Proxy Access Reform Being Considered by the SEC: An Overview

Gary Shorter
Specialist in Financial Economics

May 20, 2010

Congressional Research Service
7-5700
www.crs.gov
R41247

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Members of public company boards are supposed to play key fiduciary and management watchdog roles for the shareholders. At annual public company shareholder meetings, incumbent boards submit slates of board nominees for shareholder consideration as part of the official corporate proxy materials and statement sent to shareholders in advance of the meeting. Whereas states like Delaware (the home of a large proportion of sizeable public firms) have largely governed substantive corporate matters for firms that they incorporate, the Securities and Exchange Commission (SEC) oversees matters related to the content of proxy materials.

Historically, the SEC has interpreted applicable federal securities laws as allowing companies to exclude from proxy materials shareholder proposals involving the nomination of persons to their boards, thus denying shareholders proxy access. Shareholders interested in pushing an alternative slate of nominees for fellow shareholder consideration must bear the printing and distribution costs themselves, which many believe poses a significant obstacle to such proxy fights: there are fewer than 100 a year in a universe of several thousand U.S. public companies.

In May 2009, for the third time in seven years, the SEC proposed proxy access reforms. The most controversial proposal would amend federal securities laws to give shareholders with certain levels of stock holdings the right to include the names of their director nominees in company proxy materials. The agency observed that it needed to "structure the proxy rules to better facilitate the exercise of shareholders' rights to nominate and elect directors ... "

The proposal has earned the support of several union and pension funds, including the Council of Institutional Investors, a large investor advocacy group. Opposition to the proposal has come from various U.S. corporations, business advocacy groups such as the U.S. Chamber of Commerce, the Business Roundtable, and the American Bar Association.

Supporters argue that public company boards, many of whom have chairs who also serve as CEOs, too often display a management bias, inadequately discharging their duty as the shareholders' champions and fiduciaries. By helping to produce boards with greater numbers of directors who are more sensitive to shareholders' needs, and by injecting greater competition into board elections, many supporters of proxy access characterize it as a much needed development.

By contrast, opponents of the proxy access proposal express concerns that it would usurp traditional state-based corporation laws, ignore strides that have been made in empowering shareholders (including the growing adoption of majority voting), undermine collegiality that is arguably critical to the viability of corporate boards, and subject corporations to a uniform and inflexible regime of proxy access that would be insensitive to their differences. Concerns over the alleged inefficiencies of a "cookie cutter" federal proxy access regime have led many of the opponents of the SEC's access proposal to advocate an "opt out" feature: companies, through shareholder action, would be allowed to adopt bylaw amendments that provided for more restrictive proxy access provisions than are in the SEC access proposal.

H.R. 4173, the financial regulatory reform bill that passed the House in December 2009, would authorize the SEC to prescribe rules for proxy access. S. 3217, the financial regulatory reform bill currently under consideration in the Senate, says that the SEC "may" prescribe rules giving shareholders proxy access. This report will be updated as events dictate.

Contents

Introduction 1
The May 2009 SEC Proxy Access Proposals 2
Various Groups Comment on the Proxy Access Proposal 4
Additional Criticisms of the Proxy Access Proposal 6
Additional Arguments in Favor of Proxy Access and Rebuttals to Criticism 9
Private Ordering, Opting In and Opting Out 11
Key Studies 12
The NERA Report for the Business Roundtable 12
The SEC Staff Study, Share Ownership and Holding Period Patterns in Form 13F Data 13
Key Legislation 13

Contacts

Author Contact Information 14

Introduction

Directors on the boards of public corporations are fiduciaries responsible for overseeing the best interests of the corporation and its shareholders. Among other things, they oversee management (which includes the hiring and firing senior officers and approving officer compensation), provide overall strategic direction (including providing advice on long-range business strategy), and approve annual business plans. Typically, state-based business laws such as those in Delaware (where about half of large U.S. public corporations are headquartered) set the legal parameters for their incorporated firms. In the corporate governance area, the state laws typically mandate that (1) management of a corporation's business shall be under the board's direction; and (2) shareholders generally have the right to vote for the election or removal of directors, amend the charter and bylaws, and vote on extraordinary transactions such as mergers or liquidation, if and when proposed by the board of directors.

Although substantive corporate governance matters have traditionally been delegated to the states, the Securities and Exchange Commission (SEC) has historically concerned itself with the disclosure and contents of proxy statements and materials, including official management and shareholder corporate proposals for shareholder consideration and the slates of board-selected director nominees that are typically voted on at annual shareholder meetings. Currently, an incumbent board and its nominating committee will, via a company's proxy material, put forward a slate of directors to be voted on at the meeting. Attendees can vote at the gathering and shareholders who do not attend can use the proxy ballots. Historically, the SEC has repeatedly confirmed that Rule 14a of the Securities and Exchange Act of 1934 allows companies to exclude from their proxy materials shareholder proposals to nominate their own board candidates. As a consequence, shareholders do not generally have the right to nominate board candidates through the vehicle of a company's proxy materials. That denied right is known as proxy access.

Shareholders interested in fellow shareholder consideration of an alternative slate of board nominees must instead bear the distribution and printing costs of getting the slates to dispersed shareholders on their own. Although there is some disagreement, many say that the cost of mounting such a proxy fight poses a significant obstacle to shareholders deciding to do so, It can reportedly cost up to hundreds of thousands of dollars to wage a proxy fight, many contests reportedly involving repeated mailings to every investor:[1] among the several thousand public U.S. firms, there tend to be far fewer than 100 such proxy fights in any given year.[2]

In May 2009, the SEC proposed to amend federal securities laws to provide for proxy access. This report provides an overview of significant responses to the proposals, key arguments for and against the proposals, important research on the proposals, and key related legislation.

---

[1] Joanne Lublin, "Reimbursements Aim For a Fairer Proxy Fight," *Wall Street Journal*, October 27, 2009.

[2] RiskMetrics, a proxy advisory firm, reportedly found that the number of proxy fights increased slightly in 2009, as it did in 2008 (39 through September 2009, 35 from January to September 2008, and 30 in all of 2007). In 2009, dissident shareholders who ran such board nominees reportedly saw at least some of their nominees elected in 22 of those 39 companies. In addition, as often happens, a number of companies who faced potential proxy contests entered into settlements and often added one mutually agreed upon person to their boards. David A. Katz "Reviewing the 2009 Proxy Season And Looking Ahead to 2010," *the Harvard Law School Corporate Governance Blog,* November 29, 2009, available at http://blogs.law.harvard.edu/corpgov/2009/11/29/reviewing-the-2009-proxy-season-and-looking-ahead-to-2010/.

The May 2009 SEC Proxy Access Proposals

In a May 2009 split partisan vote, the SEC voted to propose two rules involving proxy access, representing the third time in seven years that it had wrestled with the issue of giving shareholders the ability to use corporate proxy materials to nominate candidates to corporate boards.[3]

Proposed Rule 14a-11 under the Exchange Act would, under certain circumstances, require companies (including registered investment companies) to include stockholder nominees for director in company proxy materials. Investors seeking to nominate directors under Rule 14a-11 would need to meet certain eligibility criteria regarding length and percentage of stock ownership. The nominating stockholder would be required to have shares in the company for at least one year in an amount equal to at least

- 1% of the company's securities for large accelerated filers and registered investment companies with net assets of $700 million or more;
- 3% of securities for accelerated filers and investment companies with net assets of between $75 million and $700 million; or
- 5% of company securities for non-accelerated filers and investment companies with assets of less than $75 million.

Rule 14a-11 would not be available to stockholders seeking to gain more than a limited number of seats on a board of directors or change control of a company. The maximum number of nominees a company would be required to include under the rule would be either one or 25% of the board, whichever is greater. A company with more than one eligible stockholder would be required to include up to the maximum number of nominees on a "first-come, first-served" basis in the order the notices of nominations are received.

[3] U.S. Securities and Exchange Commission, "Facilitating Shareholder Director Nominations, SEC Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09, available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf. In October 2003, the SEC proposed a rule that would have made access available to stockholders upon the occurrence of certain issuer-related triggers. The 2003 proposal would have required stockholders to meet certain eligibility requirements, including owning more than 5% of a company's stock for at least two years at the time of a director nomination. The proposal would have permitted stockholder nominations only upon certain triggering events (material percentage of withhold votes or majority support for proxy access) that suggested lack of board responsiveness to stockholder concerns. After attracting thousands of letters to the SEC both in opposition and support, the SEC 2003 proposal was never voted on. In July 2007, the SEC proposed two competing rules relating to stockholder proposals. The first rule (the Exclusion Proposal) codified the SEC's historical view that Rule 14a-8(i)(8) of the Exchange Act would have allowed public companies to exclude stockholder proposals that may result in contested director elections, including proxy access proposals. The second rule (the Access Proposal) would have required companies to include stockholder proposals for bylaw amendments regarding director nomination procedures. The stockholder making such a proposal would have needed to beneficially own more than five percent of the company's stock, and have held the stock for at least one year. The SEC received tens of thousands of letter supporting or opposing these proposals. In November 2007, the agency adopted the "Exclusion Proposal." John Finley, Avrohom Kess, and LeAnn Leutner, "The SEC's New Proxy Access Proposals," *Corporate Board*, September-October 2009, available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/proxy-access-roundtable-09-materials/Finley,%20John_Commentsonproxyaccessarticle.pdf.

Of the two proposals, the Rule 14a-11 proposal is the one that has generated the most attention and it is generally what informed observers speak of when they refer to the SEC's proxy access proposal. Unless stated otherwise, future reference to the proxy access proposal in this report will refer to proposed Rule 14a-11.

Proposed Amendment to Rule 14a-8(i)(8) under the Exchange Act would provide that a company must include a stockholder's proposal and supporting statement in its proxy materials if the stockholder satisfies certain eligibility and procedural requirements, and the proposal is not excludable on specified substantive grounds. Although the election exclusion pursuant to Rule 14a-8(i)(8) had historically provided a basis for excluding proxy access proposals, the SEC's proposed change to Rule 14a-8(i)(8) would, under certain circumstances, require a company to include in its proxy materials a stockholder's proposal that would amend company documents regarding nomination procedures. The proposal could not, however, conflict with proposed Rule 14a-11 unless the proposal made proxy access easier than the SEC's rules.

As stated earlier, in contrast to the Rule 14a-11 proposal, the 14a-8 proposal has provoked little to no controversy.

The SEC explained its rationale in voting out the two proxy access proposals:

> Based on the staff's and Commission's review of the proxy solicitation process and the extensive public input that we have received over the past several years on the topic of shareholders' ability to meaningfully exercise their rights to vote for and nominate directors of the companies in which they invest, we have decided to propose changes to the current proxy rules relating to the nomination of directors. First, we believe that we can and should structure the proxy rules to better facilitate the exercise of shareholders' rights to nominate and elect directors. The right to nominate is inextricably linked to, and essential to the vitality of, a right to vote for a nominee. The failure of the proxy process to adequately facilitate shareholder nomination rights has a direct and practical effect on the right to elect directors. As noted, the proxy rules have been designed to improve the proxy process so that it functions, as nearly as possible, as a replacement for an in-person meeting of shareholders. This is important because the proxy process today represents shareholders' principal means of participating effectively at an annual or special meeting of shareholders. Based on the feedback we have received over the last few years, it appears that the federal proxy process may not be adequately replicating the conditions of the shareholder meeting. Second, we believe that parts of the federal proxy process may unintentionally frustrate voting rights arising under state law, and thereby fail to provide fair corporate suffrage. These two potential shortcomings in our regulations provide compelling reasons for us to reform the proxy process and our disclosure requirements relating to director nominations....[4]

However, reflecting key concerns held by various critics of the Rule 14a-11 proposal, one of the two dissenting SEC Commissioners, Troy Paredes, observed that

> It is important to recognize how the proposal, particularly Rule 14a-11, would operate in practice. Even if a majority of a company's shareholders determine that Rule 14a-11 is not in the firm's best interests, the proposal would nonetheless force the company's shareholders into the Rule 14a-11 access regime, as shareholders cannot opt out of Rule 14a-11 by prohibiting access or by adopting eligibility requirements more restrictive than those of Rule 14a-11. Nor can the board, even when in compliance with its fiduciary duties, choose for the

---

[4] It is available at http://www.sec.gov/rules/proposed/2009/33-9046fr.pdf.

> company not to be subject to Rule 14a-11. By way of illustration, assume that the shareholders of Delaware Corp., a large accelerated filer, adopt a proxy access bylaw pursuant to section 112 of the Delaware code, and that the bylaw requires that a nominating shareholder or group has beneficially owned at least three percent of Delaware Corp.'s shares for at least two years. The interplay between state law and Rule 14a-11 would result in the substantive negation of the shareholder-approved bylaw, as the lower one-percent/one-year Rule 14a-11 eligibility requirements would, in effect, override the shareholder-approved three-percent/two-year requirements. Put simply, the mandates of Rule 14a-11 not only work to displace private ordering and state law, but risk negating the import of a shareholder vote. In addition to the concerns I have already raised, there are numerous questions concerning the practical implementation of the rules; the disclosures that may be appropriate; the proper triggering events and shareholder eligibility requirements; and the possible untoward influence of so-called "special interest" directors. On this last point, we need to be mindful that proxy access might privilege certain shareholders at the expense of others. More generally, some shareholders presumably do not welcome access, and some that presently do may reconsider once access begins to play out in practice. Shareholders are not monolithic, and at least some shareholders will undoubtedly be skeptical of how other shareholders take advantage of the access they are afforded....[5]

Various Groups Comment on the Proxy Access Proposal

The SEC has received several hundred comments on the proxy access proposal. On balance, proposals from corporate or institutional interests are divided along fairly predictable lines: corporations and corporate trade groups tend to oppose the access proposal, whereas pension and union-based institutional investor groups tend to support it.[6]

For example, the California Public Employees' Retirement System (CALPERS), California State Teachers' Retirement System, Florida State Board of Administration, Ohio Public Employees Retirement System, Colorado Public Employees' Retirement Association, and the Connecticut Retirement Plans and Trust Funds endorsed the proposal.

CALPERS' perspective was fairly typical for such supporters:

> A national standard for proxy access should be established. CALPERS considers that the commission has clear authority to adopt the proxy access rule proposal. Federalism issues aside, the main advantage of a national standard is to ensure that the companies that need the reform the most actually implement the rule. In CALPERS' experience, recalcitrant companies may unreasonably resist shareowner proposals. Investors are best protected when board directors are responsive and accountable to the shareowners. Having an effective channel through which to nominate directors through access to the company's proxy card is critical to ensuring this accountability….[7]

---

[5] Commissioner Troy A. Paredes, "Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations," May 20, 2009, available at http://74.125.113.132/search?q=cache:R44uEHpG54YJ:www.sec.gov/news/speech/2009/spch052009tap.htm+paredes+%22proxy+access%22&cd=1&hl=en&ct=clnk&gl=us.

[6] This is based on the sampling of various comments and readings from various observers of the comments.

[7] Available at http://www.sec.gov/comments/s7-10-09/s71009-259.pdf.

In addition, the Council of Institutional Investors, a group that represents institutional investors who are not mutual funds or hedge funds, lent the proposal its general support. It did, however, criticize the "first-in approach" in the proposal that gives first priority to shareholder groups that file their nominations first to nominate the maximum number of directors that would be allowed, noting that it is likely to cause a pointless and potentially harmful race to qualify as the first filers.

The proxy access proposal also received support from a group of economics, business and law professors at Harvard University, who added their concerns that the 1% threshold for large companies would likely invite too many board nominee contests:

> The absence of a direct means for shareholders to influence the composition of the boards of the companies they own has been one reason for investors to rely on "the Wall Street Walk"[8] when they are unhappy with their company's performance. Further, the current lack of direct shareholder power in relation to boards and management has also contributed to the array of shareholder proposals, many of which contribute little to effective governance. While we all support the broader goals of the proposed rule we do have some concerns about its form and specific provisions. The one percent threshold for share owners of large companies is too low. It potentially allows for too many contests, some of which will distract boards from the real work of leading their companies. This is especially so since groups of shareholders would be able to band together to reach the threshold. Furthermore, we could envision a number of competing slates from different shareholder groups in the same contest….[9]

Many companies, including Procter & Gamble Co., 3M Co., AT&T Inc., Emerson Electric Co., Boeing Co., and UnitedHealth Group Inc., submitted letters to the SEC opposing adoption of the proxy access proposal. Others that opposed the access proposal include major corporate advocacy groups, the United States Chamber of Commerce, which has threatened to sue in the event that proxy access becomes law; the Business Roundtable, a group of large corporate executives; and the Financial Service Roundtable, a group of large financial service companies.[10]

Citing a fairly representative array of opposing arguments, the Chamber of Commerce observed that

> The proposal exceeds the SEC's authority under Section 4 of the Exchange Act. Adopting the proposal would be costly and disruptive to companies. Adopting the proposal will impair the functioning of boards of directors to the detriment of all shareholders. There has been no compelling or objective showing of need for the new rules. The SEC has failed to address significant issues in the proxy proposal, including the ability of activist investors to "rent" the voting interests of a large number of shares.[11]

The Securities Industry and Financial Markets Association (SIFMA, a major association of financial service firms) provided conditional support for the access proposal, arguing that cost issues and the need to minimize its potential disruptive aspects required raising the investor holding eligibility threshold and the required stock holding period:

---

[8] This is the notion that if an investor is displeased with a security or its company, he or she has the option to simply liquidate his or her holdings.

[9] Available at http://www.sec.gov/comments/s7-10-09/s71009-164.pdf.

[10] The comments can be found at http://www.sec.gov/comments/s7-10-09/s71009.shtml#33-9046.

[11] Available at http://www.sec.gov/comments/s7-10-09/s71009-618.pdf.

> In our experience, both traditional proxy contests and 'vote no' or 'withhold' campaigns arise when dissatisfied shareholders perceive corporate failures and then agitate for significant changes, and that reason will likely be the driving force behind the use of Rule 14a-11 to propose nominees.... In order to preserve a balance between providing shareholders with access while mitigating the cost and disruption to the company, we propose that the Commission increase the threshold for large accelerated filers from 1% to 5%, with a 10% threshold if shareholders aggregate their holdings. We believe that the slightly higher thresholds would still provide a substantial opportunity for shareholders to make nominations. … Consistent with this goal… we believe that each nominating shareholder should be required to hold the company's voting securities for a continuous period of at least two years rather than only one year. A two-year holding period would better ensure that the proponents invoking Rule 14a-11 are long-term shareholders.

Echoing concerns that the proposal would usurp states' legal authority with respect to state-based corporate law, the Delaware State Bar Association's Section of Corporation Law took the unprecedented step of writing the SEC. It wrote that the access proposal "would unnecessarily deprive Delaware corporations of the flexibility state law confers to deal effectively with myriad different circumstances that legislators and rulemakers cannot anticipate."[12]

A group representing individual shareholders, the Committee of Concerned Shareholders, wrote to the SEC deriding the proposal as a piece of theatre that would provide the illusion of enhanced enfranchisement for a select number of institutional investors, but is an essentially meaningless exercise that does little for individual investors:

> There are 9,000+ corporations with publicly traded securities where the legitimate corporate governance needs of all investors should be protected. Institutional investors, alone, will not have the interest or the resources to nominate director-candidates at many of those corporations.… The SEC, institutional investors and the BRT [Business Roundtable] are engaged in a political kabuki dance to the detriment of the investing public. An ineffective proxy access reform rule will probably be implemented. The SEC and institutional investors will probably claim "victory" on the part of shareholders. The BRT will publicly moan and groan and, privately, claim "victory" for the proponents of business as usual.… However, BODs [boards of directors] will remain just as unaccountable to individual shareholders as before the strange dance began.[13]

Additional Criticisms of the Proxy Access Proposal

Other major criticisms of the proxy access proposal have also been articulated, making the following arguments:

- During the last several years, senior managers at various financial firms reflected the dominant goals of their shareholders in the sense that their duty was to manage in a manner that maximized the market price of company stock. As such, they managed to a market that focused on increasing observable earnings, but failed to factor in attendant and largely unobserved increases in risk. Consequently, reasonable doubts exist over whether expanding shareholder power through reforms like proxy access would have

[12] Available at http://www.sec.gov/comments/s7-10-09/s71009-65.pdf.

[13] Available at http://www.sec.gov/comments/s7-10-09/s71009-9.pdf.

resulted in the adoption of more effective risk management regimes that could have helped to avert the financial crisis at the firms.[14]

- Under state law, the board of directors is given the authority to manage the affairs and business of a corporation. Boards also have fiduciary duties with respect to carrying out their responsibilities. Mandating shareholder access to the corporation's proxy statement to nominate directors would affect the use of corporate assets and control of the corporation's proxy mechanism, which are key areas of director responsibility. Doing this would, however, interfere with the board's authority over the management of the corporation under state law.

- One study that examined companies that had been removed from the S&P 500 during the 2008 financial crisis found that among the "at risk" financial firms in the group, their rates of CEO turnover greatly exceeded normal CEO turnover rates. The study saw this as evidence that well-functioning corporate governance systems were generally present.[15]

- Proxy access may be unnecessary in light of widespread corporate governance changes over the past several years, including (1) growing corporate adoption of majority board voting over plurality board voting in which an uncontested board nominee only requires a single vote to be victorious;[16] (2) new Delaware business laws that allow firms to vote on whether they will allow proxy access and permit them to amend their bylaws to provide for a policy that under certain circumstances allows them to reimburse shareholders for expenses incurred in board elections. On the latter point, some observers say that access to a ballot, without reimbursement, is a major hindrance to shareholders who are seeking to influence board composition. Thus, they argue that the Delaware reimbursement statute achieves something of significance in an area that the SEC's current proposals would not.

- Numerous large shareholders would exploit proxy access to push parochial goals having little to do with maximizing shareholder value.[17]

---

[14] For example, see William Bratton and Michael Wachter, *The Case Against Shareholder Empowerment*, University of Pennsylvania Institute for Law & Econ Research Paper No. 09-35, April 4, 2010, available at http://ssrn.com/abstract=1480290.

[15] Brian R Cheffins, "Did Corporate Governance Fail During the 2008 Stock Market Meltdown? The Case of the S&P 500," *The Business Lawyer*, November 2009, pp. 1.

[16] Critics could respond that while the number of corporate adoptions of majority voting has been growing steadily, a significant number of firms still have plurality voting. For example, according to one study, about 22% of S&P 500 companies and 19% of Fortune 500 companies currently have plurality-based regimes and a majority of smaller public firms are still said to have such voting systems. For example, see Lisa M. Fairfax, "The Future of Shareholder Democracy," *Indiana Law Journal*, fall 2009.

[17] In a potentially related study, a researcher examined the proxy votes of AFL-CIO pension funds in director elections of 504 companies from 2003 to 2006. He found that AFL-CIO funds are more likely to vote against directors of firms in which there is greater frequency of plant-level conflict between labor unions and management during collective bargaining and union member recruiting. The sensitivity of director votes to union conflict was also found to decrease at firms in which the AFL-CIO no longer represents workers or represents significantly fewer workers, suggesting that AFL-CIO affiliated shareholders vote against directors partly to support union worker interests rather than increase shareholder value alone. Ashwini K Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, NYU Stern Working Paper Series No. Fin-08-006, September 1, 2008, available at http://ssrn.com/abstract=1285084.

- Proxy access would further empower hedge funds who are known to have exceptionally short-term corporate investment horizons that could jeopardize a company's longer-term viability.[18]

- Proxy access would generate significant implementation hurdles for the SEC, including increased compliance costs and issues surrounding potential abuse.

- Proxy access would give significant indirect power to a few non-shareholding entities known as the proxy advisory firms, such as RiskMetrics, which many institutional investors rely for corporate governance and proxy advice.[19]

- Many of the union-based and pension-based institutional investors who have been the most vocal opponents of proxy access hold billions of dollars in assets, which suggests that the cost of conducting proxy fights should not be an insurmountable obstacle.

- Because of asymmetric information, outside shareholders may be less well positioned than management to choose the most appropriate board candidates.

- Access to the proxy will likely incur additional costs to shareholders for mass media campaigns. Such costs could in fact be larger than expenditures that are avoided through proxy access. Thus, compared to waging a proxy fight, which has no restrictions on the number of board nominees, proposing alternative nominees via proxy access could be a less efficient nomination vehicle.[20]

- Well-functioning boards depend on collegial relationships between their members, an important dynamic that could be jeopardized by the nature of the directors that may emerge from successful nominations conducted through proxy access.

---

[18] Others, however, assert that hedge funds and private equity funds tend to play a highly beneficial role in aggressively monitoring the companies they have stakes in because their investment strategies are designed to squeeze various managerial excesses and other inefficiencies out of underperforming companies in contrast to pension funds and mutual funds. Robert C. Illig, "What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight," *American University Law Review*, vol. 57, no. 225, 2007, available at http://ssrn.com/abstract=1079532. In addition, other observers argue that while hedge fund short-termism is a potentially serious problem that appears to pervade hedge fund activism, a sufficient case for legal intervention in this area has yet to be made. However, most importantly, they argue that market forces and adaptive devices adopted by individual companies are ultimately better able to deal with the potentially negative effects of hedge fund short-termism, while also serving to maintain the positive aspects of hedge-fund activism. Marcel Kahan and Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*," ECGI - Law Working Paper No. 76/2006, available at http://ssrn.com/abstract=919881.

[19] For example, see Robert Hershey, "A Little Industry With a Lot of Sway on Proxy Votes," *New York Times*, June 18. 2006. Two academic researchers examined data on proxy recommendations and voting results for uncontested director elections from 2005 and 2006 at S&P 1500 companies to understand how four dominant proxy advisors made their recommendations and how the recommendations affected the shareholder vote. Their conclusion was that proxy advisors are largely intermediaries who aggregate information that investors find important in determining how to vote in director elections. The finding is at odds with the view that proxy advisors are autonomous centers of power. Stephen J. Choi, Jill E. Fisch, and Marcel Kahan, *Director Elections and the Influence of Proxy Advisors*, University of Pennsylvania, Law & Economics Research Paper Series No. 08-22, April 28, 2008, available at http://ssrn.com/abstract=1127282.

[20] "Possible Unexpected Costs of Proxy Access," *Pensions & Investments*, November 16, 2009.

- Proxy access could provide an environment that would discourage directors from running for board positions.
- Proxy access could lead hedge funds and other activist investors to use proxy access elections to influence control of the company via alleged loopholes in the SEC proposal. The SEC has indicated that it does not intend proxy access to be a vehicle for corporate control, however, some observers say that a number of the provisions in the proposals would allow activist investors to circumvent that.
- Federally mandated proxy access would allegedly impose an unwieldy and inflexible "one size fits all" paradigm on often quite different state laws and individual corporate characteristics.
- Empirical evidence suggests to some that, at least in the short run, investors perceive the proxy access rule as potentially costly. One "event study" found that around the initial announcement of the SEC's access proposals, a cross section of public firms suffered cumulative average abnormal negative loss of about 2.25%. It also found that companies with entrenched management tended to take the greatest negative stock hits.[21]
- The integrity of proxy access could be undermined by a process known as empty voting in which economic interest and stock voting rights are separated. For example, there are observed instances in which a short-seller borrows shares to vote in a company's annual meeting, and then returns them to the owner after having profited from favorable price moves.

Additional Arguments in Favor of Proxy Access and Rebuttals to Criticism

Major arguments made in support of the proxy access proposal or those used to rebut criticisms of it include the following:

- During the recent financial crisis, corporate management and boards frequently failed to consider the long-term interests of their shareholders as they allowed the pursuit of risky short-term gains. Proxy access would give shareholders a more meaningful say in their companies and a better opportunity to have problematic risk-taking behavior adequately monitored and checked. [22]
- Proxy access would help mitigate collective action and free rider problems that some believe interfere with shareholder monitoring and a well-functioning system of corporate checks and balances. By shifting some of the cost of nominating director candidates from

[21] Ali C. Akyol, Wei Fen Lim, and Patrick Verwijmeren," Shareholders in the Boardroom: Wealth Effects of the SEC's Rule to Facilitate Director Nominations," December 14, 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1526081.

[22] For example, see "Opening Statement of Paul E. Kanjorski Chairman Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Committee on House Financial Services on Corporate Governance and Shareholder Empowerment," April 21, 2010.

the nominating shareholder to the company, proxy access would increase the likelihood of shareholder nominated directors even though much of the benefit accruing from a successful challenge would be enjoyed by "free riding" shareholders.

- Between 1990 and 2003, three academic researchers examined a corporate management entrenchment index based on several provisions in corporate charters (like staggered boards,[23] limits to shareholder bylaw amendments, and supermajority requirements for mergers and for charter amendments). They determined that increases in the level of entrenchment were statistically correlated with economically significant reductions in firm valuation, which is said to suggest that entrenching provisions cause lower firm valuation.[24] Some consider proxy access an antidote to managerial entrenchment.
- Proxy access would give shareholders a beneficial counterweight to the many boards whose managerial bias is heightened when the CEO also serves as the board chair, the dominant scheme among U.S. public companies.[25]
- Maintaining the status quo, in which Delaware and other states would individually decide on proxy access regimes for their incorporated firms, could result in a variety of standards that would differ from company to company and from state to state, posing a burdensome, costly and unnecessarily complex scenario for investors.
- A number of other developed nations such as the United Kingdom have adopted proxy access apparently without deleterious consequences.
- If the SEC's proxy access proposal is adopted as currently formulated, the increase in the number of shareholder nominees throughout corporate America and within individual firms may not be that large since its use would largely be confined to the most egregious situations. In addition, the SEC access proposal limits shareholders' nominees to no more than a quarter of board slots. In this context, several observers have said that the essential value of proxy access is not securing shareholder nominees for the purpose of producing new board members, but the fostering of a more competitive environment in which management-selected board members are forced to be more attentive to shareholders.

---

[23] This is a board in which only a fraction of its directors are elected each year; it is often a structure that is used to deter hostile takeover attempts.

[24] Lucian A Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?*, Harvard Law School John M. Olin Center Discussion Paper No. 49, 2004, available at http://ssrn.com/abstract=593423 or doi:10.2139/ssrn.593423.

[25] A recent study examined this "CEO duality" using a large sample of U.S. public companies. Although the study noted that an increasing number of firms had converted from a dual to non-dual CEO structure, it concluded that there appeared to be no significant relationship between CEO duality and firm performance or improvement in firm performance after such changes had occurred. The study, however, cautioned that the observed absence of a relationship between CEO duality and firm performance appeared to derive from the possibility that CEO duality was endogenously determined. This means that the dependent variable, firm performance, may have been affected by independent variables such as whether a firm's CEO was also its board chair, firm characteristics, and firm ownership structure. Chia-Wei Chen, J. Barry Lin, and Bingsheng Yi, "CEO Duality and Firm Performance, an Endogenous Issue," *Corporate Ownership & Control*, fall 2008, available at http://www.virtusinterpress.org/additional_files/journ_coc/Paper07.pdf.

Private Ordering, Opting In and Opting Out

The SEC's proposed access rule contains a limited, "one-way" right for boards or shareholders to alter prescriptive proxy access regimes through adopting bylaws that make proxy access easier, not harder. This is known as "opting in" private ordering, which is supported by many of the proponents of the SEC's access proposal. Many of the critics of the access proposal, however, support amending the proposal to allow shareholders to freely engage in adopting bylaws that would alter the SEC access regime, a process known as "opting out" private ordering. Under a regime of opting out, companies, through shareholder action, would be permitted to adopt bylaw amendments that provide for more restrictive proxy access provisions than those mandated by SEC rules.

The general discourse on proxy access appears to be increasingly dominated by the subject of opting out as a potentially viable policy option for the SEC as its considers its proposals.[26]

Much of the advocacy for opting out has come from corporations and law firms, whereas union and pension funds have tended to look unfavorably upon opting out.[27] For example, in a comment letter to the SEC, Alexander M. Cutler, chairman of the corporate leadership initiative of the Business Roundtable, suggested that instead of an SEC-imposed "one-size-fits-all" federal mandate, state law should flexibly allow individual companies to decide on amending their corporate bylaws to provide for shareholder access.[28]

A corollary argument for opting out is that if there are aspects of the SEC's final rule that some companies decide are not workable or not optimal, they would be able to use their bylaws to correct the perceived deficiencies in the SEC rule. The view was echoed by a committee of the American Bar Association's with jurisdiction over federal securities regulation, which wrote the SEC to observe "... a prescriptive default rule mandating proxy access that did not permit private ordering under an opt-out paradigm would not be able to successfully resolve all the workability

[26] "The Pros and Cons of Voluntary Implementation of Proxy Access at 2010 Annual Shareholder Meetings," *Latham & Watkins LLP and Georgeson Inc.*, 2010, available at http://www.lw.com/upload/pubContent/_pdf/pub2914_1.pdf.

[27] Noting that the best case for private ordering presumes that shareholders will be able to initiate proposals opting into or out of a proxy access regime and that voting outcomes reflect the will of a majority of shareholders, a study commissioned for the Council of Institutional Investors, which is opposed to opt out private ordering, examined a large cross-section of U.S. public corporations. Among other things, it found that (1) data on bylaw amendment limitations show that in between 38% and 43% of companies, shareholders are either unable to amend the bylaws or face significant challenges in the form of supermajority vote requirements; (2) there is a lack of clarity on the validity of binding proxy access shareholder proposals in states other than Delaware, which raises issues about the feasibility of shareholder-initiated opt-in efforts at the nearly 40% of companies incorporated outside Delaware; and (3) between 7% and 9% of companies have disparate voting stock, which gives disproportionate voting influence to holders of super voting shares. Beth Young, "The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process," *The Corporate Library*, November 2009, available at http://www.cii.org/UserFiles/file/The%20Limits%20of%20Private%20Ordering%20UPDATED%2011-17-09.pdf. Some critics of the study have attempted to rebut these arguments by arguing that (1) variations on voting requirements for shareholder amendments of bylaws are not a persuasive reason to dispense with shareholder choice in its entirety; and (2) disparate voting rights at a small minority of companies are not a persuasive reason for generally precluding shareholder choice at public companies. "Letter from the American Bar Association's Committee on Federal Regulation of Securities of the Section of Business Law to the SEC," January 19, 2010.

[28] These comments are available at http://www.sec.gov/comments/s7-10-09/s71009.shtml#33-9046.

issues that would arise in application of a one-size-fits-all rule to the 10,000 or so public companies that would be subject to the rule....”[29]

By contrast, in a letter to the SEC, the executive director of the Washington State Investment Board wrote that any departure from a uniform, federalized approach to proxy access would harm the gains in corporate governance that the SEC’s proposals were aimed at achieving. She also argued that the companies who tend to be most in need of corporate governance improvements were the most likely to opt out of a proxy access rule, continuing their board’s ability to deny “shareowners the fundamental right to nominate and elect directors.”[30]

One of the leading advocates of shareholder access and increased shareholder empowerment, Harvard University’s Lucien Bebchuk, has endorsed allowing shareholders to opt out of a federal proxy access regime as long as it is approved by a majority of shareholder votes, the benefits to shareholders of proxy access are adequately disclosed, and shareholders are always permitted to reverse previous opt-out decisions.[31]

Others with concerns over the advisability of allowing unalloyed opting out, however, argue that evidence exists that (1) when opting out from a default proxy access arrangement that serves shareholder interests, such a change is more apt to take place when it is favored by the board than when it is disliked by the board; and (2) impediments to shareholders’ opting out when they want to, but when the board does not want to, appear to be widespread.[32]

Key Studies

Several research studies have assumed a central role in the public-policy discourse surrounding proxy access. Two of them, a NERA study done at the behest of the Business Roundtable and an SEC staff study, are briefly described below.

The NERA Report for the Business Roundtable

The Business Roundtable, a group of executives at very large companies, oppose mandated proxy access and sponsored an empirical study that examined the impact of a federally mandated proxy access regime as provided by the proposal. Among other things, the report, *NERA Economic Consulting’s Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation, in Support of Comments by the Business Roundtable*, broadly concluded that if the SEC’s proxy access proposal were implemented:[33]

---

[29] “Letter from the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association to the SEC,” January 19. 2010.

[30] It is available at http://www.sec.gov/comments/s7-10-09/s71009-594.pdf.

[31] Lucien Bebchuk and Scott Hirst, “Private Ordering and the Proxy Access Debate,” November 1, 2009. The Business Lawyer, vol. 65, no. 2, pp. 329-360, *Harvard Law and Economics Discussion Pape*r No. 653, available at http://ssrn.com/abstract=1513408.

[32] Lucien Bebchuk and Scott Hirst, *Private Ordering and the Proxy Access Debate*, November 1, 2009, Harvard Law and Economics Discussion Paper No. 653, available at http://ssrn.com/abstract=1513408.

[33] It is available at http://www.sec.gov/comments/s7-10-09/s71009-267.pdf.

- There would be substantial costs in terms of efficiency, competitiveness, and capital formation.
- At best, there would be modest savings for shareholders at a modest number of companies, while imposing substantial costs on all public companies.
- Proxy access would impose substantial efficiency costs on public companies, impair their competitiveness, and erode the attractiveness of U.S. equity markets.

The SEC Staff Study, Share Ownership and Holding Period Patterns in Form 13F Data

Written by the SEC Division of Risk, Strategy, and Financial Innovation, the memorandum provides an analysis of the percentage of public companies with shareholders meeting various hypothetical proxy access ownership thresholds and holding periods, using the mandatory Form 13F[34] reports of holdings by institutional investment managers. Among other things, it found that with respect to the proxy proposal, across all public companies, the percentage of eligible investors with at least a year of stock holdings and at least 1% of a company's overall stock numbered: (1) one or more for 74% of the companies; (2) two or more for 65% of the companies; (3) three or more for 59% of the companies; (4) four or more for 54% of the companies; and (5) five or more for half of the companies. With respect to the number of eligible investors with at least one year of holdings and at least 3% of overall company stock, it found (1) one or more at 64% of the companies; (2) two or more at a half of the companies; (3) three or more at 39% of the companies; (4) four or more at 28% of the companies; and (5) five or more at 19% of the companies.

Because the study does not address the prospect that separate shareholders could combine to meet the SEC access proposal's ownership thresholds, some have questioned its usefulness.

Key Legislation

Congressional interest in proxy access reform has manifested itself in several ways. For example, a hearing was held on the subject on April 21, 2010, by the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. In addition, there is major financial reform legislation, one bill which passed the House in 2009 (H.R. 4173), and the other, which was marked up by the Senate Banking, Housing, and Urban Affairs Committee in 2010 (S. 3217). H.R. 4173 would authorize the SEC to prescribe rules for proxy access. S. 3217 says that the SEC "may" prescribe rules giving shareholders proxy access.

[34] Institutional investment managers who exercise investment discretion over $100 million or more must make quarterly disclosures of their securities holdings on Form 13F.

Author Contact Information

Gary Shorter
Specialist in Financial Economics
gshorter@crs.loc.gov, 7-7772