

## The SEC and Corporate Governance

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*In 2010 the Securities and Exchange Commission passed a rule that made it easier for shareholders to nominate people for the slate for a corporation's board of directors. The rule was challenged successfully before a federal circuit court and the rule was invalidated on the grounds that it was "arbitrary and capricious." The article discusses whether the rule (or the circuit court case) was justified and what the burden of proof should be when a circuit court reviews a rule of an administrative agency.*

### INTRODUCTION

What is a "shareholder"? Is a shareholder an owner of a corporation? If so, does a shareholder have some control of the corporation? Of course, as we all know, one of the fundamental distinctions between a corporation and a general partnership is that general partners control their business *directly*. In a corporation (except close corporations), the shareholders are separated from control by two entities: the board of directors and the managers. However, since the shareholders elect the board and the board picks the managers, it would seem that shareholders do in some sense control the corporation (indirectly). But is this actually the case? Do shareholders of most medium to large corporations even indirectly have any major control over companies?

This article will examine that question and how shareholder control has changed over the decades and how it continues to evolve. Because shareholders have many rights, the article will mainly focus on the relationship between shareholders and the board members. The Securities and Exchange Commission (SEC) passed several rules related to shareholder access to having a say on who sits on the board. The article will examine the SEC's recent rules relating to the subject and a recent D. C. Circuit ruling striking down one of the rules.

In earlier times, with corporations whose major shareholders were John Rockefeller, Cornelius Vanderbilt, Andrew Carnegie, and Andrew Mellon, it was probably correct to think that these shareholders did control their corporations. In recent years, few corporations exist where one individual both owns a major portion of the corporation and also controls it--such as Mark Zuckerberg, Bill Gates, and Sam Walton. During a number of decades, corporate shareholder ownership has fractionated significantly (particularly for those traded on major stock exchanges). Many of those who do own shares, either directly or through mutual funds, may own just a few shares in many different companies. With this dilution, shareholder control has diminished enormously.

Thus, it is probably correct today that shareholders do not own the corporation in the same way that one owns a car or a house. Shareholders own shares and the question is what ownership of shares practically means. In all states, shareholders do get to vote for the board of directors; but for large to medium sized companies this means little. Since management controls the slate for the ballot and since there is no choice for shareholders, voting has all the effect of a North Korean election. The net result is what is called the “Wall Street Rule”: shareholders can either live with management control or sell their shares (Monks and Minow, 2011). Shareholders are left with little control. But is this a bad thing?

The arguments, both economic and otherwise, swirl over whether or not shareholders should have more control over the board election. The basic economic arguments fall into two camps: (1) The shareholders do not understand the complexities of the economy or the situation of the corporation and thus are unable to exercise any rational control of the company. (2) Not all shareholders are ignorant. Many corporations do have shareholders who are large parties or entities and who can make an informed judgment about whether the corporation is being run efficiently. These may include mutual funds, pension funds, institutional funds, and in some cases employee stock plans. Note that there also can be non-economic reasons, as noted below.

## **WHO OWNS STOCKS TODAY**

For a long time it has been assumed that ownership of stock is and was spread among many shareholders, and thus it undoubtedly is the case that the owners are unlikely to have all but a cursory understanding of what is happening with the corporations whose shares they own. At one time this was substantially true. The chart below, derived from the U.S. Census Office, shows that in 1952 over 90% of the shares were owned by private households. In 2010, that percent was significantly reduced to around 37%. The other large categories would include pension funds, life insurance companies, and mutual funds (including closed end funds and ETFs).

Now the “Household Sector” may be somewhat misleading. These are shares owned by private individuals. But this could include individuals who own large stakes in particular companies; persons like Bill Gates and Warren Buffet might be included.

Certainly large shareholders, mutual funds, retirement funds, and insurance companies would have a large incentive to follow the inner workings of the corporations in which they own shares. The rise of the Internet makes it easier than ever to study the performance of particular companies that are traded on stock exchanges. Cable channels such as CNBC and Fox Business examine particular stocks. Legally required financial statements such as 10-K’s and 10-Q’s are freely available online.

On the other hand, it would be wrong to think that casual investors or even institutions such as mutual funds know as much about a company as its top managers. Nevertheless, it is sometimes the case that top management has performed poorly. In such cases, shareholders could sell (often at a loss) but they might feel that the company could be turned around with new management and thus their share price or dividends may increase. Should they have an option other than just to sell?

## HOLDINGS BY TYPE OF INVESTOR (U.S. CENSUS OFFICE, 2011)

Type of investor	Holdings		
	2011	2010	%
<b>EQUITIES \1</b>	168.		
<b>Holdings, total</b>	6	#####	
<b>HOUSEHOLD SECTOR \2</b>	151.	8,513.6	36.55%
State and local governments	0.0	115.3	0.49%
Federal government	0.0	43.3	0.19%
<b>REST OF THE WORLD \3</b>	3.7	3,091.1	13.27%
Commercial banking	0.0	37.1	0.16%
Savings institutions	0.3	19.7	0.08%
Property-casualty insurance companies	3.2	228.0	0.98%
Life insurance companies	2.4	1,423.2	6.11%
Private pension funds	1.8	1,983.3	8.51%
State and local government retirement funds	0.1	1,778.8	7.64%
Federal government retirement funds	0.0	133.8	0.57%
Mutual funds	3.3	4,801.4	20.61%
Closed-end funds	2.0	100.8	0.43%
Exchange-traded funds	0.0	853.9	3.67%
Brokers and dealers	0.6	117.2	0.50%

### THE RIGHTS OF SHAREHOLDERS

It would be presumptuous to say that shareholders own shares and thus control the corporation. Perhaps we can only say that shareholders own shares. But what does that mean?

Monks and Minow (2011) argue in their book that the loss of control of the corporation is linked with the limited liability of shareholders. With limited partnerships, general partners have control and unlimited liability, whereas limited partners, while having no general control, have limited liability. Still in recent years we have seen the rise of limited liability companies in which the member-owners have both limited liability and control (for member-managed LLCs).

So what specific rights do shareholders have? Edward Epstein (1986) mentions five: (1) the right to sell their stock; (2) the right to vote the proxy (though this has been very limited); (3) the right to bring shareholder derivative lawsuits for grossly mismanaged companies; (4) the right to certain information from larger companies (such as 10-K's), and (5) the right to be repaid their investment.

There are typically other rights that shareholders have. They can expect those management to exercise their fiduciary duty to act in the interest of shareholders and the shareholders can bring a "derivative lawsuit" if that duty is broken. They also have the right to inspect the books, to notice of shareholder meetings, and to vote on various matters such as amending the corporate charter, mergers, and the sale of the business.

Shareholder meetings are often arranged by top management with little or no shareholder involvement. Monks and Minow (2011) say that such meetings are just “formalities.” Usually, the shareholders have the right to ask questions, but in some cases management may avoid the questions. Board members may not be present. In one case, a Houston based company moved their shareholder meeting to a remote Texas town. In another case the meeting was moved to Asia. In 2010, Symantec had a “virtual” meeting with no one physically present.

## **THE SEC ACTS TO PROVIDE SHAREHOLDER ACCESS TO VOTING FOR THE BOARD**

On August 25, 2010, the Securities and Exchange Commission on a three to two vote agreed to adopt a rule 14a-11 (later struck down) which would have provided some access for shareholders to nominate board members. To be sure, the rule was substantially limited. Access was to be denied if the state in which the company is incorporated prohibits such access. The rule applied only to companies that are “registered” with the SEC. (SEC Facilitating Shareholder Director Nominations (2010), p. 56674)

This rule required the shareholder (individually or in a group) to hold at least 3% of the total voting shares that are entitled to vote for the board. The shareholder or group would also have to own the shares for three years.

More importantly, under Rule 14a-11, the number of proposed directors was substantially limited. A successful proposal was not going to give such shareholders control of the company. The number of board members that could be elected was either one or one quarter of the board, whichever is higher. If the one quarter rule was used, the number would be rounded down. For example, if the number of directors is 9, the number that could be proposed would be 2. These maximum numbers would have applied regardless of whether the directors were voted in all together or whether they were elected in a staggered election (SEC Facilitating, p. 56675).

If there were competing shareholders that were nominating, the group with the highest number of votes would have priority. If the group with priority did not use up all of the available number that could be nominated by shareholders, the lesser group could “fill in the gap.”

And if those limitations were not enough, the shareholders could not have the purpose of “changing control” of the company. While in a sense this appears to be a big change for the SEC, which had always limited shareholder access significantly, the newly proposed change hardly had the effect of really threatening management’s control of a company. The original proposal was part of a 451 page explanation by the SEC. In the opening page, the SEC said that the proposal “will benefit shareholders by improving corporate suffrage, the disclosure provided in connection with corporate proxy solicitations, and communication between shareholders in the proxy process”(SEC Facilitating, p. 56668).

The opening justification would seem to indicate that the SEC was interested in more than just economic efficiency. The use of the word “suffrage” harkens back to the women’s movement to vote. It seems to be a defense of a right that ought to exist and a right that is currently suffocated by the current system. It is a right that exists not only as an economic right but also would seem to be a personal right (perhaps a property right), as viewed by the SEC. The justification also seems to indicate that it would improve corporate proxy disclosure, in that management’s proxy might have to compete with that of the shareholder. Finally, it might improve the shareholders’ understanding of corporate matters through communication, not only between the corporation and the shareholder, but also between shareholder and shareholder.

## **THE JUDICIAL CHALLENGE TO THE RULE**

The Business Roundtable and the Chamber of Commerce of the United States challenged the rule as being “arbitrary and capricious” (Business Roundtable v. United States (2011), p. 1148, *citing* Administrative Procedure Act (2010) §706(2)(a)). The District of Columbia Circuit Court cited a Supreme Court case that the agency should “examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made”

(Business Roundtable v. SEC (2010), p. 1148, citing Motor Vehicles Manufacturers Association of the U.S v. State Farm Mutual Auto Insurance Co. (1983), p. 53.) The Circuit Court also had a duty to consider the effect of a rule upon “efficiency, competition, and capital formation” (Business Roundtable v. SEC (2011), p. 144).

The D.C. Circuit Court said that the Commission:

inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters (Business Roundtable v. SEC (2011), pp. 1148-49).

The Court recognized the fairly strict limitations of the rule, as noted above (Business Roundtable v. SEC (2011), p. 1147). The SEC said that the rule would reduce the costs of a conventional proxy fight and “has the potential of improving board performance and enhancing shareholder value” (SEC Facilitating, p. 56,670). But the Commission also noted that there would be increased costs to the corporation in sending out the shareholder proxy materials. Also, there was the possibility of adverse effects on the board and company performance. (SEC Facilitating, p. 56,764). But overall, the Commission thought that the rule would benefit the efficiency of the economy as a whole and that the benefits would justify the costs (SEC Facilitating, p. 56,771).

The Circuit Court believed that the SEC underestimated the costs involved. The Chamber of Commerce pointed out that the costs that companies had incurred in fighting proxy contests ranged from \$4 to \$14 million for large companies and \$800,000 to \$3 million for smaller ones (Business Roundtable v. SEC (2011), p. 1150).

The Circuit Court noted that the SEC looked at some conflicting economic studies about how companies with hybrid boards (with management controlled and proxy board members) perform compared to their peers. Several studies showed that such companies underperformed, with one study saying they underperformed from 19% to 40% (Business Roundtable v. SEC, p. 1151, citing Buckberg and Macey, 2009). The SEC also looked at several studies that showed that proxy directors or hybrid directors improved shareholder value. The Circuit Court found these studies unpersuasive (Business Roundtable v. SEC, p. 1151). The Court also found that the SEC discounted the costs of the rule, but not the benefits, because under traditional State law, the right to nominate directors would cause directors to reduce the time spent on strategic and long-term thinking (Business Roundtable v. SEC, p. 1151).

The second criticism by the Court was that the SEC had failed to consider how union and state pension funds might “leverage” the rule to gain concessions, “such as additional benefits for unionized employees, unrelated to shareholder value” (Business Roundtable v. SEC, pp. 1151-52). The SEC thought that the problem would be rather limited because unions and pension funds could not control the board; this is because of the rule’s limitations on the number of board members nominated, and also because other shareholders would be alerted to such candidates’ interests (Business Roundtable v. SEC, p. 1152).

The third issue that the District Court had with the rule relates to the number of contests that would be initiated as a result of the rule. The SEC had dropped the number from an earlier proposal because of additional limitations on who could use the rule and new information on the number of contested elections in the previous year (Business Roundtable v. SEC, pp. 1152-53). The Court criticized this argument by saying that the SEC did not consider to what extent this new proxy method might take the place of the traditional proxy fight. The SEC thought there might be fewer traditional proxy fights with this avenue available. The Court said that the SEC could not quantify this, though (Business Roundtable v. SEC, pp. 1153-54). Several commentators that participated in the rule making thought that the number of new directors being proposed through this new rule might be considerably higher than the SEC thought (such as 15% higher). (Business Roundtable v. SEC, p. 1154 citing Altman Group (2011)). In addition, there might be more proxy fights from groups that have special interests such as “public and union funds”

which might be more concerned with jobs rather than shareholder value (Business Roundtable v. SEC, p. 1152).

Finally, the Court said that the SEC anticipated frequent use of the rule when looking at benefits and infrequent use when looking at the associated costs. These problems made the adopting of the rule “arbitrary” (Business Roundtable v. SEC, pp. 1153-54).

## **THE SEC’S RESPONSE**

On September 6, 2011, the Chairman of the SEC, Mary Shapiro, announced that the SEC would not appeal the Circuit Court’s decision. Chairman Shapiro issued the following statement about her position on the issue:

I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets. It is a process that helps make boards more accountable for the risks undertaken by the companies they manage. I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.

At the same time, I want to be sure that we carefully consider and learn from the Court’s objections as we determine the best path forward. I have asked the staff to continue reviewing the decision as well as the comments that we previously received from interested parties (Shapiro, 2011).

Perhaps the SEC was worried about losing before the Supreme Court. While the SEC lost the battle for shareholder access to the board, it has not completely lost the war, as is clear in Ms. Shapiro’s statement. When the SEC adopted Rule 14a-11 (which was struck down by the D.C. Circuit), it also adopted Rule 14a-8 (SEC Allowing Shareholders Proposals (2011)). This rule, which was not challenged in the Business Roundtable case may provide for shareholders to get access to the corporate board by asking that rules (such as the by-laws) be subject to a shareholder vote.

This is discussed in Ms. Shapiro’s statement:

Last year, when the Commission adopted Rule 14a-11, it also adopted amendments to Rule 14a-8, the shareholder proposal rule. Under those amendments, eligible shareholders are permitted to require companies to include shareholder proposals regarding proxy access procedures in company proxy materials. Through this procedure, shareholders and companies have the opportunity to establish proxy access standards on a company-by-company basis -- rather than a specified standard like that contained in Rule 14a-11 (Shapiro, 2011).

Ironically, while Rule 14a-11 is a more indirect and lengthy process for shareholder access to the board, this rule could have even more effect. While Rule 14a-8 allowed for only one shareholder or a quarter of the board to be elected through proxy access, Rule 14a-11 does not have such a limit.

Use of Rule 14a-8 does not allow for a direct nomination of a particular person, but it does appear to allow for the adoption of general rules for access to the slate for the board. The requirement to submit such a proposal is only 1% or \$2,000 of market value of stock. (SEC Allowing, pp. 56674-56678).

One commentator on Rule 14a-8 has said that this rule compared to 14a-11 may be even more useful for corporate activists:

The revisions to Rule 14a-8 are a potent weapon for activist investors that we have long advised clients could create far more issues than the now vacated proxy access rules. The reason is simple: There are no onerous ownership or length of holding thresholds. Under Rule 14a-8, a shareholder need only own \$2,000 worth of stock and have held it for one

year. Long time Rule 14a-8 activists like John Chevedden may have a field day. Well funded activists may become disruptive (Radoff, 2011).

It is perhaps surprising that the plaintiffs did not challenge Rule 14a-8 along with Rule 14a-11. The enactment of the changed Rule 14a-8 may also be part of the reason that the SEC did not appeal the DC Court's decision. The American Bar Association's Business Law Section urged the SEC to negate Rule 14a-8 given the court's decision (American Bar Association, 2011). Perhaps the Business Roundtable and its associates may challenge 14a-8 in the future.

### **DID THE D.C. CIRCUIT'S OPINION ESTABLISH THAT SEC RULE 14A-11 WAS "ARBITRARY AND CAPRICIOUS"?**

Under the Federal Administrative Procedure Act, the agency is not to act in a way that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law" (Administrative Procedural Act, § 706(2)(A)). The Circuit Court cited a 1983 U.S. Supreme Court Case which said that the agency should "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made" (Business Roundtable, p. 1148 *citing* Motor Vehicle Manufacturers Association of U.S. v. State Farm Mutual Insurance Co. (1983), p. 43). It also cited one of its cases (from the D.C. Circuit) saying that the Commission has a "statutory obligation to determine as best it can the economic implications of the rule" (Business Roundtable v. SEC, p. 1148 *citing* Chamber of Commerce v. Securities Exchange Commission (2005), p. 143).

The standard for examining administrative rules appeared to change dramatically in 1971 with a Supreme Court case, Citizens to Preserve Overton Park, Inc. v. Volpe (1971). The idea of what is "arbitrary and capricious" under court review of an agency's rule making is far from a low standard, as is found under the equal protection clause for most economic regulation. The Supreme Court said in this case that while the appeal was not a new review, it still required "the reviewing court to engage in a substantial inquiry" (Citizens to Preserve Overton Park, Inc., p.415). The court should find that "the decision was based on a consideration of the relevant factors." Still the court said that the "decision is entitled to a presumption of regularity" and that the reviewing court should determine "whether there has been a clear error of judgment." Finally, "the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency" (Citizens to Preserve Overton Park, Inc., p.416).

This has come to be known as the "hard look" standard. But, the caveats quoted immediately above show that there should still be a presumption in favor of the agency. The D.C. Circuit cited a later case in line with the above Citizens ruling: Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co (1983). As discussed earlier, an "agency must examine the relevant data and articulate a satisfactory explanation for its action." (Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co. (1983), p. 43) But the Supreme Court also indicated some deference is due the agency: "We will, however, 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned'" (Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co., (1983), p. 43, *citing* Burlington Truck Lines, Inc. v. United States (1962), p. 168).

The petitioners in their brief to the court (Business Roundtable) relied on Motor Vehicle Manufacturers. It also relied (Petitioner's Brief of Business Roundtable (2011), p. 27) on some D.C. Circuit cases that require that "the agency must respond in a reasoned manner to those that raise significant problems" (Covad Communications Co. v. FCC (2006), p. 550). It also said the court should "vacate the order" if it adopted the rule with a "flawed rationale." (Natural Fuel Gas Supply v. FERC (2006)).

The Supreme Court has also said that the courts must be unusually deferential when the agency is making predictions, though this was in the area of science. (Baltimore Gas & Electric Co. v. Natural Resources Defense Council (1983), p. 103). This is known as the "soft look rule." But this was in the

area of nuclear reactors, a matter of science. Still while it is in the realm of estimating the effects of the rule, the SEC is involved in making predictions.

The SEC also relied on a Supreme Court Case, Black & Decker Disability Plan v. Nord in which the Court ruled that when an agency adopts a “comprehensive regulatory scheme,” “the scope of permissible judicial innovations is narrower in areas where other federal actors are engaged” (2003, pp. 831, 832). Still, it might be doubted whether the SEC’s rule that was struck down is a “comprehensive regulatory scheme.”

One question about the Circuit Court’s ruling is that it seems to say that a rule is “arbitrary and capricious” unless it carefully picks the absolutely best rule based on economic factors. There doesn’t seem to be any wiggle room for factors based on non-economic concerns or for trying to choose between conflicting economic studies which have not and cannot predict the exact consequences of a rule that has yet to be put in place for the first time. If the agency does not know precisely what would happen under the rule, the regulation would under the D.C. Circuit’s ruling would seem to be “arbitrary and capricious.” Then, the question is whether it is an impossible criteria for an administrative agency. It is probably the case that the SEC did not do a perfect job of analyzing every factor. But such a tough burden would seem to paralyze any administrative rule making.

The crucial question, it would seem, is whether the ruling on appeal to a court should be granted some deference under the “arbitrary and capricious” standard. The U.S. Supreme Court took up this matter in 2001 in United States v. Mead (2001). The Supreme Court admitted that in previous cases there was found “a spectrum of responses, from great respect at one end... to near indifference at the other...” in regard to deference (United States v. Mead (2001), p. 228). If there is an explicit or implicit legislative delegation from Congress to the agency, “a reviewing court has no business rejecting an agency’s expertise or its generally conferred authority to resolve a particular statutory ambiguity because the agency’s chosen resolution seems unwise” and this forms the basis of the meaning of “arbitrary and capricious.” (United States v. Mead, (2001), p. 229) But according to the Court, if it is not clear that that the agency was delegated authority, a much tougher standard is in order (United States v. Mead (2001), p. 231).

In the case of proxy access, the most explicit and recent statutory grant is a provision of the Dodd-Frank Act, sections 971 (A) and (B). Dodd-Frank does not say that the SEC must pass rules for shareholder proxy access to the board of directors, but it does explicitly say that it may. It also says that it may exempt certain entities and it explicitly mentions “small issuers.” The law reads:

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

(c) EXEMPTIONS.—The Commission may, by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section.

In determining whether to make an exemption under this subsection, the Commission shall take into account, among other considerations, whether the requirement in the amendment made by subsection (b) disproportionately burdens small investors. (Dodd-Frank Act (2011)).

The text of the law does not say that economic cost-benefit analysis should be the sole criterion for the rule (except perhaps for small issuers). Obviously, how the rule will affect the financial success of covered corporations must be a relevant factor given the Administrative Procedure Act and other securities laws. Given the language of Mead, it is apparent that Congress specifically delegated authority to the SEC regarding director proxy access.



The D.C. Circuit Court does not mention the Dodd-Frank Act, even though it was in effect. The Court says that the SEC does have an obligation “to consider the rule’s effect upon efficiency, competition, and capital formation” as required by the Exchange Act and the Investment Company Act of 1940 (2010). The language of Dodd-Frank, as noted above, includes other factors, not specifically mentioned by the Court: interests of shareholders and protections of investors. Also, the Exchange Act says that the Commission should regulate proxies “as necessary or appropriate in the public interest or for the protection of shareholders” (Securities and Exchange Act of 1934 (2010)). Is it the sole interest of the shareholders and the public interest to maximize efficiency and profits within the company? This would seem to go straight at the shareholder/stakeholder theory faceoff. These terms, however, seem to assume that shareholders themselves are only interested in payoff for their investments; maybe they are interested in other stakeholders. Furthermore, it may be more realistic to add a third theory to shareholder and stakeholder positions and that is “agency theory” (or the principal/agent problem): it may be in the managers’ interest to run the corporation to their own benefit. Of course, it may be possible that the managers are running the corporation poorly to no one’s interest. Thus the protection of investors may mean that some oversight could be useful.

### **DID THE SEC DO A PROPER ANALYSIS: AN EXAMINATION OF BOTH SIDES**

Some support for the D.C. Circuit’s opinion comes from an analysis of the economic issues in the case. There were two studies which the Circuit Court said were relied upon “exclusively and heavily” by the agency to support its proposed rule, though the court characterized these studies as “relatively unpersuasive” (*Business Roundtable v. SEC* (2011), p. 1151). The first was an article by Mulherin and Poulsen (1998) entitled “Proxy Contests and Corporate Change: Implications for Shareholder Wealth.” The study was prompted by previous findings of other researchers which tended to show that proxy contests correlated negatively with changes in shareholder value. Mulherin and Poulsen argued that this is counterintuitive since a proxy contest in conjunction with a takeover attempt should be an economic device to target and discipline badly managed firms. If the “market for corporate control” is working efficiently, such contests should more often increase rather than lessen shareholder value.

Using a broader sample than earlier studies had, the authors found a fairly strong correlation between proxy contests and increases in shareholder value (Mulherin and Poulsen, 1998, p. 293). The pattern was that a substantial positive “announcement effect” on share values occurred at the initiation of the takeover attempt; some of this effect would be dissipated later but the long term result was a modest but significant gain for shareholders. There could be a serious problem with the agency putting too much reliance on this study, however. The study focused on proxy contests occurring in the context of a takeover attempt, not in the context of attempts of a dissident faction to gain seats on a corporate board in the absence of a takeover attempt. Mulherin and Poulsen devoted a substantial portion of their paper to disaggregating their overall data and carefully explaining that the finding of corporate wealth gains from proxy contests is driven by the proxy contest resulting in a successful takeover, or at least in major subsequent changes in corporate management at the highest level. In the absence of such major changes, they found no positive wealth effects on shareholder value from proxy contests (Mulherin and Poulsen, 1998, pp. 302-303). The SEC rule would have made easier the creation of “hybrid” boards (containing one or more non-management-appointed directors). This would not be the type of relatively drastic change in management which Mulherin and Poulsen show producing increases in shareholder value after a proxy contest. Thus the study was a bit off focus for the specific issue of the probable effects on shareholder value of adoption of proposed rule 14a-11.

The second study relied on by the SEC, to the Circuit Court’s disapproval, was “Effectiveness of Hybrid Boards” a publication of the IRRC (Investor Responsibility Research Center) Institute, published by four co-authors, Cernich, Fenn, Anderson, and Westcott (2009). Much of this study is a valuable documentation of the increasing importance of hybrid boards. A very positive view--one often taken issue within the literature--is presented of the effect of institutional investors placing directors on boards and, in particular, of the effects of hedge funds as informed, savvy investors whose activities often tend to

promote positive managerial changes. The result of the study that would seem most directly relevant to the proposed SEC rule was a statistical finding based on a sample of 120 firms in the period 2005-2008 that corporations with hybrid boards showed a shareholder value 17.8% higher than in peer corporations without hybrid boards (Cernich, Fenn, Anderson, and Westcott, 2009, p 3).

Upon analysis, however, two reservations occur about the usefulness of this study as support for the SEC's proposed rule. One is mentioned by the four authors themselves, and may be why the Circuit Court said that the study's "long-term findings on shareholder value creation are difficult to interpret." The study's overall average hides results that show a high degree of "bimodality". In the words of the authors, "perhaps most significantly, though, the individual outcomes within the group of ongoing businesses varied substantially, dwarfing the mean average results within each measurement period and significantly reducing the relevancy of these averages" (Cernich, Fenn, Anderson, and Westcott, 2009, p. 27) (emphasis added).

The other problem is more conceptual. The study looks at the performance of hybrid boards which came into being despite the absence of any SEC rule facilitating the creation of such boards. It shows-- apart from some statistical raggedness referenced above--that these hybrid boards may increase shareholder value on average. But it is likely that hybrid boards that develop outside of the context of federal regulatory authorities encouraging such boards tend to be those in circumstances where, for one reason or another, such a board can improve the management of the company. By contrast, it is undisputed by both advocates and opponents of the rule that there may be particular situations where such boards would not improve and perhaps even weaken the performance of a board for a particular company. In the absence of any rule facilitating proxy challenges, companies in this kind of a circumstance would probably be significantly less likely to experience a proxy challenge aimed at creating a hybrid board. Thus, to some degree the Cernich study is weighted towards looking at corporate contexts in which hybrid boards would indeed tend to work better and thus enhance performance, whereas the proposed rule would apply not only in those contexts, but also in those in which hybrid boards would not tend to work well and thus weaken performance. The Cernich study doesn't give direct evidence, thus, about how adoption of the rule might affect shareholder value overall.

The major study cited in the Circuit Court opinion in opposition to the proposed SEC rule was an article by Elaine Buckberg and Jonathan Macey (2009), "Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation", published by NERA Economic Consulting. This article was more directly on point in the sense that it was written specifically as an evaluation of the proposed rule. It does not contain new research but summarizes previous research that might have negative implications for the proposed rule. Thus it cites several empirical studies which found negative correlations between dissident board directors winning seats on the one hand and share performance on the other. One study was the subject of a direct, detailed critique in the article by Mulherin and Poulsen (1998, pp. 284-85) cited above which persuasively cast doubt on its finding. However, several other studies with similar results (a 19-22% negative correlation) are cited, though none of the studies are more recent than 1997 (Buckberg and Macey, 2009, pp. 9-10). Another major concern of Buckberg and Macey's article was the potential problem for corporations and their shareholders posed by institutional investors who, as shareholders, might be more interested in political goals or their own institutional goals rather than in maximizing shareholder value. Large corporations are always faced with the problem of trying to align the incentives of their management with that of their theoretical bosses, the shareholders. But when a shareholder is itself an institution with its own principal-agent problem (e.g., the imperfect alignment of union officials' interests with those of the pension funds they manage) there is a resulting "principal-agent problem within the principal-agent problem" with unpredictable, perhaps negative efficiency results (Buckberg and Macey, 2009, p. 12). Because of this concern Buckberg and Macey suggest adoption of a much higher threshold level for subsidized shareholder proxy access than that proposed in the SEC rule (p. 15). In sum, what this study presents in a thorough manner is a survey of some of the reasons to oppose the proposed rule; it doesn't seem to be definitive on the question, though, in the sense of establishing beyond reasonable dispute the undesirability of the proposed SEC rule.

On the other side of the question, one could argue that the D.C. Circuit Court should not be acting as a fact-finder as long as the SEC did not act in an arbitrary and capricious manner regarding the promulgation of the rule. The cost-benefit analysis of the rule is about 96 pages long, and the whole justification of the rule includes more factors than just board and company's economic performance.

The SEC examined four benefits:

(1) facilitating shareholder's ability to exercise their state law rights to nominate and elect directors; (2) minimum uniform procedures for inclusion of shareholder director nomination and enhanced ability for shareholders to adopt director nomination procedures; (3) potential improved board performance; 4) more informed voting decisions in director elections due to improved disclosure of shareholder director nominations and enhanced shareholder communications.

The Committee also looked at three costs: adverse effects on company and board performance, additional complexity in the process, and costs of disclosure, printing and mailing. The SEC also looked at the "consideration of burden on competition and promotion of efficiency, competition, and capital formation." It also examined significant issues raised by public comments and reasons to reduce the burden for small entities (SEC Facilitating, pp. 56,671-56,676).

The SEC quickly stated that some benefits of the rules are not easily computed: "We note, however, the benefits of the new rules are not limited to those that are quantifiable (such as the direct savings in printing and mailing costs) and instead include benefits that are not as easily quantifiable (such as the possibility of greater shareholder participation and communication in the director nomination process...) We believe that these benefits, collectively, justify the costs of the new rules" (SEC, Facilitating, p. 56,755).

The SEC noted a June 2009 survey that said that 82% of shareholders thought they should be able to nominate and elect directors (SEC Facilitating, p. 56,775 n.863, citing ShareOwners.Org Letter (2010)). But should the right to nominate directors be a property right of shareholders?

While the SEC said that there was more to the proposal than efficiency, it noted a number of economic studies that showed that companies with stronger shareholder rights had better performance. As one of many examples, the agency cited an article by Gompers, Ishii and Metrick that stated that "firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth..." (SEC Facilitating, p. 56,761 citing Gompers, Ishii, and Metrick, 2003). Another study by Hermalin and Weisbach (1998) showed a link between accountability of the board and performance. They noted a comment from Harvard Law Professors Bebchuk and Hirst (2010) that said there was "substantial empirical evidence indicating that director insulation from removal is associated with lower firm value and worse performance" (SEC Facilitating, p. 56,761 citing Bebchuk and Hirst (2010)). Other studies relating to firm performance were cited both pro and con. The SEC noted limitations on both types of studies (SEC Facilitating, pp. 56,763).

One can imagine all the variables in such studies that one would have to control. First, there are probably not all that many boards that have members that are independently elected. Second, the negative studies, that show that boards with members that are independently elected after a proxy fight do worse than their peers, do not necessarily prove anything conclusively either. The reason for proxy fights and the push for independent directors may be caused by a company's poor performance compared to their peers. Shareholders owning stock in companies that are doing well do not have much incentive to intervene.

The SEC noted that even if a company is doing poorly, it may be unattractive for shareholders to mount a full scale proxy fight. If the shareholder owns the stock as part of a mutual fund (such as an indexed fund), "voting with their feet" by selling may also not be a good alternative (SEC Facilitating, p. 56,773). The SEC also said that the range of proposals in its new rules would lead to more informed voting decisions for the board and increase and improve the disclosure relating to the candidates.

Shareholders who form groups to nominate directors can have improved communication (SEC Facilitating, p. 56,764).

The SEC also looked at comments and studies relating to costs. Besides the fact that proxy-nominated directors could be distracting and time consuming for boards, it is also possible that the proposal may lead to lower quality boards. The Commission noted that its proposal did not allow for anything close to a takeover of the board, given the number of directors that could be elected under its proposals. Furthermore, the requirement of substantial disclosure for director candidates can allow shareholders to make more informed decisions about whether or not changes need to be made to the board. If the bulk of the shareholders are satisfied with company performance and the board, they would vote against any change (SEC Facilitating, p. 56,765).

The Commission also examined the more quantifiable costs and complexities: for example, cumulative versus standard (or straight) voting or different classes of voting stock (which are found, for example, at Facebook and other companies). But the SEC also said that it had simplified the process by instituting standard procedures, minimum stock ownership, and methods to resolve multiple groups that might attempt to use the process (SEC Facilitating, pp. 56,767-56,768). The Commission also considered printing and mailing costs, though some of these costs would be incurred when the company sends out its own proxy requests to the shareholders (SEC Facilitating, pp. 56,768-56,770). Another cost mentioned by many comments is that many boards and management groups might incur extraordinary costs to fight any independent board members (SEC Facilitating, p. 56,770). While this could happen, it would seem to be mitigated by the small number of directors that can be elected in this fashion; the rule does not allow for a hostile takeover of the company. The SEC questioned whether such expenditures would normally be in the best interests of the company. It might even violate the board member's "fiduciary duty" to the company, leading in some cases to the shareholders putting up a fight (SEC Facilitating, p. 56,770). This raises the possibility that this might occur at a poorly run company where there is fear that the truth of the management's ineptitude might be exposed.

Finally, the SEC looked at the effect of the rule on competition, efficiency, and capital formation. Much of the discussion seems to have been already examined above. The Commission noted that no state prohibits shareholders from nominating board members (though companies may often make it difficult). The Commission noted that in many other capitalist economies, shareholders have access to nominating directors. Overall, it thought the rules would "promote efficiency of the economy on the whole" (SEC Facilitating, p. 56,771) and would result in "improved board accountability and corporate governance" (SEC Facilitating, p. 56,761).

The Commission also viewed it as a way to restore "investor confidence in the U.S. markets" (SEC Facilitating, p. 56,774). They also noted that some states such as Delaware have moved toward greater access for shareholders to nominate directors (SEC Facilitating, p. 56,775 n. 1056).

Delaware is an important state since a majority of the large corporations are incorporated there. Thus, its state law is particularly relevant. Effective August 2009, section 112 of Delaware incorporation's law provides that the bylaws may include the following: (1) the amount of stock owned by the nominator; (2) a certain period of time of ownership; (3) certain types of information about the nominator and the nominee; (4) limits on the number or proportion of directors that can be nominated at a given time; (5) a prohibition of nominating those who have acquired a certain amount of control of the corporation; and (6) indemnification of the corporation for false or misleading information submitted (Act to Amend Title 8 of Delaware Corporate Code (2009)). Note that this is an "opt-in" law. These provisions are not mandatory. However, shareholders can make them mandatory by proposing them as part of the bylaws.

While the initial bylaws can be determined by the incorporators or the initial board, later "the power to adopt, amend, or repeal bylaws shall be in the stockholders entitled to vote" (Act to Amend Title 8 of Delaware Corporate Code (2009)). The bylaws also may include provisions that require the corporation to reimburse shareholders' expenses for proxy solicitation (Act to Amend Title 8 of Delaware Corporate Code (2009)).

The Delaware provisions are potentially more potent than the SEC's now deceased Rule 14a-11. Potentially the voting shareholders could remove all or most of the board and thus gain control of the

corporation from the previous board. SEC Rule 14a-11 only allowed one board member or 25% of the board. However, the Delaware process is more laborious since the bylaws must be passed before new board members can be nominated. Of course, for successful corporations, this would be unlikely. Poorly run corporations are more likely to be targeted.

The SEC still has Rule 14a-8 on the books, as noted above. It allows shareholders with as little as \$2,000 of stock ownership to propose bylaws. The rule does not allow the corporation to exclude bylaws that allow for shareholder nominated directors. However, one limitation is that 14a-8 cannot be used if state law does not permit shareholders to vote on changes to the bylaws. (SEC Allowing (2010)) Rule 14a-11 could have been used regardless of state law. The burden of showing that state law does not permit shareholders to vote on bylaws is on the corporation, according to Rule 14a-8 (SEC Allowing (2010)).

Some states do vest the power to make bylaws in the board. For example, in Nevada the board can override even a shareholder-passed bylaw (Nevada, An Act Relating to Business Associations (2009)). In Missouri, the default rule is that shareholders may pass bylaws unless it is prohibited in the articles of incorporation. Then the board has the sole right (Missouri. Revisions to the Corporate Code of 1975, 2009). Thus, whether Rule 14a-8 is useful for shareholder access depends on state law and sometimes on the articles of incorporation.

## **CONCLUDING REMARKS**

Did the D.C. Circuit make the right decision regard SEC Rule 14a-11? Was the decision made in an “arbitrary and capricious” manner? The statutory authority under Dodd-Frank would seem to indicate that Congress thought that the SEC might well implement such a rule and that in effect Congress might be encouraging such a rule though it left the details to the agency and did not mandate the rule. But was the “arbitrary and capricious” standard met under the “hard look” rule? It certainly requires the agency to justify the rule using available studies and reasoning.

The SEC did look at a number of studies and engaged in extensive reasoning in reaching its rule. The agency did admit that some of its studies (both pro and con) had deficiencies. Would such an admission make it “arbitrary and capricious”? As noted above, the economic studies are on both sides of the issue though an evaluation might lean slightly against the SEC. Still is it appropriate for a reviewing court to be in effect a fact finder on somewhat close calls—particularly when the statute indicates that there are non-economic factors to be considered?

The problem with such a position is that there is no economic study that examines the specifics of the particular rule because it never has been tried before. So there are no past studies that would fit exactly and any detailed study would be, at best, speculative. The comments (and there were many) were somewhat useful but lined up (not surprisingly) by the two sides. Corporate managements’ comments indicated that they want to continue to select directors and not have disruptive board members. Such corporations are used to being able to “cherry pick” their directors with virtually no chance that they will be challenged. As noted above, in business ethics, we often talk about the shareholder versus stakeholder theory; but there is also the principal/agent problem. Managers may, in some cases, manage largely in their own economic interests, though they cannot ignore their stock price, their profits, or their own shareholders. The rise of the “principal/agent” problem (which may be also called “agency theory”) (Noe, Hollenbeck, Gererhart, and Wright, 2003) has corresponded to the rise of boards that are in “the pocket” of management.

On the other side comments were from shareholder activists, individuals, and other groups. Their position would naturally be the opposite of corporations. The shareholder activists view proxy access not only as a way to discipline poorly performing companies, but they also may have other interests in mind—their own or other social interests. It is possible that their interests may be counter to those of the shareholder (such as those of a union). They tend to view proxy access as a property right (associated with the ownership of stock)—a right that has been gradually taken from shareholders in recent decades.

Indeed, the SEC Rule 14a-11 did seem to create a type of property right. While economic efficiency and profits are important, it might seem that corporations may also be or should be trying to benefit other interests—as are commonly associated with stakeholder theory—customers, workers, and the community.

What is generally considered to be a result of this case is that it will be difficult for the SEC (and other agencies such as CFTC) to meet the burden of proof to issue regulations because of the stiff economic requirements to justify the rule. One commentator, who liked the result, thought the burden for the agency in trying to promulgate a regulation may not be justified:

There are many (and I am one) who, although believing the SEC acted unwisely in adopting proxy access, at least in the form of Rule 14a-11, are concerned about the high, nigh impossible, bar the Court set that could put in jeopardy most SEC rulemaking of any complexity or controversy (Keller, 2011).

Rule 14a-11 was, at best, a fairly weak rule in terms of proxy access since the board could hardly be taken over as a result of the rule. Unions or employees could not take control though they could potentially be disruptive. Still dissenting board members may provide a useful perspective. Undoubtedly, corporations probably viewed the rule as a slippery slope where management could lose total control of their boards. The rule was struck down though it is apparent that the proxy access fight continues. The fight continues at the corporate level in certain cases, in state law governing the corporation, and within the SEC.

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