No. 12-04
January 2012

WORKING PAPER

THE LAW AND ECONOMICS OF SHAREHOLDER VOTING REFORM AND THE COSTS OF PROXY ACCESS

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I. Introduction

Proxy access is a controversial legal rule to permit shareholders of publicly traded companies to place nominees onto the corporate proxy card in certain situations. Proponents of proxy access have long argued that it will make companies more accountable to their shareholders. Critics have warned that it instead risks empowering shareholders whose motives may conflict with maximizing shareholder value. For example, union pension funds and state pension funds that function under the influence of elected officials may wish to use their new powers to pursue politically motivated goals at the expense of shareholder returns for other investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 gave the U.S. Securities and Exchange Commission (SEC) the authority to adopt a proxy access rule.[1] Though the legislation urged an exemption for companies with less than $75 million in market capitalization, the SEC unexpectedly failed to provide a permanent exemption from the rule for those companies.[2]

We use that unanticipated event to test the effect of proxy access on firms with less than $75 million in market capitalization. This white paper summarizes our results, and we report

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] Facilitating Shareholder Director Nominations, Securities Act Release No. 9,136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,670 (Sept. 16, 2010, adopted Aug. 25, 2010).

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them in detail in an article forthcoming in the *Stanford Law Review*.[3] We find that, for the roughly 900 publicly traded companies we study with under $75 million in market capitalization, the proxy access rule caused on the order of $335 million in shareholder losses. This finding urges caution in the SEC's continued efforts to adopt proxy access and other corporate governance reforms broadly designed to empower shareholders.

II. Shareholder Voting Regulation and Proxy Access

Share ownership in U.S. public companies has historically been highly fragmented due to the interests of many investors in diversifying their ownership. Legal scholar Adolph Berle and economist Gardiner Means described this "separation of ownership from control" in their pioneering work on corporate governance. They argued that this situation is problematic because shareholders with low stakes in companies have little incentive to use their shareholder voting powers to police managerial excess.[4]

Berle and Means described a collective action problem in which millions of individual shareholders did not have a significant enough stake in the outcome of a shareholder election to take the time to vote their shares to replace bad managers. Many academics have since taken up their argument to urge regulation and legislation to make it easier for shareholders to challenge managers by making shareholder voting easier or less expensive.[5]

[3] A version of this work is forthcoming in the *Stanford Law Review*. See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Publicly Traded Companies?"64 *Stanford Law Review* (forthcoming 2012). When possible and appropriate, please cite to that version. For information, see http://lawreview.stanford.edu.
[4] See generally Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: McMillan, 1993).
[5] See, e.g., Lucian A. Bebchuk, "Letting Shareholders Set the Rule," *Harvard Law Review* 119 (2006): 1784–813.

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The rise of institutional investor ownership in publicly traded companies since the 1960s has slowly reduced the fraction of shares held by individuals. Today, large institutional owners such as pension funds, mutual funds, and hedge funds dominate the shareholder electorate. Over the last two decades, some of those institutional investors have pushed for new shareholder voting powers such as the proxy access rule considered in this study and the recently granted ability to seek shareholder advisory votes on executive compensation.

Opponents of shareholder voting reform have urged caution, noting that many institutional shareholders have goals that might conflict with maximizing the value of the company.[6] For example, unions form one of the more active and influential shareholder voting blocs and may therefore find shareholder voting a useful source of leverage in their bargaining negotiations with companies that employ union workers. A union might threaten a proxy fight if the company fails to concede on a labor negotiation. That result may be good for the union, but it may also destroy shareholder value for the other investors in the company.

Ashwini Agrawal conducted a study to test whether the AFL-CIO pension fund alters its voting strategy depending on whether the company subject to the vote has union employees or not.[7] He found not only that the AFL-CIO pension fund does alter its voting strategy at unionized companies but that the differences in voting strategies were more pronounced at companies with a prior history of labor disputes. Most importantly, Agrawal uncovered evidence that union pension fund opposition to candidates nominated by incumbent management is associated with

[6] See generally, e.g., Iman Anabtawi, "Some Skepticism About Increasing Shareholder Power," *UCLA Law Review* 53 (2006): 561, 564. See also generally Martin Lipton and Steven A. Rosenblum, "Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come," *Business Law* 59 (2003): 67, 78.
[7] See generally Ashwini Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting* 17 (NYU Stern Working Paper Series No. Fin-08-006, 2010, and forthcoming in *Review of Financial Studies*), available at http://ssrn.com/abstract=1285084.

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negative abnormal stock returns for those companies.[8] This presents a potential explanation for why our study shows that proxy access was associated with negative abnormal returns for small firms.

At various times in the SEC's history, it has considered rules to alter the power dynamic between shareholders and companies through changes to rules governing the annual election of boards of directors. For instance, the SEC considered drafts of rules in 2003, 2007, 2009, and 2010 to provide shareholders with the right to proxy access to nominate candidates to the board onto the company ballot without having to pay for the expense of sending out their own ballot.[9] Owing to the controversial nature of the proxy access rule and the fact that the SEC was unsure whether it actually had the legal authority to adopt the rule, the SEC did not pass the proposals it considered in 2003, 2007, and 2009.

However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included a provision confirming the SEC's authority to adopt a proxy access rule. On August 25, 2010, the SEC decided to adopt a new version of its proxy access rule by a close vote of three to two. The SEC's 2010 Proxy Access Rule allowed shareholders with at least 3 percent ownership of a publicly traded company to nominate candidates to the board of directors. The Dodd-Frank Act had urged the SEC to adopt an exemption for companies with less than $75 million in market capitalization, and markets generally assumed the SEC would do so.

But the SEC failed to adopt a permanent exemption for small companies, instead granting merely a three-year delay in application. It also included a companion rule that permitted

[8] Ibid., 21, 26-27.

[9] See J.W. Verret, "Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank," *Journal of Corporate Law* 36 (2011): 391–495.

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shareholders at all companies to adjust the default provisions in the SEC's proxy access rule to make them easier to use (and also prohibited adjustments that made it more difficult to use). That companion rule applied to small firms immediately. These developments ran counter to the market's assumption about how the rule would be designed. These surprise developments present a unique opportunity to test the effect of the proxy access rule on small companies and also to shed light on the broader corporate governance debate.

III. Empirical Study

A combination of language contained in the Dodd-Frank Act itself, as well as market expectations based upon prior SEC rule proposals on proxy access, show that three surprise events on August 25, 2010 each significantly enhanced the probability and frequency with which proxy access would be expected to be used at small firms.[10] First, the SEC 2010 proxy access rule did not permanently exempt small firms, despite language in the bill and pressure from Congress strongly urging to the SEC to do so. Second, the rule gave small firms only a temporary exemption from one section of the rule (Rule 14a-11 providing for mandatory proxy access) and provided for the immediate application of another section of the rule (Rule 14a-8 allowing shareholders to make the rule easier to use). Third, the SEC's proposed rule in 2009 required 5 percent stock ownership for a shareholder to use proxy access at small firms, but the

[10] An alternative explanation could be that the market was already made aware of these details prior to the SEC's announcement of the rule of August 25. There are three reasons why this possibility is highly unlikely. First, no publicly available comment from legislators or regulatory officials at the SEC prior to August 25 indicated the unexpected changes nor is there any evidence of it contained in a basic search of the Westlaw AllNews Database during the period between the date of the Dodd-Frank Act and the date that proxy access was adopted. Second, the SEC's news release about the proxy access rule was not released until the morning of the date of the meeting. Third, the SEC staff are subject to ethics rules that provide for high penalties for any officials who trade on information they learn as a result of their work at the SEC.

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rule adopted on August 25, 2010 allowed shareholders with just 3 percent ownership to use the proxy access rule, making it much easier for shareholders to use proxy access than the market had anticipated prior to that time.

This paper tests whether abnormal returns for companies with a market capitalization below $75 million were negative on August 25, 2010. We assume that, prior to August 25, the market expected that a permanent exemption from the proxy access rules was highly likely for firms with a market capitalization below $75 million. We hypothesize that the unexpected news that small firms would only obtain a temporary exemption from Rule 14a-11, would obtain no exemption from changes to Rule 14a-8, and would face a 3 percent ownership threshold for proxy access use should result in significant abnormal negative returns for small firm stock prices, particularly for those firms with institutional investors able to use proxy access. We define institutional investors likely to use proxy access as those with greater than 3 percent ownership in the firm.

To carry out our study, we obtained data for firms that had less than $125 million in market capitalization on August 25, 2010. For these firms, in order to compute abnormal returns, we used daily return data for our estimation windows, and we defined four different estimation windows to check the sensitivity of our results. We estimated regressions for these estimation windows.[11] We used these estimation windows to compute abnormal returns for firms with between $25 and $75 million in market capitalization. We tested whether these returns were negative on August 25, 2010 and statistically different from zero. To test the sensitivity of our

[11] We followed the procedures described in http://dss.princeton.edu/online_help/stats_packages/stata/eventstudy.html.

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results, we used the same procedure for firms with between $25 and $60 million in market capitalization.

In addition to this traditional event study methodology, we developed an additional model that included a control group. In that model, firms with a market capitalization of between $25 million and $75 million were in the treatment group while the group of firms with more than $75 and less than $125 million in market capitalization were in the control group. The goal of this approach was to test whether we had similar findings in this second approach as in our first approach. Similarity of findings enhances our confidence in the results.

IV. Results

For all of our four estimation windows, we find that firms with a market capitalization between $25 and $75 million had statistically significant negative abnormal returns on August 25, 2010. Depending on the specification, the stock market value of these firms decreased between 0.39 and 0.59 percent. We find very similar results when we limit our sample to firms with between $25 to $60 million market capitalization.

When testing for the effect of the unexpected SEC rule and focusing on the subsample of firms that had at least one institutional investor who held 3 percent of the shares, we find somewhat larger negative abnormal returns than in the full sample. The stock market value of these firms decreased between 0.47 and 0.62 percent. This shows that that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3 percent ownership stake.

Next, we test whether abnormal returns are different between firms with a market capitalization between $25 and $75 million and our control group of firms with a market

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capitalization between $75 and $125 million. Again, we do so for all estimation windows. We find that the firms below $75 million market capitalization have on August 25 between -0.64 to -0.75 percent lower abnormal returns than firms that have more than $75 million and up to $125 million in market capitalization. This is additional evidence that the SEC announcement on August 25 lowered the returns of firms with below $75 million in market capitalization. When examining the differential impact on firms that had at least one institutional investor with at least 3 percent of the shares, we find that the announcement is associated with between 1.1 and 0.8 percent lower abnormal returns.

In an additional sensitivity test, we restrict our sample to firms with a market capitalization between $25 and $60 million and those with a market capitalization between $90 and $125 million. When we compare the abnormal returns between these two types of firms, we find that the abnormal returns for the smaller group firms were between 0.67 and 0.92 percent lower than for the somewhat larger firms. As in all above cases, these point estimates are statistically significant. When focusing on this subsample and examining abnormal returns for the subsample of firms that have at least one institutional shareholder with at least 3 percent ownership, we find that the smaller firms have between a 1.3 and 0.96 percent lower abnormal returns. Once again, the point estimates are statistically significant.

V. Conclusion

We determine that the unexpected application of the 2010 proxy access rule to small firms caused approximately $335 million in losses to the value of shares in small firms. Subsequent to the events of this study, the D.C. Circuit overturned the 2010 proxy access rule on the grounds that it did not contain sufficient economic analysis demonstrating that the costs of

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the rule exceeded its benefits.[12] The SEC has indicated its intention to revisit the rule in the future. This study offers evidence that proxy access may be harmful to publicly traded companies. In particular, this study demonstrates that proxy access is harmful to smaller companies. It also indicates that regulators should remain cautious in writing new rules to affect the balance of power between shareholders and boards of directors, as the potential for unintended consequences and the costs of those consequences could be significant.

[12] See *Business Roundtable v. SEC*, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011).

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