

2012

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Recommended Citation

Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 Emory L. J. 435 (2012).
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THE DESTRUCTIVE AMBIGUITY OF FEDERAL PROXY ACCESS

*Jill E. Fisch**

ABSTRACT

After almost seventy years of debate, on August 25, 2010, the U.S. Securities and Exchange Commission adopted a federal proxy access rule. The D.C. Circuit promptly invalidated the new rule before it ever went into effect. This Article examines the ill-fated rule and concludes that, although the D.C. Circuit did not identify its flaws, the rule was ambiguous in its application and unlikely to increase shareholder input into the composition of corporate boards. More troubling was the SEC's ambiguous justification for its rule, which was neither grounded in state law nor premised on a normative vision of the appropriate role of shareholder nominations in corporate governance.

Although the federal proxy access rule in its current form is now dead, had it gone into effect, its practical significance would have been minimal. The SEC's ambiguous approach to proxy access, an approach that significantly predates its adoption of Rule 14a-11, is particularly problematic because its rules continue to burden issuer-specific innovations in nominating procedures. The SEC has acknowledged this criticism but has refused to remove existing regulatory burdens.

The core of the problem, as illustrated by the SEC's experience with proxy access, is that federal regulation is poorly suited for regulating corporate governance. Private ordering offers a more flexible mechanism for maintaining equilibrium in the allocation of power between shareholders and managers. Absent federal regulatory interference, existing state law permits issuer-specific innovation regarding the shareholder role in nominating director candidates. This Article concludes by outlining the federal regulatory changes necessary to enable effective private ordering.

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INTRODUCTION

Under U.S. corporate law, the shareholders elect the board of directors.¹ In most cases, however, those shareholders do not nominate director candidates. Instead, the nominating committee of the board chooses a slate of candidates, and those candidates are submitted to the shareholders for approval.² Absent the infrequent phenomenon of an election contest,³ shareholders do not participate in the nomination process.⁴

¹ See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (2001) (“[A]n annual meeting of stockholders shall be held for the election of directors . . .”).

² See Order Approving NYSE and NASD Proposed Rule Changes and Amendments Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154, 64,177 (Nov. 4, 2003) (approving a New York Stock Exchange rule change requiring listed issuers to have an independent nominating committee).

³ See Lee Harris, *Missing in Activism: Retail Investor Absence in Corporate Elections*, 2010 COLUM. BUS. L. REV. 104, 120–21 (summarizing several reports on the frequency of contested elections and finding that, over the time period from 1996 to 2008, the number of contested elections at public companies averaged around thirty-six per year).

⁴ Election contests, in which a challenger files a separate proxy card and conducts an independent solicitation, generally involve a substantial shareholder that is either seeking control of the company or seeking, through board representation, to effect a change in corporate strategy. See CHRIS CERNICH ET AL., IRRC INST., EFFECTIVENESS OF HYBRID BOARDS 7–11 (2009), available at http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf (describing how hedge funds use partial board representation to attempt to change corporate strategy). Few election contests are premised on differences in directors’ personalities as opposed to the policies they propose to implement. Cf. *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1955) (distinguishing between election contests premised on policy disagreements and those based on personal issues).

The Securities and Exchange Commission (SEC) has struggled for years to regulate the shareholders' role in nominating directors.⁵ As early as 1942, the SEC proposed a rule that would have required issuers to include shareholder-nominated candidates in their proxy statements.⁶ Ultimately, the SEC abandoned the proposal. In the ensuing almost-seventy years, the SEC revisited the issue at least five times but failed to adopt a rule allowing proxy access.⁷

Adoption of a shareholder nomination rule faced several obstacles. First, from the outset, the rule faced strong opposition from business interests. Indeed, measured by the number of comment letters, proxy access is, by far, the SEC's most controversial rule-making initiative.⁸ Second, as the SEC refined the federal proxy rules in response to ongoing marketplace developments, the details of a proxy access rule became both increasingly important and impossible to perfect. Fundamentally, the SEC was unable to draft a proxy access rule that would satisfy everyone. Third, the D.C. Circuit

⁵ State corporation law, rather than federal securities regulation, is the source of any shareholder power to nominate director candidates. Since the 1930s, however, the federal proxy rules have regulated the procedures and disclosures associated with shareholder voting and the solicitation of proxies. *See* Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1130–31 (1993). Although the federal rules ostensibly do not modify shareholders' substantive voting rights, as a practical matter, federal regulation has substantially limited the exercise of those rights. *Id.* at 1134 (“[T]he SEC has affirmatively impeded the effectiveness of the shareholder voting process . . .”); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1087 (2008) (“[T]he use by stockholders of their state law rights had been stymied by the SEC itself . . .”).

⁶ Securities Act Release No. 2887, Exchange Act Release No. 3347, Holding Company Act Release No. 3988, Investment Company Act Release No. 417, 1942 WL 34864 (Dec. 18, 1942).

⁷ *See* DIV. OF CORP. FIN., SEC., 96TH CONG., STAFF REP. ON CORPORATE ACCOUNTABILITY 29–32 (Comm. Print 1980) (describing task-force and public hearings on proxy access in the late 1970s); Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274) [hereinafter Proposing Release] (proposing a proxy access rule); Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, 43,472 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240) (proposing a rule that would allow 5% shareholders to propose proxy access bylaw amendments); Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274) (proposing a proxy access rule); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276, 48,288 (Oct. 22, 1992) (to be codified at 17 C.F.R. pts. 240, 249) (considering a universal ballot as part of proposed amendments to the bona fide nominee rule).

⁸ *See* Broc Romanek, *Doing the Math: How Many Proxy Access Comment Letters This Decade?*, THECORPORATECOUNSEL.NET BLOG (Feb. 12, 2010, 7:50 AM), <http://www.thecorporatecounsel.net/Blog/2010/02/math-of-comment-letters.html> (stating that the SEC had received almost 52,000 comment letters on proxy access as of February 2010). It should be noted that many of these were duplicate or form letters. *Id.*

declared in its 1990 decision in *Business Roundtable v. SEC* that the SEC lacked the authority to regulate corporate governance through the proxy rules.⁹ A shareholder nomination rule was likely to raise a potential conflict with this holding and to trigger litigation seeking to invalidate the rule.¹⁰

When Congress authorized the SEC to adopt a federal proxy access rule as part of the Dodd–Frank financial regulatory reforms,¹¹ it removed the last of these hurdles, clearing the way for the SEC both to adopt proxy access and, more importantly, to consider explicitly the corporate governance implications of increasing shareholder access to the proxy. Yet Rule 14a-11,¹² the SEC’s proxy access rule, adopted on August 25, 2010, when the ink on Dodd–Frank was barely dry,¹³ was limited in scope and ambiguous in both its application and its justification. Indeed, once Congress authorized the SEC’s adoption of proxy access, the SEC’s most significant change to its prior proposals was to tighten the qualification requirements, sharply limiting the number of shareholders that would be able to use the rule.

Although the SEC described the proxy access rule as “facilitat[ing] the rights of shareholders to nominate directors to a company’s board,”¹⁴ it failed to do so. The restrictive limitations on which shareholders qualify to use the rule, coupled with new and existing burdens on shareholder collective action, suggested that the rule would be a nonstarter, ineffective in enabling shareholders even to exercise their nominating power, much less to affect board composition or increase director accountability. In addition, the SEC battened down the hatches with respect to state law and private ordering efforts

⁹ See 905 F.2d 406 (D.C. Cir. 1990).

¹⁰ See Letter from Henry A. McKinnell, Chairman, Bus. Roundtable, to Jonathan G. Katz, Sec’y, SEC 4–6 (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf> (arguing that the 1990 *Business Roundtable* decision limited the SEC’s power to regulating disclosures, not corporate governance).

¹¹ Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (codified as amended at 15 U.S.C. § 78n(a)(2) (Supp. IV 2010)).

¹² Rule 14a-11 was reserved from the 2010 Code of Federal Regulations pending litigation over its validity in the D.C. Circuit. After the rule was invalidated in *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), the 2011 Code of Federal Regulations omitted the rule entirely. The rule as it was adopted can be found at Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,677–93 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) [hereinafter Adopting Release]. The remainder of this Article will refer to the final rule as released in the Federal Register.

¹³ President Obama signed the Dodd–Frank Act into law on July 21, 2010. *Overhaul Forces Loan Wording Change*, BOS. GLOBE, Jan. 6, 2011, at 8.

¹⁴ Press Release, SEC, SEC Adopts New Measures to Facilitate Director Nominations by Shareholders (Aug. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-155.htm>.

to facilitate shareholder nominating power. Although it purported to leave issuers the option of further extending shareholder nominating rights, the new rule burdened the use of issuer-specific alternatives to it—even though recent amendments to the Delaware statute explicitly authorized issuers to establish shareholder nominating procedures.¹⁵

When the D.C. Circuit invalidated Rule 14a-11,¹⁶ it removed a largely ineffective tool for shareholder nomination of directors but not the preexisting and continuing burdens on private ordering. Existing SEC rules continue to impose extensive regulatory requirements on the exercise of shareholder nomination rights and to frustrate shareholder efforts to enhance those rights through state law mechanisms.

Regardless of whether one supports shareholder nomination of directors, the Rule 14a-11 experience raises a puzzle. If the SEC intended to facilitate shareholder nomination of directors, why did it adopt a rule that largely insulates issuers from shareholder input into the selection of director candidates? If, instead, the SEC determined that increasing shareholder nominating power was a bad idea, why go through the pretense of adopting a proxy access rule at all? More broadly, the SEC's rule-making releases offer no insight into the SEC's normative position as to whether proxy access will improve the corporate governance of public companies. Absent such justification, the exercise of rule-making authority appeared disturbingly arbitrary. Yet the D.C. Circuit appeared untroubled by these deficiencies and, instead, took the unprecedented approach of second-guessing the conclusions of the SEC's economic analysis.

This Article explores the destructive ambiguity of federal proxy access. It demonstrates the tension between the federal requirements for the exercise of shareholder nominating rights and the state law principles upon which the SEC purported to ground those rights. It unpacks the ambiguities in the SEC's conception of which shareholders should nominate director candidates. And it reveals the ambiguity resulting from the SEC's failure to confront, in adopting its rule, the appropriate allocation of power between shareholders and management, and the effects of proxy access on that balance. Ironically, these deficiencies highlight the advantages provided by state law regulation of corporate governance and strengthen the case for implementing shareholder nominating procedures through private ordering.

¹⁵ See DEL. CODE ANN. tit. 8, § 112 (Supp. 2011) (authorizing issuers to adopt proxy access bylaws).

¹⁶ *Bus. Roundtable v. SEC*, 647 F.3d at 1146.

Because it is important to consider Rule 14a-11 in its historical context, Part I of this Article briefly recounts the history of federal proxy access. In Part II, the Article describes the major features of Rule 14a-11, the SEC's accompanying changes to Rule 14a-8, and the subsequent history of the rules, including the D.C. Circuit's decision. Part III identifies the SEC's ambiguous rationale for adopting a federal proxy access rule. In Part IV, the Article situates proxy access within the broader context of corporate governance and demonstrates how latent ambiguity in the appropriate allocation of power within the corporate structure and the inability of a mandatory federal rule to adjust as necessary to maintain a stable equilibrium render a federal standard inferior to state law and private ordering.¹⁷ Part V proposes an alternative regulatory approach designed to facilitate such private ordering.

The existing political climate makes it unlikely that the SEC will propose a revised proxy access rule, at least in the short term, and the revisions to the Delaware statute and Rule 14a-8 provide, at least nominally, the opportunity for shareholders to experiment with proxy access through private ordering. As described in this Article, however, federal law continues to impede such experimentation. With the invalidation of Rule 14a-11, adoption of the reforms advocated in Part V of this Article to remove such impediments becomes increasingly important.

I. THE HISTORY OF FEDERAL PROXY ACCESS

The tepid support offered by the SEC for proxy access and the limited scope of Rule 14a-11 are particularly surprising in light of the rule's long gestation period. The SEC has been considering proxy access for almost seventy years. Indeed, the SEC first considered a rule that would have required issuers to include shareholder-nominated director candidates on the proxy statement in 1942.¹⁸ This consideration was part of the rule-making process that resulted in the adoption of the shareholder proposal rule, now Rule 14a-8—rule making that resulted from the changes to the proxy solicitation process

¹⁷ This Article uses the term *private ordering* to describe issuer-specific corporate governance provisions, as distinguished from corporate law rules established by statute or regulation. Such governance provisions are contractual in nature and typically take the form of a charter or bylaw provision, although they may alternatively be embodied in a traditional contract. See *UniSuper Ltd. v. News Corp.*, 898 A.2d 344, 345–46 (Del. Ch. 2006) (describing an agreement between a board and a corporation's shareholders regarding the board's power to adopt a poison pill); D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 *FORDHAM L. REV.* 125, 127 n.12 (2011) (discussing various uses of the term *private ordering*).

¹⁸ See Jill E. Fisch, *The Transamerica Case*, in *THE ICONIC CASES IN CORPORATE LAW* 46, 63 (Jonathan R. Macey ed., 2008) (describing the 1942 rule proposal).

that reduced in-person attendance at shareholder meetings.¹⁹ Although the SEC adopted a requirement that issuers include shareholder proposals in the proxy statement, the SEC abandoned the provision addressing shareholder nominations in the face of substantial opposition by corporate management.²⁰

Subsequently, the SEC revised the shareholder proposal rule to preclude proposals relating to director elections. As time went on, the SEC's interpretations of this exclusion became increasingly restrictive, leading the SEC to authorize the exclusion of proposals that nominated or advocated the election of a particular director, as well as proposals that addressed director qualifications or election procedures more generally.²¹

Investors repeatedly challenged the SEC's restrictive approach to shareholder voting and urged the SEC to reverse its position. In 1977, the SEC established a task force to undertake a comprehensive review of the federal proxy rules.²² As part of the review process, the SEC held a series of public hearings in which it received testimony and submissions from a wide variety of constituents concerning the nomination process.²³ Critics of shareholder nominations, primarily corporate management, testified that the use of nominating committees would adequately address any perceived problems about the director nomination process.²⁴ At the conclusion of the process, the SEC did not propose a shareholder nomination rule.²⁵ Instead, as the SEC task force reported to the Senate, due to the emergence of nominating committees, a shareholder nomination rule was unnecessary.²⁶

In response to continued investor complaints, the SEC undertook another "comprehensive review" of the proxy rules in 1990.²⁷ Following two years of study, the SEC adopted a variety of controversial rule changes designed to

¹⁹ Securities Act Release No. 2887, Exchange Act Release No. 3347, Holding Company Act Release No. 3988, Investment Company Act Release No. 417, 1942 WL 34864 (Dec. 18, 1942).

²⁰ Fisch, *supra* note 5, at 1163.

²¹ Fisch, *supra* note 18, at 63–64.

²² See DIV. OF CORP. FIN., SEC, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 3 n.10 (2003), available at <http://www.sec.gov/news/studies/proxyreport.pdf> (describing the SEC's consideration of proxy access in 1977).

²³ See DIV. OF CORP. FIN., *supra* note 7, at 29–30.

²⁴ *Id.* at 122–27.

²⁵ In response to the task force report, the SEC developed three proposals, two of which would have substantially reduced the SEC's role in regulating shareholder access to the ballot. Fisch, *supra* note 5, at 1165 n.169. The SEC did not adopt these proposals. *Id.*

²⁶ DIV. OF CORP. FIN., *supra* note 7, at 122–27.

²⁷ See Fisch, *supra* note 5, at 1165–66 (internal quotation marks omitted) (describing concerns leading up to the SEC's 1990 review of the proxy rules).

reduce the “chilling effect” and costs associated with shareholder participation in the proxy solicitation process.²⁸ Despite proposals for a universal ballot that would have facilitated investor choice among competing slates of candidates, the SEC did not adopt such a proposal, nor did it adopt a shareholder nomination rule.²⁹

Finally, in the wake of the Sarbanes–Oxley Act of 2002³⁰ and the wave of corporate governance scandals that precipitated its adoption,³¹ the SEC returned to the subject of proxy access. In May 2003, the SEC solicited public comment on its review of the proxy rules relating to the nomination and election of directors.³² Several months later, the SEC proposed a proxy access rule.³³

The proposed rule, in general terms, would have allowed shareholders that had held at least 5% of the company’s stock for at least two years³⁴ to nominate from one to three director candidates, but only upon the occurrence of a triggering event.³⁵ Triggering events included one or more directors receiving a 35% withhold vote, submission of a direct access proposal by holders of at least 1% of the issuer’s stock and approval of the proposal by a majority of votes cast, and, possibly, the issuer’s failure to adopt a shareholder resolution or proposal that had received majority approval.³⁶

²⁸ See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276, 48,279 (Oct. 22, 1992) (to be codified at 17 C.F.R. pts. 240, 249).

²⁹ See *id.* at 48,287–89.

³⁰ Pub. L. No. 107-204, 116 Stat. 745.

³¹ Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 924–25 (2010) (describing frauds at Enron and WorldCom as the most prominent examples of these scandals).

³² Notice of Solicitation of Public Views Regarding Possible Changes to the Proxy Rules, Exchange Act No. 47,778, 68 Fed. Reg. 24,530 (May 7, 2003).

³³ Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,784–85 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). The rule was explicitly subject to state corporate law provisions concerning shareholder nomination rights. *Id.* at 60,808. In particular, the SEC noted that, to the extent that state law permitted a corporation to prohibit shareholder nominations through provisions in its charter or bylaws, the proposed proxy access procedure would not be available to shareholders of corporations choosing to do so. *Id.*

³⁴ *Id.* at 60,806. Where multiple shareholders were eligible to use the rule, the company would only be required to include the nominee(s) of the shareholder with the largest stake in the company. *Id.* at 60,798.

³⁵ *Id.* at 60,789, 60,797. The proposed rule also included various disclosure and independence requirements, including a requirement that the nominee be independent of the nominating shareholder. *Id.* at 60,795–96. The independence requirement provided, *inter alia*, that a natural person could not nominate himself and that an entity could not nominate a current or former employee. *Id.* at 60,796.

³⁶ See *id.* at 60,789–91 (describing triggering events).

As proposed, the extent to which Rule 14a-11 would have resulted in the inclusion of shareholder-nominated directors was unclear. With respect to the triggering conditions, the SEC found, in a study of director elections over the preceding two years, that roughly 1.1% of companies had total withhold votes in excess of 35% of the votes cast.³⁷ The SEC also observed that 84% of companies listed on an exchange or NASDAQ had a least one shareholder that would have been eligible to submit a proxy access resolution.³⁸ According to the SEC, in the event proxy access was triggered, 42% of filers had at least one shareholder that, individually, met the necessary ownership requirements to nominate a director candidate, and 18% had two or more such shareholders.³⁹ The SEC did not provide information about the characteristics of these shareholders that might provide a basis for assessing whether they would be likely to nominate a director. Based on this data, the SEC estimated that the proxy access rule would be triggered annually in seventy-three companies and that, in forty-five of these companies, at least one shareholder would make a nomination.⁴⁰

Although the SEC's estimates may have been overly generous and, even under those estimates, shareholder nominations under the proposed rule were unlikely to occur frequently,⁴¹ business interests mounted substantial opposition to the proposal. A total of 504 individuals and entities submitted comments on the proposal,⁴² and an additional 185 comments were

³⁷ *Id.* at 60,790.

³⁸ *See id.* (observing that 84% of these companies had at least one shareholder that owned at least 1% of the outstanding shares for at least one year).

³⁹ *Id.* at 60,794.

⁴⁰ *Id.* at 60,810. These estimates were made as part of the SEC's analysis under the Paperwork Reduction Act. *Id.* at 60,807. The SEC conceded that "there is no reliable way to predict how many more security holder proposals would be submitted based on the proposed amendments, how often the events would be triggered or how many security holders would be able to meet the applicable requirements (*e.g.*, minimum ownership threshold)." *Id.* at 60,811.

⁴¹ In 2002, the SEC indicated that there were approximately 9400 reporting issuers. *See* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Web Site Access to Reports, Securities Act Release No. 8128, Exchange Act Release No. 46,464, 67 Fed. Reg. 58,480, 58,489 n.95 (Sept. 16, 2002) (to be codified at 17 C.F.R. pts. 210, 229, 240, 249). By 2006, that number had increased to almost 12,000. *See* Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 8876, Exchange Act Release No. 56,994, Trust Indenture Act Release No. 2451, 73 Fed. Reg. 934, 935 (Jan. 4, 2008) (to be codified at 17 C.F.R. pts. 210, 228, 229, 230, 239, 240, 249, 260, 269).

⁴² *Summary of Comments: In Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations*, U.S. SEC. & EXCH. COMM'N (Mar. 5, 2004), <http://www.sec.gov/rules/extra/s71903summary.htm> [hereinafter *Summary of Comments*].

subsequently submitted in response to an additional solicitation of comments.⁴³ As the SEC explained in its summary, most of those supporting the proposal favored a stronger rule—one providing greater proxy access rights.⁴⁴ Corporations, corporate executives, and corporate directors, however, “were nearly unanimous in their opposition to the proposed rules.”⁴⁵ Faced with this business opposition, coupled with claims that any consideration of shareholder nomination should be deferred pending an assessment of the impact of Sarbanes–Oxley, Chairman Donaldson abandoned the proposal.⁴⁶

The SEC’s decision not to mandate proxy access in 2003 might have laid the issue to rest, but institutional investors were not satisfied. Having failed to persuade the SEC to adopt proxy access, they sought, through private ordering, to implement proxy access procedures at individual issuers.⁴⁷ In 2006, the Second Circuit upheld an effort by the American Federation of State, County and Municipal Employees (AFSCME), a union pension fund, to submit a proxy access bylaw for a vote by AIG shareholders.⁴⁸ The decision, by holding that Rule 14a-8 permitted the submission of proxy access bylaws,⁴⁹ opened the door for investors to establish issuer-specific procedures for shareholder participation in the nominating process.⁵⁰

The SEC promptly closed the door on these private ordering efforts. Expressing concern that the decision would lead to “uncertainty and confusion” in the upcoming proxy season and that proxy access bylaw amendments could result in contested director elections that did not comport with the disclosure requirements applicable to election contests, the SEC

⁴³ DIV. OF CORP. FIN., SEC, FILE NO. S7-19-03, SUPPLEMENTAL SUMMARY OF COMMENTS RECEIVED ON OR AFTER FEBRUARY 6, 2004: IN RESPONSE TO THE COMMISSION’S PROPOSED RULES RELATING TO SECURITY HOLDER DIRECTOR NOMINATIONS 3–8 (2004).

⁴⁴ *Id.* at 9–10 (“[M]ore than half the Supporting Commenters desired a stronger rule.”).

⁴⁵ *Summary of Comments, supra* note 42.

⁴⁶ Gretchen Morgenson, *All’s Not Lost, Disgruntled Investors*, N.Y. TIMES, Oct. 1, 2006, at B1 (explaining that corporate lobbying “helped to defeat” the 2003 proxy access proposal).

⁴⁷ See Fisch, *supra* note 18, at 66 (describing issuer efforts to obtain proxy access through bylaw amendment proposals in the wake of the failed 2003 proposal).

⁴⁸ AFSCME v. AIG, Inc., 462 F.3d 121, 130–31 (2d Cir. 2006).

⁴⁹ *Id.*

⁵⁰ The court noted that the SEC was free, however, to change the scope of the election exclusion. See *id.* at 130 n.9 (“[I]f the SEC determines that the interpretation of the election exclusion embodied in its 1976 Statement would result in a decrease in necessary disclosures or any other undesirable outcome, it can certainly change its interpretation of the election exclusion, provided that it explains its reasons for doing so.”).

reopened the issue of proxy access.⁵¹ The SEC proposed two alternatives. The first alternative would have authorized large shareholders that satisfied certain conditions to propose proxy access procedures through bylaw amendments.⁵² The second alternative proposed codifying the position that the SEC had advocated in *AFSCME v. AIG, Inc.*, authorizing issuers to exclude shareholder nomination bylaw proposals.⁵³ On December 6, 2007, the SEC adopted the latter alternative, overturning the court's decision in *AFSCME*.⁵⁴

The 2007 amendment, which precluded shareholders from establishing nominating procedures on an issuer-specific basis through private ordering, was the most restrictive approach to shareholder nomination that the SEC had ever taken. President Obama's election and his subsequent appointment of Mary Schapiro to serve as the new Chair of the SEC made proxy access appear more likely. In her confirmation hearings, Schapiro pledged to give large shareholders more say in the selection of corporate directors.⁵⁵

Subsequently, on June 10, 2009, the SEC introduced another proxy access proposal.⁵⁶ The proposal contained two components. First, the SEC proposed a revised version of Rule 14a-11 that would have authorized shareholders that owned from 1% to 5% of the issuer's stock (depending on the size of the issuer) for at least a year to nominate candidates for up to 25% of the board of directors.⁵⁷ Although the proposal required shareholder candidates to meet applicable standards of independence,⁵⁸ it eliminated the requirement of a triggering event⁵⁹ and the limitations on relationships between the candidate

⁵¹ Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27,914, 72 Fed. Reg. 43,488, 43,491 (proposed July 27, 2007) (to be codified at 17 C.F.R. pt. 240).

⁵² *Id.* at 43,470 (proposing a rule allowing shareholders that held at least 5% of the company's stock for at least a year and who had filed a 13G in addition to making a variety of further disclosures to propose a proxy access bylaw amendment). The proposed rule did not seek to dictate any specific procedures or qualifications for proxy access.

⁵³ *Id.* at 43,493.

⁵⁴ Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,914, Investment Company Act Release No. 28,075, 72 Fed. Reg. 70,450 (Dec. 11, 2007) (to be codified at 17 C.F.R. pt. 240).

⁵⁵ Zachary A. Goldfarb, *SEC Pick Pledges to Ratchet Up Oversight*, WASH. POST, Jan. 16, 2009, at D1.

⁵⁶ Proposing Release, *supra* note 7.

⁵⁷ *Id.* at 29,032–44. The rule proposed to allow shareholders to nominate one director candidate or 25% of the board's directors, whichever was greater. *Id.* at 29,043. Where multiple qualifying shareholders sought to nominate director candidates, the company would only be required to include those candidates from the first nominating shareholder or group. *Id.* at 29,044.

⁵⁸ *Id.* at 29,040–42.

⁵⁹ *Id.* at 29,032 (“Today's proposal does not require a triggering event.”).

and the nominating shareholder that had been part of the 2003 proposed rule.⁶⁰ The rule also required new disclosures on proposed Schedule 14N—disclosures that the SEC described as “substantially similar” to those proposed in 2003.⁶¹

Second, the SEC proposed amending Rule 14a-8 to permit shareholder proposals concerning nomination procedures or disclosures as long as the proposals did not conflict with proposed Rule 14a-11.⁶² The amendment would have treated such proposals similarly to all other shareholder proposals—proposing shareholders would have been required to hold a minimum of \$2000 worth of stock for at least a year⁶³ and would not have been required to make any mandated disclosures or filings.⁶⁴ The SEC explained that this proposal, which essentially reversed its 2007 rule change, was feasible in light of the fact that any issuer-specific shareholder nomination process would now be subject to mandated disclosure under new Rule 14a-19, which included the requirement that a nominating shareholder file a Schedule 14N.⁶⁵

The SEC received 537 comments in the initial sixty-day comment period.⁶⁶ Some of these comments provided data and analysis suggesting that the SEC’s review had been incomplete. As a result, in December 2009, the SEC reopened the comment period for an additional thirty days, specifically inviting the public to comment on this additional material.⁶⁷ Approximately sixty comments were submitted during this additional period.⁶⁸

⁶⁰ *Id.* at 29,041.

⁶¹ *Id.* at 29,045–46. The SEC described Schedule 14N as requiring “disclosure similar to what would be obtained in an election contest.” *Id.* at 29,046.

⁶² *Id.* at 29,056.

⁶³ *Id.* at 29,056 n.256.

⁶⁴ *Id.* at 29,056.

⁶⁵ *See id.* at 29,056–58.

⁶⁶ J.G. Ballard, *Regulatory Watch: SEC Extends Comment Period for Proposed Director Nomination Rule*, BUS. L. CURRENTS (Dec. 15, 2009), http://currents.westlawbusiness.com/Articles/2009/12/20091215_0022.aspx?cid=&src=E100629001&sp=.

⁶⁷ Facilitating Shareholder Director Nominations, Securities Act Release No. 9086, Exchange Act Release No. 61,161, Investment Company Act Release No. 29,069, 74 Fed. Reg. 67,144, 67,145 (proposed Dec. 14, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274) (referencing four documents containing such data and analysis and included in the public comment file).

⁶⁸ *Comments on Proposed Rule: Facilitating Shareholder Director Nominations*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/comments/s7-10-09/s71009.shtml> (last modified Nov. 1, 2010) (listing and providing links to submitted comments and including approximately sixty comments submitted after December 2009).

As indicated above, commentators have repeatedly questioned the authority of the SEC to mandate proxy access.⁶⁹ With the adoption of the Dodd–Frank Wall Street Reform and Consumer Protection Act⁷⁰ on July 15, 2010,⁷¹ Congress addressed these concerns. The new legislation explicitly authorized the SEC to adopt rules requiring proxy access, although Dodd–Frank did not require the SEC to adopt a proxy access rule.⁷² President Obama signed the legislation on July 21, 2010.⁷³ Just a month later, on August 25, 2010, the SEC voted 3–2 to adopt a proxy access rule.⁷⁴

II. THE FEDERAL PROXY ACCESS RULE

The SEC’s final rules contained the same two components as the 2009 proposal: new Rule 14a-11 (the proxy access rule) and an amendment to Rule 14a-8 permitting shareholder proposals relating to nomination procedures.⁷⁵ Both rules were similar to the 2009 proposals, but Rule 14a-11 reflected two significant changes. First, Rule 14a-11 limited proxy access to shareholders that have owned at least 3% of the issuer’s stock, providing a uniform minimum ownership requirement for all companies rather than varying the threshold depending on company size.⁷⁶ For the largest companies, this change was a substantial increase from the 1% threshold originally proposed. Second, the final rule increased the required holding period before a shareholder could qualify to nominate a director candidate from one to three years.⁷⁷ Nominating shareholders were required to continue to hold the stock through the annual

⁶⁹ See, e.g., DIV. OF CORP. FIN., *supra* note 22, at 6 (describing these objections).

⁷⁰ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

⁷¹ See Brady Dennis, *Senate Passes Landmark Bill in Triumph for Obama*, WASH. POST, July 16, 2010, at A1.

⁷² Compare Dodd–Frank Wall Street Reform and Consumer Protection Act § 971 (authorizing the SEC to adopt proxy access rules), *with id.* § 951 (adopting an explicit requirement of periodic shareholder votes on executive compensation).

⁷³ Helene Cooper, *Obama Signs a Contentious Overhaul of the U.S. Financial System*, N.Y. TIMES, July 22, 2010, at B3.

⁷⁴ Adopting Release, *supra* note 12.

⁷⁵ *Id.* The description in this Part summarizes the key features of the rule. The adopting release contained numerous technical details not discussed here including the basis upon which ownership was calculated, the procedures for contesting a shareholder nomination and the time periods applicable to such procedures, and the manner in which a disqualified nominating group or nominee was to be replaced. See *generally id.* at 56,677–740 (detailing the specific provisions of the adopted changes to Rules 14a-11 and 14a-8).

⁷⁶ *Id.* at 56,674–75.

⁷⁷ *Id.* at 56,675. The rule addressed various technical details concerning these ownership requirements. Among these, ownership, for the purpose of using Rule 14a-11, was defined to include both voting and investment power. *Id.*

meeting and to disclose their intentions with respect to continued ownership after the meeting.⁷⁸ As with the 2009 proposal, shareholders were limited to nominating a maximum of one director or candidates for 25% of the board, whichever was greater.⁷⁹

The final rule included new disclosure requirements for nominating shareholders and their nominees. Under the rule, a nominating shareholder or group had to file a Schedule 14N between 120 and 150 days prior to the first anniversary of the mailing of the proxy statement for the issuer's prior annual meeting.⁸⁰ Rule 14a-18 (adopted at the same time) extended the requirement of filing a Schedule 14N to shareholder nominations made pursuant to state and foreign law, as well.⁸¹ Schedule 14N provides notice to the issuer and the SEC of the shareholder's intent to nominate one or more director candidates and requires, inter alia, information about the nominating shareholder's securities ownership; disclosures about the nominating shareholder and the nominees as well as any relationships between the nominating shareholder, the nominees, and the issuer; and disclosures about the nominees' qualifications, including a statement that the nominees meet the objective stock exchange independence criteria.⁸²

Presumably recognizing that few shareholders would be able to satisfy the minimum ownership and holding period requirements individually, the adopting release contemplated—indeed, embraced—the formation of nominating groups.⁸³ The federal securities laws have traditionally treated collective shareholder action with suspicion. Indeed, the adopting release specifically warned that communications among shareholders for the purpose of forming a nominating group constitute proxy solicitations that are themselves subject to Regulation 14A.⁸⁴ Nonetheless, to facilitate the formation of nominating groups, the SEC adopted new Rule 14a-2(b)(7). Rule 14a-2(b)(7) provided a limited exemption from certain of the proxy rules for

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* This uniform notice period would have preempted an issuer's advance notice bylaws. For a discussion of advance notice bylaws, see *JANA Master Fund Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 343–44 (Del. Ch. 2008).

⁸¹ Adopting Release, *supra* note 12, at 56,748–49.

⁸² *See id.* at 56,789–92.

⁸³ *See id.* at 56,674 (“Shareholders will be able to aggregate their shares to meet the [ownership] threshold.”).

⁸⁴ *Id.* at 56,725.

oral and limited written communications in connection with the formation of a nominating group.⁸⁵

The exemption applied only to shareholders seeking to form a nominating group pursuant to Rule 14a-11; it did not apply to communications that would have had the purpose or effect of changing control of the company, and it did not protect shareholders seeking to exercise nominating rights pursuant to state law or issuer-specific nominating procedures.⁸⁶ The rule limited the content of written solicitations to specified information, required that all written solicitations be filed with the SEC, and required disclosure of oral communications prior to the occurrence of the first such solicitation.⁸⁷

Other aspects of the proxy rules impeded collective shareholder action.⁸⁸ In response to concerns about these impediments, the SEC amended Rule 13d-1(b)(1) to provide that participation in a nominating group did not, by itself, require a shareholder to file a Schedule 13D, rather than a Schedule 13G.⁸⁹ This amendment was of particular significance for activist shareholders that might have been concerned, after *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, about the implications of engaging in collective action.⁹⁰ Group formation could, however, trigger the obligation to file a Schedule 13G, and the rule did not provide an exemption.⁹¹ In addition, the adopting release explicitly stated that nominating groups were not exempt from the provisions of section 16 of the Exchange Act, effectively precluding the formation of groups with aggregated holdings that exceed 10%.⁹²

⁸⁵ *Id.* at 56,726.

⁸⁶ *Id.* at 56,726–27.

⁸⁷ *Id.* at 56,726.

⁸⁸ Fisch, *supra* note 5, at 1198.

⁸⁹ Adopting Release, *supra* note 12, at 56,736 (describing the amendment to 17 C.F.R. § 240.13d-1(b)(1)(i) (2011)).

⁹⁰ *See* 562 F. Supp. 2d 511, 554 (S.D.N.Y. 2008), *aff'd in part, vacated in part*, 654 F.3d 276 (2d Cir. 2011) (finding that communications and common objectives of two hedge funds resulted in the formation of a group and triggered the disclosure requirements of section 13(d) of the Exchange Act). Qualification to file a Schedule 13G, rather than a Schedule 13D, also offers shareholders the opportunity substantially to delay disclosure of their intentions. *See infra* notes 224–27 and accompanying text (describing differences between Schedule 13G and 13D disclosure obligations).

⁹¹ Adopting Release, *supra* note 12, at 56,735 (“[I]t is possible that in aggregating shares to meet the ownership requirement, a nominating shareholder or group will trigger the reporting requirements of Regulation 13D–G . . .”).

⁹² *Id.* at 56,737 (“[A]n exclusion from Section 16 is not appropriate for groups formed solely for the purpose of nominating a director pursuant to Rule 14a-11, soliciting in connection with the election of that nominee, or having that nominee elected as director.”).

Finally, the adopting release made clear that Rule 14a-11 was not available to shareholders that sought to affect the control of the issuer.⁹³ Although the SEC attempted to justify this restriction by stating that the rule was not intended to serve as a substitute for the existing disclosures and other regulation of control contests—despite the expanded disclosure requirements of Schedule 14N—the resulting limitations were highly restrictive.⁹⁴ Each nominating shareholder or member of the nominating group was required to certify on Schedule 14N that it was not “holding the company’s securities with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board of directors that exceeds the maximum number of nominees that the company could be required to include under Rule 14a-11.”⁹⁵ In addition, no member of a nominating group was permitted to join with another shareholder or group in soliciting proxies, to conduct a separate proxy solicitation, or to be a participant in another person’s solicitation.⁹⁶

The amendment to Rule 14a-8 was similar to that in the 2009 proposal; it reversed the SEC’s 2007 rule change and required issuers to include otherwise valid shareholder proposals to amend the issuer’s governing documents relating to director nominating procedures or disclosures.⁹⁷ Proposals conflicting with Rule 14a-11 or applicable state law were not permitted, nor were proposals focused on specific directors or director candidates.⁹⁸ As with the 2009 proposal, shareholders wishing to submit such proposals merely needed to satisfy the standard minimum ownership and holding requirements of Rule 14a-8.⁹⁹ As discussed further below, however, shareholders that use

⁹³ See *id.* at 56,698.

⁹⁴ Seemingly, however, the SEC did not view these limitations as sufficient. As it explained, the concern about control contests also warranted extending the required holding period from one to three years. *Id.* at 56,697–98. “[A] longer holding period is another safeguard against shareholders that may attempt to inappropriately use Rule 14a-11 as a means to quickly gain control of a company.” *Id.* at 56,698.

⁹⁵ *Id.* at 56,675.

⁹⁶ *Id.* at 56,682.

⁹⁷ *Id.* at 56,730–32.

⁹⁸ *Id.* at 56,730. The rule, as amended, permitted the exclusion of any proposal that

- (i) [w]ould disqualify a nominee who is standing for election;
- (ii) [w]ould remove a director from office before his or her term expired;
- (iii) [q]uestions the competence, business judgment, or character of one or more nominees or directors;
- (iv) [s]eeks to include a specific individual in the company’s proxy materials for election to the board of directors; or
- (v) [o]therwise could affect the outcome of the upcoming election of directors.

Id. at 56,732.

⁹⁹ *Id.* at 56,730.

issuer-specific nominating procedures must comply with the complete filing and disclosure requirements of Regulation 14A in a similar manner to shareholders that mount a proxy contest.¹⁰⁰

The new rules applied to all issuers that were subject to the federal proxy rules, including investment companies as well as controlled companies in which minority shareholders lack sufficient voting power to elect a shareholder nominee.¹⁰¹ Many commentators objected to the one-size-fits-all approach and urged the SEC to allow private ordering.¹⁰² Specifically, commentators argued that issuers should have been able to design proxy access procedures that were tailored to their individual circumstances.¹⁰³

The SEC refused. The final rule explicitly precluded issuers from adopting more restrictive approaches to proxy access through charter or bylaw provisions.¹⁰⁴ The SEC nonetheless purported to ground its approach in state law by stating that shareholders could not use the rule if state law (but not a specific issuer's charter) prohibited shareholder nominations.¹⁰⁵

At the time it adopted the rules, the SEC intended them to be effective in time for the 2010–2011 proxy season.¹⁰⁶ On September 29, 2010, however, the Business Roundtable and the U.S. Chamber of Commerce brought suit challenging Rule 14a-11.¹⁰⁷ The suit alleged that the rule was arbitrary and capricious and that the SEC failed to comply with its statutory obligation to assess its effect on efficiency, competition, and capital formation.¹⁰⁸ The SEC voluntarily stayed the effectiveness of Rule 14a-11 and the other amendments,

¹⁰⁰ *Id.* at 56,733.

¹⁰¹ *Id.* at 56,682–83. The rule exempted companies that were subject to the proxy rules solely because they had a class of debt securities registered under section 12 of the Exchange Act. *Id.* at 56,683.

¹⁰² *Id.* at 56,670–74 (referencing and rejecting commentators' argument that proxy access rules should be determined through private ordering).

¹⁰³ *Id.* at 56,670–71. For an example of this argument, see Letter from Alexander M. Cutler, Chair, Corporate Leadership Initiative, Bus. Roundtable, to Elizabeth M. Murphy, Sec'y, SEC 2–3 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-267.pdf> (“State law . . . provides shareholders and boards of directors with the opportunity to deal effectively with the myriad of different circumstances applicable to their companies in designing a proxy access and/or proxy reimbursement regime.”).

¹⁰⁴ Adopting Release, *supra* note 12, at 56,678–89.

¹⁰⁵ *Id.* at 56,674.

¹⁰⁶ *See id.* at 56,668 (setting the effective date of the regulations at November 15, 2010). The SEC delayed the effective date of the new rules for “smaller reporting companies” as defined in the Code of Federal Regulations. *Id.* (quoting 17 C.F.R. § 240.12b-2 (2011)) (internal quotation marks omitted).

¹⁰⁷ Petition for Review, *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (No. 10-1305).

¹⁰⁸ *Id.*

including the amendment to Rule 14a-8, pending the resolution of the litigation.¹⁰⁹

On July 22, 2011, the D.C. Circuit vacated Rule 14a-11.¹¹⁰ The D.C. Circuit noted that the SEC “has a unique obligation to consider the effect of a new rule upon ‘efficiency, competition, and capital formation.’”¹¹¹ According to the court, the SEC acted arbitrarily and capriciously by failing “adequately to assess the economic effects of” Rule 14a-11.¹¹² In particular, the court stated its belief that “the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.”¹¹³

Following the announcement of the D.C. Circuit’s decision, the SEC announced that it would not seek rehearing or appeal the decision to the U.S. Supreme Court.¹¹⁴ By the terms of the stay, it expired once the D.C. Circuit issued its mandate.¹¹⁵ On September 20, 2011, the SEC published a brief notice indicating that the amendment to Rule 14a-8 and the additional amendments to the federal proxy rules, other than Rule 14a-11, would become effective on that day.¹¹⁶

III. JUSTIFYING FEDERAL PROXY ACCESS

A. *The SEC’s Explanation*

Despite the years of attention that the SEC has devoted to proxy access, it offered a surprisingly limited defense of Rule 14a-11 in its proposing and adopting releases. The SEC did not defend the rule in terms of possible corporate governance objectives, such as increased shareholder voice, better

¹⁰⁹ See Bus. Roundtable, Securities Act Release No. 9149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 WL 3862548 (Oct. 4, 2010).

¹¹⁰ *Bus. Roundtable*, 647 F.3d at 1156.

¹¹¹ *Id.* at 1148 (quoting 15 U.S.C. §§ 78c(f), 80a-2(c) (2006)).

¹¹² *Id.*

¹¹³ *Id.* at 1151.

¹¹⁴ Press Release, SEC, Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation (Sept. 6, 2011), available at <http://www.sec.gov/news/press/2011/2011-179.htm>.

¹¹⁵ Bus. Roundtable, Securities Act Release No. 9149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 WL 3862548, at *2 (Oct. 4, 2010).

¹¹⁶ Facilitating Shareholder Director Nominations, Securities Act Release No. 9259, Exchange Act Release No. 65,343, Investment Company Act Release No. 29,788, 76 Fed. Reg. 58,100, 58,100 (Sept. 20, 2011).

board composition, or improved corporate performance.¹¹⁷ Instead, the SEC's releases offered two narrow and ambiguous justifications. First, the SEC stated that the rule was necessary to ensure that shareholders enjoy the same rights that they could exercise through personal attendance at an annual meeting.¹¹⁸ Second, the SEC suggested that proxy access might increase director accountability to shareholders.¹¹⁹

As the SEC explained, the federal proxy rules were designed to replicate, as nearly as possible, an in-person shareholder meeting.¹²⁰ At an in-person meeting, shareholders have the power to nominate as well as elect director candidates.¹²¹ The SEC acknowledged that, despite this objective, it has exercised its rule-making authority to restrict, rather than enhance, shareholder voting power. One example of this restrictive approach is the SEC's refusal to adopt a universal ballot or form of proxy that would require issuers to disclose all validly nominated director candidates.¹²² Another example is its approach to Rule 14a-8, which has limited shareholders' ability to establish nomination procedures through private ordering.¹²³ Recognizing that the federal proxy rules have imposed affirmative impediments on "the exercise of shareholders'

¹¹⁷ Ironically, these were nonetheless the criteria against which the D.C. Circuit evaluated the rule. *Bus. Roundtable*, 647 F.3d at 1150–51.

¹¹⁸ Adopting Release, *supra* note 12, at 56,670.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ Although state statutes do not explicitly articulate shareholder nominating power, the claim is that such power is implicit in the statutory power to elect directors. See Carolyn Check & Michael Miller, *Determining Shareholder Access: Examining Shareholder-Management Relationships Through the Differing Lenses Used by the SEC and the "Common Law" of Corporate Bylaws*, 44 WAKE FOREST L. REV. 297, 300 (2009). In truth, existing director elections more closely resemble shareholder ratifications of the board's choice of directors. Alternatively, shareholders might be viewed as "confirming" the issuer's slate, in much the same way that the Senate confirms the President's appointment of judges and other public officials. Issuers appear, however, to assume that shareholders have the power to nominate director candidates. A recent empirical study found, for example, that in a sample of large U.S. corporations, virtually all had bylaw provisions that explicitly authorized shareholders to nominate director candidates. See *id.* at 303–04.

¹²² Rule 14a-4(d)(4), the bona fide nominee rule, explicitly precludes the use of a universal ballot by requiring nominees to consent to their inclusion on a proxy card. See, e.g., Fisch, *supra* note 5, at 1168–69 (describing the SEC's refusal to adopt a universal ballot and its continued efforts to preclude shareholders from having an opportunity to choose from among shareholder-nominated and issuer-nominated director candidates); Richard J. Grossman & J. Russel Denton, *Never Mind Equal Access: Just Let Shareholders "Split Their Ticket,"* M&A LAW., Jan. 2009, at 28 (describing the inability of shareholders to split their votes when voting by proxy absent a universal ballot).

¹²³ See *supra* notes 47–54 and accompanying text (discussing the SEC's response to private ordering efforts by AFSCME).

rights” to nominate and elect directors to company boards of directors, the SEC explained that Rule 14a-11 was designed to remove these impediments.¹²⁴

Critically, the SEC did not defend either its historically restrictive approach to proxy access or its new regulations in terms of a normative perspective. In other words, the SEC did not purport to be identifying an appropriate level of shareholder nominating or voting power or to ground its regulations in identified deficiencies in existing corporate governance mechanisms. Instead, the SEC claimed simply to be implementing shareholder power under state law. As the SEC repeated throughout the adopting release, its objective was to “facilitate the effective exercise of shareholders’ traditional State law rights to nominate and elect directors to company boards of directors.”¹²⁵

Second, the SEC drew a relationship between the impediments to the exercise of shareholder nominating rights and a lack of director accountability. As the SEC explained in the proposing release, the 2008 financial crisis led many commentators “to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence.”¹²⁶ The SEC suggested that the federal proxy rules “may be impeding the ability of shareholders to hold boards accountable,”¹²⁷ observing that the academic literature “points to a link between board accountability and company performance.”¹²⁸ Although it did not specifically find either that boards were insufficiently responsive to shareholder needs or that Rule 14a-11 would increase board responsiveness, the SEC nonetheless concluded that its rule changes would “significantly enhance the confidence of shareholders who link the recent financial crisis to a lack of responsiveness of some boards to shareholder interests.”¹²⁹

The SEC’s effort to defend Rule 14a-11 as facilitating the exercise of state law rights was disingenuous. By specifying qualifications and criteria for the exercise of nominating power, Rule 14a-11 attempted to create a federal nominating power—a power far narrower than that granted to shareholders by state law. State law gives all shareholders equal power to nominate directors without regard to the quantity of stock they own or the period for which they

¹²⁴ Proposing Release, *supra* note 7, at 29,025–26.

¹²⁵ Adopting Release, *supra* note 12, at 56,677.

¹²⁶ Proposing Release, *supra* note 7, at 29,025.

¹²⁷ *Id.*

¹²⁸ *Id.* at 29,026.

¹²⁹ Adopting Release, *supra* note 12, at 56,670.

have held it. With limited exceptions, state law grants all shareholders governance rights proportionate to their economic interest without requiring a minimum ownership threshold or holding period.¹³⁰ State law does not condition the exercise of voting power on shareholder-specific characteristics, such as independence, lack of control, intent, and the like. Moreover, to the extent that shareholder nominating power is based on the power to elect directors, state law provides no basis for limiting such nominating power to a lesser number of nominees than those upon whom the shareholders vote, much less an arbitrary limit of 25% of the board.

At the same time, state law grants issuers substantial power to determine the scope of shareholder nominating rights, power that the SEC eliminates through the mandatory nature of the federal nominating power that it creates. Although the SEC asserted that shareholder nominating power is implicit in the shareholders' right to elect the board,¹³¹ nothing in state corporation law requires corporations to give shareholders this power. The SEC's claim that this power is "imposed by statute" and "cannot be bargained away"¹³² was simply incorrect. State law allows corporations to limit or eliminate shareholder nominating rights. Indeed, state corporate law does not even require that the board of directors be elected by the shareholders—shareholder election of directors is merely a default rule that may be modified in the corporate charter.¹³³ To the extent that Rule 14a-11 prohibited corporations from adopting provisions that provide more limited nominating rights, it was flatly inconsistent with existing state law. Similarly, the continued burdens imposed by the proxy rules on nominations that do not conform to the

¹³⁰ Exceptions to this general principle include tenure voting rights, which increase voting power for long-term shareholders, *see Williams v. Geier*, 671 A.2d 1368, 1370, 1373 n.10 (Del. 1996) (discussing a tenure voting plan in which shares held for three years would enjoy ten times the voting power of shares held for a lesser period), and some state antitakeover statutes, which may have the effect of disenfranchising large shareholders, *see CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 73–75, 85 (1987) (upholding a state antitakeover statute that removed voting rights of acquired shares unless restored by a vote of minority shareholders).

¹³¹ *See* Adopting Release, *supra* note 12, at 56,672–73.

¹³² *Id.* at 56,672.

¹³³ *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(a) (2001) (authorizing corporations to issue one or more classes of stock that may have "such voting powers, full or limited, or no voting powers" as set forth in the certificate of incorporation). Indeed, prior to the adoption of the federal securities laws, a number of corporations restricted or eliminated the voting rights of common shareholders. *See* W.H. Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*, 40 Q.J. ECON. 353, 357–60 (1926) (describing the use of nonvoting common stock by major public corporations in the 1920s). It is worth noting that many state statutes require shareholder approval of specified transactions, such as mergers and charter amendments, and that those provisions may afford voting rights to otherwise nonvoting stock. *See id.* at 359 (observing that corporate law may have required a shareholder vote to ratify certain actions).

requirements of Rule 14a-11 frustrate, rather than facilitate, the exercise of state law rights.

This frustration is most apparent in the context of Delaware corporation law.¹³⁴ Delaware, the state of incorporation for most publicly traded companies, recently amended its statute, explicitly authorizing corporations to establish bylaws requiring the inclusion of shareholder nominees in the issuer's proxy statement.¹³⁵ The Delaware amendments authorize shareholders to establish shareholder nomination procedures on an issuer-specific basis and to adopt (or reject) minimum ownership and holding period requirements appropriate to the issuer and its shareholder base.¹³⁶ Rule 14a-11, however, prohibited bylaw provisions that were more restrictive than the federal rule and subjected more lenient provisions to the same federal regulatory requirements as mounting a proxy contest. In short, Rule 14a-11 eviscerated the enabling approach of the Delaware statute.

That state law does not offer a foundation for federal proxy access is illustrated most dramatically by the fact that Rule 14a-11 provided proxy access for shareholders of investment companies.¹³⁷ Most investment companies are not even organized as corporations under state law, but as business trusts.¹³⁸ State law does not require business trusts to have shareholder-elected directors.¹³⁹ Rather, the requirement of a shareholder-elected board stems from the Investment Company Act.¹⁴⁰ In responding to

¹³⁴ Rule 14a-11 similarly frustrates the exercise of shareholder nomination rights under North Dakota law. North Dakota permits 5% shareholders to nominate director candidates without requiring a minimum holding period or limiting the number of director nominees. N.D. CENT. CODE § 10-35-08 (2007). In addition, the North Dakota statute explicitly limits the disclosures that an issuer may require from a nominating shareholder. *Id.*

¹³⁵ DEL. CODE ANN. tit. 8, § 112 (Supp. 2011). Delaware's legislation followed a debate over the validity of such bylaws under Delaware law. Although many commentators took the position that such bylaws would be valid, the SEC prevented courts from resolving this question for a number of years by allowing issuers to exclude shareholder bylaw proposals. *See Strine, supra* note 5, at 1086–88 (describing the debate and the SEC's basis for exclusion).

¹³⁶ DEL. CODE ANN. tit. 8, § 112.

¹³⁷ *See Adopting Release, supra* note 12, at 56,683–85 (describing the application of Rule 14a-11 to investment companies).

¹³⁸ Philip H. Newman, *Legal Considerations in Forming a Mutual Fund*, in ALI-ABA COURSE OF STUDY: INVESTMENT COMPANY REGULATION AND COMPLIANCE 7, 9 (2008) (explaining that most mutual funds today are organized as Massachusetts business trusts, Delaware statutory trusts, or Maryland corporations).

¹³⁹ *See id.*

¹⁴⁰ Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to -64 (Supp. IV 2010)); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1967 (2010).

commentator suggestions that investment companies be excluded from Rule 14a-11, however, the SEC stated its belief “that facilitating the exercise of traditional State law rights to nominate and elect directors is as much of a concern for investment company shareholders as it is for shareholders of non-investment companies.”¹⁴¹ The adopting release contained no source of authority for the claim that the right to nominate and elect directors is a “traditional State law right[]” for mutual fund shareholders.¹⁴²

The SEC’s conception of shareholder nominating groups similarly lacked a basis in state law. State law does not contemplate or require that shareholders exercise their nominating or voting power collectively by forming shareholder groups. Indeed, it is unclear how state law would respond to a shareholder group’s exercise of corporate power—the selection of director candidates who will be included in the company’s proxy statement—when that corporate power is not available to shareholders generally. Would members of the shareholder group, for example, owe fiduciary duties to other shareholders? More generally, to what extent did a rule like Rule 14a-11 infringe on existing board responsibilities such as determining the qualifications of the corporation’s directors?¹⁴³

Rule 14a-11 thus attempted to create a federal nominating power that was both narrower and broader than shareholders’ traditional state law rights. Specifically, Rule 14a-11 reflected the SEC’s ambiguous determination of which shareholders are eligible to exercise nominating power and under what conditions. In the next section, this Article examines that determination to gain a better understanding of the objectives of federal proxy access. Although Rule 14a-11 has been invalidated, the rule was the culmination of repeated SEC efforts to structure proxy access through arbitrary qualification requirements, and as such, the following analysis should operate as a constraint on future rule-making proposals.

B. The Terms of Federal Proxy Access

The SEC’s predictions about the effect of Rule 14a-11 were guarded. As indicated above, it defended the rule in terms of “facilitating” shareholder

¹⁴¹ Adopting Release, *supra* note 12, at 56,684.

¹⁴² *See id.* Although the D.C. Circuit criticized the application of Rule 14a-11 to investment companies, its criticism was limited to concerns about the SEC’s cost-benefit analysis. *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1156–58 (D.C. Cir. 2011).

¹⁴³ The relationship of state law to federal proxy access is considered in more detail in Part III.C.

nominating power, rather than expressing an intention to increase the number of shareholder nominees. Moreover, although the SEC predicted that the rule “will result in a greater number of nominees appearing on a proxy card,”¹⁴⁴ it offered no judgment that the existing level of shareholder nominations was insufficient and provided no benchmark by which to assess whether an increase would be appropriate.¹⁴⁵ Indeed, the SEC made all its substantive arguments in support of proxy access without attempting to quantify the extent to which shareholders would use it. It was only seventy-four pages into its adopting release (as published in the Federal Register), in the context of its statutorily required cost–benefit analysis under the Paperwork Reduction Act (PRA), that the SEC provided any quantitative analysis.¹⁴⁶

Both the analysis and resulting statistics were underwhelming. The SEC estimated that, out of approximately 11,000 reporting companies other than investment companies,¹⁴⁷ forty-five companies per year would receive a shareholder nomination under Rule 14a-11.¹⁴⁸ The basis for this estimate was “the number of contested elections [fifty-seven] and board-related shareholder proposals [118] that have been submitted to companies.”¹⁴⁹ Although neither contested solicitations nor shareholder proposals bear any relationship to director nominations under Rule 14a-11, the SEC stated that these numbers indicate shareholders that “have shown an interest in using currently available means under our rules to influence governance matters.”¹⁵⁰ Significantly, of course, shareholders did not need to meet any of the eligibility criteria of Rule 14a-11 to initiate an election contest or submit a shareholder proposal. The SEC also did not explain the methodology by which these numbers translated into an estimate of forty-five nominations.

Even if the statistics regarding election contests and shareholder proposals offered a measure of the number of shareholders interested in corporate governance, it is unlikely that any of those shareholders would have qualified to use federal proxy access. Hedge funds, which were unlikely to be eligible,

¹⁴⁴ Adopting Release, *supra* note 12, at 56,673.

¹⁴⁵ See Jonathan R. Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759, 768–71 (2007) (questioning the availability of a baseline by which to determine whether the existing level of contested director elections is appropriate).

¹⁴⁶ Adopting Release, *supra* note 12, at 56,742.

¹⁴⁷ *Id.* at 56,751.

¹⁴⁸ *Id.* at 56,744. It further estimated that six investment companies would receive such a nomination. *Id.*

¹⁴⁹ *Id.* at 56,743 & n.408.

¹⁵⁰ *Id.* at 56,743.

for reasons discussed below, to use Rule 14a-11,¹⁵¹ conducted virtually all of the contested solicitations in the Georgeson list upon which the SEC relied.¹⁵² Shareholders submitted the “[b]oard related proposals”¹⁵³ pursuant to Rule 14a-8, which requires a shareholder to own just \$2000 worth of stock.¹⁵⁴ In neither case did the number of shareholders that chose to use these mechanisms provide the SEC with a basis for estimating the number of shareholders that would have been able and willing to use Rule 14a-11.¹⁵⁵

To understand the SEC’s expectations better, it is useful to consider more carefully the conditions upon which Rule 14a-11 allowed shareholders to nominate director candidates. The minimum required ownership level was perhaps the most controversial issue in the debate over the various formulations of the SEC’s proposed proxy access rule. As the SEC observed in its proposing release, commentators argued in favor of minimum ownership levels ranging from the \$2000 ownership level required under Rule 14a-8 to a requirement that shareholders own 3, 5, 10, or even 15% of the issuer.¹⁵⁶

At the heart of the debate is the question of which shareholders should be able to nominate director candidates. The SEC accepted the position that shareholders should be required to have a substantial financial interest in the issuer to exercise nominating power.¹⁵⁷ A minimum ownership requirement could be defended as preventing nuisance nominations and unqualified

¹⁵¹ Any contest in which a dissident filed a proxy statement and distributed a separate proxy card was included in Georgeson’s list. GEORGESON, 2009 ANNUAL CORPORATE GOVERNANCE REVIEW 47 n.* (2009), available at <http://www.georgeson.com/usa/download/acgr/acgr2009.pdf>. As a result, the list includes issue-based contests, such as proposals to remove a classified board, which involve a very different type of shareholder engagement than proposing a competing slate of directors. The list also includes at least twelve solicitations at investment companies, *id.* at 47, which raise very different issues than a contest at an operating company. Moreover, by definition, a contested election involves a shareholder that is willing to incur the costs of a separate solicitation.

¹⁵² Adopting Release, *supra* note 12, at 56,743 n.804 (citing GEORGESON, *supra* note 151).

¹⁵³ *Id.*

¹⁵⁴ 17 C.F.R. § 240.14a-8(b) (2011).

¹⁵⁵ The SEC considered and rejected, as alternative bases for its estimates, a variety of predictions made in connection with its earlier proposals, specifically the 2009 proposed rule. *See* Adopting Release, *supra* note 12, at 56,743. These earlier estimates were largely based on counting the number of shareholders that met the qualification criteria and then predicting what percent of eligible shareholders might choose to submit a proposal. Specifically, the SEC estimated that 5% of those companies with at least one eligible shareholder would receive a 14a-11 nomination. *Id.* The SEC first recognized that it could not rely on these numbers because the 2009 rule had a much lower threshold for eligibility. *Id.* It then rejected the methodology behind this approach, reasoning that the presence of a qualifying shareholder did not provide evidence about that shareholder’s interest in nominating directors. *Id.*

¹⁵⁶ Proposing Release, *supra* note 7, at 29,035.

¹⁵⁷ *Id.*

candidates. Although state law does not impose this requirement, the SEC based federal proxy access on its own determination as to which shareholders would make the best use of this power.

Neither the comment letters in support of a minimum ownership requirement nor the SEC's various proposals contained any empirical justification for the claim that a minimum ownership requirement will result in higher quality nominations. The releases did not show that investors with larger shareholdings are more sophisticated, better able to identify qualified directors, or more expert in corporate governance. Indeed, at least some academic commentary has criticized institutional investors for supporting governance reforms that are not correlated with improved corporate performance.¹⁵⁸ The releases did not demonstrate that investors with larger shareholdings spend more money to research and monitor their investments; many large investors have limited budgets and do not spend substantial resources on governance research. The releases did not show that the interests of investors with larger holdings are correlated with those of other shareholders.¹⁵⁹ Indeed, commentators have demonstrated that large institutions may have competing objectives with respect to their portfolio companies.¹⁶⁰

Of course, a minimum ownership requirement drastically limits the number of shareholders that can use a proxy access rule. First, as a practical matter, any required ownership level beyond the most minimal precludes all retail investors from nominating director candidates. This preclusion is arguably at odds with the fact that, as a group, individual investors are most likely to benefit from the cost savings associated with proxy access since their interests are insufficiently large to make an independent solicitation cost-justified. Because retail investors, as a group, tend to be long-term investors, the exclusion is also at odds with the SEC's articulated objective of placing nominating power in the hands of long-term holders.¹⁶¹

¹⁵⁸ See, e.g., Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001) (reviewing empirical literature and concluding that institutional activism has little or no effect on the performance of targeted firms).

¹⁵⁹ See Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 881 (2010) (observing that institutional intermediaries' objectives with respect to their portfolio companies may not be limited to maximizing firm value).

¹⁶⁰ See, e.g., *id.*

¹⁶¹ See Proposing Release, *supra* note 7, at 29,035 (articulating this objective).

The SEC did not explain why retail investors are presumptively disqualified from identifying appropriate director candidates. Concededly, corporate managers have long disparaged activism by individual shareholders. Yet activists such as John and Lewis Gilbert, early champions of the shareholder proposal rule, advocated a variety of corporate governance reforms that have been embraced by today's institutional investors, including proper auditing, the elimination of staggered boards, and limits on executive compensation.¹⁶² Harvard law professor and retail investor Lucian Bebchuk has served as a type of modern corporate gadfly, challenging executive pay policies and crafting innovative bylaw proposals to address the scope of a board's power to deploy a poison pill.¹⁶³ Denver activist Gerald Armstrong's frequent shareholder proposals have included requests to eliminate classified boards and to implement advisory shareholder votes on executive compensation¹⁶⁴—both issues that have been the frequent focus of large institutional investors. Armstrong's proposals at Supervalu, where he has held 350 shares for approximately a dozen years, received the support of a majority of shareholders.¹⁶⁵ Indeed, both Bebchuk and Armstrong are likely to be among the investors counted in the SEC's PRA analysis as those interested in using existing corporate governance mechanisms, although neither qualified to use Rule 14a-11. Retail investors may challenge management viewpoints, but the SEC's releases presented no evidence that, as a class, they are incapable of participating meaningfully in the election process.

Even if a minimum ownership requirement is appropriate, neither the SEC nor commentators offered any basis for selecting 3% as an appropriate minimum. If the threshold was designed to limit nominations to those with a substantial economic interest, one might have expected a threshold tied to the overall size of the interest rather than to the proportion of shares that it represented.¹⁶⁶ If 3% is a proxy for a large dollar value, one would have

¹⁶² See Fisch, *supra* note 18, at 50 (recounting the Gilbert brothers' shareholder initiatives).

¹⁶³ See, e.g., Geoff Colvin, *The Gadfly in the Ivory Tower*, FORTUNE, Apr. 16, 2007, at 40, 40 (describing Bebchuk as "America's most influential critic of CEO pay"). Bebchuk owned 140 shares of Computer Associates as of 2006. *Bebchuk v. CA, Inc.*, 902 A.2d 737, 738 (Del. Ch. 2006).

¹⁶⁴ See Matt McKinney, *Shareholders OK "Say on Pay,"* STAR TRIB. (Minneapolis, Minn.), June 26, 2009, at D1.

¹⁶⁵ *Id.*

¹⁶⁶ Nor does the release consider relative significance—the size of a given investment relative to a particular investor's overall portfolio or total wealth. Consider, for example, the Florida State Board of Administration, the \$100 billion state pension fund that was the subject of extensive public criticism for its loss of \$334 million on its investment in Enron. See Alison Frankel, *Class Warfare*, AM. LAW., Mar. 2002, at 76 (describing the Florida State Board and the size of its loss); Mark Hollis, *Enron Losses Trigger Scrutiny of*

expected the release to contain statistics quantifying the typical dollar value of a 3% stake and explaining why investments of less than that amount are not economically significant. Such an analysis might note, for example, that a 3% stake in the toy company Mattel, currently number 392 on the Fortune 500 list,¹⁶⁷ is worth more than \$345 million¹⁶⁸ and explain why an investment of less than \$345 million does not give its owner a sufficient incentive to make responsible director nominations.

In fact, existing evidence suggests that shareholders view investments of far less than 3% as economically significant and act accordingly. In 2001, the Regents of the University of California had purchased more than two million shares of Enron stock for the university's retirement funds.¹⁶⁹ The Board of Regents was selected by the court to serve as lead plaintiff in the Enron securities class action based on the size of the funds' losses in the company stock and a congressional determination, reflected in the Private Securities Litigation Reform Act of 1995¹⁷⁰ (PSLRA), that lead plaintiffs should be those whose economic interest in the litigation is substantial.¹⁷¹ That the Regents had sufficient incentives to litigate vigorously was reflected by the fact that the Enron settlement included the rare requirement that outside directors contribute toward the settlement out of their personal assets.¹⁷² The funds' interest, however, which at one time was worth close to \$200 million,¹⁷³ represented less than 0.3% of the company.¹⁷⁴ The Regents would not have come close to qualifying to nominate an Enron director under Rule 14a-11.

State Panel, SUN-SENTINEL (Fort Lauderdale, Fla.), Mar. 24, 2002, at 6B (noting mounting "criticism . . . over the Florida pension fund's losses in Enron stocks and bonds"). Clearly the loss, which represented one-third of 1% of the fund's assets, was financially significant. Similar CalPERS' and CalSTRS' Enron stock represented less than 0.1% of each fund's total portfolio in June 2001. Kathleen Pender, *CalPERS Had Enron Because Many Did*, S.F. CHRON., Dec. 9, 2001, at G1.

¹⁶⁷ *Fortune 500 2011: Top 500 American Companies—Mattel*, CNRMONEY (May 23, 2011), <http://money.cnn.com/magazines/fortune/fortune500/2011/snapshots/272.html>.

¹⁶⁸ As of March 30, 2012, Mattel had a market cap of \$11.51 billion. *MAT Industry: Toys & Games*, YAHOO! FIN., <http://finance.yahoo.com/q/in?s=MAT> (last visited Mar. 30, 2012).

¹⁶⁹ *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 454 (S.D. Tex. 2002).

¹⁷⁰ Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

¹⁷¹ *In re Enron Corp.*, 206 F.R.D. at 442, 459. See generally Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 61–62 (2001) (describing the lead plaintiff provision of the PSLRA).

¹⁷² See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (describing the terms of the Enron settlement and demonstrating the infrequency with which directors are required to contribute personal assets).

¹⁷³ Enron stock peaked at approximately \$83/share. *The Enron Scandal*, USA TODAY, Jan. 21, 2002, at 3B.

¹⁷⁴ At the time of its collapse, Enron had 754.3 million shares outstanding. *Id.*

As the Enron example illustrates, the 3% ownership requirement would have had the effect of limiting proxy access to a very small subset of institutions. Public pension funds, union pension funds, foundations, and the like virtually never hold as much as 3% of a company—holdings of even 1% are comparatively rare because such concentrated holdings increase the risk of a portfolio. Hedge funds often buy stakes of more than 3% but, as discussed below, are unlikely to meet the three-year holding period requirement.¹⁷⁵ The only institutional investors that regularly hold 3% stakes for at least three years are mutual funds, and even then, only a small few funds are likely to achieve that ownership level for any given company.¹⁷⁶ At the same time, mutual funds have historically been among the least active investors in corporate governance. Mutual funds do not serve as lead plaintiffs or submit shareholder proposals.¹⁷⁷ Indeed, until they were forced to do so, mutual funds neither voted their shares¹⁷⁸ nor filed claims to recover their damages in securities fraud litigation.¹⁷⁹

Indeed, the recognition that mutual funds and hedge funds were the most likely investors to meet the ownership threshold may provide some explanation for the second requirement to nominate directors under Rule 14a-11: a three-year holding period. The SEC stated that this requirement would limit nominating power to shareholders with a long-term perspective, based on the premise that a short-term perspective is detrimental to an issuer's long-term performance and that, as a result, the interests of shareholders with a short-term focus are in conflict with those of other shareholders.¹⁸⁰ The empirical

¹⁷⁵ See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1420 tbl.8 (2007) (finding a mean holding period of twenty-one months for hedge fund investments in a sample studied).

¹⁷⁶ See Gerald F. Davis, *A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States*, 5 EUR. MGMT. REV. 11, 16–17 (2008) (documenting increased block ownership by mutual funds from 1999 to 2005).

¹⁷⁷ See Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 880 (2005) (“Mutual funds have failed to participate in securities fraud litigation at all, despite their substantial holdings.”); Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 319 (2008); Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, J. APPLIED CORP. FIN., Winter 2007, at 55, 63 fig.3 (documenting sponsors of corporate governance shareholder proposals).

¹⁷⁸ See H. Anne Nicholson, Note, *Securities Law: Proxies Pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 OKLA. L. REV. 687, 696–97 (2004) (describing the adoption of federal requirements for mutual funds to vote their stock).

¹⁷⁹ See James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 879 (2002) (reporting that mutual funds regularly failed to file claims in successful securities fraud class actions).

¹⁸⁰ Adopting Release, *supra* note 12, at 56,697.

support for this conclusion is limited. Although corporate America has cited the short-termism of institutional investors as a basis for restricting shareholder power,¹⁸¹ there is little evidence that shareholders are able to convince managers to sacrifice long-term firm value in favor of short-term interests.¹⁸² Indeed, short-term investors, because they trade actively, may be better informed.¹⁸³ A recent study by Yan and Zhang found that trading activity by short-term institutional investors forecasts future returns and that the resulting performance does not reverse over a longer time period—refuting the argument that short-term institutions pressure managers to maximize short-term earnings at the expense of long-term returns.¹⁸⁴ The authors found no evidence that long-term institutional investors had superior long-term information or were superior monitors.¹⁸⁵

The three-year holding period, however, would likely have eliminated any remaining shareholders that could have used Rule 14a-11. Empirical studies of hedge fund activism show that, contrary to many claims, activist hedge funds are not particularly short-term in focus.¹⁸⁶ Nonetheless, their median holding period is about twenty months,¹⁸⁷ far less than required by Rule 14a-11. The average mutual fund turnover ratio has gradually increased to almost 100%, meaning that the fund turns over its entire portfolio in a year.¹⁸⁸ Of course, the ratio is an average—some securities are held for just a few months, some for much longer. Nonetheless, actively managed funds are likely to hold relatively few securities for more than three years. In addition, those securities held for longer are least apt to trigger board nominations because the longer holding period likely reflects the portfolio manager's satisfaction with the company's

¹⁸¹ See, e.g., Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 203 (1991) (describing “[t]he short-term bias imposed by institutional stockholders” and suggesting reforms to remedy the problem).

¹⁸² See George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97 (2010) (explaining that no one has demonstrated that shareholders are myopic and that myopic shareholder behavior would conflict with basic principles of market efficiency).

¹⁸³ Xuemin (Sterling) Yan & Zhe Zhang, *Institutional Investors and Equity Returns: Are Short-Term Institutions Better Informed?*, 22 REV. FIN. STUD. 893, 920–22 (2009).

¹⁸⁴ See *id.*

¹⁸⁵ *Id.* at 922.

¹⁸⁶ E.g., Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731 (2008). Bratton finds a similar median holding period of twenty-one months. Bratton, *supra* note 175, at 1420 tbl.8.

¹⁸⁷ *Id.* at 1732.

¹⁸⁸ See Katie Rushkewicz Reichart, *Is Your Manager Trading Too Much?*, MORNINGSTAR (Aug. 18, 2009, 6:00 AM), <http://news.morningstar.com/articlenet/article.aspx?id=304376> (explaining that a firm with a turnover ratio of 100% has an average holding period of one year for its portfolio securities).

performance. A portfolio manager can more readily address a perceived problem by invoking the Wall Street Rule and selling the stock of a disfavored issuer than by nominating candidates for the board.

Even indexed investors that do not actively trade were relatively unlikely to meet the holding requirement of Rule 14a-11. First, because they are indexed, such investors hold relatively small percentages of each portfolio company. Second, fluctuations in the underlying indexes create a significant amount of fluctuation in the resulting portfolios. As CalPERS explained to the SEC, just two-thirds of the securities in its domestic index portfolio as of June 30, 2010, had been in the portfolio three years earlier.¹⁸⁹

The SEC acknowledged the restrictive nature of these requirements. In its adopting release, the SEC admitted that two-thirds of publicly traded companies did not have even a single shareholder that met the holding and ownership requirements of Rule 14a-11.¹⁹⁰ This statistic reflects the significance of the modifications made to the Rule shortly before its adoption.¹⁹¹ The SEC had previously reported that more than 99% of large accelerated filers had at least one shareholder that could meet the ownership and holding period requirements of the proposed rule, more than 85% of accelerated filers had at least one such shareholder, and “roughly 59% of [nonaccelerated] filers . . . ha[d] at least one shareholder” that could meet the requirement.¹⁹² Even under the provisions of the 2003 proposed rule, which would have required the occurrence of a triggering condition, a higher percentage of issuers—42%—had a shareholder that would have qualified for proxy access.¹⁹³

¹⁸⁹ See Letter from Anne Stausboll, Chief Exec. Officer, CalPERS, et al., to Mary L. Schapiro, Chairman, SEC (Aug. 17, 2010) [hereinafter Stausboll Letter], available at <http://www.calpers-governance.org/docs-sof/marketinitiatives/initiatives/proposed-proxy-disclosure-rules.pdf> (reporting that 1570 of 2322 securities were held three years earlier).

¹⁹⁰ See Adopting Release, *supra* note 12, at 56,692. The SEC “estimate[d]” this data based on data collected and reported in its proposing release that related to a one-year holding requirement rather than the three-year requirement adopted in the final rule. *Id.* at 56,690 n.221. Given the significance, in assessing the rule’s rationality, in determining the number of shareholders eligible to use it, it is unclear why the SEC viewed an estimation process as sufficient.

¹⁹¹ *Id.* at 56,690 n.221.

¹⁹² Proposing Release, *supra* note 7, at 29,036; accord Adopting Release, *supra* note 12, at 56,693 (noting that other studies reporting investor ownership levels typically did not include the requirement of a continuous three-year holding period).

¹⁹³ Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,794 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pt. 240, 249, 274).

The SEC's claim that Rule 14a-11 facilitated the exercise of shareholders' state law rights was seriously flawed if the majority of issuers lacked even a single qualifying shareholder.¹⁹⁴ Moreover, qualifying alone was not enough—for proxy access to have been meaningful, those shareholders that qualified must have been willing to use it.¹⁹⁵ Thus, the SEC's release should have included an analysis of the extent to which cost considerations, liability concerns, and institutional structure might have precluded eligible shareholders from seeking to nominate directors under Rule 14a-11,¹⁹⁶ an issue to which this Article will return.

The SEC's attempted solution to these eligibility concerns was the nominating group. Rule 14a-11 granted nominating power to a “nominating shareholder or nominating shareholder group.”¹⁹⁷ Specifically, Rule 14a-11 provided that the 3% holding requirement could be met by a shareholder group that, “in the aggregate, . . . hold[s] at least 3% of the total voting power.”¹⁹⁸ The SEC clearly expected that institutional investors would engage in collective action to form groups with holdings of sufficient size to meet the 3% threshold.

That the rule permitted aggregation did not mean that a qualifying group would have been easy to assemble. The SEC's own data indicated that, at 69% of issuers, a qualifying group would require the participation of six or more shareholders—six or more of the very largest institutional investors.¹⁹⁹ By way of concrete example, CalPERS explained to the SEC in its comments on the proposed rule that aggregating the holdings of the twenty largest pension funds on the share register of Goldman Sachs would result in a holding of only

¹⁹⁴ Somewhat anomalously, for purposes of its cost-benefit analysis, the SEC projected that eleven issuers would receive nominations made by a single shareholder. *See* Adopting Release, *supra* note 12, at 56,744 n.805. Given that two-thirds of public companies lacked even a single shareholder that was eligible to use Rule 14a-11, it is unclear who would have submitted those nominations.

¹⁹⁵ In addition, the SEC did not exclude corporate insiders, such as founders, CEOs, and existing directors, from its statistics on qualifying shareholders, despite the fact that such insiders do not need Rule 14a-11 to influence board composition. For example, the shareholders who own more than 3% of Yahoo! include founders David Filo and Jerry Yang. *See* Yahoo! Inc., Proxy Statement (Form DEF 14A), at 36 (Apr. 29, 2010). Similarly, Warren Buffet and Bill Gates (through the Bill and Melinda Gates Foundation) own more than 3% of Berkshire Hathaway. Berkshire Hathaway Inc., Proxy Statement (Form DEF 14A), at 16–17 (Mar. 11, 2011). Warren Buffet is the company's chairman and CEO, and Gates is a director. *Id.* at 7–8.

¹⁹⁶ The D.C. Circuit did not view this omission as a deficiency in the SEC's economic analysis. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–56 (D.C. Cir. 2011).

¹⁹⁷ Adopting Release, *supra* note 12, at 56,781.

¹⁹⁸ *Id.* at 56,755 n.861.

¹⁹⁹ *Id.* at 56,692.

2.88%.²⁰⁰ Similar data previously released by CalPERS indicated that the ten largest public pension funds together hold less than a 2.5% stake at Bank of America, Microsoft, IBM, and Exxon Mobil.²⁰¹ As will be described below, federal law imposes various burdens on group formation, but even in the absence of those burdens, overcoming the consent and coordination problems necessary to assemble a group of this size is not trivial.

To complicate matters, the SEC was ambiguous with respect to permissible group size and the appropriate methodology to be used in aggregating the holdings of group members. The SEC did not explain whether each individual group member had to satisfy the three-year holding requirement for the total number of shares that it contributed to the group's holdings or whether group members could tack their holding periods. Tacking, which is permitted in other regulatory contexts, such as the calculation of holding periods under Rule 144,²⁰² would enable a shareholder that owns 3% for two years and then sells to another shareholder that holds for an additional year to meet the holding period by forming a group. Similar issues could arise with respect to members of a mutual fund family—would the group satisfy the requirements by holding a net position of at least 3% for three years, or would each fund's contribution to the total be limited to the number of shares that it held individually for the entire three-year period?

Aggregation highlights a more fundamental ambiguity in the SEC's stated objectives. Rule 14a-11 did not limit the number of shareholders whose holdings could be aggregated for the purpose of satisfying the rule. If group size is unlimited, dozens or even hundreds of shareholders might join together to meet the ownership threshold. Yet the SEC's stated rationale for the threshold was to limit nominating power to those shareholders that possess a substantial interest. A large group comprised of smaller holders would likely result in a delegation of power either to a shareholder that does not individually meet the 3% threshold or to a third-party agent or intermediary. Either delegation would be inconsistent with the concerns articulated in the adopting release.

²⁰⁰ Stausboll Letter, *supra* note 189, at 2.

²⁰¹ Lucian A. Bebchuk, *Another View: Don't Gut Proxy Access*, N.Y. TIMES DEALBOOK (June 21, 2010, 9:00 AM), <http://dealbook.nytimes.com/2010/06/21/another-view-dont-gut-proxy-access/>.

²⁰² See 17 C.F.R. § 230.144(d)(3) (2011) (combining the holding periods of acquirer and acquiree for certain transactions, including securities acquired through pledge, gift, or conversion).

The early experience with the selection of a lead plaintiff under the PSLRA highlights the potential challenges posed by allowing aggregation of shareholder interests.²⁰³ Plaintiffs, often with the assistance of counsel, created lead plaintiff groups in an effort to assemble the largest collective interest in the litigation and thereby secure the lead plaintiff appointment.²⁰⁴ In a few notable cases, courts were asked to approve the appointment of lead plaintiff groups consisting of hundreds or even thousands of shareholders that individually lacked substantial financial stakes.²⁰⁵ The formation of these groups created agency costs both because the groups were themselves unwieldy mechanisms for making litigation decisions and because, in some cases, the group was effectively controlled by a third party—in this case, lead counsel—whose financial interests differed from those of the group members.²⁰⁶

Ultimately, courts largely rejected extensive aggregation under the PSLRA as inconsistent with the statutory objectives.²⁰⁷ Nonetheless, even smaller groups pose coordination and collective-action problems. For example, the lead plaintiff group in the *Cendant* case,²⁰⁸ which consisted of three institutional investors, could not reach a consensus position with respect to challenging the fee awarded by the trial court through an auction procedure.²⁰⁹

Even if these ambiguities were resolved, formation of nominating groups would be hindered by existing federal regulatory burdens on collective shareholder action. The adopting release explicitly recognized these

²⁰³ See generally Fisch, *supra* note 171, at 67 (describing formation of large lead plaintiff groups under the PSLRA).

²⁰⁴ *Id.* at 54.

²⁰⁵ See, e.g., *In re Network Assocs., Inc.*, Sec. Litig., 76 F. Supp. 2d 1017, 1019 (N.D. Cal. 1999) (considering lead plaintiff applications from two competing groups, one consisting of more than 1725 investors and the other consisting of over one hundred institutions and thousands of individual investors).

²⁰⁶ See Fisch, *supra* note 171, at 71–73 (explaining how large lead plaintiff groups transfer authority to counsel, creating agency costs).

²⁰⁷ See, e.g., *In re Tarragon Corp.* Sec. Litig., No. 07 Civ. 07972 (PKC), 2007 U.S. Dist. LEXIS 91418, at *4–5 (S.D.N.Y. Dec. 6, 2007) (citing *In re Donnkenny Inc.* Sec. Litig., 171 F.R.D. 156, 157–58 (S.D.N.Y. 1997)). The courts premised their analyses on the explicit statutory purpose of the lead plaintiff: reducing litigation agency costs. See, e.g., *In re Donnkenny Inc.*, 171 F.R.D. at 157–58 (explaining that the appointment of a lead plaintiff group was inconsistent with the statutory goal of “prevent[ing] lawyer-driven litigation”). In contrast to the PSLRA, the SEC’s release adopting Rule 14a-11 contains no such specification of the rule’s objectives, making it impractical for the SEC or a court to find that a particular example of aggregation frustrates those objectives.

²⁰⁸ *In re Cendant Corp.* Sec. Litig., 109 F. Supp. 2d 273 (D.N.J. 2000), *aff’d*, 264 F.3d 286 (3d Cir. 2001).

²⁰⁹ See Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 717 n.363 (2002) (describing the disagreement among the *Cendant* group members).

burdens,²¹⁰ but the rule changes did not offer adequate relief. In the absence of such relief, the potential for formation of nominating groups is substantially reduced. Regulation 14A, for example, requires shareholders that engage in proxy solicitations to file those communications, as well as a proxy statement, with the SEC.²¹¹ The adopting release explicitly stated that shareholder communications in connection with the formation of a nominating group would be treated as proxy solicitations.²¹²

The SEC offered two limited concessions to the need for shareholder collective action under Rule 14a-11. First, the SEC adopted a narrow exemption, in Rule 14a-2(b)(7), for solicitations in connection with the formation of a nominating group.²¹³ To qualify for the exemption, written communications were limited to four items: a statement of the shareholder's intent to form a nominating group, a description of the proposed nominees or the characteristics of intended nominees, the percentage of voting power held by the soliciting shareholder, and the means by which shareholders can contact the soliciting party.²¹⁴ Compliance with these limitations did not exempt the communications from a filing requirement—written communications had to be filed with the SEC as of the date they were first used,²¹⁵ precluding shareholders from testing the waters or exploring whether they wanted to proceed with a 14a-11 nomination before publicly disclosing their intentions. The exemption did not limit the content of oral solicitations, but soliciting shareholders were required to file a Schedule 14N notice as of the time they commenced oral solicitations.²¹⁶

Importantly, the exemption applied only to shareholder nominations conducted pursuant to Rule 14a-11. To the extent that shareholders attempted to nominate a director candidate through other mechanisms, such as state statutory rights or issuer-specific charter provisions, they would have been ineligible for the exemptive provisions of Rules 14a-2(b)(7) and (8). Now that

²¹⁰ See Adopting Release, *supra* note 12, at 56,681 (“We remain concerned that the Federal proxy rules may not be facilitating the exercise of shareholders’ ability under State law to nominate and elect directors . . .”).

²¹¹ See Fisch, *supra* note 5, at 1140–41 (describing regulatory requirements for the solicitation of proxies).

²¹² See Adopting Release, *supra* note 12, at 56,725.

²¹³ See *id.* at 56,780–81. In addition to the new exemption under Rule 14a-2(b)(7), shareholders could continue to use the exemption under Rule 14a-2(b)(2) for solicitations made to no more than ten persons. *Id.* at 56,676.

²¹⁴ *Id.* at 56,781.

²¹⁵ *Id.*

²¹⁶ *Id.* at 56,727.

Rule 14a-11 has been invalidated, shareholders' efforts to form a group for the purpose of meeting a required minimum of nominating shareholders or seconders under issuer-specific nominating procedures will be regulated as proxy solicitations.²¹⁷

Second, once shareholders formed a nominating group pursuant to Rule 14a-11 and filed a Schedule 14N, Rule 14a-2(b)(8) permitted them to solicit on behalf of their nominees, and against the issuer's nominees, without filing a formal proxy statement.²¹⁸ The rule only permitted such solicitations once the shareholders received notice from the issuer that their nominees would be included in the proxy statement.²¹⁹ In addition, the rule required specific disclosures and obligated soliciting shareholders to file all written solicitation materials with the SEC.²²⁰

Commentators raised the concern that these filing requirements imposed an unnecessary burden on shareholder efforts to organize a nominating group.²²¹ The SEC responded that the exemption was sufficient because it provided shareholders "with the opportunity to engage in activities for which they would otherwise need to file a proxy statement or have another exemption available."²²² The SEC did not explain how burdening efforts by shareholders to communicate about the prospect of nominating a director candidate was consistent with either the objectives of Rule 14a-11 or shareholders' state law nominating rights.

Other aspects of the federal securities laws increase the burden on shareholder collective action. Regulation 13D, for example, requires extensive disclosure from shareholder groups whose aggregate holdings exceed 5%.²²³ Rule 13d-1(b) reduces the regulatory burden for most institutional investors by

²¹⁷ See *id.* at 56,729 ("Given the range of possible criteria that companies and/or shareholders could establish for nominations, we continue to believe it would not be appropriate to extend the exemption to those circumstances.").

²¹⁸ See *id.* at 56,781. The SEC previously adopted Rules 14a-2(b)(1) and (6) to exempt proxy solicitations by disinterested shareholders from certain of the proxy rules, including the obligation to file a proxy statement. See 17 C.F.R. § 240.14a-2(b)(1), (6) (2011). New Rule 14a-2(b)(8), which appears to be in effect despite the invalidation of Rule 14a-11, extends this protection to members of a nominating group, so long as they comply with the other requirements of Rule 14a-11. Adopting Release, *supra* note 12, at 56,781. It is unclear how this rule operates in the absence of a valid Rule 14a-11.

²¹⁹ Adopting Release, *supra* note 12, at 56,781.

²²⁰ *Id.*

²²¹ See *id.* at 56,726–27 (describing objections raised by commentators).

²²² *Id.* at 56,727.

²²³ See §§ 240.13d-1(a), 13d-101.

permitting them to file the less burdensome Schedule 13G.²²⁴ Significantly, while a Schedule 13D must be filed within ten days after a shareholder passes the 5% threshold,²²⁵ a 13G need not be filed until forty-five days after the end of the calendar year in which the shareholder has passed the threshold.²²⁶ A 13G filing is permitted, however, only for passive investors.²²⁷ SEC Rule 13d-5(b)(1) explicitly extends the trigger for the disclosure requirements of section 13(d) to group formation for the purpose of voting.²²⁸

As part of the adopting release, the SEC amended the beneficial ownership reporting rules to provide that participation in the 14a-11 nominating procedure would not, by itself, cause an investor to forfeit its eligibility to file a Schedule 13G.²²⁹ The SEC refused, however, to relieve shareholders from the burden of filing a Schedule 13G if their aggregated holdings exceeded 5% and explicitly acknowledged that, as a result of aggregation, some new shareholders would be subject to the 13G filing requirement.²³⁰ In addition, the adopting release warned that a Schedule 13G filing would only be available to those shareholders that limited their activity to that permitted under Rule 14a-11: “[A]ny activity other than those provided for under Rule 14a-11 [such as approaching the board and proposing strategic alternatives] would make the exception inapplicable.”²³¹

The prospect of avoiding filing obligations or potential liability under section 13(d) might, in itself, have created an incentive for shareholders to use Rule 14a-11 to obtain proxy access, rather than to experiment with alternative procedures.²³² The invalidation of Rule 14a-11, however, appears to have rendered this amendment meaningless. As a result, shareholders that engage in

²²⁴ See *id.* § 240.13d-1(b) (describing conditions under which an investor may file a Schedule 13G in lieu of a Schedule 13D); *id.* § 240.13d-102 (setting forth information that must be included in a Schedule 13G filing).

²²⁵ *Id.* § 240.13d-1(a).

²²⁶ *Id.* § 240.13d-1(b)(2).

²²⁷ See *id.* § 240.13d-1(b)(1)(i) (providing that an investor may not have acquired the securities “with the purpose nor with the effect of changing or influencing the control of the issuer”).

²²⁸ *Id.* § 240.13d-5(b)(1). See *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 654 F.3d 276 (2d Cir. 2011) (describing how group formation triggers section 13(d) disclosure requirements).

²²⁹ See Adopting Release, *supra* note 12, at 56,676, 56,680 (describing the amendment to § 240.13d-1(b)(1)(i)).

²³⁰ *Id.* at 56,751.

²³¹ *Id.* at 56,736.

²³² This regulatory advantage would potentially be far more important than any cost savings that proxy access would provide to an activist investor. *Cf.* Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1405 (2011) (arguing that activists such as hedge funds would not use proxy access because the trivial value of the cost savings of proxy access would be outweighed by its disadvantages).

collective action in connection with efforts to nominate director candidates or adopt proxy access procedures risk being treated as a group for purposes of section 13(d) and being subject to the resulting disclosure requirements.

Similarly, the SEC refused to create an exemption from the requirements of Exchange Act section 16 for shareholder groups with aggregated holdings that exceed 10%. The provisions of section 16, although triggered less frequently than those of Regulation 13D, are more onerous in that they are not limited to disclosure requirements. Members of a section 16 group are required to forfeit short-swing trading profits under appropriate circumstances to the corporation.²³³ Again, the SEC explicitly declined to exempt 14a-11 groups from the scope of section 16, explaining merely that, “[b]ecause the ownership threshold . . . for Rule 14a-11 eligibility is significantly less than 10%, shareholders will be able to form groups with holdings sufficient to meet the Rule 14a-11 threshold without reaching the 10% threshold in Section 16.”²³⁴

Critical to the operation of Rule 14a-11 was new Schedule 14N.²³⁵ Schedule 14N, which remains in effect despite the invalidation of Rule 14a-11 and now applies to all shareholder efforts to nominate director candidates, requires extensive disclosure.²³⁶ The SEC has characterized the required disclosure as “similar to that currently required in a contested election.”²³⁷ The requirements are not limited to information about the nominees but include information about the nominating shareholders, such as disclosure of any legal proceeding in which any member of the nominating group has been involved during the past ten years.²³⁸ If members of the nominating group are corporations, the rule requires disclosure by officers, directors, and controlling persons.²³⁹ Because the nominating shareholders are not themselves up for election, this disclosure requirement seems somewhat intrusive, but the SEC explained “that the disclosures will enable shareholders to gauge the

²³³ 15 U.S.C. § 78p(b) (Supp. IV 2010).

²³⁴ Adopting Release, *supra* note 12, at 56,737.

²³⁵ 17 C.F.R. § 240.14n-101 (2011).

²³⁶ The disclosure requirements in prior proposals were even more extensive. *See, e.g.*, Annette L. Nazareth, Comm’r, SEC, Remarks Before the International Corporate Governance Network (Oct. 29, 2007), available at <http://sec.gov/news/speech/2007/spch102907aln.htm> (stating that the proposed disclosure requirements were “more extensive than those in a proxy contest” and “more extensive than that required of someone seeking to take over the company”).

²³⁷ *Facilitating Shareholder Director Nominations*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/info/smallbus/secg/14a-8-secg.htm> (last updated Sept. 19, 2011).

²³⁸ § 240.14n-101(5)(d).

²³⁹ *Id.* § 240.14n-101(5)(c)–(d).

nominating shareholder's or group's interest in the company, longevity of ownership, and intent with regard to continued ownership in the company.”²⁴⁰

The disclosure requirements also present a liability risk for shareholders considering the formation of a nominating group. Schedule 14N requires the nominating group to make various representations regarding the net economic interest of its members, the independence of the nominee, and the group's intention to hold its stock through the date of the annual meeting.²⁴¹ In addition, a Rule 14a-11 nominating group was required to certify that it did not have the intention to change the control of the issuer or to seek more board seats than permitted by the rule.²⁴² The SEC explicitly noted in its adopting release that the nominee, nominating shareholder, and each member of any nominating group are potentially liable for any misrepresentations or omissions in the Schedule 14N and “any other related communication.”²⁴³ Nothing in the release limited liability to a group member's representations about itself. This created the possibility that the SEC or courts would impose on group members the responsibility of verifying the veracity of each other's shareholdings, relationships, and intentions.

In short, the impediments to group formation were substantial, a factor that had to be considered within the context of the large number of shareholders required to create a qualifying group under Rule 14a-11, especially at the larger public companies. The impediments are more substantial with the invalidation of Rule 14a-11 and its limited exemptions, and make it impractical for issuers to adopt nominating procedures that require the formation of nominating groups.

Disclosure, the practical and regulatory requirements associated with group formation, and the other elements of liability exposure make proxy access costly. Many institutional investors are already struggling with limited resources, making it difficult to allocate funding for proxy access. At public pension funds and unions, such allocations may generate political outrage. As Francis Byrd, a managing director at the Altman Group, a proxy solicitation

²⁴⁰ Adopting Release, *supra* note 12, at 56,715.

²⁴¹ See § 240.14n-101 (setting forth disclosure requirements).

²⁴² *Id.* § 240.14n-101(8)(a)(1).

²⁴³ Adopting Release, *supra* note 12, at 56,676 (“Final Rule 14a-9(c) makes clear that the nominating shareholder or group will be liable for any statement in the Schedule 14N or any other related communication that is false or misleading with respect to any material fact, or that omits to state any material fact necessary to make the statements therein not false or misleading, regardless of whether that information is ultimately included in the company's proxy statement.”).

firm, asks, “Can you imagine CalPERS or CalSTRS trying to justify spending \$500,000 on a proxy contest, while the state is struggling to keep libraries open?”²⁴⁴ Similarly, many mutual funds, especially indexed funds, will have difficulty justifying the costs in the face of market pressure to reduce fees and provide competitive returns.²⁴⁵

C. *The Exclusivity of Federal Proxy Access*

The analysis in Part III.B suggests that few shareholders would have met the eligibility requirements of Rule 14a-11. Of those shareholders that qualified, many would not have been interested in shareholder activism. Those that both qualified and were interested would have faced major burdens in terms of compliance costs and liability exposure. One might infer from this analysis a lack of SEC enthusiasm for increasing shareholder nominations. Why did the SEC adopt a federal proxy access rule that did not provide proxy access?

As indicated above, the SEC faced substantial challenges in adopting a proxy access rule. These challenges may have led the SEC to draft its rule narrowly, leaving the market to respond to any perceived deficiencies by providing shareholders with more extensive proxy access rights than those available under Rule 14a-11. Indeed, in the adopting release, the SEC stated that any deficiencies in federal proxy access could be addressed through private ordering.²⁴⁶ The SEC noted that shareholders can adopt issuer-specific nominating procedures that expand the rights provided under Rule 14a-11, such as reducing the requirements described in Part III.B above.²⁴⁷ Indeed, the accompanying amendments to Rule 14a-8 explicitly permitted the use of shareholder proposals to adopt issuer-specific nominating procedures.²⁴⁸

²⁴⁴ *Preparing for the Dodd-Frank Act*, ISS, <http://www.issgovernance.com/weekly/20100723DoddFrank> (last visited Mar. 27, 2012).

²⁴⁵ *See, e.g.*, Fisch, *supra* note 140, at 1989 (describing Fidelity’s and Charles Schwab’s reductions of fund fees in an effort to compete with Vanguard funds).

²⁴⁶ *See* Adopting Release, *supra* note 12, at 56,693 (“Of course, to the extent that shareholders believe the 3% threshold is too high our amendments to Rule 14a-8 will facilitate their ability to adopt a lower ownership percentage.”).

²⁴⁷ *See id.* at 56,755 (noting that issuers’ governing documents may be modified to “enhance[]” the benefits to shareholders by lowering the required ownership threshold or shortening the required holding period).

²⁴⁸ *See id.* at 56,759 (“With the adoption of the amendment to Rule 14a-8(i)(8), shareholders will be able to establish procedures that can further facilitate [their state law nominating power], if they wish.”).

Historically, federal regulation of proxy solicitation has disfavored issuer-specific attempts at private ordering.²⁴⁹ As recounted above, the SEC rules prohibit issuers from adopting a universal ballot combining shareholder and management nominees. Although shareholders have always had the option of nominating director candidates by conducting an independent proxy solicitation, such a solicitation requires the shareholder to file a proxy statement and all solicitation materials with the SEC.²⁵⁰ The SEC directly opposed investor efforts to use the corporate bylaws to establish alternatives to a full-scale election contest.²⁵¹ Even with the amendments to Rule 14a-8, shareholders that successfully propose and adopt issuer-specific nominating procedures will have to comply with the proxy solicitation rules that apply to a full election contest. In addition, shareholders that engage in collective action are subject to the disclosure requirements of section 13(d)²⁵² and, to the extent their collective holdings exceed 10%, may also be subject to the short-swing trading limitations of section 16(b).²⁵³

The SEC's stated rationale for proxy access was to reduce existing impediments to shareholder exercise of state law nominating rights. With respect to shareholder nominations conducted through procedures other than now-invalid Rule 14a-11, however, the new rules did nothing to remove these impediments. Shareholders that nominate directors pursuant to state law, issuer-specific charter or bylaw provisions, or foreign law are not relieved from the filing requirements associated with a full-scale proxy solicitation. The

²⁴⁹ In its 2009 proposing release, the SEC observed that "the director nomination and shareholder proposal processes are two areas in which our current proxy rules pose impediments to the exercise of shareholders' rights." Proposing Release, *supra* note 7, at 29,026. Curiously, this statement is not included in the adopting release.

²⁵⁰ Independent solicitations are also costly. The ministerial costs of printing and mailing a proxy statement may be limited, *see id.* at 29,073 (estimating these costs at \$18,000), although these costs depend on the size of the shareholder base. One proxy solicitation firm estimates that printing and mailing costs range from \$4 to \$6 per investor, resulting in a cost of \$60,000 each time a shareholder conducts a mailing if the company has just 15,000 investors. Julie Connelly, *Proxy Access: Worth Little More Than a Hill of Beans*, CORP. BOARD MEMBER, Third Quarter 2010, at 50, 52. For General Electric, with five million shareholders, these costs are obviously much higher. *Investing with GE: Investor Information, Investor Types*, GE, <http://www.ge.com/investors/investing/index.html> (last visited Mar. 27, 2012).

In addition to the ministerial costs, however, the costs of a contested election include, at a minimum, legal fees, advertising, the costs of a proxy solicitation firm, and the costs of seeking the support of proxy advisors. Connelly, *supra*, at 51–52. By way of example, Carl Icahn stated that he spent over \$1 million in his campaign to gain two board seats in 2009 at Biogen Idec. *Id.* at 51.

²⁵¹ *See AFSCME v. AIG, Inc.*, 462 F.3d 121, 127 (2d Cir. 2006) (describing the SEC's opposition to the inclusion of a shareholder-proposed bylaw amendment).

²⁵² 15 U.S.C. § 78m(d) (2006).

²⁵³ *Id.* § 78p(b).

SEC's rule changes did not permit such shareholders, even if they did not seek control, to take advantage of the limited exemptions from the regulation of proxy solicitations under Rules 14a-2(b)(7) and 14a-2(b)(8). Indeed, shareholder efforts to experiment with nominating procedures by adopting firm-specific charter or bylaw provisions offer a nominating shareholder little advantage under current law over conducting an independent solicitation. Absent a reduction in the regulatory burdens, shareholders have little reason to adopt such procedures.

D. Rationalizing Proxy Access

The foregoing discussion highlights the destructive ambiguity in Rule 14a-11. After so many years of debate, the SEC adopted a proxy access rule that held limited promise in terms of increasing shareholder access to the proxy. Even that limited promise was lost in the face of the SEC's halfhearted defense of the rule. At the same time, the SEC's regulation of proxy solicitations continues to forestall further attempts to increase shareholder nominating power through state law and private ordering. What explains this regulatory approach? Several explanations for the ambiguity in Rule 14a-11 are possible.

First, Rule 14a-11 may simply have reflected caution. Faced with extensive controversy over the likely effects of proxy access, the SEC may have decided to draw the narrowest possible rule in an effort to test the waters. There are three problems with understanding Rule 14a-11 in these terms. First, as described in Part III.B above, the qualification requirements under Rule 14a-11 were so stringent as to preclude virtually all shareholders from using it, making it unlikely that the rule would have provided policymakers with a basis for evaluating the efficacy of expanding shareholder nominating rights. Second, the limited number of shareholders that would have qualified to use the rule were not representative of other shareholders generally or activist shareholders in particular. Third, those shareholders that would have qualified to use Rule 14a-11—those with the largest stakes—were precisely those shareholders that stood to gain the least from the rule because they had the financial resources and sophistication to nominate directors by running independent solicitations.

Finally, as was evident from the opposition to Rule 14a-11 and the immediate court challenge, the SEC will face a substantial battle if it seeks to broaden proxy access in the future. Rule 14a-11's brief life was likely the product of a rare opportunity—the confluence of the 2008 financial crisis and the impetus it supplied for regulatory reform coupled with a rise in the political

power of Democratic officials who were more receptive to shareholder interests. The effectiveness of these forces in generating regulatory reform has already decreased. Given the history of proxy access, SEC officials were presumably aware that the political climate offered them a rare opportunity to adopt a proxy access rule. They could not reasonably have anticipated an opportunity to expand the rule later.

If Rule 14a-11 was not in fact an initial effort to ascertain the effects of increasing shareholder nominating rights, how should it be understood? Perhaps the SEC decided that this highly controversial battle was not the best use of its limited political capital. As indicated above, business interests expended tremendous resources opposing proxy access and predicting horrible effects that would flow from its adoption. The SEC was presented with empirical studies that, although seriously flawed, purported to demonstrate that proxy access would damage firm performance.²⁵⁴ The adopting release failed to confront these comments or to identify their flaws, suggesting the possibility that, in the end, comments from business groups persuaded SEC officials that proxy access was an undesirable governance change.²⁵⁵ Indeed, one might have accused the SEC of sandbagging its economic analysis to provide the

²⁵⁴ Commentators presented the SEC with two empirical studies purporting to show that the SEC's proposed proxy access rules reduce shareholder wealth. See Joseph A. Grundfest, *Measurement Issues in the Proxy Access Debate 2* (Rock Ctr. for Corporate Governance, Working Paper No. 71, 2010). The studies by Akyol and Larcker measured correlations between stock price movements and various significant news events concerning the likelihood that the SEC will adopt a proxy access rule. See Ali C. Akyol et al., *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations*, 46 J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2012), available at <http://ssrn.com/abstract=1526081>; David F. Larcker et al., *The Regulation of Corporate Governance* (May 3, 2010) (unpublished manuscript), available at http://rockcenter.stanford.edu/wp-content/uploads/2010/05/The-Regulation-of-Corporate-Governance_Larcker.pdf. A combination of problematic coding decisions and confounding events raises serious doubts about the studies' empirical claims. In addition, a subsequent study employing a similar methodology reached the opposite conclusion. See Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge 4* (Harvard Bus. Sch., Working Paper No. 11-052, 2011), available at <http://www.hbs.edu/research/pdf/11-052.pdf> (finding that the market placed a positive value on proxy access). Because the SEC does not discuss this research in its releases, it is impossible to determine the extent to which the research influenced the Commissioner's views.

²⁵⁵ It is worth noting that business interests conducted a substantial number of in-person meetings with SEC officials in connection with the proxy access rule making. See *Comments on Proposed Rule: Facilitating Shareholder Director Nominations*, *supra* note 68. Similar meetings were conducted with members of the institutional investor community. *Id.* Although the existence of these meetings is disclosed in the SEC comment files, the substance of the meetings is not. See, e.g., Memorandum from Kayla J. Gillan, Deputy Chief of Staff, SEC, to File No. S7-10-09 (Mar. 31, 2010), available at <http://www.sec.gov/comments/s7-10-09/s71009-648.pdf> (reporting a meeting between SEC officials and the chair of the ABA's Corporate Laws Committee and stating that "[a]mong the topics discussed were the Commission's proposed rules regarding facilitating shareholder director nominations").

D.C. Circuit with an easy basis for invalidating the rule. After all, the D.C. Circuit had previously warned the SEC of its obligation to consider the economic consequences of its rules.²⁵⁶

Why then adopt a proxy access rule at all? The Obama Administration and the SEC leadership had made a variety of public statements avowing their support for proxy access.²⁵⁷ A failure to adopt any rule may have been viewed as a sign of weakness or as catering to the opponents of proxy access. Members of the press who had been following the battle over proxy access with interest touted the adoption of the rule as a shareholder victory despite the rule's limitations.²⁵⁸ Some institutional investors publicly defended the rule, stating that its limitations would ensure that shareholders selected director candidates who enjoyed broad support.²⁵⁹ Notably, the last-minute changes to the prerequisites for using Rule 14a-11, changes that dramatically limited the scope of the rule, received limited public attention.²⁶⁰

Alternatively, the SEC may justifiably have been concerned about the litigation challenge that any proxy access rule was likely to face. In recent years, the SEC's rule making, particularly rule making opposed by business groups, has been repeatedly challenged through litigation. A number of these challenges have been successful, resulting in the invalidation of SEC rules and,

²⁵⁶ See, e.g., *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005) (invalidating SEC rules regulating mutual fund governance and noting the SEC's "statutory obligation to determine as best it can the economic implications of the rule it has proposed").

²⁵⁷ See, e.g., Sarah N. Lynch, *Activists, Take Note: SEC Delays a Proxy Vote*, WALL ST. J., Oct. 3, 2009, at B3 (describing SEC Chair Mary Schapiro as having "championed the proxy-access proposal in response to the financial crisis"); Kara Scannell, *Corporate News: Policy Makers Work to Give Shareholders More Boardroom Clout*, WALL ST. J., Mar. 26, 2009, at B4 (reporting that three of five SEC Commissioners publicly stated their support for proxy access). Although President Obama did not address proxy access directly, he publicly supported increased shareholder voice, including sponsoring Say on Pay legislation, while in the Senate. See Matthew Kirdahy, *Say-on-Pay Edges Closer to Law*, FORBES.COM (Nov. 11, 2008, 3:15 PM), http://www.forbes.com/2008/11/11/say-on-pay-lead-compensation-cx_mk_1110corp-governance.html.

²⁵⁸ E.g., Jessica Holz & Dennis Berman, *Investors Gain New Clout*, WALL ST. J., Aug. 26, 2010, at A1 (stating that the rule gives investors "greater sway" in the selection of directors).

²⁵⁹ See, e.g., Letter from Donna F. Anderson, Vice President & Global Governance Analyst, T. Rowe Price Assocs., Inc., and Darrell N. Braman, Vice President & Managing Counsel, T. Rowe Price Assocs., Inc., to Elizabeth Murphy, Sec'y, SEC (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-218.pdf> ("[T]he rule should be structured to encourage collaboration among investors so as to increase the likelihood that contested elections of non-controlling slates of directors take place primarily at companies where there is broad consensus among shareholders that a change in the boardroom is warranted.").

²⁶⁰ The Administration appeared to back away from proxy access at the eleventh hour, proposing a measure that would have required a 5% ownership threshold—even higher than that adopted by the SEC. See *White House Intervenes to Weaken Corporate Governance Bill*, COMPLIANCE INTELLIGENCE (June 18, 2010), <http://complianceintel.com/articleprint.aspx?articleid=2603470&single=true>.

more significantly, the dismantling of controversial SEC reform efforts. Notable examples include *Goldstein v. SEC*, in which the D.C. Circuit invalidated the SEC's effort to require registration of hedge funds,²⁶¹ and *Chamber of Commerce v. SEC*, in which the court overturned SEC rules imposing increased independence requirements on mutual fund boards.²⁶² The decisions have reduced the SEC's credibility and power in pursuing its regulatory agenda.

SEC Chair Mary Schapiro clearly anticipated a legal challenge to whatever proxy access rule the Commission adopted.²⁶³ The SEC may have believed, however, albeit erroneously, that adopting a highly restrictive rule would reduce the incentive for business interests to challenge the rule or reduce the willingness of the D.C. Circuit to invalidate such a rule. It is plausible to believe that business interests might have been deterred from challenging a proxy access rule if its requirements were so stringent as to make its use virtually impossible. This may also explain the lack of protection afforded to private ordering; a regulatory approach that reduces the incentive for institutional investors to push for greater access through state law or private ordering favors business interests.

It is possible that the SEC saw proxy access, like the shareholder proposal rule, not as a tool for increasing the effectiveness of shareholder voting but as a communication device. The SEC has long defended the value of shareholder proposals in communicating shareholder views to management;²⁶⁴ indeed, the shareholder proposal rule existed and was used for four decades despite the fact that shareholder proposals virtually never received majority approval.²⁶⁵

²⁶¹ 451 F.3d 873, 874, 884 (D.C. Cir. 2006).

²⁶² 412 F.3d 133, 145 (D.C. Cir. 2005); *accord* *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 936 (D.C. Cir. 2009) (invalidating SEC regulation of indexed annuities), *amended by* 613 F.3d 166 (D.C. Cir. 2010); *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 493 (D.C. Cir. 2007) (vacating an SEC effort to exempt broker-dealers from certain statutory requirements).

²⁶³ See Martha Graybow, *Schapiro Braces for Fight over Proxy Access*, REUTERS (Apr. 29, 2009, 1:56 PM) <http://www.reuters.com/article/idUSTRE53S6I520090429> (paraphrasing Schapiro as saying that "litigation may result from whatever rule change is endorsed").

²⁶⁴ See, e.g., Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018, Investment Company Act Release No. 23,200, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (codified at 17 C.F.R. § 240.14a-8) (explaining, as basis for overturning its prior controversial *Cracker Barrel* no-action position, that "we have gained a better understanding of the depth of interest among shareholders in having an opportunity to express their views to company management on employment-related proposals that raise sufficiently significant social policy issues").

²⁶⁵ See Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 883 (1994) ("As of 1981, only two contested shareholder proposals of the thousands submitted had ever won.").

The “proposals-as-communication” perspective is reflected in the SEC’s encouragement of nonbinding or precatory proposals,²⁶⁶ proposals that have no predicate in state law and that Vice Chancellor Strine has termed “imaginary voting.”²⁶⁷ Although precatory proposals have no legal effect even if they receive majority approval, they enable shareholders to communicate with each other.²⁶⁸ Senator Dodd defended precatory proposals as providing shareholders with “an essential democratic shareholder right to speak to each other.”²⁶⁹ This view of shareholder voting as a communication device is also reflected in the advisory votes on executive compensation mandated by Dodd–Frank.²⁷⁰

Like the submission of a precatory proposal, filing a Schedule 14N enables shareholders to communicate their dissatisfaction with the issuer’s board candidates even if the shareholders do not succeed in assembling a nominating group or electing a shareholder nominee to the board. Indeed, the practical obstacles to successful shareholder use of Rule 14a-11 were unimportant if the rule was not designed to enable shareholders to nominate and elect director candidates.

Further support for this communication reading of Rule 14a-11 can be found in the SEC’s decision to extend its coverage to controlled companies. In controlled companies, minority shareholders—those other than the controlling shareholder—lack sufficient voting power to influence director elections. Despite the seeming futility of a rule allowing minority shareholders at such companies to nominate directors, the SEC refused to exempt controlled companies from the rule.²⁷¹ In so doing, the SEC conceded that the purpose of allowing proxy access at these companies was not to further the election of

²⁶⁶ See Fisch, *supra* note 18, at 54–55 (describing the SEC’s “creat[ion]” of the precatory proposal in 1976).

²⁶⁷ *Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law*, U.S. SEC. & EXCH. COMM’N (May 7, 2007), www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf; accord Strine, *supra* note 5, at 1088 (describing precatory proposals as “a pretend polity under Rule 14a-8 that had no reference to principles of state law” (footnote omitted)).

²⁶⁸ See, e.g., Paul S. Atkins, Comm’r, SEC, Shareholder Rights, the 2008 Proxy Season, and the Impact of Shareholder Activism, Address Before the U.S. Chamber of Commerce (July 22, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch072208psa.htm> (describing and criticizing precatory proposals).

²⁶⁹ Press Release, U.S. Senate Comm. on Banking, Hous., & Urban Affairs, Dodd Stands Up for Shareholder Rights (Nov. 1, 2007), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=796095f1-ade9-4777-9b56-587b06cf6430&Region_id=&Issue_id=

²⁷⁰ Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified as amended at 15 U.S.C. § 78n-1 (Supp. IV 2010)) (requiring the SEC to adopt rules requiring advisory votes on Say on Pay).

²⁷¹ See Adopting Release, *supra* note 12, at 56,685–86.

shareholder-nominated directors: “[T]hrough applying Rule 14a-11 to controlled companies would be unlikely to result in the election of shareholder-nominated directors . . . , we appreciate that shareholders at controlled companies may have other reasons for nominating candidates for director.”²⁷²

A related theory is that Rule 14a-11 was designed to raise the level of director discomfort without presenting a real threat of contested elections. Public company directors are highly sensitive to visible criticism. Withhold votes and negative Institutional Shareholder Services (ISS) recommendations, even in the context of an uncontested election in which the directors face no realistic threat of replacement, cause them concern.²⁷³ As a result, proxy access may be understood to offer institutions a bargaining chip with which they could demand board responsiveness or at least board attention in exchange for foregoing the steps associated with forming a nominating group.

Finally, the SEC may simply have lost perspective. After years of considering proxy access—years in which opponents raised vigorous challenges to every proposed rule-making effort—the SEC was derailed by the effort to address each of these potential challenges.²⁷⁴ Each response led, in turn, to additional line drawing. Commentators argued, for example, that activist shareholders would use proxy access to circumvent the rules governing control contests.²⁷⁵ Rather than evaluating whether the disclosure requirements of Schedule 14N and the other restrictions of Rule 14a-11 provided adequate protection in the context of a control contest,²⁷⁶ the SEC attempted to identify

²⁷² *Id.*

²⁷³ See AMY L. GOODMAN ET AL., PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES § 10.03 (5th ed. 2010) (describing issuer compliance with ISS policy guidelines to avoid withhold recommendations).

²⁷⁴ In part, this response may be a byproduct of the notice-and-comment rule-making process. Over the years, as the SEC has attempted to structure its rule making to consider all possible arguments and objections to proxy access, its proposals have become increasingly complex. As James McRitchie puts it:

I’m afraid too many will be distracted by the hundreds of questions raised by the SEC, the labyrinth of language only an SEC attorney could love, and the need to arrive at a consensus document that all with a vested interest in the status quo can at least live with.

James McRitchie, *Proxy Access*, CORPGOV.NET (Aug. 20, 2009), <http://corpgov.net/2009/08/proxy-access/>.

²⁷⁵ See, e.g., Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth Murphy, Sec’y, SEC 3–4 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> (identifying provisions of Rule 14a-11 that, in combination, might allow shareholders to obtain a change in control).

²⁷⁶ Significantly, most contested solicitations for director elections include shareholder nominations for only a minority of board seats. See *SEC Grants No-Action Relief to Activist Shareholders Seeking to “Round Out” Short Slates with Each Other’s Nominees*, GIBSON DUNN (Apr. 2, 2009), <http://www.gibsondunn.com/publications/pages/SECGrantsNo-ActionReliefToActivistShareholdersSeekingtoRoundOutShortSlates.aspx> (explaining that running a “short slate” has become “the preferred approach for dissidents seeking board representation” (internal quotation marks omitted)). Among the reasons for this approach is that proxy

the appropriate percentage of director candidates that would not pose a control threat.²⁷⁷ Limiting the number of nominees forced the SEC, in turn, to formulate procedures to choose among candidates proposed by multiple nominating groups.²⁷⁸

The same can be said for the required ownership threshold and holding period. Critics warned that proxy access would give union pension funds and other special interest groups a tool to use against existing management.²⁷⁹ The SEC responded by adopting a 3% ownership requirement—effectively precluding unions and similar special interest groups from using the rule. Critics expressed concern about the short-term objectives of hedge funds, which frequently assemble holdings of greater than 3%.²⁸⁰ The SEC again responded by imposing a three-year holding period designed to preclude hedge funds as well. As former Commissioner Paul Atkins explained it, the SEC was attempting “to find the magic number where ‘good’ shareholder groups (like state pension funds) are in, but ‘bad’ groups (politically incorrect shareholders, like hedge funds) are out.”²⁸¹

The SEC’s efforts to avoid all possible bad effects or “unintended consequences”²⁸² may have led it to choose instead a rule that would have had no consequences, intended or otherwise. Importantly, the SEC’s focus was seemingly on avoiding bad consequences rather than identifying an affirmative value to increasing shareholder nominating power and determining the changes necessary to achieve that value. This evaluation, of course, would have brought the SEC into the core of the corporate governance debate, an area the SEC has

advisors, such as ISS, are more likely to support activists who are not seeking to replace a majority of the board. *Id.*

²⁷⁷ Adopting Release, *supra* note 12, at 56,706–07 (explaining the rationale for the limitation of 25% in terms of preventing the use of Rule 14a-11 for control contests).

²⁷⁸ *Id.* at 56,710–11.

²⁷⁹ See, e.g., Christine Hall, *Dodd–Corker Fed Bill May Contain Left-Wing “Shareholder” Power Grab*, COMPETITIVE ENTERPRISE INST. (Mar. 3, 2010), <http://cei.org/news-releases/dodd-corker-fed-bill-may-contain-left-wing-shareholder-power-grab> (reporting that a coalition of seventeen groups expressed these concerns in opposition to Dodd–Frank’s proposed proxy access provision).

²⁸⁰ See, e.g., Letter from Darla C. Stuckey, Soc’y of Corporate Sec’y & Governance Prof’ls, to Elizabeth M. Murphy, Sec’y, SEC 1 (Jan. 19, 2010), available at <http://www.sec.gov/comments/s7-10-09/s71009-610.pdf> (“[M]any hedge funds seek to direct the operations of a company with a view to short-term profitability or otherwise to the detriment of the long-term interest of companies and their shareholders.”).

²⁸¹ Paul Atkins, *The SEC’s Sop to Unions*, WALL ST. J., Aug. 27, 2010, at A15.

²⁸² Melissa Klein Aguilar, *Proxy Access Debate Rages On*, COMPLIANCE WEEK (Aug. 18, 2009), <http://www.complianceweek.com/article/5545/proxy-access-debate-rages-on>.

struggled to avoid since the 1990 *Business Roundtable* decision.²⁸³ Any debate over proxy access that fails to evaluate its effect on the allocation of power between shareholders and managers is, however, destructively ambiguous because the best argument in favor of proxy access—increasing board accountability—requires that proxy access increase shareholder power. Similarly, the most potent arguments against proxy access are based on claims that increasing shareholder power is ill-advised. In the following section, this Article turns to the corporate governance debate and demonstrates how the role of proxy access within the context of corporate governance highlights the limitations of federal rule making.

IV. PROXY ACCESS AND CORPORATE GOVERNANCE

The SEC's failure to articulate a normative justification for proxy access was the primary source of the ambiguity in Rule 14a-11. The SEC did not offer empirical support for the proposition that U.S. corporate governance is defective or explain how the proxy access provided by Rule 14a-11 would improve it.²⁸⁴ Nor did the SEC provide a theory as to how shareholders might, through proxy access, increase board accountability. The SEC did not demonstrate that public company boards are insufficiently responsive to shareholder interests; indeed, some scholars have argued that the 2008 financial crisis was exacerbated by an excessive focus on shareholder interests.²⁸⁵ Nor did the SEC explain how the nomination and election of directors representing a minority of the board is likely to impact board decision making.²⁸⁶

These questions about the desirability of proxy access implicate fundamental issues of corporate governance—determining the optimal

²⁸³ See Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 783–84 (1994) (explaining the SEC's caution in regulating corporate governance because of ongoing questions over its statutory authority to do so).

²⁸⁴ Commentators are divided on this point. Compare Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1 (2009) (arguing that the financial failure did not demonstrate the existence of a governance problem), with Grant Kirkpatrick, *Corporate Governance Lessons from the Financial Crisis*, 2009 OECD J.: FIN. MARKET TRENDS, no. 1, at 61 (identifying failures in board oversight as a substantial factor contributing to the financial crisis).

²⁸⁵ See, e.g., William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 720–22 (2010) (explaining that focus on shareholder value maximization led financial firms to take excessive risks).

²⁸⁶ At least one study has considered the impact on stock returns of a dissident obtaining minority board representation. See CERNICH ET AL., *supra* note 4, at 25–37 (surveying 120 hybrid boards and evaluating their effect on governance structures and shareholder value).

equilibrium between management and shareholder power, evaluating the extent to which the existing allocation of power has deviated from that optimal balance, and assessing whether the regulatory reform under consideration is likely to restore that balance. Critics and commentators strongly disagree about these points.²⁸⁷ Reviewing and evaluating that debate is a difficult task that extends beyond the scope of this Article. The challenges presented by this task create substantial impediments to SEC efforts to regulate shareholder nominating power through a federal proxy access rule. In this Part, this Article identifies the problems inherent in mandatory federal regulation of corporate governance.

A. *Proxy Access and Corporate Governance*

Shareholder nominating power—which, in turn, is an element of shareholder voting power—is a component of corporate governance: the mechanisms that allocate power between shareholders and management.²⁸⁸ This allocation of power addresses operational decision making and, in the public corporation, attempts to minimize the agency costs that result from the separation of ownership and control.²⁸⁹ Critically, to function well, corporate governance must maintain a balance between managerial and shareholder power.²⁹⁰ Excess managerial power increases managerial agency costs.²⁹¹ Excess shareholder power creates inefficiency and may, in some cases, create intrashareholder agency costs.²⁹²

²⁸⁷ Compare Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) (arguing that the existing allocation of power is insufficient to enable shareholders to initiate value-increasing changes), with Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579–83 (2006) (arguing that large shareholders will use any increase in shareholder power to obtain private gains at the expense of the firm and other shareholders), and Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1758 (2006) (claiming that the existing system of limited shareholder voting rights provides “substantial efficiency benefits”).

²⁸⁸ See JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 2 (2008) (explaining that corporate governance is a “framework of institutions and processes” that, “[t]aken together, . . . determine how power within a company is exercised”); *id.* at 50 tbl.3.1 (listing major corporate governance mechanisms for U.S. public companies).

²⁸⁹ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976) (describing agency costs that result from separation of ownership and control).

²⁹⁰ See *id.*

²⁹¹ See *id.*

²⁹² See Nina Walton, *On the Optimal Allocation of Power Between Shareholders and Managers* (Univ. of S. Cal. Law Sch. Law & Econ. Working Paper Series, Paper No. 118, 2011), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1172&context=usclwps> (modeling governance rules in an effort to evaluate this trade-off).

A variety of governance mechanisms contribute to the balance of power in the public corporation. Internal governance mechanisms include the allocation of decision-making authority established by the corporation's statute, charter, and bylaws as well as the ability of shareholders to impose accountability on director decisions through their power to elect and remove board members. Internal governance mechanisms also include the poison pill, which increases management power in the takeover context,²⁹³ and the ability of shareholders to call a special meeting, which enhances shareholder power.²⁹⁴ External governance mechanisms include gatekeepers such as credit rating agencies, regulators, and the disciplinary effect of the capital markets.²⁹⁵

Evaluating the effect of corporate governance mechanisms or changes to those mechanisms is difficult. First, a specific governance mechanism does not exist in isolation. Its effectiveness is based on its interaction with other aspects of a firm's governance structure. Bebchuk, Coates, and Subramanian, for example, found that the impact of a staggered board on management power to resist a takeover attempt was greatly enhanced when the staggered board was coupled with a poison pill.²⁹⁶ Similarly, Coates has noted that the effects of staggered boards, which are typically viewed as a powerful management entrenchment device, are avoidable in companies at which shareholders have the right to expand the board or remove directors without cause.²⁹⁷ Alternative governance mechanisms may also serve as substitutes.²⁹⁸

²⁹³ See Shira Ovide, *Marty Lipton: Why I Invented the Poison Pill*, WALL ST. J. DEAL J. BLOG (Dec. 29, 2010, 1:33 PM), <http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/> (paraphrasing Marty Lipton as explaining that he invented the poison pill "to give boards of a target company a chance to 'level the playing field'").

²⁹⁴ See Ted Allen, *Showdown over Special Meetings*, ISS (Jan. 20, 2010, 1:36 PM), <http://blog.issgovernance.com/gov/2010/01/showdown-over-special-meetingssubmitted-by-ted-allen-publications.html> (explaining the controversy over proposals that give shareholders the right to call special meetings).

²⁹⁵ See, e.g., MACEY, *supra* note 288, at 50 tbl.3.1.

²⁹⁶ Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 904 (2002) ("Pills made staggered boards important.").

²⁹⁷ See John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1352 tbl.3 (2001) (finding that these provisions made the staggered boards ineffective for 18% of issuers in the study).

²⁹⁸ See Greg Hallman et al., *Carrots and Sticks: The Threat of Dismissal and Incentive Compensation 3–5* (Oct. 21, 2004) (unpublished manuscript), available at <http://www.areuea.org/conferences/pdf/52/723.pdf> (describing the substitution effect of two governance mechanisms in management compensation—the threat of termination and pay for performance).

Internal and external governance mechanisms further interact.²⁹⁹ For example, scholars have devoted the greatest effort to attempting to assess the impact of antitakeover mechanisms on corporate performance based on the premise that, by reducing the disciplinary effect of the market for corporate control, antitakeover mechanisms reduce board and management accountability. Studies of any specific antitakeover mechanism are difficult to evaluate, however, in that an issuer's susceptibility to a takeover is a function of a multiplicity of governance mechanisms that may include a poison pill and a staggered board, a state antitakeover statute, and judicially adopted legal standards for review of a board's conduct in the takeover context.³⁰⁰

The second challenge in evaluating governance mechanisms is that their effectiveness depends on firm-specific characteristics, including the firm's existing management team, its shareholder base, and its life-cycle stage. A firm with a long-term, imperial CEO, for example, may require greater director independence. A mature company may be run by managers who are unduly inclined to engage in empire-building mergers or to retain excessive cash flows. Firms owned by a high percentage of retail investors may face excessive free riding and apathy, while those with many activist owners may be influenced by short-termism or conflicting shareholder objectives. The very governance mechanisms that are valuable for some firms impose excessive costs upon others. In particular, increasing board accountability by enhancing shareholder power is likely to be valuable for poorly managed firms and wasteful, at best, for well run issuers.³⁰¹

Finally, the governance needs of issuers are dynamic. In addition to the firm-specific factors described above, which can change over the life cycle of an issuer, a variety of market, economic, and even political developments can disrupt the equilibrium between management and shareholder power.³⁰² The

²⁹⁹ See Stuart L. Gillan et al., *Explaining Corporate Governance: Boards, Bylaws, and Charter Provisions* (John L. Weinberg Ctr. for Corporate Governance, Working Paper No. 2003-03, 2003), available at <http://ssrn.com/abstract=442740> (explaining that such mechanisms "interact to determine a firm's governance environment").

³⁰⁰ See, e.g., Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 471 (1995) (reviewing ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993)) (questioning event studies that analyze the wealth effect of antitakeover mechanisms without controlling for other factors that affect the firm's vulnerability to execute a takeover).

³⁰¹ See *id.* at 469 (explaining how provisions that increase management discretion may increase the value of well-managed firms but decrease the value of poorly managed firms).

³⁰² Similarly, such developments can change the effect of specific governance mechanisms. Robert Daines conducted a highly publicized study concluding that Delaware incorporation was associated with increased firm value. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 555 (2001).

dramatic increase in the institutionalization of the U.S. securities markets, for example, has increased the potential disciplinary effect of shareholder voting power.³⁰³ The adoption by many firms of majority voting is likely to have a similar effect.³⁰⁴ In contrast, the Delaware Supreme Court's adoption of the *Unitrin* standard³⁰⁵ enhanced management power by reducing the susceptibility of issuers to the discipline of the takeover market.³⁰⁶

Several distinctive features render state corporate law robust to firm-specific differences and market and regulatory developments, as discussed in more detail below. First, state law is largely enabling, rather than mandatory. Second, state law is subject to regulatory competition.³⁰⁷ Third, the development of state law is incremental. These features, which are absent in federal securities regulation, enable state law to maintain an equilibrium in the allocation of power between managers and shareholders.

Although state corporation statutes constrain some issuer choices, in most cases, state statutes provide default rules that enable issuers to customize their governance structures. With respect to shareholder power to elect directors, for example, statutes offer a variety of choices, allowing shareholders to elect directors through majority or plurality voting, permitting supermajority voting requirements, and authorizing special voting structures, such as staggered

Daines identified Delaware's takeover law as one possible explanation for this result. *Id.* When Guhan Subramanian extended Daines's analysis for a subsequent time period, he found that the "Delaware effect" had disappeared. Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 33 (2004). One possible explanation for the difference was a change in the importance of state takeover law between the respective time periods. *Id.* at 52–53.

³⁰³ See Fisch, *supra* note 159, at 879–80 (citing statistics on the growth in institutional ownership of publicly traded equity).

³⁰⁴ See J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007, 1009 (2007) (explaining how majority voting "could serve to alter significantly the balance of power between shareholders and board members").

³⁰⁵ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1373–74 (Del. 1995).

³⁰⁶ In *Unitrin*, the Delaware Supreme Court clarified that proportionality review under *Unocal* required an assessment of whether the defensive measure was "preclusive" or "coercive" and, if not, whether it fell within a "range of reasonableness." *Id.* at 1387–89; see also Paul L. Regan, *What's Left of Unocal?*, 26 DEL. J. CORP. L. 947, 967–68 (2001) (explaining how the *Unitrin* decision disrupted the director–shareholder balance of power).

³⁰⁷ Although issuers can elect to incorporate in any state, the majority of public corporations incorporate in Delaware. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1061 (2000). I have argued that the flexibility and responsiveness of Delaware corporate law are distinctive features that explain, in part, Delaware's attractiveness as a state of incorporation. See *id.* at 1064. Consequently, the following discussion focuses heavily on Delaware law.

boards, cumulative voting, tenured voting, and nonvoting stock.³⁰⁸ Statutes enable firms to allocate voting rights among multiple share classes and, in some cases, permit corporations to grant nonshareholders the right to elect directors.³⁰⁹ State law also permits issuers to adopt charter and bylaw provisions that limit or condition shareholder nominating power, such as qualification requirements for directors and advance notice bylaws.³¹⁰

This enabling character allows firms to fine-tune their governance structures to reflect differences in their shareholder bases, the extent to which they have a high percentage of institutional investors, the need to protect distinctive shareholder groups such as founding families, the extent to which managers are substantial shareholders, and so forth. Fundamentally, the range of available choices reflects the fact that the optimal structure and distribution of voting power will not be identical for all firms and that customization will increase the efficiency of the shareholder franchise. The enabling approach also furthers experimentation. Issuers can introduce a variety of mechanisms for increasing shareholder participation in the selection of directors, and their workability and legality can be assessed on a case-by-case basis.³¹¹

The flexibility provided by enabling statutes is further enhanced by regulatory competition. Corporate law allows corporations to choose the state in which they are incorporated and, as a result, the law that will govern the corporation's internal affairs. Regulatory competition enables issuers to choose from a menu of corporate structures and features and creates a natural experiment in the effectiveness of specific governance provisions. Regulatory competition provides two independent values. First, state differences allow product differentiation. Nevada offers a legal regime that is particularly management-friendly,³¹² for example, and North Dakota recently adopted a

³⁰⁸ Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 408–10 (1983).

³⁰⁹ See, e.g., N.Y. BUS. CORP. LAW § 703(a) (McKinney 2003) (authorizing the certificate of incorporation to provide bondholders with the right to elect one or more directors).

³¹⁰ See, e.g., *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008) (upholding board power to adopt advance notice bylaws).

³¹¹ See Strine, *supra* note 5, at 1098 (explaining how the enabling approach enables “livable practices . . . to emerge and awkward ones to be discarded,” judicial review to test the validity of new practices, and “state statute writers” to address dissatisfaction with the judiciary’s treatment).

³¹² See Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1856 (2002) (describing Nevada’s distinctive provisions and observing that “Nevada has 15% of the non-Delaware out-of-state incorporations market”).

distinctively shareholder-friendly regime.³¹³ Second, individual states provide laboratories for experimentation with innovations that can be subjected to a market test and, if successful, adopted more broadly. State antitakeover statutes³¹⁴ and statutes authorizing director exculpation provisions in corporate charters³¹⁵ are two examples in which such innovations spread and, over time, were adopted by the majority of states.³¹⁶

Third, the development of state law is incremental.³¹⁷ State judicial decisions employ a common law methodology that maintains consistency and stability while providing the flexibility for courts to adapt legal rules to new developments.³¹⁸ The Delaware cases concerning the scope of director fiduciary duties in the takeover context,³¹⁹ for example, involved a series of adjustments to the relative power of shareholders and boards, adjustments that were able to reflect changes in the structure of hostile tender offers, the development of financing structures, such as junk bonds, and the interaction of state fiduciary principles with other regulatory developments, such as state antitakeover statutes and the Williams Act.³²⁰

Legislative intervention, which frequently occurs as a response to issues that have been developed through the factual context of specific disputes,

³¹³ See N.D. CENT. CODE § 10-35-01 to -33 (2007).

³¹⁴ See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 735–36 (1998) (describing the spread of state antitakeover statutes).

³¹⁵ See Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (describing how Delaware's innovative provision authorizing director exculpation "diffused rapidly among the states").

³¹⁶ See Carney, *supra* note 314, at 737–41 (citing other examples of provisions that spread among states).

³¹⁷ See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 683 (2005) (describing incremental evolution of Delaware corporate law through Chancery Court decisions).

³¹⁸ See, e.g., GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* 4 (1982) ("The incremental nature of common law adjudication meant that no single judge could ultimately change the law, and a series of judges could only do so over time and in response to changed events or to changed attitudes in the people.").

³¹⁹ A similar evolution can be seen in the Delaware decisions over the duty of good faith. Initially, a series of decisions seemed to articulate good faith as a distinctive fiduciary duty, supplementing the preexisting duties of care and loyalty. *E.g.*, *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."). Perhaps in response to subsequent lawsuits that suggested that the duty had the potential to create excessive litigation, thereby chilling the board's discretionary decision making, the courts cut back, retreating from the characterization of good faith as a separate duty and limiting the scope of its reach. *E.g.*, *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) ("[T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.").

³²⁰ See Regan, *supra* note 306, at 951–70 (recounting the evolution of Delaware case law concerning director fiduciary duties in the takeover context).

offers a corrective measure for reconsideration of judicially created rules. Unlike federal regulation, which is typically an initial regulatory response, corporate legislation is frequently a second step, taken after courts have attempted to apply existing legal rules to a variety of fact patterns and the legislature has been able to observe the consequences.³²¹ As Ed Rock explains, “[T]he Delaware legislature and courts cannot promulgate ex ante the standards to govern new situations until they see a variety of cases and figure out how well or badly people behaved.”³²² Thus, after the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*³²³ appeared to subject outside directors to excessive liability risk, the legislature authorized director exculpation charter provisions.³²⁴ When the Supreme Court rejected a proxy reimbursement bylaw as invalid under Delaware law,³²⁵ the legislature amended the statute to authorize proxy reimbursement bylaws.³²⁶

B. Federalizing Proxy Access

Federal proxy access offers none of the advantages of state corporate governance described in the preceding section. As a general matter, federal regulation does not provide the opportunities for experimentation and variation offered by state law. Federal regulation imposes mandatory and uniform rules on issuers and limits the options for opting out of these rules.³²⁷ Mandatory rules increase the stakes involved for regulators such as the SEC in ascertaining the optimal regulatory structure. They also reduce the potential for competition and the market to discipline politically motivated choices that may be inefficient.³²⁸ In contrast, rules that allow issuer-specific choice produce valuable evidence on the efficiency of regulatory choices, both directly by producing the variation needed to assess the effects of the rules and indirectly by prompting issuers to opt out of inefficient regulation.³²⁹

³²¹ See Strine, *supra* note 5, at 1098 (“[I]f either the stockholders or managers are dissatisfied by the judiciary’s treatment of those proposals, pressure will be put on state statute writers to address their concerns.”).

³²² Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1102 (1997).

³²³ 488 A.2d 858 (Del. 1985).

³²⁴ Romano, *supra* note 315, at 1160.

³²⁵ CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 239–40 (Del. 2008).

³²⁶ DEL. CODE ANN. tit. 8, § 113 (Supp. 2011).

³²⁷ See ROMANO, *supra* note 300, at 86–96 (summarizing arguments in the debate over mandatory versus enabling corporate law).

³²⁸ See *id.* at 82–83.

³²⁹ An example is the takeover context. Empirical studies reported a substantial negative price effect on issuers that were subject to the restrictive Pennsylvania antitakeover statute. See, e.g., P.R. Chandey et al., *The*

That is not to say that mandatory rules are always inappropriate. As the preceding section has explained, however, uniform national rules are likely to be suboptimal tools for regulating corporate governance. In particular, shareholder nominating power is embedded in the state regulatory framework of shareholder voting. State law is the source of shareholder voting power. State law provides the tools by which issuers can customize shareholder voting power through charter and bylaw provisions. State law supplies the fiduciary principles that limit management power to interfere with shareholder voting rights.³³⁰ Shareholder nominating rights interact with both the scope of their substantive voting rights and the structural mechanisms that govern the voting process.

Both this interaction and the difficulty of evaluating the effect of corporate governance regulation create challenges for the regulation of shareholder nominating power. Federal regulation is poorly suited for the kind of experimentation that is particularly valuable in an area in which it is difficult, *ex ante*, to identify the optimal regulatory approach.³³¹ The process is complicated by the heavily politicized nature of the SEC rule-making process. The massive letter-writing campaigns and lobbying efforts associated with the SEC's consideration of proxy access contributed to regulatory gridlock and vastly complicated the task of structuring the regulation. The nature of proxy access, which involves a shift of power from concentrated and well-funded corporate managers to dispersed investors with comparatively small stakes, increased the potential that the rule-making record would be distorted.³³² Under private ordering, issuers could vary their nominating procedures, and

Shareholder Wealth Effects of the Pennsylvania Fourth Generation Anti-Takeover Law, 32 AM. BUS. L.J. 399, 403 (1995). Because the statute provided an opt-out provision, however, issuers could and did avoid the price effect by exercising their ability to opt out. *See id.*

³³⁰ *See, e.g.,* *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988) (articulating the heightened standard of "compelling justification" for review for board decisions that interfere with the shareholder franchise).

³³¹ As Vice Chancellor Strine explains, private ordering through issuer-specific bylaws enables "the market [to] assess what works best without the high costs that come with the imposition of an unproven, invariable mandate." Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 7 (2010).

³³² *See* NEIL K. KOMESAR, *IMPERFECT ALTERNATIVES* 62–63 (1994) (explaining how concentrated groups with large stakes can present distorted pictures of the public interest to political officials); *cf.* Letter from Joseph A. Grundfest, Co-Dir., Rock Ctr. on Corporate Governance, to Elizabeth M. Murphy, Sec'y, SEC (Jan. 18, 2010), *available at* www.sec.gov/comments/s7-10-09/s71009-599.pdf (attaching a working paper for the purpose of "drawing the Commission's attention" to two highly flawed empirical studies that demonstrated, according to the commentator, that "proxy access . . . is inimical to the best interests of the shareholder community as a whole").

one issuer's approach could differ from that of its competitor. This variation eliminates the pressure to ensure that a single mandated rule is optimal.

Nor can federal regulation be defended, in the context of proxy access, as a necessary response to the inability of shareholders to obtain minimally acceptable levels of proxy access through state law and private ordering.³³³ First, as indicated above, the level of proxy access that Rule 14a-11 provided to investors was truly minimal. To the extent that few, if any, shareholders would have qualified to use Rule 14a-11 and that those few qualifying shareholders already had sufficient access to the proxy by mounting an election contest, Rule 14a-11 did not remedy any existing obstacles.³³⁴ Second, federal regulation, not state law, has historically been the dominant obstacle to private ordering. The SEC rules, not state law, prevent the use of a universal ballot that would afford shareholders the freedom to choose from a complete list of issuer and shareholder candidates.³³⁵ The SEC rules, not state law, burden shareholder attempts to engage in collective action in connection with the election process by regulating such attempts as proxy solicitations. And the SEC rules impose compliance costs, including filing requirements, on shareholders seeking to exercise their state law nominating power.

Third, and most importantly, while state law cannot provide shareholders with the ability to overcome existing federal regulatory obstacles, it can nonetheless undercut the minimum level of nominating power afforded by a

³³³ Some commentators argued that a mandatory federal proxy access rule was necessary because of the limitations on shareholder ability to establish proxy access procedures through private ordering. *See, e.g.*, Letter from Julie Gresham, Corporate Sec'y, Shareowner Educ. Network, and Ann Yerger, Exec. Dir., Council of Inst. Investors, to Mary Schapiro, Chairman, SEC (Nov. 18, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-568.pdf>.

³³⁴ The extent of those obstacles may also be overstated. For example, the SEC identified various limitations on shareholder power to amend the bylaws to establish proxy access procedures. Adopting Release, *supra* note 12, at 56,673. However, only about 4% of Russell 3000 companies do not permit shareholders to amend the bylaws. Beth Young, *The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process*, COUNCIL INSTITUTIONAL INVESTORS 6 (2009), <http://www.cii.org/UserFiles/file/The%20Limits%20of%20Private%20Ordering%20UPDATED%2011-17-09.pdf>. In addition, market developments suggest that institutional investors are making substantial progress in increasing shareholder voting power, despite the SEC's resistance to their efforts. *See* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 872–76 (2010).

³³⁵ *See* 17 C.F.R. § 240.14a-4(d)(4) (2011) (prohibiting the inclusion of director candidates on proxy cards without their consent); accord Zachery Kouwe, *Ackman and Target Tangle in Ballot Brawl*, N.Y. TIMES DEALBOOK (Apr. 21, 2009, 7:48 PM), <http://dealbook.nytimes.com/2009/04/21/ackman-and-target-tangle-in-ballot-brawl/> (“Currently, shareholders in most contested corporate elections, including Target's, receive two proxy cards and can vote only for one slate of candidates.”).

federal rule. Thus, to the extent that Rule 14a-11 was an effort to respond to limitations in state law or private ordering, it was inadequate.

Rule 14a-11 explicitly provided that it was subject to the availability of shareholder nominating rights under state law.³³⁶ Accordingly, state legislatures could have completely nullified the effect of the rule by eliminating shareholder nominating power—such as by vesting such power in the board or a board nominating committee. Similarly, after the rule’s adoption, commentators immediately suggested that issuers consider implementing director qualification bylaws.³³⁷ Although Rule 14a-11 did not permit an issuer to exclude a shareholder nominee from the ballot on the basis that the nominee did not meet the company’s qualification requirements,³³⁸ nothing in the SEC rules required a company to seat a director that did not meet its qualification requirements.³³⁹ Similarly, issuers could have thwarted shareholder efforts at group formation by adopting low-threshold poison pills.³⁴⁰ One academic outlined fifteen possible ways of limiting shareholder nominating power,³⁴¹ and it seems difficult to imagine the SEC precluding these responses without taking on a much more substantive role in regulating corporate governance—a role extending well beyond the authorization in Dodd–Frank.

Finally, state regulation of corporate governance offers extensive safeguards against excessive or inefficient shareholder activism. Individual issuers can limit proxy access, in the same manner that Rule 14a-11 did, by

³³⁶ Adopting Release, *supra* note 12, at 56,674 (“The rule defers entirely to State law as to whether shareholders have the right to nominate directors and what voting rights shareholders have in the election of directors.”).

³³⁷ See, e.g., Adam O. Emmerich, *Shareholder Proxy Access: Time to Get Ready*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 16, 2010, 9:21 AM), <http://blogs.law.harvard.edu/corpgov/2010/09/16/shareholder-proxy-access-time-to-get-ready/> (suggesting that companies review their director qualification bylaws and stating that “companies may, subject to state law, preclude nominees from serving as directors for failure to satisfy reasonable qualification requirements”).

³³⁸ See *id.*

³³⁹ Indeed, there is case authority suggesting that the election of a director who did not, at the time of his election, meet the company’s qualification requirements would be invalid. See Keith Paul Bishop, *Director Qualification Requirements, Nominations & Proxy Access*, CAL. CORP. & SEC. L. (Sept. 7, 2010), <http://calcorporatelaw.com/2010/09/director-qualification-requirements-nominations-proxy-access/> (citing and discussing *Waterbury v. Temescal Water Co.*, 105 P. 940 (Cal. Ct. App. 1909)).

³⁴⁰ See, e.g., *Versata Enters. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010) (upholding the validity of a pill with a 4.99% trigger).

³⁴¹ J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware’s Future Reviewing Company Defenses in the Era of Dodd–Frank*, 36 J. CORP. L. 391, 404–15 (2011).

imposing minimum ownership and holding period requirements.³⁴² To the extent that such bylaws unduly restrict shareholder nominating power, state courts and legislatures have a variety of responses available, ranging from the use of judicially imposed limits on the extent to which these bylaws can limit shareholder voting rights³⁴³ to legislative requirements that such limitations be included in the corporate charter (and thus approved by shareholders) rather than being implemented through a director-adopted bylaw.³⁴⁴

V. AN ALTERNATIVE REGULATORY APPROACH

This Article has questioned the SEC's motives in adopting a federal proxy access rule and challenged the SEC's competence to establish appropriate criteria for modifying the balance of power between shareholders and management in determining the composition of the board of directors. Although existing political forces are likely to preclude the SEC from responding to the D.C. Circuit decision in the short term, the invalidation of Rule 14a-11 should cause the SEC to reconsider its overall approach to shareholder participation in the nomination of directors.

The solution to the deficiencies described in this Article, along with the concerns identified by the D.C. Circuit, is not to return to the pre-Rule 14a-11 status quo. As the SEC itself recognized, both the promulgation and interpretation of the federal proxy rules directly interfere with the exercise of shareholder power and shareholder attempts to reallocate the balance of authority at individual issuers with respect to both the composition of the board of directors and other governance issues. Rather than attempting to determine an appropriate balance of power, the SEC should simply stop trying to regulate corporate governance. Instead, the SEC should revise the federal proxy rules to remove the impediments that currently limit the ability of states, issuers, and shareholders to experiment with, vary, and improve governance structures.

³⁴² Cf. *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 340–46 (Del. Ch. 2008) (upholding the validity of an advance notice bylaw but reading it narrowly); ROBERT R. CARLSON & JEFFREY T. HARTLIN, PAUL, HASTINGS, JANOFSKY & WALKER LLP, REVISITING ADVANCE NOTICE BYLAWS IN LIGHT OF RECENT DELAWARE DECISIONS 1 (2008), available at <http://www.paulhastings.com/assets/publications/981.pdf> (advising clients on how to revise advance notice bylaws to reflect concerns raised by recent Delaware decisions).

³⁴³ See *JANA Master Fund, Ltd.*, 954 A.2d at 338 (determining whether CNET's advance notice bylaw, if construed broadly, should be held invalid as "an unreasonable restriction on [the] shareholder franchise").

³⁴⁴ E.g., DEL. CODE ANN. tit. 8, § 141(d) (Supp. 2008) (permitting issuers to establish classified boards through charter provision but not through director-adopted bylaw).

Removing these impediments is easy. Instead of trying to structure proxy access, the SEC should allow state law to determine both the circumstances under which shareholders have the power to nominate director candidates and the appropriate qualifications for nominating shareholders and their nominees. State law can make these determinations in a variety of ways. State statutes can set forth the scope of shareholder nominating power. Similarly, state statutes can, as Delaware already does, explicitly authorize issuers to adopt individually tailored nominating procedures and to describe the manner for doing so. Under the traditional enabling approach of state law, issuers can establish individually tailored nominating procedures directly, through charter and bylaw provisions, and indirectly, by specifying director qualification requirements, advance notice rules, annual meeting procedures, and so forth. Overreaching by either shareholders or corporate management can be constrained through judicial review—state courts can evaluate the permissible scope of issuer-specific provisions and restrictions consistent with shareholders’ statutory voting authority and management’s fiduciary obligations. Federal proxy rules should, instead, focus on the SEC’s core competency—disclosure.

Accordingly, this Article advocates the following regulatory changes. First, the SEC should amend Regulation 14A to require issuers to disclose in their proxy statements all properly nominated director candidates, whether the nominations are made by a nominating committee, a shareholder, or some other mechanism.³⁴⁵ State law, including case law, state corporation statutes, and the issuer’s governing documents (to the extent those documents are consistent with state law), would determine whether a nomination is proper. This amendment would enable individual issuers to experiment with varying criteria, such as the ownership threshold or holding period, to determine the extent to which their choices affected the quality and quantity of shareholder nominations. It would also allow issuers to experiment with other mechanisms for increasing shareholder input, such as expense reimbursement or shareholder representation on nominating committees. Issuers would also have the power to adopt mechanisms to limit the extent of shareholder input,

³⁴⁵ In 2002, Les Greenberg and James McRitchie filed a rule-making petition with the SEC proposing an amendment to Rule 14a-8 that, although structured somewhat differently from the proposal in this Article, would have had the similar effect of providing “that the solicitation of proxies for *all* nominees for Director positions, who meet the other legal requirements, be required to be included in the Company’s proxy materials.” *Request for Rulemaking to Amend Rule 14a-8(i) to Allow Shareholder Proposals to Elect Directors*, U.S. SEC. & EXCH. COMM’N (Aug. 1, 2002), <http://www.sec.gov/rules/petitions/petn4-461.htm>.

including imposing qualification requirements and establishing methods for determining priority among director candidates.

In terms of disclosure, federal law would require that the issuer provide comparable disclosure in the proxy statement for all director candidates, including the directors' employment, compensation, other directorships, and qualifications. Nominating shareholders and their nominees would be required to supply this information to the issuer as a condition of inclusion in the proxy statement. Issuers would also be required to disclose, in the proxy statement and for each director candidate, the source of that director's nomination (e.g., issuer nominating committee or shareholder). If the issuer's proxy statement includes a statement in support of any of the board-nominated director candidates, Regulation 14A would require the board to give nominating shareholders the opportunity to include a supporting statement of equal length for their nominees.

Second, consistent with the disclosure in the proxy statement, the SEC should amend Rule 14a-4 to require the issuer's proxy card to give shareholders the opportunity to vote for any of the candidates included in the proxy statement. The proxy card would thus constitute a universal ballot for all properly nominated candidates.

Third, the SEC should adopt exemptions from sections 13(d) and 16(b) for collective shareholder action in connection with the election of directors so long as the shareholders do not, individually or collectively, seek to obtain economic control of the issuer. Specifically, the exemption should provide that collective shareholder action does not, itself, create a group for purposes of 13(d) or result in the aggregation of shareholder holdings for purposes of 13(d) or 16(b). Such exemptions should extend to both the nomination and the election of directors and the collective action associated with proposed bylaw amendments concerning director qualifications, nominating procedures, and similar issues.

Finally, the federal proxy rules should directly facilitate issuer efforts to experiment with different mechanisms for private ordering. In particular, the SEC should extend the disinterested shareholder exemption under Rule 14A-2(b)(1) to exempt shareholders engaging in collective action for the purpose of nominating director candidates pursuant to their issuer's nominating procedures from the notice and filing requirements of the federal proxy rules. This change would remove the important existing impediment to nominating

procedures that require a minimum number of shareholders to support or second a nomination.

A major advantage of this proposal is that it enables shareholders and issuers to experiment with a broader range of options for increasing shareholder input into board composition. Rule 14a-11 was, after all, roughly modeled on a proxy access procedure developed by shareholders.³⁴⁶ Absent regulatory interference, issuers could develop a variety of alternative procedures. Issuers could use the existing nominating committee to nominate two candidates for each board position. This approach meets some of the current objections to proxy access by enabling the nominating committee to maintain control over director selection, control that addresses concerns over director qualifications, conflicts of interest, and overall board composition, while increasing the degree of shareholder choice. Another approach could authorize corporations to increase board size to accommodate shareholder-nominated candidates without displacing existing issuer nominees. This approach would increase shareholder input without creating an active contest that might displace sitting directors.

In experimenting with proxy access procedures, investors and issuers might also look to the experiences of other common law countries.³⁴⁷ Australia and Canada, for example, allow nominations by 5% shareholders without the requirement of a minimum holding period.³⁴⁸ Australia also authorizes nominations by groups of one hundred shareholders.³⁴⁹ Although caution is necessary in importing the governance approaches of countries with different corporate structures and ownership models, the experiences of these countries cast doubt on the objections posed by critics of proxy access. Shareholder candidates are rarely nominated and still less frequently elected. Rather than inciting frequent contested elections, the Australian system, for example, is

³⁴⁶ See *supra* notes 47–54 and accompanying text (discussing the *AFSCME* decision and the SEC's response).

³⁴⁷ Examining proxy access from a global perspective suggests the availability of alternative governance rights that might substitute for increased nominating power as well. Shareholders in some common law countries have the right to amend the corporation's charter and the right to call an extraordinary shareholders meeting at which they can take actions such as removing directors with whom they are dissatisfied. See Jennifer Hill, *Evolving 'Rules of the Game' in Corporate Governance Reform*, 1 INT'L J. CORP. GOVERNANCE 28 (2008).

³⁴⁸ Letter from Michael O'Sullivan, President, Austl. Council of Super Investors, to Elizabeth M. Murphy, Sec'y, SEC 1 (Aug. 14, 2009) [hereinafter O'Sullivan Letter], available at <http://www.sec.gov/comments/s7-10-09/s71009-195.pdf>; Robert McDermott & Sean Farrell, *Canada*, GLOBAL CORP. GOVERNANCE GUIDE 2004, http://www.globalcorporategovernance.com/n_america/134_140.htm (last visited Mar. 27, 2012).

³⁴⁹ O'Sullivan Letter, *supra* note 348, at 1.

said to promote the peaceful transition of directors in whom investors have lost confidence.³⁵⁰

An alternative approach would provide minority shareholder groups of sufficient size with the right not merely to nominate director candidates but to secure board representation. Under the voting list approach taken by Italy and Spain, for example, minority shareholders can propose a list of shareholder nominees that competes with the official list of candidates and ensure that at least one of their representatives obtains a director seat.³⁵¹ One commentator reports that the system, which has been in effect in Italy since 2006, has worked “smoothly” and has affected the board composition of listed companies.³⁵²

Another option is shareholder participation on the issuer’s nominating committee. In Sweden, the nominating committee consists of shareholders rather than directors.³⁵³ The Swedish shareholder nominating committee approach has recently been publicized by the Centre for Tomorrow’s Company, a think tank that had urged United Kingdom corporations to adopt a similar structure for selecting directors.³⁵⁴ A variation on this approach might be a nominating committee jointly comprised of shareholders and independent directors.

It is, of course, beyond the scope of this Article to evaluate the relative costs and benefits of these and other alternatives. The point is that the corporate structure contains a variety of methods and mechanisms for increasing shareholder input into the selection of directors. In the absence of empirical or normative justification for the SEC’s chosen approach, it is imprudent to prevent states and issuers from considering these alternatives.

³⁵⁰ *Id.*

³⁵¹ Marco Ventoruzzo, *Empowering Shareholders in Directors’ Elections: A Revolution in the Making* 35–36 (European Corporate Governance Institute, Working Paper No. 147/2010, 2010), available at <http://ssrn.com/abstract=1558467>. See generally Matteo Erede et al., *Italy’s ‘Vote by Slate’—An Innovative Method to Elect Minority Directors*, in INTERNATIONAL CORPORATE GOVERNANCE NETWORK 2009 YEARBOOK 54 (Kevin Eddy ed., 2009), available at http://www.icgn.org/files/icgn_main/pdfs/year_books/icgn_yearbook_2009.pdf (describing list voting in Italy); Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: Can Hedge Funds Activism Play Any Role in Italy?* 20–24 (Apr. 6, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1397562> (describing Italian law provisions protecting rights of minority shareholders).

³⁵² Ventoruzzo, *supra* note 351, at 36.

³⁵³ See TOMORROW’S CO., TOMORROW’S CORPORATE GOVERNANCE: BRIDGING THE UK ENGAGEMENT GAP THROUGH SWEDISH-STYLE NOMINATION COMMITTEES 3 (2010) (describing the Swedish system), available at http://www.forceforgood.com/Uploaded_Content/tool/243201011485875.pdf.

³⁵⁴ *Id.* at 9, 42–43, 45, 47.

The amendments proposed by this Article might not result in effective shareholder nominating rights. Issuers might respond by adopting bylaw provisions that impose procedural requirements, director qualifications, filing deadlines, or conditions for nominating shareholders that are impossible to meet. Indeed, private ordering may lead to more limited nominating rights than those the SEC attempted to provide through Rule 14a-11. Critically, however, regulating shareholder nominating rights as a component of corporate governance offers a variety of fail-safes and counterbalances that limit potential managerial overreaching in the way that a restrictive federal rule does not. As we have seen in recent years, private ordering and state regulation have enabled corporate governance mechanisms to adapt to firm and market developments. Innovations, such as majority voting and firm-specific modifications like the elimination of staggered boards, shift the balance of power between shareholders and management. In the current environment, the pump is primed for reform of nominating procedures. The SEC just has to get out of the way.

CONCLUSION

There was no need for the SEC to try to determine the optimal level of shareholder nominating power. The area would have been free for state law and issuer-specific experimentation if the SEC had simply held seventy years ago that issuers were required to disclose the existence of all properly nominated director candidates on the issuer's proxy statement and to provide shareholders with a chance to vote on the election of such candidates. Instead, the SEC viewed its responsibility with respect to proxy access too broadly. The SEC's expertise with respect to market regulation, disclosure, and investor protection does not translate into expertise over corporate governance. Nothing in the SEC's structure, composition, or experience indicates that it is better positioned than state legislatures, state courts, and corporations themselves to determine who should sit on corporate boards or to allocate power between shareholders and managers to decide this question.³⁵⁵

³⁵⁵ See Troy A. Paredes, Comm'r, SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), available at <http://www.sec.gov/news/speech/2009/spch052009tap.htm> ("The Commission is not well-positioned to decide 'who is in' and 'who is out.'"). Whether Congress can or should make those determinations is a separate matter. Since the adoption of Sarbanes-Oxley, Congress has made increasing, albeit cautious, inroads into the type of policy determinations over corporate law and governance that previously had been left exclusively to state law and, to an extent, private ordering. See Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG., Spring 2003, at 26, 26, 28 (describing the increasing federal control of corporate law). Dodd-Frank provides

The SEC's adoption of a proxy access rule in 2010 was misguided. Market and legal developments had reduced the need for a mandated form of proxy access, and the SEC's rule was so narrow and restrictive that it was unlikely to enhance shareholder nominating power. At the same time, the SEC's attempt to funnel shareholder nominating efforts through the federal procedure would likely have frustrated experimentation with more effective alternatives. In adopting Rule 14a-11, the SEC acted as corporate governance czar—displacing existing state law governance mechanisms in order to decide how much governance power shareholders should enjoy.

In responding to the D.C. Circuit's decision, the SEC should reconsider a regulatory approach that continues to impede shareholder efforts to impose accountability on corporate boards. Specifically, the SEC should modify its proxy rules to facilitate shareholder choice about nomination procedures. This Article has identified minor amendments to the federal proxy rules that would reduce federal interference with private ordering. Although issuer-specific experimentation may not produce the perfect proxy access procedure, it—unlike the SEC's regulatory process—is likely to produce experiential data that, at a minimum, can facilitate more informed governance choices. In the absence of federal interference, issuers, state legislatures and courts, and investors themselves can respond to that experience.

fragments of the most aggressive federalization of corporate law to date with its inclusion of provisions concerning shareholder approval of executive compensation, the composition of compensation committees, the separation of the positions of CEO and chairman of the board, and the promulgation of self-regulatory organization standards specifying director duties. *See* Pub. L. No. 111-203, §§ 763(a), 951, 972, 124 Stat. 1778, 1899, 1915 (2010) (codified as amended at 15 U.S.C. §§ 78j, 78n (Supp. IV 2010)). To date, however, the federalization remains largely a piecemeal effort. With the limited exception of Say on Pay, *see supra* note 270, which is, in any case, a nonbinding advisory vote, Dodd-Frank does not modify the substantive issues upon which shareholders can vote or the procedures by which they exercise that voting power.