the comptroller, 33 were targeted because they were in industries directly related to climate change, 24 were targeted for a lack of board diversity, and 25 were cited for having received "significant opposition to their 2014 advisory vote on executive compensation."[85] As a result, 20 of the 75 target firms were from the petroleum and natural gas industry, 9 were from the utilities industry, and 6 more were from the coal industry.[86] This sample is significantly overweighted with firms that are either producing or consuming huge quantities of

[79] Five firms were removed from the sample because they had made earnings announcements on that day. *Id.* at 18.
[80] *Id.* at 4.
[81] *Id.* at 24.
[82] *Id.*
[83] *Id.* at 28.
[84] *Id.* at 17.
[85] Press Release, Office of the New York City Comptroller, Comptroller Stringer, NYC Pension Funds Launch National Campaign to Give Shareowners a True Voice in How Corporate Boards Are Elected (Nov. 6, 2014), *available at* http://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected/.
[86] Bhandari et al., *supra* note 14, at 43, table 3.

carbon-based fuels, and is therefore not representative of the current universe of US public companies. Moreover, the sample size is small, so it is not possible to support the overall result with cross-sectional analysis. Selection bias and small sample size mean that the results cannot be generalized to the market as a whole or be used to draw strong conclusions.[87] In sum, the study suffers from a lack of external validity. That is, the results of the study may provide information about how proxy access may affect the firms in the sample, but they cannot be generalized to the thousands of other firms that make up the universe of public companies.

Summary

Mandated shareholder-initiated proxy access strays from the principle that it is not the role of the federal securities laws to determine how authority is to be distributed in a public company. That is the role of private ordering as sanctioned by state corporate law. In 1997, the SEC understood that principle when it discussed shareholder proposals in the context of the "ordinary business" exclusion:

> The shareholder proposal process affects the internal governance of corporations, and it is state law—not federal securities law—which is primarily concerned with corporate governance matters. In its current form, rule 14a-8 in fact defers to state law on the central question of whether a proposal is a proper matter for shareholder action. The "ordinary business" exclusion is based in part on state corporate law establishing spheres of authority for the board of directors on one hand, and the company's shareholders on the other.[88]

The discussion in this section offers several lessons. First, private ordering under corporate law is a structured approach that purposefully selects the board to take the lead in determining the optimal corporate governance arrangements.

[87] ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 121 (2012) ("Since there are thousands of stocks that could be considered part of this universe, researchers often choose to use a smaller universe. When this choice is random, this does limited damage to the results of the study. If the choice is biased, it can provide results which are not true in the larger universe.").
[88] Proposed Rule: Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 39,093 (Sept. 18, 1997).

Second, superior decision-making efficiency is the rationale that explains why the outcome of the bargaining process always allows DGCL Section 141(a) to be incorporated without substantive modification in a public company and by extension allows the board to control the private ordering of governance arrangements, including proxy access.

Third, shareholders may propose and approve binding bylaws. However, those bylaws, as well as bylaws in general, will not survive a legal challenge if they interfere with the board's substantive decision-making authority under DGCL Section 141(a).

Fourth, shareholder proposals on proxy access in and of themselves request that the board be relieved of some of its authority to participate in the director nomination process without a charter amendment to authorize such a change as required under DGCL Section 141(a) and *CA, Inc*.

Fifth, DGCL Section 112 is an outlier under Delaware corporate law and was passed in response to the prospect of SEC-mandated proxy access and not to overrule the judicial approach taken *CA, Inc.*

Sixth, proxy access may allow certain shareholders, such as public pension funds and labor union–related entities, to act opportunistically if they deem it to be their advantage without the burden of fiduciary duties to the company or other shareholders. Moreover, once a binding bylaw is in place, the direct nomination of directors by shareholders may not follow a value-maximizing path. For example, what would stop the comptroller from continuing to target firms for the direct nomination of directors using the same criteria that it used in its proxy access initiative? Therefore, the negative wealth effects from inefficiency in the targeting of firms would arguably only expand as potentially opportunistic shareholders used the direct nomination of director candidates as a negotiating tool to accomplish their non-wealth-maximizing goals.

Those implications suggest that fiduciary duties may be required of shareholders who nominate directors through proxy access.[89]

The lessons learned in this section also lead to a policy recommendation that the SEC reinstate the ability of boards to exclude shareholder proposals on director elections under Rule 14a-8(i)(8), thereby allowing boards to once again have sole authority to determine whether the proxy access process should be initiated.

Universal Proxy Access

Despite the SEC's public recognition of the value provided by a board nominating committee,[90] the SEC has made several attempts over the years to change that paradigm and institute universal proxy access. The SEC's first attempt occurred in 1942.[91] However, the rule proposal was quickly withdrawn after strong opposition from corporate management.[92] In 1977 and again in 1992, the SEC seriously studied proxy access but did not pursue its implementation.[93] In 2003, the SEC once again proposed universal proxy access but with a twist.[94] Universal proxy access would not be required unless a specific triggering event occurred at the company.[95] For example, if one or more directors had received a 35 percent withhold vote, then proxy access would be mandatory.[96] That rule was also withdrawn because of opposition from corporate management

[89] Roberta Karmel, former SEC commissioner, was the first to suggest the idea of fiduciary duties for those shareholders who take advantage of proxy access. Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 20–21 (2004). *See also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).
[90] As reported to Congress by an SEC task force organized in 1977. *See* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 441 (2012) ("[A]s the SEC task force reported to the Senate, due to the emergence of nominating committees, a shareholder nomination rule was unnecessary.").
[91] *Id.* at 440.
[92] *Id.* at 441.
[93] *Id.* at 441–42.
[94] Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,784–85 (proposed Oct. 23, 2003).
[95] Fisch, *supra* note 90, at 442.
[96] *Id.*

and the desire of commentators to wait until the impact of the recently passed Sarbanes-Oxley Act of 2002 had become known.[97] Most recently, on June 10, 2009, the SEC introduced another universal proxy access proposal.[98] However, not until after the enactment of the Dodd-Frank Act—which contained a provision, Section 971, providing the SEC with express authority to implement universal proxy access[99]—did the SEC go ahead and adopt Rule 14a-11,[100] a rule that was to become effective on November 15, 2010. In response, the Business Roundtable and the US Chamber of Commerce filed a lawsuit in the D.C. Circuit Court of Appeals seeking that the court vacate the rules.[101] The three-judge panel of the D.C. Circuit Court of Appeals unanimously decided to vacate Rule 14a-11 after determining that the SEC had violated the Administrative Procedure Act (APA) by promulgating the rule in violation of the act's "arbitrary and capricious" standard of review.[102] That violation was the result of the SEC's failure

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[97] *Id.* at 444.

[98] Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, Exchange Act Release No. 60089 (proposed June 10, 2009).

[99] Section 971 of the Dodd-Frank Act provides the following:

(a) PROXY ACCESS.—Section 14(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(a)) is amended—(1) by inserting "(1)"after "(a)"; and (2) by adding at the end the following:

> "(2) The rules and regulations prescribed by the Commission under paragraph (1) may include—"(A) a requirement that a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer; and "(B) a requirement that an issuer follow a certain procedure in relation to a solicitation described in subparagraph (A)."

(b) REGULATIONS.—The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines *are in the interests of shareholders and for the protection of investors*. (emphasis added)

Providing such statutory authority to the SEC in the Dodd-Frank Act was necessary to erase any doubts that the SEC had the authority to promulgate proxy access rules that arose in an over 20-year-old decision involving the Business Roundtable. *See* Fisch, *supra* note 90, at 438 (citing Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (arguing that the SEC does not have authority to interfere with the substantive features of company voting rights as established under state corporate law)).

[100] 17 C.F.R. § 240.14a-11 (2010).

[101] 17 C.F.R. § 240.14a-11 (2011). Brief of Petitioner at 1–2, Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (No. 10-1305), 2010 WL 3770710.

[102] 647 F.3d 1144, 1156.

"adequately to consider the rule's effect upon efficiency, competition, and capital formation" as required by statute.[103]

The discussion in the preceding section of this study suggests that allowing the nomination of directors to be controlled by the board and its nominating committee has significant value for shareholders. If so, why has the SEC revisited universal proxy access over the years?

Whatever the reason, one could still make the case that universal proxy access is efficient if the empirical evidence demonstrated its efficiency. After all, the benefits of proxy access may exceed the value of board-initiated private ordering if the absence of proxy access has led to significant "managerial rent extraction,"[104] or what is more commonly referred to as *agency costs*, created by the separation of share ownership from the management of a public company.[105] According to Macey, "Ultimately, the best way of evaluating the relative desirability of an enabling regime of corporate law, as opposed to a mandatory regime, is by examining the relevant empirical evidence."[106] This empirical approach is totally consistent with what is required of the SEC under its statutory obligations as discussed in *Business Roundtable*.[107] If the SEC decides to make another attempt at universal proxy access, then it will need to do a comprehensive review of the empirical work available to show that it has met "its

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[103] *Id.* at 1146 *citing* § 3(f) of the Exchange Act and § 2(c) of the Investment Company Act of 1940. According to the Court,

> Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

Id. at 1148–49.

[104] Larcker et al., *supra* note 39, at 431.

[105] *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932), and Jensen & Meckling, *supra* note 33.

[106] Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185, 207 (1993).

[107] 647 F.3d 1144.

statutory responsibility to determine the likely economic consequences of" a new rule "and to connect those consequences to efficiency, competition, and capital formation."[108]

Enhancing Shareholder Wealth as the Objective of Universal Proxy Access

Before reviewing the existing empirical evidence, it is critical to determine the objective of universal proxy access. After all, a review of empirical studies would be worthless without an understanding of what a researcher would be looking for in those studies. Fortunately, Section 971(b) of the Dodd-Frank Act takes a shareholder-centric approach to any new SEC rule on universal proxy access. That is, any such rule must be "in the interests of shareholders and for the protection of investors."[109] Somewhat surprisingly, the meaning of that statutory requirement was not discussed in the original SEC release finalizing Rule 14a-11,[110] or in the *Business Roundtable* decision that vacated the rule.[111] So, how will the SEC interpret the statutory language if it tries to implement another universal proxy access rule? For starters, it is not enough to say that "proxy access is a fundamental right of long-term shareowners."[112] Although "that sentiment may have a vaguely constitutional ring to it,"[113] it offers the SEC no tangible guidance in terms of what is meant by "in the interests of shareholders and for the protection of investors."[114] Moreover, long-term shareholders have never had a fundamental right to proxy access under either corporate or federal securities law.[115] The only requirement in terms of director nominations is that at least some shareholders must have the power to nominate directors

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[108] *Id.* at 1148.
[109] Dodd-Frank Act, § 971(b).
[110] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Aug. 25, 2010).
[111] Bus. Roundtable v. SEC, 647 F.3d 1144, 1151–52 (D.C. Cir. 2011).
[112] COUNCIL OF INSTITUTIONAL INVESTORS, *supra* note 17, at 1.
[113] Bernard S. Sharfman, *Public-Pension Funds Play with Newest Toy in Corporate Governance* (R Street Institute, R Street Shorts No. 12, 2015), at 2, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2643622.
[114] Dodd-Frank Act, § 971(b).
[115] *Id.*

at the annual meeting itself.[116] In addition, it is not adequate to say that "[o]ne of the key tenets of the Federal proxy rules on which the Commission has consistently focused is whether the proxy process functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders."[117] This statement may be true, but it is not relevant to interpreting the new language found in the Dodd-Frank Act.

However, there is no reason for the SEC not to interpret the language of the Dodd-Frank Act, as it pertains to universal proxy access, to mean enhancing shareholder wealth. That approach is consistent with a number of established ways of looking at corporate governance. For example, under a nexus of contracts understanding of the firm, shareholders are the sole claimants on the residual cash flows generated by the firm, because other parties transacting with the corporation can adequately protect themselves by contract. That is, shareholders have the greatest risk of ending up with nothing as a result of their dealings with the corporation. The board may have ultimate authority to act and make decisions under the default rules of corporate law, *but* that authority is given by shareholders only if the board acts to enhance shareholder value. Moreover, having a board and executive management target the enhancement of shareholder wealth means that all other parties that have contracted with the corporation must be paid off before the shareholders receive a residual, if any.[118] Therefore, these other contracting parties should be supportive of enhancing shareholder wealth as the objective of corporate authority. As stated by Henry Manne, the result is an example of "pure positive economics" and

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[116] Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117, 150–51 (2014).
[117] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,670 (Aug. 25, 2010).
[118] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991) (noting that "maximizing profits for equity investors assists the other 'constituencies' automatically").

should be accepted as such.[119] In sum, that objective is what all parties to the corporate contract agree to and what the courts should be expected to enforce.

From a sustainability perspective, that approach is consistent with how the management of public companies should go about making decisions to create value.[120] A firm creates *value* by generating enough cash inflows to cover its cash outflows.[121] The timing of the inflows and outflows must then be discounted by the proper interest rate to determine if they have a positive net present value.[122] If they do, then the firm has value.[123] Moreover, continuously making investments with present values expected to be positive should lead to sustainable value creation.[124]

However, if management wants to make sure that sustainable value creation has the best chance of occurring, then it should also have the responsibility of trying to maximize the net present value as part of its decision-making calculus at any point in time.[125] The process of maximization can be referred to as *long-term value creation*, a process that management should be striving to implement.[126] As a result, long-term value creation equals maximizing a firm's net present value and thus also equates to shareholder wealth maximization.[127]

The benefits of that equivalency have been described in terms of sustainability by Eugene Fama and Michael Jensen:

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[119] Email from Henry G. Manne, professor emeritus of law, Geo. Mason Univ., to Bernard S. Sharfman (Dec. 29, 2012) (on file with author).
[120] Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813, 832 (2015).
[121] *Id*.
[122] *Id*.
[123] *Id*.
[124] *Id*.
[125] *Id*.
[126] *Id*.
[127] *Id*.

> Contracts [entered into by organizations such as public companies] that direct decisions toward the interests of residual claimants . . . add to the survival value of organizations. Producing outputs at lower cost is in the interests of residual claimants because it increases net cash flows, but lower costs also contribute to survival by allowing products to be delivered at lower prices.[128]

The Empirical Evidence

Critical to deciding whether the SEC should use its authority to implement universal proxy access is a proper evaluation of the empirical evidence that is available. For that purpose, this section takes the perspective of an impartial SEC commissioner who is trying to decide whether to implement universal proxy access. This decision is difficult for the commissioner because the issue of universal proxy access resides in the world of corporate governance, not securities regulation, and its focus on disclosure. Moreover, the world of corporate governance arrangements rests primarily in the hands of state corporate law—again not an area of expertise for the commissioner—and its private ordering approach to such arrangements. If such an approach can be understood to be generally wealth enhancing for shareholders, then the commissioner must tread very carefully when considering the implementation of universal proxy access. Such careful consideration requires that a vote for universal proxy access be supported by empirical evidence that consistently shows (from study to study) its value over time and that does not simply support proxy access at any one point in time. This section argues that such empirical evidence does not currently exist.

So far, the empirical evidence on proxy access comes exclusively from event studies. Event studies investigate the effect of new information—the event—on the expected stock

[128] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

returns of a targeted cross-section of firms.[129] The null hypothesis to be tested is whether the mean abnormal return at the time of the event is equal to zero.[130] That is, event studies are used to determine "whether there is an abnormal stock price effect associated with an unanticipated event"[131] on a targeted sample of firms that may have been uniquely affected by the event.

In the context of using event studies to evaluate proxy access, one can think of the standard null hypothesis, as previously described, as corresponding to the following statement: The "preservation of managerial discretion" in the nomination of directors is wealth enhancing for shareholders.[132] Therefore, if the SEC feels compelled to interject universal proxy access into the governance of public companies, then the SEC has the burden to demonstrate that the available empirical studies provide sufficient evidence to show that proxy access consistently generates abnormal returns to the extent that the SEC has comfort that this null hypothesis has been rejected. Moreover, because event studies report what the market thinks only at a point in time, significant consistency between studies is needed to provide comfort that the burden has been met over a period of time (stationarity), not just at any one point in time. If that burden cannot be met, then the SEC once again risks being found by a court to have "relied upon insufficient empirical data" when the SEC concludes that its universal proxy access rule "will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees."[133] Finally, although not a statutory requirement, the threshold

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[129] Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 187, note 37 (2001).
[130] S. P. Kothari & Jerold B. Warner, *Econometrics of Event Studies*, *in* HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 1, 9 (B. Espen Eckbo ed., vol. 1, 2006).
[131] S.V.D. Nageswara Rao & Sreejith U., *Event Study Methodology: A Critical Review*, 3 MACROTHEME REV. 40, 44 (2014).
[132] This null hypothesis is derived from Stephen Bainbridge's argument that the "[p]reservation of managerial discretion should always be the null hypothesis." Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004).
[133] 647 F.3d 1144, 1150.

of evidence must be high because of the political reality that if the SEC implements a mandatory rule, that rule will be very difficult to unwind, even if the evidence becomes overwhelming that the rule is generally harmful to shareholders.

So far, all the event studies on proxy access can be characterized as being natural experiments.[134] That is, those event studies provide statistical analysis on proxy access–related events that are understood to be exogenous shocks to the stock market, such as when the court in *Business Roundtable* vacated the SEC's universal proxy access rule on July 22, 2011. A summary of those studies follows.

Larcker, Ormazabal, and Taylor. David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor evaluate 13 proxy access–related events that occurred between April 2007 and June 2009.[135] The authors characterize eight of those events as increasing the likelihood of proxy access regulation, and they identify the other five as decreasing the likelihood.[136] Overall, they find "a weak negative reaction to proxy access regulation,"[137] an average abnormal event day return of −0.32 percent.[138] Also, on a cross-sectional basis they find "strong evidence that abnormal returns are increasingly negative for firms with a greater number of large institutional blockholders."[139]

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[134] The term *natural experiments* may be defined as "a naturally occurring state (event) resulting from a social or political situation and thus not intentionally set up by the researcher." Jennifer Gippel et al., *Endogeneity in Accounting and Finance Research: Natural Experiments as a State-of-the-Art Solution*, 51 ABACUS 143, 156 (2015). The "naturally occurring state, often comes about from a social or political situation such as a government policy change." *Id.* at 158. Moreover, "[n]atural experiments are not 'true' experiments . . ." *Id.* "This is because the so called naturally occurring state is not intentionally set up by the researcher and so the *treatment group* is not randomly assigned. Such experiments are more like observational studies where the researcher cannot manipulate the environment, although; the researcher must choose the comparison or control group." *Id.*
[135] Larcker et al., *supra* note 39, at 442–43.
[136] *Id.* at 432.
[137] *Id.*
[138] *Id.* at 444, table 5.
[139] *Id.* at 432.

Financial firms were excluded from their sample.[140] Abnormal returns were computed on the day of the event relative to the Center for Research in Security Prices value-weighted market index that excluded dividends and distributions.[141]

As the first empirical study on proxy access, of course, Larcker and his colleagues enabled subsequent studies the opportunity to provide their share of criticism. Ali Akyol, Wei Fen Lim, and Patrick Verwijmeren find the approach in Larcker, Ormazabal, and Taylor problematic because the average abnormal return of a large portfolio of US firms compared with the US market index should be close to zero.[142]

Bo Becker, Daniel Bergstresser, and Guhan Subramanian criticizeLarcker and his colleagues' report for using events that are of "questionable importance."[143] For example, they question whether April 24, 2007, the date the SEC announced that it was scheduling a series of discussions on proxy access, was an event that increased the likelihood of proxy access or was even directionally clear because "the *AFSCME* decision permitted proxy access on a company-by-company basis."[144] Moreover, the authors suggest that many of the events used by Larcker, Ormazabal, and Taylor were predicted in advance.[145] For example, it is commonly known that the Delaware legislature gives great deference to the recommendations of the Corporate Law Section of the Delaware Bar Association when amending the DGCL. Therefore, when the Corporate Law Section voted in favor of a shareholder access amendment on February 26, 2009,

[140] *Id.* at 438.
[141] *Id.* at 439, note 39.
[142] Ali C. Akyol et al., *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations*, 47 J. FIN. & QUAN. ANAL. 1029, 1036, table 1 (2012).
[143] Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 J.L. & ECON. 127, 137 (2013).
[144] *Id.*
[145] *Id.*

its implementation in Delaware became very likely.[146] Nevertheless, as Becker and his colleagues point out, Larcker, Ormazabal, and Taylor do not include the February 26, 2009, announcement but do include as events that decreased the possibility of proxy access three subsequent and anticipated steps in the Delaware statutory process to make the shareholder access amendment law.[147] According to Becker and his colleagues, because the marketplace may have fully anticipated those subsequent events, the events studied may have had no value.[148]

Akyol, Lim, and Verwijmeren. Ali C. Akyol, Wei Fen Lim, and Patrick Verwijmeren evaluate 17 proxy access–related events between September 2006 and September 2010.[149] Nine of the 17 events can also be found in Larcker and his colleagues' study.[150] In contrast to Larcker, Ormazabal, and Taylor, Akyol and his colleagues use a global market index (excluding US firms) and a Canadian market index as benchmarks.[151] Because the SEC's rule affects only US companies, an abnormal return for the US portfolio compared with either the world index or the Canadian index on event days should demonstrate the value relevance of the proxy access–related events.[152] The authors use a sample of firms totaling 4,719.[153] They observe a statistically significant daily abnormal return of −0.70 percent for 10 events that increased the probability of

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[146] *Id.*
[147] *Id.* at 137–38.
[148] *Id.* at 138.
[149] Akyol et al., *supra* note 142, at 1036, table 1.
[150] *Id.* at 1035. Akyol and his colleagues also did a follow-up study that focused on how a firm's governance characteristics affected the returns from proxy access–related events. *See* Ali C. Akyol et al., *Governance Characteristics and the Market Reaction to the SEC's Proxy Access Rule*, 12 INT'L REV. FIN. 175 (2012). In that study, they find that announcement effects are positively related to the fraction of independent directors and the ratio of non-cash-based compensation but negatively related to board size. According to the authors, "We find that the market reaction to the proxy access rule is more negative for firms that have a larger board, a lower fraction of independent directors, a lower non-cash-based compensation to total compensation ratio, a CEO who is also a chairman, and a higher number of eligible institutional investors. Overall, our results suggest that the one-size-fits-all proxy access rule is not perceived as value increasing by the marginal shareholder." *Id.* at 194.
[151] Akyol et al., *supra* note 142, at 1030.
[152] *Id.*
[153] *Id.* at 1031.

proxy access and a significantly positive return of 0.80 percent for the 7 events in which the probability of proxy access declined.[154] They also observe that the overall wealth effect for proxy access was −0.70 percent relative to the global index and −0.60 percent relative to the Canadian market index.[155] They find the overall wealth effect to be statistically significant at the 5 percent level under both the global market index and the Canadian market index.[156] Their findings are also consistent with Larcker and his colleagues in showing that the firms with more eligible institutional investors had the most negative wealth effects.[157] As with Larcker, Ormazabal, and Taylor, Becker and his colleagues criticized Akyol, Lim, and Verwijmeren for using some event dates that may be of "questionable importance."[158]

Cohn, Gillan, and Hartzell. Jonathan Cohn, Stuart Gillan, and Jay Hartzell focused on three proxy access–related events before Rule 14a-11 was vacated.[159] The first event was the June 16, 2010, announcement by Senator Christopher Dodd that he was submitting a proposal amending the Dodd-Frank Act to direct the SEC to require that an investor or group of investors own at least 5 percent of a firm's shares for two years before gaining access to a firm's proxy for purposes of nominating directors.[160] At the time, the SEC had proposed a much less stringent tiered system, with minimum holdings of 1 percent, 3 percent, and 5 percent, respectively, for firms with market capitalizations greater than $700 million (large accelerated filers), between $75 million and $700 million (accelerated filers), and less than $75 million (nonaccelerated

[154] *Id.* at 1030.
[155] *Id.* at 1044, table 3.
[156] *Id.*
[157] *Id.* at 1031.
[158] Becker et al., *supra* note 143, at 137.
[159] Cohn et al., *supra* note 73.
[160] *Id.* at 2.

filers).[161] The second event was the dropping of Dodd's proposal on June 24, 2010, which led to a restoration of the SEC's proposed thresholds as the likely outcome of proxy access.[162] The third event occurred on October 4, 2010, when the SEC voluntarily stayed implementation of the universal proxy access rule in response to the *Business Roundtable* litigation.[163]

Cohn and his colleagues compared the abnormal returns of accelerated filers and large accelerated filers who were expected to be affected by these events with those of nonaccelerated filers who were not expected to be affected by the first two events and were expected to be affected, to a lesser extent, by the third event because they had already been given a three-year exemption from proxy access. Financial firms were excluded from the study's database, which included 3,102 firms.[164]

As expected, Cohn, Gillan, and Hartzell find about zero abnormal returns for nonaccelerated filers for all three events.[165] However, for accelerated and large accelerated filers the results are mixed, even though directionally they show that the market favored proxy access.[166] For the first event, Cohn and his colleagues find a statistically insignificant negative response for both accelerated and large accelerated filers.[167] For the second event, the researchers find a statistically significant (10 percent level) positive large response for accelerated filers (2.01 percent) but a statistically insignificant positive response for large accelerated filers.[168] For the third event, they find a statistically significant (10 percent level) negative response for accelerated filers (1.68 percent) and a statistically insignificant negative response for large

[161] *Id.*
[162] *Id.*
[163] *Id.*
[164] *Id.* at 9.
[165] *Id.* at 35, table II.
[166] *Id.*
[167] *Id.*
[168] *Id.*

accelerated filers.[169] However, when Cohn and his colleagues combine the returns found in all three events, the statistical significance increases dramatically to the 1 percent level for both accelerated and large accelerated filers.[170] That combination enables Cohn, Gillan, and Hartzell to conclude that universal proxy access is value enhancing for shareholders.[171]

Nonstationarity. Cohn and his colleagues raise the issue of nonstationarity. *Nonstationarity* refers to how the stock market may react differently to the same events at different points in time.[172] That is, the stock market may provide "one result for a period and a diverse outcome for another period."[173] Nonstationarity "is due to the change in perception of investors over a period of time."[174] That change is consistent with an efficient market in which the market price is an unbiased estimate of the true value of the investment but is not necessarily a correct one at any point in time.[175] As a result, it is possible that as the market becomes more informed about the real impact of an event, the market may change its opinion on how the event affects shareholder value.[176]

Cohn, Gillan, and Hartzell find it disconcerting that their study's results differ significantly from the results found by both Larcker and his colleages and Akyol and his colleagues.[177] Cohn and his colleagues suggest that the differences could have been the result of nonstationarity:

> We cannot reject the possibility that the differences between our results and those of Larcker, Ormazabal, and Taylor (2010) [and those of Akyol and his colleauges as well[178]]

[169] *Id.*
[170] *Id.*
[171] *Id.* at 28.
[172] Rao & Sreejith, *supra* note 131, at 44.
[173] *Id.*
[174] *Id.*
[175] DAMODARAN, *supra* note 87, at 112.
[176] Yaniv Konchitchki & Daniel E. O'Leary, *Event Study Methodologies in Information Systems Research*, 12 INT'L J. ACCT. INFO. SYSTEMS 99, 108 (2011).
[177] Cohn et al., *supra* note 73, at notes 6 and 7.

are driven by changes over time in the market's beliefs about the value of shareholder control. One possible trigger of such a change is the financial crisis. However, we exclude from our analysis financial firms, where concerns about mismanagement were likely to have been the strongest after the crisis. Moreover, our events take place in 2010, after the worst part of the crisis period, and complementary results regarding subsequent events in contemporaneous working papers (Becker, Bergstresser, and Subramanian (2013) and Jochem (2012)) suggest that our characterization of the perceived value of proxy access persisted at least until mid-2011.[179]

Even if the market had a positive perspective on proxy access on the dates studied by Cohn, Gillan, and Hartzell, it is easy to see how the market may change its mind over time. The market's valuation of proxy access is based on very little data. Proxy access has yet to be used to nominate a director let alone provide information traders with enough data to evaluate how board members who were nominated by shareholders have enhanced or subtracted from firm performance and market value. This lack of data makes the results of any empirical study at this time and for a number of years in the future susceptible to nonstationarity. Therefore, it may be a long time before the market gets a handle on the ultimate value, positive or negative, of proxy access.

The role of activist hedge funds. Most importantly, to understand why Cohn, Gillan, and Hartzell find universal proxy access to be wealth enhancing for shareholders on the event dates, one needs to understand the significant role that activist hedge funds may have played in the results. On all three event dates, Cohn and his colleagues find the market response to be stronger for firms that had a known activist hedge fund as a shareholder.[180] Moreover, chronologically, sitting between the second and third events was a fourth event that the researchers also analyze, the SEC's passage of the final proxy access rule on August 25, 2010.[181] Even though passage was

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[178] *Id.* at note 6.
[179] *Id.* at note 7 *citing* Becker et al., *supra* note 143, and Jochem, *infra* note 213.
[180] *Id.* at 3.
[181] *Id.* at 5.

anticipated, uncertainty remained about whether the minimum holding period was going to be two or three years.[182] As it turned out, the final rule had a three-year holding period.[183] Cohn, Gillan, and Hartzell find that the three-year holding period had a negative effect for activist hedge funds relative to others.[184] The finding makes sense because for activist hedge funds to maximize returns to their investors, they cannot hold the stock of their targets for a long period of time.[185] That is, to maximize their profits, they must maximize the number of their interventions.[186] That statement is consistent with the argument that anything that negatively affects hedge fund activism should negatively affect the stock market because hedge fund activism is the only form of activism that has been shown to be significantly wealth enhancing for shareholders over time.[187] In sum, Cohn, Gillan, and Hartzell's findings that universal proxy

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[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] Holding periods of activist hedge funds are estimated to average around 20 months. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1732 (2008) [hereinafter Brav et al., *Hedge Fund Activism, Corporate Governance*].
[186] Sharfman, *Activist Hedge Funds*, *supra* note 120, at 823–24.
[187] *See* Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 185 at 1731; *see also* Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 175–78, 201 (2011) (examining data from 1994–2005 and finding that hedge fund activism improved by short-term and long-term performance of companies); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008) (finding that in a control group containing hedge funds that filed Schedule 13Gs, "firms targeted by hedge funds for active purposes earn larger, positive [returns] than firms targeted by hedge funds for passive purposes"); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 374 (2009) (finding that "activists are most successful at creating value when they are able to [force] a change in control"); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013) (examining empirical results consistent with these studies but focusing on hedge fund activity outside the United States); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 213, 217–18 (2009) (focusing on activist campaigns by both hedge funds and other types of entrepreneurial activists and finding that both types of campaigns produced average abnormal returns for target shareholders); Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism* (Ind. Univ., Kelley Sch. of Bus., Research Paper No. 2014-05, 2014) (finding a link between improvements in innovation efficiency and hedge fund activism at firms with a diverse set of patents as a result of the activism leading to a more targeted approach to innovation); C. N. V. Krishnan et al., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise* (Vand. L. Sch., Law & Economics Working Paper No. 15-9, 2015) (discussing that hedge fund activism continues to generate positive, abnormal stock returns for an account period using a dataset collected from 2008 through mid-2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2589992; Marco Becht et al., *The Returns to Hedge Fund Activism: An International Study* (European Corporate Governance Institute, Finance Working Paper

access is wealth enhancing on the event dates tested leads to the conclusion that those results may have been driven by the wealth-enhancing effects of hedge fund activism. Ironically, that value was driven out by the SEC's three-year holding period, a holding period that has become standardized in shareholder proposals on proxy access and in the binding proxy access bylaws implemented by boards.[188]

Campbell, Campbell, Sirmon, Bierman, and Tuggle. Joanna Tochman Campbell, T. Colin Campbell, David G. Sirmon, Leonard Bierman and Christopher S. Tuggle focus their study exclusively on one event date, August 25, 2010, the day the SEC approved its universal proxy access rule.[189] Their sample of firms is taken from the S&P 500.[190] After Campbell and her colleagues removed firms that had confounding events, such as dividends and earnings announcements, and missing data, the sample contained 392 firms.[191] Like Akyol and his

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No. 402/2014, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2376271; Shane C. Goodwin, *Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom*, WORKING PAPER (Harvard Bus. Sch.), June 13, 2014, at 10–13, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id =2450214 (reporting excess returns for activist hedge funds that gain board representation); Nicole M. Boyson et al., *Serial Activists* (Northeastern U. D'Amore-McKim Sch. of Bus., Research Paper No. 2727371, 2016) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2727371&download=yes (using data from 2001–2013 to demonstrate that target performance is best when experienced hedge fund activists are involved). *But see* K. J. Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value*, WORKING PAPER, Nov. 2015, *available at* http://ssrn.com/abstract=2693231, and Yvan Allaire & François Dauphin, *The Game of "Activist" Hedge Funds: Cui bono?*, INT'L J. DISCLOSURE & GOVERNANCE (forthcoming), *available at* https://igopp.org/en/the-game-of -activist-hedge-funds-cui-bono/. For a sharp critique of the Cremers et al. study, *see* Lucian Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism: A Reply to Cremers, Giambona, Sepe, and Wang*, HARVARD LAW SCHOOL FORUM ON CORPORATE LAW AND FINANCIAL REGULATION (Dec. 10, 2015), https://corpgov.law.harvard .edu/2015/12/10/the-long-term-effects-of-hedge-fund-activism-a-reply-to-cremers-giambona-sepe-and-wang/.

[188] It is important to note that the SEC's Rule 14a-11 has provided the parameters for current proxy access proposals. Such proposals typically allow shareholders who have owned 3 percent of the company's voting common stock for at least three years, on an individual but more commonly on an *aggregated* basis, access to a publicly traded company's proxy-solicitation materials for purposes of nominating their own candidates for board membership. That rule means that, at those companies for which a proxy access bylaw has been approved by shareholders or the board, certain shareholders, either individually or in a group, may now include their own slate of nominees (typically up to 20 percent or 25 percent of the board seats that are up for election) in the companies' proxy materials.

[189] Joanna Tochman Campbell et al., *Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value*, 33 STRAT. MGMT. J. 1431, 1433 (2012).

[190] *Id.* at 1441.

[191] *Id.*

colleauges, they use a market index of Canadian firms (but not a global index) to calculate expected returns.[192] They find a relatively large abnormal return of 0.83 percent.[193]

What is quite disconcerting about the study is the way the authors characterize the event as one of significant uncertainty.[194] They cited the 3–2 vote of the SEC and the absence of "widely held expectation of the outcome of the vote in advance" as attesting to this uncertainty.[195] However, this characterization of the event is incorrect. At the time, observers noted a lack of uncertainty about how the vote would go, long before the vote was ever taken. According to Becker, Bergstresser, and Subramanian, the majority view was that Section 971 of the Dodd-Frank Act made universal proxy access inevitable.[196] Moreover, according to a *Wall Street Journal* article that ran on Aug. 5, 2010, "people familiar with the matter" believed that the SEC would approve the proxy access rule,[197] making the event largely anticipated.[198] Moreover, as discussed by Cohn and his colleagues, although the decision was anticipated, the holding period was uncertain, leading one to expect a negative effect on shareholder wealth as a result of the three-year holding period.[199]

Consistent with the announcement being anticipated, Akyol and his colleagues find the event to have a small statistically insignificant negative effect of 30 basis points on shareholder wealth.[200] So why are Campbell and her colleagues' returns so large and positive, 83 basis

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[192] *Id.*
[193] *Id.* at 1445.
[194] *Id.* at 1442. What is also striking is the authors' mischaracterization of the overlap and differences between shareholder primacy, director primacy, team production, and stakeholder theory. *Id.* at 1443. However, a critique of this mischaracterization is beyond the scope of this study.
[195] *Id.* at 1442.
[196] Becker et al., *supra* note 143, at 132.
[197] Akyol et al., *supra* note 142, at 1034, citing Kara Scannell, *SEC Set to Open Up Proxy Access*, WALL STREET JOURNAL, Aug. 5, 2010.
[198] Akyol et al., *supra* note 142, at 1053.
[199] Cohn et al., *supra* note 73.
[200] Akyol et al., *supra* note 142, at 1044, table 3.

points, even though the event may have been highly anticipated and expected to be negative? That conflict is yet to be resolved.

Becker, Bergstresser, and Subramanian. Bo Becker, Daniel Bergstresser, and Guhan Subramanian focuson October 4, 2010, the day when the SEC announced that it would stay implementation of its proxy access rules in response to the *Business Roundtable* litigation.[201] SEC stays are not a common occurrence, leading credence to choosing the stay as an unanticipated event.[202] Becker and his colleagues use a sample taken from the S&P Composite 1500 consisting of 1,388 firms.[203] They also use measures of institutional ownership as a proxy for measuring a firm's vulnerability to proxy access.[204] In doing so, they divide their sample into deciles, ranging from low to high levels of institutional ownership.[205] The bottom decile has institutional ownership of 25.3 percent, the top decile has almost 70 percent.[206] Becker, Bergstresser, and Subramanian find that the average equal-weighted return was a negative 124 basis points on the event day, but firms in the top decile dropped 44 basis points more than the firms in the bottom decile.[207] This finding implies that firms that were most susceptible to proxy access experienced significantly greater losses than firms that were most protected.[208] Therefore, the study indicates that universal proxy access is wealth enhancing for shareholders.

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[201] Becker et al., *supra* note 143, at 139.
[202] Bhandari et al., *supra* note 14, at 12, note 22. Note that several other recent motions to stay SEC rules, including rules related to mutual fund governance, conflict minerals, resource extraction, and securities issuance under Regulation A, were denied.
[203] Becker et al., *supra* note 143, at 143.
[204] *Id.* at 129.
[205] *Id.* at 143.
[206] *Id.*
[207] *Id.* at 143–44.
[208] *Id.* at 129.

It is interesting to note that Becker and his colleagues based their study of proxy access on the SEC's voluntary stay of Rule 14a-11. If the study is right, then one must ask why the stay surprised the market. One likely scenario is that the market must have believed that the request for a stay would fail at least one of the four factors the SEC used to evaluate a stay.[209] By granting the stay, the SEC must have determined that all four factors had been satisfied. The four factors are

1) whether there is a strong likelihood that a party will succeed on the merits in a proceeding . . . (or, if the other factors strongly favor a stay, that there is a substantial case on the merits);
2) whether, without a stay, a party will suffer imminent, irreparable injury;
3) whether there will be substantial harm to any person if the stay were granted; and
4) whether the issuance of a stay would likely serve the public interest.[210]

The most notable factor is the first, the SEC's determination that there was a strong likelihood that the petitioners would succeed on the merits. If the market was truly surprised by the stay, then perhaps the surprise reflected a market that had underestimated the probability that the plaintiffs could win in court.

Jochem. Torsten Jochem focuses exclusively on the event date of July 22, 2011, the day when the D.C. Circuit Court of Appeals vacated Rule 14a-11.[211] He estimates the shareholder wealth effects of greater proxy access by comparing the average daily abnormal returns of various portfolios of firms that were expected to have been affected by the event to the abnormal returns

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[209] Order Denying Stay, Exchange Act Release No. 68197, at 5, 2012, *available at* https://www.sec.gov/rules/other/2012/34-68197.pdf.
[210] *Id.* at 3.
[211] Torsten Jochem, *Does Proxy Access Increase Shareholder Wealth? Evidence from a Natural Experiment* (2012) (on file).

of the corresponding control portfolios that were not expected to be affected by the repeal.[212] Overall, he does "not find any significant shareholder wealth effect for the US market as a whole."[213] However, whenever he does find statistically significant results, they are consistent with proxy access being wealth enhancing.[214] Moreover, he finds a "monotonically increasing valuation decline the smaller a firm" became.[215] However, Jochem does not find any significant effects on large capitalized firms or on firms with capitalization below $75 million.[216]

The greatest effect was on firms with capitalization between $75 million and $184 million.[217] He finds a difference of 23 to 38 basis points between the smallest quintile of affected firms and the largest quintile of firms.[218] He also finds weak negative effects at firms where investors were eligible to immediately take advantage of proxy access.[219] He also finds a negative effect where a company has implemented a large number of antitakeover provisions such as staggered boards.[220] Finally, he does not find any effect on firms caused by the presence of public pension funds and labor union–related funds as shareholders.[221]

Stratmann and Verret. Thomas Stratmann and J. W. Verret test whether small firms with a market capitalization of between $25 million and $75 million performed differently on August 25, 2010, the date the SEC approved universal proxy access, compared with a control group of

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212 *Id.* at 12.
213 *Id.* at 1.
214 *Id.* at 22.
215 *Id.*
216 *Id.* at 23.
217 *Id.*
218 *Id.*
219 *Id.*
220 *Id.* at 22.
221 *Id.* at 23.

firms with a market capitalization of between $75 million and $125 million.[222] Stratmann and Verret's sample consists of small firms because there were several surprises involving firms with capitalization of less than $75 million (nonaccelerated filers).[223] First, small firms obtained only a three-year exemption from Rule 14a-11 instead of an expected total exemption.[224] Second, small firms did not receive any exemption from changes to Rule 14a-8.[225] Third, such firms would face a lower 3 percent ownership threshold for proxy access use versus the expected 5 percent.[226] Stratmann and Verret find that their sample had statistically significant (1 percent level) negative abnormal returns of 75.3 basis points compared with the control group.[227]

Unlike the case in the other studies discussed, Stratmann and Verret argue that they could "use a control group to *precisely* identify the effect of the event" (emphasis added).[228] Their control group consists of firms that were only slightly larger in market value than the sample firms and were not affected by the SEC announcement like the small firms because their market capitalization was greater than $75 million.[229] In essence, they have almost a perfect control group.

Stratmann and Verret then estimate how much the SEC announcement on August 25 lowered the stock market capitalization of their sample firms. They estimate the loss at $347 million after multiplying the average loss in stock market value of the sample firms (75.3 basis points) by the average market capitalization of the sample of those firms ($47 million) and by

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[222] Thomas Stratmann & J. W. Verret, *Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?*, 64 STANFORD L. REV. 1431, 1458 (2012).
[223] *Id.* at 1454.
[224] *Id.*
[225] *Id.*
[226] *Id.*
[227] *Id.* at 1460.
[228] *Id.* at 1454.
[229] *Id.* at 1458.

multiplying that product by the number of firms in the sample (980 firms).[230] Most importantly, the Stratmann and Verret study raises an important question regarding the effect of universal proxy access in general. That is, if it can be shown so clearly that small firms are negatively affected by a proxy access event under optimal testing conditions, why wouldn't the same result hold for medium to large firms, which appear to be more susceptible to proxy access because of their greater institutional ownership?

Implications of Empirical Studies for Universal Proxy Access

In *Business Roundtable*,[231] a primary factor in the court's decision to vacate the SEC's universal proxy access rule was a determination that the SEC failed to adequately consider its statutory obligations because it relied on "insufficient empirical data"[232] in assessing "the economic effects of a new rule."[233] More specifically, the SEC was found to have "relied upon insufficient empirical data" by completely discounting studies "because of questions raised by subsequent studies, limitations acknowledged by the studies' authors, or [its] own concerns about the studies' methodology or scope."[234] Therefore, all these empirical studies, including that of Bhandari, Iliev, and Kalodimos,[235] will need to be considered and weighed in the promulgation of any new universal proxy access. Excluding any of them from the SEC's benefit-cost analysis will be inconsistent with the holding in *Business Roundtable*. If any are excluded, then the SEC

[230] *Id.* at 1462.
[231] Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).
[232] *Id.* at 1150.
[233] *Id.* at 1148. For a summary of the SEC's statutory obligations, *see* Memorandum from the Div. of Risk, Strategy, & Fin. Innovation of the SEC & the Office of Gen. Counsel of the SEC, to Staff of the Rulewriting Divs. & Offices, Current Guidance on Economic Analysis in SEC Rulemakings 1–4 (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.shtml.
[234] 647 F.3d 1144, 1150–51.
[235] Bhandari et al., *supra* note 14.

will be repeating the same mistake it made when it implemented Rule 14a-11, a mistake that will not hold up under judicial review.

So far, the empirical evidence provides weak and conflicting evidence on the value of universal proxy access. Some studies support the value of proxy access, while others do not. The results are not consistent from study to study and from various points in time. Moreover, contradictions between studies have yet to be reconciled. In addition, as Cohn and his colleagues point out,[236] there is a concern that the results suffer from a lack of stationarity, a major drawback when all the empirical evidence comes in the form of event studies. Finally, the findings in Cohn suggest that the value of universal proxy access is driven primarily, or at least significantly, by the wealth-enhancing effects of hedge fund activism. But this value is almost completely undone by requirements that shareholders must have held the stock in question for a minimum of three years, a holding period that is found in the SEC's voided universal proxy access rule and that, ironically, has become standardized in shareholder proposals on proxy access and in the proxy access bylaws implemented by boards.[237] In sum, there is not yet enough information to reject the null hypothesis concerning universal proxy access: the "preservation of managerial discretion" in the nomination of directors is wealth enhancing for shareholders.

Conclusion

Until recently, the default rules of corporate and securities law have provided the board with exclusive authority to decide whether shareholder proposals on proxy access are to be included in a public company's proxy solicitation materials. However, that exclusive authority is no longer the rule because the SEC currently allows such proposals to be included. This study

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[236] Cohn et al., *supra* note 73.
[237] Sharfman, *Critiquing the CFA Institute's Report on Proxy Access*, *supra* note 15.

recommends, because there is weak and conflicting empirical evidence about the value of shareholder-initiated proxy access, that the SEC's current regime of proxy access be abandoned and urges the SEC not to put universal proxy access back on its agenda. These recommendations are efficiency based: the board—the locus of authority with the expertise and access to information that is not accessible to shareholders—is simply in the best position to determine whether proxy access is wealth enhancing for shareholders. The shareholders themselves are not in such a position.

Dating at least to 1942, when the SEC first attempted to mandate proxy access for all public companies, board-initiated proxy access has been the default rule. Moreover, during this time period, it has been empirically observed that proxy access has rarely been initiated at public companies. If proxy access were believed by the parties to the corporate contract to be wealth enhancing, then one would expect to see at least some experimentation, either by boards that allow shareholders to include their nominees in the proxy solicitation materials or by contracting parties that provide the right of shareholder-initiated proxy access through the charter modification process.

It is still possible that proxy access is wealth enhancing for shareholders but that board members are unanimously resistant because implementing proxy access is not in their personal interest. That is, the argument can be made that agency costs are inhibiting the implementation of proxy access and that universal rules allowing shareholder-initiated proxy access or providing universal proxy access are required to overcome those agency costs. To test whether that theory is correct, one must start with the null hypothesis that the "preservation of managerial discretion" in the nomination of directors is wealth enhancing for shareholders. For one to reject this null hypothesis with empirical analysis, it would appear reasonable to require multiple empirical

studies that consistently reject this null hypothesis with statistically significant results over a significant period of time. This approach appears to be consistent with what was required by the court in *Business Roundtable*.

Yet such empirical evidence has yet to reject the null hypothesis. For the current regime of shareholder-initiated proxy access, the empirical evidence is limited to one event study, a study whose results cannot be considered representative of the entire universe of US public companies. For universal proxy access, the empirical evidence provides conflicting results and conclusions and is subject to a lack of stationarity. Therefore, at this point, it would be reasonable for the SEC (a) to allow public companies to once again exclude shareholder proposals on proxy access from their proxy solicitation materials and (b) to continue to keep universal proxy access off its agenda.