

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

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Abstract: The Securities and Exchange Commission has proposed proxy rules mandating shareholder access under conditions that can be modified by a shareholder majority to make proxy access easier, but not more difficult. From a legal perspective, this Mandatory Minimum Access Regime is so riddled with internal contradictions that it is unlikely to withstand review under the arbitrary and capricious standard of the Administrative Procedures Act. Fully-enabling opt-in proxy access rules are, in contrast, entirely consistent with the administrative record developed to date by the agency and are easily implemented.

From a political perspective, and consistent with the agency capture literature, the Proposed Rules are easily explained as an effort to generate megaphone externalities and electoral leverage that benefit constituencies allied with currently dominant political forces, even at the expense of the will of the shareholder majority. Viewed from this perspective, the Proposed Rules have nothing to do with shareholder wealth maximization or optimal governance, and everything to do with a traditional contest for economic rent common to political brawls in Washington D.C.

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

Keywords: Proxy access, Securities and Exchange Commission, corporate governance, directors, boards, shareholder rights, shareholder voting,, corporate elections, administrative law, arbitrary and capricious,

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

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1. Introduction.

The strong agnostic position in theology is that “I don’t know whether god exists. And neither do you.”¹ The strong agnostic position in the proxy access debate is that “I don’t know whether proxy access is a good or bad idea at every corporation in America, and if it is a good idea at some, many, or every corporation, I don’t know how to structure the access rules for every corporation. And neither do you.”

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

Because I (and you) don’t know how to structure a proxy access regime that is suitably tailored to address the individual circumstance of thousands of publicly traded corporations in the United States,² it makes sense to support a fully enabling approach to proxy access that allows every publicly traded corporation, easily and cheaply, to determine by majority vote the rules governing shareholder access to the corporate proxy.

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¹ For a more formal definition of strong agnosticism, see William L. Rowe, *Agnosticism: Degrees of Agnosticism*, in *Routledge Encyclopedia of Philosophy*. v. 9, 121 (Edward Craig ed., 1998), available at <http://www.rep.routledge.com/article/K001SECT1?ssid=1249288075&n=2#>. For an alternative view on agnosticism, see the Catholic Encyclopedia, *Agnosticism*, available at <http://oce.catholic.com/index.php?title=Agnosticism> (scanned copy from 1913 original).

² As of December 2008, the NYSE had approximately 8,500 listed issues. “Listings” NYSE Euronext.com, <http://www.nyse.com/about/listed/1170350259411.html> (accessed Oct. 2, 2005). NASDAQ had approximately 3200 listings. “NASDAQ Facts.” NASDAQ Corporate, http://www.nasdaq.com/reference/nasdaq_facts.stm (accessed Oct. 2, 2005). As of 2006, 11,898 companies filed annual reports with the SEC under the Exchange Act. *See* Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 33-8819, Exchange Act Release No. 34-56013 (July 5, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8819.pdf>

The Securities and Exchange Commission (“SEC” or “Commission”) can easily achieve this objective. It can structure its proxy rules to allow shareholders, acting on their own initiative, to propose, and by majority vote to adopt, proxy access standards that are suited to the individual circumstances of each corporation. This simple opt-in approach is consistent with the academic literature and with existing state law. This opt-in approach is also the only approach consistent with the administrative record established to date in the Commission’s 2009 Proposed Proxy Access Rules.³

The Securities and Exchange Commission, however, is anything but agnostic in the proxy access debate. The Commission’s 2009 proposed Proxy Access Rules would dramatically transform the process by which directors of publicly traded corporations are nominated and elected. The Commission’s Proposed Rules would establish a “Mandatory Minimum Access Regime” under which corporations would be compelled, even against the will of the shareholder majority, to provide proxy access in accordance with SEC-established standards. Shareholders could, by majority vote, set less stringent access standards, but not even an overwhelming majority could adopt more stringent proxy access rules. These Proposed Rules presume, with no support in the record whatsoever, that the Commission knows better than the majority of shareholders at every publicly traded corporation precisely how to structure proxy access for every corporation. The Commission’s Mandatory Minimum Access Regime thereby effectively disenfranchises the shareholder majority from playing any meaningful role in setting proxy access rules. It is thus not a mere rhetorical flourish to observe that the Commission’s proposal is fundamentally anti-democratic.

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

The Administrative Procedure Act (“APA”)⁴ prohibits the Commission from adopting rules that are arbitrary and capricious.⁵ Internally contradictory rules are, by definition, arbitrary and capricious, and therein lies the rub. Because the text of the Proposing Release is at war with the text of the Proposed Rules in a clash that generates two profound contradictions, each of which is alone sufficient to cause the Proposed Rules to be viewed as arbitrary and capricious, there is little prospect that the Proposed Rules can withstand APA challenge.⁶ Indeed, the Commission’s recent decision to defer its consideration of its Proposed Rules is motivated in part by the Commission’s

³ Facilitating Shareholder Director Nominations, Exchange Act Release No. 60,089, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified in scattered parts of 17 C.F.R.) (the “Proposed Rules” or the “Mandated Minimum Access Regime”). As a technical matter, this opt-in alternative is easily achieved by amending “Rule 14a-8(i)(8) specifically to permit stockholder proposals for proxy access (and for proxy contest reimbursement expense) regardless of whether such proposals are more or less restrictive than” the Proposed Rules. Letter from Cravath, Swaine & Moore LLP, et. al, to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission (Aug. 17, 2009) (the “Seven Firm Letter”), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf>

⁴ Administrative Procedure Act, 5 U.S.C §§ 701-706 (2009).

⁵ 5 U.S.C § 706(2)(A) (2009).

⁶ See Section 5, *infra*.

recognition that it “needed to shore up rulemaking requirements under the Administrative Procedure Act in light of potential litigation. Although the Commission cannot do anything regarding its authority to issue the rule it can at ensure that a record has been developed to satisfy the APA ...”⁷ The more fundamental question, however, is whether the any modification to the record can save the Commission’s Proposed Rules as currently written.

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

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

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

⁷ Yin Wilczek, SEC Delays Vote on Proxy Access Proposal; Staff Reviewing Comments, Schapiro Says, 41 Sec. Reg. & L. Rep. (BNA) 1811 (Oct. 3, 2009).

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

How then did the Commission come to propose a proxy access rule that is so essentially anti-democratic and internally inconsistent? One answer lies in the politics of the proxy access debate. Labor unions and public pension funds rationally value proxy access for reasons that have nothing to do with the prospect of actually electing directors to corporate boards. Proxy access generates significant "megaphone externalities" in the form of the ability to draw attention to union and pension fund causes, even if the nominees have no chance of prevailing at the ballot box. These megaphone externalities are valuable to shareholder proponents even if they promote objectives that the majority of shareholders view as inimical to the best interests of the corporation. Proxy access advocates are therefore rationally and heavily invested in assuring that the Commission's proxy access rules make it as easy as possible to qualify for the ballot even if there is no prospect that their nominated candidate can prevail.

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

Unions, pension funds and other proxy access advocates also appreciate that, if the matter were put to a majority shareholder vote, then there is a significant probability that the shareholder majority would establish qualifications for proxy access more stringent than those proposed by the Commission. Those standards would dramatically constrain megaphone externalities. Maximizing the private value of megaphone externalities to special interest constituencies therefore requires the imposition of an anti-democratic Mandatory Minimum Access Regime that is purposefully designed to negate the will of the shareholder majority in a manner that has no analogue in state law. Put another way, proponents of shareholder access seek to win a victory at the Commission table that they could never attain at the corporate ballot box. This politically animated articulation of the Commission's motives explains, with precision, how and why the Commission has drafted an internally inconsistent rule that, in the name of shareholder democracy, disenfranchises the shareholder majority.

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

relating to the role of shareholder voice in corporate governance, the heavy weight of precedent supports a fully-enabling opt-in approach to proxy access. An opt-out approach has less support in the literature and raises difficult challenges that generally do not arise with equivalent force in other governance debates over the choice between an opt-in or opt-out regime. In particular, the opt-out approach would require that the Commission define a default rule. The administrative record in the proxy access proceeding already establishes that this is a very difficult, highly technical task, and that the Commission's proposal is subject to a plethora of complex flaws and objections rooted in mechanical issues that have nothing to do with the battle over the underlying philosophy of proxy access.⁸ Further, because the Commission has no particular insight as to the preferences of the shareholder majority that might be viewed as value-maximizing at each company subject to the proxy access rules, the Commission would have to guess at the appropriate default rule. The Commission's conjecture as to the optimal default rule introduces a level of subjectivity and randomness that is entirely avoided through the opt-in approach.

Also, there is no support in the published academic literature, of which I am aware, for a Mandatory Minimum Access Regime with an asymmetric opt-out in the form proposed by the Commission. The intellectual basis for the Letter of Eighty Professors ("Eighty Professors Letter")⁹ supporting the Commission's proposed Mandatory Minimum Access Regime is thus mysterious and elusive.

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

But this approach may be too democratic for the Commission. If influential constituencies calculate that the majority of shareholders surveyed would propose standards that impair the value of megaphone externalities, then these constituencies would also oppose the simple step of surveying shareholders to determine their preferences in order to establish default rules governing proxy access. By this logic, proxy access must be imposed by the Commission in a form that would never obtain majority support from the shareholder community.

⁸ See, e.g., Seven Firm Letter, *supra* note 3.

⁹ Letter of a Bi-Partisan Group of Eighty Professors of Law, Business, Economics, or Finance in Favor of Facilitating Shareholder Director Nominations to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission, (Aug. 17, 2009)("Eighty Professors Letter"), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-282.pdf>

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

Part 2 of this article briefly describes the Commission’s proposed proxy access rules. Part 3 explains the internal contradictions created by the Commission’s own proposals, and the basis on which a reviewing court can easily vacate the proposed rules as arbitrary and capricious. Part 3 also observes that these contradictions can only be resolved by a fully enabling proxy access rule that empowers shareholders to decide whether, when, and how proxy access should be permitted. Part 4 considers the political pressures operating on the Commission, and suggests that the Commission has a powerful incentive to support the proxy access rules as proposed, warts and all, even if those rules are likely to be vacated. Part 5 considers the academic literature, and observes that the literature strongly supports a fully enabling approach to proxy access, and provides no material support for the Mandatory Minimum Access Regime now proposed by the Commission. Part 5 also explains that if the Commission elects to adopt an opt-out regime, then default values should be determined as the result of a properly structured survey of shareholder preferences subject to symmetric majoritarian opt-outs. Part 6 considers some of the larger changes now occurring in the corporate governance arena, and observes that a fully enabling opt-in structure of the sort advocated in this analysis has profitable application in other aspects of the governance debate, including the debate over reimbursement of insurgents’ proxy expenses. Part 7 concludes.

2. The Proposed Mandatory Minimum Access Regime

The Commission proposes to add one new rule and amend an existing rule.

Proposed Rule 14a-11 would provide for proxy access in the event a nominating shareholder, or group of shareholders, of a large accelerated filer have, for at least one year, held one percent or more of the company’s voting securities.¹⁰ Access would not be available to stockholders seeking a change in control, or to stockholders seeking more

¹⁰ The threshold for accelerated filers is three percent and for non-accelerated filers it is five percent. Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29035.

than a limited number of seats on a board.¹¹ Nominating stockholders would be required to make certain disclosures, subject to the antifraud provisions of Rule 14a-9.¹² These disclosures include representations that the nominees satisfy the objective criteria for director independence set forth in listing standards, that there is no agreement with the company regarding the nomination of the nominees, and that the nominating stockholders intend to continue holding the requisite number of shares through the date of the stockholder meeting.¹³ Disclosure would also be required of relationships between the nominating stockholders, the nominee, and the company, if any.¹⁴

Modifications to Rule 14a-8(i)(8) would recast the election exclusion so as to require that companies include in their proxy materials stockholder proposals that would amend, or propose to amend, the company's governing documents regarding shareholder nominations. The proposals could not, however, weaken or eliminate the proxy access criteria prescribed by proposed Rule 14a-11.¹⁵

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

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

Administrative agencies are wise not to contradict themselves when rulemaking: contradictions invite courts to overturn agency action as arbitrary and capricious.¹⁶ Also, like Charles Barkley's claim that he was misquoted in his autobiography, contradictions spawn skepticism as to the credibility of the entire enterprise.¹⁷

¹¹ *Id.* at 29037, 29043. "[A] company would be required to include no more than one shareholder nominee or the number of nominees that represents 25 percent of the company's board of directors, whichever is greater." *Id.* at 29043. In addition, if shareholder nominees were to possess one directorship or 25 percent, as above, their continued presence on the board would preclude the company from any duty to provide access for other shareholder nominees in subsequent elections. *Id.* Conflicts arising as to which shareholders may include nominees will be decided based on who first provides the company with notice of their intent. *Id.* at 29044.

¹² *Id.* at 29041 n.165.

¹³ *Id.* at 29035, 29040-41.

¹⁴ *Id.* at 29041.

¹⁵ *Id.* at 29056.

¹⁶ See Section 5 *infra* for a brief discussion of the Administrative Procedure Act's requirement that Commission rulemaking not raise internal contradictions lest it be deemed arbitrary and capricious.

¹⁷ CHARLES BARKLEY & ROY S. JOHNSON, *OUTRAGEOUS!: THE FINE LIFE AND FLAGRANT GOOD TIMES OF BASKETBALL'S IRRESISTIBLE FORCE* (1992); Don Benevento, *Barkley: 'Outrageous' misquotes 76ers star*, USA TODAY, Dec. 13, 1991, at 4C.

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

A. The First Contradiction: Self Determination and Proxy Access

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

As the Proposing Release explains, "we believe that investors are best protected when they can exercise the rights they have as shareholders, without unnecessary obstacles imposed by the federal proxy rules."¹⁸ These rights include the right to set standards governing proxy access and are not limited to the right to approve nominees pursuant to a Mandatory Minimum Access Regime adopted without any regard for the will of the majority. It is more than a touch ironic that the Mandatory Minimum Access Regime actually eliminates the shareholders' right to propose and adopt proxy access standards, thereby creating the very "unnecessary obstacles imposed by the federal proxy rules" that the Proposing Release purports to eliminate, and negating that "greater voice" that the Commission proclaims to provide.¹⁹

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

To be sure, the Proposing Release questions whether the Proposed Rules should be mandatory, whether they should be structured as opt-in or opt-out provisions, and whether shareholders should, pursuant to proposed Rule 14a-8(i)(8), be permitted to offer proposals to make proxy access requirements more rigorous.²⁰ Each of these questions, however, places the burden of proof with the wrong party. Asking for alternatives to an internally contradictory proposal does not cure the proposal's internal contradictions.

¹⁸ 74 Fed. Reg. at 29027, col.1.

¹⁹ 74 Fed. Reg. at 29031, col.2

²⁰ *Id.* at 29033, para. B.7; 29058, para. I.2.

B. The Second Contradiction: Replicating the Shareholder Meeting.

The Commission asserts that “[t]he proxy rules seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual in-person meeting of the shareholders. Refining the proxy process so that it replicates, as nearly as possible, the annual meeting is particularly important given that the proxy process has become the primary way for shareholders to learn about the matters to be decided by the shareholders and to make their views known to company management.”²¹ The Proposing Release also states that “[p]arts of the federal proxy process may unintentionally frustrate voting rights under state law, and thereby fail to provide fair corporate suffrage.”²²

The proposed Mandatory Minimum Access Regime, however, fails utterly to replicate the annual meeting process. As an initial matter, it is for the shareholders themselves to propose and adopt bylaw provisions governing proxy access. These standards are today not imposed by third parties or by state law on the corporation.²³ The proposed Mandatory Minimum Access Regime would, however, impose a standardized, mandatory form of proxy access that replicates nothing about the current annual meeting or about any aspect of corporate law governing the operation of those meetings. Thus, rather than promote fidelity to the principles of shareholder democracy as they exist at physical shareholders’ meetings, the Commission is inventing a procedure entirely alien to the shareholder voting process.

The Commission seems to argue at cross purposes with itself when trying to justify this one size fits all approach to corporate law.²⁴ For example, as evidence of proxy “impediments to the exercise of shareholders’ rights,”²⁵ the Proposing Release cites Delaware Vice Chancellor Leo Strine’s comment that federal proxy laws seem “a little bit perverse” because Rule 14a-(8)’s exclusions can keep shareholder proposals valid under state law off the proxy while mandating inclusion of certain precatory proposals

²¹ *Id.* at 29025, col.3; *see also id.* n.32. The Proposing Release continues to observe that “[t]he action we take today is focused on removing burdens that the federal proxy process currently places on the ability of shareholders to exercise their basic rights to nominate and elect directors.” *Id.* at 29027, col. 1.

²² *Id.* at 29027, col.2.

²³ The single exception appears to be North Dakota’s corporate code which now permits “five percent shareholders to provide a company of notice of intent to nominate directors and require the company to include each such shareholder nominee in its proxy statement and form of proxy. N.D. CENT. CODE § 10-35-08 (2009); *see* North Dakota Publicly Traded Corporations Act, N.D. CENT. CODE § 10-35 *et al.* (2007).” 74 Fed. Reg. at 29029 n.70. But even so, the Proposed Rules conflict with North Dakota law. Further, if North Dakota shareholders wanted to amend the proposed federal standard to comport with the state’s standard, Proposed Rule 14a-8(i)(8) would preclude any such action.

²⁴ The Delaware State Bar Association (DSBA), charged with recommending business law amendments to the Delaware General Assembly, critiqued the Commission’s homogenous mandate in a Comment Letter submitted to the SEC. “[We] concluded that [the proxy access mandates] would be inconsistent with the overall philosophy of the Delaware General Corporation Law: to enable stockholders and boards to establish their own corporation’s internal rules in light of the wide variety of circumstances in which Delaware corporations function, rather than to limit their ability to do so.” Letter from the Delaware State Bar Association to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission (July 24, 2009)(“DBSA letter”), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-65.pdf>

²⁵ 74 Fed. Reg. at 29026, col.2.

not even considered under state law.²⁶ Yet, the Proposing Release does not mention that Strine's logic is founded on the incongruity between state and federal law which the Proposed Rules will magnify and compound. Such "perversity" exists because federal law enables unenforceable proposals while disabling enforceable proposals. Ironically, Strine's emphasis "on company-specific decision[s] by stockholders to opt-in" via proxy access bylaws instead of "an invariable federal mandate" is also at odds with the Commission's Proposed Rules, yet Strine is quoted in the Proposing Release as providing support for the Commission's approach.²⁷ Quite divorced from Strine's arguments, the Proposed Rules impose new standards of propriety wholly independent of underlying state law, fulfilling the Vice Chancellor's warning that "federal action will be taken to mandate that all public companies adopt certain election practices favored by institutional investors."²⁸

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

The conflict between the reality of corporate law and the Commission's assertion that it is merely seeking to replicate the reality of the "actual in-person meeting of the shareholders"²⁹ through the proxy process is most apparent in Delaware. New Section 112 of the Delaware General Corporation Law, effective as of August 1, 2009, expressly authorizes corporations to provide by-law provisions that would permit proxy access, and to impose any lawful condition on the access provision.³⁰ Expressly permissible access requirements include minimum ownership provisions, minimum holding periods, information disclosure requirements, restrictions on the number of nominees, and a requirement that nominating shareholders indemnify the company for losses resulting from false or misleading statements by shareholders in connection with the nomination of directors.³¹

Section 112 establishes no minimum standard for proxy access in terms of the percentage of shares held or the required holding period, and permits the imposition of any lawful condition on access.³² The Mandated Minimum Proxy Access Regime, however, prohibits the imposition of an infinite number of lawful conditions. The Proposed Rules thus fail to replicate the situation that would exist at physical shareholders' meetings in Delaware, and are therefore fundamentally inconsistent with

²⁶ *Id.*, at fn. 33, quoting Leo E. Strine, Jr. "Unofficial Transcript of the Roundtable Discussion on Proposals for Shareholders" May 25, 2007, at 112, available at http://www.sec.gov/news/openmeetings/2007/openmtg_trans052507.pdf

²⁷ Leo E. Strine, Jr., Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward, 63 *BUS. LAW.* 1079, 1087 (2008).

²⁸ *Id.*, at 1096

²⁹ 74 *Fed. Reg.* at 29025.

³⁰ *DEL. CODE ANN.* tit. 8, § 112 (2009).

³¹ *Id.*

³² *See id.*

the Commission's own stated objective in proposing the proxy access rules. The contradiction could not be more clear.³³

C. Internal Contradictions and the Administrative Procedure Act

Commission rules are subject to review under the “arbitrary and capricious” standard of the Administrative Procedure Act.³⁴ As interpreted by the Supreme Court in *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Auto Insurance Company*, 463 U.S. 29 (1983), the arbitrary and capricious standard compels judicial scrutiny of administrative agency rules beyond minimal rational basis review. When crafting administrative rules, agencies must consider relevant factors and “articulate a satisfactory explanation for its action including a ‘rational connection’ between the facts found and the choice made.”³⁵ Agency rules that offer explanations running “counter to the evidence before the agency” are considered arbitrary and capricious.³⁶ Agencies must also consider known alternatives before promulgating rules.³⁷ Thus, “at its core, arbitrary and capricious review, or ‘hard look’ review as it is sometimes called, enables courts to ensure that administrative agencies justify their decisions with adequate reasons. . . Agencies should explain their decisions in technocratic, statutory, or scientifically driven terms, not political terms.”³⁸

An agency is arbitrary and capricious when its logic is internally inconsistent. “Internally contradictory agency reasoning renders resulting action ‘arbitrary and capricious;’ [inasmuch as] such actions are not ‘founded on a reasoned evaluation of the relevant factors.’” *Defenders of Wildlife v. United States EPA*, 420 F.3d 946, 959 (9th Cir. 2004), citing *Ariz. Cattle Growers' Ass'n v. U.S. FWS*, 273 F.3d 1229, 1236 (9th Cir. 2001) (quoting *Marsh v. Or. Natural Res. Council*, 490 U.S. 360, 378, 104 L. Ed. 2d 377, 109 S. Ct. 1851 (1989)). See also *Gen. Chem. Corp. v. United States*, 260 U.S. App. D.C.

³³ The Model Business Corporations Act (“MBCA”) has been adopted by twenty four states, MODEL BUS. CORP. ACT, introduction at xxvii (2002). It grants shareholders concurrent authority with the board to amend the company’s bylaws so as to adopt shareholder access provisions. MODEL BUS. CORP. ACT §206(b). The Committee on Corporate Laws of the American Bar Association’s Section of Business Law recently approved proposed amendments to the MBCA that would largely track Section 112 of the Delaware General Corporation Law. 26 Corp. Counsel Wkly (BNA) 203 (July 8, 2009). When these amendments are adopted, the conflict between the Commission’s Mandatory Minimum Access Regime and the MBCA will be just as stark as the conflict with Delaware law.

³⁴ Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (A reviewing court must determine that agency decisions are not “arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law.”).

³⁵ *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Auto Insurance Company*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U. S. 156, 168 (1962)).

³⁶ *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Auto Insurance Company*, 463 U.S. 29, 43 (1983).

³⁷ See *City of Brookings Mun. Tel. Co. v. FCC*, 822 F.2d 1153, 1169 (D.C. Cir. 1987) (agencies have “a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives.”)

³⁸ Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L.J. (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1353519, at 1. Accord Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2380–81 (2001) (*State Farm* demands that the agency “justify its decision in neutral, expertise-laden terms to the fullest extent possible”).

121, 817 F.2d 844, 857 (D.C. Cir. 1987) (finding agency action "arbitrary and capricious" because it was "internally inconsistent and inadequately explained.")

In *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) the court vacated and remanded the Commission's Hedge Fund Rule because, in part, the agency could not explain the contradictory implications of its proposed reading of the Investment Advisers Act of 1940, 15 U.S.C. §80b-1 et seq. "The Commission cannot explain why "client" should mean one thing when determining to whom fiduciary duties are owed, and something else entirely when determining whether an investment adviser must register under the Act." 451 F.3d at 882 (citations omitted). Because the Commission had not "adequately explained" these inconsistencies, the court concluded that the Hedge Fund Rule "is an arbitrary rule." *Id.* at 884.

Most recently, in *American Equity Investment Life Ins. Co. v. SEC*, No. 09-1021, 2009 WL 2152351 (D.C. Cir. 2009), the Commission argued that it was not required to conduct a §2(b) analysis of its fixed indexed annuity rule.³⁹ This position, however, contradicted the fact that the Commission had "conducted a §2(b) analysis when it issued the rule with no assertion that it was not required to do so." *Id.* at *10. The court therefore rejected the Commission's position and ruled that a §2(b) analysis was indeed necessary. It then proceeded to vacate the rule on grounds that the Commission's §2(b) analysis was arbitrary and capricious because, among other matters, it failed "to analyze the efficiency of the existing state law regime" which provided an alternative to the Commission's proposed rule. *Id.* at *11.⁴⁰

Several of the Commission's more recent prominent rulemakings, adopted as a result of vigorous political pressure, and have not fared well under judicial scrutiny.⁴¹ When rules are vacated and remanded, the Commission must restart the rulemaking process and address the concerns raised by the court, if the Commission is to act at all. That process can take several years. It is thus a Pyrrhic victory, at best, for champions of shareholders rights if the agency adopts proxy access rules that are simply waiting to be vacated and remanded by the courts. If the Commission is intent on crafting proxy access rules that are likely to be implemented on a prompt basis, without being overturned by the courts, then it will have to confront the more vocal and extreme advocates of proxy access. It will have to reject their agenda, and instead adopt a more measured and nuanced set of

³⁹ Section 2(b) of the Securities Act states that for every rulemaking in which the SEC "is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. §77b(b).

⁴⁰ Section 3(f) of the Exchange Act, 15 U.S.C. § 78c(f), imposes an identical obligation on the Commission to justify its proposed Mandatory Minimum Access Regime. Thus, in addition to the agency's obligation not to contradict itself, the agency has an obligation to explain why its proposed Mandatory Minimum Access Rules "in addition to the protection of investors... will promote efficiency, competition, and capital formation" better than existing state law standards.

⁴¹ See, e.g., *Fin. Planning Assoc. v. SEC*, 482 F. 3d 481 (D.C. Cir. 2007) (vacating the Commission's rule interpreting an exemption from the Investment Advisers Act); *Goldstein v. SEC*, 451 F. 3d 873 (D.C. Cir. 2006) (vacating the Commission's Hedge Fund Rule); *Chamber of Commerce v. SEC*, 412 F. 3d 133 (D.C. Cir. 2006) (vacating the Commission's Mutual Fund Rule).

rules that can pass muster before a dispassionate court that will not be subject to the political pressures that today buffet the agency.

D. Curing the Contradictions

These internal contradictions are cured if the Proposed Rules are amended to allow shareholder resolutions that define the terms and conditions under which a majority of shareholders can set the rules for proxy access.⁴² This “fully enabling” strategy is entirely consistent with principles of shareholder self-determination: the same shareholders that are sufficiently intelligent and responsible to nominate and vote on director candidates are also sufficiently intelligent and responsible to define the process by which they nominate and elect those directors.⁴³ This “fully enabling” strategy is also entirely consistent with the Commission’s stated desire to replicate the meeting process as it currently exists.⁴⁴ Further, this fully enabling opt-in approach generates three distinct benefits that are widely appreciated in the academic literature. “First, even if the same arrangement were good for all public companies, public officials might err in identifying it.... Second, even if the arrangements selected by public officials were initially the right one, things might change over time, and private ordering can then provide adjustment to new circumstances. Third, one size does not fit all: corporations differ in their circumstances, attributes, and needs.”⁴⁵

It should thus come as little surprise that leading scholars are already on record stating that “to facilitate shareholder adoption of election arrangements, shareholders should be permitted to place on the corporate ballot any proposed by-law concerning elections that would be valid under state law if adopted.”⁴⁶ This approach also avoids the problem that arises because “public officials have neither the information nor the resources to tailor different arrangement to the particular features of different

⁴² The Commission is, as a legal matter, required to consider this alternative and explain why it is inferior to its Proposed Rules. “[W]here a party raises facially reasonable alternatives ... the agency must either consider those alternatives or give some reason ... for declining to do so.” *Chamber of Commerce*, 412 F. 3d 133, 144–45 (D.C. Cir. 2005) (quoting *Laclede Gas Co. v. FERC*, 873 F.2d 1494, 1498 (D.C. Cir. 1989)) (emphases removed) (overturning the Commission’s Mutual Fund Rule because, in part, the agency had failed adequately to consider alternative regulatory resolutions as required by the APA). Alternatives that resolve the Commission’s internal contradictions cure a fatal flaw in the agency’s rulemaking and therefore cannot be “unworthy of consideration.” They are therefore also not “frivolous or out of bounds.” *Id.* at 145.

⁴³ Even strong advocates of proxy access recognize that shareholders are fully able to resolve the most critical matters relating to corporate governance including, without limitation, the power to “initiate and adopt rules-of-the-game decisions, to amend the corporate charter, or to reincorporate in another jurisdiction.” Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005). The very same logic supports the conclusion that shareholders can “initiate and adopt” proxy access rules.

⁴⁴ The Commission recognizes that in “*CA, Inc. v. AFSCME*, 953 A.2d 227 (Del. 2008), the Delaware Supreme Court held that shareholders can propose and adopt a bylaw regulating the process by which directors are elected.” 74 Fed. Reg. at 29029 n.70. The Mandatory Minimum Access Regime, however, prevents shareholders from exercising that right because it imposes a proxy access regime without regard to the will of the majority.

⁴⁵ Bebchuk, *Letting Shareholders Set the Rules*, 119 Harvard L. Rev. 1784, 1787 (2006).

⁴⁶ Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev., 675,707 (2007).

companies.”⁴⁷ For that reason, “it would not be optimal to have all companies abide by a general arrangement chosen by public officials. Rather it would be desirable to allow private parties, armed with the best information about their needs and best incentives to choose and tailor the most fitting arrangement, to make the relevant choices.”⁴⁸ The fully enabling opt-in approach achieves precisely this objective.

It is significant to observe that an opt-out approach under which the Commission’s mandatory access rule allows a majority of shareholders to amend the rule in any manner they wish, as could be implemented through a revised Rule 14a-8(i)(8), fails to cure either contradiction. Most obviously, the proxy access rules would then not replicate the physical shareholder meeting.⁴⁹ More fundamentally, an opt-out approach is inconsistent with shareholder self-determination because the Commission would be presuming, without any supporting evidence, that a majority of shareholders at every corporation would prefer an opt-out approach over an opt-in approach.⁵⁰ Even worse, the Commission would, without any supporting evidence, be assuming that a majority of shareholders at every corporation would prefer the precise form of default rule proposed by the Commission. Put another way, the Commission would, without any foundation, be assuming its conclusion that a majority of shareholders at every corporation would prefer its Mandatory Minimum Access Regime subject to an opt-out, over the alternative of being able to decide for themselves, *ab initio*, the rules governing proxy access.

E. Pending Legislation

Pending legislation would mandate that the Commission adopt regulations requiring that every publicly traded firm offer proxy access, subject to the constraint that the Commission may not require access for any shareholder or group of shareholders who have held less than “one percent of the voting securities of the issuer, directly or indirectly, for at least the 2-year period preceding the date of the next scheduled annual meeting of the issuer.”⁵¹ This legislation, if adopted, would eliminate uncertainty

⁴⁷ Bebchuk, *The Case for Increasing Shareholder Power*, 118 *Harvard L. Rev.* 835, 867 (2005).

⁴⁸ *Id.* at 869.

⁴⁹ There is no proxy access provision with an opt-out in Delaware or in any other leading commercial state. The proxy access provisions recently adopted in North Dakota also fail to replicate the Commission’s Proposed Rule, even if it is structured as an opt-out provision. *See* 74 *Fed. Reg.* at 29029 n.70.

⁵⁰ The opt-out approach would therefore fail to satisfy the basic conditions for the application of the principles of libertarian paternalism, even if the Commission sought to rely on that literature to support its Proposed Rules. *See* RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 *U. CHI. L. REV.* 1159 (2003); Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism* 93 *AM. ECON. REV.* 175 (2003)..

⁵¹ *See, e.g.*, Shareholder Bill of Rights Act of 2009, S. 1074, § 4 (proposing to amend Section 14A of the Exchange Act of 1934 by adding a new section 14A(d) that states as follows:

(d) Confirmation of Commission Authority on Shareholder Access to Proxies for Board Nominations-

(1) COMMISSION RULES- The Commission shall establish rules relating to the use by shareholders of proxy solicitation materials supplied by the issuer for the purpose of nominating individuals to membership on the board of directors of an issuer.

regarding the Commission's statutory authority to adopt proxy access rules,⁵² but it would not resolve the contradictions inherent in the Commission's Mandated Minimum Access Regime. The Proposed Rules would remain therefore highly vulnerable to challenge as arbitrary and capricious under the APA, even if they were adopted pursuant to the statutory authority that would be created pursuant to pending legislation. Indeed, nothing in pending legislative language would preclude the Commission from adopting a fully enabling opt-in approach to proxy access.

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

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

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

When Republicans controlled the Commission corporate interest groups lobbied hard to stall any and all efforts to facilitate proxy access in any form. Proxy access opponents prevailed and the Commission did nothing to facilitate proxy access while Republicans were in charge. It is no small irony that many of these proxy access opponents could well regret their lobbying efforts today. Had the Commission years ago established an intellectually credible opt-in regime, consistent with state law, the political pressure in

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

S. 1074, § 4. *See also* H.R. 2861, § 2 (proposing to add a new Section 16A to the Exchange Act of 1934 with text that largely parallels the language of S. 1074).

⁵² The decision in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) raises questions regarding the Commission's authority to adopt proxy access rules. *See also* Elisse B. Walter, Comm'r, Sec. Exchange Comm'n, *The American Corporation and its Shareholders: Dooryard Visits Disallowed*, Address Before the Society of Corporate Secretaries and Governance Professionals (June 27, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch062709ebw.htm>.

support of a Mandatory Minimum Access Regime, however structured, would almost certainly be greatly diminished.⁵³

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

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

To be sure, political constituencies are entirely within their rights to attempt to structure any Commission regulation so as to maximize private benefits at the expense of shareholder wealth maximization, the greater public good, or any other objective. But leading scholars have a different view of the matter. They "do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective.... From this perspective, increased shareholder power would be desirable only if it would operate to improve corporate performance and value."⁵⁴ The battle over megaphone externalities and

⁵³ See, e.g., Letter from the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission (Sept. 18, 2009) ("ABA Comment Letter"), available at <http://www.sec.gov/comments/s7-10-09/s71009-535.pdf>; Seven Firm Letter, *supra* note 3; DBSA letter, *supra* note 24.

⁵⁴ Bebchuk, The Case for Increasing Shareholder Power, 118 Harvard L. Rev. 35, 842-43 (2005). See also Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 678 (2007) ("increased shareholder power to replace directors would be desirable if and only if such a change would improve corporate performance and value ... I do not view "shareholder voice" and "corporate democracy" as ends in themselves – or as a necessary corollary of the nature of shareholders' ownership rights."); Bebchuk, The Case for Shareholder Access to the Ballot, 59 Bus. Lawyer 43, 44 (2003) ("Increased shareholder power or

electoral leverage, however, establishes a clear mechanism of action whereby proxy access can work to impair shareholder value, and thus underscores the value of a fully enabling approach to the question that allows shareholders themselves to determine whether, when, and how proxy access might or might not be value enhancing.

A. Megaphone Externalities.

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

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

In today's environment, the simple act of running proxy access candidates is sure to gain significant press coverage. How many articles will Gretchen Morgenson run about the first candidates to get proxy access, regardless of whether they prevail? How much coverage will the press give to candidates with controversial or novel proposals for corporate governance even if their candidates are hopeless as an electoral matter? Consider a board candidate who wants to limit the export of jobs to foreign factories, or to close down foreign factories in order to bring manufacturing jobs back to America. Consider a candidate who wants to cap all executive salaries at a multiple of the average hourly wage of the rank and file. Consider a candidate who wants the company voluntarily to comply with emissions standards that reduce global warming but that place the corporation at a competitive disadvantage in the marketplace. Just think of the talking head opportunities on CNBC, CNN, Fox, or MSNBC. Any of these candidates will garner valuable, low-cost publicity for their cause, and the value of that publicity has essentially nothing to do with the probability of winning the election.

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

participation would be desirable if and only if such a change would improve corporate performance and value.”)

Megaphone externalities also explain why proxy access advocates fight so hard to keep the access threshold at one percent rather than at three percent or five percent. If a candidate can only garner five percent shareholder support to get on the corporate proxy, the odds of winning a board seat are, I suggest, quite low. If the candidate can only garner one percent, the odds of winning are even lower. Why then all the *sturm und drang* over the difference between a candidate who can only satisfy an essentially hopeless one percent threshold and a candidate who can satisfy a slightly less hopeless five percent threshold? The battle is so pitched because unions and pension funds rationally care about the cost of getting onto the ballot (*i.e.*, the price of buying the megaphone) and not just the probability of prevailing. With a one percent threshold, advocates will be able to grab the megaphone pretty much whenever they like.⁵⁵ With a three or five percent threshold, unions and pension funds will need more cooperation from third parties who may not share their agendas. The megaphone then becomes much more expensive and the private benefits of proxy access to unions and pension funds decline.

From an academic perspective, it is valuable to note that megaphone externalities are private benefits that accrue to unions and pension funds, just as surely as membership on a board generates private benefits to individual directors in terms of prestige, or that service as a CEO generates non-cash emoluments. A rich academic literature explores the potential adverse effects of private benefits,⁵⁶ and megaphone externalities should be subject to equivalent analysis.

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

B. Electoral Leverage.

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

The public relations costs of dealing with megaphone externalities can make it entirely rational for management to offer concessions to proxy access candidates with no realistic chance of winning a board seat. The degree of electoral leverage is a function of management's sensitivity to the issue being advocated. If the issue relates to ongoing legislative battles or regulatory initiatives, particularly if the shareholder advocates are

⁵⁵ 74 Fed. Reg. at 29035, col.1.

⁵⁶ See, e.g., Lucian A. Bebchuk, The Case for Increasing Shareholder Power. 188 Harv. L. Rev. 833, 868 (2005).

allied with forces that can be pivotal in the political or regulatory process, then managements may be more willing to make concessions. Similarly, if the corporation is unpopular, ensnared in litigation or regulatory proceedings, or requires shareholder approval for any significant pending initiative, electoral leverage is again enhanced.

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

Safeway Corporation's 2003-2004 proxy fight with institutional investor CalPERS serves as an example of megaphone externalities and attempted electoral leverage. CalPERS, the pension fund for the state of California, was a major shareholder of Safeway. The president of CalPERS' board, Sean Harrigan, was also the executive director of United Food and Commercial Workers (UFCW) union. In 2003, the UFCW organized a strike against Safeway because the Safeway had cut worker's health care benefits. After the CalPERS board discussed the UFCW and Safeway's ongoing contract negotiations, Harrigan, acting in capacity as CalPERS' president and with the support of the CalPERS board, wrote Safeway's CEO Steven Burd, stressing that the company finish union negotiations “fairly and expeditiously” because “fair treatment of employees is a critical element in creating long-term value for shareholders.”⁵⁷ Two months later, Harrigan lead a union rally where he called Safeway “a bad investment” and demanded the Burd's resignation.⁵⁸ A month later, CalPERS announced it would withhold support for the re-elections of Burd and two other Safeway directors. Although Safeway “tried to mollify dissidents by announcing plans to replace three of its other directors,” CalPERS was not satisfied, and joined with pension funds in Illinois, Connecticut, New York and Massachusetts to wage a proxy fight.⁵⁹ In the end only 17% of Safeway's shares, CalPERS included, voted against the targeted directors.⁶⁰ The affair illustrates the value of megaphone externalities even in situations where the candidate does not come close to prevailing, and the ability to generate leverage as a corollary of megaphone externalities.⁶¹

⁵⁷ Jonathon Weil & Joann S. Lublin, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, Wall St. J., Dec. 1, 2004, at A1.

⁵⁸ *Id.*

⁵⁹ James F. Peltz, *Investors Lose Bid to Oust Safeway Chief*, L.A. Times, May 21, 2004, at C-1.

⁶⁰ Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS Shareholder Activism*, 16 J. of Investing, 66 (Winter 2007).

⁶¹ The LA Times reported that “some of the dissidents had hoped Burd would be denied 25% or more of stockholders' votes,” a goal far below a prevailing threshold. Peltz, *supra* note 59, at C-1. The CalPERS board ultimately voted to remove Harrigan as a board member in December 2004 following scrutiny of Harrigan's political activities. See Marc Lifsher, *Activist Chief at CalPERS is Voted Out*, L.A. Times, (Dec. 2, 2004)

C. Shareholder Politics and Commission Politics.

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

And therein lies a critical political observation. Labor unions and public pension funds would prefer to win the 3-2 vote at the Commission level, and impose a Mandatory Minimum Access Regime, than to rely on an authentically majoritarian approach under which they could lose the majority vote at the shareholder level. The well-worn politics of agency capture are thus again at work at the SEC, and explain with precision how and why the SEC has crafted internally inconsistent Proposed Rules that marginalize authentic shareholder self-determination so as to maximize the megaphone externalities and electoral leverage that accrues to the benefit of favored constituencies.

5. The Academic Perspective

A rich academic literature addresses the proxy access debate and the closely related debate over the optimal design of corporate default rules.⁶² Significantly, there is a strong and broad academic consensus that immediately rejects the Commission's proposed Mandatory Minimum Access Regime. As described by leading scholars, "[t]here is no dispute ... that a substantial part (if not all) of corporate governance should be regulated in an enabling manner, allowing companies to choose the arrangement that will govern them."⁶³ This consensus arises in part because the literature proceeds "using the premise that market players and investors in any given company are more likely than public officials to identify the superior arrangement for their company."⁶⁴ Because the Commission's Mandated Minimum Access Regime expressly precludes reliance on an enabling approach, whether structured as an opt-in or as a symmetric opt-out protocol, the Proposed Rules stand well outside the norms prescribed by the academic canon.

⁶² See generally, FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 1991; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, (1995); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991); Adrian Vermeule, *Interpretive Choice*, 75 N.Y.U. L. REV. 74, 85 (2000);

⁶³ Lucian A. Bebchuk & Assif Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 496 (2002). 496.

⁶⁴ Bebchuk and Hamdani at 497. The literature also observes that "[i]ssues for which public officials are likely to know better than market participants what the desirable arrangement is should be regulated by a mandatory rule and thus should be outside the scope of the theory of corporate law defaults," but nothing in the literature or in the Proposing Release supports the conclusion that public officials know how to construct proxy access rules better than shareholders. *Id.* at 497. Indeed, the literature is replete with examples of situations where shareholder choice is advocated as the preferred mechanism of action for decision more profound than or quite similar to proxy access. See e.g., *supra* note 64

With regard to structuring the optimal enabling approach for a proxy access regime, “[a] natural and widely accepted approach is to try to assess which ... arrangement[] would be more likely to serve shareholder value. Under this approach, when public officials are uncertain which of two possible arrangements would be value maximizing, they should determine which arrangement would be more likely, in their judgment, be the one that, *if applied*, would maximize shareholder value. This question is equivalent to asking which arrangement fully informed and rational shareholders would have most likely chosen had they considered the question. This so-called “hypothetical bargains” approach seeks to identify what arrangements *would have been* most likely adopted by shareholders had they considered the matter when the company first went public.”⁶⁵

So how is the Commission, in the context of the proxy access debate, to determine whether the majority of shareholders would prefer the proposed Mandatory Minimum Access Regime, a rule that facilitates opt-in proxy access regimes, or a rule that sets a default but then provides for a symmetric opt-out?

The short, irreverent response is that the Commission doesn’t care about the answer to this question. The Proposing Release cites to no data and expresses no concern for the will of the shareholder majority. Instead, the Proposing Release cites data measuring the probability that one or two shareholders will be able to satisfy a one-percent shareholder access trigger.⁶⁶ These data are relevant only if one cares about how cheap and easy it will be to generate megaphone externalities and electoral leverage for candidates with low probabilities of prevailing in an electoral contest. These data are entirely irrelevant to any assessment of the will of the shareholder majority. These data might therefore also constitute the administrative equivalent of a Freudian slip. By considering only the ease with which insurgents can mount campaigns, has the Commission displays its animating agenda, which is to make access as easy as possible, without any regard to the will of the shareholder majority?

The more substantive response is that the Commission could simply ask shareholders. The Commission could conduct a stratified random sample survey of America’s shareholders inquiring about their preferences for a proxy access regime. Academics have long emphasized that “public officials have neither the information nor the resources to tailor different arrangements to the particular features of different companies,”⁶⁷ but this situation is not immutable.

The Commission might learn that shareholders prefer the Commission’s proposed Mandatory Minimum Access Regime, though I would wager against that outcome. Alternatively, the Commission could learn that shareholders prefer an opt-in regime that allows them to propose and vote upon a range of proxy access regimes. Or, the Commission could learn that shareholders are comfortable with an opt-out regime, but with default values that differ from those suggested by the Commission. The Commission

⁶⁵ Bebchuk and Hamdani, at 491 (*italics in original*) (footnotes omitted).

⁶⁶ 74 Fed. Reg. at 29035, 29036..

⁶⁷ Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harvard L. Rev. 835, 867 (2005).

therefore need not regulate in the dark, or through a process of introspection that is subject to influence through the traditional dynamics of agency capture, if its objective is truly to replicate the will of the shareholder majority. If the Commission cares about the will of the shareholder majority it could ask the shareholders. It is that simple.

Another theme in the academic literature suggests that default rules should be designed according to a “reversible defaults” principle.⁶⁸ This literature exists in two distinct strands. With respect to charter provisions and other governance rules that require board approval as a precondition to a shareholder vote, the literature emphasizes that in any such situation managements have “an effective veto power,”⁶⁹ and that “an optimal approach to designing default rules must take this asymmetry into account.”⁷⁰ When the asymmetry is present, and “when public officials face significant uncertainty about which choice would be value maximizing, a better strategy would often be to make the choice in a way designed to facilitate change in the event that the chosen default arrangement turns out to be disfavored by shareholders.”⁷¹ As a practical matter, this reversible defaults principle urges that in the presence of the electoral asymmetry and uncertainty, regulators should select the arrangement that is more restrictive of (or less preferred by) management because if that arrangement “then turns out to be inefficient, relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement.”⁷²

The reversible defaults principle leads to a different recommendation when the question presented involves a by-law amendment that does not require director initiation, and therefore does not give management an “effective veto power,” as is the case with proxy access proposals. There, the analysis focuses instead on whether collective action problems “can be expected to impede the initiation of bylaw amendments by shareholders.”⁷³ These collective action problems are unlikely to arise “when the issue governed by the default arrangement is sufficiently important to shareholders.”⁷⁴ Examples of issues that are sufficiently important include “takeover arrangements” where “the recent emergence of shareholder proposals to amend bylaws of public corporations in order to impose limits on the board’s power to use the pill” indicates that collective action problems are not severe.⁷⁵

There is little doubt that the proxy access debate is very important to shareholders, and that collective action costs are low. More than 500 comments have been submitted in the current rulemaking⁷⁶, and more than 34,000 comments were submitted in prior

⁶⁸ Bebchuk and Hamdani at 489.

⁶⁹ Bebchuk and Hamdani at 492.

⁷⁰ Id. at 492.

⁷¹ Id.

⁷² Id. at 492-493.

⁷³⁷³ Id at 505.

⁷⁴ Id.

⁷⁵ Id.

⁷⁶ Jesse Westbrook *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*. BLOOMBERG.COM, Oct. 2, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a2ZCxme0W84Y>

rulemakings on the matter.⁷⁷ The subject has received extensive coverage in major press outlets,⁷⁸ and shareholders have repeatedly emphasized the importance of the issue.⁷⁹ The Securities and Exchange Commission has been vocal about the significance of the question.⁸⁰ Drafting proxy access proposals also imposes little cost on proponents inasmuch as standard form proposals have already been drafted and are in the public domain⁸¹ and the Commission's own Proposed Rules can also serve as a template for a shareholder proposal to amend a corporation's bylaws. The ability to place proposals on corporate proxies is very well understood by shareholders: in 2008, more than over 185 proposals were submitted and voted on pursuant to Rule 14a-8⁸², and qualification is so easy that even law professors are able to use the process.⁸³

Under these circumstances, “on issues that are of sufficient importance to shareholders, reversible defaults approach can be consistent with public officials choosing whichever arrangement they deem most likely to be value enhancing provided that opting out via bylaw amendment be allowed.”⁸⁴ Value enhancing rules are those that seek to “improve corporate performance and value,” and not those adopted because they promote the private interests of political constituencies that might be influential with the Commission.⁸⁵ The symmetric structure of the opt-out is important because “[b]y allowing opting out via a bylaw amendment, public officials would ensure that, if the

⁷⁷ Annette Nazareth, Commissioner, U.S. Sec. and Exch. Comm'n, Opening Statement-Shareholder Proposals Relating to the Election of Directors (Nov. 28, 2007).

⁷⁸ See e.g. Jefferey McCracken and Kara Scannel, *Fight Brews as Proxy Access Nears*, Wall St. J. Aug. 26, 2009, available at <http://online.wsj.com/article/SB125123103942758059.html>; Stephen Labaton, *S.E.C. to Propose Change in Board Elections*, N.Y. Times, May 19, 2009, available at <http://www.nytimes.com/2009/05/20/business/20sec.html>.

⁷⁹ See, e.g., Letter from Terence O'Sullivan, President of Laborers International Union of North America, to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission (Aug. 14, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-238.pdf>; Letter from Joseph A. Dear, Chief Investment Officer of CalPERS, to Elizabeth M. Murphy, Secretary, U.S. Securities and Commission (Aug. 14, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-259.pdf>

⁸⁰ E.g. Mary Schapiro, Chairman, U.S. Sec. and Exch. Comm'n, Opening Address to the Council of Institutional Investors (April 6, 2009) (“I strongly believe that all of the items on our [the SEC's] immediate agenda are direct responses to some of the many failures that have led us to this difficult point in time” including “proxy access [to make] boards more accountable for the risks undertaken by the companies they manage.”)

⁸¹ See Committee on Corporate Laws, ABA Section of Business Law, *Change in the Model Business Corporation Act—Proposed Shareholder Proxy Access Amendments to Chapters 2 and 10*, 64 BUS. LAW. 1157 (Aug. 2009); ABA Comment Letter,

⁸² David A. Katz and Laura A. McIntosh, “Sign of the Times: Shareholders Focused on Stability” N.Y.L.J. Nov. 11, 2008, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202425930351> (quantifying shareholder proposals by category); see also David A. Katz and Laura A. McIntosh, Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes, <http://blogs.law.harvard.edu/corpgov/files/2008/11/shareholders-focused-on-stability-in-proxy-votes.pdf>

⁸³ Lucian Bebchuk, 14a-(8) proposal for Electronic Arts proxy, available at <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Electronic-Arts-Precatory-Proposal.pdf>.

⁸⁴ Bebchuk and Hamdani at 505.

⁸⁵ Bebchuk and Hamdani at 505-506. Leading academics take the position that “increased shareholder power or participation would be desirable if and only if such a change would improve corporate performance and value.” Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Law. 43, 44 (2003). Simply amplifying “shareholder voice” is an insufficient objective by this metric unless it also improves “corporate performance.”⁸⁵ Id., *The Case for Access*, at 44, note 4.

chosen default turned out to be value decreasing, shareholders would be able to reverse it easily and not be stuck with a value decreasing arrangement.”⁸⁶ Thus, no formulation of the reversible defaults principle, even if read most aggressively as favoring proposed Rule 14a-11, would support an asymmetric opt-out, as currently proposed by the Commission’s amendment to Rule 14a-8. And again, because of the uncertainty over the default rule that would be value enhancing, the easiest resolution that is immune to the influence of agency capture and special interest politics is simply to ask the shareholder base through a properly structured stratified random sample of the shareholder base. Introspection by the SEC will not be able to discern the arrangement that most improves “corporate performance and value.”⁸⁷

Viewed against this background, the Comment Letter of a Bi-Partisan Group of Eighty Professors of Law, Business, Economics, or Finance in Favor of Facilitating Shareholder Director Nominations⁸⁸ is a bit mysterious. The Eighty Professors Letter states that “[a]ll of the Submitting Professors urge the SEC to adopt a final rule based on the SEC’s current proposals, and to do so without adopting modifications that could dilute the value of the rule to public investors.” Does this locution support the Proposed Rules without any amendment, thereby creating an asymmetric opt-out notwithstanding the lack of support for this approach in the academic literature? Or does this locution support a modification of the Proposed Rule to allow a symmetric opt-out on the rationale that such an amendment would not dilute the value of rule to public investors but would instead enhance the value of the rule? Or, does this locution support the adoption of higher shareholder thresholds, again on the rationale that these higher thresholds would not dilute the value of the rule to shareholders, depending perhaps on the level at which the thresholds are set? Or, does this locution support eighty different modifications consistent with eighty different interpretations of amendments that dilute the value of the rule to public investors?

The Eighty Professors Letter also observes that “[p]roviding shareholders with minimum rights of access to the company’s proxy card, and allowing companies to provide shareholders with additional rights but not to take away the set minimum, is consistent with the long-standing and established role of the proxy rules (and the securities laws in general) and the division of labor between them and state corporate law. The proxy rules ... have long provided mandatory arrangements ... with companies being free to add additional protections but to not reduce investors’ protections below the established minimum.”⁸⁹ But even if correct as a descriptive matter, this statement fails utterly as a prescriptive matter. It does not explain why a mandatory default rule with an asymmetric opt out is the social optimum for any aspect of the proxy rules, much less for

⁸⁶ Bebchuk and Hamdani at 505-506.

⁸⁷ The libertarian paternalism literature suggests reliance on “the approach that the majority would choose if explicit choices were required and revealed,” or an approach that “would force people to make their choices explicit,” or the approach that “minimizes the number of opt-outs” that would occur from the designated default rule. See, e.g., Richard H. Thaler, and Cass R. Sunstein, *Libertarian Paternalism*, 93 *Amer. Econ. Rev.* 175, 178-79 (2003). The stratified sample approach is entirely consistent with the prescriptions provided by libertarian paternalism.

⁸⁸ Eighty Professors Letter, *supra* note 9.

⁸⁹ Eighty Professors Letter at 2.

the pending proxy access rule. Indeed, the academic literature repeatedly states a case against the asymmetric opt out approach embedded in the Commission's Mandatory Minimum Access Regime.⁹⁰

The Eighty Professors Letter further observes that “[i]n evaluating eligibility and procedural requirements, the SEC should also keep in mind that many institutional investors lack incentives to invest actively in seeking governance benefits that would be shared by their fellow shareholders. Accordingly, the final design of the rule should avoid imposing any unnecessary hurdles or costs on shareholders organizing or joining a nominating group.”⁹¹ To the extent this statement intends to suggest that significant collective action costs might support an opt-out default rule for proxy access, the fact that “many institutional investors lack incentives” to engage in governance activism does not negate the obviously correct proposition that a very large group of institutional investors have very strong incentives to engage in powerful forms of governance activism, and have indeed invested heavily in these activities in promoting proxy access. Nor does this statement negate the observation that proxy access rules can generate valuable megaphone externalities and electoral leverage that constitute private benefits to special interest shareholder constituencies. Nor does it contest the conclusion that collective action costs in the case of proxy access are sufficiently low as to negate application of a restrictive approach pursuant to the reversible default rule. The mystery of the meaning of the Eighty Professors Letter is thus again magnified.

7. Other Mechanisms for Enhancing Shareholder Voice: “Just Vote No,” Majority Voting, and Proxy Reimbursement

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

Recent research finds “consistent evidence across a broad set of measures suggesting that on average [just vote no] campaigns are effective in spurring boards to act. The typical target has significant post-campaign operating performance improvements.”⁹² Further, in “campaigns motivated by firm performance and strategy reasons, ... boards take a variety of value-enhancing actions: 31% of these targets experience disciplinary CEO turnover and 50% of the remaining targets that do not dismiss the CEO make other strategic changes.”⁹³ These benefits arise even if no director is ousted from the board as

⁹⁰ See, e.g., Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 677 (2007) (“Whatever default arrangements public officials choose, they should at a minimum facilitate adoption of bylaws opting out of these arrangements.”); Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Lawyer 43, 59 (2007) (arguing that if “one size does not fit all” then “the adopted SEC rule should leave firms free to opt out of the rule with shareholder approval.”)

⁹¹ Eighty Professors Letter at 2.

⁹² Diane Del Guercio, Laura Seery & Tracie Woidtke, *Do Boards Pay Attention When Institutional Investor Activists “Just Vote No”?*, 90 J. FIN. ECON. 84, 85 (2008).

⁹³ *Id.* at 86.

a consequence of a majority no vote. The empirical evidence thus demonstrates, as has long been suggested, that “just vote no” campaigns can be highly efficient, low-cost mechanisms for the positive expression of shareholder voice, notwithstanding their precatory nature.⁹⁴ Boards are thus not impervious to the expression of shareholder disaffection even if shareholders lack the power to oust any director or to place their own nominees on the corporate ballot.

Recent data suggest that “just vote no” campaigns are gaining steam among shareholders. The percentage of directors standing unopposed who had at least twenty percent of votes cast marked to withhold authority for their re-election increased from 5.5 percent in 2008 to 9.8 percent in 2009. The percentage of directors with forty percent of votes marked to withhold authority increased from 1 percent in 2008 to 2.1 percent in 2009. A total of 84 directors failed to garner majority support in 2009, triple the incidence observed in 2008.⁹⁵ The fact that only a small number of directors receive a majority of votes withheld, or that directors continue to serve even with a strong expression of disapproval, does not suggest that “just vote no” campaigns have failed. As described above, even failed campaigns can significantly increase shareholder value because these campaigns appear to instigate other forms of value-enhancing governance reform.

For example, Dollar Tree’s lead director received 50.5% withheld votes in June of 2008. The board observed that shareholder disapproval was based on disaffection with its classified board structure. The board decided to recommend declassifying its board at its 2010 annual election, and rejected the director’s offer to resign, which was made in accordance with its majority vote policy.⁹⁶ A similar pattern emerged at Pulte Homes where, after three directors received a majority of withheld votes, the board determined to phase out its classified board.⁹⁷

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

Majority voting has spread rapidly and widely in corporate America, but remains concentrated among larger publicly traded corporations.⁹⁸ If the Commission seeks to promote the adoption of certain forms of majority voting, it could impose additional disclosure and communication requirements on registrants who fail to satisfy specified

⁹⁴ See Joseph A. Grundfest, “Just Vote No”: A Minimalist Strategy for Dealing With Barbarians Inside the Gates, 45 STAN. L. REV. 857 (1993).

⁹⁵ Gretchen Morgenson, Too Many ‘No’ Votes To Be Ignored, The New York Times, Sept. 20, 2009, Sec. 3, at 1, col. 1.

⁹⁶ Kristen Gribben, *Trouble Looms for Director Elections*, Agenda, Oct. 5, 2009, available at www.agendaweek.com

⁹⁷ *Id.*

⁹⁸ 74 Fed. Reg. at 29029, cols. 1–2 & n.69.

majority voting standards.⁹⁹ The Commission could attempt to support these additional disclosure and communication requirements, in registration statements and in periodic filings, on the rationale that the lack of a majority vote provision creates governance risks that warrant heightened shareholder scrutiny. However, if Congress mandates majority voting,¹⁰⁰ then there would be no need for such action by the Commission.

Scholars have also called for situational reimbursement of insurgent expenses incurred in mounting a proxy campaign, but with differing views as to the optimal structure of these reimbursement rules.¹⁰¹ Again, the Commission has no special insight as to the optimal structure of these rules at any corporation, and a fully enabling approach would allow shareholders to determine the optimal arrangement for their corporation. An expanded rulemaking could easily encompass an opt-in proxy reimbursement proposal alongside a proxy access proposal.

8. Conclusion

While “foolish consistency” may be the “hobgoblin of little minds,”¹⁰² the inconsistencies between the Proposing Release and the Proposed Rules are far from foolish. They are fundamental to the Commission’s enterprise. They are also likely fatal to the Proposed Rules under the Administrative Procedure Act. The inconsistencies can, however, be cured by revising the Proposed Rules so that they constitute fully enabling provisions that allow a majority of shareholders to adopt a wide range of proxy access rules through an opt-in mechanism.¹⁰³

⁹⁹ For a discussion of the relative benefits of majority voting regimes over proxy access regimes, see Joseph A. Grundfest, *The Wizard of Oz, the United States Constitution, and Corporate Governance*, (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 9, 2007), available at <http://ssrn.com/abstract=1028424>.

¹⁰⁰ See, e.g., Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. §5; Shareholder Empowerment Act of 2009, HR 2861, 111th Cong. §2.

¹⁰¹ See e.g., Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va.L. Rev. 675, 697-700 and references at footnote 39 (2007); Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Lawyer 43, 64-65 (2003); Bebchuk and Kahan, *A Framework for Analyzing Legal Policy Toward Proxy Contests*, 78 Cal. L. Rev. 1071, 1096-100 (1990).

¹⁰² Ralph Waldo Emerson, *Self Reliance*, in *THE COMPLETE ESSAYS OF RALPH WALDO EMERSON* 152 (Brooks Atkinson ed., 1940).

¹⁰³ This brief article focuses on the implications of the inconsistencies between the text of the Proposing Release and the text of the Proposed Rules. It does not address the myriad operational difficulties raised by the Commission’s proposals; the adequacy of the rationale supporting the Commission’s view that proxy access is the optimal means of enhancing shareholder voice; the evidence (or lack thereof) supporting the view that the current economic crisis is caused, to any material degree, by a lack of proxy access; or the Commission’s ability successfully to conduct a §3(f) analysis of its proposed rules. Other commentators are likely to address the operational difficulties inherent in the Commission’s proposal. A summary of the argument that proxy access is not the optimal means of addressing the problem of shareholder voice can be found in Grundfest, *supra* note 34. Counterfactual analysis is likely to suggest that, even if proxy access rules were in place prior to the recent economic crisis, the crisis would neither have been averted nor ameliorated to any material degree. For a description of this form of analysis see, e.g., Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS L. REV. 199 (forthcoming), available at http://hosted.law.wisc.edu/lawreview/issues/2009_2/2_-_dunbar_sen.pdf.

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

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