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Internal Contradictions in the
SEC's Proposed Proxy Access Rules

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Stanford Law School and
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The Rock Center
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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. The Proposing Release, however, contradicts the Proposed Rules in two distinct respects that render the Proposed Rules arbitrary and capricious in violation of the Administrative Procedure Act.

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 to nominate and elect directors. But the Proposed Rules prohibit the identical shareholder majority from establishing a proxy access regime, or from amending the Proposed Rules to establish more stringent access standards. The Commission offers no rationale as to why an identical majority of shareholders is so selectively intelligent and responsible that it can be relied upon to elect directors nominated pursuant to the Commission's imposed access standards, but cannot be relied upon to set its own access standards.

The second contradiction relates to the Commission's assertion that the Proposed Rules replicate the physical shareholder meeting as governed by state law. Nothing in state law sets a minimum proxy access standard, defines the contours of any access proposal to be considered by shareholders, or prohibits a majority of shareholders from amending an access standard to make it more stringent while allowing the same majority to relax the standard. The Proposed Rules thus fail to achieve the Commission's stated objective, and instead erect barriers to shareholder action that exist nowhere in state law.

Both contradictions are potentially cured by a fully-enabling approach in which proxy rules are modified to allow shareholders to propose, and a majority of shareholders to adopt, access rules that are appropriately suited to the individual circumstances of individual corporations. Only this fully-enabling approach is consistent with core principles of shareholder self-determination, and with the operation of state law governing by-law amendments.

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.

Administrative agencies are wise not to contradict themselves when rulemaking: contradictions invite courts to overturn agency action as arbitrary and capricious.¹ Also, like Charles Barkley's claim that he was misquoted in his autobiography, contradictions spawn skepticism as to the credibility of an entire enterprise.²

This simple observation strikes a death knell for the Securities and Exchange Commission's 2009 proposed Proxy Access Rules.³ If adopted, these rules would dramatically transform the process by which directors of publicly traded corporations are nominated and elected. They 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 could not adopt more stringent proxy access rules.

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¹ 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.

² 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.

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").

The text of the Proposing Release is, however, at war with the text of the Proposed Rules in a clash that generates two profound contradictions. Each contradiction is sufficiently material that there is little prospect that the Proposed Rules can withstand challenge under the Administrative Procedure Act (“APA”).⁴⁴

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 Rules prohibit 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 reliance on the majority’s mandate, the Mandatory Minimum Access Regime cannot withstand scrutiny under the APA.

A second contradiction relates to the Commission’s repeated assertion that the Proposed Rules merely modify the proxy process better to replicate the physical

⁴⁴ See Section 5, *infra*.

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 eliminated? 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 do the principles guiding proxy access emanate?

Alternatively, and more realistically, the Commission can cure its self-created contradictions by restructuring the Proposed Rules so that they are fully enabling. Fully enabling rules would create shareholder referenda pursuant to which shareholders could propose, and a majority could adopt, proxy access standards for each individual corporation. No other strategy resolves the contradictions inherent in the Commission's Proposing Release, or generates a rulemaking record able to withstand APA review.

These same observations are relevant to the rules that the Commission might adopt in the event Congress enacts legislation mandating proxy access. Pending legislation would resolve questions regarding the Commission's statutory authority to adopt proxy access rules, but would not affect the Commission's obligation to comply with the APA.

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.⁵ Access would not be available to stockholders seeking a change in control, or to stockholders seeking more than a limited number of seats on a board.⁶ Nominating stockholders would be required to make certain disclosures, subject to the antifraud provisions of Rule 14a-9.⁷ 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

⁵ 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.

⁶ *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.

⁷ *Id.* at 29041 n.165.

stockholder meeting.⁸ Disclosure would also be required of relationships between the nominating stockholders, the nominee, and the company, if any.⁹

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-11.¹⁰

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 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.

⁸ *Id.* at 29035, 29040–41.

⁹ *Id.* at 29041.

¹⁰ *Id.* at 29056.

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.”¹¹ 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.

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.¹² Each of these questions,

¹¹ 74 Fed. Reg. at 29027, col.1.

¹² *Id.* at 29033, para. B.7; 29058, para. I.2.

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.

4. 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.”¹³

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.”¹⁴

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.¹⁵ The proposed Mandatory Minimum Access Regime would, however, impose a standardized, mandatory form of proxy access that replicates nothing about the current annual meeting

¹³ *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.

¹⁴ *Id.* at 29027, col.2.

¹⁵ 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.

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. 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"¹⁶ 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.¹⁷ 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.¹⁸

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

¹⁶ 74 Fed. Reg. at 29025.

¹⁷ DEL. CODE ANN. tit. 8, § 112 (2009).

¹⁸ *Id.*

any lawful condition on access.¹⁹ The Mandated Minimum Proxy Access Regime, however, prohibits the imposition of an infinite number of lawful conditions. The Proposed Rules thus fail to replicate the situation that would exist at physical shareholders' meetings in Delaware, and are therefore fundamentally inconsistent with the Commission's own stated objective in proposing the proxy access rules. The contradiction could not be more clear.²⁰

5. Internal Contradiction and the Administrative Procedure Act

Commission rules are subject to review under the “arbitrary and capricious” standard of the Administrative Procedure Act.²¹ “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.... [T]he Supreme Court's famous 1983 decision in *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Auto Insurance Company*, 463 U.S. 29 (1983), has been read to clarify one aspect of arbitrary and capricious review: Agencies should explain their decisions in technocratic, statutory, or scientifically driven terms, not political terms.”²²

¹⁹ *See id.*

²⁰ 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.

²¹ 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.”).

²² 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”).

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. 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.²³ This position, however,

²³ 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).

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 *11.²⁴

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.²⁵ When rules are vacated and remanded, the Commission must restart the rulemaking process and address the concerns raised by the court, if the Commission is to act at all. That process can take several years. It is thus a Pyrrhic victory, at best, for champions of shareholders rights if the agency adopts proxy access rules that are simply waiting to be vacated and remanded by the courts. If the Commission is intent on crafting proxy access rules that are likely to be implemented on a prompt basis, without being overturned by the courts, then it will have to confront the more vocal and extreme advocates of proxy access. It will have to reject their agenda, and instead adopt a more measured and nuanced set of rules that can pass muster before a dispassionate court that will not be subject to the political pressures that today buffet the agency.

²⁴ 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.

²⁵ *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).

6. Curing the Contradictions

The proposal's 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.²⁶ 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.²⁷ This “fully enabling” strategy is also entirely consistent with the Commission's stated desire to replicate the meeting process as it currently exists.²⁸

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

²⁶ 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.

²⁷ 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.

²⁸ 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.

replicate the physical shareholder meeting.²⁹ 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.³⁰ 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.

7. “Just Vote No” and Majority Voting

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.

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

²⁹ 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.

³⁰ 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)..

improvements.”³¹ 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.”³² 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.³³ 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.

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.³⁴ 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

³¹ 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).

³² *Id.* at 86.

³³ See Joseph A. Grundfest, *“Just Vote No”: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

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

majority voting standards.³⁵ 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,³⁶ then there would be no need for such action by the Commission.

8. 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.”³⁷ This legislation, if adopted, would eliminate uncertainty regarding the Commission’s statutory authority to adopt proxy access rules.³⁸

³⁵ 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>.

³⁶ 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.

³⁷ 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.

(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.'.)

Enactment of this legislation would not, however, 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. Accordingly, in exercising any new rulemaking authority that might be granted by pending legislation, the Commission would be prudent to consider adopting the fully enabling approach described above.

Alternatively, even if the legislation is interpreted as mandating the imposition of a proxy access regime in a manner inconsistent with an opt-in mechanism, the Commission could conduct a series of surveys designed to identify the parameters of the proxy access regime that would authentically be preferred by the majority of shareholders if the matter were put to a vote.³⁹ These surveys might indicate that different categories of corporations have shareholder bodies with different preferences regarding the design of proxy access regimes. To respect that natural variation in shareholder preferences, the Commission could adopt a family of proxy access criteria that would seek to synthesize the default rules that shareholders would prefer if the matter were put to a vote. The family of default rules could then further be subject to an opt-out rule allowing a majority of shareholders to strengthen or relax proxy access standards at individual corporations in a manner consistent with the legislative mandate. But this regime, which would respect

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).

³⁸ 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>.

³⁹ This approach would, in effect, constitute an effort to apply principles of libertarian paternalism to the design of a mandatory proxy access regime. *See supra* note 31 and accompanying text.

the expressed wishes of the shareholder majority, clearly differ from the Commission's Mandatory Minimum Access Regime which operates with no respect whatsoever for the will of the shareholder majority in establishing the principles governing proxy access.

9. Conclusion

While “foolish consistency” may be the “hobgoblin of little minds,”⁴⁰ 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 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.⁴¹

⁴⁰ Ralph Waldo Emerson, *Self-Reliance*, in *THE COMPLETE ESSAYS OF RALPH WALDO EMERSON* 152 (Brooks Atkinson ed., 1940).

⁴¹ 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.